CREDIT UNION CENTRAL OF CANADA
300 The East Mall, Toronto, Ontario M9B 6B7   Telephone: (416) 232-1262   Facsimile: (416) 232-9196
Website: cucentral.ca   Email Address: cucc@cucentral.com

May 30th, 2001

Mme Daniele Nouy
Basel Committee Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel,
Switzerland

Email: BCBS.Capital@bis.org

Dear Madame:

RE: Consultative Paper issued January 2001

In response to your request for comment on the consultative paper for a new capital adequacy framework issued by the Committee in January 2001, the Canadian credit union system hereby submits the following comments.

Background of the Canadian Credit Union System

Canadian credit unions located in the provinces of Alberta, British Columbia, Manitoba and Ontario are required to comply with capital adequacy regulations based on modifications of the Basel Committee on Banking Supervision's 1988 Capital Accord.

Each province has a body, referred to as a "credit union central", which, among other things, acts as the manager of liquidity for its respective member credit unions. The assets of a credit union central consist, therefore, of highly-liquid securities, secured loans to their member credit unions, and a limited portfolio of commercial loans. Credit union centrals are generally regulated by both the Canadian federal government and also the government of the province in which they are located.

Credit unions are generally consumer lenders, making personal and residential mortgage loans, and have commercial and agricultural loan portfolios in varying sizes. A credit union's business is primarily based within the geographic region in which the credit union is located, and domiciled entirely in Canada. Credit unions are regulated by the laws of the province in which they are located.

Concerns Regarding the January 2001 Consultative Paper

We have chosen to comment on five areas:

1. The lack of a definition of what constitutes a "corporate" and what constitutes a "bank";
2. The Canadian credit union system's preferred option for risk weighting a bank;
3. The need for further recognition of the limited liquidity and credit risk of an organization, the major purpose of which is to provide liquidity;
4. The need for further recognition of the low risk associated with loans made by a liquidity provider to those financial institutions to which it provides liquidity; and
5. The second option for risk weighting exposures to banks.

1. Definition of "Bank" and "Corporate"
There is no clear definition of what constitutes a "bank" and what constitutes a "corporate". It should be clear that both credit unions and credit union centrals are included in the definition of "bank" rather than the definition of "corporate".

2. Preferred Option for Risk Weighting a Bank
The two proposed options for risk weighting a bank (we assume this term includes a rated credit union) are: (i) based on the sovereign in which the bank is incorporated less one category, or (ii) based on the independent rating assigned by an external credit assessment.

The Canadian credit union system's preference is for a bank's rating to be independent of the country in which it is incorporated. As a result of the global diversification of bank assets, the credit assessment of a bank is not so much dependent on its sovereign's risk as on the quality of its own assets, which will likely include assets located in many different sovereigns of varying credit ratings.

This preference does, however, cause problems for credit union centrals and credit unions which do not have an independent rating assigned by an external credit assessment. A risk weighting based on the sovereign in which the credit union central or credit union is incorporated is, in the system's view, appropriate in this instance since a credit union central or credit union confines its operations to a single sovereign. The Canadian credit union system proposes that the supervisor be given the authority to apply both options in his or her jurisdiction, as he or she believes it appropriate.

3. Treatment of a Credit Union Central
As already discussed, the natural asset base for a credit union central is highly liquid because the credit union centrals are the liquidity managers for their respective member credit unions. At the present time, deposits or commercial paper of a credit union central held by a credit union would generally be risk weighted by provincial rules at 0%. Deposits or commercial paper of a credit union central held by a bank would generally be risk weighted by federal rules at 20%. In the view of the Canadian credit union system, a preferred risk weighting of 0% is appropriate for deposits or commercial paper of a credit

union central held by a credit union because of the extremely low liquidity and credit risk associated with such an institution. There should be a minimal capital cost to holding highly liquid investments, typically deposits with an initial term of one hundred days or less and callable on demand, in a financial institution the purpose of which is to provide liquidity to the investor/depositor. The Basel Accord should recognize that investment in a low risk credit union central be provided at no capital cost.

4. Loans by a Credit Union Central to its Member Financial Institutions
A portion of a credit union central's assets will be comprised of loans to the credit unions to which it provides liquidity. These loans may consist of both lines of credit and also term loans of varying lengths. Virtually all credit unions have no independent credit rating, and therefore, depending on its treatment and the term of the claim, would receive a risk weighting of 100%, 50% or 20%. It is the view of the Canadian credit union system that this is inappropriate, and that a credit union central should be permitted to use the internal rating based ("IRB") approach on loans to those institutions to which it provides liquidity even if it otherwise uses a standardized approach. These loans are well-secured, typically with a general security agreement and an assignment of book debts. Credit union centrals have experienced no losses on these loans. It would create perverse incentives if a bank using the IRB approach could assign a lower risk weighting to loans to a credit union, and thereby maintain less capital against that loan and make the loan at a lower cost, than could the credit union central which provides that credit union with liquidity but unfortunately cannot use the IRB approach referred to above.

5. Risk weights for banks – second option – some technical comments
It seems strange to us that the second option for banks (including rated credit unions), which is based on the external credit assessment of the bank, does not distinguish between A and BBB and unrated, each of which is weighted at 50%. We believe that an A rating should be weighted more favourably than the other two, most likely somewhere between 20 and 50%.

We note that risk weights for short-term claims may be claimed when the *original* maturity is *three months or less*. We would like to make two points about this. First, it is our recommendation that residual term to maturity be used and not original term because the same credit with the same term remaining should rank equally, all other things being equal. Second, we recommend that one year, rather than three months, be used as the yardstick because most of the market uses under one year to define short term obligations.

As a general statement regarding the proposals in the consultative paper, the Canadian credit union system supports the Committee's efforts to focus capital requirements on the risks inherent in the assets under management, rather than on balance sheet measures which do not take account of risk. The majority of Canadian credit unions are required to meet, either in addition to or instead of a risk-weighted capital adequacy test, a simple leverage test of $1 in capital for every $20 in total assets. This is an arbitrary test which does not capture the true risks which the Committee has tried to address in the

consultative paper. The Canadian credit union system recommends that supervisors and credit unions work towards the replacement of the leverage test with a risk-weighted assets test based on the Committee's proposals.

If you have any questions regarding our few comments, please feel free to contact me by telephone at (416) 232-3439 or by e-mail at rogersg@cucentral.com . Thank you for your consideration of our comments.

Yours truly,

Gary Rogers
Senior Vice President & CFO