Union Bank of India
Risk Management Department
Central Office, Mumbai,
India

Sub: Comments on BCBS Discussion Paper on "Regulatory treatment of sovereign exposures"

We refer to Basel discussion paper on Regulatory treatment of sovereign exposures, which was issued for comments by March'18 and submit our views/suggestions/feedback on the same.

Views:

- The proposed definition of sovereign exposure shall bring in more clarity to what shall be classified as Sovereign Exposure across jurisdictions, which is one of the major objectives of the exercise.
- Domestic sovereign exposures based on both the currency denomination of the exposure and the currency denomination of the funding is in line with the perceived higher risk for foreign currency denominated sovereign exposure on account of foreign exchange risk.
- The relative rank ordering of different sovereign entities is a prudent idea as different sovereign entities can be categorized to be carrying varying perceived risk on the basis of the entity's autonomous powers that allow it to generate sufficient revenues from the economic output and resources of the jurisdiction. This is already practiced in India as the risk weight for State government guaranteed claims carry higher risk weight (20%) than the central government guaranteed claim (0%).
- There are constraints on the robust modeling of sovereign exposure owing to non availability of sufficient default data for sovereigns.

Suggestions:

1. **Standardized treatment of sovereign exposure**
   - Standardized treatment of sovereign exposure, without any national discretion may be avoided, as the sovereign defaults are rare events and all sovereign debts cannot be considered bearing similar risk characteristics.

- While assessing the risk of the sovereign, along with default history, inflation records, government's commitment to fiscal prudence, economy's growth rate and ability to service debt may also be taken into consideration.

2. <u>Risk Weight should not be applicable to Domestic Sovereign exposure</u>

➢ <u>Increased cost of funds in the economy:</u>

- In financial theory, returns earned on the government securities normally serve as the benchmark rates, the risk free return, which in turn is used to price all other non-government securities in financial markets.
- If risk weight for Government bonds is increased, the return on the entire gamut of financial instruments that are priced out of the risk-free rate will increase.
- This could have a magnification effect on the cost of capital, and thereby, hurt investment and growth.
- In Indian context, Banks have to maintain Statutory Liquidity Ratio (SLR) which is in the form of Government Securities. Developing countries need government funding for carrying out expansion programs including infrastructure development, which in turn stimulates GDP growth. During period of the excess liquidity and low credit off-take, the only avenue to park excess liquidity for Indian Banks is Government Securities. Introducing positive risk weights for the sovereign exposure shall increase the borrowing cost for the government, which shall affect fiscal deficit, inflation and other macroeconomic indicators.
- Few Advanced Economies such as Japan and Italy, have voiced concern on change in regulatory treatment of sovereign exposures as a small risk weight could have significant impact in the financial markets in particular and the overall economy in general.
- LCR regulations require banks to maintain HQLAs. In India, Corporate bond market has not developed resulting in negligible securities, other than G-secs, qualifying for HQLA.

➢ <u>Complications in Monetary Policy transmission:</u>

- As of end-March 2017 banks in India held about 47 per cent of the total outstanding domestic central government debt. Any risk weight on such exposures could lead to a major shift in banks' securities portfolio causing financial market volatility and impairing monetary policy transmission.
- Assigning a risk weight to G-sec for capital adequacy purpose will immediately alter the demand for G-sec (and therefore yields) and will also require higher haircuts for repos, which in turn will alter the pricing of collaterals and levels of access to

liquidity against any given stock of excess statutory liquidity ratio (SLR) maintained by banks.

- Presently, fixed rate repo under liquidity adjustment facility (LAF) require 4% haircut and market repos 2% to 5% depending on liquidity in the security.
- In an easing cycle of monetary policy, both money market rates and yields may not be in tune with the policy decisions.
- Capital charge is a cost factor by banks, whereas non-banks do not face such a regulatory constraint and therefore the bidding pattern of banks and non-banks may change in primary/secondary markets, possibly adding volatility to yields.

3. <u>Sovereign exposure may not be part of Large Exposure framework</u>

- Banks faced with a risk weight on government debt can satisfy the regulatory capital requirements by reducing the exposure to other assets, with no need to raise further capital. However, the LE limit would require either off-loading of banks' exposure in government debt or increase in capital (coupled with compulsory shrinkage of balance sheet).

- Banks in many economies, both AEs and EMEs, hold a sizeable share of government debt in their portfolio.

- Even in Japan and Italy, government debt constitutes around 18 per cent of banks' asset portfolio. Thus, LE limits could, in general, be more challenging for monetary policy transmission than risk weight.

- Banks rely heavily on sovereign bonds to meet their requirements of liquid assets in the absence of other liquid assets like corporate bonds. It may create disruption in govt. securities market and bank's ability to meet the LCR requirements.

- Corporate Bond Market in India is still not developed well. Corporate bonds are illiquid and may not qualify for HQLA (High quality liquid assets) as per the definition of LCR framework. Thus Government Securities are the only avenue for HQLA, for parking excess liquidity. All the government securities are denominated in INR. The regulatory supervision is prudent. The processes for valuation, trading, settlement, clearing are well defined and the processes are performed on automated electronic platforms without any manual intervention.

- In view of the above, we are of the opinion that the sovereign exposure should be kept out of the Large Exposure framework. However, RBI has already prescribed a limit of 20% of NDTL for the investment in HTM category.

4. **Supervisory discretion to continue for haircut/s for sovereign repo-style transactions.**
   - In Indian context, Repo borrowings are allowed on G-Sec, SDL, Oil bonds & Uday bonds and 0% risk weight is applicable for Sovereign/ PSE security under Standardised approach.

   - In case national discretion is removed, the entire collateralised repo market would be impacted adversely as presently market repo and LAF repo is allowed only in sovereign bonds.

   - Further, with a positive hair-cut, the cost of borrowing funds would increase as Banks would be required to keep additional capital for credit risk in case of repo borrowings.

   - Banks would pass on the additional cost to the corporate borrowers, which would increase the cost of funds in the economy. Development work in the economies in the expanding phase of cycle would be impacted more as compared to advanced economies in which development work is saturated.

5. Assessing sovereign risks based on sovereign ratings is also an issue of discussion as reliance on credit rating agencies is being questioned.

6. As Sovereign defaults are seen every day but are one-off events. Hence, Risk arising out of Sovereign exposure may be covered under Pillar 2.

Apart from the above suggestions we have also responded to the questions posed by the committee and the same is enclosed as Annexure I.

Thanking you,

With warm regards,

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Annexure I

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?

- Sovereign exposure, if significant & funded from outside world, may pose global systemic risk.
- Sovereign risk may also emerge from exposures to Joint Ventures between:
  - Two different central governments
  - Central government and PSE
  - Government of one country and PSE of the other
  - Sub national government and PSE within the same country
- Exposure to countries considered as tax heavens
- Exposure to countries non compliant with Anti money laundering norms as per FATF.

The above factors may be captured in prudential regulatory treatment of foreign sovereign exposures.

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?

Sovereign exposure is also used for directed lending to a particular sector. In Indian context, in case a Bank is unable to meet priority sector/ specific lending target, Bank is required to invest in Rural Infrastructure Development fund/ NABARD bonds/SIDBI/NHB.

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

The proposed definition of sovereign exposure shall bring in more clarity to what shall be classified as Sovereign Exposure across jurisdictions, which is one of the major objectives of the exercise.

However, the national discretion given for treating other sovereign entities as exposure to central government has potential to bring diversity in the interpretation of the criteria set i.e. autonomy criteria and support criteria. If at all committee decides to stick to keeping this discretion the criteria should be made more objective.

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?

Yes, the Domestic sovereign exposures based on both the currency denomination of the exposure and the currency denomination of the funding is in line with the perceived higher risk for foreign currency denominated sovereign exposure on account of foreign exchange risk. As higher capital requirement is prescribed for Globally Systematically Important Banks, similarly higher capital may be prescribed for sovereign exposure of countries which have significant debt funded from outside world.

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

The relative rank ordering of different sovereign entities is a prudent idea as different sovereign entities can be categorized to be carrying varying perceived risk on the basis of the entity's autonomous powers that allow it to generate sufficient revenues from the economic output and resources of the jurisdiction.

This is already practiced in India as the risk weight for State government guaranteed claims carry higher risk weight (20%) than the central government guaranteed claim (0%).

However, the proposed criteria for treating other sovereign entities as exposure to central government are subjective in nature and may lead to inconsistency in the interpretation and application across jurisdictions.

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

Yes, there are constraints on the robust modeling of sovereign exposure owing to non availability of the default data for sovereigns. We believe the estimation of the key risk inputs (PD, LGD, EAD) for the sovereign on the basis of limited default data of other sovereigns shall not be a prudent move.

The standardized approach treatment of the sovereign exposure shall bring in the consistent treatment of risk weight application across jurisdictions.

Q7. What are your views about how a standardized 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?

Standardized treatment of sovereign exposure, without any national discretion, should be avoided as the sovereign defaults are rare events and all sovereign debts cannot be considered bearing similar risk characteristics.

While assessing the risk of the sovereign, along with default history, inflation build up, government's commitment to fiscal prudence, economy's growth rate and ability to service debt may be considered.

The proposed risk weighing of the sovereign exposure on the basis of external rating of the sovereign may not be a prudent idea in the light of recently witnessed adverse impact of over reliance on the external credit rating.

Committee has suggested two additional measures to reduce mechanistic reliance on external credit rating;

- Due diligence
- Additional (non- rating) indicators (macroeconomic variables, fiscal variables / credit aggregates)

Creating an objective framework for risk weighing sovereign exposure with all the above criteria shall be tough ask for emerging economies with low / nil sovereign defaults and uncertain likely benefits of the same.

A small positive risk weight for sovereign exposure may have significant impact on financial markets in particular and overall economy in general:

Any increase in risk weight of government bond shall increase the required return on all the financial instruments, which are priced on the basis of risk free rate. This shall increase cost of capital and thereby hurt investment and growth.

Another important aspect is that as a backstop measure – Leverage ratio ensures that capital is maintained at all times for all the exposure including sovereign Exposure.

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

Considering the impact of Over-reliance on external rating during the financial crisis, non-rating indicators shall play vital role in reducing the reliance on the rating to determine the potential riskiness of the country. However, the non rating indicators for the country may be biased and lack comparability.

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?

The current Exemption of Sovereign Exposure from the Large Exposure framework should continue as following issues shall arise

- Bank faced with additional risk weight from the exposure to sovereign, can fulfill the capital requirement without actually raising capital by reducing the exposure to other asset classes.

- However, fixing large exposure limit would not provide any such flexibility and the only option left will be offloading the sovereign exposure coupled with reduction in balance sheet or raising capital.

- Banks in many economies (AE as well as EME) including India hold a sizeable share of government debt in their portfolio. So LE limits could be more challenging for monetary policy transmission than risk weights.

- Banks rely heavily on sovereign bonds to meet their requirements of liquid assets in the absence of other liquid assets like

- Band Market in India is still not developed well. The bond issuances are illiquid and dol not qualify to be HQLA (High quality liquid assets) as per the definition of LCR framework. Thus G-secs is the only avenue for investing in HQLA, for parking excess liquidity .All the government securities are denominated in INR. The regulatory supervision is prudent. The processes for valuation, trading, settlement, clearing are well defined and the processes are performed on automated electronic platforms without any manual intervention.

Considering all this we are of the opinion that the Domestic sovereign exposure should be kept out of the Large Exposure framework. However RBI has already prescribed a limit of 20% of NDTL for the investment in HTM category.

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?

- Presently, fixed rate repo under liquidity adjustment facility (LAF) require 4% haircut and market repos 2% to 5% depending on liquidity in the security.

- We are of the opinion that the national discretion to apply a haircut of zero should continue.

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

If the national discretion for preferential risk weight for the sovereign exposure prevails, the role of pillar 2 guidance will be enhanced.

While analyzing the concentration to a particular sovereign, the exposure to the Bank's sovereign of incorporation should be excluded.

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

Addressing sovereign exposure through Pillar II & Pillar III may not disrupt the real economy and hence better suited to address risk arising through Sovereign exposure.

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?

Sovereign exposure of other countries may also be one of the parameters which working out Banks which are Globally Systematically Important Banks.

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

Nothing more.

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