ASSOCIATION DES BANQUIERS CANADIENS
CANADIAN BANKERS ASSOCIATION

Box 348, Commerce Court West
199 Bay Street, 30th Floor
Toronto, Ontario, Canada M5L 1G2
www.cba.ca

Marion G. Wrobel
Vice-President
Policy and Operations
Tel: (416) 362-6093 Ext. 277
mwrobel@cba.ca

June 26, 2013

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

Dear Basel Committee members:

Re: CBA[1] Comments on consultative document:
"*Supervisory framework for measuring and controlling large exposures*"

We appreciate the opportunity to review the Basel Committee's consultative document, *Supervisory framework for measuring and controlling large exposures* dated March 26, 2013. We recognize that the proposed new standard aims to ensure greater consistency in the way banks and supervisors measure, aggregate and control exposures to single counterparties. We understand that the new standard will replace the 1991 guidance *Measuring and controlling large credit exposures*.

Overall, we are concerned that the proposed framework is overly conservative and unnecessarily burdensome in some areas. Not only is the limit proposed to be calculated on a much lower capital base, but the definition of what qualifies as an exposure has been broadened considerably, including for the definition of connected counterparties. In addition, new exposure measures are being proposed.

We have two over-arching areas of concern with the proposed framework:

- Our first concern is that introducing new measures for over-the-counter (OTC) derivatives and securities financing transactions (SFTs) would result in banks needing to maintain multiple measures for the same exposure: their internal measures used for limit setting and exposure management; their capital measures (which may differ for regulatory and economic capital purposes); and a new measure for large exposures. We recommend that banks should also be given the option of using their existing measures of "Peak Exposure", as these produce results that are meaningful to banks' risk managers. Should this recommendation not be accepted, we request that the exposure measures used in the risk-based capital framework apply. We are ultimately concerned that the proposed measures

[1] The Canadian Bankers Association works on behalf of 55 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 275,000 employees. The CBA advocates 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 and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

will be viewed as arbitrary, will be used only for reporting purposes, and will be disconnected from the measures used by the bank to manage its risk, thereby creating an unnecessarily burdensome process.

- Our second concern is that banks are being asked to contemporaneously comment on the large exposure limit, as well as what is to be included under the large exposure measure and how exposure is to be calculated. It is our preference that the process for commenting on the exposures to be included and how they are to be measured should be bifurcated from the process of commenting on the appropriateness of the large exposure limit. Without the ability to model the underlying large exposure metrics, banks have insufficient basis to fully comment on the 25% large exposure limit.

We offer our comments on the consultative document below and in the attached detailed appendix.

Trading Credit Exposure Measurement

As noted above, for OTC derivatives and SFTs, we question the utility of creating a new measure that differs from the measures used by banks for exposure management purposes and those used for capital purposes.

Many Canadian banks use internal models to estimate "Peak Exposure", defined by the Basel Committee and the Office of the Superintendent of Financial Institutions (OSFI) as a:

> "*a high percentile (typically 95% or 99%) of the distribution of exposures at any particular future date before the maturity date of the longest transaction in the netting set. A peak exposure value is typically generated for many future dates up until the longest maturity date of transactions in the netting set.*[2]*"*

Peak Exposure is used by these banks for measurement, management, approval and internal reporting of counterparty risk, and this practice has been supported by regulators.[3]

We believe that, due to the use of a high-confidence interval, Peak Exposure derived from internal models provides an appropriately conservative measure of counterparty credit risk exposure, even if the internal model has not been approved to produce the lower "*Expected Positive Exposure*[2]" values for regulatory capital purposes. Moreover, where banks have such models in place, metrics will be readily available, which will allow for implementation of large exposure limit monitoring without time-consuming and costly systems development. Since Peak Exposure is already used by banks for internal credit management, providing banks with the option of using the same measure for compliance with the regulatory limit for large exposure will avoid the potential operational risk associated with using multiple measures of exposure.
We recognize the Basel Committee's concerns regarding the potential for lack of conservatism and comparability if it allows the use of internal models. However, we believe that these concerns could be addressed through Common Portfolio Analyses conducted at an appropriate frequency.

Should the Basel Committee be unwilling to use the "Peak Exposure" measure, we respectfully request that the exposure measure for trading credit follow the risk-based capital framework so as to avoid the need to maintain a third measurement type for the same exposure. For OTC

[2] OSFI Capital Adequacy Requirement, Chapter 4 Page 8, January 2013.
[3] For example, see the US Interagency Supervisory Guidance on Counterparty Credit Risk Management, Appendix A, "*Banking organizations should consider peak potential exposure when setting counterparty credit limits*".

derivatives in particular, we suggest that the bank's approved capital methodology (whether Current Exposure Method or Internal Models Method) be used.

Trading Book Equities and Debt

We believe that equity and debt instruments held in the trading book, and any offsetting hedge positions, are market risk exposures, not counterparty credit exposures, and should not be aggregated in large exposure calculations. Further, their inclusion in the large exposure limit is impractical because these positions are typically held for relatively short periods.

Look-through Approach

The look-through approach (LTA) proposed for investments and securitization presents potentially significant implementation challenges, which are disproportionate to the risk management benefit. The approach fails to recognize that certain types of investments, and the underlying components of such investments, may change frequently, and it does not permit any recognition of the benefit for credit risk mitigation provided by more junior tranches. Further, for a bank's exposure to an untranched fund (e.g. hedge, pension, or mutual funds), clients are usually not willing to provide sufficient information for the bank to assess the underlying concentrations.

We recommend that the LTA be based on a materiality threshold, to be applied first, and then a granularity test. We also recommend that the large exposure calculations exclude Collective Investment Undertakings (CIUs), securitizations, and other vehicles that fall below the materiality threshold. For those vehicles that meet the materiality threshold, any individual exposures that fall below the granularity test should be excluded. Furthermore:

1. The addition of a materiality threshold helps ensure the framework does not generate LTA reporting requirements where the transaction/exposure amount in question is immaterial in relation to the bank's capital base. We suggest that this could be set for the bank by its regulator after considering the size of the bank (e.g. a certain percentage of Tier 1 capital).

2. We consider the proposed granularity threshold of 1% of the total value of the transaction (for index positions, securitizations, hedge funds, and CIUs) to be excessively conservative. We respectfully request a 10% threshold. Further, we believe there is little practical regulatory or risk management value realized from applying the LTA to <u>all</u> exposures in an asset pool simply because one exposure represents more than 1% (or 10%, as we suggest) of the pool's value. We believe that aggregation for large exposure purposes should only be required for those exposures that exceed the defined granularity threshold.

Definition of Connected Counterparties

The definition of connected counterparties based on economic interdependence is broad, and it would be extremely difficult to identify connected counterparties and consolidate exposures across both the banking and trading books based on some of the proposed "minimum qualitative criteria" set out in paragraph 34.

We recommend that the considerations set out in paragraph 34 be treated as examples only of economic relationships other than control that may, if material, lead to interconnectedness, rather than minimum criteria. Regulators could then assess whether banks have appropriate policies

and procedures in place to ensure that interconnectedness is properly addressed when it is material.

We would also note that Canadian banks have many forms of exposure to the Government of Canada (e.g. through pledges of government securities as collateral, through Export Development Corporation (EDC) guarantees, through Canadian Mortgage and Housing Corporation (CMHC) insurance, and through government lending programs such as Farm Canada, to name a few). Including a bank's exposure to its home sovereign in reporting requirements is a complex matter, and the benefits of applying a limit to such exposures are unclear.

Credit Risk Mitigation Techniques

The proposed large exposure framework states that, where a bank uses the substitution approach to reduce the capital requirement for a guaranteed exposure, the bank "*will also **have to adopt it** for large exposure purposes*" (emphasis added). However, for credit management purposes, a bank may choose not to reduce the exposure to the original obligor. It may also choose to recognize, separately, a potential claim against both the original obligor and the guarantor. We would appreciate confirmation that banks would have sufficient flexibility to adopt the same approach for compliance with the large exposure framework as they do in their internal credit management processes.

The proposed hybrid approach for treatment of financial collateral, specifically the aggregation of the exposure to the collateral with other exposures to the issuer of the collateral, is overly conservative. In addition to creating significant operational complexity for the banks, it may have the unintended effect of discouraging the use of financial mitigants and / or restricting the liquidity available through repurchase agreements and securities financing markets. We believe the existing requirements under the comprehensive approach in the capital framework are sufficiently conservative since they take into account the possible negative movements in potential exposure value. Exposure to loss from a deterioration in the value of the collateral is mitigated in that collateral values are monitored daily and contracts require the pledging of additional collateral to cover collateral value deterioration.

Reporting before and after credit risk mitigation may be a challenge, depending on how credit risk mitigation is defined (e.g. if it includes financial collateral posted in the normal course for derivative transactions). We request clarification as to whether credit risk mitigation includes financial collateral for OTC derivative transactions and SFTs.

Definition of Large Exposures

The Basel Committee is proposing to define "large" exposure as 5% or more of a bank's eligible capital base. This is twice as onerous as the definition previously proposed by the Basel Committee. We note that Basel's *Core Principles for Effective Banking Supervision* September 2012 suggests:

> *"In respect of credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following:*
> *(a) ten per cent or more of a bank's capital is defined as a large exposure; …"*

We suggest that the large exposure definitions be aligned to the greatest extent possible, and believe that the current standard (also adopted by some regulators) of 10% is reasonable.

Level of Large Exposure Limit

We believe that it would be appropriate that the large exposure limit of 25% be defined relative to Tier 1 Capital instead of Common Equity Tier 1 capital (CET1). This would recognize the loss absorption characteristics of common and preferred shares and Basel III eligible non-controlling interests in subsidiaries' Tier 1 instruments on a going-concern basis, as they provide the bank with the ability to restrict or forgo distributions without legally triggering the insolvency of the bank. Further, the large exposures framework, like the Basel III Leverage Ratio, is constructed to complement risk-based capital standards. As the Basel III Leverage Ratio is based on Tier 1 Capital, the same should be true for the large exposures framework so as to ensure consistency among backstop measurements.

Transition Arrangements

We are supportive of the proposed effective date of January 1, 2019. Given the new processes and calculations that banks will be required to develop for the sole purpose of calculating large exposures, the framework as proposed would require extensive investment in new systems capabilities, and it is difficult to anticipate how long it will take to develop and implement the new processes. Further, without the opportunity to model the new metrics, it is difficult to anticipate how challenging it might be to comply with the new limit. Therefore, an effective date of 2019 is appropriate in order to allow for these fairly extensive implementation activities.

We thank you for taking our comments into consideration and look forward to future discussions on these issues.

Sincerely,

cc: Joel Starkes, Director, Securitization and Structured Products, OSFI Capital Division
Mary Thomas, Analyst, OSFI Capital Division

Attachment

CBA comments on the Basel Committee's consultative document: *Supervisory framework for measuring and controlling large exposures*

CBA Members' Comments and Requests for Clarification
I. INTRODUCTION *(Pages 1 – 3)*
A. Rationale and objectives of a large exposures framework *(page 1)*
The reasons for implementing a common framework appear logical (i.e. protect a bank from material losses as a result of a large counterparty default; protect the system from the impacts of a bank failure due to a counterparty default), and the objective for it to be simple sounds good. However, the proposed framework is complex and will be difficult and costly to implement, as it captures a broad group of entities and exposures that cannot be readily aggregated using present systems, and in some cases, we question whether the risk management benefits will justify the cost. We believe that any regulatory guidance on this matter should adhere to the following principles: ▪ The guidance for measuring exposure should not require additional exposure measurements methodologies where existing measurements methodologies are in place and provide an appropriate, conservative measure of exposure. For example, banks should be permitted to use their existing internal models of potential exposure for over-the-counter (OTC) derivatives. ▪ The regulatory guidance for aggregating exposures to different obligors should be principles based, with a requirement that the principles be applied in a conservative manner. Interdependence can arise from a variety of relationships, and it would be overly complex to set out all possible scenarios. The application of these principles would be subject to review by the home supervisor as part of its normal oversight of risk management at banks. ▪ Requirements for grouping should consider materiality. For example, the look-through requirements should only be required where the exposure is material to the bank's capital base.

CBA Members' Comments and Requests for Clarification
B. **Other types of concentration risk** *(page 3)*
Canadian banks already have processes in place to control other exposure concentrations (e.g. by sector and geography). We believe that the cost and benefit should be a primary consideration should the Basel Committee revisit types of risk not covered in the current consultative document to avoid burdensome requirements for limited incremental risk management benefits.
II. OVERALL DESIGN OF A PRUDENTIAL FRAMEWORK FOR LARGE EXPOSURES *(Pages 3 – 8)*
A. Scope and level of application *(page 3)*
We believe that the application of large exposure limits should be at the same level as risk-based capital requirements (i.e. total consolidated level). In particular, for subsidiaries operating in other jurisdictions that are not internationally active, we would suggest that the home supervisors for the parent bank not require application of the Basel Committee large exposures framework for the subsidiary. Local host regulations would continue to apply, since foreign subsidiaries that are not internationally active are unlikely to pose systemic risks. We believe that local regulations are in place to prevent adverse concentrations that could pose a risk to the bank itself, and there would be significant costs and effort to implement the level of data aggregation and reporting required of the large exposure framework.
B. Nature of a large exposure limit *(page 4)*
C. Definition of a large exposure *(page 4)*
1. The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting.
▪ Regarding reporting on exposures both before and after credit risk mitigation (paragraph 24), we request clarification as to whether the hard limit as part of the new Pillar 1 test will apply (i.e. the pre or post CRM amount). We agree with the proposed "hard limit" concept, provided it is post CRM.

CBA Members' Comments and Requests for Clarification

- We believe a future framework for sovereign exposures would also be useful, including addressing a bank's exposure to its own sovereign.
- We request clarification with respect to the definition of "regulatory consolidation". Is the definition contained in the consultative document limited to Basel III regulatory frameworks? If so, certain businesses would be excluded, for example, insurance and client positions.
- For reporting purposes, it would be beneficial to align the definition of exposures to existing regulatory reporting requirements so as to mitigate operational complexities and confusion.
- We recommend a large exposure be defined as 10% of eligible capital rather than 5%, to align with the Basel Committee's *Core Principles for Effective Banking Supervision*.

D. Definition of connected counterparties *(page 5)*

2. The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

We agree in principle with the definition of connected counterparties if there is evidence of either a control relationship or material economic inter-dependence. However we note that it may be very difficult to establish "economic interdependence" in practice, as this definition could easily be taken to unreasonable lengths. We recommend that the grouping requirement to be more principles-based and that the criteria cited in paragraph 34 be guidance only. We recommend that the regulators' focus should be on whether banks have appropriate policy / procedures in place for determining connectedness rather than the proposal for banks to convince regulators on connectedness in paragraph 35.

We do request clarification on the proposed criteria outlined in the consultative document; in particular:

- We would like additional clarification on paragraph 31 and how this would apply to financial sponsors (i.e. a private equity investor that provides capital, capital market expertise and strategies to the underlying borrower). While we generally agree with the principle that an entity that owns more than 50% of another entity should be assessed as connected counterparties, in the case of certain financial sponsors, there may be limited or no economic interdependence between underlying borrowers and no correlation between business and business lines. Under these circumstances, flexibility should be permitted for determining economic interconnectedness.
- As well, with respect to paragraph 32 on economic interdependence, the aggregation of exposures related to the secondary risk associated with unrelated, arm-length third parties (for example supplier / customer relationships) may not be practical. Some flexibility should be

CBA Members' Comments and Requests for Clarification

permitted with respect to materiality.

- Many of the factors proposed in the consultative document for determining a connection are consistent with current practices; however not all of them are (such as significant customers or tenants or gross receipts/expenditures). Furthermore, some of that information may change in a fairly regular manner. As a result, they would be highly ambiguous to implement in an industry-wide consistent manner. We believe that these provisions would be more likely to detract than add to comparability across different banks.
- To aid in a standardized identification of related parties, we believe that the large exposure guidelines should be consistent with the Financial Stability Board's Global LEI System to define legal entities (i.e. Legal Entity Identifiers).

E. Level of large exposure limit *(page 7)*

We believe that it would be more appropriate that the limit be defined relative to Tier 1 Capital instead of Common Equity Tier 1 Capital (CET1). This would recognise the loss absorbency characteristics of preferred shares and non-controlling interest in subsidiaries Tier 1 instruments.

III. DEFINITION AND CALCULATION OF THE LARGE EXPOSURE LIMIT *(Pages 8 – 18)*

A. Capital measure – definition of eligible capital *(page 8)*

3. The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.

- As noted in II(E) above, we believe that it would be more appropriate that limit be defined relative to Tier 1 Capital instead of Common Equity Tier 1 Capital (CET1). This would recognise the loss absorbency characteristics of preferred shares and non-controlling interest in subsidiaries Tier 1 instruments.
- Further, the large exposures framework, like the Basel III Leverage Ratio, is a complement to risk-based capital standards, and as such should use the same base (i.e. "Tier 1 capital") for consistency.
- It should be recognized that a large exposure regime is a supplementary measure to the primary risk-based capital ratios and should only be

CBA Members' Comments and Requests for Clarification

the binding constraint in exceptional circumstances where the primary measure fails.

B. Exposure measure – definition of exposure *(page 9)*

4. The Committee welcomes views on the extent and nature of the use of internal models (when they have received supervisory approval for being used for Pillar 1 capital requirements purposes) to measure large exposures.

The proposed large exposure framework recommends "*that model risk should have no bearing on exposure values in a large exposures framework*" and opts for a one-size fits all "standardised" methodology. We acknowledge the Basel Committee's concerns, but we believe that internal models developed for exposure measurement purposes provide a more accurate and conservative approach than the proposed methodology for measuring exposures relative to OTC derivatives and SFTs. Moreover, where banks have robust models in place, metrics will be readily available, which will allow more timely implementation of large exposure limit monitoring without time-consuming and costly systems development. As such, we recommend that banks be permitted to use the "Peak Exposure" measure for counterparty credit risk. However, if this recommendation is not accepted, we request that the measurement method for counterparty credit risk follow the risk-based capital framework. For OTC derivatives in particular, the bank's approved capital methodology (whether CEM or IMM) should be used as the measurement method. We believe that it would be unnecessarily burdensome to introduce another required exposure measure.

- Internal models calibrated to a high-confidence level provide a superior representation of the economic risk of counterparty exposure due to its calibration to market risk factor volatilities, and more appropriate recognition of transaction and collateral netting.
- We recommend that the Basel Committee assess model comparability by establishing a Common Portfolio Analysis at an appropriate frequency.
- For banking book exposures, we agree that the use of notional exposures is preferable as it would ensure the large exposure framework is applied in a consistent manner across all banks. The use of internal models should also be permitted for SFT exposures. For financial collateral, adding the exposure to the collateral issuer is overly conservative given the daily revaluation/posting requirements.

CBA Members' Comments and Requests for Clarification

5. The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives.

- As noted above, the banks believe that internal models developed for exposure measurement for OTC derivatives provide a more accurate and conservative approach than the proposed methodology. If the "Peak Exposure" measure recommendation is not accepted by the Basel Committee, we recommend that the exposure measurement for counterparty credit risk follow that of the risk-based capital framework. In this situation, for OTC derivatives, we believe that the bank's approved capital methodology (whether CEM or IMM) should be used as the measurement method.
- Banks already use multiple exposure calculations – one for prudent exposure management, and others for calculating capital. We do not believe there is sufficient value in creating an additional measure to justify the cost and operational burden.

6. The Committee welcomes views on the proposal for how the exposure values of banks' investments in securities financing transactions should be calculated, in particular on the need to deviate from the risk-based capital requirement rules given the objectives of a large exposures framework.

Similar to above reply to question 5, we believe that banks should be able to use their internal exposure measurement systems, where robust systems are in place (verified through regulatory oversight). Also, we believe that banks should not have to aggregate the exposure to the collateral issuer with other exposures to that issuer given the daily revaluation/posting requirements.

7. The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.

In order to achieve simplicity and consistency with banks' internal credit risk management practices, we recommend that banks have the option to apply a 100% credit conversion factor (CCF) for all off-balance sheet credit arrangements that have been approved by the bank. This would include credit arrangements where the obligor has agreed that any undrawn portion of a defined credit limit can be unilaterally cancelled by the bank (these lending arrangements are often known as "demand" or "advised" lines of credit) This would also include the undrawn portion of a credit limit, even when the obligor has not been advised of the limit amount.

CBA Members' Comments and Requests for Clarification

C. Recognition of credit risk mitigation techniques *(page 13)*

We agree that where banks use the substitution approach, the amount of the hedge (i.e. collateral) should reduce the exposure to the original debtor and be added to the exposures the bank has to the credit risk mitigation provider. However, we also believe that banks should have the option not to recognize a guarantee as a credit risk mitigant and hence not to shift exposure to the guarantor.

Indirect exposures

The section on credit risk mitigation techniques sets out a framework whereby certain exposures guaranteed by an entity with the bank's direct exposures to that entity, if the guarantee is an eligible credit risk mitigant; however, the banks may use mitigants that are not recognized for capital relief, but are useful for risk management purposes. For example, the bank may be named beneficiary on borrower's credit insurance policies as a way of mitigating risks. Some protection may be eligible for capital relief, others not. Generally, the bank tracks indirect exposure to an insurer whether or not there is capital relief. We believe that banks should be encouraged to manage and control potential claims on credit mitigant providers, even when the credit risk mitigation does not meet the standards of a guarantee for capital purposes.

It is extremely difficult to identify/isolate collateral (both physical and financial guarantees), and so it will be difficult to add back physical collateral in order to arrive at the exposure amount that complies with the proposed large exposure framework.

8. The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.

The "hybrid approach" is problematic on a few grounds:

- It is operationally very difficult to link the collateral issuer to the credit adjudication process. In some cases, banks may not have a credit relationship with the collateral issuer.
- The requirement to use statutory haircuts, where the financial supervisor has approved the use of internal haircuts, requires maintenance of a dual process that raises complexity and potential operational risk for banks. The use of internal haircuts should be permitted where they have been approved for capital purposes.

  Additionally, we note that a pledge of collateral in respect of an OTC derivative or SFT netting set where the bank net owes the counterparty should not give rise to an exposure to the counterparty, except where the risk adjusted value of the collateral exceeds the net present value (NPV) of the underlying OTC derivative or SFT netting set. In such cases, the exposure should be equal to the difference between these

CBA Members' Comments and Requests for Clarification

values (or if an internal model incorporates the effect two-way collateral transfers, the internal measure of exposure).

D. Calculation of exposure value for trading book positions *(page 14)*

- We believe that the trading book exposures should be excluded from the large exposure calculations, as trading book exposures represent market risk, not counterparty exposure, particularly where the bank has effective discipline around holding periods. At the very least, equities should be excluded; otherwise, banks may find themselves in the position of having to sell an equity that has risen in value because its new higher value is putting undue pressure on the bank's large exposure limit.
- In addition, it should not be necessary to include contracts that reference such securities, provided that the securities are liquid and the contracts are short term and/or designated to hedge the trading book exposure.

9. The Committee welcomes views on whether the approach proposed for calculating exposure values for trading book positions raises specific issues.

We believe that, in attempting to impose consistent methodologies for trading book positions, the large exposure "rules" will become needlessly complex. A more practical approach would be to permit each bank the option to use the same, internally modeled "Peak Exposure" estimates as are used by the bank for measurement, management, approval and internal reporting of counterparty risk. The ongoing appropriateness of these internal measures should be confirmed by supervisors through regular Common Portfolio Analyses.

The following are a sampling of our concerns with implementing the substitution approach:

- Paragraph 92 requires, where positions are hedged with credit derivatives, "*any reduction in exposure to the original counterparty will correspond to a new exposure to the credit protection provider following the logic of the substitution approach mentioned in paragraph 69*."
- This is effectively a notional substitution of underlying reference exposure for protection provider and is far more conservative than risk-based capital requirements, as exposure is measured under risk-based capital requirements based on a potential future exposure concept (via CEM or IMM, with adjustment for wrong-way risk under Basel III).
- Additionally it is overly conservative, as trading book positions typically are subject to daily collateralization (whereby protection seller pledges

CBA Members' Comments and Requests for Clarification

high-quality collateral to protection buyer as the reference exposure deteriorates), and are often composed of many different reference entities.

- Applying a substitution approach that ignores collateralization and diversification implies a scenario where the protection buyer's exposure to a given protection seller assumes a simultaneous default of all underlying reference obligations with no recovery on the underlying reference obligations or on any collateral pledged by protection seller.
- To address this, while recognizing the need to guard against a concentrated uncollateralized exposure developing to a single protection seller, we propose that where a bank (protection buyer) and protection seller exchange collateral daily under a derivative collateral arrangement (e.g. an ISDA CSA), the maximum exposure allocated to the protection seller be capped by the protection seller's unsecured exposure threshold under the collateral arrangement (plus counterparty exposure calculated through the applicable CEM or IMM approach).
- Lastly, we note that the advent of mandated clearing for certain types of credit derivatives may significantly reduce the diversity of protection sellers available in the market (for instance if a CDS on a given reference entity or index is required to be cleared, the only permissible protection sellers will be CCPs that clear the contract). The treatment of credit derivatives in the trading book should be considered in this context.
- For paragraph 82, we would like clarification that the large exposures framework will follow the same approach as the risk-based capital requirement for swaps/futures/forwards/credit derivatives. If so, we are in agreement. We would also like to ensure that, in the case of derivatives, it is the counterparty exposure that is being captured and not the exposure to the reference asset. For example, if bank X is long a total return swap with bank Y and the reference asset is corporation Z, the counterparty exposure is to bank Y and not to corporation Z. In addition, would the Basel Committee clarify the fact that ''*only legs representing an exposure subject to the large exposure framework need to be considered*''. Does this mean that for the calculation of the maximum loss of the instruments we have to consider all the legs decomposed, and that for the large exposure standard we only have to consider those legs that are subject to the large exposure standard?
- Furthermore, we believe that paragraph 83 and 84 should be revised. The concept of a jump-to-default by the underlying in options (as well as for securitizations, hedged funds and collective investment undertakings (CIU)) is extremely punitive, and this assumption is not consistent with the large exposure framework. If we consider that all underlying positions in options simultaneously default, we are including in the analysis a severe and global credit event and market disruption where other instruments would be impacted (and not only options or securitizations, hedge funds and CIU positions). The jump-to-default hypothesis would be more in line with a Pillar 2 stress testing requirement and not with the Basel Committee's intended goal of having a hard Pillar 1 standard applied to the large exposure framework.
- With respect to paragraph 85 referring to the exposure value for investments in index positions, securitizations, hedge funds or CIU, the

CBA Members' Comments and Requests for Clarification

calculation and monitoring needed to check if no single underlying asset has more than 1% of the total transaction (and therefore avoid the decomposition into individual positions) is operationally burdensome. While we understand the motivation, we believe the threshold set in paragraph 85 (1%) is too low and will require extensive resource commitments that are not justified by the associated risk. We recommend 10% or a minimum threshold (e.g. a certain percentage of eligible capital), which would be set for the bank by its supervisor after considering the size of the bank.

- We request clarification from the Basel Committee as to which physical collateral types are not permitted to reduce exposure values for large exposure purposes based on immediately availability and liquidity. As an example, is physical gold held as collateral part of this prohibition?
- We would like clarification that trading book exposures arising from equities held to hedge the bank's risks associated with total return swaps (TRS), or other transactions referencing a security obligation, would not be required to be aggregated with other exposures to the issuer of the equities; rather, the exposure to be measured for large exposure purposes would be the counterparty credit risk to the TRS counterparty.

E. Offsetting long and short positions in the trading book *(page 16)*

We would like clarification as to whether a long position in particular equities that is effectively offset by a total return swap (TRS) or other hedging arrangement, results in an offset exposure (i.e. can be included on a net basis).

10. The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues.

- We support the recognition of offsets between different issues of the same issuer, noting that additional guidance should be given with respect to the dividing line between subordinated debt and equities. We do not support substitution of counterparty exposure for issuer exposure, and do not support its application where protection sellers (i.e. put sellers) provide MTM collateralization of exposures.
- Further, we support an offset of the component portion of a basket against positions in the same issuer (e.g. if a bank has sold protection on an index and bought protection on one of the index constituents, the rules should allow an offset subject to seniority restrictions).
- Also, the proposal in paragraph 122 for recognition of an exposure for each underlying entity (in a basket product) should be clarified with respect to options/non-linear products on baskets/indices in the trading book (e.g. should a pro-rata share of the notional approach apply, or a

CBA Members' Comments and Requests for Clarification

change in NPV from individual jump-to-default tests?).

- Besides long and short positions in the same issue of a financial instrument referencing a single name, the Basel Committee recognizes netting between a short and a long position only if the short position is junior to the long position. This is a conservative approach. At default, all long and short positions referencing the single name will be exercised. We believe that the criteria for offsetting long and short positions should be based on legally enforceable agreements.

IV. TREATMENT OF SPECIFIC EXPOSURE TYPES *(Pages 18 – 27)*

A. Sovereign exposures and entities connected with sovereigns *(page 18)*

- Given the breadth of exposure to our home sovereign through direct exposure, guaranteed exposure and collateral, the same limit framework may not work for a bank's home sovereign and certain other sovereigns.
- We believe that banks should not have to report sovereign exposures if it is not part of the large exposure limit calculation. If we are to report such exposures, we would need clarification as to how the exposures should be grouped***.***

B. Interbank exposures *(page 18)*

In this section of the consultative document, the Basel Committee indicates that the large exposure limit will apply to all interbank exposures, including, presumably, daylight and overnight exposures, since in paragraph 101 it states that it is seeking evidence to determine if exemptions would be required with respect to these two latter exposures. In paragraph 99, the Basel Committee proposes "*to apply the large exposure limit to interbank exposures in the same way that it is applied to any other exposures to third parties*". Clarification is needed on the Basel Committee's position on settlement risk facilities in general.

CBA Members' Comments and Requests for Clarification
11. The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

- We recommend that all intraday exposures should be exempted (see paragraph 101) because intraday exposures are transitory and important to the provision of payment system services within an economy.
- We request clarification to paragraph 102 to identify which overnight exposures will be exempted. To avoid any unintended consequences on the smooth functioning of payment and settlement systems or in monetary policy implementation, examples of transactions that we believe should be exempt from the large exposures calculation include:
  - Canadian Payment Association (CPA) payments and settlement transaction, which are self-insured by participating banks (e.g. Large Value Transaction System (LVTS) and Automated Clearing Settlement System (ACSS)).
  - Minor amounts of clearing transactions for credit card settlements (e.g. Visa and MasterCard).
  - Settlement Exchange Transactions (SETS) used by banks' treasury managers to balance their Bank of Canada accounts by lending to each other.
  - Daylight overdrafts arising from a bank providing currency clearing services for its correspondent banks. In particular, this should include daylight overdrafts arising from a bank acting as a "pay-in agent" to satisfy the foreign exchange (FX) settlement obligations of correspondent banks to the CLS multilateral FX netting system.
  - Any exposures arising from payment or delivery of securities to settle FX or securities transactions, provided that the exposure remains within normal market conventions for settlement (i.e. it is not a "failed" trade).
- We do not believe that the large exposure calculation should be aggregating pre-settlement risk with settlement risk. This is inconsistent with how banks currently aggregate credit risk, and accordingly we believe that all settlement risk should be excluded.
- We agree that exposures attracting a capital charge, such as failed settlement and non-delivery-versus-payment (non-DvP) transactions, should be captured under the large exposure framework. Similar to the existing approach, exposures arising from custody arrangements, cash settlements and DvP transactions, as well as intraday positions, should be excluded from the large exposure framework.
- The concentrated nature of the Canadian banking industry (compared to its US and European counterparts), as well as the interconnectedness of the Canadian banks, have resulted in them having the largest lines and exposures amongst each other. Although we acknowledge that

CBA Members' Comments and Requests for Clarification
diversification is typically beneficial, we do believe that interbank restrictions may have an adverse effect on the credit profile of Canadian banks as it will result in the migration of counterparty risk to less creditworthy institutions. This in turn will adversely impact the capital charges imposed on banks, and perhaps defeating the purpose of the large exposure rule itself. We believe that we should be more in line with those jurisdictions that allow a higher upper-limit or change to what exposures are to be aggregated. ▪ We believe that only exposures to entities outside a bank's regulatory consolidation should be subject to the large exposure regime. The large exposures regime is a supplementary measure to assess and mitigate the tail risk arising from large exposure amounts (even if the risk is assessed as a product) and, as exposure to entities within the regulatory consolidation do not expose the consolidated entity to this tail risk, intra-group exposures should not be constrained. Other measures, including host country supervision, are the appropriate supplementary tools to deal with intra-group exposures. The Canadian marketplace has a relatively small number of institutions and inclusion of interbank transactions within Canada and the U.S. marketplace will constrain financing activities.
C. Collective investment undertakings, securitisations and other vehicles *(page 19)*
Indirect Exposures This section proposes that indirect risks from third party service providers or guarantors be added to the direct exposures to those entities. An example is given of a fund manager. There are situations where the bank enters into relationships with fund managers in order to provide financing to the fund's customers, which are collateralized by their mutual funds. These relationships can generate sizeable portfolios of diversified clients, not only from a single-name exposure standpoint, but also from a product type and geographic standpoint. Though fraud on the part of the fund manager represents a real risk, the actual exposure cannot be considered to be 100% of the collateralized loans since it is highly unlikely that all customers default on their loans at one time or another and that the all the collateral will be worthless. Hence the actual exposure to the fund manager is substantially less than 100% of the collateralized portfolio. Considering 100% in such cases would be inappropriate and would severely restrict lending not only to the customers but to the fund manager. To manage these relationships, the bank sets a limit to cap its involvement with and potential dependence on the fund manager. However that limit is distinct from the single-name credit limit. Otherwise, in order to sensibly aggregate such an indirect exposure to a direct credit exposure, the bank would need to perform an actuarial appraisal of the indirect exposure in order to convert it into something more meaningful. Such a

CBA Members' Comments and Requests for Clarification

procedure would however introduce model risk and variations in calculations between banks, both of which the Basel Committee wants to avoid.

Securitizations:

The credit risk of the underlying counterparties in a securitization is different than other types of exposure to that counterparty due to the credit enhancement in the securitization structure. We recommend that the Basel Committee exclude securitization exposures from the grouping due to the fact that they are credit enhanced. If the Basel Committee decides to include these exposures, then we would want the look-through requirements to be modified, as below.

12. The Committee welcomes comments on the calibration of the granularity threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues.

- The need to recognize and monitor same name and highly correlated portfolio exposures is a basic tenet in managing portfolio risk. However, the LTA as proposed is excessively onerous and will require IT changes to implement. Further, the incremental risk management benefit only exists where exposures are large.
- The size of the undertaking is magnified by the fact that positions within vehicles can change frequently depending on the nature of the investment. The dynamic management of assets within many funds types would mean that real-time monitoring of LTA would be onerous. The value of periodic monitoring would be questionable and prone to arbitrage/window dressing.
- In addition, banks may have little control as to how the positions evolve. Therefore, in order to ensure compliance, banks will need to review investment policies of each vehicle and take into account not the actual exposure, but the maximum possible exposure to any given issuer according to the vehicle's investment policy.
- The effort is further complicated if positions include derivatives. If the LTA applies to vehicles that do derivatives, particularly options, the banks will generally face an opaque structure. Consequently, the limit to unknown clients may unduly constrain the banks in vehicles where strategies are short term and cover a diversified number of positions. Further, funds do not currently provide OTC derivative counterparties with sufficient information to apply the LTA. A significant change in market practice would be required.
- The approaches suggested in paragraph 111 to "strongly" incent LTA application will result instead in a reduction in credit availability to small and mid-market names that add diversification to securitized credit portfolios, and gear portfolio construction more to satisfying arbitrarily

CBA Members' Comments and Requests for Clarification

defined granularity tests than achieving portfolio mix and diversification sought by investors in a securitized asset pool.

- For these reasons, we propose:
    - Securitizations/funds/vehicles backed by retail assets, including mortgages, be exempt from the LTA. These exposures are typically well diversified and there would be little benefit in attempting to aggregate each exposure with other exposures to the same name.
    - That the granularity test threshold be increased to 10% and that only those exposures over 10% be subject to aggregation with other exposures to the same name. The 1% threshold as proposed would be unnecessarily burdensome and it is not realistic to add up all of the unknown exposures across funds; this could result in an overly exaggerated "unknown" client.
    - A minimum transaction amount (i.e. materiality threshold) for applying the look-through: we would suggest a percentage of a bank's total assets or capital.
- If look-through is required for securitizations (we are recommending that it is not due to the difference in type of exposure), existing transactions should be grandfathered (i.e. no look-through for the duration of the term for existing arrangements) as underlying assets for securitizations are not identified in all cases (may not be a requirement that the seller provides a breakdown). Further, the aggregation requirement should be relative to funded exposures only. The definition of exposure (in paragraph 52 (a)) is the notional amount of the commitment. We would only be able to identify the look-through for funded securitization exposures, not for commitments, either for on-balance sheet exposures or unfunded liquidity backstop facilities, as for anything not yet funded, we would not yet know the name of the entity.

13. The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the large exposures framework.

- We recommend a principles-based approach to treatment of identified additional risks.
- We agree that it is appropriate to recognize and identify additional risks, such as sponsors/originators/managers of funds/trusts, etc. However, there should be some recognition in the framework that these risks are not "primary" risks but are of "second order" magnitude. Therefore, a single large counterparty exposure limit should not be set to be independent of the type of risk. For example, it should be recognized that the risk associated with making an unsecured investment in, for example, a financial services company, is materially greater than the inherent risk associated with a making an investment in a retail asset securitization issued/sponsored by the same financial institution.

CBA Members' Comments and Requests for Clarification

- The "case-by-case" approach suggested would in practical terms be unworkable and impossible to apply consistently across jurisdictions, banks, and time. Also, the proposal for treatment of identified risks in the large exposures framework is not practical and appears to be highly subjective with potentially punitive implications. We request further clarification from the Basel Committee.
- We acknowledge that "key party" risks need to be identified in any transaction where the quality of a party's performance in the role they play can materially impact the realization of value. However, aggregating the dollar value of an asset pool where a party performs an administrative role with any direct financial obligations it may have to a bank distorts the perception of the name risk and will limit any firm's willingness to assume those types of roles on behalf of banks.
- For securitizations, we think the servicer risk is mitigated by the ability to use a replacement (stipulated in the agreements).
- For seller credit enhancement, we believe this would need to be grouped with other exposures to the seller, but we do not know how this could be accomplished.

  Aggregating exposure to a single manager has value, but the risk is not equivalent to interconnected borrowers, so we believe it should be exempted from any hard limits. These could be monitored to ensure that proportionate measure to prevent fraud and other operational risks are in place.

D. Exposures to central counterparties *(page 25)*

14. The Committee welcomes views on the options for the treatment of banks' exposures to CCPs.

- References to "CCPs" below should also be understood as referring to "QCCPs".
- Given Basel incentives to encourage banks to transact with CCPs, we favour reporting of exposures to CCPs, but without a limit. The move towards CCPs has been driven by regulatory requirements, and as such is beyond a banks' control. We believe that the second option (i.e. to report all large exposures to CCPs to their supervisors) is the more appropriate option. Analogous to the regulatory capital framework, we believe non-qualifying CCPs should be treated as bilateral counterparty exposures and subject to the same reporting and limit requirements.
- We would be opposed to two or more CCPs being considered as a group of connected counterparties. While they may share the same membership base, the members are of high creditworthiness and have collateralized their exposures on an intra-day basis to the CCPs.

CBA Members' Comments and Requests for Clarification
Furthermore, they may not be contributing equal amounts of risk to the CCPs (example clearing large nationals on one CCP not another). ▪ Each CCP has different financial safeguards and default mechanisms, and operates under different jurisdictions. As such it would be difficult to determine the connectedness of the CCPs based on the aforementioned arguments. ▪ Exposures to CCP should be monitored as an indication of the magnitude of systemic risk concentrations. In this regard, default fund commitments need to be counted as well as contributions. However there is no benefit to making these subject to a limit. The onus should be on supervisors to ensure that the CCP is sufficiently robust and not overly connected.
V. LARGE EXPOSURES RULES FOR GLOBAL SYSTEMICALLY IMPORTANT BANKS *(Page 27)*
▪ Imposition of lower caps on exposures to systemically important banks could force banks to increase activities with riskier counterparties, or forego some prudent activities (e.g. hedging) altogether. This is a concern in particular in Canada where the industry is concentrated to a few lower-risk banks. ▪ If lower limits are contemplated, the limit proposal should include analysis to support the recommendation. The potential for "unintended consequences" should be explicitly considered.
VI. TRANSITIONAL ARRANGEMENTS *(Page 28)*
▪ With respect to implementation and transitional arrangements, it will be important that the new rules be effective for all parties at the same time. We also request that the timeline allow institutions to adequately plan for, and effectively manage, implementation. ▪ The framework proposed would require extensive investment in new systems capabilities, and thus will take time to implement; therefore, the domestic implementation timeline should not be earlier than 2019, as proposed in the consultative document.

CBA Members' Comments and Requests for Clarification
ANNEX 1 *(Page 30)*
The proposal taken as a whole contains layer upon layer of complexity and introduces new processes and calculations that we believe are unwarranted. Moreover, we are concerned some of the proposed metrics and calculations that deviate from current risk management practices will result in unintended consequences that can have significant impacts on certain market activities, such as the interbank funding markets.