



March 9, 2018

**Filed electronically**

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

Re: Discussion Paper – *The Regulatory treatment of sovereign exposures*  
(Dec. 2017)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee on Banking Supervision’s (Committee) discussion paper *The Regulatory treatment of sovereign exposures*.<sup>1</sup> Credit unions are cooperative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 68,000 credit unions in 109 countries with USD 1.8 trillion in total assets serving 235 million physical person members.<sup>2</sup>

***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?***

World Council believes that the biggest sovereign risk for debt denominated in a local currency arises not so much from “monetary policy geared towards inflating debt away,” but rather from supply shocks to the domestic economy resulting from decreased supply. These supply shocks are often the unintended result of public policy decisions.

As a threshold matter, it is not simple to generate inflation in an economy with spare capacity. In Japan, for example, authorities have been trying to generate inflation for years with relatively little success. The prudential safety and soundness concerns regarding inflation of debt, however, stem from inflation resulting from reductions in supply. Further, when both the domestic sovereign debt and the depository institution’s funding for it are in the same currency, the inflationary effects on the institution’s balance sheet are muted because inflation affects both the institution’s assets and liabilities the same way.

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<sup>1</sup> Basel Committee on Banking Supervision, Discussion Paper: *The Regulatory treatment of sovereign exposures* (Dec. 2017), available at <https://www.bis.org/bcbs/publ/d425.htm>.

<sup>2</sup> World Council of Credit Unions, *2016 Statistical Report* (2017), available at [https://www.woccu.org/impact/global\\_reach/statreport](https://www.woccu.org/impact/global_reach/statreport).



Regarding supply shocks causing inflation, the oft-cited cases of Weimar Germany or Zimbabwe are examples of what can happen to inflation—and sovereign risk—in the case of dramatic supply shock resulting from decreasing domestic economic output.

After the First World War, the German economy experienced supply shock in the form of the Treaty of Versailles, which transferred effective control of the Rhineland region to the “Entente” group of the Allied Powers and mandated exports of raw materials (e.g., coal, lumber, etc.) as reparations, which removed these materials and other capital from the local economy. Zimbabwe, through its Fast-Track Land Reform Program in the early 2000s, crippled the country’s agricultural output capacity.

The proximate cause of hyper-inflation in both case of Weimar Germany and Zimbabwe—and in others—were public policies that precipitated supply shocks, not the monetary policy response. Regarding domestic-currency sovereign debt, we believe that the Committee should focus on the risks associated with public policies that reduce local economic supply.

***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?***

Guarantees issued by domestic sovereigns play an important role in financial markets for credit unions and other community-based cooperative depository institutions. Domestic sovereign guarantees such as deposit insurance or loan guarantees often help support stability in the financial system or other important public policy goals such as supporting housing finance or lending to small and medium-enterprise (SMEs). Domestic sovereign guarantees are also an important supervisory tool to help prevent runs on depository institutions, especially during periods of macroeconomic stress.

We believe existing Basel III reserve requirements already adequately control for the risks of a domestic sovereign default in a proportional manner, including the Common Equity Tier 1 (CET1) Countercyclical Capital Buffer, the CET1 Capital Conservation Buffer, the Liquidity Coverage Ratio, and the Net Stable Funding Ratio. Further, domestic creditors are typically made whole if the domestic sovereign defaults and, as the Committee’s paper states, no sovereign defaults have occurred in countries with a per capital gross domestic product (GDP) above USD 25,000 since the 1950s.<sup>3</sup>

The four main categories of domestic sovereign guarantee to which community-based financial cooperatives are often exposed include: (1) as an insured depository institution, such as if the applicable deposit insurance fund is backed by the full faith and credit of the sovereign, because public perception of the creditworthiness of the sovereign guarantor can affect an insured institution’s liquidity position; (2) as an

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<sup>3</sup> See Basel Committee on Banking Supervision, Discussion Paper: The Regulatory treatment of sovereign exposures, at 6.



investor in sovereign-insured deposit accounts held by other insured depository institutions; (3) as the beneficiary of a sovereign guarantee of a loan; and (4) as the beneficiary of a sovereign guarantee of an investment, such as an asset-backed security guaranteed by a sovereign or a bond issued by a sovereign.

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

World Council supports the Committee’s proposed “support criteria” under which exposures to public sector entities (PSEs)—such as administrative agencies, governmental deposit insurance funds, and government-sponsored enterprises—can be treated as “exposures to a central or autonomous subnational government if there are sufficient legislative constitutional or other arrangements to facilitate the transfer of financial resource or other means directly from a particular central or autonomous subnational government.”

Many sovereign exposures are exposures to PSEs rather than exposures to central banks or the central government’s treasury per se. The institution’s real credit exposure is to the sovereign, however, if the PSE is backed by the full faith and credit of the sovereign government sponsoring the PSE.

We also question the distinction between exposures to a central bank and to a central government in the context of domestic-currency central government sovereign exposures. While we recognize that this distinction may be necessary in the context of the Eurozone or similar monetary unions like the West African Communauté Financière d’Afrique franc (West African CFA franc), in most jurisdictions the central bank and central government are integrated from an ownership/currency issuing perspective, as is the case in Australia, Canada, the United Kingdom, the United States and most other countries that are not part of the Eurozone or a similar monetary union.

We urge the Committee to treat domestic-currency central government exposures similarly to exposures to central banks by using a 0% risk-weight.

***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?***

World Council agrees with the proposed definition of “domestic-currency sovereign exposures” that is based on both the currency denomination of the exposure and the currency denomination of the funding. Credit unions rarely operate on a cross-border basis and therefore usually make investments that are in the same currency in which their balance sheet is denominated. For example, investments made by federally



chartered credit unions in the USA must usually be denominated in US Dollars.<sup>4</sup> Matching sovereign exposures with the currency of the sovereign, however, would provide a clear rule on what sovereign exposures are considered “domestic.”

In terms of operationalizing this approach, we believe that a domestic sovereign exposure denominated in the same currency as the currency in which the institution’s balance sheet is denominated should be presumed to qualify as a domestic-currency sovereign exposure in order to limit unnecessary regulatory burdens.

***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?***

World Council supports the Committee’s proposed “support criteria” under which exposures to PSEs—such as administrative agencies, governmental deposit insurance funds, and government-sponsored enterprises—can be treated as “exposures to a central or autonomous subnational government if there are sufficient legislative constitutional or other arrangements to facilitate the transfer of financial resource or other means directly from a particular central or autonomous subnational government.”

PSEs play an important role with respect to guaranteeing financial cooperatives’ deposits and some types of loans and investments. Credit unions’ and other mutuals’ deposits are often insured by a savings guarantee scheme backed by the full faith and credit of a domestic central government or an autonomous provincial government.

Loans made by credit unions can also often be guaranteed by PSEs supported by central governments. For example, mortgages made by Canadian credit unions are often required to have a guarantee from a mortgage insurer that is backed by the federal government of Canada, such as the Canada Mortgage and Housing Corporation.

Similarly, business loans made by credit unions in the European Union to SMEs can be eligible for guarantees from the European Commission’s program for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME)<sup>5</sup> and similar programs operated other EU-institutions or by European national governments.

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<sup>4</sup> See 12 C.F.R. § 703.14(a), available at <https://www.law.cornell.edu/cfr/text/12/703.14>; Permissible Foreign Currency Investments for Federal Credit Unions and Corporate Credit Unions, 72 Fed. Reg. 41956 (Aug 7, 2007) (“For [Federal Credit Unions], the general investment rule does not expressly prohibit foreign currency denominated investments, but ties variable rate investments to a domestic interest rate and, consequently, limits FCU investment authority to U.S. dollars.”), available at <https://www.ncua.gov/Legal/Regulation%20History/703P-72fr41956.pdf>.

<sup>5</sup> See generally “COSME financial instruments”; [https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments\\_en](https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments_en) (last visited Mar. 7, 2018).



We urge the Committee to adopt the “support criteria” as proposed.

Regarding the Committee’s proposed “autonomy criteria,” we support the two proposed criteria for determining whether a governmental entity is autonomous in general, and we believe that these criteria will appropriately treat provincial governments in federal systems, such as Canadian provinces and Australian or US states, as autonomous sovereigns.

We urge the Committee, however, to clarify how this framework may apply in the context of exposures to the EU and its instrumentalities.

We support the Committee’s proposal that “central governments”—defined as the “government of a state”—be the framework’s most senior level of governmental responsibility and urge the Committee to consider each Member State of the EU to be an independent “central government” as proposed.

We believe, however, that exposures to the EU and its instrumentalities are most similar to an exposure to a central government (albeit one that is an international organization that does not have subnational governments per se) and therefore request clarification on this issue.

***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?***

Yes, World Council agrees that capital requirements for sovereign exposures cannot be modelled robustly using Internal Ratings Based (IRB) approaches and we further agree that such exposures should be subject to a standardised approach treatment.

We believe that the risk associated with bank exposures to a sovereign whose debt is denominated in its own currency is largely a political one. In other words, the ultimate inflation/technical/discretionary non-payment decisions would arise because of political or distributive decisions, not technical economic ones. Political risk cannot be easily modelled. In addition, IRB-based approaches present level-playing-field concerns for community-based depository institutions that must follow the standardised approach.

Credit unions and other community-based financial cooperatives subject to Basel III are usually required to follow the standardised approach for all balance sheet items. While we recognize that large, IRB-approach banks may need a more granular analysis of their balance sheets than would a credit union for some types of complex financial positions, IRB approaches appear to give large banks myriad opportunities for capital arbitrage. The Basel III capital “output floor” for IRB-approach institutions of 72.5 percent of what the institution’s capital requirement would be under the standardised



approach<sup>6</sup> recognizes that IRB-approach institutions often hold less capital on a per-asset basis than would a standardised-approach institution.

IRB-approaches in general seem inconsistent with efforts to promote international standardisation of capital requirements and to allow comparability between institutions because each large bank gets, in effect, to write its own capital rules in areas where IRB-approaches remain allowed. Each large bank making its own, differing determinations concerning how to risk-weight sovereign exposures would neither promote safe and sound prudential regulation nor promote a level regulatory playing field.

We urge the Committee to finalize the removal of IRB-approaches for sovereign exposures as proposed.

***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?***

World Council urges the Committee to establish a 0% risk-weight for domestic-currency central government exposures, including for exposures to central-government PSEs that meet the Committee’s “support criteria,” as a general policy matter. Alternatively, we urge the Committee to continue to permit 0% risk-weightings for domestic sovereign exposures as a national discretion. Existing Basel III reserve requirements such as the CET1 Countercyclical Capital Buffer, the CET1 Capital Conservation Buffer, the Liquidity Coverage Ratio, and the Net Stable Funding Ratio already adequately control for the risks of a domestic sovereign default in a proportional manner.

At a minimum, there is a very strong case that domestic-currency central government exposures to sovereigns with AAA to A- credit ratings should be treated as riskless for risk-based capital purposes. We believe, however, that domestic-currency central-government exposures held by domestic creditors should be treated at a 0% risk-weighting in all jurisdictions.

The Committee states in this paper that “[o]utright defaults by central banks on local currency liabilities have historically been very rare” and while “some have still occurred . . . they were generally associated with monetary reforms or currency conversions”<sup>7</sup> that would affect both sides of a non-internationally-active institution’s balance sheet in the same way. In addition, the discussion paper concludes that “the costs of external

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<sup>6</sup> See Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms*, at 137-38 (Dec. 2017), available at <https://www.bis.org/bcbs/publ/d424.htm>.

<sup>7</sup> *Id.*



defaults tend to be borne by non-residents”<sup>8</sup>, i.e. domestic sovereign creditors typically are made whole during an externally driven sovereign default even if foreign creditors of the sovereign are not.

In addition, stringent portfolio-shaping rules, coupled with a sovereign deposit guarantee of the institution’s deposits, make what the Committee describes as the “sovereign-bank nexus”<sup>9</sup> inexorable with respect to community-based cooperative depository institutions and their domestic sovereigns.

Credit unions and other community-based financial cooperatives often have few investment options that do not involve sovereign exposures. Credit unions often operate under investment portfolio-shaping rules that limit their permissible investments primarily to loans to their members, bank deposits, and debt instruments guaranteed by a domestic sovereign.

Cooperative depository institutions are also exposed to domestic sovereigns indirectly when the sovereign (often through a PSE) acts as the institution’s deposit insurer, meaning that a sovereign default would likely have significant macroeconomic and liquidity knock-on effects. In addition, credit union supervisors often have extraordinary guarantee powers backed by the full faith and credit of a domestic sovereign that can be used in addition to deposit insurance to support financial stability.<sup>10</sup> Supervisors being able to use such guarantees and similar resolution authorities without delay helps reduce losses to the jurisdiction’s savings guarantee scheme or deposit insurance fund.

Extreme macroeconomic dislocations and liquidity events would be associated with a domestic central-government sovereign default that impairs the claims of local creditors. Such macroeconomic stress periods and liquidity events are already controlled for in Basel III through the CET1 Countercyclical Capital Buffer, the CET1

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<sup>8</sup> Basel Committee on Banking Supervision, Discussion Paper: The Regulatory treatment of sovereign exposures, at 6.

<sup>9</sup> *Id.* at 1.

<sup>10</sup> See, e.g., 12 U.S.C. § 1788(2) (“Whenever in the judgment of the [National Credit Union Administration] Board such action will reduce the risk or avert a threatened loss to the [savings guarantee] fund and will facilitate a merger or consolidation of an insured credit union with another insured credit union, or will facilitate the sale of the assets of an open or closed insured credit union to and assumption of its liability by another person, the Board . . . may guarantee any person against loss by reason of its assuming the liabilities and purchasing the assets of an open or closed insured credit union.”), available at <https://www.law.cornell.edu/uscode/text/12/1788>; NCUA Guaranteed Notes (NGN) Program; <https://www.ncua.gov/regulation-supervision/Pages/guaranteed-notes.aspx> (last visited Mar. 9, 2018) (“The National Credit Union Administration (NCUA) announced the Corporate System Resolution Program on September 24, 2010. As part of the resolution, the NCUA created the NCUA Guaranteed Note (NGN) Program to provide long-term funding for distressed investment securities (Legacy Assets) from the five failed corporate credit unions . . . The timely repayment of principal and interest to the investors in NGNs is guaranteed by the NCUA and backed by the full faith and credit of the United States.”).



Capital Conservation Buffer, the Liquidity Coverage Ratio, and the Net Stable Funding Ratio.

If these existing Basel III reserve requirements are not sufficient to control for the local financial crisis, liquidity events, and market dislocations associated with a domestic-currency sovereign default, it seems unlikely that revisions to the risk-based capital framework vis-à-vis domestic sovereign exposures would be able to play a material role in preventing institutional failures without imposing disproportionate compliance burdens on regulated institutions.

These factors strongly support a 0% risk-weighting for domestic central-government sovereign exposures, especially in countries with per capita GDP of more than USD 25,000, which the Committee's discussion paper notes have not had a sovereign default since the 1950s.<sup>11</sup> The risk of a sovereign default that causes losses to domestic creditors in general, however, is very low and providing a preferential risk-weighting to domestic central-government exposures often furthers the central government's macroeconomic and fiscal objectives, especially during economic stress periods. Treating exposures to domestic sovereigns by domestic creditors in all jurisdictions as riskless from a risk-based capital perspective would be consistent with the principle of proportionality and historical evidence.

We believe existing Basel III reserve requirements already adequately control for the risks of a domestic sovereign default in a proportional manner.

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

In terms of non-credit rating indicators of creditworthiness, we urge the Committee to consider seriously dividing sovereign exposures into three or more classes that are not reliant on credit ratings per se, such as: (a) domestic sovereign exposures (which present lower credit risks than foreign sovereign exposures); (b) "investment grade" foreign sovereign exposures; and (c) "non-investment grade" foreign sovereign exposures. The US National Credit Union Administration (NCUA) has adopted a similar approach for federally chartered credit unions in the USA.

The NCUA adopted its non-rating indicator approach after the Dodd-Frank Act prohibited the use of credit ratings for regulatory purposes.<sup>12</sup> To implement this requirement of the Act, the NCUA promulgated a definition of "investment grade" under which federally chartered credit unions are permitted to invest in some types of "investment grade" instruments, subject to portfolio limits, defined as follows:<sup>13</sup>

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<sup>11</sup> *Id.*

<sup>12</sup> See Alternatives to the Use of Credit Ratings, 77 Fed. Reg. 74103 (Dec. 13, 2012), available at <https://www.ncua.gov/Legal/Documents/Regulations/FIR20121214CreditRatings.pdf>.

<sup>13</sup> 12 C.F.R. § 703.2 ("Definitions"), available at <https://www.law.cornell.edu/cfr/text/12/703.2>.





“Investment grade means the issuer of a security has an adequate capacity to meet the financial commitments under the security for the projected life of the asset or exposure, even under adverse economic conditions. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest on the security is expected. A Federal credit union may consider any or all of the following factors, to the extent appropriate, with respect to the credit risk of a security: Credit spreads; securities-related research; internal or external credit risk assessments; default statistics; inclusion on an index; priorities and enhancements; price, yield, and/or volume; and asset class-specific factors. This list of factors is not meant to be exhaustive or mutually exclusive.”

NCUA’s regulations, however, also exempt domestic central-government sovereign exposures from this “investment grade” credit analysis, which limits unnecessary regulatory burdens and essentially standardises the treatment of these domestic sovereign exposures for regulatory purposes:<sup>14</sup>

“A Federal credit union must conduct and document a credit analysis on an investment and the issuing entity before purchasing it, except for investments issued or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations or fully insured (including accumulated interest) by the National Credit Union Administration or the Federal Deposit Insurance Corporation. A Federal credit union must update this analysis at least annually for as long as it holds the investment.”

We urge the Committee to consider seriously the NCUA’s approach of promulgating a definition of “investment grade”, as well as to exempt domestic central-government sovereign exposures from the “investment grade” credit analysis requirement, as a means of determining sovereign exposure risk weights.

***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?***

World Council does not support imposing a marginal risk weight add-on for domestic sovereign exposures. We urge the Committee to limit any marginal risk weight add-on rules to apply only to foreign sovereign exposures.

Credit unions and other community-based depository institutions are usually subject to portfolio shaping rules that limit their permissible investments to loans, deposits in other depository institutions, and debt instruments guaranteed by a domestic sovereign. In addition, credit unions and similar financial cooperatives are usually only exposed to

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<sup>14</sup> 12 C.F.R. § 703.6 (“Credit Analysis.”) (emphasis added), available at <https://www.law.cornell.edu/cfr/text/12/703.6>.



domestic sovereigns, both because of portfolio-shaping investment regulations as well as because they rarely operate on a cross-border basis. The portfolio-shaping rules can be statutory in nature and are designed to reduce credit risk to the institution by limiting its investment options to low-risk assets.

As a result of these stringent investment portfolio shaping rulebooks, credit unions and other financial cooperatives often have few investment options that do not involve a domestic sovereign guarantee. Penalizing credit unions on a risk-based capital basis for their exposures to domestic sovereigns would not be a proportional regulatory approach when applicable investment portfolio shaping rules provide few alternative investment options.

Creating a marginal risk weight add-on for exposures to domestic sovereign debt also presents potential unintended consequences, especially when an institution does not have available under its rulebook the full range of investment options enjoyed by large commercial banks. A marginal risk weight add-on for institutions with limited investment powers could push them into making investments or loans with higher credit risks than domestic sovereign debt—such as by lowering loan underwriting standards in order to have a way to utilize excess liquidity, or by placing their excess liquidity with weak banks that must offer high rates of interest in order to attract deposits—that could undermine prudential safety and soundness objectives.

World Council does not support imposing a marginal risk weight add-on approach for domestic sovereign exposures. We urge the Committee to limit any marginal risk weight add-on rules to apply only to foreign sovereign exposures.

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

World Council does not support requiring institutions to stress test the creditworthiness of their exposures to domestic sovereigns. Credit unions and other financial cooperatives are regulated by supervisory agencies that report to domestic sovereigns. The Committee is contemplating mandating that these supervisory agencies promulgate rules to implement a standardised risk-based-capital approach to sovereign credit exposures.

We do not believe that it would be useful from a supervisory standpoint or consistent with the principle of proportionality to have institutions regularly model the worst-case scenario of a domestic sovereign default when: (a) the likelihood of a domestic sovereign default that results in significant losses for domestic creditors is remote; and (b) the stress testing exercise would likely require making assumptions that are at odds with the risk-based capital regulations issued the institution's supervisor.

To the extent that the supervisory agency might not agree with its own regulations concerning its own sovereign's creditworthiness, the supervisory agency is in a much



better position to assess the sovereign's creditworthiness and communicate it to regulated institutions than would be the regulated institutions themselves. Rule of law principles militate in favor of the supervisory agency revising its regulations concerning the risk-based capital treatment of domestic sovereign debt rather than trying to use the stress testing process as a substitute. Further, stress testing of community-based depository institutions is often a disproportionate regulatory burden on both the regulated institution and on its supervisor, especially when the supervisory agency may have limited personnel resources to devote to stress testing and may want to focus on higher-risk issues than the unlikely event of a domestic sovereign default.

World Council does not support requiring institutions to stress test the creditworthiness of their exposures to domestic sovereigns.

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

World Council supports the Committee's proposal for Pillar 3 disclosures to disclose high-level information concerning sovereign exposures by jurisdiction, currency, and accounting classification. We do not believe that additional disclosure requirements are necessary, however, community-based financial cooperatives' less-complex business model means that nearly all sovereign exposures for these institutions will be to domestic sovereigns in local currency. We believe that limiting institutions' disclosure requirements to reporting sovereign exposures by jurisdiction, currency, and accounting classification is a proportional approach.

World Council appreciates the opportunity to comment to the Committee on its discussion paper *The Regulatory treatment of sovereign exposures*. If you have questions about our comments, please feel free to contact me at [medwards@woccu.org](mailto:medwards@woccu.org) or +1.202.508.6755.

Sincerely,

A handwritten signature in black ink that reads "Michael S. Edwards".

Michael S. Edwards  
VP and General Counsel  
World Council of Credit Unions