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Secretariat of the Basel Committee on Banking Supervision
Bank for international Settlements
CH-4002 Basel, Switzerland

Japanese Bankers Association

JBA Comments on the BCBS Consultative Document: *Voluntary disclosure of sovereign exposures*

Dear Basel Committee members:

The Japanese Bankers Association (the JBA[1]) appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision (the BCBS) Consultative Document on "*Voluntary disclosure of sovereign exposures*" (the Proposal).

While the JBA recognizes that the disclosure templates suggested in the Proposal are voluntary for jurisdictions and each jurisdiction can determine if they require their banks to apply the templates, the regulatory treatment of sovereign exposures is a fundamental issue for all banks, regardless of whether it is mandatory or not for them, given that it, in nature, may have broader implications for global financial market and its stability. The JBA therefore would like to share our views on the necessity and rationality of such disclosure as well as its potential unintended consequences.

As a general comment, while transparency and comparability of disclosed information are key elements for stakeholders, the BCBS should also be mindful of the risk that the disclosure of sovereign exposures would have negative implications for financial markets and financial stability. It should be noted that a number of issues and concerns were raised against the BCBS Discussion paper on "*The regulatory treatment of sovereign exposures*"[2] (the Discussion Paper) by various stakeholders – not only the private sector[3] but also regulators, central banks and ministries of finance from many jurisdictions.

Nevertheless, it is not clear from the Proposal (a) what the motivation, objective and cost/benefit are behind the Proposal, (b) how concerns raised against the Discussion Paper have been addressed and (c) why the voluntary disclosure of sovereign exposures is justified taking into account those concerns. Given that those concerns raised against the Discussion Paper were not merely political, but rather concerns over negative implications for the financial markets and monetary and fiscal policies, due consideration should be given to these potential issues.

The primary role of the BCBS is to *set international standards for the prudential regulation and supervision of banks*, and those *standards constitute minimum requirements across jurisdictions*[4]. Still, "*BCBS members may decide to go beyond them,*" if necessary. It is therefore questionable to set such *voluntary requirement*s as a part of the BCBS mandate.

The BCBS should focus its efforts on ensuring full, timely and consistent implementation of Basel III post-crisis reforms by member jurisdictions, rather than setting fragmentary voluntary add-ons to the international minimum requirements, which could lead to additional source of market fragmentation as discussed below.

The following sections provide details of the issues and our concerns over the disclosure of sovereign exposures. It

[1] The Japanese Bankers Association (JBA) is a premier financial organization whose members consist of banks, bank holding companies and bankers associations in Japan. As of January 1st, 2020, JBA has 117 Full Members (banks), 3 Bank Holding Company Members (bank holding companies), 74 Associate Members (banks & bank holding company), 58 Special Members (regionally-based bankers associations) and 1 Sub-Associate Member for a total of 253 members.
[2] https://www.bis.org/bcbs/publ/d425.htm
[3] Our comments on the Discussion Paper can be found at https://www.zenginkyo.or.jp/fileadmin/res/en/news/news180309.pdf
[4] Basel Committee Charter , V. BCBS standards, guidelines and sound practices : https://www.bis.org/bcbs/charter.htm

is highly recommended that the BCBS gives due consideration to these potential issues before finalizing the Proposal.

"Sovereign-bank nexus"

- If the Proposal intends to break the "Sovereign-bank nexus," the idea is fundamentally flawed. A government, its central bank and private-sector banks in its jurisdiction are inherently interconnected via domestic public debt financing and monetary policy in the financial system, and therefore it is not logically and practically possible to segregate the banking sector from sovereign risk. Furthermore, the scope of sovereign debt subject to disclosure requirements could be misleading, given that domestic sovereign debt denominated in domestic currency has a very different nature from sovereign debt denominated in foreign currency with respect to risks to the global financial stability.

- Sovereign-bank nexus is essentially an issue that should be addressed by macro-prudential measures[5] and fiscal surveillance by international institutions, rather than micro-prudential measures to banks. As observed in the past in the Greek crisis or Sovereign Debt Crisis in "GIIPS countries," the market puts pressure on banks to reduce sovereign exposures to vulnerable countries in a time of stress, even if the bank's position is well-managed and marginal to its prudential risk. Micro-prudential disclosure requirements therefore will not be an effective measure to address the sovereign-bank nexus, rather, they could even contradictorily tighten it by inducing over-reactive market discipline.

Potential impact on global financial market and stability

- It should be examined how the disclosure of sovereign exposures would affect market participants' behavior both in normal times and in times of stress. The objective of Pillar 3 of the Basel framework is to *promote market discipline through regulatory disclosure requirements*[6]. The disclosure of sovereign exposures, whether intended or not, has the effect of putting banks under pressure to reduce their positions in a time of stress. This is exactly the risk that many of the stakeholders are concerned about regarding the Discussion Paper.

- To make banks be more vigilant to sovereign risks by market discipline has not only positive but also negative effects. For instance, it would put unnecessary pressure on cross-border banks to reduce sovereign exposures to emerging countries. It would also restrict fiscal stimulus packages to overcome severe economic downturns by impeding the financing of the government. If it is revealed that banks reduced their position in a time of stress, it can trigger a fire-sale by other investors and thus exacerbate cyclicality of the market as broadly observed during the European Sovereign Debt Crisis[7] and 1997 Asian financial crisis[8]. In some cases, it may even spread contagiously to other countries with similar fiscal deficits or foreign reserve balance.

Conflict with Pillar 1 and Pillar 2 requirements

- The disclosure of sovereign exposures could conflict with the Pillar 1 and Pillar 2 requirements. Banks are required to hold high quality liquid assets (HQLA) to meet liquidity and margin requirements. Given that sovereign debt is virtually, not just in the regulatory treatment, the highest asset class in quality and has the deepest and most liquid market in most jurisdictions, it may be impossible for banks to satisfy these requirements without sovereign debt, even if banks are pressured to reduce sovereign exposures.

- While it would be the only option for banks to scale down their businesses in the jurisdiction along with sovereign exposures to the jurisdiction, it definitely contradicts the Basel III objective of *provid(ing) a regulatory foundation for a resilient banking system that supports the real economy*[9]. Banks may be able to shift

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[5] For instance, macro-prudential framework in Japan can be found at https://www.boj.or.jp/en/finsys/fs_policy/fin111018a.pdf.
[6] DIS – Disclosure requirements, 10.1: https://www.bis.org/basel_framework/chapter/DIS/10.htm?inforce=20220101
[7] For example, ECB Financial Stability Review, November 2014 – "Fire-sale externalities in the Euro area banking sector" studied the effects of fire-sale externalities in the euro area banking sector by using individual bank balance sheet data, and concluded "the outbreak of the euro area sovereign debt crisis in 2010 is also captured" as fire-sale spillovers.
See https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart201411_01.en.pdf, page 99.
[8] For example, IMF WP/98/155 (Taimur Baig and Ilan Goldfajn) "Financial Market Contagion in the Asian Crisis", November 1998, tested for evidence of contagion in sovereign debt markets of Thailand, Malaysia, Indonesia, Korea and the Philippines and concluded that "The Asian crises suggest that during a period of financial market instability market participants tend to move together across a range of countries. Shocks originating from one market readily get transmitted to other markets, thus becoming a source of substantial instability".
See https://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/_wp98155.ashx, page 42.
[9] Basel III: Finalising post-crisis reforms, December 2017: https://www.bis.org/bcbs/publ/d424.pdf

their sovereign exposures from vulnerable countries to stable countries without bearing incremental risks of currency mismatch within euro-area counties. However, the JBA is not sure if it is an intended consequence of the Proposal and is acceptable by all EU member countries.

- Pillar 3 should be a complementary framework to Pillar 1 and Pillar 2. Any inconsistency arising from the Consultative Document should be avoided. Provided that the BCBS does not intend to make any changes to the regulatory treatment of sovereign exposures at this juncture, it would be counterproductive to introduce such inconsistent framework. If a supervisory body needs to collect data on sovereign exposures of their banking sector for macro-prudential purposes, sovereign exposures with values equal to or above 10% of the bank's Tier 1 capital have been already required to be regularly reported to the supervisor under *the Supervisory framework for measuring and controlling large exposures*[10].

Sensitive information for both banks and central banks

- Information on sovereign exposures is sensitive for both banks and central banks. For banks, the disclosure of sovereign exposures by jurisdiction, currency and maturity may reveal banks' portfolio investment strategies. This could raise competitive issues and an uneven level playing field, not only between banks that are required to disclose and those that are not, but also between banks and non-bank institutional investors that are not subject to the disclosure requirements. Furthermore, if bank's investment strategies are revealed, it could induce speculative attacks or speculative investment strategies by other investors, which could exacerbate market volatility particularly when the market is reactive to sovereign risks.

- For central banks, it could impede their monetary policy and the flexibility of their market operations. Given that monetary policy is, in nature, an intervention to the market, it does appear logically flawed to place the banks' position in the central bank reserves and sovereign debt under market discipline. The central bank reserve should be purely determined by monetary policy, central bank operation and deposit inflow to banks, not by market discipline.

Value of information for investors

- While the JBA recognizes the BCBS's initial objective in the Discussion Paper to *provide important and relevant information for market participants to better understand and assess the different elements of bank's sovereign risk*[11], it is not clear what value the disclosure of sovereign exposures is intended to provide for investors and what reactions are expected/intended from the investors with that data. According to the Proposal, it seems that *the Committee reviewed the feedback received […] and further evaluated the merits and demerits of pursuing such measures*, but again those considerations have not been explained at all in the Proposal.

- In our view, when sovereign risk is in question in a country, the information essential to investors is the total amount of all exposures in the country. While the JBA believes that it is an extraordinary situation, at least not frequent, related information can be found in *Table CRB: Additional disclosure related to the credit quality of assets,* in which b*reakdown of exposures by geographical areas* is disclosed under the Pillar 3. Ad hoc disclosures by banks[12] are also available during times of stress.

- In general, no matter what information is disclosed, it would be better than nothing for investors. However, in determining the scope of disclosure requirements, it should be carefully examined whether the benefits outweigh the costs as well as risks. Although various data on sovereign exposures proposed may be "useful," it should be examined whether every item is "crucial" for investors and for the global financial stability without any unintended consequences both in normal times and in times of stress.

Necessity and rationality for setting voluntary disclosure requirements

- The fact that *"the Committee has not reached a consensus to make any changes to the regulatory treatment of*

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[10] LEX- Large exposures, Sovereign exposures and entities connected with sovereigns, 30.34: https://www.bis.org/basel_framework/chapter/LEX/30.htm?inforce=20191215

[11] Discussion paper - The regulatory treatment of sovereign exposures, Pillar 3 disclosure requirements: https://www.bis.org/bcbs/publ/d425.htm

[12] For instance, SMFG disclosed its exposures to GIIPs counties from fiscal year 2012 onwards: https://www.smfg.co.jp/english/investor/financial/small/pdf/e2013sept_pre.pdf (p.37). Other major Japanese banks disclosed its data as well.

sovereign exposures at this stage" does not provide any rationality for setting voluntary requirements. The necessity and rationality for setting voluntary disclosure requirements should be judged purely by whether or not it contributes to financial stability without negative side-effects, not by whether or not the Committee has reached a consensus.

- As noted above, it is predictable that the disclosure of sovereign exposures would have negative implications for financial markets and financial stability, at least in the jurisdictions where the disclosure is made mandatory. Furthermore, due consideration should be given as to whether the voluntary disclosure requirements that are "free to decide" for a jurisdiction, would intensify conflicts of national interest between home and host jurisdictions. In the case where banks in a jurisdiction have a relatively large amount of exposures to another jurisdiction, a decision made by the home jurisdiction could have unintended negative impacts on the host jurisdiction. If the host jurisdiction negatively affected moves to ring-fence capital and liquidity of cross-border banks in order to protect their financial stability and national interests, the disclosure could be even a source of market fragmentation.

With the above in mind, the JBA is, at this juncture, unable to support the Proposal even if the disclosure requirements of sovereign exposures are voluntary with jurisdictions being free to decide. While it may be preferable to have a unified template rather than various templates decided by each jurisdiction in general, the JBA believes that those benefits will never outweigh the risks and negative impacts in total as discussed above.

(End)