



DG Internal Market and Services, Banking and Financial Conglomerates Unit

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COMMENTS ON THE COMMISSION SERVICES STAFF WORKING DOCUMENT - POSSIBLE CHANGES TO THE CAPITAL REQUIREMENTS

1. General

Finnish Financial Supervisory Authority (later FIN-FSA) welcomes the opportunity to comment on the Consultation Paper regarding the further possible changes to the CRD.

As a member of the Committee of European Banking Supervisors, we support the comments submitted by CEBS on potential changes to the CRD.

FIN-FSA shares the view of the Commission services 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.

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. 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 analysing 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.

FIN-FSA strongly believes that the forthcoming changes on 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 Commission seem to work against this objective, leverage ratio being the most significant case.



From Finnish point of view, the proposals where we have the most significant concerns about are the following,

- On the leverage ratio: the level on which the ratio will be set, as well as the status of the ratio
 - If implemented, the leverage ratio should be a part of the Pillar II framework.
 - 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 would affect market players inconsistently compared to risk-based capital requirements.
 - Furthermore, a non-risk based leverage ratio could 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 the best incentives for effective risk management by banks.

- On the definition of own funds: the treatment of minority interest as well as the investments to institutions and insurance companies, and the treatment of instruments issued by NJS companies.
 - For co-operative banks, there are several criteria regarding the Core Tier 1 capital, which might be problematic. 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.
 - We would welcome a clarification that the regulatory scope of consolidation will capture also the financial conglomerates which are subject to the supplementary supervision in the European Union. ¹

- On the quantitative liquidity requirements: the composition of the high quality liquid assets and the role of the host supervisors regarding the subsidiaries of the cross-border credit institutions.
 - With regard to the stock of liquid assets, we believe that the broader regulatory definition of liquid assets should be implemented, i.e. the definition including high quality covered bonds and corporate bonds, should be implemented. Instruments accepted to the liquidity buffer should be both central bank eligible and liquid in private markets.
 - LCR buffer solo requirement should be applied to cross-border branches which accept deposits in host countries. Due to differences in insolvency and company laws, the transfer of liquidity and assets cannot be guaranteed in crisis situations. Liquidity buffer at the home country level in parent bank is not satisfactory from host country

¹ Clarification is in other words needed on 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.



point of view. Branches should be required to keep local liquidity buffers to safeguard the interests of local depositors. Branches may also be systemically important in host countries. As long as crisis management and responsibility for the stability of markets remains with local authorities, the supervisory responsibility of branches should remain with host supervisors.

- The standards have been originally drafted for large international banking groups and may thus be ill-suited for small local banks. The solutions for small banks should be considered.

Regarding the questions raised, the FIN-FSA provides the Commission Services with the following answers:

Section I: Liquidity standards

We welcome proposals for two quantitative liquidity standards and supervisory monitoring tools. In order to fully assess the proposals, quantitative data is needed for the calibration of the stress test parameters, contents of the liquidity buffer and balance sheet weightings.

Question 1: Comments are sought on the concept of the Liquidity Coverage Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex I. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

Question 1. We welcome the concept of the LCR. In order to prevent the liquidity crisis from re-occurring, banks will have to hold more liquidity buffers in better quality. A survival period of 30 days gives the bank and the regulators time to consider further measures.

Question 2: In particular, views would be welcome on whether certain corporate and covered bonds should also be eligible for the buffer (see Annex I) and whether central bank eligibility should be mandatory for the buffer assets?

Question 3: Views are also sought on the possible implications of including various financial instruments in the buffer and of their tentative factors (see Annex I) for the primary and secondary markets in which these products are traded and their participants.

Questions 2. & 3. We believe that the broader regulatory definition of liquid assets should be implemented, i.e. a definition including high quality covered bonds and corporate bonds. Instruments accepted to the liquidity buffer should be both central bank eligible and liquid in private markets.

Question 4: Comments are sought on the concept of the Net Stable Funding Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of



liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex II. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

Question 4. We welcome the concept of NSFR, which should contribute to reduce the reliance on short-term wholesale funding and ensure a more stable funding structure. However, its role in the supervisory tool kit should be considered (e.g. would it be better placed in Pillar II)

Question 5: Comments are in particular sought on the merits of allowing less than 100% stable funding for commercial lending that has a contractual maturity of less than one year. Is it realistic to assume that lending is reduced under liquidity stress at the expense of risking established client relationships? Does such a differentiation between lending with more and with less than one year maturity set undesirable incentives that could discourage for instance long term funding of non-financial enterprises or encourage investment in marketable securities rather than loans?

Question 5. From macro-economic perspective, treatment of commercial lending in NSFR should be carefully assessed based on QIS data.

Question 6: Views are sought on possible implications of inclusion and tentative "availability factors" (see Annex II) pertaining to various sources of stable funding for respective markets and funding suppliers. Would there be any implications of the tentative required degree of coverage for various asset categories for respective bank clients?

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Question 7: Do you agree that all parameters should be transparently set at European level, possibly in the form of Technical Standards by the EBA where parameters need to reflect specific sub-categories of retail deposits?

Question 7. We welcome the suggestion to use EBA Technical Standards to facilitate timely updating of parameters.

Question 8: In your view, what are the categories of deposits that require a different treatment from that in Annexes I and II and why? Please provide evidence relating to the behaviour of such deposits under stress.

Question 8. Definitions of product categories differ on national level. Harmonized categories across EU may be difficult to reach. However, EBA Technical Standards can helpfully contribute to finding liquidity characteristics for e.g. deposits. National discretion should be allowed to take into account differences. To promote transparency and equal treatment, national specificities could be published in EBA Standards.

Question 9: Comments are sought on the scope of application as set out above and in particular on the criteria referred to in point 17 for both domestic entities and



entities located in another Member State.

Question 9. Scope of application should be on three levels: 1. solo requirements, 2. sub-consolidation on national level, 3. full consolidation. Baseline assumption should be that waivers could only be granted at national level. We fully agree with Commission note (page 9, paragraph 18) that cross-border asset transferability cannot be guaranteed before harmonization of insolvency and company laws (as well as crisis management procedures are established at the EU level). Cross-border waivers should only be granted on a case-by-case basis whereby both home and host supervisors agree to the waiver. In case of disagreement, the final decision should rest with the host supervisor.

Question 10: Should entities other than credit institutions and 730K investment firms be subject to stand-alone liquidity standards? Should other entities be included in the scope of consolidated liquidity requirements of a banking group even if not subject to stand-alone liquidity standards (i.e. financial institutions or 50K or 125K investment firms)?

Question 10. LCR buffer solo requirement should be applied to cross-border branches which accept deposits in host countries. Due to differences in insolvency and company laws, transfer of liquidity and assets cannot be guaranteed in crisis situations. Liquidity buffer at home country level in the parent bank is not satisfactory from a host country point of view. Branches should be required to keep local liquidity buffers (local assets) to safeguard the interests of depositors. Branches may be systemically important in host countries. As long as crisis management and responsibility for the stability of markets remains with local authorities, the supervisory responsibility of branches should remain with host supervisors.

The standards have been drafted for large international banking groups and may thus be ill-suited for small local banks. The solutions for small banks should be considered. Options might be e.g. a simpler "standard method"; single buffer requirement based on balance sheet size; national discretion; or threshold limits to enforce the proportionality principle.

Question 11: Should the standard apply in a modified form to investment firms? Should all 730K investment firms be included in the scope, or are there some that should be exempted?

Question 11. Application of standards should firstly be implemented on banks. After gathering information on suitability for investment firms, application could be considered as second tier implementation.

Question 12: Comments are sought on the different options and in particular for how they would operate for the treatment of intra-group loans and deposits and for intra-group commitments, respectively. Comments are also sought as to whether there should be a difference made between the liquidity coverage and the net stable funding ratio.

Question 12. Treatment of intra-group transactions and commitments should be considered parallel with LCR and NSFR, as different options may have a considerable effect on meeting solo level



standards. As regards symmetrical vs. asymmetrical treatment, symmetrical treatment is probably most suitable.

Question 13: Do stakeholders agree with the conclusion that for credit institutions with significant branches or cross-border services in another Member State, liquidity supervision should be the responsibility of the home Member State, in close collaboration with the host member States? Do you agree that separate liquidity standards at the level of branches could be lifted based on a harmonised standard and uniform reorganisation and winding-up procedures?

Question 13. LCR buffer solo requirement should be applied to cross-border branches which accept deposits in host countries. Due to differences in insolvency and company laws, transfer of liquidity and assets cannot be guaranteed in crisis situations. Liquidity buffer at home country level in parent bank is not satisfactory from host country point of view. Branches should be required to keep local liquidity buffers to safeguard the interests of depositors. Branches may be systemically important in host countries. As long as crisis management and responsibility for the stability of markets remains with local authorities, the supervisory responsibility of branches should remain with host supervisors - aligning the pre and post incentives.

Question 14: Comments are sought on the merit of using harmonised Monitoring Tools, either in the context of Supervisory Review or as mandatory elements of a supervisory reporting framework for liquidity risk. Comments are also sought on the individual tools listed in Annex III, their quality and possible alternatives or complements.

Question 14. We welcome harmonization of Monitoring Tools for supervisory purposes.

Question 15: What could be considered a meaningful approach for monitoring intraday liquidity risk?

Question 15. The appropriate approach for monitoring intraday liquidity risk could be elaborated by CEBS / EBA.

Section II: Definition of capital

Question 16: What are your views on the prudential appropriateness of eliminating the distinction between upper and lower Tier 2, and of eliminating Tier 3 capital?

Question 16: The split-up of capital to going concern and gone concern capital is very drastic and makes Article 66 (4) of the Directive 2006/48/EC partly redundant. The Tier 2 capital is able to support negative reserves in certain jurisdictions but it must be admitted that in a severe stress situation the refinancing with solely Tier 2 capital would not be sufficient.

The simplification of Tier 2 capital seems to be made at the cost of Tier 1 capital, where two different buckets remain. In stress situation the current upper Tier 2 instruments have the flexibility not to pay interest, which is a useful feature. As a result, of the proposed list of criteria, the quality of the future Tier 2 capital may be more equivalent to lower Tier 2 capital than upper Tier 2 capital, which we regret.



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We do not have objections for the elimination of the Tier 3 capital. The amounts of Tier 3 capital held by institutions in Finland are insignificant.

Question 17: Are the criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2 sufficiently robust and how might they be improved?

Core Tier 1 criteria and 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. For example, the criterion requiring the equity classification under relevant accounting standards is problematic. 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 and very significant amount of the supplementary co-operative shares would no longer be eligible for Core Tier 1 on the consolidated basis .

In addition to, the no redemption criterion outside of the liquidation is problematic for the co-operative banks. The supplementary cooperative shares are subscribed by the members of the bank. When the member resigns, the bank must according to 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. Co-operative banks are not listed and their current Core Tier 1 capital instruments have no access to secondary markets which explains 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. The existing supplementary co-operative shares are structured allowing the redemption and therefore adequate transitional period and grandfathering rules are needed. We support the CEBS's initiative to allow co-operative shares with similar rights and priority in the liquidation among themselves.

Tier 2 criteria

Tier 2 criteria proposed do not set any constraints to the level of interest rate and the coupon payments to the issued Tier 2 capital. The proposal shall change the role of Tier 2 capital but the uncertainty of the new limit system makes it difficult to assess its impact. We have experienced the desire of companies seeking authorization to take deposits to structure lower Tier 2 instruments to paying very high interest. The interest must be paid even if the institution is distressed and it does not have distributable funds. We wonder whether the criteria are robust enough.

Question 18: In order to ensure the effective loss absorbency of non-Core Tier 1 capital, would it be appropriate under certain circumstances to require the write down of the principal amount of an instrument or its conversion to a Core Tier 1 instrument? To what extent should the trigger for write-down / conversion be determined objectively or at the discretion of an institution or its supervisor?

Question 18: The write down mechanism for non Core Tier 1 capital is not supported by the national legislation. There is no requirement for mandatory liquidation when the amount of equity is less than one half of the share capital. However, under severe stress situation conversion or write down of principal might help the refinancing and to return the institution to fulfill the capital requirements. Conversion to Core Tier 1 instrument does not necessarily increase the amount of regulatory capital,



but undoubtedly it will enhance the quality of it. Again the new limit system may have an impact, but at this stage it is difficult to assess it.

The Constitution of Finland sets limits for the discretion exercised by the supervisor and therefore the discretion must be limited by objective criteria. The trigger can be left at the discretion of the institution provided that the investor is conscious of the possibility of conversion or write-down.

Question 19: Which of the prudential adjustments proposed have the greatest impact? What alternative, robust treatments might be considered and what is their prudential rationale?

Question 19: The impact of the elimination of minority interest from the group capital should be carefully assessed and an adequate transitional period provided. It would not be correct to eliminate all the minority interest from core Tier 1 capital as the minority interest supports the risk weighted assets of the subsidiary and which are consolidated to the group risk weighted assets. The current treatment allowing the inclusion of minority interests in the Tier 1 capital is too generous, as the minority interest may have arisen also from instruments which are classified as Tier 2 instruments.

The deduction of investments in other institutions and insurance companies is significant. The Basel wording of regulatory scope of consolidation is unclear and creates uncertainty of its application to financial conglomerates.

Question 20: Are the proposed requirements in respect of calls for non-Core Tier 1 and Tier 2 sufficiently robust? Would it be appropriate to apply in the CRD the same requirements to buy-backs as would apply to the call of such instruments? What restrictions on buy-backs should apply in respect of Core Tier 1 instruments?

Question 20: The criteria for exercising the call are the same for non-core Tier 1 and Tier 2. We agree with the criterion 5 c. If the institution fulfils the current capital requirements for a foreseeable future, we would not object redemptions or buybacks.

CEBS implementation guidance on CRD Article 57 (a) instruments requires that buy-backs shall be subject to a prior supervisory approval. CRD is silent about buy-backs and our national legislation does not require prior supervisory approval. In our opinion this something that should be dealt with the Pillar 2 dialogue between institution and supervisor. The supervisor would not have objections for buy-backs if the institution has adequate amount of capital to cover the risks taken.

Question 21: What are your views on the need for further review of the treatment of unrealized gains? What would be the most appropriate treatment of such gains?

Question 21: Before the finalization of the IFRS 9 it is premature to take a view on the treatment of unrealized gains and losses.

Question 22: We would welcome comments on the appropriateness of reviewing the use of going concern Tier 1 capital for large exposures purposes. In this context, would it be necessary to review the basis of identification of large exposures (10 % own funds) and the large exposure limit (25 % own funds)?

Question 22: For small and medium sized institutions this amendment would be significant and it would be necessary to review the current limits.



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Question 23: What is your view of the purpose of contingent capital? What forms and triggers would be most appropriate?

Question 23: The Basel Committee's consultative document is not very transparent about the contingent capital. The Commission explains that the principal write-down or conversion feature could be part of the eligibility criteria for non-Core Tier 1 and Tier 2 Capital. If contingency would be eligibility requirement also for Tier 2 Capital, how it can be justified to call Tier 2 capital as gone concern capital. The bucketing system of different capital instruments is not easy to understand.

Question 24: How should the grandfathering requirements under CRD II interact with those for the new requirements? To what extent should the grandfathering provisions of CRD II be amended to bring them into line with those of the new capital requirements under CRD IV?

Question 24: Legislation with retroactive effects is not the ideal way to implement new requirements. The industry has been accustomed to the grandfathering rules. The new proposals are not easy to assess as part of them are still under development and depending of the results of the quantitative impact study carried out by the CEBS and the Basel Committee. Only few Finnish institutions have issued hybrid instruments and they are mainly so called innovative and non-innovative instruments and we do expect major problems with the implementation of CRD II. CRD IV goes further than CRD II in some aspects and there will be a need for new adjustments in grandfathering the existing instruments.

SECTION III Leverage ratio

- The following questions concerning the leverage ratio were posted by the Commission services staff working document:

Question 25: What should be the objective of a leverage ratio?

Question 26: Which element of going concern capital do you consider would be a more appropriate basis for the leverage ratio? What is your rationale for this view?

Question 27: What is your view on the proposed options for capturing the overall extent of an institution's derivatives business in the denominator of the leverage ratio?

Question 28: What is your view of the proposed approach to capturing leverage arising from credit derivatives?

Question 29: How could the design of the leverage ratio ensure that it would act as an effective constraint only in benign economic conditions?

Question 30: What would be the appropriate calibration of a leverage ratio?

- Response to Qs 25-30:

If implemented, the leverage ratio should be a part of the Pillar II framework. 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 would affect market players inconsistently compared to risk-based capital requirements. Furthermore, a non-risk based leverage ratio could generate adverse stability effects. It might create incentives for those market actors that face leverage restrictions but still exceed capital requirements, to focus on riskier



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activities. Therefore, the main focus should be maintained on the risk-based capital adequacy measures, which provide the best incentives for effective risk management by banks.

Section IV Counterparty credit risk

Question 31: Views are sought on the suggested approach regarding the improved measurement or revised metric to better address counterparty credit risk. With respect to suggestion to incorporate - as an interim measure - a simple capital add-on by means of calculating the loan-equivalent CVA charge, views are sought on the implications of using VaR models for these purposes instead.

Question 31: At the moment Finnish banks use mark-to-market method for calculating EADs for OTC-derivative contracts. Since netting rules for add-ons are so conservative, the prudent treatment is embedded in EAD calculations. In general the method has worked well for small, mid-size and large banks in Finland. Our opinion is that additional CVA charge 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.

Question 32: Stakeholders are invited to express views on whether the use of own estimates of Alpha should continue to be permitted subject to supervisory approval and indicate any evidence in support of those views.

Question 32: Since there are not any credit institution or investment firm using IMM for EAD calculations currently in Finland, we lack the experience needed for commenting the use of own estimates of Alpha.

Question 33: Views are sought on the suggested approach regarding the multiplier for the asset value correlation for large financial institutions, and in particular on the appropriate level of the proposed multiplier and the respective asset size threshold. In addition, comments are sought on the appropriate definitions for regulated and unregulated financial intermediaries.

Question 33: Referring to our answer on question 31, our opinion is that the current mark-to-market method works well. We are not in favour of adding complexity to EAD calculations, including multiplier for the large financial institutions or unregulated financial intermediaries.

Question 34: Views are sought on the suggested approach regarding collateralised counterparties and margin period of risk. Views are particularly sought on the appropriate level of the new haircuts to be applied to repo-style transactions of (eligible) securitisations. In this context, what types of securitisation positions can, in your view, be treated as eligible collateral for purposes of the calculation of the regulatory requirements? Any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

Question 34: We support additional prudence with exotic derivatives in the form of larger initial margining. Also challenges in pricing of securitisation bonds should be taken into account with additional haircutting.'



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Question 35: Views are sought on the suggested approach regarding central counterparties and on the appropriate level of the risk weights to be applied to collateral and mark to market exposures to CCPs (on the assumptions that the CCP is run to defined strict standards) and to exposures arising from guarantee fund contributions.

Question 35: CCPs which are run according to the strict qualitative standards regarding margin requirements could be treated as zero EAD in capital charge calculations. CEBS or its successor should maintain an 'official list' of CCPs with zero RW status.'

Question 36: Views are sought on the risk management elements that should be addressed in the strong standards for CCPs to be used for regulatory capital purposes discussed above. Furthermore, stakeholders are invited to express their views whether the respective strong standards for CCPs to be used for regulatory capital purposes should be the same as the enhanced CPSS-IOSCO standards.

Question 36: It should be clearly defined how CCPs are to calculate the margin requirements (both present value and the add-on for potential future exposure, PFE). Also the procedures in collateral management and termination procedures in collateral deficit situations are important.'

Question 37: Views are sought on the suggested approach regarding enhanced counterparty credit risk management requirements.

Do the above proposed changes to the counterparty credit risk framework (in general, i.e. not only related to stress testing and backtesting) address fully the observed weaknesses in the area of risk measurement and management of the counterparty credit risk exposures (both bilateral and exposures to CCPs)?

Question 37: Basel II standard add-ons in mark-to-market method are derived from historical volatilities using chosen confidence level. It would be important to calculate also stressed add-ons for PFE using extreme market movements. Some high volatility data and stress periods should be available from financial crisis. Stress test results should be part of Pillar II assessments.

Section V Countercyclical measures

1.1 Through-the-cycle provisioning of expected losses

Question 38: The Commission services invite stakeholders to perform a comparative assessment of the three different methods (ie ECF, incurred loss and IRB expected loss if it could be used for financial reporting) for credit loss provisioning from 2002 onwards based on their own data.

Question 38: The FIN-FSA has not performed a quantitative assessment of the three models.

However, we have followed the wide discussion on these three different methods and our opinion is that the current incurred loss method (in IAS 39) is too restrictive, therefore not prudent enough. This



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is because credit risk provisions (impairment) are not usually recognized until a fairly late stage in the lifetime of the bank credit. The current IAS 39 method doesn't include any forward looking aspect and therefore tends to promote cyclicity in banks' earnings from their lending activities. That is because IAS 39 doesn't include the possibility of building up any additional reserves in good times.

Discussions regarding the IASB ECF-method are still underway in many different forums and the consultation period is running until 30 June 2010. The most notable discussion forum is the IASB's Expert Advisory Panel (EAP), which is still working until the end of June. In the ECF method, there are additionally considerable operational complexities, which are currently being discussed with potential simplifications; especially EAP has concentrated on this topic.

Our initial view is that ECF- method achieves a more timely recognition of expected credit losses than the current accounting model, and it could possibly be less cyclical than the current incurred loss method. It should be noted however, that IASB's ECF proposal is established especially for the purpose of financial reporting of impairment losses and not for prudential purposes. Combining and balancing the accounting (i.e. financial) and prudential targets is the most challenging task. Therefore we are of the opinion that before making any decision regarding the provisioning for the prudential purposes, finalized IASB standard should be available. Only after the provisioning regarding the accounting framework is known, the possible supplementary requirements regarding the prudential framework can be considered.

Question 39: Views are sought on the suggested IRB based approach with respect to the through-the-cycle provisioning for expected losses as outlined above.

The FIN-FSA welcomes, in principle, Commissions revised approach to use internal rating-based models for capital purposes to calculate through-the-cycle expected loss provisions. This would entail a better estimating expected credit risk losses through-the-cycle thus dampen the impact of cyclicity in developments on net income. Although IRB based approach might have merits due to its counter-cyclical nature and credit losses are recognized in the income statement earlier than currently, we see some practical problems in this approach, for example

- IRB based approach requires the use of the current IAS 39 incurred loss model within accounting figures. How this proposal would fit with the IASB's new ECF model.
- The timing of many remarkable and important projects, which interact with each others, is a big problem. The Basel Committee is currently working on with pro-cyclicity which includes inter alia forward looking provisioning, the IASB's timetable is later than the timetables of the Commission and the Basel and in addition the Commission and the Basel time are different. The Basel Committee states in its document: "The Committee will continue to work with the IASB with an aim to ensuring that these principles are met in practice when the details of the IASB's proposals are fleshed out over the coming months".
- We support that the IASB's final standard would be waited and after that could be done additional analyses what kind of measures concerning pro-cyclicity for prudential purposes is needed before final decisions.
- We support that the Commissions technical group of Member States experts on credit loss provisioning should further work for the technical issues raised in paragraph 148. Also a field testing and an impact assessment of this approach are necessary before final decisions.



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1.2 Capital buffers and the cyclical nature of minimum requirements

Question 40: Do you agree with the proposed dual structure of the capital buffers? In particular, we would welcome your views on the effectiveness of the conservation buffer and the counter-cyclical buffer, separately and taken together, in terms of enhancing the resilience of banking sector going into economic downturn and ensuring the flow of bank credit to the "real economy" throughout economic cycle.

Q40: Yes, we agree with the proposed dual structure of buffers, as long as the final decision of counter cyclical add-ons stays on national supervisors, and both the level of add-on and moments of increasing and decreasing of buffer can be based on supervisor's own discretion. If there will be a selected set of macro variables, it should be seen only as a proposal of possible indicators for measuring the possible add-on requirement.

A rule based add-on to all banks could be seen as an unfair punishment to those banks that already take into account the effects of cyclical nature in their capital models. For example, in markets dominated by a couple of large banks, all the small banks are potential sufferers of irresponsible behavior of large entities. Due to that, a measurement of possible add-on should be bank specific, not only on macro economic variables.

Question 41: Which elements should be subject to distribution restrictions for both elements of the proposed capital buffers and why?

Q 41: -

Question 42: What is the appropriate timing – following the breach of capital buffer targets – for the restriction to capital distributions to start? Should the time limits for reaching capital buffer targets be determined by supervisors on a case-by-case basis or harmonised across EU?

Q42: Because all crises have different elements behind them and effects to banks and economy vary, our opinion is that capital buffer targets and time limits should be determined by supervisors on a case-by-case basis. Guidelines could be devised by the EBA to harmonize supervisors' actions.

Question 43: What is the most suitable macro variable (or group of variables) that may be used in the counter-cyclical buffer to measure the dynamics of macro-level risks pertinent to the banking sector activities?

Q43: The measuring of comprehensive indicator variables should be left to supervisors. It should be admitted that there are differences in loaning and borrowing practices between countries.

The measuring of new indicators should also be a continuous process. There is no proof that any single variable, or even large group of indicators, really can capture the effects of forthcoming crisis.

Question 44: What are the relative merits and drawbacks of capital buffers versus through-the-cycle provisioning for expected losses with respect to minimising procyclical effects of current EU banking regulation?



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Q44: One problem of a counter-cyclical buffer is the unfair allocation of add-ons to the whole banking sector. The add-on should be based on not only macro economic variables, but also the behavior and used methods of the bank should have an effect to the possible add-on. Banks that already take into account the effects of cyclical and try to smooth the peaks should not be punished with almost arbitrary add-ons.

Question 45: Do you consider that it would be too early to fully assess the cyclical of the minimum capital requirement

Q45: No, timing is perfect to start. It is important to highlight, that both the development of sensible indicators, and measuring the effects of cyclical, should be a continuous rather than a single task. Additional capital requirements should be timed so as not to jeopardize the macroeconomic recovery.

2 Systemically important financial institutions

Question 46: What is your view of the most appropriate means of measuring and addressing systemic importance?

Question 47: How could the Commission services ensure a consistent prudential treatment of systemic importance across financial sectors and markets?

Q46 - 47: The measurement and addressing of systemic importance is a multifaceted question. The stance of FIN-FSA is that in order to ensure the level playing field in prudential supervision, all institutions should be treated similarly.

3 Single rule book

Question 48: In which areas are more stringent general requirements needed given national or other circumstances? Is Pillar 2 a sufficient tool to address specific negative circumstances at credit institutions and if not, how could it be strengthened?

3.1 Treatment of real estate lending

Question 49: What is your view of the suggested prudential treatment for exposures secured by mortgages on residential property outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on residential property?

Question 50: What is your view of the suggested prudential treatment for exposures secured by mortgages on commercial real estate outlined above? What indicators



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and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate? In particular, are additional preconditions needed to ensure the soundness of this treatment? Do you believe that the existing preferential risk weight applied to exposures secured by mortgages on commercial real estate should be increased?

Question 51: Should the prudential treatment for exposures secured by mortgages on residential property be different from the prudential treatment for exposures secured by mortgages on commercial real estate? If so, in which areas and why?

Question 52: What is your view of the merits of introducing measures that would help to address real lending throughout the economic cycle? Which measures could be used for such purposes? What is your view about the effectiveness of the possible measures outlined above?

Q 49 - 52:

Credit decisions should always be based on a credit analysis. The factors that should be considered in the credit analysis, should be defined in the credit granting criteria. One of the factors that should be considered is the borrower's repayment capacity. When estimating the borrower's repayment capacity, the credit institution reduces the mandatory expenses of the family from the net salary. The remainder is considered to be used for the repayment of housing loan. The credit institution estimates the amount of the housing loan which can be granted and easily repaid. It should be noted, that since Finland lacks the positive credit register, the credit institution granting the loan is dependent on the borrower to tell diligently the loans obtained from other credit institutions.

What is said above is part of a sound credit risk management, and it is hard to see, how binding LTI-ratios could work in the capital adequacy framework.

The prudential treatment for exposures secured by mortgages on residential property and the prudential treatment for exposures secured by mortgages on commercial real estate should not be the same. The LTV-ratio should be higher for residential real estate than for commercial real estate. The LTV-value of 80 % is too high for both residential and for commercial real estate. From Finnish point of view the right level for residential real estate could be 70 % and for the commercial real estate at tops 50 %.

In Finland the residential real estate market is considered to be well-developed and long-established with low loss rates. The situation on the commercial real estate market is different. The commercial real estate market has proved to be influenced more heavily by economic downturn than the housing market. The level of renting has been lower and the underutilization of commercial real estate has been higher in economic downturn. The economic downturn has also affected more heavily to the prizes of commercial real estate than to residential property. Furthermore, Finnish banks have suffered significantly more losses from the commercial real estate lending than from the residential real estate lending. . It should also be noted that the use of the commercial property should carefully



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be taken into account. The preferential treatment should not be allowed for example in the case of single-purpose commercial property.

Should national discretion regarding commercial real estate be deleted, introducing a hard test as a general condition for the preferential treatment would be very important. Additionally, we do not support the increase of the preferential risk weight applied to exposures secured by mortgages on commercial real estate.

Generally said, too explicit indicators may be hard to implement in the capital adequacy framework, especially when the real estate markets differ so much in the EU. The indicators proposed by the Commission could possibly be taken as qualitative factors, which should be considered when granting the loan. Too strict regulatory requirements can also restrict too heavily the sound credit granting function.

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