SEK

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**SEK's response to the Basel Committee's consultation "Recognising the cost of credit protection purchased"**

Swedish Export Credit Corporation (SEK) is a public company, wholly owned by the Kingdom of Sweden. SEK's mission is to secure access to financial solutions on a commercial basis to the Swedish export industry. SEK provides, inter alia, financing to buyers of Swedish goods and services by granting export credits and also by directly lending to Swedish exporters. SEK also, on behalf of the Swedish government, administers the state-supported export credit system as a public policy role.

SEK appreciates this opportunity to comment on the Basel Committee's consultative document "*Recognising the cost of credit protection purchased*".

We strongly support the Basel Committee in its effort to increase the resilience of the financial system in order to prevent future crises. However, we are concerned that the proposed changes to the credit risk mitigation framework may increase the price of credit protection and therefore may hamper the financial institutions ability to hedge credit risk. We believe that credit risk mitigation is an important tool of financial institutions' sound credit risk management system and thus it should not be regarded as regulatory arbitrage by definition.

The Basel II framework allows financial institutions' to reduce the risk-weighted assets (RWA) of a loan to a counterparty only if the credit risk protection used and the credit protection provider are eligible under the Basel II framework. In this case, the financial institution may substitute the risk weight of the counterparty for the lower risk weight of the protection provider.

*Operational requirements common to guarantees and credit derivatives*
*189. A guarantee (counter-guarantee) or credit derivative must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. Other than non-payment by a protection purchaser of money due in respect of the credit protection contract it must be irrevocable; there must be no clause in the contract that would allow the protection provider unilaterally to cancel the credit cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure. It must also be unconditional; there should be no clause in the protection contract outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.*[1]

Under the Internal Rating Based Approach (the IRB-approach) the financial institution may also use the double default method. This method recognizes that the joint default probability of a hedged exposure is usually much smaller than the minimum of the individual default probabilites of the obligor and the guarantor. Double default treatment is only allowed when the following conditions are met: (i) the credit protection provider is an institution, insurance and reinsurance undertaking or an export credit agency regulated in a manner equivalent to the Basel standards (ii) the credit protection provider has, at the time the credit protection is provided, or for any period of time thereafter, an internal rating with a probability of default (PD) equivalent to or lower than that associated with credit quality step 2[2] (iii) the credit protection provider has an internal rating with a PD equivalent to or lower than that associated with credit quality step 3[3] or above. In other words, in order for a financial institution to obtain capital relief for use of any credit risk mitigation technique, the credit protection provider must be creditworthy and requlated in a manner equivalent to the Basel standards. In addition, the degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor shall not be too high.We are of the opinion that the Basel II framework for credit risk mitigation already provides a sound basis for credit risk and capital management. In our view, the proposed rules should therefore be clearer targeted on those transactions that are speculative and are made to benefit from regulatory arbitrage.

Credit risk mitigation is a natural part of the financial institutions' business models and risk management. We are concerned that the Basel Committee's proposal to require financial institutions to capitalize the present value of credit protection costs might also affect fully legitimate transactions, e.g. those transactions not made to benefit from regulatory arbitrage. For example, in an environment when risk aversion is high, the present value of future premiums might make most transactions look expensive. If the cost of credit protection becomes too high, the financial institutions might choose not to hedge their credit exposures. In addition, especially during periods of system-wide stress, the cost of capital can be too high and the financial institutions can be capital constrained due to the regulatory requirements. In these cases, the credit risk mitigation techniques, such as guarantees and CDS contracts, play an important role in facilitating financing.

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[1] *Recognising the cost of credit protection purchased*, Basel Committee on Banking Supervision, March 2013, page 3.
[2] Credit quality step 2 corresponds ratings ranging from A+ to A- from Standard & Poor's and ratings ranging from A1 to A3 from Moody's.
[3] Credit quality step 3 corresponds ratings ranging from BBB+ to BBB- from Standard & Poor's and ratings ranging from Baa1 to Baa3 from Moody's.

According to the technical standards of the Basel Committee's proposal, some supervisors may conclude that spread income from the underlying exposure could be taken into account when calculating the present value of credit protection costs. Where spread income would exceed credit protection costs in all circumstances, supervisors may determine that it is not necessary to undertake calculations and that the present value of credit protection costs may be taken as zero. In our opinion, spread income should always be taken into account when determining the present value of credit protection costs if the credit protection cost will be seen as a part of the lending transaction like the Basel Committee proposes. We believe that this should be included as a standard provision in the proposed regulations, instead of only being a part of the proposed technical standards. This should be done to prevent the proposed rules from affecting non-speculative credit risk mitigation negatively and also, to facilitate consistent implementation of the rules.

The Basel Committee welcomes feedback on whether, in addition to the 150% risk-weight threshold, additional exemptions should be considered for certain types of transactions. In particular, the Committee welcomes feedback on: (1) exposures guaranteed by governmental entities (including sovereigns and public sector entities) and (2) trade finance transactions with guarantees. SEK's view is that both long term export finance and short term trade finance products with guarantees should be exempted from the proposed regulation. Export finance and trade finance do not cause systemic risk in the financial system. Export finance and trade finance is characterized by government support, since they are, for a significant proportion of a loan, backed by a guarantee or the insurance of a national export credit agency (ECA). During the financial crisis, guarantees provided by ECAs played an important role in keeping world trade functioning. The export finance and trade finance loans enjoy very low final default rate as a final default would be linked to a double default (default of primary borrower, followed by default of the guarantor or the insuring ECA). Furthermore, ECA-covered export credits can often be the only possibility to conduct business in certain developing countries and emerging market economies since insurance companies and banks do not provide finance in these regions. In our opinion, export finance and trade finance products with guarantees or insurance from an ECA in combination with a guarantee from a financial institution should not be likened to a source of regulatory arbitrage. Both trade finance and export finance are fundamental for the economy and are characterized – in particular when they are ECA-covered – by a very low risk profile.

It is extremely important that the proposed rules will be analyzed carefully, with respect to the interplay with other regulatory reforms. We believe that overly restrictive rules can unduly hamper credit risk mitigation, increase the price of the credit protection and therefore also reduce financial institutions' credit capacity.

We thank you for your consideration of our comments.

SEK

Sincerely yours,
SWEDISH EXPORT CREDIT CORPORATION

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| Peter Yngwe<br>President | Per Jedefors<br>Chief Risk Officer |