Helsinki 31.5.2001

In response to the second Consultation Document of the Basel Committee concerning capital adequacy requirements, the OKOBANK Group Central Cooperative respectfully submits the following:

General

1.1 Time scale for consultations

In view of the extent and complexity of the new proposals, the deadline of May 31, 2001 allows banks far too little time to evaluate the effects of the proposals. Exact evaluation of the effects is furthermore impossible due to the fact that several specifications included in the proposals continue to lack clear definition.

1.2 Competitive distortion

The proposal fails sufficiently to address the conformity of competitive factors among various lines of business. The principles included in the proposal, such as the capital requirement on operational risk, may lead to significant increases in capital requirements, particularly with respect to credit institutions engaged in retail banking. As the boundaries of banking activities grow increasingly indistinct, greater capital requirements may encourage the trend whereby low-risk business operations are increasingly handled by market operators to whom comparable equal capital requirements do not apply. Furthermore, both capital requirements and extensive disclosure demands will cause banks to incur additional expenses that will weaken their competitiveness.

1.3 Jointly liable groups

Moreover, the proposal includes neither principles nor specifications as to the application of capital requirements to credit institutions operating on a basis of mutual, joint liability. With regard to jointly liable groups, capital adequacy regulations currently vary greatly among countries. Finland has adopted an approach whereby general credit institution risk weights are also applied to debt outstanding between OKOBANK Group Central Cooperative and its members as well as debt outstanding between members themselves, though this is not required by the so-called group consolidation included in the European Parliament and Council Directive relating to the taking up and pursuit of the business of credit institutions (2000/12/EC), nor do risk weights bear any factual significance as member banks are jointly liable for the commitments of each other. The application of capital requirements with respect to debts outstanding among credit institutions and financial institutions operating on a basis of mutual, joint liability and their central organisation is furthermore unwarranted due to the fact that such debts have no effect on the consolidated capital adequacy of such jointly liable groups.

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The proposal should therefore describe in detail the application of capital requirements to credit institutions operating on the basis of mutual, joint liability. When using internal ratings, the probability of default on such liabilities becomes zero and the risk weight is annulled. In order to ensure consistency, the risk weight for such liabilities should be set at zero in the standard model as well. Zero risk weights would apply to credit institution liabilities wherein both the creditor and debtor bank are part of the same central organisation and mutual, joint liability is applied to commitments undertaken by the central organisation and all organisations belonging thereto, or the central organisation underwrites in full the commitments of its member organisations. Furthermore, the total capital adequacy and liquidity of the central organisation and all member organisations are supervised in a consolidated manner, and the management of the central organisation has the authority to instruct the management of member institutions.

1.4 Adoption of the internal ratings-based approach

Included in the proposal is the principle that if a bank were to adopt the internal-ratings based approach with respect to a single credit portfolio, it must within a short period of time adopt the same approach with respect to all its credit portfolios. This principle may effect significant difficulty in the adoption of the internal ratings-based approach and possibly prevent such adoption altogether. The introduction of new products and entry into new markets, for instance, may become compromised, since data sufficient to the requirements of the internal ratings-based approach may not necessarily be available for several years with respect to such products and markets. The internal ratings-based approach is also excessive when applied to portfolios of minor significance. Due to the reasons stated above banks should be allowed simultaneous use of standardised risk weighting approaches and the internal ratings-based approach in a manner that allows the bank complete freedom to choose which approach it shall apply to each portfolio. The supervisory authority, through its supervisory processes, can ensure that the bank refrains from attempts to manipulate the capital requirement and is always capable of presenting appropriate grounds for the adoption of various approaches.

1.5 Investment in subsidiaries

Included in the proposal is a requirement whereby in the calculation of capital adequacy, not only for a consolidated group but also for individual parties being supervised, the party being supervised must deduct from its capital investments in other subsidiary credit institutions and financial institutions. This deduction method is unjustifiably harsh and unnecessary in the avoidance of multiple utilisation of capital.

1.6 Investment in insurance companies

The proposal suggests that banks be required to deduct from their capital investments in insurance companies. This requirement cannot be considered justified as insurance companies have no comparable

obligation. The treatment of interests in insurance entities should be postponed until specifications for supervision of financial conglomerates have been adopted.

1.7 Other general statements

According to the proposal, the risk management process of each credit institution shall be subject to official supervision. An integral element of any such process is a sufficient and appropriate information and reporting system. Reports on the part of the banks currently required by the authorities result in significant amounts of additional labour and costs. Data obtained through the operational risk management systems of the credit institution and approved by the authority should be utilised as such in all official supervision in order to avoid incurring unnecessary costs.

Banks should be reserved a sufficient transition period before any changes take effect. New instructions should therefore not be enforced until at least two years after such time as the supervisory authorities have given their final instructions.

2 Detailed statements

2.1 Minimum capital requirements

2.1.1 Credit risk: the standardised approach

Due to the lesser risks of retail banking in comparison to other portfolios, an overall risk weight of 50 per cent should be applied to retail banking. A risk weight of 25 per cent would be applicable when the credit is fully covered by a mortgage on residential real property used as a personal residence or leased to a third party by the debtor. The smaller than average risk of retail banking is based on the diversification of the credit portfolio and may be verified from public credit loss statistics. For instance, according to statistics gathered in Finland by the Financial Supervision Authority on entities having received state banking subsidies in the years 1991-1999, natural persons were responsible for losses only in the amount of M€ 153.8; total losses for all sectors and businesses were M€ 4,298.

The time limit on short-term receivables between banks should be one year instead of three months.

2.1.2 Credit risk: the internal ratings-based approach

Insufficient incentive exists for the introduction of an internal-ratings based approach, as even when applied to good credit portfolios with comprehensive collateral the resulting capital requirement may not much differ from that resulting from a standardised approach. Furthermore, the internal ratings-based approach is likely to result in substantially greater volatility in capital requirements.

The internal ratings-based approach includes a number of constraints (floors, caps, add-ons, haircuts) the grounds for whose determination, including estimates, have not been made public and which contain an assumption of the simultaneous and full realisation of all possible risks. Furthermore, the capital requirement is calculated twice for certain risks. The justification for the w factor, for instance, is given as the uncertainty related to the realisation of collateral, when the capital requirement on operational risk has already provided for such uncertainty.

On the grounds presented heretofore, banks should be allowed freely to choose between the standardised approach and the internal ratings-based approach with respect to each portfolio.

The introduction of the internal ratings-based approach in conjunction with the introduction of the new capital adequacy framework would require banks to begin collecting data employed in estimation immediately at the beginning of 2002. However, at that time banks would not necessarily yet be in possession of the final, detailed instructions concerning capital adequacy calculations.

The segmentation requirements concerning retail customers are too complicated in the current presentation. Segmentation is mandated at least by borrower risk and product type; further segmentation is required, when calculating estimates, with respect to delinquency status and vintage of the liability. Data included in the credit application and information on the customer´s credit history should be equally applicable in estimating the probability of default of a retail customer.

2.1.3 Credit risk mitigation techniques

Approved credit risk mitigation techniques should conform with techniques regularly applied in banking with respect to e.g. collateral. Otherwise the capital adequacy framework may be considered to assign equal value to credit granted with and without collateral, which appearance will not serve properly to guide the risk management of banks. The capital adequacy framework should encourage banks to hedge their risk e.g. through use of collateral, and in a broader perspective to develop their methods of risk management. Should collateral within the capital adequacy framework be treated in a manner divergent from the real-life banking environment, data provided by the capital adequacy framework would furthermore not be applicable in determining the cost of credit. Therefore company business premises as well as office buildings and industrial properties and corresponding shares, mortgages on company assets and targeted collateral securities issued by financial institutions should all be applicable to the mitigation of credit risk even when a bank employs the standardised approach in the calculation of the capital requirement of its credit risks.

Legal certainty, the minimum precondition for use of movable property as collateral, should be verifiable in a cost-effective manner. This translates into obtaining expert opinions on model agreements only, not on individual contracts based on approved models. Furthermore, the approval of the

supervisory authority should be allowed to stand in substitute for expert opinion.

The frequency at which collateral is revised should be proportionate to the probable or historical fluctuation of the collateral. Annual revision of value should thus be considered sufficient in cases where fluctuations in the value of the collateral are only minor (e.g. < 10% annually).

2.1.4 Operational risk

Consideration of operational risk in the supervisory process of credit institutions is justifiable. The capital requirement on operational risk derived in accordance with the principles included in the proposal, on the other hand, contains substantial weaknesses. The setting of the capital requirement on operational risk at a level of some 20 per cent of total capital requirements may be considered clearly excessive with respect to retail banking, nor are there any statistically confirmed grounds to sustain such a demand.

The definition of operational risk also remains inadequate in a number of ways. In retail banking, the majority of operational risk is finally realised in the form of credit losses and may become discernible prior to any actual write-offs in the form of increased capital requirements on credit risks. In low-risk business operations, such as housing finance, capital requirements on operational risk may thus be realised in an overlapping manner and in magnitudes too great with respect to the actual risk of the business.

There is insufficient incentive for the use of operational risk mitigation techniques, as the proposal remains vague as to the approval of such techniques.

2.2 The supervisory review process

One of the objectives of the new capital adequacy framework is to secure the capital adequacy of individual credit institutions, taking into consideration the risk profile and operating environment of each credit institution. Risk management processes at individual credit institutions remain subject to official supervision. The proposal and all official guidelines and instructions to be drawn up on the basis of the proposal should define in greater detail the requirements demanded of the risk management processes of banks operating on the basis of mutual, joint liability. The official supervisory review process should concentrate on evaluating the appropriateness and sufficiency of group-level risk management processes.

Demands made on the risk management processes of credit institutions should be further refined. All such demands should also be made public in order to ensure conformity of practical interpretation on the part of supervisory authorities.

According to the proposal, supervisory authorities may propose credit institution-specific demands of additional capital if the existing capital fails to

reflect the risk profile of the bank or the risk management process of the bank is considered lacking. The proposal thus grants extensive powers to the supervisory authority. The grounds whereby the supervisory authority is allowed to dictate binding provisions should be defined in legislation. Likewise, such legislation should include the right of the supervised party to appeal the decisions and measures taken by the supervisory authority. The grounds for determination of additional capital demands should be clearly defined. Furthermore, all credit institution-specific demands for additional capital should also be made public; this is mandatory for banks quoted on the Stock Exchange, and other banks should not be treated differently.

2.3 Disclosure requirements

The goal of increased transparency and the demand for disclosure of all such information as may influence the decision-making of individual market operators, as included in the proposal, are laudable. We also support in general the concept presented in the proposal of dividing disclosure into basic data and supplementary data.

The proposal would require credit institutions to disclose information on a scale substantially more extensive than currently. In our view a significant proportion of the data whose disclosure is demanded is by nature supervisory rather than suitable as such for utilisation by market operators. In the proposed format, both the extent of disclosure and the complexity of data disclosed would only serve to further complicate the generation of a correct and sufficient view of the financial standing of a credit institution.

Especially with respect to small credit institutions, the demands of disclosure in the proposed format lead to a situation wherein required information cannot be disclosed without jeopardising both bank secrecy and trade secrets. The proposal does not take any stand as to the applicability of the proposed disclosure requirements to credit institutions operating on the basis of mutual, joint liability. It is our view that the disclosure requirements on individual credit institutions operating on the basis of mutual, joint liability should be lessened.

Semi-annual disclosure of information is unnecessary and would result in substantially higher costs than publication once per annum. The information whose disclosure requirements are now under debate is also of such a nature that little change usually takes place over a period of six months, while general disclosure principles already demand full disclosure on the part of credit institutions, should any significant changes take place.

OKOBANK Group Central Cooperative

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