Svenska
Bankföreningen
Swedish Bankers' Association

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Basel Committee on Banking Supervision

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Supervisory framework for measuring and controlling large exposures

The Swedish Bankers' Association welcomes the opportunity to comment on the consultation regarding a supervisory framework for measuring and controlling large exposures. As a member of the European Banking Federation (EBF) we support the EBF response to the consultation. Nonetheless we would like to make some additional comments.

In the consultation it is stated that some types of exposures warrant special treatment in the large exposure framework due to their special features or the potential effects on the functioning of certain markets if these exposures were treated like other exposures. This is in particular true for markets located in small currency areas. Banks need to be of a certain size in order to be economically efficient and be able to diversify its risks. This means that the number of counterparties on the interbank market in small currencies will be limited and that a too restrictive large exposure regulation could disrupt the functioning of such markets. In this context we would like to stress the importance of an exemption for interbank exposures in small currency areas like Sweden, especially for intraday, overnight and tomorrow next exposures. Moreover, it is crucial for the functioning of the Swedish financial system that exposures to covered bonds continue to have special treatment in accordance to current EU and Swedish legislation.

Exposures to covered bonds

Covered bonds are in addition to government bonds the only high rated, SEK denominated and liquid security that is available to the extent needed to fulfil the current requirement on liquidity reserves and for fulfilling collateral requirements with SEK denominated assets. Since the bonds are sheltered by a pool of high quality assets it can also be discussed to what extent the bond should be regarded as an exposure on the issuer. It is only under very exceptional circumstances that the bond holders will suffer any reduction in coupon or principal due to the liquidation or

bankruptcy of the issuer. We are thus of the opinion that exposures to covered bonds should, due to their special features, be exempted from the framework for measuring and controlling large exposures.

The special features of covered bonds

Covered bonds are issued in accordance with a special legislation requiring that the holders of the bonds should benefit from a priority claim over a pool of high quality assets (the "Cover Pool") in the event of the issuing institution's bankruptcy. According to the Swedish regulation assets eligible for inclusion in the pool are mortgage loans not exceeding special loan to value limits and loans to - or guaranteed by - the Swedish sovereign or Swedish municipalities. According to the covered bond legislation the pool of assets must be of a size sufficient to protect the bonds from losses even if the value of the assets falls, i.e. there is a certain degree of overcollateralization. If the value of the assets in the pool deteriorates the issuer of the bonds is obliged to add additional assets to the pool. If the issuer goes bankrupt the covered bonds and the cover pool shall be separated from the bankrupt's estate and the bond holders will continue to receive timely payments financed by the cash flow from the cover pool. The assets in the pool will not be available for the other creditors of the issuer until all obligations towards the bond holders are fulfilled. The credit quality of covered bonds is hence significantly higher than on senior unsecured debt issued by the same issuer. This is also reflected in the rating of covered bonds usually being significantly higher than on senior unsecured liabilities issued by the same issuer. E.g. in Sweden all outstanding covered bonds are rated AAA while the rating of senior unsecured debt from the issuing banks varies between A-/A3 to AA-/Aa3 from S&P and Moody's.

The treatment of covered bonds in European legislation

Covered bonds have a special status in the EU legislation as well as under national law in many EU member states. These exemptions are based on the high quality of the product – there has so far not been any default. According to current EU rules on capital adequacy and also in coming (CRR/CRD 4) it is possible (at national supervisor's discretion) to exempt exposures to covered bonds in calculations of large exposures. Sweden has implemented this exemption into national legislation. This exemption was provided due to the high level of security offered by covered bonds, the high quality assets in the cover pool (mortgages with strong eligibility rules and public sector assets), strict compliance with CRD rules and constant national supervision of covered bonds.

Covered bonds are essential for the Swedish financial system
Covered bonds are essential for the Swedish financial system and crucial for a well functioning housing financing. In Sweden, mortgages are typically funded through specialised mortgage institutions (owned by the larger banks), which are solely focused on mortgage lending. These institutions typically give mortgage loans secured by collateral in residential real estate within a restricted loan-to-value ratio (typically around 75 %), and finance these mortgage loans by issuing covered bonds. The main part of private savings in Sweden is channelled to pension funds and UCITS. These funds are investing significant amounts in Swedish covered bonds.

Covered bonds are perceived by the market to be a very low risk, and thus a cheap funding source for the institution. The reason for the low risk is mainly that the bonds are sheltered by the pool of low risk mortgages. The transparency is further enhanced by the covered bond label initiative whereby standardised information about the bonds and the pools backing the bonds are made public on a regular basis.

The outstanding volume of covered bonds denominated in SEK equals 1/3 of the Swedish GDP and is today in the range 125% of the SEK denominated government debt. The volume of SEK denominated government debt is however rapidly decreasing which will make covered bonds even more important as a benchmark in the SEK fixed income market than today. A significant part of the Swedish bank's liquidity reserves consists of SEK denominated covered bonds.
If the current exemption for covered bonds in the large exposure framework is removed these bonds must be sold and the only SEK denominated alternative will be government bonds as long as they are available. The other alternative for the banks will be to hold a larger part of the liquidity reserve in securities denominated in other currencies than SEK. This will however create additional risks and complexity since the banks must then also handle the currency risks associated with these securities. This will in particular be problematic for smaller banks, e.g. savings banks, not being very active in the FX markets.

The Swedish covered bond market is very liquid and has been functioning throughout the financial crisis. The liquidity is facilitated by the larger Swedish banks acting as market makers. If the exception for covered bonds was removed from the large exposure rules it is doubtful whether the Swedish banks are able to uphold their market maker roles.

Intra-group exposures

Concerning intra-group exposures we are of the opinion that they should be exempted from limits. Limits would without doubt affect capital markets nationally and internationally. It is common in many banking groups to have funding centralised to one or a few entities for cost, efficiency and security reasons. With centralised funding the banks could avoid duplicating the set up costs for funding programs; in addition the issued debt will become more liquid – and hence cheaper - when the transactions are larger in scale. In a scenario with limits for intra group exposures we would have a situation where the centralised functions of liquidity management most probably have to be reorganised. A serious effect of this is that the parent company and its subsidiaries must compete on the international capital markets for the funding of the same banking group. A consequence of this is that we will have smaller units surging for capital leading to higher cost of capital for these units but also involving more personnel from a group perspective resulting in higher costs. Most probably this would lead to implications on how banks' organise their business.

Interbank exposures

According to current EU rules on capital adequacy and also in the coming (CRR/CRD 4) it is possible (at national supervisor's discretion) to exempt specific interbank exposures. Sweden has implemented exemptions for intraday and overnight exposures into national legislation. For Swedish banks exemptions for intraday, overnight and tomorrow next exposures are very important. A restriction of the interbank rules on large exposures would have a large negative impact on the functioning of the Swedish financial system and increase risks in the system. Sweden is a small currency area with a limited number of large banks. This means that banks that have excess liquidity in SEK must place it overnight with other Swedish banks. As there are only a limited number of banks, overnight deposits in individual banks can be large.

Currently there are only five banks that have access to the Central bank clearing in SEK. All other banks active in SEK do hence place their excess funds at the five clearing banks. The five clearing banks do also for historical reasons diverge in their customer bases, e.g. some banks being more oriented towards the larger enterprises and other more oriented towards households. This means that large cash balances are shifting between the clearing banks during the month due to the customer's payment patterns. E.g. the retail oriented banks receive a lot of cash from the corporate oriented banks at the end of the month when the retail customers receive their salaries, giving the retail oriented banks a surplus that they need to deposit at one of the other SEK clearing banks. This system is only possible to manage if there are exceptions for short time interbank large exposures. Currently the EU legislation provides exceptions for intraday and overnight exposures. It would

however be preferable if also tomorrow next exposures were exempted. The major part of the upcoming payments is known a couple of days in advance. If there was an exemption for tomorrow next exposures the banks would have more room for planning their cash balances in advance, and thereby reduce operational risks, than is currently the case.

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