12.8.2003

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Comments on Consultative Paper 3

The Basel Committee on Banking Supervision issued on 29 th April 2003 a third Consultative Paper on the New Basel Capital Accord.

The Finnish Bankers' Association respectfully submits the following comments. The Finnish Bankers' Association is a member of European Banking Federation and refers also to Federation's comment papers sent to the Basel Committee.

1. General remarks

The Finnish Bankers' Association believes that the Basel Committee should carry out further calibration of the Accord before implementation in 2006. A further calibration would help to assess methodology convergence and increase confidence in the New Accord.

We feel that the current proposal permits too much national discretion/alternative options to national authorities. While we acknowledge that national discretion might be necessary in a limited number of areas, any area of national discretion which could potentially cause competitive distortion should be phased out over time. As far as the discretion and alternative options remain at national level, information should be publicly available.

The Finnish Bankers' Association is concerned that the purpose and scope of Pillar 2 remains unclear. It seems to us, that the Pillar 2 is moving toward a system of automatic capital add-ons, where netting of capital deficiencies and surpluses would not be possible. This would be unacceptable, not least because these requirements have not been included in the calibration of the Accord. We would also like to draw attention to the fact that parameters used in the Foundation IRBA are conservative and therefore lead on average higher capital requirements as the real risk would presumed.

2. Detailed observations

Scope of application

Requirements on a sub-consolidated basis

The Finnish Bankers' Association doesn't support the requirement to establish groups for application of capital requirements on a sub-consolidated basis. Under the current legislative framework in the EU, banking and financial holding groups are subject to prudential supervision. The requirement for

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the parent undertaking institution to apply capital requirements on a consolidated basis means that the group's risk exposure is fully captured and set against the capital effectively available within the group.

According to footnote 2, an alternative to requirements on a sub- consolidated basis would be permitted provided that any holdings in subsidiaries and significant minority -owned institutions are deducted from the bank's capital. We don't find this requirement appropriate as far as the deduction would apply to investments in subsidiaries. The solvency ratio requirements to all group institutions on an individual basis ensure that capital is spread appropriately within the group.

Deduction of investments from capital

The Consultative Document states that deductions of investments in deconsolidated entities should be made 50% from Tier 1 capital and 50% from Tier 2 capital. The proposed rule, replacing the present deduction from total capital, would have impact of the total capital base for banks. This is due to the fact that amount of Tier 2 capital is limited to the amount of Tier 1 capital. If, however, the rules are to be changed, we suggest that the deduction of goodwill should be made 50% from Tier 1 and 50% from Tier 2 and not 100% from Tier 1 as proposed in paragraph 19.

We would like to emphasize that the New Basel Accord does not make any reference to reform the definition of the capital base. The Finnish Bankers' Association is therefore of the opinion that no proposals to change the rules should be made as far as they limit the current capital base.

<u>The Standardised Approach</u>

Claims on banks

As already indicated in our previous responses, we don't find it appropriate to retain two options for the treatment of claims on banks. This would lead in claims on the same bank being treated differently depending on the jurisdiction in which they arose. Furthermore, it would cause additional costs for international financial groups when presenting consolidated figures. We believe that only option 1 should be retained but with the risk weight for short-terms claims in option 2 made a feature of option 1.

Claims on corporates

Banks would be allowed to risk weight, subject to national discretion, all corporate claims at 100 % without regard to external ratings. It should be specified, whether this rule would apply to past due corporate loans.

Past due loans

We support the proposed risk weights linked to the specific provisions of the outstanding amount of the loan. However, the Finnish Bankers' Association believes that the preferential risk weights should not be subject to the national discretion but rather made a permanent rule.

In addition, there is a need to clarify the relationship between the paragraphs 46 and 51. It remains unclear, whether 35 % risk weight would be allowed in any circumstances to past due residential mortgage loans.

<u>The Internal Ratings- Based Approach</u>

Treatment of small business in the retail portfolio

The Finnish Bankers Association is of the opinion that requirement to treat small business retail exposures in the same manner as household exposures and not to be managed individually ("SME use test") gives an incentive to lower risk management standards of small business exposures. This is in contradiction with Basel II goal of improving risk management practices and should not be included in definition of retail portfolio.

Definition of the qualifying revolving retail exposures

The Finnish Bankers' Association believes that differentiation in the treatment of qualifying revolving retail exposures and other similar product offers such as personal loans is not justified by an assessment of the risks. The definition of the third retail exposure class should be therefore product neutral.

Availability of the data for the retail portfolio

The Finnish Bankers' Association finds it important that national authorities would promote the availability of the data used to class private persons in the portfolio as well as the possibility to restore such information for the risk management purposes. Consequently, existing rules in the national data protection legislation (concerning e.g. information on credit behaviour) that could create an obstacle to the implementation of IRB should be removed.

Definition of eligible receivables

The Consultative Document refers particularly to purchased retail and corporate receivables when defining the eligible collateral.

We would like to draw attention to the fact that factoring business is carried out in different forms. Whereas in the Central Europe factoring normally means that the factoring company purchases the receivables, and thereby takes a credit risk (non- recourse factoring), factoring in Finland and other Scandinavian countries as a rule means that the factoring company lends money to this client with the receivables as collateral (recourse factoring). The loan to collateral value varies with the risk, but usually amounts to about 80 % of the total value of the invoices held as collateral. This means that the risk level is already taken into account when the factoring transaction is made. In addition, the client is normally obliged to take back receivables when the debtor is in default, including the credit risk. As a consequence, the risk level of factoring for factoring companies is extremely low.

Finnish Banker's Association proposes that the definition of eligible receivables would also cover lending against receivables (recourse factoring).

LGD floor for residential retail exposures

The Finnish Bankers' Association believes that the introduction of a transitional LGD floor of 10% for residential retail exposures is against the objectives of the IRB Approach. We think that the low LGD would be justified for example in cases where large over- collateralisation exists. If the LGD floor is however retained, the floor should apply at the level of the portfolio and not at the level of each rating band within the portfolio.

Commercial real estate as eligible collateral

Under the foundation approach, the applicability of a lower LGD (35 %) to commercial real estate lending should be clarified. As opposed to QIS 3 Technical Guidance and previous Consultative Documents where capital lower LGD was permitted to every bank meeting certain minimum requirements, footnote 64 refers to "exceptional circumstances for well- developed markets". As already stated above, the Finnish Bankers' Association is not in favour of capital relief that is subject to national discretion. Consequently, proposed preferential treatment for commercial real estates should be permanent.

Claims on banks

The Finnish Bankers' Association is of the opinion that the 45% LGD in the Foundation Approach assigned to senior claims on banks not secured by recognised collateral is too high when assessed against the low loss rate experience. We suggest that a one third reduction in the LGD to 30% would better reflect the risks. The 75% LGD on subordinated claims on banks should be reduced to 50 %. We also note that the differentiation in the treatment of banks and corporates in the Standardised Approach is not reflected in the IRB approach. The Finnish Bankers Association believes that it would be consistent with the Committee's objectives to introduce such a differentiation.

Rules for equity exposures

Concerning the risk weighted assets for equity exposures, the Finnish Bankers' Association suggests lowering the proposed risk weight floors in various methods, which are not justified by an assessment of the risks and creates a disincentive to move from the standardised approach to the internal models method.

Other improvement concerning the treatment for permanent equity investments would be to lower the proposed LGD factor of 90%. The proposed floor of 100% is not justified and would disproportionately penalise high credit quality equity exposures.

<u>Operational risk</u>

The Finnish Bankers' Association is concerned that there remains little incentive for banks to move from the Basic to the Standardised and Advanced approach for the calculation of the operational risk charge. This undermines the Basel Committee's intention that the Accord should encourage banks to move to a more risk sensitive approach.

We believe that there is a case for the Committee to extend the use of insurance to banks on the Basic Indicator and Standardised approaches. All banks should have an opportunity to use insurance as part of their overall risk management strategy.

We don't agree with the proposal that it is necessary to require insurance provided by a captive to be laid off to an independent third party entity. Captives are part of a sound operational risk management process as they give institutions a good overview and centralised control over losses arising from operational risk. It should be also taken into account that the insurance captive's capital is fully deducted from the bank's capital.

The Consultative Document proposes alternative standard approach to operational risks. The aim of this proposal remains unclear to us. The alternative method is subject to national discretion, which may distort the competition. It also increases complexity in the treatment of operational risks. For these reasons, we don't find the alternative method necessary.

Pillar 2: Supervisory Review Process

The Finnish Bankers' Association is of the view that the relationship between Pillars 1 and 2 should be clarified. According to new proposal, Pillar 2 is moving toward a system of automatic capital add-ons, driven less by the specific circumstance of each bank and more by a general regulatory requirement. This would be unacceptable, not least because these requirements have not been included in the calibration of the Accord. It should also be clear that additional capital requirements under Pillar 2 should be the exception and not the rule.

The Finnish Bankers' Association find it important that additional capital requirement should be a net adjustment within Pillar 2. We strongly believe that a net adjustment is required where the under and overstatements of required capital produced by poor model fit are netted off. Pillar 2 should not simply sum the areas of capital deficiency and disregard the areas of capital surplus. For example, the positive impact of diversification of risk should be recognised.

Concerning the level of application, we believe that Pillar 2 should be applied at the top consolidated group level by the home supervisor. It should not be applied, except in exceptional circumstances, by host supervisors.

Finally, we don't find it appropriate for supervisors to assess reputational and strategic risks, as proposed in paragraph 700. We suggest this paragraph to be deleted.

Pillar 3: Market discipline

The Finnish Bankers' Association believes that the disclosure requirements remain too prescriptive and would require disclosure of proprietary information.

We are concerned about the confidential nature of certain data to be disclosed. We refer particularly the quantitative disclosures for portfolios subject to IRB approaches and insurance cover of the operational risk charge. This kind of information should not be disclosed as it could be against the banking secrecy rules or violate the commercial secret of the institution.

We believe that double disclosures resulting from conflicting accounting and regulatory requirements must be avoided to remove the risk of inconsistencies. We find it therefore important that the Basel Committee align its Pillar 3 disclosure requirements with those set out in the International Accounting

Standards. Emphasis in Pillar 3 should therefore be on supplementing the accounting disclosure requirements to the minimum extent necessary.

THE FINNISH BANKERS' ASSOCIATION

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