

World Bank Group Comments and Feedback on the Basel Committee Discussion Paper on “The Regulatory Treatment of Sovereign Exposures”

Dear Basel Committee Members,

The World Bank Group (WBG) comprising of the International Bank for Reconstruction & Development, the International Finance Corporation and the Multilateral Investment Guarantee Agency, thank the Basel Committee for issuing the Discussion Paper (DP) on the Regulatory Treatment of Sovereign Exposures articulating the issues and the potential ideas, and seeking the views of interested stakeholders.

We are aware that though the Basel standards are required to be implemented by the Basel Committee member jurisdictions, these are being implemented in several non-Basel committee member jurisdictions. In this background, we are concerned that the issues and considerations in the DP can have significant implications for several of our member jurisdictions, particularly those that are Emerging Market and Developing Economies (EMDEs). Though clearly unintended, the issues and considerations in the DP can also impact the WBG’s operations in a material way. These considerations have encouraged us to share the WBG views on the DP.

While we can understand the concerns arising from the sovereign-bank nexus, we are of the view that the changes if any to the regulatory treatment of the sovereign exposures must be discussed from a larger perspective that takes into consideration, among others, the specific features of sovereign exposures in EMDE jurisdictions, the role that these play in their respective real economies, the stage of their economic development, and the stage of the development of their financial markets.

Similarly, the discussions should also take into consideration the special mandate and the role played by the WBG to end poverty and boost prosperity for the poorest people across the globe. We try to achieve these by (a) helping create sustainable economic growth, the surest path out of poverty, (b) investing in people, through access to health care, education, water and sanitation, and energy, and (c) building resilience to shocks and threats that can roll back decades of progress.

In this background, we urge the Basel Committee to carefully consider our feedback and comments below. We would also like to highlight that our providing inputs and comments on the questions raised in the DP should not be construed as our unconditional support for the approach, design and potential ideas contained in the DP. These are intended to serve as additional inputs for ongoing discussion among the stakeholders. Broadly, we see these

as a menu of options that were discussed in the Basel Committee, and that it is not necessary to implement all the items in the menu, or in the manner articulated. For example, it may perhaps be adequate to limit the changes, if any, to the Pillar 2 and/ or Pillar 3 elements.

Given the far-reaching implications of the issues and the potential ideas that are on the table, particularly for our member jurisdictions and to the WBG's operations, we request the Basel Committee to allow the WBG to participate in the future discussions on the regulatory treatment of sovereign exposures in the High-level Task force on Sovereign exposures or in the Committee.

Our comments and responses to the questions raised in the DP are presented in the Table below.

With Kind Regards
The World Bank Group
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WBG Feedback and comments on the questions raised in the DP:

Q1. Are there any additional sources and channels of sovereign risk in the banking system that are relevant to, and that should be captured in, the prudential regulatory treatment of sovereign exposures?
Feedback/ Comments: The sources and channels of sovereign risk identified in the Discussion Paper (DP) are comprehensive. It is likely that the potential ideas laid out in the DP relating to the regulatory treatment of sovereign exposures would also imply changes to the regulatory treatment of similar or related sovereign exposures. From that perspective, it would be helpful if the Basel Committee could consider clarifying the status of the following kinds of exposures and whether the potential ideas articulated for sovereign exposures would also extend to the following kinds of exposures: a) Exposures to non-sovereign entities that are guaranteed by the sovereign or collateralized by the debt securities issued by the sovereign or guaranteed by guarantee schemes sponsored by the sovereign; b) Exposures to non-sovereign entities that are guaranteed by the PSEs or collateralized by the debt securities issued by them; c) Exposures to non-sovereign entities that are guaranteed by the MDBs or collateralized by the debt securities issued by them.

Q2. Are there additional roles of sovereign exposures in financial markets and the broader economy that are of relevance to the prudential regulatory treatment of sovereign exposures?

Feedback/ Comments:

Some of the indirect sovereign exposures that are flagged under Q1, can suggest additional roles of sovereign exposures, particularly in EMDEs. For example, in some of the EMDEs there are state owned or state supported specialized financial institutions (including development banks or policy banks or SPEs) that strive to promote or support lending to certain sectors or activities (SMEs, housing, public infrastructure, NPL resolution through AMCs) or to support international trade (Exim banks, Export credit guarantee organizations). Such exposures can arise through direct exposures to these institutions or more likely through the exposures that are guaranteed by these specialized institutions. Exposures to these specialized financial institutions can be viewed as serving public policy objective or economic objective.

As explained in the cover note, banks' direct and indirect exposures to the WBG entities can be considered as a separate class of exposures that play a unique developmental role across jurisdictions, particularly in the EMDEs.

Banks operating in several jurisdictions are required to maintain reserves in local currency and in foreign currencies with the central banks in those jurisdictions. Depending on the objective, these could either serve a monetary policy objective or a liquidity management objective.

With reference to Graph 7 on page 15 of the DP, we note that the investor base of government debt (as % of outstanding government debt) shows a wide distribution of the level of holdings by banks in G20 jurisdictions. We request the Basel Committee to also review the investor base in the EMDEs while reviewing the potential regulatory treatment of sovereign exposures, as we have noted higher concentrations in these jurisdictions. Among others, this could be attributed to the state of development of the financial markets in these jurisdictions and the level of diversity of financial institutional investors in these jurisdictions.

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

Feedback/ Comments:

The definition of sovereign entities in the DP on page 23 is clear. At the same time, taking into consideration our comments and feedback under Q1 and Q2, the Basel Committee can review the definition and clarify the status of the indirect exposures to sovereign.

As regards PSEs, there is scope for a more comprehensive and clearer definition to avoid ambiguity or mis-application. The elements of the definition that may need to be re-visited include:

- a) Clarification of the status of the PSEs where the sovereign exercises control or exerts substantial influence;
- b) Clarification of what constitutes "part" ownership by sovereign;
- c) Clarification of what constitutes "support" by sovereign;

- d) Clarification of what constitutes “accountable” to sovereign;
- e) Allowing jurisdictions to treat exposure to state owned commercial undertaking as PSE exposure: this, will be a deviation from the approach articulated under the revised standardized approach for credit risk published in December 2017, hence the reasons for the deviation and the implications may need to be understood and discussed further to justify the special treatment;
- f) Allowing exposure to state owned banks to be treated as PSE exposure will be a deviation from the approach articulated under the revised standardized approach for credit risk published in December 2017; hence the reasons for the deviation and the implications may need to be understood and discussed further to justify the special treatment; Additionally, allowing such option for PSE banks can un-level the playing field in the banking system.

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 operationalised in practice?

Feedback/ Comments:

Yes, we agree with the intent and the underlying reason for the distinction between the domestic-currency sovereign exposures and the foreign-currency sovereign exposures.

However, there can be room for improvement in the definition of domestic-currency sovereign exposures. As we understand, the present definition will fully capture the nature of exposures assumed by banks operating in a jurisdiction when they assume domestic currency exposures on the sovereign of that jurisdiction. However, the current definition can allow certain other exposures also to be treated as “domestic currency sovereign exposure”. For example, a bank in Asia investing in Euro denominated sovereign bond of a Euro area jurisdiction using the Euro denominated deposits collected by it in Asia, can be treated as a “domestic currency sovereign exposure”. It is not sure whether the Basel Committee intends to allow such exposures to be treated as “domestic currency sovereign exposure”. If that is not the intention of the Basel Committee, the current definition can be operationalized with the support of an illustration as below.

“Domestic currency exposures to sovereign A are those that are denominated and funded in the currency of sovereign A, and are assumed by the banks (branches) that are operating in jurisdiction A.”

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?

Feedback/ Comments:

We broadly agree with the potential relative rank-ordering of the different sovereign entities. As articulated in the cover note and for the reasons explained in response to Q7, in the light of its unique status, the WBG should be included in a separate category along with national central banks.

Further, to promote consistent and comparable application of the criteria for treating exposures to ‘other’ sovereigns and PSE’s as central government exposures, supplementary guidance and clear criteria will be necessary. Some of the areas which can benefit from supplementary guidance include

- Pertaining to “autonomy criteria”: (a) how to determine legislative and constitutional significance, (b) how to determine sufficiency of ability to generate taxes, (c) what constitutes economic output and resources, (d) what constitutes priority claim on national wealth.
- Pertaining to “support criteria”: how to determine sufficiency of legislative, constitutional or other arrangements.

Q6. Do you agree that capital requirements for sovereign exposures cannot be modelled robustly, and that such exposures should be subject to a standardised approach treatment as a result?

Feedback/ Comments:

No comments

Q7. What are your views about how a standardised approach treatment for sovereign exposures should be designed and calibrated? How should such an approach balance simplicity, comparability and risk sensitivity? Are there any holistic considerations which could justify a differentiated treatment across different types of sovereign entities, including the relative treatment of central bank and central government exposures?

Feedback/ Comments:

We believe that the Basel Committee should take into consideration several additional factors while deciding on the design of the revised risk weights to be assigned for the different types of sovereign exposures. These should also be subject to wider consultation before introduction. The comments below should not be construed as WBG support for implementing a revised risk weight framework for sovereign exposures.

As the Basel Committee is aware, the Basel capital adequacy framework has been implemented in several non-Committee jurisdictions. Hence, the changes in the standardized approach to risk weighting sovereign exposures needs considerable and careful consideration of factors that are relevant not only for the Committee’s member jurisdictions but also for the non-member jurisdictions. This is essential to avoid any unintended consequences arising from the implementation of the Basel reforms.

As the Basel Committee has observed heterogeneity of sovereign exposures even among Basel Committee jurisdictions, we believe that the heterogeneity can only increase when the review is extended to non- Basel Committee jurisdictions. Some of the issues that need to be taken into consideration, particularly from EMDE perspective, include the state of economic development, state of development of the financial markets, the significance of the banking systems in the national financial systems, the significance of the role of the banking systems in funding the real economy, and the scarcity of capital.

As in the case of central bank exposures, we believe that the exposures to the WBG should also receive a zero risk weight. The reasons in support of this include, (a) the exposures to the WBG do not promote the sovereign-banks nexus that the Committee is concerned about, (b) the ability of the WBG to meet its commitments is not linked to the ability of individual sovereigns or jurisdictions, (c) bank exposures to the WBG arise largely from participation in key development / infrastructure projects in the WBG member jurisdictions which are critical for promoting the real economy, public infrastructure and housing to name a few, and (d) the WBG has a unique mandate explained in the cover note.

We broadly agree with the approach for risk-weighting sovereign exposures placing reliance on external ratings. The suggestions, in addition to the above, that we have are the following:

- a) The external ratings that can be used for determining the relevant risk weights should be **only** “solicited” ratings.
- b) The reference to external ratings can serve as an anchor but not the sole criterion. As in the case of exposures to corporates and banks, due diligence must be a supplemental requirement. The Basel Committee can develop suitable guidance on how the due diligence can operate. For example, they could rely on additional non-rating indicators such as those mentioned in the DP, market indicators (like CDS spread, Eurobond Z spread), credible country risk ratings by other agencies that have robust processes (like export credit institutions), and past performance on meeting commitments.
- c) For unrated sovereign exposures, the Basel Committee can consider developing a standardized credit risk assessment approach similar to the one provided for exposures to unrated banks under the revised standardized approach for credit risk, with supporting guidance for implementation.
- d) The spread between the risk-weights assigned to domestic-currency sovereign exposures and foreign-currency sovereign exposures should be supported by additional analyses or studies. Currently, it appears to be ad-hoc determination.
- e) The spread between the risk-weights assigned to central government exposures and other sovereign exposures should be supported by additional analyses or studies. Currently, it appears to be ad-hoc determination.
- f) To avoid cliff effects, the risk-weight table can include six rating buckets instead of the three buckets included in Table 6 of the DP.

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

Feedback/ Comments:

Please see comments in response to Q7. The non-rating indicators could be considered for inclusion in the due diligence requirements or/ and in the standardized credit risk assessment methodology for sovereign risk.

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?

Feedback/ Comments:

We agree with the need for addressing concentration among sovereign exposures. The design for applying the risk weight add-on as laid down in examples in Table 7 and Table 8 are clear.

It is believed that the concentration of sovereign exposures could be higher among the EMDEs primarily because of the stage of development of their financial markets and absence of a diverse set of financial market investors. In this background, the WBG view is that this issue needs further discussion among the stakeholders, taking into consideration the situation in EMDEs to better understand the factors that can contribute to the concentration of sovereign exposures and to explore other options for addressing concentration risk instead of having a mandatory or automatic Pillar 1 type risk weight add-on as the sole option.

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?

Feedback/ Comments:

There may not be a need to remove the discretion to apply a haircut of zero for repo-style transactions. This will be relevant in jurisdictions where there is a functioning and liquid repo market with evidence of minimal price differentiation. Consideration should also be given to the potential impact of such removal on the liquidity in the repo markets. In jurisdictions where the repo market is not fully functional, we observe that haircuts on repo style transactions are being applied in several cases.

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

Feedback/ Comments:

The potential Pillar 2 guidance on sovereign exposures seems to be designed for jurisdictions that have developed bond markets where the sovereign debt securities are actively traded, and for jurisdictions where banks' sovereign exposures are largely through investment in tradeable sovereign debt securities.

In the EMDEs, the sovereign exposures mainly arise through (a) investment in sovereign securities that are non-tradeable due to absence of liquid and deep secondary markets, and that are usually held-to-maturity, (b) exposures to non-sovereign entities that are guaranteed by the sovereign or collateralized by sovereign debt securities, (c) direct exposures to PSEs and MDBs that are treated as sovereign, and (d) exposures to non-sovereign entities that are guaranteed by the PSEs or MDBs

Given the wide-spread implementation of the Basel capital frameworks among non-Basel Committee member jurisdictions, the Basel Committee should study the sovereign exposures in EMDEs, and supplement the potential Pillar 2 guidance in the DP with additional guidance.

Q12. Do you have any comments on the potential Pillar 3 disclosure requirements for sovereign exposures? Is there a need for additional disclosure requirements?

Feedback/ Comments:

The potential Pillar 3 disclosure requirements seem to be largely adequate. A few points for the Committee's consideration are:

- a) The national supervisors should have the discretion to simplify the templates as relevant for the types of sovereign exposures in that jurisdiction;
- b) The disclosure templates seem to be oriented towards direct sovereign exposures. Given that there can be indirect exposures to the sovereign through, among others, the exposures to non-sovereign entities that are collateralized by sovereign debt securities or that are guaranteed by the sovereign, the disclosure templates can be modified to capture distinctly the indirect exposures.
- c) The supporting guidance for disclosures can clarify whether the disclosures of exposures to central government, central bank and other sovereign should be based on the counterparty basis or based on how the exposures are treated for prudential purposes. For example, it is not clear if an exposure to a PSE that is treated as an exposure on central government should be included under the segment on central government or under other sovereign. Perhaps, such 'revised' exposures may need a separate disclosure.

Q13. Do you agree that home authorities of internationally active banks should be encouraged to recognise the prudential treatment of sovereign exposures applied by host authorities for subsidiaries?

Feedback/ Comments:

We agree with the potential framework articulated in the Home-host arrangements section of the DP, whereby the home authorities are encouraged to recognize the host's prudential treatment if it is compliant with the Basel framework and if considered necessary, the home authorities have the option to apply higher risk weights at a consolidated level. To ensure that the EMDE jurisdictions do not come under pressure to implement Basel III unless they and their banking systems are able to achieve effective and meaningful implementation, the Committee can clarify that, as in the case of the Basel Core Principles Assessment Methodology the reference to 'Basel Framework' here refers to the 'applicable' Basel framework that the jurisdiction is implementing, which can be either Basel I, or Basel II or Basel III.

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

Feedback/ Comments:

No comments.

Any other feedback or comments:

If the Basel Committee is considering changes to the regulatory treatment of sovereign exposures, we suggest that, in addition to the above, the committee consider the following:

- a) Take into consideration, among others, the specific features of sovereign exposures in EMDE jurisdictions, the role that these play in their respective real economies, the stage of their economic development, and the stage of the development of their financial markets.
- b) Review the proposed changes to the regulatory treatment of sovereign exposures and their implications for interconnections with other elements of the Basel framework to ensure clarity of the framework and consistency in treatment. For example, the changes in the risk-weights for sovereign exposures can have implications for the LCR framework
- c) Allow for at least one round of public consultation on the proposals for changes, even if it is to any one of the Pillars, namely 1, or 2, or 3.
- d) Allow sufficient transition time for ensuring smooth implementation.