

State Bank of Pakistan's Comments on
BCBS Discussion Paper 'The Regulatory Treatment of Sovereign Exposures'

SBP would like to share following views on the paper:

1. The paper identifies that domestic-currency sovereign exposures to sovereign entities with autonomy in issuing the same currency are rare and have a lower risk of default. We would like to point out that some enabling structural developments across the globe over the recent years have further subdued risk e.g. introduction of floating exchange rate regime, initiatives to develop capital markets, introduction of fiscal responsibility laws, improved disclosure about government's fiscal, etc.
2. In many developing countries, domestic currency sovereign exposure of banks plays crucial role in the economy. This is more so in countries, which face fiscal account deficits and have less developed capital markets and limited access to foreign funding. Public debt instruments generally play a significant role in liquidity management and monetary policy transmission. The application of risk weights on domestic currency exposures of banks thus could have serious repercussions on the developing economies. So their application needs to be restricted to select institutions having significance for global financial stability.
3. The application of risk weights or marginal risk-weight adds-on on the domestic currency exposures of Central Govt. may have a number of repercussions:
 - a. In the absence of well-developed capital markets, any application of risk weight on banks' domestic currency exposures on central govt. or marginal risk weight add-on may impede the financial intermediation process. This may also push the govts. to resort to such modes of financing that are inefficient and create market distortions. For examples, a govt. may setup or promote its own savings schemes, which may not be operating on the pure dictates of market.
 - b. There will be repercussions for liquidity management of banks and operationalization of monetary policy.
 - c. Pricing of sovereign bonds (particularly central bank and central govt.) are used as reference rates for pricing assets, as they are widely seen as a good proxy for 'risk-free rates'. However, application of non-zero risk weight against sovereign exposure means these exposures cannot be considered as risk free, which may have adverse implications for pricing debt instruments etc.
 - d. In some host jurisdictions, foreign banks operating in branch modes are required to maintain a certain portion of their capital in restricted account in the form of cash or host government's papers. Application of risk weight on sovereigns' exposures/paper would add additional cost and dissuade foreign banks from investing/operating in underdeveloped economies.

Suggestions:

Based on the review of the paper and aforementioned points, we have following broad suggestions:

- ❖ In the case of public debt denominated and funded in the domestic currency by domestic financial institutions, it would be appropriate to left it to the discretion of the jurisdictions to decide on application of the risk weights to domestic currency sovereign exposures of both Central Banks and Central Government.
- ❖ The marginal risk add-on is not desirable, as it would pose substantial challenges to the smooth operation of financial markets in a number of developing countries where capital markets are not

well developed and banks play key financial intermediation role for both public and private sector credit.

SPECIFIC COMMENTS ON QUESTIONS:

Our comments on some of the specific questions asked in the discussion paper are given below:

Q3. What are your views on the potential definition of sovereign exposures?

Comment: Specifying the definition of sovereign exposure for capital adequacy, liquidity, large exposure and other intended purposes is a good initiative, which will bring further clarity with respect to implementation of various instructions and guidelines related to sovereign exposures. However, it would be useful to conduct a holistic assessment of the public debt markets across jurisdictions for identifying any unintended consequences of proposed definition, to further refine the framework.

Q4. Do you agree that the definition of domestic sovereign exposures should be based on both the currency denomination of the exposure and the currency denomination of the funding? How would such a definition be operationalized in practice?

Comment: Yes, for better identification and management of sovereign risk, this approach/definition is appropriate. However, the operationalization of this definition will be a challenging task due to the fact that funds are fungible and it is difficult to link to specific assets. For this purpose, the banks may need to institute advanced MIS systems and introduce more sophisticated transfer-pricing mechanisms in their decision-making processes, which will be neither cost effective nor desirable for many institutions that are local and less complex.

Q5. Do you agree with the potential relative rank ordering of different sovereign entities and with the principle of a potential risk equivalence criteria for treating certain non-central government exposures as central government exposures? Do you have any comments on the criteria?

Comment:

The potential rank ordering of different sovereign entities is natural because of the different legal and constitutional arrangements in place concerning immutability of powers of revenue generation. Further, the risk equivalence criteria seems appropriate and also in line with the prevailing practices in the market.

Q8. What role could specific non-rating indicators play in determining sovereign exposure risk weights in the potential standardised approach?

Comment:

A sovereign default, particularly on domestic currency obligation, is generally a rare phenomenon and very difficult to predict and estimate because of the lack of data etc. Hence, non-rating indicators become important e.g. past history of defaults on domestic currency, fiscal laws, features and efficiency of fiscal policy & monetary policy, any element of political risk which may not have much significance for domestic exposures, etc. As such non-rating indicators vary across jurisdictions, instituting of these non-rating indicators should be left on the discretion of jurisdictions.

Q9. What are your views regarding the potential marginal risk weight add-on approach for mitigating sovereign concentration risk? Do you have any views on the potential design, granularity and calibration of such an approach?

Comment: The marginal risk weight add-on approach for mitigating sovereign concentration risk would result in difficulties in liquidity management and monetary policy transformation. The challenges arising from this approach would be more pronounced in economies with high levels of public debt held by the banks due to less developed/absence of capital markets.

Q10. What are current market practices related to haircuts for sovereign repo-style transactions? Do you believe that the current repo-style discretion to apply a haircut of zero should be removed from the credit risk mitigation framework?

Comment: In Pakistan, instructions for haircuts on sovereign repo style transactions are applicable as per the Basel requirement. The current repo-style discretion to apply a haircut of zero **should not be removed** as it could have implications for the liquidity & flow of credit in the financial markets that could have systemic implications for certain jurisdictions.

Q11. Do you have any comments on the potential Pillar 2 guidance on sovereign exposures? Is there a need for additional guidance?

Comment:

The enhancement in the supervisory framework and controls on excessive sovereign exposure should be made institution specific. It should be noted that only a limited number of financial institutions have exposure on sovereign entities in numerous jurisdictions. Following the principle of proportionality, the financial institutions that have a substantially lower exposure to sovereign risk across jurisdictions should not be required to conduct diligence on the sovereign risks in their portfolio. A suggestion can be limiting the application of enhanced guidance under Pillar 2 and increased disclosure requirements under Pillar 3 to a select sample of institutions like GSIFs. The potential Pillar 2 guidance should be left to the discretion of jurisdictions for application.

Q14. Are any further revisions to the regulatory treatment of sovereign exposures needed?

Comment:

Any proposal for change in the current regulatory treatment of sovereign exposures should only be considered for consultation, after a holistic assessment of structure and level of financial market development in different countries (particularly developing economies) and possible implications on financial intermediation, monetary policy management, efficiency of financial markets, etc.
