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SEK's response to the Basel Committee's consultation "Supervisory framework for measuring and controlling large exposures"

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 "*Supervisory framework for measuring and controlling large exposures*".
We strongly support the Basel Committee in its effort to ensure greater consistency in the way financial institutions and supervisors measure, aggregate and control exposures to single counterparties or group of connected counterparties. While we support the case for more consistent standards for the treatment of large exposures, we are concerned with the risks that the proposed requirements could actually reduce credit availability, constrain risk mitigation and hinder the possibilities for smaller institutions to hedge risks. We believe that the possible implications of the proposed rules must be considered with great care, through a distinct comprehensive philosophy with due consideration of important desirable consequences, as opposed to a simplified "one-size-fits-all" approach.

Sweden, as many other committee member jurisdictions, currently apply a large exposure limit of 25% of a financial institution's total regulatory capital. The Basel Committee is proposing that the large exposure limit should be based on Common Equity Tier 1 (CET1) or Tier 1 capital as defined in Basel III rather than on total regulatory capital. We are concerned that the large exposure limit will be unnecessarily constraining, if the limit were to be measured against CET 1 or Tier 1 capital.

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Under the forthcoming regulation in the EU, the Capital Requirements Regulation (CRR), financial institutions will be required to hold more and better capital as a cushion against hard times, i.e. a minimum of 8% good-quality capital, of which just over half must be Tier 1, the highest quality and lowest risk form (a doubling of today's Tier 1 requirement). Tier 1 capital must have the ability to absorb losses on a going-concern basis. The instruments that do not meet the new, stricter capital eligibility criteria for Tier 1 or Tier 2 have to be phased out over a 10-year-period. Under the CRR, the basic rule is that a bank may not incur an exposure to a customer or group of connected clients, which exceeds 25% of its "eligible capital". Under the CRR "eligible capital" is defined as the sum of Tier 1 capital and Tier 2 capital, where the amount of Tier 2 capital that may be included in eligible capital must be equal or less than one third of Tier 1 capital. Tier 1 capital is further subdivided into CET1 and Additional Tier 1 capital.

Our view is that the CRR will already introduce sufficiently strict requirements for what can be included in eligible capital under large exposure regime. If large exposures are to be measured against either total Tier 1 or CET1 instead of total regulatory capital, we believe that this is likely to have a severely negative impact on the financial institutions' credit capacity. We are of the opinion that the large exposure limit should be measured based on the eligible capital, as defined in the CRR.

The aim of a large exposures' standard is to ensure that each financial institution can absorb losses from the sudden failure of a single counterparty or group of connected counterparties without itself failing. In order to meet this goal, it is also imperative to measure the exposure values precisely.

We believe that the strictness of the Basel Committee's proposal is further intensified by the deficiencies in the Current Exposure Method (CEM). Today, many smaller and less sophisticated financial institutions use this method to measure exposure value for OTC derivatives. While this method is simple to use, it has many well-known shortcomings. For example, it does not allow full netting, it double counts trades of opposite directions and it does not recognize portfolio diversification. Therefore, the CEM substantially overstates counterparty derivatives exposures, when compared to more risk-sensitive methodologies. The Basel Committee has determined that non-internal model methods are better suited to quantify exposure value, since they do not introduce model risk into the exposure measure. It is our understanding from the Basel Committee's proposal that the CEM will be put under review and an alternative standardized methodology will be developed. We strongly support this effort, however, according to the Basel Committee's proposal, until the approval of a successor method to the CEM is approved, financial institutions should use the same measuring approach for large exposure purposes, as for risk-based capital requirements. Since the development and approval of a new method may take time, we are concerned that financial institutions might find themselves measuring the large exposure limits based on a tougher definition of capital (CET1 or Tier 1), while calculating the exposure value for derivatives based on much criticized CEM that most likely consistently overstates risks.

The Basel Committee also proposes to apply the substitution approach for the recognition of unfunded credit protection. Under the present EU rules, substitution for guarantees/protection providers is optional and the treatment is in general not interconnected between the calculations of capital requirements and large exposures. According to the Basel Committee's proposal, when a financial institution uses substitution approach for risk-based capital requirements, it will also have to adopt it for large exposure purposes.

Under the substitution approach, there is a one-for-one reduction in the underlying exposure by the amount of the hedge (guarantee, credit derivative or financial collateral). At the same time, the bank is required to risk-weight this amount using the risk weight of the credit risk mitigation provider. When the bank adopts such an approach for risk-based capital requirement purposes, it will also have to adopt it for large exposure purposes. In particular, the amount of the hedge should reduce the large exposure to the original debtor and be added to the exposures the bank has to the credit risk mitigation provider.

According to the substitution approach, when a financial institution has hedged exposure, it would have to add the notional value of the hedged item to its counterparty exposure to the protection provider. We believe that the substitution approach overstates the exposure to a protection provider. If the protection provider fails, the actual risk of loss is equal to the cost to replace the protection, not the entire notional amount of the protection. Indeed, the only time the risk would be greater than the replacement cost is when there is a simultaneous default of both the underlying exposure and the protection provider (double default). In addition, if the hedging instrument is a credit derivative, collateral is usually required to mitigate the counterparty risk exposure.

The issue of double default is completely overlooked in the Basel Committee's proposal. In our view, double default should be factored into the large exposure framework. If this was found not to be achievable, the financial institutions should be able to choose, whether to assign the exposure to the direct creditor without taking into account the credit protection for large exposure purposes, or to assign the exposure to the credit protection provider, assuming the default of the direct creditor. This choice should at least be made possible, when a financial institution is allowed to account for hedged or guaranteed exposures using double default in the IRB approach.

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 conservative rules and assumptions can unduly reduce financial institutions' credit capacity and can also constrain risk mitigation as well as hedging. Financial institutions risk facing undesirably higher costs or lower availability in customized interest rate derivatives products, which they use to hedge their risks, unless a comprehensive philosophy is implemented with due consideration to avoiding important undesirable consequences.

We would also like to express our support to the Swedish Bankers' Association's response to the consultation, in particular regarding the importance of allowing an exemption for internbank exposures in small currency areas like Sweden and regarding the importance of

continued special treatment for covered bonds in accordance with current EU and Swedish legislation.

We thank you for your consideration of our comments.

Sincerely yours,
SWEDISH EXPORT CREDIT CORPORATION

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