Ministry of Finance of Finland
Bank of Finland
The Financial Supervisory Authority of Finland 16.4.2010

Basel Committee on Banking Supervision

STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR

Joint response by the Finnish financial market authorities to the Basel Committee consultation document of December 2009

1. General

The Finnish authorities share the view of the Committee that further regulatory measures are called for to strengthen the resilience of the banking sector. We are, however, concerned about the complexity of the set of proposed measures, resulting at this stage in difficulties to make sufficiently extensive impact studies, and later when implemented, a heavy administrative burden for the industry, possibly without clear evidence for the overall positive impact of the measures adopted.

For this reason, the Finnish authorities would like the Committee to consider solutions which would be, to the extent possible, simple, conceptually consistent and relying on information already gathered by the banks.

Since the cumulative effect of potential changes is likely to be very substantial, we would like to emphasize that the quantitative impact study plays a critical role in the work. Additionally, as far as the timing is concerned, we believe that sufficient time should be allowed to carry out further impact studies after the basic principles have been agreed upon, where necessary.

Furthermore, we would like to point out that further work should be done in working out the effects of the higher capital requirements, including capital buffers, on macro-economic developments. We should also acknowledge the possibility that some of the proposed regulatory changes eventually turn out to be unsustainable in light of the impact assessments.

Of the several important changes proposed by the Committee, we would especially like to support the measures aiming at reducing the pro-cyclicality of the capital adequacy framework. This aim is very important and we find the work done so far very valuable. However, the information regarding the actual measures is not precise enough for us to be able to take a detailed stand on them at the moment. Among other things, the clarification on how the different measures interact with each other is needed. We also consider it important that banks are allowed to use the capital buffers when needed in worsened economic conditions.

We are of the view that the forthcoming changes in the capital adequacy framework should not punish the business models that have been proved to be prudent and stable (e.g. credit institutions concentrating on the low-risk retail-orientated business, or credit institutions specializing in public sector lending (0 % risk-weighted). Some of the proposals made by the Committee seem to work against this objective, leverage ratio being the most significant case.

From the Finnish point of view, the most crucial issues, to which we would like to draw the Committee's attention, are the following:

- *On the leverage ratio*: the level on which the ratio will be set, as well as the status of the ratio (pillar I or pillar II)
    - While we see also arguments for creating a hard back stop measure to curb excessive levels of bank leverage we consider it most appropriate to integrate leverage ratio into Pillar II framework (see Section 4).

- *On the definition of own funds*: the treatment of minority interest as well as the investments to financial institutions and insurance companies, and the treatment of instruments issued by NJS companies.
    - For co-operative banks, there are several criteria for Core Tier 1 capital which might be problematic depending on the interpretation of the criterion for NJS companies. These criteria should be further investigated. Especially the criterion for permanence should not be interpreted so tightly that the typical capital instruments of such banks would not be eligible.
    - While we agree that the elimination of minority interest from the group capital is conceptually correct, its impact should be carefully assessed, undue effects should be avoided and an adequate transitional period provided. We also believe that it would be correct to eliminate the minority interest only to the extent it exceeds the capital requirement of the subsidiary in question.
    - The treatment of investments in insurance undertakings by banks belonging to financial conglomerates should not be tightened as it would have severe impact on such banks.

Please find below more detailed comments on the proposals.

2. Quality of capital

We agree with the objective to strengthen the quality, consistency and transparency of the regulatory capital base. We have, however, some concerns about the suggested approach. The introduction of the dichotomy between going concern and gone concern capital seems unnecessary at least for jurisdictions such as Finland, where the criterion for liquidation is the fulfilment of the capital requirements.[1] We believe that Tier 1 capital should be primarily defined by its general economic characteristics and taking into account equal treatment for all types of credit institutions. The rationale for simplification of Tier 2 capital is unclear and we would have preferred the simplification of Tier 1 capital. The proposed limit system could be used to achieve this.

The definition of Tier 1 capital should ideally be limited to the general economic characteristics of capital. Thus it should be adequate to ensure that all eligible capital instruments meet the following general requirements:

- subordination to other categories of regulatory capital in insolvency
- absorbing losses in going concern situations for the purpose of calculating the mandatory liquidation threshold as defined in national company law
- no obligation nor contractual incentives such as step-ups for any payouts of capital or profits in going concern situation,(apart from the members' rights to redeem their

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[1] From the Finnish perspective both Tier 1 and Tier 2 capital are currently absorbing losses in that sense that they are positive items and therefore they act as buffers for negative items. A write down mechanism would not affect the amount of capital in the bank even though it would improve its quality. Write-down mechanism could be useful only in an extreme scenario when the owners of the bank do not refinance the bank and where the bank is so inter-connected that the liquidation would endanger the stability of the financial system. In that case it could be easier to find outside investors.

shares in a co-operative bank in accordance with the national company law and provided that the bank continues to meet its capital requirements)

- annual payouts possible only from distributable profits (like dividends) and provided that the statutory capital requirements continue to be met
- no collateral pledged by connected parties
- paid in fully.

If these characteristics are ensured for every capital instrument, there should be no need to establish different sub-tiers within Tier I. The company law and accounting treatment of such capital instruments could be dealt with separately in the national law and accounting standards respectively as they are not linked to the two basic functions of the regulatory capital, which are:

i. to absorb losses with regard to the mandatory liquidation requirements in order to allow the bank to continue its business in spite of losses;
ii. to ensure that the claims of depositors and other creditors are met in the case of liquidation.

The requirement of accounting treatment (i.e. the criterion 10 for common shares requiring the equity classification under the relevant accounting standards) is problematic for certain NJS companies on consolidated basis because of the different rules of equity classification under local FAS and IFRS.[2] We would therefore like to emphasize the careful consideration of the criteria for NJS companies and appropriate transitional and grandfathering periods if the proposed criteria will remain unchanged. Several other criteria (i.e. the redemption and claim for residual assets) for Core Tier 1 capital might also be problematic depending on the interpretation of the criterion for NJS companies, especially for co-operative banks. We support the equality principle proposed by Committee of European Banking Supervisors CEBS for the core Tier 1 capital instruments under Article 57 a of CRD. [3]

In particular, we do not see the rationale of prohibiting calls during the first five years nor of requiring write downs or conversion on a going concern basis, as long as the above criteria are met. The exercising of the call options should be linked with the Pillar 2 dialogue. Restricting the use of call option only after 5 years is not always reasonable. If, for instance, the bank splits up or sells some of its operations, it could be justifiable to exercise the call and redeem the excess capital.

For Tier 2 a further improvement would be that all Tier 2 items would be equally flexible in relation to payments. If the bank does not fulfil Pillar 1 and possible Pillar 2 requirements, interest payments and redemptions should be postponed, unless it is clear that the bank is no more viable and it should be liquidated. Another issue is that there is no cap for interest payments in Tier 2 capital and this could be a good way to introduce a constraint in the stress situation. In Tier 1, the constraint already exists as dividend/coupon payments are restricted by the availability of distributable funds.

We do not have any objections of abolishing the Tier 3 capital.

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[2] Co-operative banks may have ordinary, supplementary and investment co-operative shares. Most common instruments in co-operative banks are ordinary and supplementary co-operative shares.Under the IFRS, supplementary cooperative shares are classified as liability but under FAS these shares are classified as equity. Hence, the classification in the own funds would differ on unconsolidated and consolidated basis. This means that on consolidated basis based on IFRS accounting very significant part of current core tier 1 instruments would no longer be acceptable.

[3] The supplementary cooperative shares are subscribed by the members of the bank. When the member resigns, the bank must, according to the general Co-operatives Act, refund the paid in amount to the former member within six months of the end of the financial year, on the basis of whose annual accounts to be refunded is calculated. In liquidation the holders of supplementary co-operative shares may have according to constitution of the co-operative bank priority to receive their share, which seems to conflict with the criterion 2. Co-operative banks are not listed and their current Core Tier 1 capital instruments are not traded in the secondary markets and this explains partly the current stance. In general, the repurchase of Core Tier 1 capital instruments should be allowed only if an institution has distributable funds and it fulfils capital requirements for foreseeable future. However, the aforesaid principle is not entirely compatible with the IAS 32 and IFRIC

While we agree that the elimination of minority interest from the group capital is conceptually correct, its impact should be carefully assessed and an adequate transitional period provided. Also, we believe that it would be correct to eliminate the minority interest only to the extent it exceeds the capital requirement of the subsidiary in question.

We would additionally welcome a clarification of the way the proposed treatment in the case of holdings in insurance companies would articulate with the existing treatment of such participations under the provisions of Articles 59 and 154.4 of the CRD and with Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. We would like to see that the regulatory scope of consolidation will capture also the financial conglomerates which are subject to the supplementary supervision in the European Union. In any case, the treatment of investments in insurance undertakings by banks belonging to financial conglomerates should not be tightened as it would have severe impact on such banks.

3. Counterparty credit risk

We share the Basel Committee view that the observed shortcomings in financial institutions counterparty risk management during the financial crisis call for a reassessment of some features of the capital framework regarding counterparty credit risk. We also agree with the need to improve qualitative requirements for banks' counterparty credit risk management. However, we are somewhat concerned about the danger of overregulation that might prove to be costly for the industry, and ultimately to the real economy.[4]

We agree on a general level with the proposals to formulate structures that support wider use of CCP's for OTC instrument clearing. We are, however, concerned about unduly penalizing non-CCP-eligible products as such OTC contracts serve the useful purpose of hedging risks, which cannot be adequately hedged by standard instruments. We believe, therefore, that credit institutions should not be prevented from continuing to offer OTC products tailored to hedging existing risks. However, we agree that the capital charge for particularly complex products could be increased.

We emphasize the need for rigorous quantitative and qualitative impact studies before amending the current quantitative requirements for counterparty credit risks.

4. Leverage ratio

We prefer Pillar II approach to Pillar I approach for dealing with excessive leverage.[5] While we recognise the importance of dealing with the issue of excessive leverage, an absolute, non-risk based ratio could in our opinion have negative implications on the banking sector as well as the wider economy. As a result of the detailed set up of the ratio and existing accounting differences, there is, despite corrective measures planned, still a risk that a non-risk based ratio could affect market players inconsistently compared to risk-based capital requirements.[6]

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[4] For example the proposal regarding the credit valuation adjustments (CVA), would create unnecessary complexity to the EAD calculation (provided that it is applicable also to mark-to-market method). Our opinion is that the simplicity of the mark-to-market method should be retained.

[5] While the Ministry of Finance also prefers a Pillar II approach, it emphasizes that there are also arguments in favour of the introduction of a more robust back stop regime provided that it is appropriately calibrated.

[6] The FSA points out that a non-risk based leverage ratio could, furthermore, generate adverse stability effects. It could actually create incentives to take on higher risks, as it would not penalize those risks like the risk-based capital requirements do. Therefore, the main focus should be maintained on the risk based capital adequacy measures, which provide best incentives for effective risk management by banks.

Banks should rather be required to set internal targets for the growth of their key exposure classes and the supervisory authorities should be required to assess these internal targets and include this assessment in the overall supervisory review of the bank. In addition, a harmonised regulatory target ratio could be established, accompanied with specific supervisory measures such as a prohibition to distribute profits if the target ratio is not met.

According to the proposed Liquidity Coverage Ratio, banks will be required to hold buffers comprising mainly of government securities and other non - risky assets. These buffers are also proposed to be counted as part of the leverage ratio, which constrain banks’ balance sheet growth. As a result, banks are required to hold more assets with low yields, which in turn would reduce their lending capacity. Against this background, we propose that the assets required to be held for the new liquidity requirements are deducted from the denominator of leverage ratio.

In case the leverage ratio receives broad support, we emphasize the need of a comprehensive impact analysis that also takes into account the potential effects of the ratio on the structure and development of the financial sector, as well as the impact on banks business models and risk taking. One could e.g. assume that the implications of the ratio on countries characterized by market-based financial sectors would be more limited than in countries with bank-dominated financial sectors, where retail banking dominates banks' activities.

We also believe that the leverage ratio should be defined so that it can be calculated on the basis of data already available for banks so that it would not further increase the administrative burden for banks.

5. Procyclicality[7]: forward looking provisioning, cyclicality of the minimum requirements and capital buffers

We welcome and share the Committee´s preliminary views on promoting stronger provisioning practices in the accounting regime. The Committee´s proposals in the consultative document are highly principle based at the present stage. It is important that the Basel Committee co-operates with the IASB with the aim to ensure its principles are met in practice.

The objective of establishing high quality accounting standards that take into account financial stability considerations would best be achieved within the IFRS framework. The final result of the IASB`s proposal will be seen at the end of this year and after that additional analyses will be needed in order to find out what kind of measures concerning pro-cyclicality for prudential purposes are needed. In addition to improving the accounting regime we believe that the prudential framework needs to be amended as well in order to reduce its procyclical elements. In any case, the mechanism by which the provisioning for prudential purposes would affect own funds should be clearly defined.

Committee's ongoing work on evaluating the cyclicality of the minimum requirement has our full support. We are also supportive, in principle, of the proposed structure of capital conservation. However, the information provided regarding the capital buffer range is rather limited, and further evaluation of the framework is therefore not possible at the moment.

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7 An integrated model to deal both with excessive leverage and procyclicality is proposed in a separate contribution by the Ministry of Finance as it has not been agreed with the other Authorities.