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Joint LGFA Reaction Paper on the BCBS Discussion Paper on the regulatory treatment of sovereign exposures

Introductory statement

Municipality Finance, Kommunalbanken, Kommuninvest, Agence France Locale, NWB Bank and BNG Bank welcome the opportunity to provide their comments to the Basel Committee on Banking Supervision discussion paper on the regulatory treatment of sovereign exposures. Given their common denominator, being Local Government Financing Agencies (LGFAs), the aforementioned institutions will provide their input as a group ('Group of LGFAs'). The Group of LGFAs is aware of the overarching rationale of potential regulatory treatment and appreciates the BCBS' efforts in opening up the discussion with a varied array of policy options.

LGFAs are credit institutions¹ that are owned and established by public authorities with a common business purpose of serving public policy objectives such as providing financing for national municipalities, regions and provinces. With a combined balance sheet of over €360 billion, the Group of LGFAs constitute an important source of stable and efficient funding for the long-term investments of local and regional public authorities in their respective Member States. LGFAs maximize the welfare generated from available public budgets in for instance the fields of healthcare institutions, schools, social housing, infrastructure and climate action. Due to their public policy driven business models and legal status / statutory requirements, LGFAs are inherently linked to the respective local, regional or national sovereign. Furthermore, the LGFAs are referred to as public development credit institutions in EU legislation, and belong to the Sovereign-Supranational-Agencies (SSA) landscape in terms of bond issuance.

For the LGFAs that the group represents, the current debate on sovereign exposures is somewhat concerning. The business model of LGFAs builds on the connection to the public sector owners and the importance of the public sector mandate and therefore breaking or mitigating the link between the sovereign and LGFAs using prudential measures is not feasible in general and as such for the specific measures proposed. The introduction of a general risk weight will not alter the LGFA's sovereign exposures, which is by nature and not by choice. Moreover, the LGFA's sovereign exposure is by definition highly concentrated, as the business model is directed to the public policy of its Member State. Hence, any measure directed at reducing the concentration in sovereign exposure is not in conjunction with the LGFA's business model. Without careful regulatory calibration, LGFAs may end up being unduly affected by potential new legal frameworks. In particular, insufficiently considered frameworks may, if applied to LGFAs, fail to achieve their original policy intentions and instead hamper the functioning of LGFAs. This could negatively impact governments' options to fund their public sector and/or address market failures in various sectors of the economy.

Reponses to questions posed in the discussion paper

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?

¹ As defined under the Capital Requirements Regulation (EU) No. 575/2013

The Group of LGFAs is of the opinion that an additional distinction should be made between (1) direct exposures held for capitalization or liquidity buffer purposes (i.e. regulatory purposes), (2) direct exposures that originate from lending activities to sovereign entities (e.g. municipalities, provinces, water authorities) and (3) indirect exposures stemming from guarantees or insurance policy provided by sovereign entities (e.g. lending to social housing corporations or public hospitals). The 2nd and 3rd source of loans form the lion's share of exposures of LGFAs. LGFAs have a clear public policy mandate which limits their operations to have any other business in their portfolio inevitably creating significant concentration. Any regulatory treatment as mentioned in the discussion paper will therefore disproportionately affect these banks. The suggested distinction between exposures will contribute to a more complete image of sovereign risk in the banking system. Apart from the distinction, we strongly believe it to be logical that indirect exposures guaranteed by sovereign entities are weighted as sovereign risk given that any risk would only materialize in case of double default of both the borrower and of the sovereign that guaranteed the loan.

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?

In the Group of LGFA's view, the discussion paper does not take into account the need for sub sovereigns such as local and regional governments to raise financing in order to complete their mission. As such, the discussion paper foregoes on the role of LGFAs. These are banks that are set up and owned by their respective (local, regional or central) governments and that provide finance to these governments or government linked organisations in order to serve specific public policy objectives, or address market failures. LGFAs do not aim to maximize profit and they have direct or indirect government guarantees for at least 90% of their original capital, funding or loans granted. As such they do not bear the same default risk or systemic risk as other banks.

As a consequence of this business model, the linkage between a sovereign and a LGFA is not by choice but by nature. There are clearly no (prudential) measures available to take away or mitigate this linkage. The Group of LGFAs therefore believes that the inherent role of sovereign exposures in the business model of LGFAs should be taken into account in any prudential regulatory treatment.

Q3: What are your views on the ideas set out above related to the definition of sovereign exposures?

The definition of sovereign exposures that is proposed in the discussion paper does not substantially differ from the current definitions in EU's Capital Requirements Regulation. It could however still benefit from further clarification on the definition of sovereign entities as the scope and applicability of equivalence and support criteria for subnational governments is not entirely clear (for instance, how does it apply to provinces or ministries?). To be defined as a sovereign entity it is proposed that one needs to have "(...) *autonomous powers that allows it to generate sufficient revenues from the economic output and resources of its area*". To fulfill the support criteria it needs to have "(...) *sufficient legislative, constitutional or other arrangements to facilitate the transfer of financial resources or other means directly from a particular central or autonomous subnational government to the other sovereign entity*". The Group of LGFAs acknowledges that it is difficult to create precise definitions that fit all jurisdictions in this context. However, we believe that the current proposal will imply national discretion with regard to entities qualifying to be treated as sovereign. For example, it is our view that authorities might have different views and legal basis in the evaluation of what is *sufficient* revenues or *sufficient* legislative and constitutional framework. Thus, we argue that the regulatory treatment of other sovereign entities should take this national discretion into account, please see our answer to question 9 below.

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?

The currency denomination of the funding relates to the bank alone and not to the sovereign it may have exposures to. The funding choices made by the bank do not affect the credit risk of the sovereign. To the Group of LGFAs the rationale for including the currency denomination of the funding in the definition of sovereign exposures is therefore not clear.

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 Group of LGFAs agrees that a principle of a potential risk equivalence criterion for treating certain non-central government exposures as central government exposures should always be part of any future regulation. Please note that a considerable share of LGFA exposures is not directly to the central government but consists of publicly guaranteed financing to public sector entities. Examples of such entities are housing associations and health care institutions. The same is applicable to any exposure to that regional government or local authority. We are of the opinion that this should explicitly be recognized and therefore implemented in the new regulatory framework.

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?

No comments.

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

In general, the Group of LGFAs believes that one should carefully consider the introduction of risk weighting for sovereigns given the implications it may have on the wider economy. If risk weights were to be introduced, it should be noted that a large part of the sovereigns is unrated, most notably sub-sovereigns. Rather than allocating these to the non-rated bucket, it makes sense to allocate these to the bucket based on the rating of the central government. Next, the bucketing should, in our opinion, be more refined.

We would also like to address the similarities between the underlying risk related to some LGFA institutions and multilateral development banks (MDBs). In our view, it could be argued that some LGFAs fulfill the criteria of MDBs set out in paragraph 59 of the Basel II framework, and therefore that they should be subject to a similar treatment proposed for such MDBs. Our main point in this context is that a new sovereign exposure framework should contribute to a fair competition amongst issuers in the SSA landscape. I.e. that the potential risk weight buckets for entities defined as SSA should be more refined.

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

No comments as of yet.

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 Group of LGFAs believes that due to the specificities of the LGFA business model and hence the very high percentage of sovereign exposures, the impact of a marginal risk weight add-on approach would have a disproportionate effect on these types of banks often resulting in the maximum add-on. As mentioned

before, the LGFA's concentrated sovereign exposure is not by choice but by nature. Hence, any such measure is not fit for purpose for LGFAs. The add-on would act as a type of additional leverage ratio for LGFAs, since the add-on would translate via the solvency requirement into a non-risk weighted requirement. The Group of LGFAs sees no value in such an extra leverage ratio.

If the BCBS chooses to proceed with the risk weight add-on approach, the Group of LGFAs is of the opinion that several aspects of the risk weight add-on approach need to be clarified;

- For the marginal add-ons, it is not clear what the scope of the sovereign exposure is. In the current wording, it could pertain to just direct exposures (being direct exposures to the entities incorporated in central government exposures), but potentially also to indirect exposures (being exposures to other counterparties guaranteed by central government entities). Moreover, in the large exposure regime, the exposure is allocated to the direct debtor. An allocation to the guarantor would neglect the double default feature of the exposure and overestimate the exposure on the guarantor. The Group of LGFAs would welcome further clarification by the BCBS on this aspect.
- Regarding the treatment of stand-alone entities in the marginal risk add-on, table 8 on page 29 seems to be in conflict with the text on top of page 29. At the top of the page, it is stated that 'sovereign entities that met the 'autonomy' equivalence criteria will be treated as standalone entities'. Yet, the example provided in Table 8 could still suggest that the exposure for such entities is aggregated as one exposure: "*Sovereign A entities meet 'autonomy' equivalence criteria*" can still be read as an aggregation of multiple entities. It would be more clear if one would use two exposures in the example, for instance "*Sovereign A entity 1 meet 'autonomy' equivalence criteria*" and "*Sovereign A entity 2 meet 'autonomy' equivalence criteria*" thus treating these exposures individually.

In the context of concentration risk we would also like to address an issue related to the regulatory treatment of local authorities and regional governments that are not treated as sovereign. As highlighted in the discussion paper in table 5, entities not equivalent to the central government are subject to the 25% large exposures limit in the Basel framework. We would like to remind you that the large exposure regime in the EU (ref. CRR Art. 400 (2) (b)) implies that competent authorities may fully or partially exempt assets constituting claims on regional governments or local authorities where those claims would be assigned a 20% risk weight. We encourage the BCBS to carefully assess the interaction between the definition of sovereigns and the large exposures framework for sub-sovereigns, and inform you that the ideas presented in the paper are likely to hamper the ability of certain LGFAs to fulfil their public mandate. Due to the potential of national discretion in the implementation of the sub-sovereign definition, please see our answers to question 3. We are of the opinion that the BIS framework should include a similar exemption as that of the CRR with regard to the large exposure treatment of local authorities and regional governments that are not treated as sovereign.

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?

No comments.

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

No comments.

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

No comments.

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?

No comments.

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

No further comments.