

Basel Committee
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**MINISTER FOR INDUSTRY,
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AFFAIRS**

Comments on the discussion paper on the regulatory treatment of sovereign exposures

The Danish government appreciates the opportunity to comment on the discussion paper on the regulatory treatment of sovereign exposures (RTSE). We share the Committees view that the issues raised on this issue are very important.

In general, we find that the regulatory treatment of exposures should reflect the riskiness of the exposures. As sovereign exposures are to a different degree associated with risk, albeit in many cases a low level of risk, the regulatory treatment should reflect this.

In our view, the current RTSE needs to be improved. This would strengthen the risk sensitivity of the capital requirements, contribute to financial stability and help breaking the sovereign-bank nexus with positive effects on the real economy. Furthermore, improving the RTSE may better support sound and sustainable national policies.

Sovereign exposures may serve several important and benign roles across jurisdictions, including as a benchmark for asset pricing, as a secure asset, as a highly liquid instrument etc. RTSE may affect these roles and therefore needs to be carefully calibrated to ensure that on the one hand, all risks associated with these exposures are adequately reflected while, on the other hand, avoid that too conservative or restrictive requirements unnecessarily hampers the benign roles of sovereign exposures.

On the specific issues in the discussion paper, first of all, addressing sovereign risks is relevant for all banks. Solutions should therefore cover all banks, irrespective of whether they are domiciled inside or outside a currency union. The primary purpose of changing the RTSE is to increase financial stability. Risk to financial stability only increases in cases where banks cannot diversify their sovereign portfolios without taking on additional currency risk.

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Secondly, we find that a clearer and more precise definition of sovereign exposures should be pursued as a basis for a uniform treatment of sovereign exposures across jurisdictions. In our view, the introduction of a clearer, more precise definition of sovereign exposures could provide better alignment across jurisdictions regarding the treatment of exposures to other sovereign entities as well as to exposures to a central government.

Sovereign exposures should include exposures towards central, regional, and local government. On the other hand, we find that exposures to central banks should not be included in the definition. Exposures to central banks should be treated differently as they are part of the mechanics of any banking system. Thus, exposures to central banks should receive a zero risk weight as the alternative would risk distorting the conduct of monetary policy.

Thirdly, the risk weight for sovereign entities other than central banks should reflect the riskiness of the exposure whereby riskier exposures should have higher risk weights. In our view, all risk weights of sovereign exposures should be positive. The discretion to set a zero risk weight for all domestic currency exposures should therefore be abandoned.

Furthermore, we find that an improved RTSE framework should consistently and prudently address both credit risk and concentration risk of sovereign exposures. We however do not support hard large exposures limits as hard limits would cause cliff effects and may lead to disruptions in sovereign debt market. Following the same logic, it is important to phase new rules in prudently and gradually taking into account financial stability considerations.

Finally, RTSE should recognize that a revised standardized approach is more prudent and superior to IRB models in addressing risks relating to sovereign exposures due to sparse data availability.

As always, we stand ready to answer any questions you may have in relation to the above.

Yours sincerely,



Brian Mikkelsen