Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for international Settlements
CH-4002 Basel
Switzerland

RE: Regulatory treatment of sovereign default risk charge in the trading book

Dear Mr Coen:

The Global Financial Markets Association, the Institute of International Finance and the International Swaps and Derivatives Association ("the Associations") appreciate the opportunity to provide comments on the Basel Committee on Banking Supervision (BCBS) Discussion Paper '*The regulatory treatment of sovereign exposures*". While we support the decision of the BCBS not to proceed to formulate changes in policy in this area given the need of a regulatory pause, coupled with the significant complexities involved in the discussion of regulatory treatment of sovereign exposures, the Associations believe that the Discussion Paper provides the opportunity to reflect on the trading book treatment of sovereign exposures.

In effect, the Associations would like to share industry's considerations regarding the regulatory treatment of sovereign exposures in the trading book. We believe that it is critically important to dynamically review the incentives created by regulation as they can have significant implications for low-risk assets like sovereign bonds. Sovereign bonds play a pivotal role in financing the economy and they are at the heart of the financial system. These assets are used as collateral for central clearing, margining of uncleared derivatives and other financing transactions by most market participants and serve as liquidity reserves by small and large banks. Thus, they play a critical role in the smooth functioning of financial markets. If market participants' ability to generate liquidity through these assets is impaired, particularly during stress periods, it will have ramifications for the efficient functioning of financial markets. Furthermore, sovereign bond markets and markets backed by sovereign collateral are still adjusting to the ongoing implementation of the Basel III package and, combined with the impacts of the eventual unwind of the quantitative easing programmes across key jurisdictions, the impacts on how the markets will function in the near future are not yet understood.

Bearing in mind the critical function of sovereign bonds, the Associations wish to highlight one particular element of the capital treatment of sovereign exposures which industry believes should be reviewed by the BCBS. The proposed market risk standard[1] of the Basel III framework introduced a requirement that, for banks using the Internal Models Approach, the probability of default should be subject to a floor of three basis points in determining the default risk charge. The imposition of this floor for high-quality sovereigns in the trading book, without valid or adequately explained policy reasons, creates an undesired inconsistency between the banking and trading book rules. This may have significant consequences for banks' appetite for holding trading book inventories in these high-quality assets. The floor will result in increased capital requirements for sovereign exposures which

[1] Basel Committee on Banking Supervision, *Minimum capital requirements for market risk*. January 2016. http://www.bis.org/bcbs/publ/d352.pdf

will considerably impact the liquidity of trading of sovereign debt and negatively impact funding costs.

The Associations would strongly recommend that the BCBS review whether this is the optimum time to introduce such a minimum charge on one side of the trading and banking book boundary for sovereign exposures. In particular, in order to provide consistency between banking book and trading book treatment, the industry believes that the sovereign exposures in the trading book should also be exempt from the three basis points floor.

However, should the BCBS decide that the treatment of sovereigns in the trading book should diverge from the banking book, the Associations would recommend a review of the calibration of the PD floor. The evidence shows that the current floor is overly conservative and propose that any such floor should be more commensurate with the risk of the exposure. The proposed floor is set at three basis points across all issuer types. The data below shows the historical probabilities of default (PDs) for sovereign issuers reported by each of the three principal independent rating agencies (S&P, Fitch, and Moody's). Each of these respective sovereign issuer default studies extends over historical periods of 20 to 30 years. Based on the data and feedback from our joint membership, the floor is not risk-sensitive for the highest quality issuers, resulting in disproportionally high capital requirements for these instruments. The empirical evidence suggests that the current floor of three basis points is excessive and indicates that a one basis point level would be more appropriate.

Probabilities of Default (in %)
Sovereign Issuers

		Rating Agencies		
	Rating	S&P	Fitch	Moody's
	AAA	0.00	0.00	0.00
	AA+	0.00	0.00	
	AA	0.00	0.00	0.00
	AA-	0.00	0.00	
Investment Grade	A+	0.00	0.00	
	A	0.00	0.00	0.00
	A-	0.00	0.00	
	BBB+	0.00	0.00	
	BBB	0.00	0.00	0.00
	BBB-	0.00	0.00	
	BB+	0.10	0.00	
	BB	0.41	1.33	0.55
	BB-	1.70	0.00	
Non Investment Grade	B+	2.06	0.84	
	B	2.50	1.65	2.80
	B-	6.30	1.47	
	CCC to C	34.00	24.14	12.60
		Note 1	Note 2	Note 3

Note 1: Weighted averages of one-year default rates for each year (1975-2012)
Note 2: One year average cumulative default rates (1995-2016)
Note 3: Average 12-month rates (1983-2016)

In conclusion, the Associations respectfully recommend for the BCBS to task the Policy Development Group and its relevant working groups to assess the exemption of sovereigns from the floor in the trading book in order for the calibration of sovereign risk to be consistent across the trading and banking book boundary. If the BCBS concludes that the treatment of sovereigns in the trading book should diverge from the banking book and there are strong arguments for the application of a floor for sovereign risk in the trading book, the calibration should be revised to ensure that treatment of high quality sovereigns in the trading book remains commensurate to the underlying risks.

We thank you in advance for your consideration and reiterate our commitment to continue contributing constructively to this important discussion on the regulatory treatment of sovereign exposures in the trading book.

Yours sincerely,

Panayiotis Dionysopoulos	**Allison Parent**	**Andres Portilla**
Head of Capital	Executive Director	Managing Director
ISDA	Global Financial Markets Association	Regulatory Affairs
		IIF