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Basel Committee on Banking Supervision
Basel Committee Secretariat
CH-4002 Basel
Switzerland

FINNISH AUTHORITIES' COMMENT ON PROPOSED TREATMENT OF EXPECTED AND UNEXPECTED LOSSES

In October 2003 the Basel Committee released its proposal for changing the treatment of expected versus unexpected credit losses under the New Basel Capital Accord. The Finnish Authorities' orientation towards the general nature of the proposed modification is positive. There are, however, some aspects, which we believe require consideration in finalising the modified proposal.

We consider that the Basel Committee's modified proposal brings the interaction between capital requirements and accounting rules much more clearly into focus. However, this does not change the fact that banks continue to apply different accounting and tax rules. The impending adoption of International Accounting Standards (IAS) will undoubtedly harmonise loan accounting to some extent, but at this stage our understanding is that provisions that take account of expected – but not yet incurred – losses are unlikely to be permitted under IAS. As a consequence, there will be no harmonisation between the concepts of expected losses in capital adequacy requirements and incurred losses in accounting rules.

Our main concerns in this area are twofold. Firstly, this modification results in two different definitions of regulatory capital (own funds) – one for banks on the Internal Ratings Based Approach (IRBA) and another for banks on the Standardised Approach (SA). Furthermore, there will be several hybrid users of the two approaches: banks which are in the process of adopting the IRBA and banks which avail of the permanent partial use SA for certain exposures allowed within EU. We find that it is important to analyse the likely impact of the modification in this respect.

Secondly, the treatment of shortfalls and surpluses in provisioning against expected losses (EL) can motivate banks to alter their mix of Tier 1 and Tier 2 capital in response to this treatment. Proposed rules may indeed cause unforeseen side-effects. Referring firstly to the case of a shortfall, provisioning reduces only Tier 1 capital while any shortfall in provisioning against EL can be deducted 50 % from Tier 1 and 50 % Tier 2 capital. This opens the opportunity to optimise the shortfall amount in

30 December 2003

order to benefit from the reduction rules. In the case of a surplus, incorporating surplus provisions in Tier 2 can provide an incentive for banks to increase the overall size of the capital in Tier 2, raising subordinated debt instead of equity.

Overall, we wish to emphasise the need to analyse any possible implications of the proposal very carefully.

Pekka Laajanen
Legislative Director
Ministry of Finance

Kaarlo Jännäri
Director General
Financial Supervision Authority

Heikki Koskenkylä
Head of Department
Bank of Finland