

April 16, 2010

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

Dear Sirs/Madams:

**Re: CBA Comments on the Basel Committee's consultative document
"Strengthening the resilience of the banking sector"**

The Canadian Bankers Association¹ would like to thank the Basel Committee for the opportunity to comment on the December 2009 consultation paper entitled *Strengthening the resilience of the banking sector*, and for its ongoing willingness to discuss and respond to industry concerns.

We agree with the Basel Committee's goal of promoting a more resilient banking sector with an improved ability to absorb shocks arising from financial and economic stresses, such as those experienced in the 2007-2009 crisis. The consultation paper laudably outlines potential reforms to the international regulatory framework. While we support the Basel Committee's goal and comprehensive response to the issue, we believe it would be productive for the Basel Committee to examine the factors that contributed to the ability of the banking industry in some jurisdictions such as Canada, to successfully weather the recent financial crisis.

From our perspective, both the Canadian system of regulatory oversight and our banking business model contributed to the strength and resilience of the industry. We utilize a robust, principles-based regulatory system where all banks are under the scrutiny of one regulator with a clear mandate. We believe financial institutions are made safer through effective bank supervision (i.e., an effective process whereby regulators identify and resolve risk management problems at individual institutions) not simply by enforcing compliance with fixed and detailed rules. We believe that regulators could achieve protection/oversight more effectively through well-structured principles-based requirements augmented by the disciplined Pillar 2/ICAAP process. With respect to the Canadian banking model, we would point to the following factors as sources of strength: 1) Our banking business is predominantly an "originate to hold" rather than an "originate to sell" model; 2) We utilize effective risk management practices and embed risk management as part of our culture; 3) We use simple, common sense loan-to-value (LTV) rules regarding residential mortgages and insurance requirements; 4) Our legal system provides

¹ The Canadian Bankers Association works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 263,400 employees to advocate for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions.

recourse to borrowers in the event of default; and 5) Our tax system does not incent leverage through tax deductibility of mortgage payments. The Canadian experience clearly demonstrates that effective principles-based regulation is more effective and we would caution against over-reliance on rules-based regulation. It is our recommendation that the Basel Committee give further consideration to the interplay between effective supervision, risk management, and prudent bank business practices in their efforts to reform the global banking industry.

Our analysis demonstrates that the proposed reforms are significant and we are concerned that the changes have been constructed without a holistic view of the impact and of the unintended consequences for banks and the economy at large. We encourage the Basel Committee to use the Quantitative Impact Study (QIS) results to provide a general indication of what is most important and implement those items, since the consequences of requiring too much cumulative capital can be as shocking to the world economy as managing with too little capital for the risks. For example, we believe that the cumulative impact of the capital proposals will increase the amount and cost of capital required to be held by the banking industry. This will result in increased costs to borrowers, a reduction in lending and, in some cases, curtailment of certain business activities. We also believe that it is essential that sufficient time be allowed for stakeholders to consider the possible long-term cumulative impact of the comprehensive package of reforms that are being proposed by the Basel Committee as well as other government and regulatory bodies.

Our concerns with the draft proposals are outlined below, with more detailed, paragraph-specific issues addressed in the attached Appendix 1 ("CBA Comments"). Please note our two fundamental concerns:

- We do not agree with the capital proposals being premised on a severe stress scenario, in part because this assumption would result in banks needing to hold excessive levels of capital at all times for exceptional circumstances. Nevertheless, to emphasize some of the difficulties with the proposal, we have provided our comments through this lens which assumes an extreme stress scenario; and
- We do not believe it is appropriate to take a solvency view for capital adequacy purposes. The objective of capital adequacy should be to ensure that entities are able to withstand stressed environments on a going concern basis.

1. Implementation

a. Asymmetry

It is essential that the Basel Committee develop a clear implementation strategy that highlights the importance of global, symmetric adoption of common regulatory reforms that establish a "level playing field". We are concerned about the potential for banks to be disadvantaged if there is asymmetric implementation of the proposed capital changes. In the past, regulatory changes have often been implemented asymmetrically. Banks in "first-mover" jurisdictions could be seriously disadvantaged unless the final rules are implemented at the same time and in the same manner by regulators around the world. It would be an ironic result if the the proposals were adopted more quickly, or with a shorter transition period, in jurisdictions with well-capitalized banking systems, thereby putting banks that performed effectively through the crisis at a competitive disadvantage.

b. Timing

The development of an implementation strategy should also consider timing and grandfathering issues. The transition to new requirements should be properly phased, globally aligned, and timed to minimize disruption of market recovery and of the industry's ability to meet credit demand. It will be important to grandfather existing capital instruments which were issued under the current Basel requirements. Grandfathering should cover the required proportion of Tier 1 and its components, the "predominance" requirement, and capital deductions. In designing the grandfathering and phase-in requirements, it is important that market perceptions and effects be taken into account. Relatively long (or indefinite) grandfathering periods will be necessary to avoid diluting the purpose of grandfathering, as the markets may be induced to factor in higher costs of capital well in advance of the grandfathering date, thus burdening the raising of additional financing.

2. Access to Capital/Potential Deleveraging

The ability of a capital-dependent industry to have access to deep, broad and varied sources of capital is fundamental to supporting normal economic growth. Innovative Tier 1 capital, which is the only institutionally targeted non-common Tier 1 product in Canada, is being eliminated in the proposals. In addition, Canadian banks cannot raise tax deductible non-innovative Tier 1 capital as is the case in many European jurisdictions. With this in mind, we advocate that the regulatory criterion for inclusion in Tier 1 Additional Going Concern Capital be drafted with enough flexibility to allow for high quality capital that may accommodate the tax and legal regimes of different jurisdictions. With this in mind, we advocate that the regulatory criteria for inclusion in Tier 1 Additional Going Concern Capital allow for a more flexible range of features that permit banks to access a broader range of investors (e.g., long-dated instruments with a lock-in/extension feature at maturity).

We understand the Basel Committee's focus on common equity, given the experience of inadequately capitalized banks during the credit crisis. However, it is important to note that the differing types of capital instruments provide strength to the financial system through investor diversification on a going-concern as well as gone-concern basis. With this in mind, the limit on the non-common component of Tier 1 capital should be set at a sufficiently high level that allows financial institutions the ability to access a wide investor base, including in times of stress. The Canadian regulatory limit of 40% non-common Tier 1 capital allowed Canadian banks to access sufficient capital during the financial crisis and we advocate maintaining this limit.

Overall, we believe that the cumulative impact of these proposals will increase the amount and cost of capital required to be held by the banking industry. We are concerned that there is insufficient worldwide capacity for banks to recapitalize (at any price) to the extent required by the new rules. Our concerns may be further compounded by any future proposal requiring that all capital instruments convert to common equity based on a set of triggers. Contingent capital has not yet been proven to be viable, could limit a bank's ability to recapitalize itself when it encounters modest difficulties, and may not be rated, thus limiting the investor base. Overall, the proposals will increase borrowing costs for retail and commercial/corporate customers and/or reduce lending capacity, and in some cases result in the curtailment of certain business activities. When finalizing the proposals, we strongly believe that the Basel Committee should further consider the interplay and cumulative impact of all regulatory changes, both capital and liquidity, as well as the potential impact on and capacity for both larger and smaller economies to adopt the changes.

In addition, based on preliminary assessments and using the Basel Committee's proposed definition of capital, common equity ratios could be reduced by approximately half or more for the Canadian banking industry. Depending on the calibration of the minimum common equity capital ratio in the future, the Canadian banks would be faced with a significant recapitalization requirement or would seek to reduce risk weighted assets to meet the new standard.

3. Capital Deductions

We understand the Basel Committee's desire to raise the quality, transparency and consistency of bank capital. However, we disagree with the approach the Basel Committee has taken in moving the majority of deductions to common equity which is often inconsistent with the concept of "going-concern" and "gone-concern capital". We advocate a more measured approach that is based on review of the economic characteristics of each proposed deduction. Such a review would conclude that, in some cases, a reduction of the amount of the capital deduction or a limit on the amount included in capital, and/or an allocation of at least a part of the deduction to Tier 2, would be warranted (in fact, it may be appropriate to only incorporate these deductions as part of the Pillar 2 capital adequacy assessment). For example, deferred tax assets that rely on the future profitability of the bank to be realized, are proposed to be deducted from common equity. By definition, this assumes that the bank is no longer a "going-concern". If that is the case, then the deduction should at least be shared between Tier 1 and Tier 2 capital. In addition, the full deduction of substantial investments, including insurance subsidiaries, from common equity is inconsistent with a 'going concern' assumption as no value is attributed to these investments. Again, an approach consistent with the "going-concern" and "gone-concern" focus on capital would be a partial deduction from Tier 1 and Tier 2 capital. We urge the Basel Committee to assign greater value to Tier 2 capital in adjusting for assets that may not be fully realized in a stressed, but "going-concern" scenario.

We also support an approach whereby deductions from capital are only taken for amounts in excess of defined limits; similar to what is allowed for Intangible Assets in Canada.

4. Potential Disruption to Key Markets

Unintended consequences of the proposed reforms include higher borrowing costs and lower deposit rates for consumers (as a result of higher capital and liquidity levels, and a higher cost of borrowing and capital for financial institutions); a reduction in available credit in the system, constraining economic growth; and a reduction in the bank capital investor base.

In addition, the effect of requiring banks to deduct unrealized losses on available for sale (AFS) debt securities from common equity, combined with the need for banks to both raise more long-term debt and hold more liquid assets (as envisioned by the Basel liquidity proposals), would likely lead to disruptions in the short and long end of the yield curve in the cash and derivative markets. This would be a particular concern in less liquid markets like Canada's. This would have adverse impacts not only on banks but all market participants. Certain previously regulated activities may also move into the unregulated market, which could increase rather than reduce systemic risk.

In addition, we are concerned about the proposals related to commitments and derivatives for purposes of the leverage ratio, as follows:

Commitments — The need to effectively "pre-fund" all commitments (whether committed or unconditionally cancellable) via the 100% credit conversion factor in the proposed leverage ratio (including commercial paper back-up lines, securitization backstop facilities as well as committed lending products to retail and small business) will increase the cost and reduce the availability of these products. The assumption of a 100% drawdown is not in line with actual experience during economic downturns, and we propose that unconditionally cancellable commitments not be included in the leverage ratio. We also propose that the Basel Committee review the appropriateness of applying conversion factors to committed lines.

Derivatives — The elimination of derivative netting from the leverage ratio discourages this highly effective and proven form of risk mitigation. Although the intent of the proposals may be to dampen the entire derivatives market, many derivatives are done for risk reduction purposes (i.e., hedging) and the proposal will increase the costs to clients.

5. Capital Buffers/Pro-cyclicality

Overall, we believe the proposals on capital buffers are insufficiently developed, lack specificity, and dismiss the principles and objectives of Pillar II. We question their effectiveness in combating pro-cyclicality, and strongly suggest the focus be on continually improving ICAAP and stress testing processes, along with firm-specific discussions with regulators.

In addition to this overarching concern, we believe there are flaws in other aspects of the proposals. Our preliminary analysis indicates that calibration, at what now appears to be the bottom of the cycle, will result in high levels of capital surplus at the top of the cycle, much of which will be unusable. These high levels of capital surplus would significantly impair a financial institution's risk-adjusted profitability and decelerate capital build-up during the economic expansions due to reduced net income per unit of capital base.

The capital buffer may establish adverse incentives, which may increase economic risk during upturns in order to increase the returns on deployable capital to compensate for the large amount of excess capital. This would cause banks to shift their portfolio composition, for example, towards riskier exposures. Although this would make use of the excess regulatory capital buffer, it is not the desired behaviour from a systemic risk perspective.

A key theme of the consultation paper is to reduce procyclicality. However, many of the proposed deductions, such as the deferred tax assets and counterparty/CVA deductions, would exacerbate procyclicality.

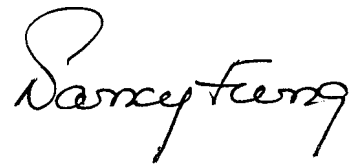
6. Best Efforts Nature of QIS

We are concerned in several respects with the short period of time being allowed for the completion of the QIS, given the importance of proposed reforms and likely impact on the industry. Much of the data required will need to be calculated and modeled on an ad-hoc basis as opposed to coming from existing databases. The compressed timeline provides little opportunity for consultation, review and alternatives, which, given the scope and significance of the exercise, is inappropriate. We have the further complication for Canadian banks of determining the impact of the pending adoption of IFRS on the calibration.

There is a risk that the safety and stability of the global financial system could be undermined by reliance on data that is not sufficiently robust, given the QIS is being conducted globally on a best efforts basis and many proxies and estimates will be necessary for data that is not available. With that in mind, it is essential that the Basel Committee engage in an active dialogue with the industry regarding the results of the QIS. It is important that the industry and regulatory community have sufficient time to analyze and discuss the data before decisions are made regarding the structure and calibration of revised regulatory reforms.

Thank you for considering our comments and suggestions.

Yours truly,

A handwritten signature in black ink, appearing to read "Samy Fung". The signature is fluid and cursive, with the first name "Samy" and last name "Fung" clearly distinguishable.

Attachment — Appendix 1: CBA Detailed Comments

cc: OSFI (Gilbert Ménard, Richard Gresser)

Canadian Bankers Association (CBA) Comments on the Basel Committee's Consultative Draft: *Strengthening the resilience of the banking sector*

1. RAISING THE QUALITY, CONSISTENCY AND TRANSPARENCY OF THE CAPITAL BASE

General (Pars. 66-68)

- We agree with the emphasis placed on Tier 1 and common equity capital but there is danger of losing sight of the importance of additional Tier 1 and Tier 2 instruments. This is important as firms may be required to seek a large amount of new financing. Excessive focus on core Tier 1 will unduly inhibit efficient financing of firms especially if the range of available instruments (and hence of investor bases to tap) is unduly constrained. This is a concern in Canada since innovative Tier 1 capital, which is the only institutionally targeted Tier 1 product in Canada, is being eliminated in the proposals.
- Similarly, too much reliance on one instrument – especially common equity subject to an extensive range of deductions – is likely to augment procyclicality and reduce firms' flexibility in responding to changes in market conditions. It is important to maintain flexibility to offer capital in forms other than common capital since this diversifies the capital base. We believe that some of the rules are too restrictive and may make it difficult for internationally active banks to raise capital internationally.
- We believe that it is necessary to have common capital targets across jurisdictions, using harmonized definitions and a consistent implementation plan.

Capital Composition Limits (Pars. 85-92)

- While we acknowledge that common equity should be the predominant form of Tier 1 capital, the limit on the non-common component should be set at a sufficiently high level that allows financial institutions the flexibility to access a wide investor base, including in times of stress. The Canadian regulatory limit of 40% non-common Tier 1 capital allowed Canadian banks to access sufficient capital during the financial crisis and we advocate maintaining this limit.
- A transition period (and grandfathering of existing exposures) should be made available for excess non-common Tier 1 capital (i.e. non-common Tier 1 capital above any prescribed "bucket" limit) that results from the introduction of new capital deductions so it continues to be included as Tier 1 capital. We advocate a reasonable allowance for "Additional Going Concern" forms of Tier 1 capital other than common equity and retained earnings to allow the flexibility to access a broader range of investors. This will allow banks to diversify their possible sources of financing on an ongoing basis. This is important to maintaining access to capital markets.

Grandfathering of Existing Capital Instruments (Par. 84)

- CBA members would recommend complete grandfathering of currently outstanding and qualifying capital until redemption, even if disqualified due to the contravention of capital composition limits (i.e., rules that limit the amount of a particular instrument that can be included in Tier 1 capital, 40% for preferred shares to provide a Canadian example).
- Grandfathering should cover the required proportion of Tier 1 and its components, the "predominance" requirement, and capital deductions.
- The transition to new capital requirements should be properly phased and timed to minimize disruption of market recovery and the industry's ability to meet credit demand.

Minority Interest in Common Equity (Par. 95)

- There is a major disconnect in the computation of the common equity ratio if minority interest is excluded from common equity. The

denominator includes 100% of the risk weighted assets of the subsidiaries but the capital provided by the minority investors is excluded. This asymmetric treatment penalizes the banks with operations funded by other investors in the consolidated group.

- Exclusion of minority interest from common equity conflates the issue of liquidity and solvency difficulties for financial institutions.
- Foreign investment plays a key role in emerging markets. However, the proposal causes a disincentive to invest in emerging markets.
- Minority interests with common equity features should be made eligible for inclusion in common equity. At a minimum, if there is excess minority interest for the subsidiary after taking account the capital required to support the risk-weighted assets of the subsidiary, the excess should be part of the consolidated bank's common equity.

Capital Deductions (Pars. 93-108)

- Regarding capital deductions, we are of the view that the proposal of full deduction against common equity is harsh and inconsistent with the dual focus on going- and gone-concern capital. An analysis of many of the items proposed for deduction would suggest both reducing the amount of the required deduction or limiting the amount included in capital and/or allocating at least part of it to Tier 2. For example, as discussed further below, deferred tax assets may have substantial value in both going and gone concern situations, indicating appropriate allocation of any deduction at least in part to Tier 2. Also, we support an approach where deductions are taken for amounts in excess of an exemption basket, similar to what is allowed for Intangible Assets in Canada. Alternatively, we believe that a phase-in of the deduction over time would be appropriate.
 - In fact, it may be appropriate to only incorporate these deductions as part of the Pillar 2 capital adequacy assessment.
 - The proposed deductions from capital are very significant in aggregate across the industry and would require banks to reduce risk adjusted assets by a material amount to maintain current capital levels, constraining economic growth, if appropriate grandfathering was not provided. Once fully implemented the higher capital requirements would need to be supported by higher borrowing costs charged and/or lower deposit rates paid to consumers and commercial/corporate customers to ensure an appropriate return was earned on the capital deployed by the industry.
- **Deferred tax assets** (Pars. 98-99) - The amount of deferred tax assets (DTAs) permitted to be recognized on the balance sheet is subject to ongoing stringent review by auditors; the amount as reported net of valuation adjustment is more likely to be realized than not and is currently 100% risk-weighted. A full deduction from common equity is contrary to the nature of the assets, which have value both on a going-concern and gone-concern basis. Even in liquidation, DTAs may be available to acquirers of parts of the business, or may be transferable to local investors. They thus relate in part to gone-concern capital, as well as having considerable value to a going concern, even if the financial institution is not immediately profitable. Deducting deferred tax assets fully from common equity is not consistent with the principal of going concern capital, which is what Tier 1 capital is supposed to be; deduction 50/50 or against Tier 2 capital or gone concern capital may be more appropriate. It is also worth noting that the deduction concept is contradictory to the counter-cyclical perspective of the consultation paper. Capital requirements should be quantified/provided in advance of a crisis. Especially, at a time of stress, it would be de-stabilizing to the banking system to deplete capital arbitrarily by taking a capital hit against DTAs, resulting from timing differences between accounting and tax in the recognition of credit losses. On a more technical point, it is not clear on how the netting of deferred tax assets against deferred tax liabilities will work (i.e., whether netting will be allowed by jurisdiction only). In a stressed scenario, the market is concerned about the capability of a bank to withstand severe losses. Although the scenario envisioned is severe, it is not a priori bank failure scenario. Assuming a total deduction of deferred tax assets from common equity is a gone-concern scenario; bondholders, however, might be interested to see if there is enough total capital to cover all losses.
 - **Defined benefit pension assets** (Pars. 106-107) – The treatment of pension assets and liabilities is likely to matter only in insolvency (gone concern), so that deduction exclusively from common equity may contribute excessively to volatility and fail to recognize the allocation of pension-related amounts between the going concern and possible gone-concern claims. The potential for volatility in the capital ratios due to the

mark-to-market nature of the proposed adjustment could lead to a reduction in the availability of these types of plans in the marketplace. As an alternative to the proposed approach, a longer-term view of the amount of contributions a bank may need to make over a defined number of years to close any pension deficit that may be outstanding may be more prudent. Please also note that the accounting regime looks at the assets on a going-concern basis, recognizing them as long-term in nature. A punitive capital charge may result in banks funding the pension plan only to the extent required. This may drive the "wrong" behaviour. We question the relevance of deducting actuarial surpluses. Most plans provide for mechanisms that enable plan sponsors to recover these surpluses over a period of time. These are therefore actual assets which can reduce future cash outflows. We understand that in a gone concern scenario, this asset would not necessarily be available to support creditors. As such, if the deduction is maintained, it should be deducted from Total capital, not common equity. Alternatively, the deduction should be net of deferred tax liabilities. It is worth noting that all other prepaid expenses (other than the proposed pension deduction) are risk-weighted 100%. Pension assets, be they subject to a capital deduction or risk-weighting, should be net of deferred tax liabilities. It is unclear whether the net asset (assets less liabilities for all such plans – Par. 106) should be deducted, or only the assets for plans in a debit position. Also, it is not clear if the requirement applies to all employee future benefits or only to pension plans and if these adjustments be net of income taxes.

- **Goodwill & Intangibles deduction** (Par. 97) - The deduction of intangibles from common equity similarly needs to be examined more closely. All Intangibles may not actually meet the description of a "high degree of uncertainty" that they would have a positive realizable value. For example, capitalized computer software development expenses are likely to have a realizable value that would be recognized in a transaction transferring a subsidiary or a business or, in some cases, the software itself. Deducting these costs from capital up front when the benefits will be realized over time is punitive and could result in banks reducing development spend or transferring these activities to external vendors within the country or offshore to minimize the impact of the deduction, which creates other risks. Mortgage servicing rights are more like tangible assets with clear income streams attached to them, which are highly predictable. Under most circumstances, mortgage servicing rights can be sold by a bank as a going concern, or transferred in isolation. Even deposit intangibles demonstrated retained value as the valuation of failed banks sold during the crisis still included deposit premiums. We recommend that the Basel Committee examine the robustness of the value of different intangible assets more closely and exclude other intangibles from the capital deductions. Presently, these assets are not all deducted from capital, reflecting their intrinsic value to our organizations in a going concern scenario. In addition, there is no credit risk associated with these assets. Specific guidance should be given regarding the goodwill and intangibles deduction to ensure a standardized application. If the deduction is maintained, it should be deducted from Total capital, not common equity.
- **Investments in own shares (treasury stock)** (Par. 100) - The requirement to look through index securities would discourage activity in index securities. This is a negative impact since index securities tend to augment rather than detract from sound risk management. Further, adding the systems and administrative costs of monitoring for look-through positions would be substantial, with little discernable corresponding risk-management benefit.
- **Insurance subsidiaries** (Par. 101) - The proposal to deduct the full amount of an equity investment in a bank-owned or controlled insurance company and other financial institutions indicates an assumption that the insurance or other business would have a zero value in a stressed going-concern situation. Yet any substantial insurance or other financial business would have a demonstrable value and there has historically been a market for such businesses, which indicates that this is not a reasonable assumption. It is often possible (as in fact has been seen in several instances since the crisis) for a group to divest itself of investment holdings, perhaps at a gain that may be significant. Thus, the full deduction ignores real resources available to the group. We believe the current 50/50 treatment remains appropriate for these investments and is aligned with the going concern/gone concern view of capital.
- **Significant investments in financial investments** (Par. 108) – This implies that these investments have "no" value. A number of institutions do "step by step" acquisitions as part of executing their acquisition strategy. If these are deducted 100% from capital, there will be an incentive to

buy 100% of the investment, which will result in appropriately risk-weighting the assets brought onto the balance sheet, but may increase the overall risk profile of the bank as a whole. In addition, this may drive acquiring banks from their current conservative acquisition strategies.

- From an emerging markets perspective, given that a large number of emerging economies do not allow for majority ownership by foreign companies, this proposal may result in unintended consequences for emerging markets since there will be a disincentive for foreign companies to invest in them.
- For many significant investments the business is such that even in a stressed scenario the value of the business is retained. Please note that in a stressed scenario, these assets could be sold, thus eliminating any concerns related to implicit support and the need for financial institutions to further support these investments.

▪ **Investments in common stock of other financial institutions (Par. 101)**

- A 100% deduction is very punitive and assumes the realizable value of stock in other financial institutions is essentially nil. We fundamentally disagree with this deduction.
- Restricting hedging to items that have zero counterparty risk does not recognize the value of tested risk mitigants. We believe that the economic hedge through a derivative should be recognized in all instances as the derivative positions currently attract counterparty credit risk capital and will continue to do so.
- In addition, the proposed counterparty credit risk rules will also significantly increase the capital requirements for these derivative hedges.
- A number of banks, through their investment dealer subsidiaries, hold common stock of other financial institutions to hedge their stock based compensation programs and for other business purposes including market making, index based trading and hedging of derivative transactions with institutional clients. To the extent that holdings act as offsets to trades that allow other financial institutions to hedge their own stock compensation, the proposal runs counter to the emphasis on more deferred compensation in the industry. The absence of hedges will result in accounting volatility, and the reduced profit and loss statement will likely threaten the viability of these businesses. One of the principal reasons banks hold financial institution equity is to hedge our exposure connected to short OTC derivative trades with institutional counterparties. This activity will cease completely given increased costs of capital.
- The banks will be forced to close their long positions due to the punitive capital treatment involved. The broader implications of this may be market disruption and a substantial reduction in share prices in financial institutions as positions are unwound to comply with the new rules.
- Alternately, the stated intent to remove the double counting of capital in the banking sector and the wider financial system can be met by recognizing derivative short positions with non-financial counterparties i.e. pension plans. In these trades the market risk is with the non-financial counterparty.
- The new proposal clearly recognizes the offset of a short derivative position (where no counterparty risk exists) and in fact, explicitly allows for netting against long positions. This would allow for long stock positions to be offset either by short positions in Listed Options or Futures (assuming Clearing Corps are deemed to have no counterparty risk). However, Basel makes a distinction for short exposures that are not listed, namely OTC derivatives like swaps. The proposals provide no recognition to an OTC derivative counterparty's ability and requirement to fulfil its contractual obligations. In fact, the OTC derivative positions will continue to attract counterparty credit risk capital and at a minimum, this appears to be a double dip capital charge.
- We would strongly argue that the proposed new capital requirements for counterparty risk capture this distinction between OTC and Listed offsets and incent banks towards the latter, so the additional restriction proposed actually provides no incremental security to the financial system and, as described, has several negative implications. The desire to strengthen the distinction between OTC and Listed derivative offsets is already captured in the new incremental capital requirements for counterparty risk, and at a minimum, this appears to be a double dip capital charge. Hence OTC offsets should not be eliminated.

- The requirement to look through index securities would discourage activity in index securities. This is a negative impact since index securities are useful to the market for a number of purposes and tend to augment rather than detract from sound risk management. Further, adding the systems and administrative costs of monitoring for look-through positions would be substantial, with little discernable corresponding risk-management benefit.
- **Unrealized Losses on AFS Debt Securities** (Par. 96) – We recommend that gains/losses on AFS Debt Securities continue to be excluded from regulatory capital. These securities are acquired in part to support maintaining the bank's target duration of debt securities at reasonable levels and in support of liquidity management. We anticipate that volumes of AFS debt securities held by banks may also increase as a result of the liquidity proposal. Including these gains and losses in regulatory capital will contribute to the volatility of the banks' capital base and volatility of earnings and seem at odds with the regulator's desire for banks to hold larger portfolios of high quality debt securities. We believe that the deduction will incentivize banks to keep the duration of AFS securities as low as possible to reduce MTM volatility. This will reduce the availability of short-dated paper, which will be exacerbated by the market impacts of the liquidity proposal described above. Banks will also need to raise considerably more long-term debt, which combined with the above, could lead to disruptions in the cash and derivative markets. It is worth noting that the creation of mortgage-backed securities in particular may be restricted given customer preference for longer-term mortgages. This restriction could increase the cost of mortgages for Canadian consumers.

CDS & Central Derivatives Counterparties (Pars. 125, 165)

- Only single name hedges will be eligible for capital reduction. It appears that market hedges and CDS index hedges will not be allowed to offset the risk. As far as business impact, this will raise capital levels significantly for all participants. We expect that pricing will also adjust accordingly.
- The paper provides clear incentives to move all OTC derivatives to central counterparties (subject to a zero risk weight). At this juncture, central counterparties are still in early stages of development. The Credit Derivatives market will only function effectively if central counterparties are better developed to meet the requirements of the consultation paper. We presume this will occur as all market participants are affected by this.
- We would also note that the consultation paper does not differentiate between risk mitigants that have been proven effective (e.g., netting of derivatives in appropriate jurisdictions) and untested risk mitigants.

Treatment of Remaining 50/50 Deductions (Par. 108)

- The 1250% risk weight results in holding more than 100% capital against an investment when banks maintain capital ratios above 4% Tier 1 and 8% Total Capital. Indeed, if the Tier 1 target is higher than 8%, then just the Tier 1 capital required portion is greater than 100% of the investment. The amount of capital to support the position should not exceed the size of the investment.
- This rule appears to be based on a drive to simplify the requirements. However, it inadvertently results in a punitive impact, depending on where the capital requirements fit.

Tax Regimes & Resulting Competitive Disadvantages in Bank Capital Structures (Par. 89)

- It is possible that other jurisdictions' tax systems may allow for tax deductible capital within the new framework. This would be a notable competitive disadvantage for Canadian banks
- Some of the most significant institutional investors in Canada are tax-exempt entities. It is essential to develop a new structure in order for this high quality investor base to participate in the non-common Tier 1 space in a meaningful way.
- It would be our preference for the Basel Committee to endorse the inclusion of a tax deductible Tier 1 99-year instrument, which is currently the only Canadian tax deductible instrument in Canada.

- We also believe continuing to offer a moderate step-up in Tier 2 capital is warranted to maximize the size of the investor base. There are other mechanics that could be employed to ensure redemption activities only occurred when a bank was adequately capitalized without forcing banks to pay the full spread to investors while the capital is in the process of being amortized from a regulatory capital perspective in the 5 years prior to maturity.

Clarification of Criteria for Inclusion in Tier 1 and Tier 2 (Pars. 88-91)

- The proposals are not clear on whether the distribution limitations will be based on a multi year average, or potentially adjusted earnings (p. 20, item 7).
- The criteria that Tier 1 additional going concern capital be perpetual (Par. 89-4: "Is perpetual, i.e., there is no maturity date and there are no incentives to redeem") should be revised to include instruments with perpetual-like qualities. For example, long-dated (99 year) instruments with other features that improve the permanence of the instrument (e.g. lock-in /extension feature at maturity in case of stress).
- We understand from par. 89, Item 11 of the Basel Committee paper that if an instrument is classified as a liability, but also includes a loss absorption conversion to a preferred share under a stress scenario, that the requirement for a further principal loss absorption (conversion or write-down) is not required. If this is not the case, we request that this allowance be included in the Basel Committee paper.
- Par. 89, Item 14 of the consultative paper pertaining to intercompany instruments is not clear. We believe the intercompany instrument may be a (long)-"dated" instrument provided that the overall structure allows proceeds to be immediately available without limitation to an operating entity. If this is not the case, we request that this allowance be included in the Basel Committee paper.
- Further detail is requested regarding the intent and necessity of the provision (Par. 89, item 14) that proceeds of instruments issued through SPVs must be immediately available without limitation to an operating entity or the holding company in a form that meets or exceeds the criteria for inclusion in Additional Going Concern Capital. The Canadian structure uses a dated inter-company instrument in combination with OSFI-approved triggers are in place that convert the instrument into perpetual preferred shares thereby meeting the definition of additional Tier 1 capital.
- It should be clarified that ACSM (Alternative Coupon Settlement Mechanism) instruments remain appropriate under many circumstances. Such instruments are non-cumulative from an economic point of view, and essentially perform the same function as contingent convertible capital instruments, diluting equity and thus acting as a means of market discipline. While it is appropriate for supervisors to insist that it be made clear that the ACSM feature will be used under clearly stated conditions, there is no reason to exclude such instruments. Specifically for the Canadian market, we believe that non-cash cumulative payment of interest in the form of Tier 1 equity meets the Basel Committee's definition of additional Tier 1 capital is.

2. RISK COVERAGE

CCR on Financial Institution Hedges

- (Pars. 21, 116) It is not clear on what "zero counterparty risk" is intended to mean with respect to hedges on holdings of capital in other financial institutions. The first observation is that the counterparty credit risk capital held against counterparties on strong hedges of investments in other banks' capital should be sufficient to validate the hedges. Second, there are numerous strategies executed by Canadian banks which result in very strong hedges and extremely low risk, even if the counterparty credit risk is not completely zero. Even collateralized hedges have operational limits which may not fit the very high bar implied by the Basel Committee consultation paper.
- (Par. 139) As a result of the "wrong way" risk nature of financial institution exposure, all financial institution exposure (in both the trading book and banking book, to regulated and unregulated financial institutions and to non-bank financial institutions) must be scaled up by a multiplier of 1.25. This will increase costs across the industry, increasing cost of capital, and coupled with the liquidity proposals, will translate into higher costs for borrowers and lower rates paid on deposits. It is not clear how the 1.25 multiplier was derived.

CVA Methodology Clarification & Commentary (Par. 116, second bullet)

- Although the wording in the document for the capital required for CVA is not clear, the current methodology to be used for the upcoming QIS is:

Capital required = 3 X (1 year total VaR99 + 1 year total stress VaR99)

This is extremely punitive, and the 3X multiplier must be questioned in absolute terms and as part of the ultimate overall calibration.

Treatment of mark-to-market counterparty risk losses (Par. 96)

- It is not clear whether matched credit hedges include the constituent names on credit index derivatives, and whether we can decompose index trades and capture any individual name matches.

Requirement 1

- The requirement to calculate the proposed new market risk capital for CVA losses on a standalone basis and not together with matched credit hedges appears unnecessarily punitive.
- The specific rules determining what qualifies as eligible hedges exclude all non-credit related hedges such as FX or commodity instruments that may be used to hedge the market risk embedded in the CVA, as well as CDS hedges, such as Credit Index trades, that are not exact name matches (for general market risk).
- Moreover, by excluding certain CVA hedges, the new rules may provide a disincentive to institutions to execute hedging trades that are economically sensible since the natural offsets will not be recognized in the market risk capital calculations. Running on a combined basis counterparty exposure bond equivalents and all corresponding hedges in the calculation of market risk capital would be an improvement on the existing guidance and the resulting portfolio would be more consistently aligned with how the bank manages its CVA MTM risks.

Requirement 2

- In determining the bond equivalents, the requirement to aggregate a counterparty's EAD across all of its netting sets is not an optimal way to represent the risk profile of potential CVA losses.
- First, it is inconsistent with how CVA itself as well as regulatory counterparty credit risk capital are calculated under the IRB approach. Both measures are calculated separately for each netting set.
- Second, it results in the need to assign a single maturity date to the counterparty's bond equivalent, with the proposed rule being to use the longest Effective Maturity across netting sets. The use of the longest Effective Maturity is unnecessarily punitive to the bank, and, by extension, to customers who are outside the scope of netting enforceability opinions.
- We therefore recommend revising the wording to allow for the creation of a distinct bond equivalent per netting set, each with its own effective maturity.

Requirement 3

- We interpret the requirement to set the notional of a contingent CDS instrument that is an eligible hedge to be its current value as equivalent to setting the notional of the contingent CDS to its current MTM value. We note that the MTM value of a contingent CDS represents the CVA of the underlying reference asset and not its bond equivalent. Such a requirement creates an inconsistency between the notional value of the hedge and the notional value of the bond equivalent representation of the instrument it is hedging and hence does not fully reflect the risk mitigating features of a contingent CDS. We therefore propose that the notional for a contingent CDS hedge should be set to the EAD of its underlying derivative reference asset that includes the current MTM of the derivative as well as future potential exposure.

EPE & Wrong-way Risk (Pars. 116-122)

- Par. 116 (first bullet) states that the EPE is to be run on data that include a period of stress. However, the original accord detailing EPE indicates that it can be done using either “real world” or “risk neutral” measures (see for example par. 47 of Basel Committee 111 or footnote 240 of Basel Committee 128d.) If an institution chooses to use a “risk neutral” measure using market-implied volatilities, that is fundamentally incompatible with a requirement to use historical volatilities from a stressful period. In particular, CVA is predicated on a market-implied view of credit risk so the risk neutral point of view is more appropriate. The proposals are not clear on this point.
- Par. 121 states that “When parameters are estimated historically ...” in the context of calculating EPE. It is not clear whether this means that if market-implied parameters are used, this paragraph would not apply.
- Par. 122.25, states that banks should use the maximum of the portfolio-level capital charge based on an EPE using current market data and the portfolio-level charge based on an EPE using 3-year period that includes 1-year stress period used for the Stressed VaR calculation. We believe that the proposed measure is not appropriate due to portfolio differences and the nature of the risk. The relevant historical period for the stressed VaR may not necessarily correspond to that for the counterparty credit risk.
- Par. 122.62, states that banks must demonstrate empirically that proxy market data provides a conservative representation of the underlying risk under adverse market conditions. We note that by their nature, proxies are created because of lack of market data. If we can consistently demonstrate empirically that the proxy is conservative then we would not need the proxy.

CVA (Pars. 123-125)

- Exact name matches should not be a strict requirement for the inclusion of credit derivatives as CVA hedges. A significant amount of CVA risk is due to the general level of credit spreads. Broad movements in credit spreads will typically result in losses due to higher CVA charges. Furthermore, most large derivatives portfolios contain a significant number of counterparties for whom no credit default swap market exists. Typically, the calculation of the CVA for these counterparties is based on credit default swap indices or weightings of other similarly rated commonly traded credits. Thus, credit indices and single name credit derivatives without an exact name match form a significant source of the profit and loss volatility of CVA, and credit index hedges are an effective mitigant to the profit and loss volatility. Since the aim of the capital charge is to protect against losses due to variability in CVA and not default risk which is capitalized elsewhere, the charge should be sensitive to reductions in the potential volatility of CVA. For this reason, we strongly feel that credit index hedges and single name CDS without an exact match should be allowed to reduce the CVA capital requirements. Under the current proposal, entering into credit index hedges that lower risk will result in higher capital charges due the capital requirements of the market risk of the hedge with no offset in the CVA capital charge.
- The notion of assessing capital on the CVA in par. 125 makes sense. However, the proposal has a few difficulties:
 - 1) The CVA can have substantial market risk sensitivities to FX, interest rate and other market rates beyond credit spreads. Many banks actively hedge that sensitivity to lessen the market risk. However, the proposal disincentivizes that risk limiting behaviour by excluding any market risk hedges from consideration of the CVA capital. Furthermore, a bank which does have a hedging program would be left with naked hedges when calculating the standard general market risk VaR. Therefore a firm which sought to limit the market risk would end up being penalised rather than rewarded for its efforts.
 - 2) The proposal does not capture the bilateral nature of CVA. A derivative with the potential for two-sided exposures (such as an interest rate swap) transacted between two firms with similar credit rating will tend to have a CVA which largely cancels out. Furthermore, to the extent that the credit spreads of the bank and its counterparty are highly correlated, the CVA tends to be largely self-hedging, an important effect which the proposal would fail to capture.

- We suggest adapting the proposal by treating the CVA as if it were a complicated market-contingent credit derivative, rather than as a bond position. The regulations should then permit banks to feed those effective credit derivatives into their market risk VaR models. This would then address the two bullets above. To the extent that a firm could only treat a subset of a netting set in this manner, then the residual component could be treated in the manner laid out in the consultation paper.

Specific Wrong-Way Risk (Par. 134 (bullet 58))

- specifies the EAD of a derivative with specific wrong-way risk. However, most derivatives are done as part of a netting set and under a Collateral Support Annex (CSA) so that EAD is defined at the level of the margined netting set, not at the level of the individual transaction. Therefore, this requirement is ambiguous and should be amended to clarify the treatment in the contexts of a netting set and of a margined netting set.
- Also in Par. 134 (bullet 58) - a bank can be in the position of having “right-way risk” transactions. For the sake of completeness, the consultation document should recognize the mitigating effects of such trades by specifying how these are to be treated for EAD purposes.

Increased Margin Periods (Par.153)

- The proposed new rules to increase the margin period of risk as a result of illiquid trades are flawed in a number of ways.
 1. The rules are ambiguous as to what constitutes an illiquid trade and therefore are open to interpretation and may, potentially, result in materially divergent implementations at different institutions. For example, determination that a single name credit derivative on a specific reference obligor would or would not remain liquid in stressed market conditions is highly subjective, and, if determined to be potentially illiquid in stressed conditions, could result in the application of the higher 20-day margin period of risk to the entire netting set. A firm taking such an interpretation would be subject to cliff effects and higher capital at the prospect of adding a single CDS to an otherwise liquid portfolio than a firm taking a more aggressive view of the liquidity of credit derivatives.
 2. Banks will be incented to execute illiquid trades with counterparties with whom they already have illiquid trades. That is, the fact that a single illiquid trade will require the margin period of risk for a portfolio to be set to 20 days will make it advantageous to the bank to continue adding additional illiquid trades to that particular netting set so as not to “pollute” otherwise clean portfolios. The end result will be concentrations of many illiquid trades in netting sets with a small number of counterparties. Such concentrations of risk will create exactly the kind of systemic risk that should be avoided.
 3. The rules will in some cases create a disincentive to hedge certain risks. For example, it may be economically sensible for a bank to purchase a CDS on an illiquid underlying reference name to hedge a counterparty CVA risk. However, the introduction of such an illiquid trade may, under the proposed rules, require an increase in the margin period which could in turn increase EAD to the protection seller materially, outweighing the capital relieved from hedging the underlying risk. Such an increase in EAD will create a capital disincentive to hedge smaller, less liquid exposures, even though it may be economically sensible to do so.
- We therefore suggest in light of the aforementioned concerns that the proposed new rules with respect to illiquid transactions be reconsidered. We urge that additional thought be given to remove some of the ambiguity with respect to the rules of what constitutes an illiquid trade and, in particular to address the second and third points above, we suggest that an approach that creates a more gradual increase in the margin period of risk – as opposed to the “cliff effect” proposal of jumping from 10 days to 20 days – would be an improvement. The consultative paper does provide some guidelines for what constitutes illiquid transactions. Included is the requirement to determine the liquidity of trades in the context of stressed market conditions. In a stress scenario, bid/ask spreads will widen on all but the most vanilla OTC derivatives transactions. A conservative interpretation would, therefore, consider a wide range of derivatives as illiquid transactions. However, a more narrow interpretation might stick to the examples provided in the guidelines: trades that are not marked daily and trades that reference Level 3 assets. Our ask is, therefore, either that the rules be rewritten with less room for interpretation or that we get more clarity in how these requirements should be interpreted and, furthermore, that there is a consistent implementation of the change across jurisdictions.

Collateral Department Operations

- Par. 157.51(i) states that the unit must track the extent of reuse of collateral and the rights that the bank gives away to its respective counterparties for the collateral it posts.
- Par. 161.115(i) states that banks must ensure that sufficient resources are devoted to the orderly operation of margin agreements with OTC derivative and securities-financing counterparties, as measured by the timeliness and accuracy of its outgoing calls and response time to incoming calls. Banks must have collateral management policies in place to control, monitor and report: the risk to which margin agreements exposes them (such as the volatility and liquidity of the securities exchanged as collateral), the concentration risk to particular collateral asset classes, the reuse of collateral (both cash and non-cash) including the potential liquidity shortfalls resulting from the reuse of collateral received from counterparties and the surrender of rights on collateral posted to counterparties.
- Par. 153.4, Section 153.41(i) requires a minimum floor of 20 days for a netting set involving collateral that is “illiquid”. The definition of illiquid appears to only deal with securities that trade OTC – specifically, “absence of active markets with sufficient depth and liquidity so that a counterparty can, within two or fewer days, obtain multiple price quotations that do not move the market or represent a price reflecting a market discount”. It is not clear as to what would be considered as “illiquid” in exchange-traded terms (e.g., whether it would be reference to listed securities that do not meet a specified amount of daily trading volume). This comment also applies to OTC derivatives where we take a pledge of exchange-traded equities.

Stress Testing & CCR

- The language in par. 173 (bullet 56, first bullet) is not clear on what “all forms of counterparty credit risk” means beyond OTC derivatives.

Derivatives Netting: General Comments

- We note that both the Basel Committee and OSFI have historically been silent on the subject of deducting a bank's counterparty credit risk CVA from the calculation of EAD of OTC derivatives. Such a deduction of counterparty credit risk CVA from EAD is analogous to the exclusion of own risk CVA from capital, although we note that the two filters considered together will result in a lower capital ratio for the bank since the penalty arising from the reduction of capital significantly outweighs any benefit arising from the deduction from EAD. Given the proposed new explicit language around filtering out own risk CVA from capital, we ask that explicit language be introduced to allow the conceptually equivalent filtering out of the counterparty credit risk CVA portion of mark-to-market from EAD for OTC derivatives.
- The proposed new rules to strengthen the capital requirements for counterparty credit risk highlight an issue that is not explicitly addressed in the most recent consultative document.
- OSFI has historically not allowed institutions to net the amount owing on out-of-the-money OTC derivatives contracts against exposures arising from the cash collateral that has been posted to secure these contracts as part of a collateral agreements (usually a Collateral Support Annex, CSA, to an ISDA master agreement).
- We view this situation as equivalent to the reverse scenario where OSFI allows a bank to reduce credit exposure (or reduce LGD under the CEM IRB method) arising from OTC derivatives where the bank holds cash collateral.
- Assuming daily margining and legal certainty, the credit exposure at default for a bank pledging cash collateral on OTC derivatives is the net market value of the collateral and the OTC derivatives, just as it is (but in reverse) for the counterparty receiving the cash collateral. Additionally, the risk of future potential exposure (excess collateral pledged to the counterparty) arising due to an change in derivative MTM is addressed through the margin period of risk under the IMM approach and the Add-on Factors under the CEM approach, in the same manner the risk of under collateralization is addressed when the bank receives collateral.
- OSFI has previously cited GAAP accounting as not allowing netting of derivative liabilities and collateral pledged. It is our view that this is not an accounting issue, as the same can be said of derivative assets and collateral held. In both cases, netting should be based on legally enforceable agreements meeting the requirements of par. 146 and Chapter 8 in the case of CEM and Chapter 4 in the case of IMM.

3. LEVERAGE RATIO

General

- We believe that the proposed leverage ratio should be a supplementary/backstop measure, and that implementation should follow a slow/staged approach. We also believe that the leverage ratio should be internationally harmonized and treated in a consistent manner by all regulators (i.e., Pillar 1). We believe that using Total capital for the leverage measure is best, especially if contingent capital becomes a reality.
- An inappropriately designed and calibrated leverage test could easily become the binding capital constraint for retail banks running truly low risk strategies. In this situation there is no disincentive to increasing risk until the risk based capital exceeds the leverage capital requirement. Since the bank will need to earn adequate returns to attract the capital needed to support the leverage test, it will naturally push banks out the risk curve. This could also have a direct impact on the price and/or availability of retail and commercial credit.
- Also, the cross effects between the assets held for liquidity management purposes and the new leverage ratio may be a very material problem from a systemic risk and a market integrity perspective.

Definition of Capital

- (Pars. 206-208) For leverage ratio purposes, Canadian banks currently use Total capital as the capital measure. Given the very conservative nature of the asset measure proposed in the consultative paper (e.g., 100% of committed undrawn lines and unconditionally cancellable commitments), we recommend that any new leverage measure continue to use Total capital. In addition to better align with the conservative nature of the asset measure, using Total capital will also incent banks to diversify their capital structure to include Tier 2 capital.
- (Pars. 206-208, 218-219) We suggest that certain "high quality" assets such as Cash, Cash equivalents, Gold and other precious metal inventory, government treasuries issued by top tier countries, government guaranteed mortgages and loans, reverse repos, etc. should be excluded from the leverage ratio computations.
- (Par. 217) Given that large additional amounts are likely to be subject to the leverage ratio under the current proposals, we recommend that Residential Mortgage exposures directly or indirectly backed by a Sovereign Guarantee, such as CMHC-insured mortgages and HELOCs in Canada, be excluded from the calculation of the leverage ratio, as they attract a zero risk weight in the calculation of RWA under Standardized Basel II.
- (Par. 237) If not properly calibrated with appropriate accommodation for low risk assets, there would be increased risk that the proposed leverage test will disadvantage retail banks and banks running true low risk strategies. The concern is that the new leverage measure could incent riskier behaviour as these banks are driven out the risk curve in order to earn adequate returns to cover the cost of the incremental capital. This could result in the new leverage ratio becoming the binding capital constraint, rather than Tier 1 capital. As such, we believe that the proposed leverage ratio should be a supplementary/backstop measure to capital ratios. Since the leverage measure is not risk-sensitive, it should be only a complementary measure, especially for low-risk banks.

Commitments (Pars. 232-235)

- The leverage ratio requires 100% of committed undrawn lines to be included as assets in the leverage calculation. This implies an unreasonable assumption that 100% of all lines would be drawn for their full amount and does not recognize the benefit fully cancellable lines provide for mitigating risks at times of credit stress. It seems likely to constrain the overall ability of the system to provide committed back up lines. This can be expected to drive the cost of back-up lines (to our customers) higher. If implemented, this will result in banks becoming very conservative in approving lending proposals. This is contrary to what governments are looking to banks for - to lend to kick start the economy. At a minimum, the credit conversion factor, as per the Credit Risk Standardized Approach in Basel II, should be applied. In particular, unconditionally cancellable commitments should be excluded from the ratio as they can be cancelled at any time by the lending institution. More generally, we are concerned with the potential for high quality liquid assets underpinning liquidity lines to be double-counted in the leverage ratio and the new liquidity coverage ratio.

- (Pars. 232-233) The proposed guidance suggests that all commitments including unconditionally cancellable commitments should be added to determine total assets. It is not clear whether this definition includes undrawn amounts on credit cards and personal lines of credit financing.
- (Par. 233) Applying a 100% credit conversion factor for Retail undrawn commitments would not at all be justified by the actual defaults and credit losses from those exposures. While high credit risk customers may draw their credit card balances up to the maximum available limit, most of the undrawn amount is available to the lowest credit risk customers who rarely use their credit cards. Applying a heavy capital penalty through the leverage ratio against such exposures would discourage banks from extending revolving credit to their lowest credit risk retail customers, which is probably not the intention of the Basel Committee.
- (Par. 234) We believe there may be more merit to the alternative proposal being assessed by the Basel Committee of applying the Standardized Basel II credit conversion factors.

Netting of Derivatives (Pars. 214-216)

- Netting of in- and out-of-the-money derivatives (where netting laws are favourable) is a tested risk mitigant that should be encouraged. Including the gross amount of derivative exposure is a significant overstatement of risk. The leverage measure should allow netting of derivatives in order to get an accurate measure of exposures.
- (Pars. 220-221) We support the application of regulatory netting in favour of the no-netting approach for repo style transactions and derivatives in the leverage ratio. The use of appropriate haircuts in an exposure calculation that incorporates netting where there is legal certainty provides a measure of exposure that is better aligned with the economic risk of repo style transactions. We agree that repo style transactions play a key role in funding. We therefore believe it is the disappearance of that funding channel in stressed market conditions that presents the real risk for repo style transactions and not any leverage opportunities they provide, and note that the funding risk is already captured in the proposed Basel Committee liquidity framework. In the case of derivatives, we recommend Basel II netting and for the gross adjusted measure to continue to be measured as the current Derivative-Related Assets.
- (Pars. 230, 213) The proposed leverage ratio rule to employ a 100% conversion for sold credit derivatives taken together with the requirement to include positive MTM exposures on bought credit derivatives (and possibly future potential exposures as well) creates a double-count in the case of back-to-back credit derivatives. In the case of back-to-back bought and sold credit derivatives, the maximum possible loss to the bank is the notional of one of the contracts. That is, even if both the counterparty on the purchased credit derivative defaults and there is a credit event on the underlying reference asset, then the bank can lose no more than the notional amount. We therefore recommend excluding the positive MTM (and any future potential exposure) on purchased credit derivatives from the exposure calculation used in the leverage ratio when they are hedging sold credit derivatives.

Caution Regarding Over-Reliance

- Recent studies showed that leverage ratios did not “predict” distress once risk based capital ratios are taken into account (see Buehler *et al.*, 2010).
- Differences in regulatory and accounting regimes can cause significant discrepancies between the treatment of certain assets. Other concerns include the lack of clarity for the interaction between leverage ratios and liquidity ratios and the noise introduced because of some conservative adjustments.

Asymmetric Implementation & International Competitiveness (Par. 237)

- If not properly calibrated with appropriate accommodation for low risk assets, there is significant risk that the proposed leverage test will disadvantage retail banks and banks running true low risk strategies.

Advocacy of Current Canadian Assets-to-Capital Multiple as Leverage Metric

- OSFI's current simple, common-sense leverage ratio better reflects the leverage of an institution and has served the Canadian banks well through the crisis. Using a higher numerator and a lower denominator will obviously result in a much higher leverage ratio being computed. This will result in increasing the current maximums in Canada from 20 to a very high number. This will overstate the leverage of the financial institution and dilute the effectiveness of the test. We reiterate that the current Canadian method of computing the leverage ratio is a better reflection of the amount of leverage in the Canadian banking system. Making this ratio more punitive by reflecting higher than realistic leverage may send the wrong message to the financial community, and may create less faith in the financial system rather than more.
- In the event that the numerator and denominator are revised, stakeholders should be consulted as part of the process of establishing appropriate leverage targets.

4. PROCYCLICALITY

General

- As acknowledged by the Committee in Par. 240 (i.e. "...it is still too early to opine on whether the Basel II framework is proving to be more cyclical than expected"), there is a scarcity of empirical data supporting procyclicality and we, therefore, believe that measures to combat "procyclicality" are premature.
- The Basel Committee's objective to dampen pro-cyclicality in minimum regulatory capital requirements appears conceptually rational but realistically undermines the operation of appropriate risk and capital management governance processes within institutions. Hence, we do not believe that the capital buffers and procyclicality proposals are appropriate.

(Pars. 247-252)

- Countercyclical tools have design flaws and are too punitive as currently proposed. The additional "unusable" capital held as part of the capital buffer will create considerable headwinds for the bank and make it difficult to maintain a strong rate of return on total capital (in the absence of higher borrowing costs charged and/or deposit rates paid to customers).
- While capital conservation measures are supported by the industry, such measures would be more effective under a Pillar 2 approach, allowing for a firm-focused discussion with the respective supervisor.
- More fundamentally, the industry is highly skeptical as to the potential effectiveness of the capital buffer. In particular, it is unclear whether firms would be able in practice to draw from the capital buffer during times of stress. Recent experience during the crisis has demonstrated that during times of economic stress market participants expect banks to hold *additional* capital as opposed to *less* capital. Our current assessment is that markets, investors and rating agencies would prevent banks from being able to use the buffers.
- Canadian banks are already required to conduct stress tests and therefore have capital buffers in place. We fail to understand how a variable capital buffer concept can be an effective tool. It is a macroeconomic tool, not a prudential regulatory tool. It may not limit the appropriate types of lending, and if applied to all financial institutions in a country, it may cause problems for weaker institutions at an inappropriate time. If not applied consistently, it will create a competitive inequality among international banks.

- The impact analysis on a couple of stylized portfolios showed that capital surplus can reach up to 64% of risk capital with only 21% of it being usable and 43% being unusable during the top-of-the-cycle, if the capital conservation range was established as 15% of total risk capital. These levels of capital surplus would significantly impair a financial institution's risk adjusted profitability (again in the absence of higher borrowing costs charged and/or deposit rates paid to customers).
- Bottom-of-the cycle calibration will increase the disconnect between internal and external estimates of capital. Under the "bottom-of-the-cycle" calibration, regulatory capital will very likely materially exceed economic capital, especially during upturns. Financial institutions concerned about the return on the binding capital amount will look at return on regulatory capital at all levels of the bank which may cause regulatory capital to replace economic capital. This replacement would result in real economic risk, such as concentration risk, going unnoticed, not correctly priced and managed, and accumulated over time which, in return, would create significant systemic risk.
- Despite the claim to the contrary, the adjustment is not neutral to the risk rating philosophy. More point-in-time (PIT) banks will be more strongly penalized. The fixed confidence interval (of 99.9%) for the "bottom-of-the-cycle" calibration of capital does not agree with the fact that the confidence interval is driven by the target debt rating of the financial institutions and the confidence interval follows different cyclical patterns over the cycle for different target debt ratings.
- Backward looking historical stress testing is not relevant for both internal and external factors. Both macroeconomic conditions and the risk profile of the bank's portfolio have likely changed since the historical stress was established. In that respect, bottom-of-the-cycle calibration has a long memory. Consider a bank that was caught with a high risk portfolio during the last crisis but has since corrected its risk appetite, risk management practices and its management. This bank's old mistakes will carry on in its capital buffer.
- The calibration of the bottom of the cycle capital buffer depends significantly on the exposures at the time of the downturn and how they have changed over time.
- (Pars. 253-255) We are also concerned about the level of prescriptiveness of the proposals in particular in regard to the limitation to pay bonuses when capital levels are below the proposed target. While flexibility exists in regard to dividend distribution and share buybacks, contractual arrangements may limit banks' discretion to pay this component of employees' salaries.
- (Pars. 253-255) We do not support the introduction of a "capital conservation range". Introducing such a range will effectively increase the minimum capital requirements and essentially override the ICAAP/Pillar 2 process.
- We do not agree with the table on p. 70 (below Par. 258) of the consultation document, as it seems to instruct banks on how to manage their business (i.e., forgoing payment of dividends to manage risk) and infringes on the responsibility of a bank's board of directors. Constraining the discretionary distributions of earnings has the risk of interfering with a financial institution's dividend policies which are formulated, in many cases, on very legitimate economic realities. Financial institutions which historically had consistent and high dividends will be penalized under the new proposal although they did not significantly contribute to the volatility during the crisis.
- Par. 261 of the consultation document states that "The Basel Committee is in the process of reviewing a regime which would adjust the capital buffer range, established through the capital conservation proposal outlined in the previous section, when there are signs that credit has grown to excessive levels." It is not clear how the Basel Committee will know when to adjust the capital buffer range, and what signs the Basel Committee will be looking for. It appears that this will cause more systemic risk in that all banks will be contracting and expanding at the same time.

- (Pars. 244-246) It is not clear on how provisioning based on expected losses will work and whether banks will be able to draw on reserves (built up during “good times”) during economic downturns. Also, it is not clear whether the proposed expected loss provisioning is PIT or through-the-cycle (TTC).
- (Pars. 260-262) The proposed use of buffers as a macro tool to control excessive credit growth needs additional specificity as its current description does not provide sufficient information as to how it would operate in practice. However, the Basel Committee should take into account the fact that such measure, as described, could result in a situation where firms that have behaved prudently are affected by the behaviour of others. Imprudent credit growth caused by a few firms may in practice restrict sound credit activity of other firms. Such contradictory situations should be avoided.
- (Par. 242) We feel that the methodology reflected in the QIS study (as probably any “one-size-fits-all” methodology) is too rigid to account for the banks’ changing business strategies and product mix over time. The differences between the banks’ risk rating systems and product / vintage compositions for each asset class imply that any attempt to find a “one-size-fits-all” solution to dampen pro-cyclicality is likely to have counter-intuitive and counter-productive results. Any countercyclical PD adjustments, and their necessity and appropriateness for each bank’s various asset classes in the first place, should be considered on a bilateral basis between each bank and its supervisor under Pillar II.

In particular, the last sentence in the third paragraph on p.91 of the Feb 17 QIS Instructions reads: “The PD of the portfolio would obviously change over the cycle as a result of two different factors: transition of borrowers across grades; change of grade PDs”. This sentence actually misses a third possibility, which is particularly relevant for Retail. A retail credit portfolio’s product/vintage/ borrower composition is constantly changing due to the bank’s strategies. Changes in the long-run credit risk of the portfolio due to these changes in the portfolio mix ought to be reflected by an internal risk rating system, rather than being smoothed out.

Example: As part of its routine account management, a retail bank may close thousands of dormant unsecured lines of credit. They had very low RWA due to extremely low PD (as they were dormant), and no outstanding balance either (for the same reason), so neither the total RWA nor outstanding balance for Qualified Retail Revolvers will be materially affected by this account closure.

However, the portfolio-average PD (calculated based on currently open accounts in the portfolio) will actually increase for QRRE, because those dormant accounts with their extremely low PD will be now excluded from the QRRE portfolio average. Therefore the current average PD will be higher than the historical average PD. Under the erroneous assumption that this is due to the recession, the scaling factor A less than 1 will be applied to all current PDs. This will result in lower PDs and RWA for active credit cards, for example, which had nothing to do with those dormant lines of credit, and should not attract lower RWA because of their closure.

Under the current regime, RWA as % of the drawn amount will not change. However, from the QIS, it would appear that the average PD for QRRE increased and therefore the current RWA should be reduced by applying the scaling factor A . This would actually create RWA volatility where there is none under the current Basel II regime.

To make the smoothing results serve the intended purpose, a finer tool might be considered. In particular banks should be allowed to decide how their portfolios are subdivided for the purposes of applying the smoothing multipliers. This flexibility will allow banks to tailor the smoothing multipliers to their individual situations with respect to rating systems and product/vintage compositions. In particular, banks will be able to separate business cycle effects that need to be dampened from effects due to changes in business strategy and product mix that actually need to be reflected by the internal risk rating system.

5. SECURITIZATION

General (Pars. 23 and 188)

- refer to Basel Committee “conducting a more fundamental review of the securitization framework and the reliance on external ratings under the standardized and securitization frameworks.” It would be helpful if Basel provided more information on focus and scope of this review.

Capital Definitions

- Minority interest (Par. 95) exclusion from the common equity component of Tier 1 raises the issue of how Seller first loss retained positions in specific asset pools can be treated for capital purposes if consolidated.
 - Minority interest, in this context, provides direct common equity-equivalent capital support for consolidated asset pool losses rather than bank's common equity.
 - While these retained seller interests do not pass the permanency test in Tier 1, their lifespan matches up with the related asset pools which are also non-permanent.
 - Non-inclusion understates equity support available to protect depositors for these assets.

Counterparty Credit Risk

- Statements about the need for separate supervisory haircut for “securitization” collateral are overly broad (Pars. 114, 116, 146, 162).
 - There is a need for definition on what falls into securitization category and whether there is any differentiation being made.
 - Not all securitization asset classes/programs underperformed corporates – Canada Mortgage Bonds, credit card asset-backed securities (ABS), bank-sponsored asset-backed commercial paper (ABCP) vs. Maple corporates.
 - ABS at 2x corporate debt haircuts (Par. 146), without more granular assessment, contributes to the imbalances it highlights.
 - Standardized supervisory haircut tables which use rating and residual maturity in setting haircuts across Sovereign, Other and “Securitization Exposures” categories:
 - create maturity threshold issues (big changes as bonds roll from >1 year to < 1 year,
 - do not recognize market size/liquidity differences between “A+ to BBB-” rated ABS and corps and sovereigns with similar rating.

Addressing Reliance on External Credit Ratings

- We continue to support the emphasis regulators are placing on:
 - The need for enhanced credit analysis capability to augment RBA usage (Pars. 185, 186); and
 - The risks of excluding external rating agency methodologies for internal assessments of consumer and commercial asset classes (Par. 185)
 - Creating an incentive/requirement for strengthened internal credit assessment capability.
- Eligibility of ratings should be function of whether they are monitored ratings (versus point in time only) and used in broader aggregated ratings database maintained by ECAI rather than whether they are public or private ratings (Par. 197).

Leverage Ratio

- If ABCP conduit liquidity lines are to be part of the asset base in leverage test at 100% credit conversion (Pars. 223, 225, 232-234), then the following needs to be netted out:
 - Any related ABCP (backed by the liquidity lines) held in inventory or for investment purposes; and
 - Any related liquid asset holdings either:
 - required under new Basel liquidity proposals due to maturity of ABCP supported by the liquidity lines, or
 - currently held in relation to the liquidity commitments under existing bank liquidity management policies.

- If accounting standards are used as a baseline for the leverage ratio, then:
 - The capital/equity measure should not ignore the equity support provided by seller first loss positions on either consolidated securitization programs or those supported by off balance sheet ABCP liquidity facilities that are incorporated in.
 - International differences in consolidation rules need to be accounted for.
 - U.S. GAAP transition rules for new VIE consolidation rules (FASB 166/167) allow for consolidation at par, while IFRS and current Canadian GAAP require that assets be fair valued upon consolidation.

6. OTHER COMMENTS

General

- There is a significant problem of “devil-in-the-details” in the proposals by the Basel Committee. For instance, there is a significant concern that the changes to securitization and CCR may be too punitive: some change is good but a swing too far will significantly disrupt those markets.
- The lack of clarity in the proposals makes it difficult to assess the actual capital impact.
- The effect of all the capital and liquidity changes could significantly impact customer pricing, credit availability and markets in general.
- The proposals could also lead to a decline in household wealth including retirement savings and compromise the financial condition of pension funds. The impact to household wealth and pension fund assets from the recession could be exacerbated by the decline in financial institution equity values given the increased costs and lower returns for the banking industry. In turn, declining household wealth would reinforce the credit-induced recession.
- Numerous elements proposed by the consultative document require significant systems builds and other costly operational measures which are in addition to the new systems requirements related to the Basel Committee's liquidity consultative document and other requirements resulting from domestic regulatory proposals. These requirements increase the necessity of significant grandfathering provisions.

Contingent Capital

- The Basel Committee notes in the consultation paper (Pars. 16, 91) that it will continue to review the role that contingent capital and convertible capital instruments should play in the regulatory capital framework. CBA members would welcome the opportunity to participate in this consultation process.
- We have material concerns with proposals that would require all non-common forms of capital to contain a conversion feature to common equity. While in theory contingent capital would allow banks to recapitalize in a severe crisis, there are limitations and drawbacks to this form of capital. Most importantly, through industry and market dialogue we expect the available demand for these instruments to be very limited, especially in a smaller market like Canada that has a concentrated investor base. This would severely restrict our access to capital in both domestic and international markets. Many fixed income investors would not purchase these instruments due to their equity-like risk, lack of an investment grade rating (e.g. Moody's) and possible concerns over liquidity. This is particularly concerning because the baseline Basel Committee proposal already erodes the investor base for bank capital by recommending the elimination of step-up capital instruments.
- In theory, contingent capital would increase the available common equity for an institution in financial difficulty. However the instruments would likely limit a bank's ability to recapitalize itself prior to the conversion event because common equity investors would be concerned with the prospect of dilution from conversion of other forms of capital into common equity in the short term. It will also be difficult for a bank to raise additional amounts of other forms of capital if investors believe they are going to be converted into common equity.

- Actual conversion of contingent capital may also undermine the ability of banks to recapitalize themselves through the private markets after conversion. The conversion could trigger a “death spiral” effect through common share dilution and common share monetization by non-common capital holders.
- Depending on the final mechanics, the yield required by investors on contingent capital will be higher than that currently paid on non-common capital instruments and may not be significantly lower than the cost of common equity. The resulting higher cost of capital for the industry will result in higher borrowing costs and/or lower deposit rates paid to consumers and businesses and/or a reduction in available credit, restricting economic growth.
- **Where Contingent Capital Fits in the Capital Structure**
 - If contingent capital is moved forward, we recommend studying contingent capital which might be introduced into the capital structure as a new form of capital to sit alongside existing structures as opposed to implementing the change across all forms of capital.
 - If the host instrument meets the regulatory features of Tier 1 “Additional Going Concern Capital”, then the contingent capital instrument would be included as core Tier 1 capital to a specified maximum to be agreed upon through industry consultation. If the host instrument meets the regulatory features of Tier 2 “Gone Concern Capital”, then it seems reasonable the contingent capital instrument would reduce Pillar 2/buffer requirements in Tier 1.
 - The use of contingent capital would be at the option of the issuer. No minimum usage requirements would be set. A bank could choose to use common equity instead.
- **Specific Structural Features of Contingent Capital**
 1. Conversion Trigger
 - We are concerned that the mechanics of conversion of contingent capital are not consistent with the priority of ranking in bankruptcy that capital investors would have today and would continue to have in other industries.
 - Altering the liquidation risk characteristics of non-common capital will negatively impact these instruments at the outset.
 - Given a choice, investors will prefer a conversion trigger that is as remote as possible to minimize the circumstances in which conversion may occur.
 - We believe that a trigger event by one bank could cause a wave of panic in the pricing of the instruments across the entire market which would further support setting the trigger close to insolvency.
 - The trigger itself could be a capital measure or a superintendent order when the bank has ceased to be viable.
 - We note that the market would likely view a proposed trigger to convert to common equity at the regulator’s option as being highly subjective and lacking in transparency. This may dissuade the credit rating agencies from rating contingent capital instruments and thus negatively impact market access.
 2. Conversion Rate/Price
 - Setting the conversion price to be set on conversion date as either a moving average of the 30 day period prior to conversion date or with a floor feature to avoid a “death spiral” scenario where there is a run on the share price as investors try to avoid a scenario of complete dilution, is worthy of more study.
 - Designing the conversion mechanics may lead to unintended consequences not readily foreseen at this stage of product development.
 - While contingent capital is itself designed to mitigate morally hazardous behaviour in the capital markets, its existence may instead trigger other perverse market behaviour, namely encouraging short-sellers into the market who will seek to profit from the payoff offered by holding contingent capital at the point of conversion.

3. Key Issuer Considerations

- It is critical that the structure be non-dilutive to EPS.
- It is critical that the conversion features do not compromise tax deductibility.