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THE FINNISH BANKERS' ASSOCIATION

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To the Basel Committee on Banking Supervision

The New Basel Capital Accord

The Finnish Bankers' Association respectfully submits the following comments on the second Consultative Paper of the Basel Committee.

The Finnish Bankers' Association considers reform of the present capital adequacy framework justified. The proposal has improved on the earlier Consultative Paper circulated for comment. However, the proposals seem to be prepared to a large extent with large international capital markets in mind, and do not, as a whole, take sufficient account of financing for households and small and medium-sized enterprises in particular.

In response to the changes proposed by the Committee, the risks of banking should be given more consideration in the banks' own equity requirements. The Finnish Bankers' Association regards the principle behind this proposal as correct. However, the Bankers' Association would like to call attention to the fact that in an economic recession, the proposals will in many ways contribute to a weakening not only of the banks' financial situation and lending capacity, but also of the overall economic situation. Situations in which the overall economic situation is much less favourable than it is now should also be taken into consideration when setting basic values for different risks.

The Finnish Bankers' Association would like to focus special attention on the impact of the proposals on competition. Specifically, care should be taken to ensure that the new proposals do not distort competition on the one hand between banks and on the other between banks and other companies offering similar services. The proposals encumber the banks with extensive obligations that do not burden other providers of financial services. In further

work on the proposals, care should also be taken to see that the proposals are applied uniformly in different countries.

According to the Basel Consultative Paper, the objective of the proposals is not to increase the capital requirement in general, but to keep it constant on average. The Finnish Bankers' Association focuses attention on the fact that the proposal will cause a definite increase in the capital requirement in banks emphasizing retail services. The basic values for retail banking should be set in such a way that the proposal would not automatically lead to growth in the capital requirement.

The Finnish Bankers' Association draws attention to the fact that the reports to supervisory authorities related to the current capital adequacy regime require a considerable input of work and expense from banks. The proposed changes would increase the amount of information needed by the authorities concerning risks related to banking activities, in particular. To avoid unnecessary effort and costs, the changes should be implemented in a way that would allow the systems and data currently used for banks' business management and supervision to be utilized as far as possible.

The proposal includes extensive changes in the present method of calculating capital adequacy. A thorough evaluation of the changes will not be possible because of the tight schedule allowed for the opinion and the fact that not all the necessary details are available. Consequently, the Finnish Bankers' Association would hope to be able to further specify its opinion at a later date.

Scope of application

The Finnish Bankers' Association considers the proposed changes regarding consolidation justified. The extent of consolidation will have considerable significance for the competitive conditions of banks and banking groups operating in different countries. Special attention should be focused on the technical definition of banking group in situations in which the holding company is included in the group and regulations concerning banking are applied to it.

Investments in subsidiaries

The Basel Committee proposes that investments in subsidiary credit and financial institutions be deducted not only when calculating the capital adequacy of the consolidation group but also when calculating that of individual banks subject to the Accord. The Finnish Bankers' Association considers the proposed deduction unjustifiably stringent. Such a procedure is not necessary to prevent the multiple use of capital.

Minority interests

The Basel Committee proposes that minority interests would not be included in the group's own assets in their entirety. However, since minority interests as a rule also participate fully in covering any loss by the group, they should basically be included in their entirety in the group's capital.

Investments in insurance companies

According to the Basel Committee proposal, banks should deduct their investments in insurance companies from their own assets. The Finnish Bankers' Association does not consider the proposed deduction of insurance company investments from a group's own assets justified. It should be remembered here that an insurance company cannot bear in full risks for which capital is required for banks. Banking cannot be the main activity of an insurance company. Hence, neither are insurance companies required to reduce their investments in credit institutions. The Association calls attention to the fact that the EU is at present considering a draft directive that would regulate the capital adequacy calculation of financial conglomerates. The Association proposes that the Basel Committee postpone the inclusion of regulations governing insurance company investments at financial conglomerate level until agreement has been reached on a uniform international procedure governing financial conglomerates.

In the Basel Committee's proposal, half the deductions from a group's own funds would be made from Tier 1 and half from Tier 2. The Finnish Bankers' Association considers it more natural for the deduction to be made from the combined Tier 1 and Tier 2 capital.

Credit risk- the standardised approach

Claims on public sector entities

The Finnish Bankers' Association is of the opinion that claims on municipalities that are entitled to levy taxes should remain in the zero risk group. In Finland, for example, the position of municipalities is stipulated in the constitution. The position of municipalities in Finland as public sector entities is apparent from the numerous statutory functions performed by them. In Finland, municipalities have not caused any credit losses.

According to the proposal, the capital adequacy rating of claims on church parishes would be linked to the risk classification for claims on banks. The Finnish Bankers' Association does not consider the proposal justified for parishes that are entitled to levy taxes.

Claims on banks

The proposal includes two options on the basis of which national authorities could determine the capital adequacy treatment of claims on banks. To secure international competitiveness, claims on banks should be treated uniformly in different countries. The retention of a country-specific option is not necessary.

In alternative 1, a lower equity requirement would be set for short-term claims of less than three months than for longer-term claims. The Finnish Bankers' Association calls attention to the fact that a short fixed time limit might in practice lead to arrangements that would be difficult to justify commercially. The Association proposes extension of the time limit to 12 months. Relief concerning short-term claims should also be applied in alternative two.

Claims on corporates

The Association calls attention to the fact that there are very few firms in Finland whose claims have an external risk rating. Hence, the significance of the proposed, rather crude risk rating system would be limited in countries like Finland.

The Finnish Bankers' Association does not consider it necessary to set a binding lower limit on claims on public sector entities when they are financed with the currency of the home country.

The Basel Committee proposes a special 150 per cent risk group for non-performing claims that have been delayed for at least 90 days. The Bankers' Association does not consider this proposal justified. In practice, a credit loss provision has been made for these claims. Consequently, no special risk exists for the residual value in the bookkeeping. The residual value is in practice covered sufficiently with collateral. If non-performing claims were to be treated uniformly in practice, the valuation procedure in bookkeeping and the practice regarding provisions for credit losses would have to be standardized in different countries.

If a special capital adequacy requirement is set for non-performing claims, the Finnish Bankers' Association considers the proposed 90 day limit for non-performing claims justified.

Other assets

The Basel Committee does not propose any changes in the capital adequacy treatment of fixed assets such as real estate and equipment. Since the Committee proposes to set a capital adequacy requirement for operational risks that would cover direct and indirect losses due to external events, the risks to these asset items should be considered under operational risks. Hence, preservation of a separate capital adequacy requirement in this risk grouping would no longer be necessary.

The Bankers' Association also calls attention to the fact that credit loss risks incurred from housing loans have proved very limited, even during a severe recession. Since, according to the proposal, operational risks would also be explicitly retained in the capital adequacy calculation, the Basel Committee should consider lowering the capital requirement for them. The risks involved in converting property to cash have been taken into account in the valuation of collateral.

Credit risk mitigation

The Finnish Bankers' Association considers it justified that risk mitigation techniques should be taken into account more extensively when the capital adequacy requirement is calculated. Nevertheless, it calls attention to the fact that the practical effect of the proposals concerning risk mitigation techniques will be limited, especially for banks concentrating on retail banking.

The Association proposes that physical property such as real estate, assets used to secure corporate mortgages, ships, aircraft, precious metals and certificates carrying entitlement to them, and negotiable liabilities (factoring) should be accepted as collateral eligible for risk reduction. The Bankers' Association also calls attention to the fact that in Finland, real estate is of unusual significance as security for corporate loans.

The risks involved in converting property to cash can be taken into account in the valuation of collateral.

The Finnish Bankers' Association is of the opinion that the risk mitigation effect of insurance should be taken into account when calculating operational risk. Separate provisions should be formulated for the requirements to be placed on insurance.

The Basel Committee proposes that the market value of collateral should be updated at six-month intervals. Regular valuation of this kind would involve a considerable volume of work. Otherwise, it might be sufficient if the values of collateral were updated when problems arise in management of the credits secured by them or when obvious non-temporary changes occur in the values of the collateral.

According to the Committee's proposal, three different approaches are available for the treatment of pledges. In situations where the bank uses the internal ratings-based model, the 'comprehensive model' should be applied. This model, however, involves too much work. In order that the complexity of the calculation system would not in practice prevent banks from adopting more sophisticated calculation methods, banks should also be able to use the standardized model in their risk mitigation techniques even though they use the IRB approach for credit risks.

Credit risk – the internal ratings based approach

The Finnish Bankers' Association also calls attention to the fact that the true effects of the IRB approach cannot be evaluated in full in the light of the information provided. Hence, it is also impossible to take a final stand on the viability of the model.

The Association in principle welcomes the opportunity to use internal ratings. The proposal should, however, include more obvious incentives to convert to more sophisticated IRB systems. To order that adoption of more sophisticated systems would be justified for an individual bank, this should result in a lower capital adequacy requirement than in the case of less sophisticated systems.

The more sophisticated systems should be built around the banks' own risk management. Excessively detailed requirements should not be set for the systems, as capital adequacy calculation would then hinder the development of risk management procedures and would lead to overlapping calculation systems, some of which would be used to calculate capital adequacy and some for risk management.

The Finnish Bankers' Association calls attention to the fact that at present the banking system does not have a risk database that would be sufficiently reliable to allow adoption of an advanced IRB approach.

It is important for banks that the methods for internal rating be specified as soon as possible, so that they can adopt internal rating as soon as possible.

Definition of default

It is especially important to make the definition of default less ambiguous. Default is considered to occur when one or more of the four criteria are met. One of the criteria concerns reclassification of the credit as non-performing (the obligor is past due more than 90 days on any credit obligation). In the Basel Impact Study, non-performing credits were treated using the default loans criteria so that their risk weighting was 625 per cent. The proposed risk weighting is excessive. In the standardized model, a weighting of 150 per cent is set for non-performing claims. This risk weighting is excessive merely by virtue of the fact that as a rule, real collateral is not taken into account in the

IRB foundation method. The proposed risk weighting would be applied to that portion of the credit for which no credit loss provision or credit loss entry had been made, and which had not been covered with credit risk mitigation collateral. If the risk weighting proposed were to be retained, the banks would have to provide an excessive capital buffer for such credits. Setting an excessive capital adequacy requirement for non-performing credits would increase the volatility of the capital requirement, because it would multiply in a recession, particularly in comparison with the present favourable situation. It should also be noted that good debtors might also find themselves in the default loan category with respect to all their liabilities, for example due to a single contract dispute.

Bank exposures

The proposed division into different kinds of banking that would be observed in internal rating is debatable. In practice, it would not be at all clear whether a given item would be included, for example, in a retail bank portfolio or a corporate portfolio.

Project finance

The Finnish Bankers' Association calls attention to the fact that the concept of project finance in the proposal is still unclear. It should include only true project financing, and not, for example, normal building construction.

Real estate collateral

The Finnish Bankers' Association does not consider it justified to exclude all income producing/investment commercial real estate from real estate collateral eligible for corporate exposures. It should be possible to accept commercial properties used by a third party as collateral even if the property itself is the primary source for servicing the debt. Neither should rented dwellings and lending to property investment companies be excluded from the retail or corporate approach.

Simultaneous use of internal and external rating assessments

The premise behind the proposal is that the rating methods applied to companies should also be applied to countries and banks. The Finnish Bankers' Association is of the opinion that it should absolutely be possible to observe the external rating assessments with respect to countries and banks. In general, banks are not likely to be able to organise a better rating system e.g. concerning the country risks than the international rating agencies. The Association is of the opinion that simultaneous use of the internal model and the standardized model should be possible, for example by using correspondence tables in situations where the database is inadequate for internal rating, for instance.

Scoring

The Association calls attention to section 445 of the proposal, according to which the bank must segment by credit scores or the equivalent. According to the proposal, this includes segmentation based on application scoring. According to footnote 37, ongoing or behavioural scoring should be used as a basis for reassessing the estimates of loss associated with each segment rather than as a basis for segmentation. Here it should be noted that payment behavioural scoring provides a more reliable picture of the customer's situation than application scoring. Hence, it would be natural to permit its use as well.

The rating system organization

According to the proposal, an independent unit should be responsible for making the rating. In practice, the proposal will not work, however. The rating assessment should be based on a true understanding of the customer's situation. If the rating is to be reliable, the unit with customer responsibility should be committed to the rating process. The rating made should naturally then be submitted to monitoring by an independent unit. This independent unit should also confirm the rating criteria.

Operational risk

The Basel Committee's point of departure with respect to operational risks is that 20% of the customer's own assets are committed to cover his own operational risks. In practice, the proposed 20 per cent does not match the capital burden caused by the operational risks. The capital requirement should be a maximum of 10 per cent. Even this requirement level should be achieved only after a sufficiently long transition period during which the substance of the operational risk could be specified and sufficient monitoring data could be compiled to determine the risk.

The capital requirement should not be set unjustifiably high either, as the operational risks are in many respects debatable and difficult to define. Moreover, many of the issues relating to calculation of the capital requirement concerning operational risk remain open. It should also be borne in mind here that setting the capital requirement for operational risks may in part lead to a double capital adequacy requirement. The same risks would also be covered by the capital requirement set for credit risks.

The proposal might distort competition among business offering the same services. The capital requirement would not cover all firms offering the same services. It should be borne in mind here that the proposal would also weaken the competitiveness of investment service firms operating in Europe compared with those operating elsewhere because the proposed capital requirement concerning operational risks would not necessarily apply to investment service firms operating elsewhere.

The Finnish Bankers' Association calls attention to the fact that the proposal would not encourage banks to develop a system for managing operational risks. In order to provide such an incentive, the factors in more sophisticated calculation systems should in effect be lower than the alpha factor used in the basic system.

The Association calls attention to the fact that the IRB system for calculating internal risk is so time-consuming, complicated and difficult to control that banks will not adopt it extensively in the next few years. For example, there is no database that would permit reliable calculation of the factors related to the system. Consequently, it would be essential to leave the options after the

basic and standardized approaches open so that strict rules for internal calculation do not hinder development of risk management systems. The model should be developed further when an adequate international and national database is available. At present, conversion from the standardized model to the IRB model would be too big a step.

The Finnish Bankers' Association proposes that the risk mitigation effect of insurance should also be taken into account in calculating operational risks. Requirements for insurance should be set separately.

Since operational risks can vary considerably from one country to another, it should be possible when calculating the standardized model to take the sophistication of the country's banking system into account.

The Finnish Bankers' Association calls attention to the fact that the proposal includes numerous debatable points that are difficult to assess and measure in practice. These include estimates of latent losses and also assessment methods for detecting 'near misses'. The definitions and ratings require further specification.

Supervisory review process

The proposal provides the supervisory authority with broad discretionary powers concerning the capital requirement of credit institutions. The authorities also have considerable latitude to decide on the steps that credit institutions must take in a given situation to manage their risks and meet the capital requirement.

The proposal also provides for a significant change in the role of the supervisor; issuing regulations and enforcing them would be replaced by more consultative supervision. Reconciliation of these two roles in practice might be difficult.

The proposal according to which the supervisory authority could insist on a capital requirement in excess of minimum capital would be problematic with respect to the competitive neutrality and legal rights of credit institutions. Hence, it is essential to provide regulations that define the limits of the authorities' jurisdiction on both the international and the national level. There

should be a clear procedure ultimately allowing the supervisor to insist on additional capital. Banks should have sufficient time to correct the situation before a new capital requirement is set. Additional capital should be required only in exceptional circumstances.

Banks should also have an opportunity to appeal a supervisor's decision if they are of the opinion that it has exceeded its authority.

The Finnish Bankers' Association considers it justified for a decision of a supervisor requiring additional capital in excess of minimum capital to be disclosed. Requiring additional capital has such a drastic effect on the financial position of a bank that disclosure is essential merely to ensure justice to investors.

Interest rate risk

As far as interest risk management is concerned, the proposal has successfully compiled a number of key points.

The banks' own risk definition models and calculation systems should be employed in determining interest rate risk. Care must also be taken to avoid overlapping reporting by the authorities.

The Finnish Bankers' Association calls attention to the fact that the proposed 2.5-year period is too binding. An absolute time limit would hinder interest rate risk management. The time limit should be flexible enough to permit sufficient account to be taken of the very different kinds of factor affecting interest rate risk.

Banks should be given the opportunity to include non-interest bearing items when calculating interest rate risk. Since banks must also finance such items, they should be accepted for the modelling process.

Market discipline

The Finnish Bankers' Association considers it justified that, since banks would be allowed to use their own systems to calculate capital adequacy, their obligation to disclose relevant information should be standardized.

The Association is of the opinion that in principle it should be sufficient to disclose information annually.

However, the Association calls attention to the fact that overly detailed requirements would hinder the disclosure of essential information. For example, the disclosure of average exposures mentioned in appendix three or the disclosure of information concerning rating agencies might not increase understanding of the information. Further attention should be given to the 'need to know' principle.

Some of the information proposed for disclosure is related to supervision of the banks. The Basel Committee should review this information once again to determine just which information would be best suited for official reporting and which really needs to be disclosed.

The proposal also contains sections that might lead to the disclosure of bank or trade secrets, for example in small banks or geographical areas.

The Finnish Bankers' Association calls attention to the section concerning disclosure of information concerning operational risks. Since the calculation of operational risks involves numerous points that are still open and debatable, it would be sufficient here for the credit institution to explain its risk management system and if necessary supplement this information with the required capital adequacy percentage connected to the operational risks and possibly with information regarding the amount of any operational losses and the reasons for them.

Disclosure of the realization of certain kinds of operational risks (for example robbery and embezzlement) may tend to increase subsequent realization of the risk prepared.

Disclosure requirements should be coordinated, especially with the international bookkeeping standards now being worked on.

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