MEMORANDUM

April 14, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
baselcommittee@bis.org

MUNICIPALITY FINANCE PLC COMMENTS ON THE BASEL COMMITTEE'S CONSULTATION ON "STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR AND "INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISKE MEASUREMENT, STANDARDS AND MONITORING"

Municipality Finance Plc (hereinafter "Munifin") appreciates the opportunity to comment of the two referred consultation papers and we kindly ask the Basel Committee ("Committee") to draw your attention into the following views when further drafting Committee's position.

Munifin and the Finnish local government financing system

Prior to more detailed comments on the proposed amendments we would like to clarify the role of Munifin as part of the Finnish local government financing system in order to make it easier for you to comprehend the comments thereafter.

Municipality Finance Plc is a Finnish public sector owned credit institution that specializes solely in the Finnish local government finance and central government subsidized housing finance. This means that the owners and the clients of Munifin form a closed circle, within which the purpose of Munifin is to make the public sector financing more effective and efficient.

Given the special role of Munifin, where the whole client base is from the public sector, all loans granted by Munifin enjoy BIS 0% risk weighting, due to direct municipal risk or central government guarantee. There have been no defaults of these receivables during the existence of Munifin.

Munifin's funding is guaranteed by the Municipal Guarantee Board ("MGB"), an institution established under public law to safeguard and develop joint funding of the Finnish municipalities. At present, the MGB has 323 municipal members, corresponding to more than 99% of the Finnish population. The member municipalities are jointly responsible for the obligations of the MGB in proportion to the population of each member municipality. If required, recovery from the members is possible without a court order.

At present, the rating agencies Moody's and Standard & Poor's have assigned Munifin and MGB credit ratings of Aaa and AAA, respectively, the same rating as the Republic of Finland.

The guarantee arrangement through MGB has secured local government financing and Munifin's operations so as to enable financing without requiring a large reserve of own funds. This local government financing system also enjoys strong political support in Finland.

Munifin applies very conservative principles to its risk management. The aim is to minimize open risk positions and maintain the overall risk status at a low level, so as not to compromise Munifin's good credit ratings. Derivatives for hedging purposes play an extremely important role in efficient risk management. All derivative agreements are done under internationally

recognized ISDA/CSA structure, where the CSAs (Credit Support Annexes) and collateral posted accordingly form an important risk mitigation technique.

Key impacts of the proposed amendments to Munifin

The financial crisis had a severe impact on the entire banking industry, thus requiring regulatory changes. However, the need for regulatory changes must be assessed by taking into account the impact on areas other than just the banking sector. The current complex global economy is so tightly integrated with the banking sector that any regulatory amendments need to be thoroughly thought out, as they could severely impair the capability of the banking sector to fulfill the needs of the national and global economy.

From Munifin's perspective, the proposed leverage ratio is extremely harmful for public sector financing, since it would increase the cost of funding for public sector borrowers. In the current economic atmosphere, the financial needs of the public sector have increased in most European countries, and it is anticipated that these needs will remain high in the foreseeable future.

If the leverage ratio was introduced as described in the Committee's consultative dokument, it would lead to a situation in which the current level of own funds of public sector financing service providers, such as Munifin, would not be sufficient for the planned leverage ratio based requirements, thus demanding a significant increase in equity capital. This would, in turn, increase the funding cost for public sector borrowers. In Munfin's case, since its shareholders are also its clients (public sector entities), who themselves have an increasing need for funding, this would most likely result in higher municipal taxes and other cost impacts to the national economy.

Facing an increased cost of capital, financial institutions can typically either try to pass on the extra cost to their existing customers or shift their focus towards riskier asset classes with higher return expectations. For Munifin and other public sector financing service providers, the latter action is not an option, due to strictly defined operating models and a limited customer base.

Due to the financial crisis, domestic and international commercial banks stopped lending to the Finnish local government and social housing sector. As a result, Munifin effectively became the sole provider of funding to these sectors. The proposed leverage ratio would seriously impair Munifin's ability to perform this role in the future. In a crisis situation, this would harm the whole national economy, when even the entity that has been established to secure funding for the local government sector could not fulfill its task.

As Munifin's client base is in a 0% risk category, Munifin does not see any reason for the leverage ratio to include receivables from its lending. The inclusion would not only harm Munifin and Finland but also every public sector financing service provider in a way that is not justified. In fact, the risk level of this type of financing has not been affected by the financial crisis.

At the end of 2009, Munifin's own funds amounted to EUR 208 million and the size of the balance sheet totaled EUR 14.6 billion. Munifin has estimated that setting the limit for the total debts to 25 times the own funds would lead to a maximum balance sheet size of only about EUR 5 billion. Thus, to continue its normal operations, Munifin would need to dramatically increase the amount of its own funds.

Current capital requirements describe well the capital adequacy of Munifin. Munifin has a good capital adequacy ratio, well over the minimum requirement (8% vs. 20.17% on December 31, 2010), and the financial crisis had no impact on the receivables from Munifin's client base. Therefore, the measures proposed by the Commission are unreasonable for an operator such as Munifin, for which the current capital requirements framework accurately and truthfully reflects Munifin's risk position. The current annual internal capital adequacy assessment plan has created a sufficient capital buffer for Munifin and for other similar public sector financing service providers

Another issue in the Commission's consultation which would have a major impact on the industry is the proposed definition of the assets acceptable for calculating the liquidity buffer of the Liquidity Coverage Ratio. It is absolutely necessary to include to the liquidity buffer short term, liquid, high-quality securities of financial institutions. Excluding normal money-market instruments would most likely lead to a collapse in the market for these crucial securities, as the demand for them would greatly diminish. These instruments are widely used throughout the economy, between financial and other institutions for cash management. Moreover, if those instruments were still used to some extent (but not being liquid instruments), the values of the instruments in the buyers' balance sheets would no longer reliably reflect the true value of the security, due to the lack of liquidity on the market. It is difficult to envisage which institutions would use money-market instruments if banks were unable to calculate them into their liquidity buffers.

Detailed comments to the proposed amendments

In addition to the above, we would like to draw your attention to the following issues in the proposed amendments.

Liquidity requirements (Liquidity coverage ratio LCR and Net stable funding ratio NSFR)

The financial crisis resulted in lack of liquidity, and measures need to be taken to avoid such problems in the future. Therefore, in general, we see LCR and NSFR as acceptable measures. However, as described above, it is essential that at least short term, high quality securities issued by financial institutions will be included into the buffer (i.e., the definition of corporate bonds needs to include the bonds of financial institutions as well). Since the liquidity of these kinds of instruments remained good even during the recent financial crisis, we see no reason to exclude this instrument category from the liquidity buffer.

The calculation methods for both measures are, however, too complicated and will place small financial sector operators, such as Munifin, under unreasonable resource requirements. In general, it seems that there will be very few instruments available in the financial markets that could meet the criteria for inclusion into the LCR or NSFR. For calculating these liquidity ratios, it would be desirable to introduce different methods for small and large credit institutions, as has been used for calculating capital requirements for different risks (standard and advanced approach).

Furthermore, covered bonds are seen as an acceptable asset class under LCR but not under NSFR. The reasoning for this differentiation is not clear.

Quite recently, several European countries have introduced legislation allowing the issuance of covered bonds by savings banks. However, the consultation seems to forbid the use of covered bonds issued by financial institutions as part of the liquidity buffer. This would put financial sector under the requirement to reevaluate and restructure the corporate structures linked to covered bonds. It is difficult to estimate the costs of this type of complex structural

changes on the financial markets and to the end-customers, though its impact on a global level will be very high.

As a technical matter, we would like to point out that the definition of "public sector entity" (as part of the buffer) should be more detailed in order to determine what type of entities can be included into this category.

Definition of capital

The proposed changes succeed the EU Commission's Capital Requirements Directive ("CRD") II and CRD III packages, which are currently coming into force. It is important to maintain consistency between these legislative measures. If the same area of legislation is changed in an inconsistent manner, especially within a short period of time, this can lead to a lack of confidence in the legislation process and consistent regulatory environment. The CRD II package only recently allowed the amount of hybrid instruments to account for 50% of the Tier 1 capital; therefore, any change in this just recently introduced model will be seen as unreasonable. Moreover, since CRD II has also defined new limits for large exposures, there is no reason to amend these limits by the Committee as the EU legislation is drafted to synchronize with the Committee's proposal.

The new definition of capital under the proposed package will limit Tier 2 capital to be only used for calculating the capital adequacy ratio, thus narrowing the possibility of using this Tier 2 capital. This will also limit the selection of instruments offered by credit institutions to investors.

Munifin sees the removal of Tier 3 and the subcategories of Tier 2 as measures that would have no material impact on credit institutions, such as Munifin.

Leverage ratio

As described above, Munifin sees the leverage ratio as an unnecessary additional requirement for entities specializing in public sector financing, as the current Basel II already sets an appropriate framework.

The operations of credit institutions, such as Munifin, which specialize in public sector financing, are based on a rather limited capital base, due to their low-risk lending activities. Any requirement that would suddenly multiply the need for own funds is unreasonable, as the risks involved in such financing operations would remain constantly low. The leverage ratio would require radically increasing own funds, thereby increasing funding costs and finally leading to more expensive financing for the local government sector. The leverage ratio would not only impact the entities specialized to finance the public sector, like Munifin, but also credit institutions that finance also public sector.

Therefore, the cost of financing for the public sector would significantly increase in general and further cause financial distress to the public sector that is already in a difficult financial situation.

Legislative measures should be equal to all affected parties. This should hold true for the leverage ratio as well. However, we see that the required level for the leverage ratio is impossible to determine so as to ensure that the whole financial sector would be treated equally. The reason for this is that the field of operations of the different players vary, thus making the impact of the leverage ratio very different.

As a solution to the problems concerning the leverage ratio, we propose the following alternatives:

1) Entities specializing in public sector lending should be exempted from the leverage ratio,
2) Exposure from public sector lending should be exempted from the leverage ratio, **or**
3) National authorities should have powers to decide on the exemption of a single entity from the leverage ratio or the appropriate level of the leverage ratio to be applied to a single entity.

As noted, the proposed package can have very wide impacts, and it should be ensured that different requirements under the package do not contradict each other. In the light of this, we have noted that LCR partially conflicts with future plans for the leverage ratio: LCR emphasizes low-risk governmental securities as part of the liquidity buffer. This LCR requirement is contradictory if these securities then increase the need for own funds due to the leverage ratio.

Presently, derivative instruments form a very important part in the risk management of all credit institutions, including low-risk credit institutions, such as Munifin. Therefore, netting and collaterals posted based on ISDA/CSA agreements should be taken into account in the calculation of the leverage ratio. The main rationale behind the ISDA structure is the netting of multiple derivative agreements between same parties. When derivatives are only used for hedging purposes and no open positions are held, netting should be taken into account in calculating the leverage ratio, provided that the netting is based on ISDA Master Agreements. The leverage ratio should result in requirements that are based on accurate risk levels. This would also mean that collaterals posted in accordance with the ISDA CSA agreements should be taken into account when calculating the ratio

As referred to in the Committee's consultation, the US GAAP accepts ISDA-based netting, and the same should also apply under the proposed package.

At the very least the leverage ratio calculation should take into account both Tier 1 and Tier 2 capital in order to diminish the negative impact of the leverage ratio.

The leverage ratio plans include a proposal concerning the exposure method for derivatives. We see that the exposure should be calculated, as in the current CRD, by using the replacement cost method and recognizing the regulatory netting.

The leverage ratio requirement for credit institutions under IFRS requirements (i.e., all significant operators in the financial markets) would result in derivatives exposure having a double effect in the balance sheet, since part of the exposure is derived by not allowing netting and the other part by including the market values. As a consequence, we see that the capital requirement should not be higher than what it would be if be calculated based on the total netted position.

Counterparty credit risk

The desire to move towards CCP clearing, even when applied to OTC derivatives, is understandable and accepted by credit institutions, as this would create cost benefits. For example, clearing would not require as much resources as it does currently. However, the world of OTC derivatives is heterogeneous, and most of the OTC derivatives are tailor-made instruments, which are only used between two counterparties for an individual deal. Therefore, it is difficult to believe, at least in the foreseeable future, that an effective CCP clearing model could be created for these instruments. Since a significant part of these OTC instruments are used for

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risk mitigation purposes, and not for speculation, credit institutions should not be punished with higher capital requirements, resulting from the use of OTC derivatives not under the CCP clearing when such clearing is not an option for these instruments.

In general, our view is that the counterparty credit risk requirements include such complex calculation methods that small credit institutions are not treated equally compared to large institutions with extensive resources. Therefore, a simplified method based on the size of the credit institution should be available.

If you have any further questions regarding these comments, we kindly ask you to contact Ms. Mari Tyster (mari.tyster@munifin.fi, +358-9-68035626).

Municipality Finance Plc

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