On 16 January 2001, the Basel Committee on Banking Supervision released its consultative document on The New Basel Capital Accord. This paper presents the views of Finnish Authorities (Bank of Finland, Financial Supervision Authority and Ministry of Finance) on the document. Our comments on the Consultation Document concentrate on a number of key issues and are summarised as follows. The detailed comments are presented in the annex.

First Finnish Authorities welcome the new consultative document issued by the Basel Committee on Banking Supervision. In our opinion the revised framework promotes safety and soundness in the financial system. The framework enhances the risk sensitivity of the capital framework and, compared to the current accord, more comprehensively recognises the risks to which institutions are exposed. The framework has also aligned capital charges more closely with the economic risks undertaken. Our expectation is that the framework will encourage prudent behaviour, including enhanced risk management standards and techniques and will stimulate economically rational pricing behaviour.

An important objective of the reform is that the overall level of capital in the system is maintained. Lessons learned from the financial crises experienced almost on every continent during the last decade suggest that this remains an important goal. This objective should not be compromised when making a change in the regulatory system.

Second, the risk weightings in the Standardised Approach to Credit Risk are based on external ratings. In Finland presently only the larger banks and a dozen companies have external ratings. However, due to the high investment costs of the IRB approach, the Standardised Approach will probably be widely used among European banks, although they are able to make use of the risk differentiation achieved by the external ratings...
only to a limited extent. We strongly support the view that the IRB approach offers a valuable alternative to the revised standardised approach and we support the general thrust of the Basel proposal. However we would like to emphasise that, in order to encourage banks to move to the IRB approach, more sophisticated incentives should be built into the framework. We would emphasise the need to have the Foundation Internal Ratings-Based Approach (IRB) attainable by a significant number of institutions.

We support the work under way in the Basel Committee to calculate the impact of the new framework on the capital requirements of banks and to calibrate the approaches to achieve a risk sensitive framework which encourages institutions to build more sophisticated risk measurement systems. As regards credit risk in the continuum of evolving approaches, the portfolio credit risk models cannot yet be used when the amount required capital is calculated. Approaches now being accepted are partial models which may, in respect of certain portfolio compositions, produce results that are not consistent with those of other approaches and the portfolio credit risk models. We find it important that a wide variety of portfolio compositions be used to complete the impact study.

We would note that, as regards the macro-level effects of the new framework, especially the IRB approach, there is a danger that the proposed capital reform may further exacerbate business cycles. This is the case, first, because after a negative aggregate demand shock banks have to adjust to the accumulating loan losses and resulting decline in their capital by cutting lending. This would further strengthen the impact of the initial shock on the economy. Secondly, the use of external and internal ratings may have similar effects, as institutions would have to simultaneously adapt to increased capital requirements after rating downgrades. As a counter-measure, banks' internal ratings should be developed to cover sufficient long runs of data to assess the borrowers' ability to withstand normal business fluctuations.

Further, we would point out the well-known more fundamental problem with incorporating the maturity dimension in the IRB approach. We suggest that explicit minimum requirements regarding contractual maturities should be added. These could state that the bank must have a well-founded assessment of the economic maturity of a given exposure, and that the corresponding contractual maturity must be in line with this.

As regards the Standardised Approach to Credit Risk in respect of the treatment of credit institutions and investment firms, we favour the second option, which is based on the external credit assessment of the institution itself, where such a rating exists.
Third, we support the effort which the Basel Committee is making to calibrate the operational risk capital charge and the multiplication factors used in the different approaches in operational risk to provide an incentive to move from the Basic Indicator Approach to the Standardised Approach and to calculate the appropriate level of capital needed to cover the operational risks.

We also emphasise the need to have different options open when developing the approaches in operational risk. Further developments, as well as, different risk control approaches should be taken into account when the techniques to measure operational risk in capital adequacy framework are elaborated. The methods to measure operational risk are in a developmental stage. We would stress the importance of not limiting the range of possibly more sophisticated approaches to the Internal Measurement Approach and to the Loss Distribution Approach. We would also note the limited possibilities for institutions to use the Internal Measurement Approach for operational risk at the moment due to individual institutions' inadequate data on realised operational risk events. We support the work done of the Basel Committee on the categorising of losses.

We would also note that there still is a need to elaborate the concept of indicator used in the Standardised Approach. We find that the indicator 'Total Funds Under Management' may not be the best possible way to assess operational risks in Asset Management. Further analysis is needed in order to find better solutions. Gross income could be one possible solution. Where the portfolio is more difficult to manage, and hence riskier, higher management fees are charged and thus higher gross income is generated.

Finally, we support the pillar II approach. The Principles of Supervisory Review Process are an essential element for the whole concept of capital requirement. The Review Process links the requirements of good risk management and capital allocation with the regulatory capital requirement. We welcome the proposed principles that empower supervisors. However we find it important that the legal certainty and accountability related to the proposed discretionary powers of the supervisors can be ensured.

We also support the proposals for enhanced transparency and Market Discipline (pillar 3). Market Discipline is an integral part of the framework. We share the view of the Committee that market discipline is an effective complement to supervisory efforts to encourage institutions to assess risk, maintain capital, and develop sound risk management
systems and practices. The disclosures under Pillar 3 serve as an important tool to strengthen the minimum capital requirements under Pillar 1 and the enhanced supervisory review process in Pillar 2. Further, we find it very important that the Committee, as stated in the Document, intends to work with the accounting authorities, including the IASC, to promote consistency between disclosure frameworks.

In discussions concerning the publication of supervisory capital ratios, arguments have been raised both against and in favour of disclosing the figures. We are in favour of disclosing supervisory capital ratios. Under the requirements of the European Council directive on co-ordinating the conditions for the admission of securities to official stock exchange listing, listed companies are required to inform the public as soon as possible of any developments in their activities that could lead to substantial movements in their share prices. To ensure a level playing field between listed and non-listed credit institutions and investment firms, it would be appropriate to lay down rules for disclosure in the context of the capital requirements that apply equally to all credit institutions and investment firms.
DETAILED COMMENTS ON SPECIFIC ISSUES IN THE SECOND CONSULTATIVE DOCUMENT TO NEW BASEL CAPITAL ACCORD

The Scope of Application

The new Accord will apply to internationally active banks at every level (consolidated/subconsolidated/solo) within a banking group. As an alternative to full subconsolidation, the application of Accord on a solo basis is permitted, provided the full book values of investments in subsidiaries and significant minority-owned stakes are deducted from the bank's capital. In addition, the Consultative Paper includes certain cross sectoral issues, particularly as regards the treatment of investments in insurance and commercial entities.

The above-mentioned proposals will have impacts on the amount and quality of regulatory capital, i.e., the 'nominator part' of the solvency ratio. It is therefore important that deduction methods be defined within the Accord as precisely as possible. For example, there is a need to specify whether the deduction requirement defined in the section C should be applied not only to insurance subsidiaries but also other minority owned insurance companies. In addition, the term 'significant' in section E should be clearly defined so that the threshold above which the investment in commercial entities is deducted from own funds is in line with the existing EU framework (15/60%).

According to the Consultative Paper, deduction of investments in deconsolidated entities will be 50% from Tier 1 and 50% from Tier 2. We find it important to specify whether, in calculating the solvency position of the stand-alone bank, this treatment is to be applied not only to investments in deconsolidated insurance and commercial entities but also to investments in banking and other financial subsidiaries.

The Standardised Approach to Credit Risk and Credit Risk Mitigation

The Standardised Approach

The Committee's proposal on the Standardised Approach to Credit Risk is based on the use of external ratings. Presently in Finland only the larger banks and a dozen companies have external ratings. Therefore the Finnish banks are not able to make use of the risk differentiation achieved by external ratings. We would emphasise the need to have the Foundation
Internal Ratings Based Approach attainable by a significant number of credit institutions.

As regards higher risk categories, the Basel Committee has stated that 'National supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital and private equity investments.' We would suggest the inclusion of real estate investments (land and buildings held to earn rentals or for appreciation) also in this category.

Credit Risk Mitigation

The principles of Credit Risk Mitigation encompass the range of different credit risk mitigation techniques in a consistent manner. These techniques can be applied to a wide variety of risks.

However, we would suggest that the rationale and contents of the framework might be made clearer if all the principles related to a given risk mitigation technique were mentioned in the same context. The overall principles which are common to all risk mitigation techniques could be explained right at the beginning. Special requirements which relate only to a particular technique could be discussed after the general principles are set out. Exceptions to any main principle should be clearly indicated.

In addition to the general principles, there should be a statement on the scope of the principles. It could be mentioned that the principles apply to all activities of supervised entities, including retail brokerage and all off-balance sheet items.

The Basel Committee proposes two methods to calculate the effect of the chosen credit risk mitigation technique. In the comprehensive approach, the value of collateral is adjusted by the w and H factors. It seems to us that the rationale for using the w and H factors is not clear and the criteria can be interpreted as overlapping.

The Basel Committee has, in article 117, identified the risks encountered by a bank that relies on collateral. On the one hand, the risk which is addressed by means of the w factor is defined as follows: 'Bank may be unable to establish title to the collateral in order to sell it, or the collateral may otherwise turn out to be effectively worthless. Although the risks will vary depending on the type of collateral and documentation, a bank can therefore remain fully exposed to the underlying obligor.' On the other hand, the volatility and liquidity of the collateral and an exposure is covered by the H factor.
In the definition of the \( w \) factor, \( w \) is very close to the \( H \) factor in cases where the collateral is of lower quality and may be difficult to sell.

It seems to us that the \( w \) factor covers not the risks in documentation but also the difficulties in converting the collateral into cash. This is mentioned in paragraph 154, where two reasons for introducing the \( w \) factor are introduced. The first relates to the type of collateral and the second to the process on which the transaction is based, particularly the documentation and controls provided, such as remargining. The Basel Committee adds that in both cases there is a risk that the collateral may turn out to be effectively worthless, so that an exposure that is apparently secured turns out to be unsecured. We would note that the type of collateral is also related to the volatility of the collateral.

As regards guarantees, the \( w \) factor is 0 when the guarantor is a sovereign, a central bank or a bank. However, there may be documentation risk also in these transactions. Is the \( w \) factor always 0 if the guarantee is given by such counterparties?

It is unclear how the documentation risks covered by the \( w \) factor are related to the new operational risk capital requirement.

In the document on the Standardised Approach to Credit Risk, there are worked examples of credit risk mitigation techniques. We find these helpful and feel that some additional examples of different types of credit risk mitigation techniques would be useful.

**Minimum requirements for guarantees**

In 'The Standardised Approach to Credit Risk', it is mentioned that the minimum requirements for guarantees are, among other things, direct, explicit, irrevocable and unconditional. The meanings of these requirements are explained quite briefly. We would find it useful if the practical implications of these requirements would be explained in more detail.

**Minimum requirements for mortgages on residential and commercial real estate and residential property**

Neither of the proposals, of the Basel Committee and the European Commission, would require any essential changes in the treatment of mortgages. Our understanding is that the possibility to benefit from using collateral depends on the comprehensive principles of risk management in credit risk mitigation. However, the definition of risk management
principles of collateral given in the consultative document gives the impression that specific application of these principles would not be necessary in connection with mortgages on commercial real estate and residential property. It should be considered whether risk management principles could be applied also to mortgages on real estate and residential property.

Comparability of credit linked notes (CLN) and deposits

In the Basel Committee's The Standardised Approach to Credit Risk, paragraph 111, dealing with collateral instruments, deposits are conditionally equated, via footnotes 17 and 29, with credit-linked notes (CLNs). At the end of the document, in a separate discussion of operational requirements for credit derivatives, credit derivatives are mentioned only in connection with credit default swaps and total return swaps.

The document does not make clear which operational and risk management requirements would apply to CLNs. Based on the footnote, it is not clear whether a w factor would be applied to a CLN product when the comprehensive approach is applied. If a bank uses the simple approach, it seems that a general principle is applied which means that the risk weighting is 20%. Is the idea here that the overall treatment of CLNs is to be based on the Asset Securitisation Document? This document does not discuss CLN products for which there is no special purpose vehicle (SPV) nor the application of principles in cases in which there is no SPV.

Credit risk mitigation is not applied with total consistency. As regards deposits, zero w is applied to on-balance-sheet netting; otherwise 0.15 w is applied to deposits.

Asset securitisation

As regards securitisation, we feel that approaches involving minimal national discretion are preferable. Leaving too much scope for interpretation would endanger the regulatory transparency of transactions carried out in different countries.

The Consultative Document 'Asset Securitisation ' also covers the treatment of explicit risks associated with synthetic securitisation. The Committee expressed its intention to finalise its work on the capital requirements and the operational requirements related to synthetic securitisations in the near term. The Committee’s aim is that the operational requirements would be in addition to those for credit risk
mitigation, which, given the nature of synthetic securitisation, are applicable to these instruments. The operational requirements applied to synthetic securitisations should be consistent with the operational requirements of those credit derivatives which are eligible for recognition as credit risk mitigation techniques.

Internal ratings based approach (IRBA)

Finnish Authorities support the overall architecture of the Basel Internal Ratings Based Approach. However, we would pay attention to the macro-level effects of the new framework, especially the IRB approach. There is a danger that the proposed capital reform may further exacerbate business cycles. On the one hand, this is because after a negative aggregate demand shock banks have to adjust to the accumulating loan losses and the resulting decline in their capital by cutting lending. This would further strengthen the impact of the initial shock on the economy. On the other hand, the use of external and internal ratings may have similar effects, as institutions would have to simultaneously adapt to increased capital requirements after rating downgrades. As a counter-measure banks' internal ratings should be developed to cover sufficient long runs of data to assess the borrowers' ability to withstand normal business fluctuations.

In general, we would suggest that more guidance and numerical examples (eg on risk mitigation and granularity adjustment) would facilitate the understanding and implementation of the rules. These would also help supervisors in checking the validity of banks’ systems.

The rationale and contents of pillar I would also be clearer if all principles related to a given approach were mentioned in the same context. Especially the Internal Ratings-Based Approach (IRBA), Credit Risk Mitigation and Securitisation would benefit from a restructuring of the framework.

Minimum requirements of the Internal Ratings Based Approach

More guidance is needed on the estimation of probabilities of default (PDs) for banks and sovereigns within the IRBA, as this is generally seen to be very problematic. Implicit guarantees often prevent credit events from occurring and therefore from getting into the statistics. Therefore it is worth stressing that the minimum requirement of having PD estimates devoid of facility-specific aspects is particularly important – although not particularly easy to meet - in the case of banks and sovereigns.
The current definition of default causes confusion among banks. In this connection, the definition of the non-performing grades with respect to performing grades is unclear. In particular, there are certain areas which need more clarification, such as how 'non-performing' relates to the definition of default, how PDs are estimated for the non-performing grades, whether the PD for one of these should equal one, and whether the common risk-weight function used for these should also be used to derive the capital charge.

Finnish Authorities are of the opinion that the very different risk-weights on non-performing assets in the standardised approach and in the internal ratings based approach is a matter that should be given further consideration. Finnish Authorities are concerned that the considerably milder treatment of non-performing assets in the standardised approach may give rise to unnecessarily strong incentives to banks to hold to the standardised approach instead of striving after the more sophisticated IRBA, as it seems that these assets could be a major source of volatility of capital requirements in the IRBA. It may already be the case that the national supervisor requires banks to make specific loan loss provisions on the part of these assets not covered by collateral. This would often considerably reduce the LGD on these assets in practice. However, as many of these collateral positions are not recognised in the Basel framework, the resulting risk-weights especially in the IRBA may remain unreasonable high for these assets.

As a rating dimension, the importance of the age of a customer corporation - both in absolute terms and in terms of the length of the bank-customer relationship - could be explicitly mentioned in the minimum requirements.

We would welcome specific examples on 'transaction-specific' factors in ratings.

**LGD in the foundation approach**

In the Foundation Approach the way in which the priority of a bank’s claim on collateral affects the loss given default (LGD) remains unclear.

Also the 'cliff-effect' in the foundation LGD approach for physical collateral is confusing and unintuitive.

**Advanced Approach**

There is the well-known more fundamental problem with incorporating the maturity dimension in the IRB approach. Banks can have strong incentives to shorten contractual maturities in order to have lower capital
Unrestricted charges although economic maturities would remain unaltered. On the other hand, supervisors might find it particularly hard to justify their demands for more capital (say, under Pillar II) in these cases. Therefore we suggest that explicit minimum requirements regarding contractual maturities could be added. These could state that the bank must have a well-grounded assessment of the economic maturity of a given exposure and that the corresponding contractual maturity must be in line with this.

In the 'Rules' document, paragraph 225, it should be clarified what is meant by '...and where there is an explicit maturity dimension in the foundation approach...'. Does this mean maturity must be accounted for also in the foundation approach whenever a given loan contract has a clearly stated instalment plan? In particular, should this be the minimum requirement if the plan is in place but the bank would not be able to easily incorporate it in the capital calculations due to, say, defects in its IT systems, as is often the case in practice?

The Minimum data period for LGD and EAD estimation is seven years. But there should be clearer statement on what is an acceptable data period during the transition period.

It should be stressed that banks’ own LGD estimates must be based on at least as sophisticated a method as the one used in the foundation approach for collateral. This is important because a discrete rating approach to LGDs, allowed in the advanced approach, is rather different from the approach followed in the foundation approach, which is basically a continuous function. Therefore there could remain loopholes to banks to effectively apply less sophisticated methods in internal LGD estimation than what is implicit in the foundation approach.

Related to the above, there is no specific minimum number of LGD grades a bank should have.

Project finance

The definition of project finance seems to differ in different countries. For example, real estate credits may or may not be included. Therefore, more national discretion might be needed to judge whether the project finance portfolio in general is really more risky than the corporate portfolio.

Operational risks

As regards operational risk, we support the Committee's effort to calibrate $\alpha$ and $\beta$ and other multiplication factors in a way which gives institutions the incentive to move from the Basic Indicator Approach to
the Standardised Approach and to calculate the appropriate level of capital to cover the operational risks.

We emphasise the need to have different options open when developing the approaches in operational risk. Further developments, as well as, different risk control approaches should be taken into account when the techniques to measure operational risk in capital adequacy framework are elaborated. The methods to measure operational risk are in a developmental stage. Therefore it is in our opinion important not to limit the range of the possibly more sophisticated approaches only to the Internal Measurement Approach and Loss Distribution Approach.

Technically, the calculation of the Basic Indicator Approach and the Standardised Approach in operational risk are not too difficult even for smaller institutions. However, we would note that there is still a need to elaborate the concept of indicator used in the Standardised Approach. For business line Asset Management, the indicator 'Total Funds Under Management' is proposed. Funds under management do not provide the best possible way to assess operational risk in these operations. For example, the type and level of risk varies significantly as between active and passive managers. Total funds under management as an indicator in the business line of asset management is not sufficiently risk sensitive. Managing a large low-risk portfolio could lead to huge capital requirements despite very small operational risks. Further analysis is needed in order to find better solutions. Gross income could be one possible solution. It could better reflect the actual operational risks. On the one hand, the portfolio is more difficult to manage (and hence riskier) while, on the other hand, higher management fees are charged and thus gross income is higher. Thus, based on gross income, more capital would be required.

Not only the choice of the indicator but also the definition of the indicator is crucial for consistent implementation of these requirements. The precise definition of indicators is essential to minimise the regulatory arbitrage. The inclusion of off-balance-sheet items in Annual Average Assets should also be considered, as these items may account for a substantial portion of the total retail and commercial banking business.

Calculating the minimum capital requirement is just one part of a supervised entity's operational risk management. The quantitative assessment of operational risk raises various challenges and is hence difficult. Qualitative assessment is the starting point in the management of operational risk and is also the basis for supervisory assessment of these risks. Qualitative standards for operational risk management are a basic tool for regulators to assess the quality of operational risk management in
supervised institutions. Therefore Finnish Authorities welcome the effort made by Basel Committee on Banking Supervision to develop 'Operational Risk Sound Practices'.

The exact definition of operational risk loss is in a continuous state of flux, and hence there are some grey areas. As an example, we would cite the indirect losses of an implemented IT system which does not meet all expectations but which still has been taken into production. In cases like this, the operational loss is difficult to measure. The work on the categorizing of losses is therefore highly valuable.

The use of insurance as a operational risk mitigation technique should be considered. Similarly with the operational requirements applied to credit risk mitigation techniques institutions should comply with the defined minimum requirements when insurance is used as a risk mitigation technique.

Currently individual institutions’ inadequate data on realised operational risk events limits the possibility of using the Internal Measurement Approach (IMA). To use IMA in a certain business line, the bank must have enough loss data for every risk type within that business line. Some of the events in the history may be so old that they are no longer relevant for current business activity. There is a risk that expected operational risk losses calculated by institutions are not statistically reliable. One additional problem is that most of the data refer to small losses which are covered by income flow, whereas big events that are covered by own funds are very rare.

Trading book issues

Finnish Authorities welcome the explanation of the concept of trading intent. However additional guidance is needed on what liability items a bank can choose for hedging general interest rate risk in the trading book. A bank can buy back its own commercial paper, CDs and bonds. Are own debt issuances allowed to be used for hedging interest rate risk in the trading book? Are interbank deposits as liabilities of a bank allowed to be used as a hedge in the trading book?

Detailed guidelines are needed on hedging in the trading book in order to prevent cherry picking in cases where it is possible for banks to choose the liability items for hedging general interest rate risk in the trading book.

From the credit risk point of view, a good principle would be neutral treatment of assets regardless of whether they are in the banking book or
Unrestricted

in the trading book. Otherwise there is the possibility of regulatory arbitrage. In order to maintain a level playing field, we recommend that the specific risk capital charge in the trading book would be amended to reflect the principles in the credit risk standardised approach.

Pillar II (Supervisory Review Process)

The Principles of Supervisory Review Process are an essential element for the whole concept of capital requirement. The Review Process links the requirements of good risk management and capital allocation with the regulatory capital requirement. We welcome the proposed principles that would empower supervisors in this regard. However we find it important that the legal certainty and accountability can be ensured.

Pillar III (Market Discipline)

We share the view of the Committee that market discipline is an effective complement to supervisory efforts to encourage institutions to assess risk, maintain capital, and develop sound risk management systems and practices. The disclosures under Pillar 3 serve as an important tool to strengthen the minimum capital requirements under Pillar 1 and the enhanced supervisory review process in Pillar 2.

The Document covers a wide range of sound practice and best practice disclosure recommendations. Disclosures become increasingly relevant for those approaches that allow the use of institutions’ own methodologies for assessing risk in the calculation of regulatory capital requirements. In these situations, disclosures have an important role in ensuring comparability and consistency in risk and capital adequacy measures across institutions and across time. Accordingly, the disclosures are requirements here and will form part of the qualifying criteria for using an internal methodology for regulatory capital purposes.

However, a number of accounting standards and certain securities regulations presently require reasonably extensive narrative and numerical disclosures about financial instruments and financial risks. We consider it very important that the Committee, as stated in the Document, intends to work with the accounting authorities, including the IASC, to promote consistency between disclosure frameworks. The IASC is reviewing IAS 30, the disclosure standards for banks. Furthermore, the Joint Working Group of Standard Setters’ proposals for the introduction of full fair value accounting and the impact on disclosures should be taken into consideration.
We support the introduction of an explicit principle according to which all institutions should have a disclosure policy, the comprehensiveness of which would clearly depend on the size and risk profile of the respective institution.

Finally, we consider it imperative that disclosures be compiled in such a way as to guarantee disclosure of correct, timely and relevant information and that they be proportionate to the nature and scale of the institution in question.

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