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AEB COMMENTS ON THE REGULATORY TREATMENT OF SOVEREIGN EXPOSURES CONSULTATION

Summary

The Spanish Banking Association (from now on, "AEB") welcomes the opportunity to comment on the BCBS Discussion Paper "The regulatory treatment of sovereign exposures".

As a general comment, we would like to emphasise that the regulatory treatment of **sovereign debt** should always consider that sovereign debt serves multiple reasons in bank's balance sheets: among other functions, these bonds are key for interest rate risk management and also to comply with regulatory requirements, such as the Liquidity Coverage Ratio (LCR). Penalizing these positions could have far-reaching consequences for banks' risk profile as well as for sovereign debt markets, cross-border flows and the global economy.

AEB considers this review as a crucial piece of the overall reform of the prudential framework and **welcomes the Basel Committee's decision to not implement yet any change in the regulatory treatment of sovereign exposures**. The lack of agreement at a global level reveals the challenges that this discussion brings. Since these assets fulfil key functions to ensure an efficient balance sheet management, and their crucial role for both the local and global financial markets, it would be appropriate to undertake a thorough review of the unintended consequences of the different policy options presented in this discussion paper. Additionally, the costs and the benefits of each option should be analysed.

In this regard, it is worth reminding that the European Stability Mechanism has advised that "*an adjustment in the treatment of sovereign exposures provides an avenue to improve stability but considering the complexity of the issue, a successful implementation of any measure would imply overcoming important risks and would thus require a thoughtful and balanced process*". Indeed, in principle, any changes in the regulatory treatment of sovereign exposures would raise small net benefits with possible increases in tail risks. The best instrument to tackle the problem is not microprudential regulation, but sounder public finances and the adoption of adequate measures that allow breaking the nexus between banks and sovereigns such as the completion of the banking union in Europe.

Therefore, we consider that the **thorough analysis of the consequences of any policy option regarding the treatment of sovereign debt should encompass** at least the following elements:

- A review in the capital requirements on sovereign exposures could entail **unintended consequences** such as a second order impacts on the credit supply. It is paramount to preserve the crucial role that sovereigns play in the management of liquidity risk, interest rate risk in the banking book and currency risk. Therefore, we believe **a comprehensive assessment** to, a priori, assess the cumulative impact of each proposed option is needed. This assessment would consist in a holistic and rigorous quantitative capital impact study related to the design and calibration of each option. It would ensure that unintended consequences are addressed taking into account the key role that the sovereign exposures play in the banking system, financial markets and the broader economy.
- **This review should be analysed all together with all the other regulatory measures already in place** to avoid contradictory incentives (Basel III capital and liquidity requirements, countercyclical and macro-prudential measures, additional loss

absorbency capacity in the context of resolution, institutional investors and markets new requirements, CCPs, etc.) and unintended consequences. Any change on the prudential treatment of sovereign exposures would have widespread repercussions and a negative impact on financial stability. As an example, along these lines, it is worth noting that the leverage ratio already imposes a capital requirement for sovereign exposures, since in its calculation, all the exposures account for their book value. Moreover, it is important to emphasise that the review could bring about not only the very significant amount of additional capital requirements if the Pillar 1 or Pillar 2 options are implemented, but also the regulatory consequences if a Pillar 1 risk weight higher than 0% is set for these exposures since this will imply that these exposures will be subject to the large exposure limits (e.g. 25% of eligible capital) and these limits would prove too low for the average size of sovereign debt portfolios. Prudential treatment of sovereign debt is not the main driver of bank's holdings of sovereign debt. Sovereign debt serves multiple reasons in bank's balance sheets: compliance with regulatory requirements, collateral for monetary policy operations and business reasons (banks are main market makers in sovereign debt markets).

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?

AEB welcomes the discussion on the sources of sovereign risk since we believe that sovereign risk must be addressed at its roots.

It is difficult to design effective prudential measures to properly deal with sovereign risk. An effective policy to tackle the sovereign risk issue should ensure the implementation of sound fiscal policies and the maintenance of sustainable sovereign debt levels. This approach would contribute to enhancing financial integration and to the coordination of fiscal policy apart from tackling the root causes of the sovereign risk issue.

Furthermore, it is also worth noting that sovereign debt exhibits special characteristics that makes it very different from other banks' exposures:

- The frequency and probability of default is extremely low for developed countries. Indeed, sovereign debt crises have become very unusual events in developed countries.
- Notwithstanding this, in the few cases when sovereign crises occur, they entail far-reaching effects on the whole economy including on banks.
- The very low frequency of sovereign risk associated with a very high impact explains why banks have developed the necessary models to predict sovereign risk and take the necessary measures.
- In addition, although the concentration of sovereign risk tends to be quite high, the risk associated to it is very low. Indeed, the high level of concentration in sovereign is justified because the number of issuers is limited, and sovereign risk is usually seen as a kind of "floor" to other risks in the economy. It is important to note that due to the very special features of sovereign risk, the adoption of certain prudential policy measures could be counterproductive since they would increase systemic risk.

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?

We welcome the analysis on the various reasons for which bank’s hold sovereign exposures. It is often considered than the main driver for banks to hold sovereign exposures is the regulatory treatment, when sovereign debt serves multiples purposes in bank’s balance sheets:

First of all, it is important to take into account the stabilising **role played by domestic intermediaries** including banks in periods of tension on sovereign debt markets. Indeed, domestic intermediaries act as countercyclical investors by mitigating the effects of short-termism and panic selling, all in all contributing to financial stability. Stricter regulatory limits may hamper this positive function.

Secondly, sovereign debt also **serves business reasons**:

- Banks play and important role in financial markets acting as intermediaries with clients and also stepping as the counterparty of their client's trades committing their own balance sheet capacity. –
- Moreover, banks are the main market makers in public debt secondary markets, providing liquidity and depth to these markets.
- Finally, sovereign debt is the main asset accepted as collateral by central counterparties.

Third, sovereign bonds are essential for **liquidity management purposes** and are the most commonly used collateral in many financial transactions (e.g. derivative contracts and repos).

Related to the previous paragraph, it is also important to note that banks’ holding of sovereign debt are also **due to regulatory reasons**. Banks need to hold liquid assets to manage liquidity risk/cover the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) introduced by Basel III. Sovereign debt is the most liquid instrument and thus the best suited to manage liquidity risk. This is especially relevant in the case of emerging countries, in which the lack of deep, developed markets makes public debt nearly the only available instrument to comply with the LCR.

Fourth, banks need to **manage IRRBB risk**, which is the risk that movements in the interest rates have an impact in the interest margin/present value of the banking book. Local sovereign debt plays an essential role in managing that risk because it is the asset that could better match the interest rate sensitivities of the liabilities without opening credit risk. Foreign sovereign debt couldn´t perform that role as its risk sensitivity wouldn´t match with the risk sensitivity of the liability side. Thus, either the bank should be forced to hedge the IRRBB risk with third parties (that would be costly and would imply opening new counterparty risks) or to set capital aside to cover this risk. In addition, structural FX risk would also increase if exposure to foreign sovereign risk increases and again, either the bank buys third party protection or sets aside capital to cover this risk. On the other side, local non-sovereign assets could be better suited that foreign sovereign debt to manage IRRBB but at the expense of opening credit risk positions.

Finally, we consider that the Discussion Paper fails to acknowledge the relevance of sovereign exposures **for export finance.** In this sense, Export credit and loans guaranteed by Official Export Credit Agencies (ECAs - Government Agencies representing the full faith and credit of their respective governments) play a fundamental role in supporting large infrastructure and supply projects, especially in emerging markets, as they cover the commercial and political risk of the importer, improving the provision of financing to these projects. Moreover, the role of ECAs becomes even more critical in periods of recession or economic crisis, as these agencies work as countercyclical economic agents, becoming the only avenue for long term financing for specific projects or even supply chain needs of buyers or investors. Therefore, a potential limitation in their activity or an increase in the capital consumption will have a penalizing effect in the real economy.

As the document shows, sovereign exposures play an important role. This is why policy makers must consider that the adoption of new prudential constraints on sovereign exposures could have unintended consequences:

- Changing the current regulatory framework may have procyclical effects. Indeed, the introduction of new prudential rules based on the rating of sovereigns would set incentives towards those sovereign bonds that show a better rating. In this sense, the adoption of stricter regulatory limits on sovereign exposures would make it harder for sovereigns to find funding sources in times of tension since their rating could be downgraded.

  On the contrary, in economic upturns, sovereigns would be associated with a better rating which would make easier for them to find new funding sources. Indeed, the improvement in their rating would make those sovereign bonds more attractive for financial intermediaries that would benefit from a less strict capital treatment.

  All in all, it is also worth noting that stricter prudential rules on sovereign exposures may exacerbate the problem of concentration in certain sovereigns.

- The adoption of stricter rules on sovereign exposures would make it unduly difficult and costly for banks to perform activities such as acting as intermediaries with clients, being market makers in public debt secondary markets, etc.

It is also noteworthy that recent adopted regulatory initiatives have gone a long way towards breaking the perverse nexus between banks and sovereign, among other initiatives, the rules on the leverage ratio and the new resolution framework which imposes losses on private investors before weak banks can resort to any external financial support have reduced significantly the perverse bank-sovereign loop.

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

Regarding the potential definition of sovereign exposures, AEB strongly supports the following ideas:

1. The differentiation and separation between sovereigns and central banks.

A differentiation between exposures to the central government and central banks it is not only welcome but necessary. Including positions to Central banks in any change to the treatment of sovereign exposures would be inconsistent as it would apply to positions that are related to monetary policy operations. For instance, minimum reserves requirements cannot be limited by a large exposure rule, nor should these exposures be risk-weighted when they are mandatory for banks. This problem can be even more relevant in emerging countries, where minimum reserves are normally higher and more variable, to the extent that they are used as a macroprudential tool. A further complication arises from the regulatory treatment of these exposures in a consolidated basis, through which extraterritorial impact from home to host countries can result.

This differentiation, which does not exist currently, is needed whenever any potential measure is being debated in relation to sovereign exposures. Banks have certain obligations such as minimum reserves requirements that must maintain in central banks and it would not make sense to limit or even to impose a risk weight to them.

In this sense, we support the proposal to exempt from capital and limits requirements those reserves in central banks that banks are required to hold for monetary policy reasons. Without such exemption, the impact would be disproportionate for banks in countries where the required central banks minimum reserves represent an important percentage of the balance sheet. However, it is important to also apply this prudential treatment for central government exposures denominated and funded in domestic currency.

2. The differentiation between the sovereign debt denominated and funded in local currency and sovereign debt denominated and funded in foreign currency.

As highlighted in the discussion paper, according to historical evidence (please see "2016 Annual Sovereign Default Study and Rating Transitions", S&P in April 2017), the probability of default of sovereign debt denominated in local currency is clearly lower than the one of sovereign debt in foreign currency. This could be explained by the fact that countries can use monetary policy to avoid defaulting in their own currency.

3. The sovereign risk framework should be designed to cover the credit risk exclusively.

We acknowledge that, by printing money to avoid a default, other risks may emerge through the inflationary and deflationary pressures that these measures could generate. However, these other risks are already captured by other capital requirements. For instance, the FX risk at consolidated level is captured by capital requirements based on the currency mismatches. Thus, either the bank hedges this risk incurring in the cost it implies, or the bank puts aside the minimum capital required by the regulation. In order to avoid duplicating capital requirements to cover the same risk, **the sovereign risk framework should be designed to cover the credit risk exclusively.**

4. Granularity in definition of sovereign is essential

We welcome the differentiation and separation between sovereigns and central banks. This differentiation, which does not exist currently, is needed whenever any potential measure is being debated in relation to sovereign exposures. Banks exposures to Central Banks are mainly driven by regulatory requirements, such as minimum reserves requirements or due to the exercise of monetary policy operations.

In relation with the differentiation between sovereign, sub sovereigns and public-sector entities we consider that granularity in definition is key. The world of sovereign entities is complex and varies across jurisdictions.

Generally, the sovereigns do not provide explicit guarantees to debt issued by the sub-sovereign entities. Hence, they do not have a legal responsibility to honour debt defaulted by the sub-sovereigns. Their potential support depends more on a "moral obligation" which takes into account subjective factors (e.g. reputation issues). Besides this, in most of the developed countries (and even in some emerging economies) the sub-sovereign sector (typically made up of regions and local authorities) enjoy some (and potentially high depending on the country) degree of financial autonomy.

Moreover, there exists a great heterogeneity in the sovereign and sub-sovereign sector creditworthiness. In an international perspective**,** the ratings of sub-sovereign entities differ in most cases from the sovereign ratings, reflecting that despite the control mechanisms issued by the sovereigns there are relatively large (this depends on the country) differences in the credit profile between the sub-sovereigns (and compared with the sovereign).

5. Export Credit Agencies (ECAs) have to be differentiated.

AEB also considers that it is necessary to differentiate the Export Credit Agencies (ECAs) Covered Transactions from other sovereign exposures and to stablish a preferential treatment for these exposures. It is noteworthy that the nature of these exposures is completely different from Government Bonds or other sovereign exposures, as they are linked to concrete transactions of import/export of goods and services. The sovereign obligation of the ECAs' Covered Transactions is contingent to the non-payment of the original debtor and usually the ECAs have a concrete fund ring-fenced by law to pay any potential claims in a first level, having at the same time the full support of the government on a second level. Furthermore, their nature as an instrument to support international trade makes these obligations more unlikely to be affected by Country Events than other exposures.

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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?

As we have already highlighted in the previous question, according to the historical evidence, the probability of default of sovereign debt denominated in local currency is clearly lower than in foreign currency. This could be explained by the fact that countries can use the monetary policy to avoid defaulting in its own currency.

For that reason, we 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.**

Nevertheless, it is important to highlight that for banks with an international footprint, **sovereign exposures that are denominated and funded in domestic currency at subsidiary level, should be considered as domestic sovereign exposures both at local/subsidiary level and at consolidated level.**

In other words, we should be aware that domestic sovereign exposures can end up appearing as foreign sovereign debt because of the consolidation process. This problem is especially important for global banks with decentralised business models.

Due to the application of capital requirements at a consolidated level, domestic sovereign exposures held by a subsidiary can appear as foreign sovereign debt for the parent undertaking, even when these exposures are denominated and funded in the local currency of the subsidiary and may even be funded by the bank with local deposits.

In this regard, it is worth noting that if there is no recognition at consolidated level of the treatment applied at local level, banks will be required to allocate higher capital against these exposures on a consolidated basis than on a local level, while the underlying risk remains unchanged. We need to avoid this distorted treatment for global decentralised banks. Otherwise, this could create a probably unintended unlevel playing field compared to local competitors and an underestimation of the actual risk profile of these exposures.

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?

AEB agrees with the potential 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. Nevertheless, we consider that exposures to central governments and central banks, even if differentiated by definition as different counterparts should be treated in a consistent manner as their creditworthiness is very much alike. This way, we agree with the differentiation proposed in the definition but consider exposures to central banks and central governments should have the same beneficial treatment.

We consider that these criteria clarify the definition, but it is also paramount to ensure an international harmonization and consistency in the implementation of these criteria in order to ensure a level playing field at international level. This is particularly important for banks with an international footprint, which are subject to different legislations, as this consistency will ensure the same treatment of sovereign entities both at local and consolidated level.

Moreover, consistency should be also ensured within the accounting and the prudential frameworks.

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?

We do not agree with the option of disallowing the Internal Rating Based Approaches for sovereign exposures. It is important to maintain the current possibility to choose between the Internal Ratings Based (IRB) approaches and a Standardized Approach (SA) for the capital treatment of these exposures.

Internal models are extensively monitored and reviewed by supervisors and they are subject to extremely close and ongoing testing procedures through back testing and benchmark exercises. In addition, there are other safeguards in place: Pillar 2 requirements can be used to address perceived deficiencies in risk-weighting, stress testing can be used to support capital requirements and the Leverage Ratio, introduced under Basel III, acts as a non-risk sensitive complement to risk-based capital ratio and provides a control over excessively low risk weightings for credit risk.

Moreover, banks have been developing their expertise with internal rating systems which are comprised of methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates. Consequently, models are currently embedded in the business and used extensively with the aim to improve lending policies and risk-adjusted pricing. This has provided an important tool for **risk management** in the banking sector and forms the basis of well-informed risk decisions, leading to a more accurate measurement and management of risk. Therefore, in order to avoid contradictory objectives, **models used for capital calculation purposes should not be disconnected from the models that banks are using in decision-making and internal risk management.**

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?

For sovereign exposures under the standardised approach, we support the use of external ratings issued by Credit Rating Agencies and other international indicators such as the OECD Country Risk Classification. These ratings can capture a broader range of borrowers' idiosyncratic factors together with external factors and forward-looking indicators, thus providing a fuller assessment of risk. However, we believe that the banks' knowledge, through due diligence, can always provide additional value for assessing the creditworthiness of sovereign exposures, adjusting accurately ratings.

In this regard, it is very important to develop a sufficiently risk-sensitive standardised approach for sovereigns since the greater risk sensitivity facilitated by modelled approaches could be lost or effectively "overridden" through floors and replaced by the much-reduced risk sensitivity provided by standardised approaches. As such, the risk sensitivity and the calibration of the proposed credit risk standardised approach for sovereign exposures could impact both banks currently using the standardised approach and those using IRB modelled approaches.

Therefore, **it is paramount that risk sensitivity is enhanced in the standardised approach proposed for these exposures**. To this end, we suggest:

- **Complementing the external ratings with a due diligence process**. Banks have in place effective internal policies, processes, systems and controls to conduct their own assessment of the creditworthiness of the counterparties. The use of this internal assessment to complement the external ratings will ensure an alignment with internal risk

management practices and do not rely exclusively on external ratings for risk weighting purposes while ensuring that the external ratings appropriately reflect the actual creditworthiness of the sovereigns. Moreover, this will be aligned with the Basel III final revision of the standardized approach for credit risk, where, in cases where ratings are used, due diligence should be performed to assess the risk of the exposure for risk management purposes and whether the risk weight applied is appropriate. Therefore, if the due diligence analysis reflects different risk characteristics than those ones implied by the external rating bucket of the exposure, banks must be able to adjust accordingly the risk weight determined by the external rating. Therefore, the due diligence process should be undertaken by banks to adjust the creditworthiness assessments resulting from the external rating analysis.

- **Calibrating downward the proposed risk weights and increasing the granularity** of **the proposed risk weights:**
  - It is necessary to exempt from any capital charge and exposure limits not only for central banks denominated and funded in domestic currency but also for central governments exposures denominated and funded in domestic currency.
  - Some non-domestic sovereign exposures are excessively penalised: the risk weight applied to foreign-currency central government exposures has increased form 0% (in the current approach) to 10% for AAA to A- and the risk weight applied to other sovereign entities from 20% to 25%.
  - Only 3 risk buckets have been proposed and this could entail cliff effects.
- **Differentiating between short and long-term debt/liabilities**. Although default could happen at any time, the unexpected risk of default that should be covered with capital is significantly lower in short term exposures than in long term exposures. This distinction is key to preserve the proper functioning of the liquidity market and monetary policy transmission.
- Including a **preferential capital treatment for** sovereign exposure related to **Export Credit Agencies (ECAs) Covered Transactions.** As we have already mentioned in question 2 and question 3 It is important to remark that the nature of these exposures is completely different from the Government Bonds or other sovereign exposures, as they are linked to concrete transactions of import/export of goods and services. The sovereign obligation of the ECAs' Covered Transactions is contingent to the non-payment of the original debtor and usually the ECAs have a concrete fund ring-fenced by law to pay any potential claims in a first level, having at the same time the full support of the government on a second level. Furthermore, their nature as an instrument to support international trade makes these obligations more unlikely to be affected by Country Events than other exposures.

Moreover, applying a positive risk weight for sovereign exposures could have unintended consequences that should be taken into account:

Sovereign Exposures are a reliable source of value, act as collateral in repos and derivatives markets, are a key benchmark in financial markets pricing and a key instrument in fulfilling prudential requirements. Eliminating risk-free assets from financial markets would have important consequences that need to be considered in advanced.

Moreover, it would be inconsistent with other regulatory requirements, in particular with the new liquidity requirements. To fulfil with the LCR, High Quality Liquid Assets (HQLA) are defined and categorized dependent on their liquidity. Highly rated sovereign bonds are considered top tier liquid assets. the setting of a non-zero risk weight would reduce the base of assets that comply with top tier HQLA requirements, complicating the fulfilment of liquidity ratio.

This is especially true in the case of emerging markets, where sovereign debt and certain deposits held on Central Banks are the only instruments with which this liquidity requirements can be met, due to a lack of depth and liquidity in the rest of financial markets.

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

While rating indicators might have some caveats, the role of potential non-rating indicators should be carefully assessed.

- Any alternative would face a **trade-off between simplicity and accuracy**. For instance, the use of a simple ratio such as debt-to-GDP, while transparent in computation, is not a powerful measure of sovereign risk. Empirical evidence shows that some countries had problems at relatively low levels of debt (e.g. Argentina defaulted with nearly 60% debt to GDP), but others have been able to sustain much higher levels of debt without experiencing difficulties (e.g. Japan with over 150% of debt to GDP).

  This example illustrates the fact simplistic solutions should be avoided. The analysis of sovereign debt sustainability (the basis to assess sovereign default risk) is a complex matter. International organisms, such as the International Monetary Fund, have been searching for metrics that successfully encompass all the necessary elements to assess sustainability.

  Given that there are not many cases of sovereign default, it is difficult to test the reliability of any potential alternative measure. Nevertheless, it should be clear that relying on simple measures to assess sovereign default would severely understate the complexity of the problem.

- Moreover, we consider that the possibility to replace external ratings with specific non-rating indicators **could result in a loss of risk information** and it would not be aligned with the final Basel III revision. Indeed, in the final standardised approach for credit risk, the Basel Committee itself recognizes the importance to maintain a central role for external ratings in the process of creditworthiness assessment. In fact, while the BCBS initially proposed to completely eliminate the external ratings from the creditworthiness assessment process, it finally reintroduced external ratings for assessing the creditworthiness of exposures to banks and corporates.

- Additionally, AEB considers that the potential standardized approach based on **external ratings complemented with specific non-rating indicators could add unduly complexity and could jeopardize comparability**. We believe that credit ratings are able to reflect a broad range of borrowers' idiosyncratic factors together with external factors and forward-looking indicators to provide a full assessment of 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?

AEB welcomes the decision not to apply a large exposure limit to sovereign exposures, as it could have far reaching consequences

1. Banks are important holders of government liabilities. The major part of the funding provided is concentrated towards the country in which banks or their subsidiaries are headquartered. In this sense, the introduction of new limits or additional burdens on concentration would reduce significantly the ability of domestic banks to hold their own sovereign's debt which would finally imply that the sovereigns' funding costs may increase. All in all, the imposition of limits or requirements on concentration may hinder the ability of sovereigns to engage in anti-cyclical policies at times when the downturn of the economy itself puts a strain on their finances.

2. In addition, the adoption of new limits or additional burdens on concentration could affect the market maker capacities of banks, when acting as issuers of sovereign bonds.

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Moreover, hard limit with an obligation to sell all exposures above a certain limit would imply a great amount of sovereign bonds being sold at the same time, without clarity about an existing demand for them.

3. As stated before, banks comply with several regulatory requirements with sovereign debt. For that reason, **it is also important to highlight that this kind of measures should take into consideration the impact that they could have on the liquidity requirements** – the liquidity ratio (LCR) and the net stable funding ratio (NFSR) – introduced by the Committee in the aftermath of the financial crisis. Indeed, this kind of measures would restrain banks to meet the LCR by using sovereign bonds, which are the only 'very' liquid financial instrument. We also believe that a marginal risk-weight add-on for sovereign concentration could essentially amount to a capital tax on excess liquidity that a bank may have little ability to control, and potentially and deliberately be driven by the sovereign's own monetary or fiscal policies.

Any measure for mitigating sovereign concentration risk should be adequately designed and calibrated:

- In this regard, when assessing the possibility to adopt marginal risk weight add-ons for mitigating sovereign concentration risk, it should be taken into account that at the moment there is no single methodology to compute a capital requirement for concentration risk that seems to be sufficiently reliable. Analyses conducted by the BCBS in the past have showed that this issue is difficult to overcome.
- Moreover, as stated before, banks use sovereign debt to comply with several regulatory requirements. This is why any measure regarding sovereign exposures should be adequately calibrated as to ensure that those exposures held to comply with those requirements are not affected by any limitation. That is why we consider that the appropriate calibration of an option like this one should be fixed at the total capital level, instead of the proposed Tier 1 level. Finally, with a large exposure limit involved (even if it is a soft limit), it is important to differentiate between sovereigns, sub sovereigns and public-sector entities when defining the potential capital add-on. Moreover, we support the exemption of exposures to central banks that are denominated and funded in domestic currency from any measure to mitigate sovereign concentration risk, but this is important to also extend this exemption to central governments exposures denominated and funded in domestic currency.

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?

AEB believes that the current repo-style discretion to apply a haircut of zero should be maintained within the credit risk mitigation framework.

Very low risk/zero-risk assets are a key instrument for use in meeting prudential requirements: they play a fundamental role in managing liquidity risk, interest rate risk in the banking book (IRRBB) and structural FX risk. Banks need sovereign exposures to manage IRRBB risk and need to hold liquid assets to manage liquidity risk and meet the Liquidity Coverage Ratio (LCR).

As well as being the most liquid instruments, sovereign bonds are a reliable store of value, they act as collateral in the repo and derivatives markets and they are a key benchmark in financial markets pricing.

Sovereign bonds are the main source of collateral in financial markets. Currently it is at a national discretion the fixing of a haircut for these bonds to be used as collateral in financial operations. The use of the national discretions is justified by the fact that national authorities are the ones that better know the functioning of financial systems and the effect of any change on their normal functioning.

Eliminating low-risk/zero-risk assets from financial markets would significantly impact banks' risk models and portfolio management by banks and other asset managers and would also disrupt the transmission of monetary policy. Sovereign bonds are indeed crucial not only for liquidity management purposes but also for monetary policy implementation. Tighter rules will make it extremely difficult and costly for banks to perform these activities.

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

AEB considers there is no need for additional guidance on sovereign exposures. We consider that the current Pillar 2 guidance already enhances the link between the institution's risk profile, its risk management and risk mitigation systems, and its capital planning for all the banks' exposures, including sovereign exposures. Sovereign exposures are already assessed in the ICAAP, stress test and they are subject to internal governance and internal control arrangements, strategies, processes, which are also assessed under the SREP.

The potential Pillar 2 guidance on sovereign exposures could result in the override of the Pillar 1 rules, overestimating capital requirements and not necessarily ensuring a homogeneous application of these measures.

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

Banks already disclose sovereign exposures within multiple reports such as the Pillar 3 Disclosures Report, the Annual Report, the EBA transparency exercise and the EU wide stress testing exercise. Therefore, we consider that an enhancement of Pillar 3 disclosure requirements for sovereign exposures would increase the compliance cost and burden for banks without providing added value to boost market discipline, promote financial stability and strengthen investor protection.

Moreover, we consider that the template 3, related to the accounting classification breakdown of sovereign entities, could lead to misinterpretation of the information as there are different concepts used between the regulatory and accounting classifications. Moreover, these disclosure requirements are not aligned with the current reporting requirements, producing an additional burden on banks.

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?

AEB strongly agrees that home authorities of internationally active banks should be encouraged to recognize the prudential treatment of sovereign exposures applied by host authorities for subsidiaries. Consistency in the prudential capital treatment applied both at consolidated and local level is paramount for banks with an international footprint.

In this regard, it is worth noting that, if there is no recognition by home authorities of the prudential treatment applied by host authorities for subsidiaries, banks will be required to allocate higher capital against these exposures on a consolidated basis than on a local level, while the underlying risk remains unchanged. Sovereign debt and sovereign debt markets are very important for financial stability and for the functioning of the rest of financial markets, especially in emerging countries. Any change in the prudential treatment of sovereign exposures could have devastating consequences for the sovereign debt markets and financial markets in

general. Host authorities are the ones that better know the functioning of domestic markets and the effects that any change can pose on them. Therefore, this could result in unduly higher cost of capital (underestimation of capital requirements) and a competitive disadvantage for internationally active banks versus local competitors.

That is why, we consider that the decisions of host authorities for subsidiaries should be respected and maintained at a consolidated level by the home authority of the parent undertaking.

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

N/A