

Deutsche Börse Group Response

to BCBS discussion paper d425

'The regulatory treatment of sovereign exposures'

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A. Introduction

Deutsche Börse Group (DBG) welcomes the opportunity to comment on BCBS discussion paper on 'The regulatory treatment of sovereign exposures' published on 7 December 2017.

DBG operates in the area of financial markets along the complete chain of trading, clearing, settlement and custody for securities, derivatives and other financial instruments and acts as such as a provider of highly regulated financial market infrastructures.

Among others, Clearstream Banking S.A., Luxembourg and Clearstream Banking AG, Frankfurt/Main, acting as (I)CSD¹, as well as Eurex Clearing AG as a leading European Central Counterparty (CCP), are authorised as credit institutions within the scope of the European Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) which transposed i.a. the Basel III rules into European law. Clearstream subgroup is supervised on a consolidated level as a financial holding group.

The business of our companies as financial market infrastructures is highly risk-averse. The resulting assets and liabilities are very short-term and highly liquid. Moreover our companies do not do any material maturity transformation or proprietary trading activities. Any banking activity like deposit taking and lending or operating of cash accounts is only performed ancillary to the core business. Cash deposited or cash collateral placed with our companies has a very short maturity (i.e. intraday or overnight). The received cash is mainly placed via secured cash placements collateralised with high quality / highly liquid sovereign debt or is deposited at central banks. Own funds and a portion of any cash residuum is also invested in high quality / highly liquid sovereign debt. Cash deposited with us is highly volatile and depending on the decisions of our clients which gives little influence on the magnitude of the resulting assets and requires short term maturities for such assets.

In order to foster settlement and to increase settlement efficiency, our CSDs are also granting collateralised cash loans on a very short (i.e. in general intraday) basis. Such loans are as well collateralised with high quality / highly liquid sovereign debt. Due to the fact that settlement takes place in multiple currencies, cross-currency collateralisation is a common feature in this regards.

Due to the high portion of our assets being sovereign / central bank assets or being collateralised by sovereign debt, the future prudential treatment of sovereign exposures and the related treatment of sovereign debt as collateral in the credit risk mitigation framework is extremely important to us and will have substantial impacts on the well-functioning of financial markets.

The document at hand contains our general comments to the prudential treatment of sovereign exposures (Part B) as well as a dedicated response to the questions raised which do effect our businesses (Part C).

¹ (International) Central Securities Depository

B. General comments

The sovereign debt crisis in Europe has shown that exposures to sovereigns even in developed countries are not risk free. As such, the efforts undertaken by the Basel Committee to look into sovereign exposures and to reconsider their prudential treatment are a natural consequence. However, even in times of stress for sovereign exposures a substantial number of sovereigns have continued to show financial strength and have been used as safe havens. In addition, debt of international institutions like the Worldbank, the EIB and other multilateral development banks have not shown any financial weakness and as such, the potential risk charge in the capital framework also needs to take this into account. In our view the current Credit Risk Mitigation framework (CRM) has not shown any material weaknesses such that any calibration or even change should only be done after careful analysis and after discussing any idea in a comprehensive manner with the industry.

We value the points being addressed in the discussion paper as a good starting point for any adjustment of the prudential framework. However, balancing the risk sensitivity and simplicity of any future approach in our view shows room for further consideration in both areas (risk sensitivity and simplicity).

Related to the adjustments of the capital treatment, we have identified the following key topics:

- We support to continue with a zero risk weight for exposures to central banks denominated in “domestic” currency. “Domestic” for that purpose needs to be clearly defined as the currency of a group of countries using the same currency (e.g. the Euro) is to be seen as the domestic currency of the central banks of all the countries concerned. As the Basel Committee rightly points out, there is no link between assets and liabilities or – in other words – assets and their underlying funding, there should be no such theoretical link being put in place as a prerequisite to receive a dedicated treatment. Any currency mismatch in the balance sheet is being dealt with in the market risk framework and we deem that treatment as being sufficient. As such the “denominated and funded” clause should be taken out throughout the complete prudential framework and not just related to the exposure towards central banks. We value the approach for exposures to central banks in domestic currencies as being both simple and risk sensitive at the same time.
- We clearly propose to have more risk categories and therefore a better spread of risk weights than proposed by the Basel Committee. Instead of only having three buckets, we prefer to have five or even six buckets and a dedicated “unrated” bucket on top. While this maintains the element of simplicity in an adequate manner, it better reflects risk sensitivity and allows for a gradual change in case of down- or upgrades.
- In addition, High Income OECD Countries (as well as High Income Euro Area Countries) have to be considered in the first bucket of highest quality, receiving lowest risk weights as they are currently regarded as “unrated” for technical reasons on the interplay between the OECD and the BCBS framework. For more details on our proposal of a more granular approach, please see our response to Q7 of this document at hand.
- We are sceptical on the differentiation between domestic and foreign currency exposures (outside exposures towards central banks) as this adds complexity to the approach while risk

sensitivity is not clearly demonstrated. However, we have no fundamental opposition to the proposal. Before deciding on that point finally, it should be noted that the number of sovereign issuers for most currencies is limited. For some currencies, there are only non-domestic sovereign issuers which have a sufficiently good rating like multilateral development banks. For central governments, the issuance of foreign currency debt for well rated sovereigns is in addition limited and usually does not show material risk differences. For less well rated central governments the access to international debt markets is often focussed on issuance in international reserve currencies like USD, EUR, JPY or GBP. As such, the risk related to government exposures in non-domestic currencies may even be lower than that of exposures in domestic currency. Overall, a substantial differentiation in the risk weights between domestic and foreign currency will most likely have material impacts on the funding for such central governments and should only be introduced after having assessed potential impacts to the extent possible. Such assessment should include impacts on the sovereign bond markets.

- We miss the cornerstones of the Basel Committee's ideas on future CRM treatment of sovereign debt as collateral. As such, the discussion paper falls short to outline the comprehensive ideas in this regards as the topic is only tackled in a rudimental manner. It is so far unclear what the potential intentions for change are and hence it is difficult to comment on the concept in this regards.

In general we agree also to the Committee's conclusion on the need to have an appropriate approach to undue risk concentration towards sovereigns. Different from the idea put up for discussion to have dedicated capital add-ons, we rather prefer to have an adjusted large exposure framework. We cannot see any value added in having different approaches on concentration risk for sovereign exposures on the one hand side and any other exposure otherwise. As the Committee has introduced the larger exposure rules in 2014 for all kinds of exposures but sovereign exposures, we disagree to any capital add-on but rather propose a selective adjustment to the large exposure rules instead. This should also include a revision of the large exposure rules related to concentration towards collateral issuer (this is assuming double default with a 100 % probability) under the Financial Collateral Comprehensive Method. We completely disagree to force the same method and (explicitly) same choice approach for both the capital adequacy and the large exposure framework. Furthermore, we reject in particular the approach of forcing counterparty substitution under the Financial Collateral Comprehensive Method. We regard the adjustment of the large exposure framework as more simple and at least equally risk sensitive compared to the Committee's proposal.

Currently, exposures to sovereigns are exempted from the large exposure framework. We think that this should be changed but exposures being included in the first bucket of the solvency regime should not be taken into account for the large exposure regime. In general we refer to the treatment in Article 400 (1) and (2) CRR for a suitable approach the Committee should consider.

Please refer to our response to Q9 for our more detailed proposal to mitigate concentration risk.

For both, the introduction of risk weights to tackle credit risk as well as the introduction of large exposure rules, information on classifications of 'other sovereign entities' has to be available and comprehensible. Thus, competent authorities have to classify 'other sovereign entities' including the

necessary assessment if these entities can be treated as central governments as they fulfil the risk equivalence criteria. Afterwards, the categorisation has to be provided to banks. As this shows practical problems related to the technical implementation of the proposed classifications, the Committee should consider these aspects as well and rather decide on more simple solutions / concepts which can be practically implemented than to target for more sophisticated and more risk sensitive approaches which lack any implementation possibilities.

Any change on the prudential framework for sovereign exposures cannot be considered in isolation. Substantial changes in the risk weights will lead to adjustments in the structure of the assets of banks and changes in the CRM framework will have impacts on collateralisation requirements and practices. Consequentially, these changes will also result in implications for the quantitative liquidity measures, will effect concentration risks and affect overall risk management practises. In addition, changed behaviour will influence financial markets both in affecting prices as well as further differentiate demand and supply between debt instruments being treated differently going forward. These impacts include potentially divergent performance for debt instruments with same rating issued by the same counterparty but in different currencies. As such, refinancing in non-domestic currency may become substantially more expensive while underlying risk is not supposed to show a comparably degree of deviation, if there is a difference at all.

Taking our demand for a more holistic discussion on the CRM framework with regards to sovereign collateral not only for capital adequacy but also for large exposure and liquidity purposes into account, we strongly request to maintain the rule to apply haircuts of zero for certain repo-style transactions (as well as securities lending transactions) with core market participants and make this a standard rather than a national discretion.

The assessment of the impacts of proposed changes prior of being finalised and made applicable is crucial. The simultaneous fulfilment of different regulatory requirements is getting more and more difficult as actions improving one prudential measurement may harm other ones. In general, any proposed rules have to be well calibrated. As we do not have data to judge the impact of any proposed change, we see the need for adequate quantitative impact assessments before fixing any level of risk weight. We therefore refrain in general from proposing concrete values and rather propose structural adjustments only.

Overall we request the BCBS to issue its concrete proposal related to changes in the overall framework towards sovereign exposures across all regulatory standards for consultation in due course.

C. Response to selected questions raised in the consultative document

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

In general, we have no concerns on the current treatment of sovereign exposures and their definition. The proposed distinction between central banks, central governments and other sovereign entities in chapter 5 of the discussion paper is reasonable. However, practical implementation needs to be taken into account (see our remarks in section B of this paper).

In order to be more precise and prevent lack of clarity, we suggest including 'municipalities' explicitly in the definition of 'subnational governments' as they could be regarded as 'non-government'. This inclusion does not interfere with the need to fulfil both criteria mentioned ("power to raise taxes and borrow money").

Regarding the definition of 'public sector entities' it needs to be secured that this does not include banks being owned by sovereigns but operating like any other bank (e.g. savings banks owned by municipalities).

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?

We strongly disagree to such a link as in practise there is - as the Basel Committee itself mentions in the discussion paper (page 24) – no real link between any given asset and its concrete funding. As such, we clearly propose not to use such theoretical link throughout the full Basel framework and leave any currency mismatch item within the market risk framework.

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?

The outlined relative ranking of sovereign entities as well as the proposed risk equivalence criteria in general seems to be a reasonable approach.

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?

We clearly agree to derive the risk weighting for sovereign exposures with a clear structured look-up table. This fulfils the criterion of simplicity. However, in this regard any underlying definition needs to be precise and easy to implement. As such, it is important to consider further simplifications in

the way the "other sovereign exposures" are defined in order to easily identify the right category of any counterparty. Moreover, the differentiation by line of the look-up table should be reconsidered as we feel especially that the currency differentiation should be carefully considered and in any case there should not be any requirement to prove the currency of funding. Neither at the level of the bank in questions nor in particular at the level of the sovereign counterparty (as this cannot be assessed by the bank).

Having said this, we disagree to the appropriate risk sensitivity of the approach. While we have doubts on the risk sensitivity of the differentiation for non-central bank sovereign exposures between domestic- and foreign currency (though do not fundamentally oppose), we are clearly of the view that three buckets only with large jumps in risk weights between the buckets are not risk-sensitive.

We propose to maintain at least five plus one buckets (five buckets according to the respective rating / classification and one bucket of no classification / rating; one additional bucket may be introduced depending on final calibration to split the Category BB+ to B- (OECD CRC 4 – 6) into "BB+ to BB-" and "B+ to B-" ("OECD CRC 4 – 5" and "OECD CRC 6" or "OECD CRC 4" and "OECD CRC 5 – 6")) as currently applied for the standardised approach for exposures to sovereigns and central banks. This should balance the impact on banks' capital requirements for sovereign exposures as a consequence of introducing positive risk weights more smoothly, more consistent and more risk sensitive. Evidently, we cannot see any benefit in an even more simplified proposal to have only one risk weight for all central government sovereign counterparties, as here simplicity would overrule risk sensitivity in a way we regard as imbalance for prudential purposes.

It is to be noted that the OECD Country Risk Classification (CRC) since 2013 does not give CRCs to High Income OECD Countries (nor to High Income Euro Area Countries). Consequently, they are currently to be regarded as unrated which means being at the lower end of the risk scale while in fact being viewed as even better than top rank countries with a classification of "0". As the OECD is not going to change their approach in the foreseeable future, the Basel Committee needs to clarify that High Income OECD Countries are being treated like countries with a CRC of "0".

Due to the fact that we do not have sufficient data on hand to calibrate any risk weightings, we abstain from proposing concrete values but rather develop the structure of a possible future approach. In order to set concrete risk weights, the Basel Committee should derive a proposal after an adequate quantitative study, which should be included in a comprehensive proposal on the future prudential treatment under all regulatory aspects to be consulted with the interested public and the industry. Guiding principles should be deriving a very low risk weight for the highest quality bucket (if not for certain e.g. AAA rated countries or High Income countries a zero risk weight is maintained) and a risk weight for exposures to "unrated" sovereigns being derived from the second highest bucket.

We have assumed for the upper bucket and the "unrated" bucket the current risk weights. In case the BCBS wants to reduce the current applicable maximum risk weight of 150% an appropriate argumentation as well as related qualified data should be delivered. As the current example as shown in table 6 of the discussion paper is indicating lower risk weights than in the current framework (7 – 9 % instead of 150 % for domestic-currency exposures for low rated or unrated sovereigns) we are missing a well-reasoned explanation for this. Without such a well-reviewed appraisal, assigning

lower risk weights may direct exposures in the wrong direction. The risk weights has to be derived from the actual default risk of the respective entity. This is the only way to ensure risk sensitivity as well as comprehensive comparability. The delivered example is not allowing to judge the risk sensitiveness of the shown risk weights but we doubt that such a sharp reduction is reflecting the underlying risk in an appropriate manner.

The example is also indicating a zero risk weight for exposures to central governments (in domestic-currency) as a lower boundary. However, the discussion paper text is not allowing the usage of such a risk weight. While we would not exclude such a risk weight for very well rated sovereign counterparties in general, the text and the risk weights should be in synch which at present is not the case.

The following table outlines the structure of risk buckets we consider as appropriate. As stated above, the forth category may also be split and / or an additional class for AAA / High Income countries may be introduced. This as well as the potential split in domestic-currency / foreign-currency exposures requires further analysis. We have put a concrete proposal for the two upper buckets into the table, which are derived from the current framework. However, in case there is data available, which indicates that a lower risk weight would be more appropriate, the BCBS may choose a different value.

Table 1: Proposed structure to derive risk weights for sovereign exposures

External rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	CCC+ and below	Unrated
OECD CRC	0-1*	2	3	4-6	7	No classification
Central bank exposures**	0%					
Domestic-currency central government exposures***	<i>tbd</i>	<i>tbd</i>	<i>tbd</i>	<i>tbd</i>	150%	100%
Foreign-currency central government exposures***	<i>tbd</i>	<i>tbd</i>	<i>tbd</i>	<i>tbd</i>	150%	100%
Other sovereign entities	<i>tbd</i>	<i>tbd</i>	<i>tbd</i>	<i>tbd</i>	150%	100%

* including High Income OECD Countries and High Income Euro Area Countries

** as defined by BCBS, "domestic" currency only, which include currencies for which the central bank is only one of several central banks of issue (e.g. Euro currency in Euro countries for all national central banks)

*** split between "domestic currency" and "foreign currency" to be reviewed; includes non-domestic currency exposures towards central banks.

There needs to be practical rules to capture "other sovereign entities" which are treated like central governments and those which are not. A rule-based approach, which creates difficulties in practical application to determine the result, will lead to different views on the same counterparty and should therefore be avoided. Possibly the competent authorities could derive a list of "other sovereign entities" being treated like central government and report these lists to the BCBS which would publish a consolidated up to date list on its homepage.

Finally, we consider a more granular approach towards other sovereign entities as critical as (i) it will increase complexity and (ii) it will also increase practical problems to allocate the counterparties to the right caption.

Overall, we advocate to design the final approach as granular and risk sensitive as necessary, but as simple as possible.

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

We do not regard the two possible additional measures (due diligence and non-rating indicators) outlined in the discussion paper as being useful additional elements for a future standardised approach.

The recently published adjustments to the Basel framework inter alia target to reduce the reliance of banks on internal approaches. If this is the right way going forward, running additional due diligence on sovereign exposures and deriving (bank individual) views on the sovereign counterpart seems to be contradicting and in any case is making the treatment of such exposures more complex and less comparable across the banks. This is not consistent with the guiding principles of the banking framework. We stick to this view also in light of the general discussion on over-reliance on external credit ratings (see also below).

Also, the use of additional (non-rating) indicators for assessing the creditworthiness of sovereign exposures is not an appropriate approach in our view. External credit ratings combine several different attributes in a standardised figure and capture as such a multitude of different aspects to come to just one easy to catch result. Each other (isolated) figure considers only one or a few aspects while ignoring risk mitigation and further facts. In combining a single rating for multiple aspects with additional single aspect indicators would result in an imbalanced view and rules how to aggregate would create a level of complexity with unclear result on risk sensitivity. As such, currently the use of external ratings albeit existing and well understood criticism on the reliance to external credit assessment, in our view is still the most appropriate approach to find risk sensitive, but reasonably simple and not over-simplified risk indicator.

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?

In general, we disagree to the approach considered in the discussion paper to mitigate concentration risk via introducing marginal risk weight add-ons in the solvency regime. Requiring additional capital while trying to tackle the risk of concentration does not seem reasonable and justified.

The current large exposure regime that is designed to manage concentration risk does also not require capital add-ons but limits the exposures towards a group of connected clients. However, sovereign

exposures are currently excluded from the BCBS large exposure framework. Contrary, they are included to some extent in the EU framework as laid out in the CRR. We cannot see any meaningful argument why the management of concentration risk towards sovereigns needs a completely different approach than that of other types of counterparties. Having said this, inclusion in the large exposure framework nevertheless should occur taking into account the different risk profiles of sovereigns compared to other counterparties. As such, even if sovereigns are included in the large exposure framework the way such exposures count towards the limits is to be adjusted and tailored. High quality sovereigns may even not be taken into account for such limits. The related rules in Article 400 CRR are a good basis to derive future rules in that regards.

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?

Based on our own investment activities and our knowledge on market practises it is common not to apply any haircut for repo-style transactions with core market participants at least in case the conditions as required to apply a haircut of zero are fulfilled. As in such case

- (i) the counterparty risk in general is assumed to be low,
- (ii) a double default of the counterparty and the sovereign issuing the underlying debt used as collateral is more than unlikely and
- (iii) the risk attached to the sovereign exposure related to the collateral is assumed to be marginal,

the current treatment should not only be maintained but made a standard rule for such business, i.e. in case any bank is engaged in such repo-style (and securities lending) transaction and wishes for prudential purposes to recognise the collateral shall use the zero haircut approach if all conditions for such a zero haircut are fulfilled.

In case despite market practise the BCBS is considering to remove the zero haircut approach, we kindly ask the BCBS to consider a staggered approach depending on the remaining maturity of such repo-style or securities lending transactions. For short-term maturities of – suppositional 1 month or less – the arguments above are even stronger than for long-term transactions.

The discussion paper is not outspoken on the current considerations on Credit Risk Mitigation technics (CRM). The respective chapter only tackles the possibility for a zero haircut related to certain repo-style transactions. However, in case the general approach in the credit risk framework on the treatment of sovereign exposures is adjusted, this has consequence on various aspects of the CRM. In particular, the treatment of sovereign debt as collateral under the Financial Collateral Comprehensive Method (FCCM) for both solvency and large exposure purposes needs to be adjusted and the need for intended changes is to be assessed. However, without an indication of items possibly to be changed and without a proposed wording of necessary adjustments following the intended changes of the Credit Risk framework, it is impossible to reflect. In our view, as less changes as possible should be made to the CRM framework in this regards related to solvency purposes while

we see the need to adjust the CRM rules related to FCCM in the large exposure framework. This, however, is less related to sovereign debt than to other financial collateral.

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

The Pillar 3 disclosure requirements have increased over time significantly. The requirements are amended in a way that they are becoming more and more voluminous and despite all attempts to harmonise them the amount of disclosed information is rather creating disinformation than transparency to the public. In addition, only a limited number of experts understands the disclosures and as such, the intended audience ("the public") is not reached. Supervisors already get the contained information by different means in the course of the regulatory reporting as well as in the course of ongoing supervision and as such, the disclosure requirements should rather be streamlined and made more focussed instead of requiring even more or more granular information.

Furthermore, the published data is very dynamic whereas the information is – despite all attempts to bring publication closer to the reporting date – published only after quite some time which is necessary to prepare the disclosures. It is neither useful nor advisable to further increase the disclosure requirements. As such, we rather urge the Basel Committee to consider to substantially reduce the information to be disclosed substantially as already stated in our position paper on the Basel consultative document d356 'Pillar 3 disclosure requirements - consolidated and enhanced framework'².

We are at your disposal to discuss the issues raised and proposals made if deemed useful.

Faithfully,

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² DBG response to Basel Committee consultative document d356: <https://www.bis.org/bcbs/publ/comments/d356/dbg.pdf>