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POSITION PAPER
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To the Basel Committee of Banking Supervision

CONSULTATION PAPER ON STRENTGTHENING THE RESILIENCE OF THE BANKING SECTOR

The Federation of Finnish Financial Services (FFFS) welcomes the opportunity to respond to the Committee consultation on the above mentioned topic. FFFS is a member of European Banking Federation (EBF). While supporting the views put forward in the EBF's response, the FFFS respectfully submits the following additional comments.

1. General comments

FFFS stress the importance to pay attention to the following general remarks:

- The Basel Committee has left a number of key features undefined in waiting for the subsequent calibration process. We therefore urge Committee to conduct a second consultation when the results of the calibration are known.

- We believe that the proposals would also need to be reconsidered in light of the far-reaching consequences which they will have to the real economy as a whole. We note that particularly in smaller countries, like Finland, the bank lending is often the only source of finance for SME sector and large companies. By introducing proposed rules would limit the banks' capacity to lend which in turn would reduce corporate sector's ability to make new investments.

- The proposal has not carefully considered the negative interplay between different measures. We want particularly refer the interplay with the proposed leverage ratio and liquidity rules.

- The enhancement of the capital requirements should only be implemented once the recovery of the economy is assured and be proportionate to the risks involved.

- It is necessary that the Committee will put in place appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards.

2. Specific comments

2.1 Raising the quality, consistency and transparency of the capital base

Like many other parts of the resilience paper, there are still many uncertainties and incomplete proposals of the treatment of own funds. We urge the Committee to organise a second

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consultative round together with another round of QIS once the proposals will have taken more concrete and comprehensive content.

We don't find it reasonable to require deductions in financial holdings outside the scope of consolidation. We propose that at least holdings in insurance companies would be treated in a similar manner as it has been dealt within the Financial Conglomerates Directive. According to the FCD, no capital deduction should be required for banking groups which are subject to the additional supervision as a Financial Conglomerate.

The Committee has set 16 December 2009 as benchmark for the transitional arrangement stating that the instruments issued after that date will not benefit from grandfathering. We don't find this reasonable. It is our understanding that proposal has effectively blocked the market for those instruments. This is a cause of concern taking into account that huge amounts of capital are needed to meet the proposed new rules of the Committee whilst the investor base for common shares is shrinking as the returns on equity for financial institutions will decrease as a result of the turmoil and the new prudential rules. We invite the Committee to make an official statement as soon as possible clarifying that the close out date for instruments to benefit from grandfathering rules will be the date at which the final rules will become applicable or at the very least the date at which they will have been published.

According to the proposal, the minority interest will not be eligible for inclusion in the common equity component of Tier 1. We believe that the new treatment should ensure symmetry between the numerator and the denominator of the ratio. In practical terms, the risk weighted assets of the quota corresponding to the minority interest on the entity level be deducted from total RWAs. This is particularly important in cases, where new leverage ratio form a higher minimum ratio than 8 % ratio. The other solution would be that only the excess capital of the minimum requirement within the subsidiary should be deducted from the capital of the consolidated group.

We suggest that the Committee put on hold its review of the prudential filter which applies to unrealized gains and losses until the IASB has finalized its work on the replacement of IAS 39 by a more appropriate standard.

2.2 Counterparty credit risk

We believe that any change should be put in the context of the general overhaul of the prudential requirements, considering also the interplay with the rest of the measures notably those geared to stress the requirements of the market risk.

It should be noted that derivative instruments have been created as risk management tools. As such, they represent an indispensable tool for investors to pursue their investment strategies and for companies to correctly manage business risk. The revised framework should distinguish between proprietary trading and the activities which support customer business.

We agree with the idea of setting incentives to the use of derivatives settled by CCPs like the zero risk weighting, but we do not support the proposal to introduce further burdens for contracts settled bilaterally.

The vast majority of OTC instruments are engrained in the international commercial transactions of the counterparties. In general, corporates and small-medium-size businesses use OTC derivatives specifically tailored for their needs. A shift to standardisation via CCPs would compel corporates to be somewhat exposed to financial risks if the range of derivatives offered does not suit their needs. Each commercial transaction has its own conditions of maturity, currencies, etc. The vast majority will not find perfect hedge in the standard derivatives offered by a CCP.

Disincentives for banks to enter into OTC derivatives would force corporate customers to find other techniques to manage their risks. These alternatives are not as efficient as derivatives and could lead to large unintended financial risks. This could have serious consequences for the customers and the real economy.

We oppose the method proposed for determining the capital requirement for CVA risk. We understand the idea of a specific capital charge for OTC derivatives on the risk of losses due to credit valuation adjustments (CVA) that affects the balance sheet and income statement of the institution. However, we don’t support the methodology that the Committee proposes for determining the CVA capital charge. Institutions should have an option to use their own internal risk measures for CVA risk, not only the bond equivalent methodology that the BCBS proposes. It is also our view that the bond equivalent method contains several elements of double-counting. For instance, the regulatory VaR multiplier contains already a time scaling factor and it is therefore not appropriate to also use another time scaling factor. Furthermore, we are of the opinion that the capital charge for CVA risk should be determined either as the regular VaR or the stressed VaR but not the sum of both."

2.3. Leverage Ratio

We see no clear rationale behind the introducing leverage ratio type crude and simplified measure, which would be against the Basel 2 aim to move towards risk sensitive capital requirements. We believe that it would create disincentives for institutions to improve their risk management practices.

We also like to point out that the leverage ratio in its proposed form as a Pillar 1 measure will be particularly devastating to Nordic type retail banks whose lending portfolio mainly consists of well collateralized retail exposures carrying low risks. This outcome is not fair from the level playing field perspective and creates a paradox since these types of institutions have succeeded well during the recent crisis and their behavior should be seen as an example of successful banking model to operate. We also stress that the traditional housing finance structure used in Finland has proven to be sound even in the deep crisis in the beginning of the 1990’s. We see a threat that the proposed approach would be counterproductive to sustain such a structure in the future.

Leverage ratio would also require banks to hold more capital than justified from a risk-based point of view. One example of most suffering group would be the mortgage banks which are subject to specific and strict rules and supervision. In practical terms, for certain Finnish retail mortgage banks leverage ratio could act as a “frontstop” ratio (as opposed to the objective of the Committee to reinforce “backstop” measure) by requiring them hold a capital far above the minimum 8 % capital ratio at the solo level.

Against this background, we believe that proposed measure should merely form a basis for supervisors to assess the institution’s capital strength within the Pillar 2 framework. Such an

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approach would allow assessing the ratio's outcome by taking into account the bank's business model and monitor its development reflecting, where necessary, with relevant peer groups. It would also better enable supervisors to vary target ratio through the economic cycle.

We support that a harmonised definition of the concept of capital will be used as a numerator. At this stage, where reassessing of various component of capital is still considered within the Committee, the total capital (Tier 1 + Tier 2) should be the starting point and final decision would be made after the impact study results are available.

We agree that the off-balance sheet items would need to be included in the definition of total exposure. However, we think that this definition should be aligned with the concept of off-balance sheet items defined for calculating risk-weighted assets. As a result, e.g. credit facilities with a credit conversion factor of 0% (such as uncommitted credit facilities) would not be included in the denominator. We also agree that it would be appropriate to apply regulatory netting rules set out in the Basel 2 framework.

We also point out the interplay between leverage ratio and proposed liquidity risk rules. According to liquidity coverage ratio, banks will be required to hold buffers comprising mainly 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 reduce their lending capacity. It is therefore essential that the assets required to be held within the new liquidity requirements need to be deducted from the denominator of leverage ratio. Also assets which are deducted from capital need to be excluded.

We believe that the leverage ratio should apply only at a consolidated level for banking group.

To obtain a complete view of the leverage in the financial system and to ensure level playing field, the leverage ratio should also apply not only for banks, but also all other financial institutions with a "same business, same rules" principle. This is also important aiming to discourage regulatory arbitrage.

For the reasons explained above, the Committee paper still lacks a number of key features and has many uncertainties. We therefore urge the Committee to open a new consultation on this issue subsequently before final decisions will be made.

Finally, we find it important that the propose measure should only be implemented after the economic recovery has been assured. Imposing it in the middle of the current crisis would put additional de-leveraging pressure on banks. In addition, institutions should be given sufficient time to adopt the new measure.

2.4 Procyclicality

In principle, we support the provisioning based on Expected Loss model and refer a proposal prepared by the EBF. Model's suitability to smaller banks using standardized model needs however further evaluation. It is also important to wait for the outcome of the pending changes to IAS 39 on loan loss provisioning. We believe that the forward-looking element of the provisioning system will contribute to mitigate procyclicality in consequence.

Procyclicality can be managed under pillar 1 or pillar 2 or as a combination of pillar 1 and pillar 2. The preferred solution would be to manage it under pillar 2 as part of the SREP to better fit

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the measures to the institution in question and not as a blunt measure based on pure mathematics under pillar 1. A pillar 2 approach could be improved by strengthening the disclosure requirements of pillar 2 and through a higher level of standardisation and harmonization.

We will send our more specific comments after the concrete proposals by the Committee have been published.

Concerning the capital buffers through capital conservation, the proposed additional standards restrict the capital management capability of the bank even while the bank still has a capital above minimum capital requirement. The proposal would also put banks in negative competitive position compared to other financial players. Reducing pay-out will directly turn banks common equity less attractive, while the stricter definition of capital will force banks to raise equity of this kind.

Too much conservation of capital can do more harm than good to the real economy. We fear that fixing mathematical limits to dividends, what is a measure never known before among industry sectors, could bring about unintended consequences. It is crucial that the Basel Committee assesses the impact on the real economy of increasing the capital requirements in the banking industry and takes it into consideration when calibrating the minimum requirements.

A point of concern is that disclosure obligations may lead investors to misinterpret the measures taken notably the dividends pay-out constraints, with the ensuing serious risk of reputational damage

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