Secretariat
Basel Committee on Banking Supervision (BCBS)
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
SWITZERLAND
Sent by email to: baselcommittee@bis.org

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SEK's response to the Basel Committee's consultation "Revised Basel III leverage ratio framework and disclosure requirements"

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 "Revised Basel III leverage ratio framework and disclosure requirements".

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 revised leverage ratio framework may lead to a lower volume of loans and encourage financial institutions to cut back sound business activities, in particular, to reduce hedges that are low-risk lending. It may also encourage financial institutions to unwind derivative hedges, hedges that are in place to mitigate risks, and thus potentially cause financial instability.

We believe that the leverage ratio can play a useful role as a cross-check for regulators. However, it should not be the backbone of the regulation, a binding Pillar 1 -limit. We believe that marginalizing risk-based measures in favour of the leverage ratio could make the financial system less safe. Financial institutions have different business models. These institutions might assume, as SEK assumes, relatively low credit risk in most lending transactions. This because of the methodical and risk-based selection of counterparties as well as a result of the use of guaranties and credit derivatives.We are of the opinion that the

AB Svensk Exportkredit
Swedish Export Credit Corporation
Klarabergsviadukten 61-63, P.O. Box 194, SE-101 23 Stockholm, Sweden. Phone +46 8 613 83 00 Fax +46 8 20 38 94 www.sek.se

leverage ratio is too simplistic, since it does not take into account different levels of risk among assets. The leverage ratio does not make any distinction between low-risk assets on one side and high-risk instruments on the other side. Thus, the leverage ratio could be the same for two financial institutions with the same amount of capital even if one institution was holding toxic assets and the other institution was holding cash. This might encourage financial institutions to unwind low-risk positions and take on more risk to achieve a higher return.

According to the Basel Committee's proposal, all financial institutions should calculate the derivatives exposure by obtaining a replacement cost, equal to mark to market of the trade where the contract has a positive value, plus an additional charge for potential future exposure when calculating leverage ratio exposures. The potential future exposure is calculated by multiplying the notional principal of the transaction with the conservative add-on factors. When it comes to the replacement cost, financial institutions are permitted to recognize bilateral netting when a qualifying master netting agreement is in place. However, we consider this method overly conservative, since it provides only limited netting benefits. It requires 40% of any exposure to be included free of netting.

In addition, according to the Basel Committee's proposal, the leverage ratio should not take account of collateral. The derivative exposure may not be netted against collateral received (cash or non-cash). Furthermore, the replacement cost must be grossed up by any collateral amount used to reduce its value. The Basel Committee's proposal states that the treatment applies *"whether the collateral is cash or non-cash, whether or not the collateral was received or provided as part of an eligible master netting agreement, or whether it was received or provided in relation to derivatives traded on an exchange, through a central counterparty, or otherwise"*. However, the Basel Committee's proposal does not take into account the fact that the financial institution does not always have the right to rehypothecate the collateral. When no such rights exist, the collateral cannot be used to create more leverage. This is often the case with the non-cash collateral. In our view, at least such collateral should be allowed to be netted against the derivative exposure.

The financial institutions that have relative high leverage are often using derivatives for hedging purposes, e.g. to reduce volatility of earnings. Hedging can help the institution to carry out their planning without worrying about the fluctuation of the interest rates and foreign exchange rates. We are concerned that the proposed treatment of derivative exposures and collateral may force financial institutions to cut down their derivative positions and thereby increase risk. This will result in less leverage, but not necessarily in less risk, at least not if the derivative positions were intended for hedging purposes. Reducing the hedge positions may lead to an increase in maturity mismatch between assets and liabilities of the balance sheet and thus to a higher duration gap. This would in turn cause increased volatility in the financial sector.

According to the Basel Committee's proposal, off balance sheet exposures (such as liquidity facilities, direct credit substitutes, acceptances, standby and trade letters of credit, and unsettled securities transactions) are a source of potentially significant leverage. Therefore, off balance sheet exposures should be included in the denominator of the

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leverage ratio at their full value. According to the Basel Committee's proposal, the only exception of this rule is commitments unconditionally cancellable at any time by the financial institution without prior notice. The credit conversion factor of 10 per cent will apply to these commitments. On the contrary, according to the forthcoming regulation in the EU, the Capital Requirements Regulation (CRR), officially supported export credits and medium/low risk trade finance related off-balance sheet items will benefit from credit conversion factors of less than 100 per cent. We stress the importance that no changes should be made in these credit conversion factors in CRR. Export finance and trade finance do not cause systemic risk in the financial system and are 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). They have never been connected to the causes of the banking crisis. Indeed, SEK have never experienced any credit losses related to these types of trades. Therefore, our view is that ECA guaranteed loans should be exempted from the calculation of the leverage ratio with 100% uniform credit conversion factor.

Finally, we consider it 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 low-risk lending and can constrain hedging.

We thank you for your consideration of our comments.

Sincerely yours,
SWEDISH EXPORT CREDIT CORPORATION

Peter Yngwe
President

Per Jedefors
Chief Risk Officer