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July 29, 2003

Mr. Nicholas Le Pan
Superintendent
Office of the Superintendent of
Financial Institutions Canada
Kent Square
255 Albert Street, 16th Floor
Ottawa, Ontario
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Dear Mr. Le Pan:

Re: CBA Response to the Third Consultative Document on the New Basel Capital Accord

On behalf of the Canadian banks, I am pleased to forward to you the CBA's Response to the Third Consultative Document on the New Basel Capital Accord. The industry's response represents three months of extensive review and analysis by many specialist and management employees of our member banks, as well as input and advice from CBA and OSFI staff. In forwarding our response to the Basel Committee on Banking Supervision, please note that the industry is supportive of having our submission posted on the BIS website.

On behalf of the industry please accept our appreciation for the ongoing dialogue with OSFI as we worked toward developing our response to the Consultative Document. We look forward to working with OSFI in resolving the technical implementation issues arising from the New Accord.

Sincerely,

Original signed by Kelly Shaughnessy

RKS/ap

Attachment

Response to the Basel Committee on Banking Supervision on its Third Consultative Document on the New Basel Capital Accord

Canadian Bankers Association
July 31, 2003

Response to Third Consultation Document

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EXECUTIVE SUMMARY

The Canadian banks are generally pleased with the direction that the Basel Committee (the Committee) has taken with respect to the amendments contained in the Third Consultative Document (CP3). We believe the Committee is making progress in promoting a more comprehensive and accurate approach in the New Basel Capital Accord (the "New Accord").

In particular, the Canadian banks are pleased with the developments in the treatment of the retail portfolio and would like to commend the Committee for striking the appropriate balance between risk sensitivity and comparability in this diverse portfolio. While the Canadian banks appreciate the progress made in both the Securitization and Operational Risk areas, we do share the Committee's position that these areas are still works in progress, and that more work and research needs to be done. We have focused our comments in these areas on our priority concerns, with the view that there will be a need for continuing discussions.

The Canadian banks have identified some outstanding issues that we believe require revision in order to ensure that the New Accord can be fairly and practically implemented. While our detailed recommendations follow in the body of our Response, we would like to highlight the following issues for the Committee:

- Cumulative conservatism on a number of factors compound to create excessively high risk weight calculations. In our view, this is especially the case with the Credit Risk Mitigation rules, and the treatment of the Corporate and Securitization portfolios. While individually each of the conservative elements may have been reasonable, in total the results are excessively punitive. A particularly troubling aspect of this excessive conservatism is the Committee's adoption of floors in the IRB calculations.

- We would like to emphasize our serious concern regarding the disincentives contained in the treatment of the Equity portfolio. The Canadian banks urge the Committee to seek a solution that is more consistent with the Committee's larger objective of ensuring that there are incentives for adopting more sensitive risk management systems.

- With regard to Pillar II, the Canadian banks are concerned that the original clarity of purpose and scope of Pillar II has become confused and that this will directly threaten consistent implementation of the New Accord. Specifically, we have concerns with the introduction of a series of risk issues into the Supervisory Review Process.

- While the Canadian banks are supportive of the principles underlying the Pillar III disclosure rules, we remain concerned that we will be required to disclose quantitative information that is proprietary, difficult to impossible to compare, and open to misinterpretation.

- As a final point of emphasis, Canadian banks are concerned that the Basel Committee's current timeline for implementation requires that banks must use risk-rating systems that are "broadly in line" with the minimum requirements of the Accord for at least three years prior to qualification. If the current timeline is maintained, the date the New Accord is expected to be signed and the date whereby a bank's risk rating systems are required to be broadly in line with the New Accord will nearly coincide.

The Canadian banks' more detailed discussion on CP3 is outlined below, and is to assist the Committee in developing a fair, principle-based New Accord.

INTRODUCTION

The Canadian banks would like to thank the Committee for the opportunity to provide our comments on CP3. The Canadian banks are generally pleased with the Committee's integration of many of our industry's concerns as expressed in the responses to the Second Consultative Document (CP2) and the numerous specialized working papers. The Canadian banks recognize the Committee's progress in meeting its objective of providing regulatory incentives for banks to adopt increasingly advanced risk management systems and strongly support this underlying principle of the New Accord.

Our review of CP3 and the results of the third Quantitative Impact Study (QIS 3) have resulted in the identification of a number of issues and recommendations for the Committee's consideration. Our primary objective is to assist the Committee in the development of a clear set of standards that can be consistently and fairly implemented, while minimizing the level playing field issues across jurisdictions.

The Canadian banks trust that the Committee will find our recommendations constructive in achieving our mutual goal of implementing a principled, but practical New Accord. The references highlighted at the beginning of each issue refer to the paragraphs of CP3.

I. PILLAR I

A. IRB CORPORATE

The Canadian banks are generally supportive of the Pillar I Internal Ratings Based approach to the Corporate portfolio in the New Accord. However, we do have concerns with its excessive conservatism, maturity adjustments, the definition of default, and the credit conversion factors (CCFs) for undrawn commitments.

A 1 Excessive Conservatism

The cumulative effect of multiple conservative estimates in assessing each risk component of the capital calculation is excessive and undermines the integrity, appropriateness and effectiveness of the IRB approaches.

The Canadian banks recommend specific rewording of the New Accord to ensure that risk ratings reflect best practices at recognizing current risks, and that Loss Given Default and Exposure at Default estimates follow best practices at determining long-term default-weighted averages, except in unusual circumstances.

Paragraphs: 376-378, 413, 430, 437

CP3 contains conflicting rules, requiring banks to focus on long-run average parameters while incorporating the requirement for stressed Loss Given Default (LGD), Exposure at Default (EAD) and risk ratings. Clearly, requiring calibration to hypothetical adverse conditions or ill-defined values beyond expectations creates a framework with components that are inconsistent with best practices and available benchmarks, and which will lead to incomparability across banks.

The use of overly conservative risk components would likewise invalidate the QIS results and the New Accord's overall calibration, inasmuch as banks participating in QIS3 employed, not stressed estimates, but best estimates of long-term default-weighted average LGD and EAD, and best efforts at current and accurate risk ratings. Capital itself is already designed to cover variations and losses beyond these expectations.

Regulatory capital would significantly exceed the targeted 99.9% confidence level and no longer be risk sensitive, if it were based on stressed scenarios. It should suffice that banks demonstrate that in "stressed" periods they are capable of raising additional capital under a Pillar II review.

Recommendation

Paragraphs 430 and 437 currently include, "Moreover, for…estimates…volatile over the economic cycle…use estimates that are appropriate for an economic downturn". We recommend that "volatile over the economic cycle" should be clarified and replaced with "volatile in excess of normal variations over the economic cycle"

Paragraphs 376 to 378 suggest that a risk rating be based on the borrower's ability and willingness to perform despite adverse economic conditions or the occurrence of unexpected events. Regulatory requirements should not undermine the integrity of the bank's current risk rating systems, and their best efforts at setting current and accurate ratings. Accordingly, these paragraphs should, at most, suggest that the risk rating process give consideration to the probability of adverse conditions arising, and the likelihood of the borrower's ability to subsequently pay. Regulatory concerns could be further addressed with explicit text spelling out that the rating must avoid overly optimistic speculation about a borrower's prospects.

Paragraph 413 states a bank "…must add to its estimates a margin of conservatism that is related to the likely range of errors". In order to be consistent with best practices at establishing long-run average values, the text should be rewritten to the effect: "Recognizing that there is a range of errors in parameter estimation, banks must make best-efforts to determine long-run average estimates with a conservative bias where warranted." Regulatory concerns could be addressed with explicit text that banks will not be allowed to take advantage of uncertainty to establish inappropriately low parameter values.

A 2 Effective Maturity

The Canadian banks believe that short-term inter-bank lending has similar risk characteristics to the short-term exposures (listed in paragraphs 291 and 292), and therefore should also qualify for exemption from the one-year floor on effective maturity.

Moreover, the Canadian banks believe that the artificial and arbitrary distinction between transactions with original terms over and under three months will result in a "cliff effect", analogous to that created in the existing Accord between commitments with terms over and under one year. While term is an important factor in determining the appropriate level of capital for an exposure, the amount of incremental capital necessary for an exposure should be determined based on its remaining term, regardless of the duration of that term.

If the weighted average maturity of repo-style transactions that are not subject to netting agreements were less than five days, then these transactions would receive a lower effective maturity than repo-style transactions subject to master netting agreements where a floor of five days is required. This reduces the benefits of credit risk mitigation from the use of legally enforceable master netting agreements, and is inconsistent with self-liquidating trade transactions that are not subject to daily remargining and/or a floor. Furthermore, the five-day floor with respect to repo-style transactions that are subject to a master netting agreement should be eliminated.

Recommendation

The Canadian banks recommend that short-term inter-bank lending, which is provided on an uncommitted basis, should be identified in Paragraph 292 as an additional form of exposure which may be exempted from the one-year floor.

The Canadian banks recommend that the requirement for exposures to have an original term less than three months be removed from Paragraph 291.

The Canadian banks recommend that the five-day floor with respect to repo-style transactions that are subject to a master netting agreement be removed from paragraph 293.

A 3 FIRB Credit Conversion Factor for Undrawn Commitments

In the Foundation IRB Approach (FIRB), the credit conversion factor (CCF) of 75% for undrawn commitments, without regard to maturity and level of commitment, is an overly punitive treatment that is inconsistent with corresponding factors applied in the Standardized approach.

The Canadian banks recommend that the Committee lower the FIRB CCF to 50% for undrawn commitments.

Paragraph 281

The CCF for undrawn commitments in the Foundation Internal Rating Based approach (FIRB) is significantly higher than the corresponding CCF in the Standardized approach, which creates a disincentive to pursue the more risk sensitive approach. The FIRB CCF is also significantly higher than the CCF used by most banks in their economic capital models, which reflects an experience-based CCF.

Our recommended FIRB CCF of 50% for undrawn commitments is broadly in line with historic observations in the Canadian marketplace.

Recommendation

The Canadian banks recommend that the Committee lower the FIRB CCF to 50% for undrawn commitments.

A 4 Definition of Default

Selling a credit obligation at a material credit-related economic loss should not be automatically treated as a default.

The Canadian banks recommend adding qualifiers to the New Accord to recognize circumstances where economic loss is not automatically a default.

Paragraphs 414 – 416

A bank's decision to reduce exposure to an obligor does not necessarily imply that the entity is considered non-performing or "deemed to be unlikely to pay its credit obligations" as the decision could be driven by other reasons such as change in strategic focus, portfolio diversification, internal industry or transactional concentration limits, returns etc. Thus, the onus should rest on the bank to demonstrate that the sale decision was not predicated by the fact that the obligor is considered unlikely to pay as per the definition of default.

In cases where the bank has sound rationale for excluding such events from its default data, the bank should be allowed such exclusion, on the approval of the national supervisor.

Recommendation

The following should be added to paragraph 416:

"It is recognised that there are circumstances where a bank will have no reason to otherwise expect an obligor to default on its credit obligations as defined above but will nonetheless sell assets at a material economic loss. These circumstances may include, inter alia, implementing changes in a bank's strategic focus or its taking action to achieve its portfolio diversification objectives. Notwithstanding the requirements of paragraph 415, such a loss need not be treated as a default event, subject to the approval of the national supervisor. "

B. IRB RETAIL

Introduction

The risk weights for retail exposures were reduced in CP3, both in absolute terms and relative to other types of lending. This shift in the regulatory capital framework brings the New Accord in line with the economic reality, and significantly reduces both the incentive and the opportunity for capital arbitrage. Generally, retail lending is less risky than other types of lending, as evidenced by low long-run historical volatility of credit losses, lower premiums charged in the securitization markets, and higher price to earnings multiples assigned in the equity markets. By reducing regulatory capital required for retail exposures, the Committee is promoting well-diversified and stable bank credit portfolios.

The Canadian banks believe that the Committee has made the right strategic decision in this regard and therefore are strongly opposed to any further re-calibration of the risk weights. Our attention should now be concentrated on further eliminating arbitrage opportunities within the New Accord. To that end, the Canadian banks would like the Committee to consider the following issues: the 10% floor on LGDs for residential mortgages, the "use test" requirements for retail exposures, the external data source comparison requirements, and the model validation requirements.

B 1 LGD Floor for Residential Mortgages

The 10% floor on LGDs for residential mortgages should only apply where loan to value ratio (LTV) exceeds a specified threshold. Otherwise a competitive advantage accrues to banks that extend home equity lines of credit at LTVs ranging as high as 120%.

The Canadian banks propose that a 10% floor on LGDs for residential mortgages apply only where LTV exceeds a certain threshold, for example 60%. The exact level of this threshold should be subject to national discretion, to reflect differences between jurisdictions in long-run historical dynamics of housing prices, as well as differences in legal environments.

Paragraph 235

The Canadian banks agree with the Committee that a 10% floor on LGDs for residential mortgages might be warranted in order to protect banks against "the potential for very long-run cycles in house prices" (paragraph 235). However, we disagree with the premise that LGDs "cannot be set below 10% for any sub-segment of exposures". For mortgages with a low LTV measure (for example, below 60%), even a significant deterioration in house prices would not result in an LGD greater than 10%.

Consider, for example, sample calculations of loss severity of defaulting loans by LTV [1]:

[1] "Moody's Approach to Rating Residential Mortgage Pass-Throughs", Special Report, Moody's Investor Services, 1990, page 13, Figure 4, and explanation on page 9.

Loss Severity of Defaulting Loans

LTV %	95	90	85	80	75	70	65	60
LGD %	49.4	45.6	41.3	36.5	31	24.8	17.6	9.2

Note that Moody's performed these calculations in 1990, which was the most recent example of when an economic recession intersected with a significant deterioration in house prices to result in a material increase in LGDs for residential mortgages in North America. For example, "based on historical loss data, Moody's expects that the average total price appreciation on homes that go into default is 40% less than the total price appreciation on an average home".[2] This data reflects that "for example, many homes in Texas declined in value by more than 25% in the 1980s." The calculations also incorporated a 6% sales commission, lost interest payments while the loan is delinquent, in foreclosure, and being sold (a total of 22 months), and legal and maintenance expenses.

Also, in the table above, LGD was based on those accounts that proceeded to the sale of the property. A large number of mortgages that become 90 days past due are subsequently cured by the customer, and either are closed or continue to perform. The LGD on these mortgages, which meet the definition of default in CP3, is 0. Therefore the average default-weighted LGD for each LTV band is, in fact, substantially lower than the numbers reflected in the table above.

This margin of conservatism becomes even larger as LTV decreases, as more and more defaulted accounts never reach the stage of selling the property, and therefore contribute an LGD of 0 to the average default-weighted LGD for that LTV value.

Even with all these margins of conservatism, the table above clearly shows that while LGD increases dramatically with LTV (and even more so when LTV exceeds 100%, for the so-called partially secured loans), a conservative estimate of LGD would not exceed 10% for LTV below 60%.

In practical terms, there are different types of mortgage lending. One type is represented by sub-prime HELOCs (home equity lines of credit) in the U.S. market, which may have a LTV ratio of up to 120%, and may be used as a type of bridge financing for customers in financial distress. Obviously a 10% floor on LGDs is warranted for such exposures. On the other hand, there are traditional conventional residential mortgages, subject to strict limits on LTV. For example, conventional (uninsured) residential mortgages have a maximum LTV of 75% in Canada, and 80% in the U.S.

An absolute floor of 10% on LGDs would create competitive disadvantage for banks involved in low-LTV traditional mortgage lending. They would be penalized twice. First, they are not allowed to extend conventional mortgages in excess of LTV = 75% (or 80%) unless such mortgages are insured. Second, they would have to hold excessive capital that is not warranted for the relatively low LTV levels at which they extend conventional mortgages.

This would put these banks in a competitive disadvantage vis-à-vis their counterparts that extend home equity lines of credit at LTVs ranging as high as 120%. First, these banks are allowed to

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[2] Ibid, Page 9

extend home equity lines of credit in excess of 100% without having to insure them. Second, they would not be penalized by excessive capital, since at those LTV levels a 10% floor on LGDs is completely warranted.

This would create a perverse incentive for banks to engage in high-LTV mortgage lending where a 10% LGD is economically justified.

Recommendation

The Canadian banks propose that a 10% floor on LGDs for residential mortgages only apply where LTV exceeds a certain threshold, for example 60%.

This will help ensure a level playing field between different banks and different jurisdictions. This will also promote either a sound mortgage lending practice with a substantial margin of additional home equity over the amount of the loan or an amount of capital commensurate with the risk where the margin of home equity is lower. As a side benefit, by linking this potential capital relief to a LTV measure, the regulator will promote a sound risk management practice of considering LTV, as one of the risk drivers when assigning residential mortgages to a pool.

To that end, paragraph 235 could be augmented with explicit text as follows: "The 10% LGD floor shall not apply, however, to sub-segments where LTV measure does not exceed a certain threshold, for example 60%. The exact level of this threshold is subject to national discretion and should reflect long-run historical dynamics of the housing market as well as legal environment in each jurisdiction."

B 2 "Use Test" Requirements for Retail Portfolio

The "use test" requirements for retail exposures should be clarified to reflect the potential use of different rating systems for credit approval, account management, internal capital allocation and corporate governance functions in retail lending.

For retail lending, the Canadian banks recommend that the New Accord should specify that internal rating systems used for IRB purposes should play an essential role in the internal capital allocations and corporate governance functions of the bank, but not necessarily in the day-to-day activities of operational systems used for credit approval and account management.

Paragraph 406

Paragraph 406 appears to assume that there is one internal rating system used by the bank for all credit approval, account management, internal capital allocation and corporate governance activities. In retail lending, unlike other types of lending, different rating systems are used for various activities. To require only one system would unduly affect the information available to the bank at different stages of a retail exposure.

For example, the information available for risk management is much more extensive than that available at origination as the former is based upon credit behaviour while the customer is with the bank, and does not necessarily build upon the limited information available at the time of

origination, which is quickly outdated. Additionally, the information used for internal capital allocation purposes draws upon risk characteristics that cannot consider each of the millions of accounts in the day-to-day operational risk management, but nevertheless proves reliable in estimating loss volatility at a portfolio level.

Timing and legal practicalities are other factors contributing to the use of different risk ratings for different purposes. For example, delinquency of exposure is not available at the time of credit approval, but is available and being used by the banks for setting provisions for credit losses and for capital allocation. Borrower demographic characteristics such as customer age may be used by the banks in assigning exposures to the pools for capital allocation, but it may be against anti-discrimination laws to use such variables in credit approval and risk management.

Finally, expediency is another necessary consideration when dealing with millions of transactions on a daily basis. Retail product legacy systems used for credit approval and account management are designed for automated processing transactions in real time. Operationally, it is often impossible to implement sophisticated models used for assigning exposures to risk segments on these mainframe-based legacy systems. However, these sophisticated models are successfully implemented on other IT platforms where they are run on a yearly or quarterly basis, and do not interfere with the operational production environment.

This evolution and differentiation reflects best practices in retail lending. An attempt to use one system for all purposes would impede and indeed stall development of models best suited for each activity, render the one chosen model ineffective for the other types of activities, result in huge expenses for the banks in order to re-vamp their operational systems to align them with the one chosen model, and indeed be impractical to implement.

In practical terms, it would result in a bank's inability to comply with such a test and thus move from the Standardized to IRB approach for retail and, by extension, for all portfolios. To prevent this undesirable outcome, the Canadian banks recommend that paragraph 406 be augmented with explicit text to reflect the distinct nature of retail lending.

Recommendation

The Canadian banks recommend that paragraph 406 be augmented to include the following paragraph or footnote:

"The Committee recognizes that in retail lending practices, different rating systems may be used for credit approval, account management, risk management, and for capital allocation and corporate governance functions. It is not the intent of the Committee to impede development of models best suited for each internal business activity. In the case of retail lending only, internal ratings and default and loss estimates must play an essential role in the internal capital allocations and corporate governance functions of the banks using the IRB approach. They must also play an essential role at a macro level in strategic decisions regarding portfolio composition, which can then be implemented operationally in retail lending practices through the use of these or other rating systems for credit approval and risk management."

B 3 Comparison with External Data Sources

The requirement that banks must use other quantitative validation tools and comparisons with relevant external data sources is not appropriate for the retail portfolio and inconsistent with Paragraph 426.

The Canadian banks recommend that the retail portfolio be exempt from this aspect of the validation requirements.

Paragraph 465

The New Accord requires external validation for internal estimates: "Banks must also use other quantitative validation tools and comparisons with relevant external data sources." This requirement will be difficult to uphold, as there is not always publicly available data on the performance of similar loans.

However, more importantly, it should be noted that the high volumes of retail exposures ensure that comparisons between expected and realized default rates based on internal data remain an adequate verification for retail lending. Furthermore, this requirement for comparison with external data appears to contradict paragraph 426, which states, "Given the bank-specific basis of assigning exposures to pools, banks must regard internal data as the primary source of information for estimating loss characteristics."

Recommendation

The Canadian banks recommend the first sentence of paragraph 465 be expanded as follows:

"Banks must also use other quantitative validation tools and comparisons with relevant external data sources (except in retail lending, where such external data may not be available to the banks due to legal restrictions on availability and access to private customer information)."

B 4 Model Validation

Paragraph 382 currently states that if banks use statistical models in the rating process, their required documentation on methodology must "...Establish a rigorous statistical process (including out of time and out of sample performance tests) for validating the model." In certain circumstances, applying both of these performance tests may yield results which themselves are not statistically valid. As a result, modeling testing may not always include both of the prescribed tests.

The Canadian banks recommend that the wording of the penultimate bullet in paragraph 382 be changed to read, "...Establish a rigorous statistical process for validating the model, typically including out-of-time and out-of-sample performance tests; and..."

Paragraph 382

The New Accord prescribes that where a bank employs statistical models in the rating process, it must establish a rigorous statistical process that includes both out-of-time and out-of-sample performances tests as part of the validation of such a model.

While both these tests are commonly used, the Canadian banks are concerned that the text implies a requirement to use both tests in every circumstance where a statistical model is validated. Given the frequency with which scoring models can change in the retail portfolio, it can reasonably be expected that executing both of these performance tests in every case may not provide statistically valid results, as in circumstances such as:

a) The purchase of a new portfolio (for which historical data may be incomplete from a New Accord perspective),

b) A portfolio exhibiting near-zero levels of defaults (e.g., conventional mortgages), or

c) A new product is launched.

Further, there may be other appropriate tests that provide the desired robust validation of the models in such circumstances. We support the requirement that banks develop and employ a rigorous statistical process that includes, inter alia, these two tests. It is a requirement that both be done in all circumstances that is problematic.

Recommendation

The Canadian banks recommend that the wording of the penultimate bullet in paragraph 382 be changed to read:

"...Establish a rigorous statistical process for validating the model, typically including out-of-time and out-of-sample performance tests; and...".

C. EQUITY RISK

The Canadian banks have concerns with the structural disincentive to adopt sophisticated risk management systems, the internal model floors, and the treatment of unfunded equity commitments and mezzanine debt.

C 1 Disincentive To Adopt Sophisticated Risk Management Systems

The Canadian banks have serious concerns with the treatment of Equity exposures in CP3. In the absence of an approved internal model, investment would be subject to risk weights of 300% and 400%, compared to a risk weight of 100% under the Standardized approach. The resulting capital charge would force banks to dramatically reduce their provision of equity capital to corporations and would serve as a significant disincentive to adopt more sophisticated risk management processes – a result that is in direct contradiction to the Committee's stated objective.

The Canadian banks strongly encourage the Committee to seek a solution to this issue that is better aligned with the stated objective of creating incentives for banks to pursue more sophisticated risk management methodologies.

Paragraphs 54 and 315

The QIS 3 results for the Canadian banking industry show an average risk weighting of their banking book equity portfolios between 250% and 400%. These results are drastically higher than the capital charges incurred under the Standardized approach.

While we acknowledge that the adoption of the IRB approach for equity in the banking book once the IRB approach has been adopted for any other major credit segment will eliminate blatant capital arbitrage, we are still very concerned about the competitive implications of the risk weight discrepancy. The largest incentives are given to the banks with the least sophisticated risk management framework. This introduces the danger of irrational pricing in the marketplace, and discourages the banks that are most capable of managing the risks associated with such investments from providing equity capital to the economy.

We acknowledge that the national supervisors have substantial discretion in encouraging more risk-sensitive approaches, either by increasing the risk weights used in the Standardized approach (paragraph 53) and/or requiring a bank to adopt the IRB approach (even if the bank chose the Standardized approach for other credit risks – paragraph 229). However, in the interest of a level playing field, we ask the Committee to address the current imbalance in the framework of the New Accord rather than relying on national discretion.

Recommendation

The Canadian banks strongly encourage the Committee to review the current risk weights in order to establish a better alignment with the Committee's stated objective of creating incentives for banks to pursue more sophisticated risk management processes and methodologies.

C 2 Capital Floors with Internal Models

The Canadian banks believe that under the market-based approach for equity exposures, risk weight floors should reflect the riskiness of the bank portfolio as evidenced by an internal model, and not depend upon pre-defined minimum risk weights that bear no relationship to actual risk levels.

The Canadian banks recommend that the internal model floor for both public and private equities be removed. If a floor is absolutely essential for the success of the New Accord, it should be set at a level not greater than 100%.

Paragraph 322

The Canadian banks have serious concerns with the proposed risk weight floors attributable to the equity internal model based approach. The capital charges for equities under the internal model cannot be less than the capital charges that would be calculated under the simple risk weight method using a 200% risk weight for publicly traded equity holdings and a 300% risk weight for all other equities.

Index	Period	Minimum	Maximum	Average	Standard Deviation	Historical 99th % VaR
MSCI World	Jan 1970 – Mar 2003	-16.58%	15.34%	0.86%	4.14%	-10.13%
MSCI EAFE	Jan 1970 – Mar 2003	-14.62%	18.52%	0.91%	4.86%	-11.66%
S&P/TSX Composite	Jan 1969 – Mar 2003	-22.52%	16.54%	0.83%	4.85%	-13.10%
S&P 500	Jan 1970 – Mar 2003	-21.13%	16.41%	1.02%	4.45%	-9.72%
Russell 2000	Jan 1979 – Mar 2003	-32.61%	23.61%	1.00%	6.69%	-17.45%
NB Small Cap	Jan 1987 – Mar 2003	-25.93%	13.99%	0.58%	4.79%	-10.32%
NB Pref. Total Rtn.	Jan 1993 – Mar 2003	-4.51%	3.64%	0.53%	1.11%	-2.45%
NB Pref. Price Rtn.	Jan 1993 – Mar 2003	-4.84%	2.95%	0.02%	1.15%	-2.94%

The Canadian banks understand that the research underlying the risk weight floor used a three-month time horizon. This is an arbitrary time horizon that may not reflect the liquidity of a bank's portfolio. We believe that unless liquidity is taken into account, risk weights will be set at unreasonably high levels. The table above details the results from a set of indices (all in Canadian dollars) using a one-month time horizon. As can be seen, with a one-month time horizon the risk level of each index is substantially reduced. The portfolios of some banks are comprised of highly liquid public stocks that can be sold in a matter of days or even hours. The New Accord should be flexible enough to reflect this common situation.

The implementation of an equity model in accordance with regulatory guidelines should allow a bank to benefit from its sensitivity analysis and not be limited by a floor. Floors or minimum capital charges are a disincentive for banks to move to a model-based approach, which is contrary to one of the key objectives of the New Accord. The floors may also inappropriately put some banks at a competitive disadvantage.

For example, Banks A and B may have an equal notional value of public equity exposures, but Bank A's equities are risky, volatile technology or mining issues, while Bank B's equities are large multinational bank issues. Bank A's internal model capital requirements would likely require a 200% risk weight equivalent, while Bank B's model would require a lower 100% risk weight equivalent. However with a floor, both Banks are required to hold 200%.

A similar case can be made for private equity exposures. For example, Bank A's private equity positions could all be investments in single name start up exposures, whereas bank B's private equities are only diversified funds or fund of fund exposures. Internal model results for each bank will no doubt produce different weights. However, under the New Accord both banks will be required to hold a minimum capital of 300% risk weight equivalent, which would put Bank B at a competitive disadvantage.

The disincentive to move to an internal model for private equities is even greater than that of public equities because of the lack of market data. It is more difficult to implement an internal model for private equities because there is no readily available market data, so proxy indices would have to be used and there is no doubt that there will be immense regulatory scrutiny over the use of proxy indices. Accordingly, there is no incentive to implement a complex and comprehensive internal model where the maximum capital benefits to be achieved is equivalent to only a 100% risk weight reduction (i.e., 400% simple method vs. max. 300% internal model floor).

Recommendation

The Canadian banks recommend that the internal model floor for both public and private equities be removed. This will ensure that there is an incentive for banks to move to a model based approach and ensure banks that take a less risky approach to investing in equities are not disadvantaged in comparison to banks investing in riskier assets. If a floor is absolutely essential for the success of the New Accord it should be set at a level not greater than 100%.

C 3 Unfunded Equity Commitments

The treatment of unfunded equity commitments is not explicitly covered in CP3 and clarification is necessary to ensure consistency and a level playing field, as these amounts can be significant in nature.

The Canadian banks recommend that, based on data and experience, direct commitments should have a CCF of 50%, indirect commitments 20%, and for commitments that are unconditionally cancellable or that effectively allow for automatic cancellation without prior notice, a 0% CCF is appropriate. To be consistent with EAD under the Advanced approach for corporates, banks that meet the minimum requirements for internal models should be allowed to use their own estimates of CCFs.

Paragraph 286

Similar to credit commitments, a conversion factor should be applied to unfunded equity commitments based on maturity or the expected drawdown horizon, and frequency. However, several alternative approaches exist for calculating the CCF:

- One approach is to use the same CCFs as for corporate exposures under the Standardized approach, as outlined in paragraphs 55 to 57. This would assign a CCF of 20% for under one year commitments and a CCF of 50% for over one year commitments.

- Alternatively, the EAD approach under the IRB Foundation approach would assign a CCF of 75% regardless of maturity. We feel that this is overly punitive and inconsistent with the Standardized approach.

Recommendation

The Canadian banks believe the economic reality of equity-type commitments is better reflected by the expected drawdown horizon and frequency, which differs by the type of holding.

– For Direct Commitments, the expected drawdown is usually under 1 year and should attract a high CCF, such as 50%. We recommend that the Committee use a CCF of 50%, consistent with our recommendation on page 6, related to corporate commitments.

– For Indirect Commitments, with typical commitment periods of 5 to 7 years in duration, experience suggests drawdowns occur uniformly over this period with up to 50% left uninvested[3]. Therefore, a reduced CCF such as 20% is warranted. Twenty percent is suggested as a conservative assumption, to reflect a 100% drawdown over the 5-year period.

– For commitments that are unconditionally cancellable or that effectively allow for automatic cancellation without prior notice, a 0% CCF should be applied.

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[3] Source: VentureXpert database from Thompson Venture Economics.

Furthermore, to be consistent with EAD under the Advanced approach for corporates, banks that meet the minimum requirements for internal models should be allowed to use their own estimates of CCFs.

C 4 Treatment of Mezzanine Debt

CP3 is unclear on the classification of mezzanine debt as either debt or equity, and requires clarification to promote consistency and a level playing field.

The Canadian banks recommend that mezzanine subordinated debt should be treated as debt and therefore covered under the PD/LGD approach.

CP3 is silent on the treatment of mezzanine debt. The Canadian banks believe that this is an issue that requires clarification in order to promote consistency and a level playing field. We believe that to classify mezzanine debt as equity would lead to excess capital requirements under the simple risk weight formula assuming a risk weight of 400%.

Mezzanine financing represents funding that is subordinated to traditional bank financings, and senior to high-risk equity financing. Examples of mezzanine financing can include: subordinated debt, convertible debt, and debt with warrants. Typically, mezzanine financing is structured as unsecured long-term debt, and may include an "equity kicker" in the form of warrants to purchase equity or conversion rights into common stock.

The scope of this proposal deals with mezzanine financings classified as junior subordinated debt. Treating these under a PD/LGD approach is consistent with the treatment of corporate loans and better reflects the economic substance of these transactions. The LGD assigned to these investments would be a distinguishing feature with empirical evidence (see chart below) suggesting a level consistent with the ones used for preferred share issues.

Recommendation

The Canadian banks recommend that mezzanine subordinated debt should be treated as debt and therefore covered under the PD/LGD approach.

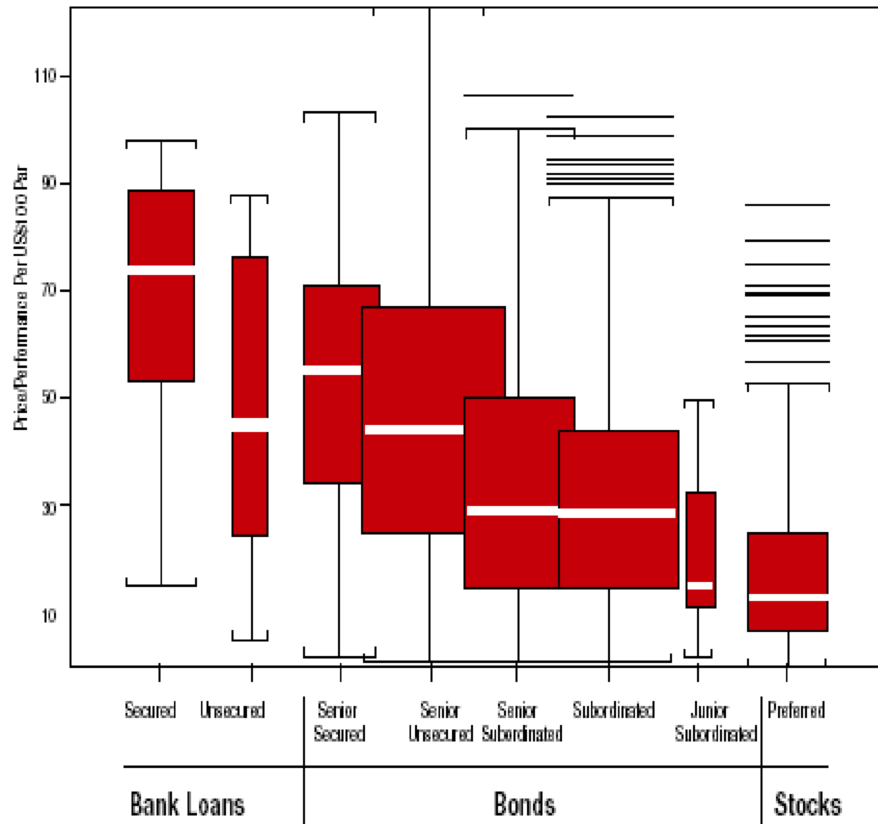

Figure 2 Default Recovery by Debt Type and Seniority, 1981-2000
This figure is adapted from Moody's 2001 annual default study; see Exhibit #20 in Hamilton, Gupton & Berthault [2001]. It highlights the wide variability of recoveries even within individual seniority classes. The shaded boxes cover the inter-quartile range with the median marked as a white horizontal line. Squared brackets cover the data range except for outliers that are marked as horizontal lines.

D. CREDIT RISK MITIGATION

The Canadian banks are concerned with the following issues relating to the credit risk mitigation rules in CP3: the "liquid" and "public market" requirements under the FIRB approach, the concentration risk requirement, the recognition of legally enforceable guarantees, and recognition of collateral for derivative exposures.

D 1 Liquid and Public Market Requirements under the FIRB Approach

In order to qualify for recognition of "other collateral" under the Foundation approach, there must be demonstrable "liquid markets" and "public market prices". These are standards that cannot be met for many of the types of collateral that underpin the bulk of mid-market lending. Nonetheless, there is ample historical evidence, of the ability to dispose of collateral in these markets on a timely basis, and a body of knowledge about average recovery rates for various types of collateral.

The Canadian banks recommend that the "liquid markets" and "public market prices" requirements be removed as they are neither justified nor necessary given other safeguards in the New Accord.

Paragraphs 484 and 485

For FIRB banks, supervisors may allow for the recognition of the credit risk mitigating effect of certain other physical collateral subject to the collateral types meeting two standards:

1. The existence of liquid markets for disposal of collateral in an expeditious and efficient manner; and
2. The existence of well established, publicly available market prices for the collateral.

These requirements for "liquid markets" and "public market prices" result in the exclusion of a *material* collateral component of inventory and equipment financing found in a typical Canadian mid-market banking book, and provide a disincentive to accept such collateral. For a smaller Canadian FIRB bank, this exclusion alone would result in an increased capital of 13% for loans collateralized by inventory and equipment.

We do not believe the requirements for "liquid markets" and "public market prices" are justified or necessary given the rigorous standards in place for recognition of such collateral (as outlined in paragraphs 472, 473 and 485, which ensure appropriate 1st liens, thorough documentation, inspection of collateral, and conservative policies and procedures, including valuation procedures and lending processes that already take into account the potential liquidity of the collateral being taken).

For purposes of the QIS 3 FIRB capital estimates, most Canadian banks included the credit risk mitigating effect of *all* "other collateral", inconsistent with the requirements for public and liquid markets that were introduced in CP3. To the extent that the Committee is satisfied with the shape of the QIS3 FIRB capital curve, we would point out that the "true" cost of capital, if the public and liquid market criteria were applied, would be significantly higher.

Recommendation

The Canadian banks recommend that the "liquid markets" and "public market prices" requirements be removed as they are neither justified nor necessary given other safeguards in the New Accord.

D 2 Concentration Risk Within A Bank's Total Exposures

The Canadian banks interpret the requirement to include "potential concentration risk within the bank's total exposures", as requiring the aggregation of indirect exposures to each issuer of a receivable that is taken as collateral, with direct exposure to that issuer/obligor in the bank's credit portfolio, on a bank-wide basis. While this is an admirable theoretical objective, it is not operationally feasible, not within a bank's control, and may introduce litigation concerns.

The Canadian banks strongly recommend that this requirement be deleted in the New Accord.

Paragraph 480

The Canadian banks support the operational requirement for the recognition of financial receivables when applied at the borrower level. Current lending and monitoring practices for receivables that secure operating or other advances already take into account concentration risk at the borrower level. This involves the review of the specific pool of receivables pledged by a borrower and evaluation of the quality of this pool of assets (e.g., banks routinely exclude receivables that are inappropriately aged, subject to offset, or arise from a related party transaction, etc.). Concentration limits within the receivable pool are employed, as well as financial analysis of the issuers of the receivables, when a small number of large-sized receivables are taken as collateral.

For an FIRB bank (and to the extent this requirement may be applied to AIRB banks), extension of the concentration risk standard to financial receivables "within a bank's total exposures" is not operationally feasible. Canadian banks do not extend concentration risk monitoring to encompass potential concentration of financial receivables taken as collateral from borrowers. This requirement goes far beyond the industry standard and creates an economically impractical and huge operational undertaking, which would be unreliable and of little value for the following reasons:

Access to Required Information
For many borrowers, where receivables are taken as security but not margined explicitly (e.g., most corporate borrowers), detailed receivables lists are not submitted on a scheduled basis and hence accurately tracking this information on a bank-wide basis would significantly change the way business is done for most corporate clients. It would also introduce a significant compliance burden and ongoing monitoring costs for both banks and clients.

Accuracy of Monitoring
In most circumstances, receivable listings are provided in non-electronic form with no observable, consistent naming conventions used. There is no ability to link names from receivables lists reliably to the names in a bank's credit portfolio. By their nature, a company's receivables change daily. The aggregation of receivables information across borrowers to "identify, measure, monitor and control" the risk would therefore be nearly impossible without international naming conventions and given the frequently changing nature of the receivables.

Legal Liability
Disclosure to clients that a receivable has been disallowed for a particular third party because of a bank's exposure concentration risk could well invite legal recourse from either the client or the third party, or both if market rumours resulted regarding the third party's financial capability and viability.

Recommendation

Given the other qualitative standards that a bank will have to meet in order to recognize the credit risk mitigation benefits of financial receivables (in paragraphs 474 to 483 and 485), the additional requirement to include "potential concentration risk within the bank's total exposures" is not operationally feasible and an unnecessary requirement. The Canadian banks recommend that this requirement be removed.

D 3 Recognition of Legally Enforceable Guarantees

Canadian banks are concerned that under the FIRB approach, legally enforceable guarantees that do not explicitly reference specific exposures of an obligor may not be eligible for recognition as a credit risk mitigation technique.

The Canadian banks recommend that, subject to national discretion, the lack of explicit references to specific exposures should not, in and of itself, preclude recognition of guarantees as "eligible collateral."

Paragraph 160

This requirement does not conform to established and tested market practice in Canada. It is general practice in the Canadian market to accept legally enforceable guarantee documents that cover not only existing advances but future unspecified advances as well. These guarantees include re-advances made under revolving facilities and amounts borrowed by way of overdrafts, etc.

The guarantees Canadian banks accept generally cover all advances of the borrower. For example, consider a borrower who has: $ 5MM Operating line, $4MM Term loan, and a $3MM Letter of Credit facility. A bank would accept only one guarantee for $12MM rather than three separate documents.

Often, general guarantees cover a variety of facilities that have varying maturities. As one loan is paid off, another may be advanced. In such cases, the need to provide explicit reference to exposures implies that a bank would be required to take a new guarantee as well as to retain earlier guarantee documents for exposures still active. Where CP3 requires explicit reference to

exposures, it is unclear how the value of the guarantee would be shared for LGD purposes. It is uncertain whether it would be based pro-rata on the original exposure size or the then-current exposure size.

In particular, a guarantee can be the means by which certain third party assets (e.g., accounts receivable) are included in an operating loan's margin calculation. By mentioning the operating loan explicitly, we would be concerned that the general and ongoing nature of a guarantee is compromised since it may introduce new grounds for the guarantor to challenge the document.

To require explicit reference to individual facilities would significantly increase the cost of managing these accounts as new back-office infrastructure would need to be introduced as well as cumbersome procedures. This requirement would also cause operational delays in advancing funds.

Recommendation

The Canadian banks recommend that an exemption be provided by way of referenced footnote to paragraph 160:

"Subject to national discretion, legally enforceable guarantees that are taken for present and future borrowings of an obligor including advances, re-advances and overdrafts, but which do not explicitly reference specific exposures, are allowed to be recognized as credit mitigants as long as they meet the other requirements of the New Accord, including paragraphs 160 and 161. Subject to national discretion, the lack of explicit references to specific exposures, in and of itself, will not preclude recognition of the guarantee as eligible collateral."

D 4 Recognition of Collateral for Derivative Exposures

Canadian banks are concerned that there is the potential to read the maturity mismatch rules in a manner that would not recognize the collateral received for derivative transactions that are subject to collateral arrangements, such as the ISDA Credit Support Annex.

Therefore, the Canadian banks recommend that the definition of maturity for collateralized derivatives should be defined so as to correspond with the frequency with which such derivatives are marked-to-market, rather than the final contractual maturity date of the underlying derivatives.

Paragraphs 172-174

As drafted, the maturity mismatch rules in CP3 do not recognize hedges of less than one-year residual maturity. Canadian banks are concerned that this rule will result in the exclusion of short-term securities and cash taken as collateral to hedge counterparty credit risk on collateralized derivative transactions of longer term.

A portfolio of derivative transactions with a counterparty subject to a collateral agreement, such as the ISDA (International Swaps and Derivatives Association) Credit Support Annex, is marked-to-market (usually on a daily basis) throughout the life of the portfolio. The counterparty must

provide collateral in the form of cash or securities to support any current exposure or positive current mark-to-market value of the portfolio. The underlying derivative transactions will usually consist of long-term derivatives (e.g., swaps of up to 20 or 30 years maturity), while collateral is either in the form of i) cash collateral, usually held as an overnight deposit; or ii) short-term government securities. This arrangement creates a maturity mismatch.

Collateralization is a significant and growing feature of derivative markets. The ISDA's 2003 Margin Survey measured the gross amount of collateral in circulation among reporting members as US$ 491 billion, and estimates the gross industry amount of collateral as US$ 719 billion. In the market today, cash and US government securities are the most commonly used forms of credit support and provide for effective and legally enforceable credit risk mitigation in capital markets.

Under the current Accord, these collateral arrangements are already recognized as valid credit risk mitigants leading to capital relief. If our interpretation of the proposed maturity mismatch rules in CP3 is correct, this would no longer be the case, and short-term collateral taken for long-term derivative transactions would be ineligible under the New Accord.

Recommendation

The Canadian banks recommend that the New Accord specify that the maturity of collateralized derivative transactions be defined to correspond with the frequency with which such derivatives are marked-to-market, (i.e. a daily mark-to-market derivative would have a term of one day), rather than the final contractual maturity date of the underlying derivatives.

E. SPECIALIZED LENDING

The Canadian banks raise the following issue in regard to specialized lending:

E 1 Exclusion of Non-asset based Transactions from the Specialized Lending Rules

CP3 is unclear on whether the specialized lending rules only apply to asset based financings.

The Canadian banks recommend that the Committee clearly exclude non-asset based transactions from the definition of specialized lending exposures.

Paragraph 188

The Canadian banks request clarity from the Committee on the treatment of tax-structured transactions and defeasances that are collateralized with cash or marketable securities. Ambiguity on this point creates level playing field issues.

Recommendation

The Canadian banks recommend that non-asset based transactions, such as tax-structured transactions and defeasances that are collateralized with cash or marketable securities, should be clearly excluded from the definition of specialized lending exposures.

F. SECURITIZATION

The Canadian banks are concerned with the following securitization issues: default excess spread levels, the different treatment of originating and investing banks, restricted use of the top-down approach in calculating K_{IRB} and the capital floor under the Supervisory Formula Approach.

F 1 Default Excess Spread Levels

The proposed 4.5% default excess spread level for revolving exposures may be appropriate for credit card securitizations, but is not appropriate for other revolving asset classes with significantly lower loss rates and higher quality underlying assets. Given the Committee's objective of increasing the sensitivity of risk measurement, default excess spread levels should reflect the level of risk in the underlying asset.

The Canadian banks recommend that separate thresholds be established for non-credit card securitizations that recognize the lower opening spread in different portfolios and the quality of the underlying assets.

Paragraph 558

It would appear that the Committee has calibrated threshold levels in a way that is only appropriate for collateral portfolios of credit cards and did not consider how it would apply to other types of revolving retail securitizations such as personal lines of credit (PLOCs) or home equity lines of credit (HELOCs).

The contingent liquidity risk associated with PLOCs is lower than for credit cards since the payment rate associated with these portfolios is generally lower than for credit cards and the quality of HELOCs is much higher as they are secured by real estate, while credit cards are not. However, as CP3 currently reads more capital would be required for PLOCs and HELOCs than for credit cards, which is inconsistent with the intent of the New Accord.

Recommendation

The Canadian banks recommend that separate thresholds be established for non-credit card securitizations that recognize the lower opening spread in different portfolios and the quality of the underlying assets. This would be consistent with how retail exposures are treated elsewhere in the New Accord.

This recommendation can be achieved by changing the thresholds to be a function of expected loss, resulting in a multiple of expected loss that is based on usual loss volatility for a specific asset class and the desired confidence level, to accurately calculate the capital required for worst-case losses. For example, in the case of credit card receivables, if expected loss is 2.25% and the multiple is calculated to be 2X, a default threshold level of 4.5% is appropriate. In the case of PLOCs, where expected loss is 0.05% and the multiple is calculated to be 3X, the

appropriate default threshold should be 0.15%. Alternatively, a third matrix could be developed that recognizes the lower opening spread.

F 2 Equal Treatment for Originating or Investing Banks

Capital requirements should be the same for any given risk whether held by an investing bank or an originating bank.

The Canadian banks urge the Committee to remove its differential treatment of originating and investing banks.

Paragraphs 568, 575 – 579, 606

One of the main reasons why the Committee originally embarked on the process to revise the 1988 Capital Accord was to recognize and take advantage of advancements in the techniques used to calibrate risk and quantify capital. In the area of securitization, the Committee had become increasingly concerned that the less risk sensitive 1988 Accord, through the use of four broad risk categories to assign capital, had resulted in capital market transactions whose main purpose was to take advantage of regulatory capital arbitrage.

As the Committee has gone to great lengths to recognize the ability of both rating agencies and internal risk management groups to more finely calibrate gradients of risk, it seems wholly unreasonable that the capital associated with any position should in any way be a function of where that risk is held and not a function of the underlying risk. Risk is risk, and all of the input variables that go into the calibration of risk and regulatory capital are the same regardless of where the risk is held. Calculating risk based upon irrelevant factors introduces arbitrage opportunities.

The Canadian banks note several examples in the securitization sections of CP3 where the amount of capital held is a function of whether the holder of that risk is the originator or an investing bank. We are not aware of any part of CP3, other than the securitization sections, where this phenomenon takes place. While securitization can be considered a “specialized” area, it certainly does not create any risks that are not already present in the underlying collateral or any risks that cannot be calibrated using techniques present in other areas. If the Committee is going to accept the rating agencies’ input on the calibration of capital in other areas by mapping capital to ratings, then it is unclear why there is a distinction in this case.

Furthermore, credit agencies do the same analysis for the generation of private ratings that they do for public ratings. It is unclear why the Committee has made this distinction.

<u>Recommendation</u>

The Canadian banks urge the Committee to remove its differential treatment of originating and investing banks. Furthermore, we urge the Committee to remove its differential treatment of public and private ratings.

F 3 Use of the Top-Down Approach in Calculating K_{IRB}

The bottom-up approach to the calculation of K_{IRB} is impractical for Asset Backed Commercial Paper administrators when they do not directly originate the assets.

The Canadian banks recommend that the top-down approach that is allowed when a bank is the liquidity provider also be available to a bank when it provides the credit enhancement.

Paragraph 574

The bottom-up approach to calculation of K_{IRB} is impractical for Asset Backed Commercial Paper administrators where they do not directly originate the assets. The data currently available from sellers is inadequate for PD and LGD estimates, making the calculation of K_{IRB} under the bottom-up approach impossible. Furthermore, there would be no material gain in the precision of risk assessment by using the bottom-up method versus the top-down method, but considerably more administrative costs.

If the top-down approach is viable for determining K_{IRB} for liquidity providers, it is not clear why it should be less viable for credit enhancement providers. The Canadian banks believe this is an artificial distinction that adds complexity without increasing risk sensitivity, creating an unnecessary burden for enhancement providers. If unable to calculate K_{IRB} using the bottom-up method, enhancement providers would have to deduct their positions from capital, which would likely cause some to exit the business and ultimately cause significant disruption and loss of liquidity in the market. This result is unnecessary and could be avoided.

Recommendation

The Canadian banks recommend that paragraph 574 be amended to permit the top-down approach to be used by credit enhancement providers.

F 4 Capital Floor under the Supervisory Formula

The capital floor of 56 bps under the Supervisory Formula provides no incentive for banks to adopt the IRB approaches.

The Canadian banks believe there is no need for the capital floor. However, to the extent that it remains, the Canadian banks recommend that it should be risk sensitive such that it should be adjusted in situations where a material amount of expected loss was sold to unaffiliated third parties.

Paragraph 589

With the floor at 56 bps there is no motivation for banks to adopt the IRB approaches as significant resources are required for the SFA (Supervisory Formula Approach) calculations with the capital requirement still constrained by the floor for the majority of exposures in any event. The floor at 56 bps would result in regulatory capital as much as double the economic capital for certain positions. This is so punitive it could have significant impact on the merits of the business. Additionally, with a floor so high, there is no incentive to sell or distribute risk to third parties. If, for example, 15 bps of expected loss was sold to an unrelated third party, the bank should be able to deduct that from the 56 bps floor.

Recommendation

The Canadian banks recommend that the capital floor under the SFA be eliminated. However, to the extent that the Committee believes that this floor must be maintained, it should be risk sensitive and adjusted in situations where a material amount of expected loss was sold to unaffiliated third parties.

G. OPERATIONAL RISK

The Canadian banks generally are supportive of the Operational Risk component of the New Accord, but we do have concerns regarding the final calibration of beta factors and related data collection, the alternative standard approach, and risk mitigation.

G 1 Data Collection and Beta Factor Calibration

The Canadian banks continue to believe that the establishment of beta factors for the Standardised approach should be based on actual loss experience and that the imposition of any interim qualitatively based process to establish the initial betas would not address concerns over risk sensitivity.

The Canadian banks recommend continued operational risk data collection through the Loss Data Collection Exercises (LDCE) and that final calibration of the betas should be done as closely in time as possible to the implementation of the New Accord. The New Accord should also permit subsequent re-calibration to reflect changes in risk profiles due to actual loss experience.

Paragraph 624 (b)

The initial betas presented in CP3 are based on historic allocations of internal operational risk capital within the global industry and not on actual loss data. While the industry is sensitive to the need for specifying initial betas, the current lack of data does not allow us to opine on the validity of the initial betas at this time. However, relative rankings of the betas presented in the paper do not appear to be beyond what we would reasonably expect.

Recommendation

While Canadian banks recognise that current loss data is not sufficient, we strongly support operational risk data collection through the ongoing LDCE process and that final calibration of the betas should be done as close as possible to implementation of the New Accord. The wording of the New Accord should also permit subsequent re-calibration during the life of the New Accord, to reflect changes in risk profiles due to actual loss experience.

G 2 Alternative Standard Approach (ASA)

The New Accord should make it explicit that firms choosing to use the ASA must meet the same qualifying criteria as those using the Standardized Approach.

G 3 Risk Mitigation

The Canadian banks recommend that the definition of risk mitigation be broadened beyond the classic example of insurance contracts to include other contracts such as alternative risk transfer products.

Paragraphs 637 - 639

For all risk mitigation products (including insurance), the Canadian banks would support a policy that would recognize mitigation to the capital charge driven by an "expiry term" computed as the lesser of the residual term to maturity, and minimum notice period for cancellation and non-renewal on the part of the counterparty. The level of mitigation to the capital charge would depend on the length of the expiry term with, for example, haircuts being applied that would still incent durations less than one year but amortize to a point at which time there would be no benefit.

Recommendation

The Canadian banks recommend that the definition of risk mitigation be broadened beyond the classic example of insurance contracts to include other contracts such as alternative risk transfer products. To qualify, these alternative risk transfer products should be directly and explicitly mapped to the operational risk exposure of the institution and be irrevocable.

H. TRADING BOOK

H 1 Add-on Factors for Protection Sellers of Credit Derivatives

The add-on factors for a protection seller to cover potential future exposure for single name credit derivative transactions in the trading book, are arbitrary and do not accurately reflect the nature of counterparty credit risk.

The Canadian banks recommend a more accurate and risk sensitive approach; that is, the add-on factor should be the maximum loss that a bank could sustain upon counterparty default and assuming credit spreads fall to zero.

Paragraph 675

In credit derivative markets, protection sellers usually sell credit derivatives for an annualized fee (only in rare circumstances is the full fee paid upfront, whereupon there would be no counterparty credit risk). The maximum loss that the protection seller can lose upon the default or insolvency of the protection purchaser is the present value of any unpaid fee amount.

For example, consider a bank that sells protection on a qualifying asset for 3 years at a fee of 90 bps per annum. At inception, the most the bank could lose if spreads contract to zero is the PV of future fees; here a maximum of 270 basis points. This represents 2.7% of the notional amount, which is less than the 5% factor. Alternatively, consider a bank that sells protection on a qualifying asset for 5 years at a fee of 350 bps per annum, which results in a maximum loss of 1,750 basis points or 17.5% of the notional amount, which is significantly more than the 5% factor.

Recommendation

The Canadian banks recommend a more accurate and risk sensitive approach; that is, the add-on factor should be the maximum loss that a bank could sustain upon counterparty default and assuming credit spreads fall to zero. This would be calculated as the total amount of any unpaid fee; that is, for greater conservatism, banks should not be able to present value this unpaid fee amount in order to determine the maximum loss.

II. PILLAR II SUPERVISORY REVIEW

The Canadian banks recognize that national regulators will play a pivotal role in the implementation of the New Accord and are supportive of the supervisory principles outlined in Pillar II. The Canadian banks have set out suggestions for improvements to Pillar II, which focus on making the supervisory process more efficient, transparent and equitable, while allowing supervisors to achieve their goal of ensuring that banks are adequately capitalized relative to their individual risk profiles.

I 1 Clarification of Scope and Purpose of Pillar II

The Canadian banks support the position jointly proposed with the Australian, American, Japanese, and European banking associations in a July 7, 2003 letter addressed to Mr. Caruana, Chairman of the Basel Committee, that asks for clarification of the objectives of Pillar II. Of specific concern is the general blurring of the purpose of Pillar II and the relationship between Pillars I and II.

The proposed New Accord includes a series of risk issues, which seem to indicate that Pillar II 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.

The Canadian banks recommend that the Committee provide clarification as to the scope and purpose of the application of Pillar II in order to better facilitate convergence in its implementation.

Paragraphs 719 - 755

I 2 Credit Risk Stress Test Add-On

The Canadian banks submit that the requirement to hold additional capital on the basis of a credit risk stress test is redundant and inefficient.

The Canadian banks recommend that the credit risk stress test add-on be deleted. At most, the credit risk stress test should be a qualitative factor that informs a supervisor's review under Pillar II.

Paragraph 724

Paragraph 724 states "A bank should ensure that it has sufficient capital to meet the Pillar I requirements and the results (where a deficiency has been indicated) of the credit risk stress test performed as part of the Pillar I IRB minimum requirements…. The results of the stress test will

thus contribute directly to the expectation that a bank will operate above the Pillar I minimum regulatory capital ratios."

The Canadian banks submit that this requirement is redundant given the requirements of Pillar I. IRB capital is specifically calibrated to address possible variation in credit losses. The QIS 3 results for the New Accord have been calibrated to ensure an appropriate level of minimum capital; it should not be an expectation that all banks will have to operate at some stressed level above the reported amounts.

The Canadian banks further submit that the stress test capital requirements are counter-productive. Paragraph 397 permits each bank to choose its own stress test, subject to supervisory review, and allows it to be implemented differently. The amount of capital required for a given credit risk stress test will therefore vary among banks. This will undermine the comparability of results, create an explicit opportunity for arbitrage, and distort the level playing field between different banks and jurisdictions. Banks with more lenient stress tests would require less capital and would have a pricing advantage over their more conservative competitors. Additionally, such a paradigm would invalidate the Committee's QIS exercises to date, and put regulatory capital into a realm where there are no standards or benchmarks. None of these outcomes is desirable from a regulatory perspective.

Recommendation

The Canadian banks propose that the credit risk stress test add-on be deleted. At most, the credit risk stress test should be a qualitative factor that informs a supervisor's review under Pillar II.

I 3 Level Playing Field/Competitive Equity/Home Host Regulators

Given the complexity of the New Accord, the opportunities for national discretion, and the differing implementation intentions between jurisdictions, it is of critical importance to banks that appropriate mechanisms be put in place to minimize the potential impact of conflicting requirements between home and host regulators, and to help ensure that the playing field is as level as possible.

The Canadian banks seek assurance from the Committee that such mechanisms will be established. To that end, we seek assurance in four specific areas, and recommend that multilateral and bilateral "Memoranda of Agreement" be negotiated between supervisors to ensure clear articulation of roles, responsibilities and order of precedence.

Pillar II

The Canadian banks recognize that each national regulator has the ultimate responsibility for promoting safety and soundness in its respective financial systems, notwithstanding the varying degree of authority that national supervisors have in their respective jurisdictions. Differing accounting, legal, financial, and market environments further complicate maintaining consistency and competitiveness on an international basis. Therefore, for a regulator to exercise national discretion, including establishment of trigger and target ratios, and defined capital categories above minimum ratios, there must be clear and transparent standards established by the

Committee. These standards are required at both the national and international levels to ensure consistent application from one regulated body to another, and from one country to another.

The Canadian banks believe consideration should be given to establishing a more structured coordination mechanism, such as the Committee or similar type body, to ensure that national discretion is exercised without unduly affecting competitive equality. This is especially important in the G-10 countries as these jurisdictions house the majority of the activities of international banks.

In the April 2003 paper entitled Overview of the New Basel Capital Accord paragraph 60 states, "…to promote consistency in the implementation of the [New Accord] across jurisdictions, the Committee established the Accord Implementation Group (AIG) for national supervisors to exchange information on the practical implementation challenges of the Basel II and the strategies they are using to address these issues." Furthermore, paragraph 66 states "…the AIG is developing a set of principles to facilitate closer practical co-operation and information exchange among supervisors."

The Canadian banks request that the Committee modify the New Accord, and that the Accord Implementation Group (AIG) establish standards and procedures for member supervisory bodies, to reflect the recommendations below.

Recommendation

The Canadian banks seek changes in the New Accord to ensure that:

1. There will be clear and transparent guidelines for how the New Accord will be implemented in each member jurisdiction;

2. An appropriate mechanism will be developed to minimize the potential for (and impact of) conflicting requirements between national supervisors (and that any such conflicts that do still arise will be worked out between supervisors);

3. While recognizing the jurisdictional responsibilities of home and host supervisors, "validation" of IRB and AMA qualification, ratings systems, parameter estimation processes and operational risk models will be done primarily for the home supervisor, and information will be shared with the relevant host supervisors, as appropriate.

4. Reciprocal recognition will be given to the work of individual supervisors so that duplication will be minimized for the affected financial institutions.

The Canadian banks also recommend the development and documentation of multilateral or bilateral "Memoranda of Agreement" between supervisors, so that the respective roles and responsibilities are clearly articulated and financial institutions are clear about what rules and guidance take precedence. Moreover, we suggest that such development and documentation be pursued with urgency, as clarity around these issues is required before banks proceed too far with their implementation preparations.

I 4 Supervisory Transparency and Accountability

The Canadian banks endorse the spirit of transparency outlined in the New Accord, and ask that this practice apply globally and consistently between international jurisdictions and domestically between industries with similar products and business lines.

The Canadian banks recommend that the New Accord clearly provide that supervisors are obliged to publicize their exercises of national discretion and supervisory guidance (including criteria, target or trigger ratios and factors) to the world at large, not just to their own institutions.

Paragraph 756

The Canadian banks wish to ensure that prudent risk management, subject to supervisory review, does not ultimately penalize the banking industry when competing against banks in other international jurisdictions and domestic less-regulated industries.

To achieve this goal we believe it is necessary for the banking supervisors in each G-10 country to publish each guidance item or interpretation referenced to the applicable paragraph in the Final Accord document, so that individual financial institutions may assess their own status, determine what the benchmarked international standards are, and make appropriate decisions as to corporate and product strategy as a consequence.

This transparency is also critical to the assessment of the New Accord itself. Transparency will allow a determination of whether the New Accord has (a) achieved its stated public policy objectives, and (b) especially given the higher degree of national and supervisory elective decisions, whether greater or lesser competitive equity has been achieved.

The Canadian banks hope that the capital adequacy requirements formulated by the Committee and national regulators ensure that capital requirements reflect the quality of risk management of an institution and not the divergence of jurisdictional supervisory interpretations.

Recommendation

The Canadian banks request that paragraph 756 of the New Accord be revised to clearly provide that supervisors are obliged to publicize their exercises of national discretion and supervisory guidance (including criteria, target or trigger ratios and factors) to the world at large, not just to their own institutions.

As an example, the Canadian banks submit that national supervisors' interpretations of the reference definition of default should be publicized internationally, in accordance with the transparency provisions of paragraph 756.

I 5: Provision for Implicit Support – Prohibition from Capital Relief

The Canadian banks submit that paragraph 747 should be revised to eliminate the power of national supervisors to deny capital relief for planned securitizations pending completion of an investigation into the provision of implicit support.

Paragraph 747

Paragraph 747 of CP3 allows a national supervisor to deny a bank capital relief for any planned securitizations pending an investigation into the alleged provision of implicit support.

This is fundamentally unfair, as it allows supervisors to punish banks for alleged misconduct prior to any investigation and prior to any finding that the bank had indeed provided implicit support. It is also unnecessary given the onerous punishments that a supervisor may impose once a bank has been found to provide implicit support (see paragraphs 745 and 746).

Recommendation

The Canadian banks recommend that paragraph 747 should be revised to eliminate the power of national supervisors to deny capital relief for planned securitizations pending completion of an investigation into the provision of implicit support.

III. PILLAR III DISCLOSURE

The Canadian banks are generally supportive of the Pillar III disclosure principles as outlined in the New Accord; however, there is concern that the proposed disclosure of quantitative information is proprietary, not comparative, and open to misinterpretation. In particular, we suggest changes to the quantitative disclosure requirements in Table 6 "Disclosures for Portfolios subject to IRB Approaches" as outlined below.

J 1 Quantitative Disclosure Requirements – Table 6

Quantitative disclosure requirements in Table 6 of Pillar III, specifically exposure and LGD by PD or EL grade, continue to raise proprietary and competitive concerns. Moreover, PD grades are frequently not comparable between banks and the reader could misinterpret these disclosures.

Notwithstanding that the Canadian banks would prefer to see Table 6 eliminated from the New Accord in its entirety, we nevertheless recommend disclosing exposures at the level of investment grade, non-investment grade, and impaired categories for each portfolio except retail, and performing and impaired categories for retail portfolios.

Table 6, Section (e)

The Canadian banks do not share the Committee's view that the requirements set out in Pillar III "…strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information". In fact, it remains a significant concern that certain required disclosures are proprietary (e.g. probabilities of default, loss given default data), and will compromise the competitiveness of the Canadian banks individually and as an industry.

It is the Canadian industry's view that making the model parameters public would (a) undermine the institution's competitive position given the impact on product pricing, and b) reduce availability of credit to both small business and sub-investment grade clients, as more institutions will be under pressure to justify the use of lower factors that can only be achieved by lending to top tier companies. In addition, it would require disclosing the effective risk management practices and techniques (i.e. best practices) an institution has adopted that support the lower model parameters, but which represent the proprietary intellectual capital of the organizations.

The development of the parameter estimates by each institution could involve different assumptions. For example, the time frame over which the "long-run average" estimates is calculated will differ among banks and will contribute to variation in the parameter estimates even where the risk is comparable. As such, there will be lack of comparability and potential for misinterpretation by users of the information, which is counter to the intent of Pillar III. As a result, disclosures should be structured in order to retain as much comparability as possible, which suggests disclosure at a level of aggregation agreeable to all.

Recommendation

Notwithstanding that the Canadian banks would prefer to see Table 6 eliminated from the New Accord in its entirety, we nevertheless recommend the following changes (underlined) be made to paragraph (e) of Table 6:

For each portfolio (as defined above) except retail:

- Presentation of exposures (outstanding loans and EAD on undrawn commitments, outstanding equities) for investment grade, non-investment grade, and impaired categories;
- For banks on the IRB advanced approach, default-weighted average LGD (percentage) for each category (as defined above); and
- For banks on the IRB advanced approach, amount of undrawn commitments and default weighted average EAD;

For retail portfolios (as defined above):

- Analysis of exposures on a pool basis (outstanding loans and EAD on commitments) for performing and impaired categories;

GENERAL CONCERNS

Extension of Minimum Capital Floors

The Canadian banks request more clarity on what circumstances would cause the minimum capital floors to be extended beyond 2008. Specifically, we request clarity around who would be making the determination, what criteria they would use, and on what level their decision would apply (i.e., internationally, nationally, or to individual banks).

Broadly in Line Requirements

The Canadian banks are concerned that the Committee's current timeline for implementation requires that banks must use risk-rating systems that are "broadly in line" with the minimum requirements of the Accord for at least three years prior to qualification. If the current schedule is kept, the date the New Accord is expected to be signed and bank's risk rating systems are required to be broadly in line with the New Accord will nearly coincide.

Less Standard Exposures

While the Committee has made significant improvements in CP3 overall, the Canadian banks are concerned that the IRB approaches will not work well for the less standard types of exposures such as margin lending, repurchase agreements and securities lending.

In these businesses areas, the level of risk undertaken is significantly less than in other portfolios, and therefore does not warrant the same level of risk assessment, compared to the more common bank portfolios. The Canadian banks propose that the Committee grant national supervisors the ability to apply different standards for portfolios of this type.

Outstanding Issues

There are specific flaws in CP3 that the Committee has indicated that they will not address during this consultation process. Although we have not formally responded to these issues in the submission, the following issues remain as points of concern for Canadian banks:

- Refusing recognition of double default considerations in credit derivatives and guarantees knowingly contradicts the very real reduction in credit risk afforded by such products, and discourages their prudential use in managing a bank's credit risk exposures.

- Incorporating expected losses into a capital calculation without full recognition of all appropriate offsets is inappropriate. Capital should be held for unexpected losses only.

- Forcing a minimum probability of default of 3 bps is arbitrarily punitive and produces an incentive to avoid conducting business with the world's most reliable firms.

- The Committee in the last line of paragraph 63 of the paper entitled Overview of The New Basel Capital Accord dated April 2003, stated that it "…intends to consider issues, such as a revised treatment of potential exposures associated with OTC derivatives, that it was unable to include in Basel II." An early review of this issue is welcomed, with consideration of the use of internal models for own-estimates of individual transaction and portfolio based potential future exposures (PFE) as originally supported, in principle, by the Committee in paragraph 117 of the second consultative paper document, The Internal Ratings-Based Approach.