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CANADIAN BANKERS ASSOCIATION

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

Dear Sir/Madam:

Re: CBA[1] Comments on the Basel Committee on Banking Supervision's Consultative Document: The non-internal model method for capitalising counterparty credit risk exposures

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document: The non-internal model method for capitalizing counterparty credit risk exposures. The CBA supports a framework that would improve upon the existing methods – the Current Exposure Method (CEM) and the Standardised Method (SM) – by better capturing the benefits of collateral, legal netting arrangements and variation margin, and correcting for some of the known deficiencies of the CEM and SM. While the CBA sees the non-internal model method (NIMM) as a step forward in achieving the BCBS's objectives, CBA members would first like to review the results of the QIS before providing any final views on the NIMM.

The CBA would like to express its general support for the joint response of the International Swaps and Derivatives Association (ISDA), the Global Financial Markets Association (GFMA), and the Institute of International Finance (IIF) to this consultative document ("joint response"). This CBA response attempts to complement the joint response by highlighting key areas where the CBA is in agreement and supportive of the joint response, but also noting potential impacts on CBA members in the Canadian context.

These comments are set out below.

Foreign Exchange and Interest Rate Risk

The CBA believes that there needs to be better integration of foreign exchange (FX) and interest rate risk. More specifically, members see the current proposal as a step back compared to the

[1] The Canadian Bankers Association works on behalf of 56 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.

CEM which allowed, through the net gross ratio, a certain level of diversification across asset classes.

Further, in the case of FX products, the CBA echoes concerns raised in the joint response as it pertains to the absence of "triangulation" of FX positions. For example, allowing banks to search for cycles of mutually offsetting FX trades and collapsing their notionals to the extent possible could be one approach.[2] As currently drafted, the proposed rules would further dis-align with banks' risk management practices.

Risk Sensitivity

The CBA is concerned that, contrary to the BCBS's stated objectives, some of the changes will reduce risk sensitivity for certain types of transactions. In particular, we note that long dated and unidirectional trades will see their capital requirement increase significantly, which does not seem to coincide with results observed using more sophisticated approaches. Further, the maturity adjustment in effective notional for interest rate swaps seems unduly punitive as currently designed. As corporate clients use these types of derivatives extensively, unintended consequences of this lack of risk sensitivity may include reduction in availability of risk management tools for large corporates or encouraging them to make use of the shadow banking sector.

For example, a 10 year interest rate swap with a 5% fixed rate would have a DV01[3] about 20% smaller than the nominal term of 10 years. Determining the DV01 of a swap is a simple exercise no more complicated than finding its MTM in the first place.

Similarly, determining option deltas analytically should be considered by the regulators for the same reason that it is a straight-forward extension of the MTM process.

Margined Trades

The CBA believes that the treatment of margined trades requires further work and clarification. In particular, the proposal does not consider the different margining regimes:

i. Exposures exceeding the counterparty thresholds: This is the primary focus of the rules.
ii. Exposures significantly below the counterparty threshold: As currently proposed, the treatment of margined transaction could lead to perverse incentives whereby banks could prefer unmargined transactions to margined transactions. The rules should not disincentivize the use of risk limiting benefits of higher thresholds.
iii. Negative MTM below the institution threshold: In this case no collateral is posted and the potential future exposure should be similar to the unmargined case.
iv. Negative MTM exceeding the institution threshold: In this case, there is a potential future exposure over the margin period of risk due to unreturned collateral in case of a default.

The proposal needs to consider the interaction between the different regimes more carefully. Also, the current proposal does not consider one-way CSA agreements with only one side

[2] This happens automatically in any portfolio-level simulation but would have to be explicitly implemented in a NIMM-type approach. This is something the industry could work on with regulators.
[3] DV01 is the mark to market change for a 1 basis point change in swap rates.

posting, which is common for transactions with supranationals and sovereigns. Another concern is the treatment of written options in portfolios that consist solely of written options.

We suggest a modification to the rules to avoid disincentivizing the use of margin agreements (i.e. required capital should be no more than in the unmargined case).

Alpha

Paragraph 14 sets out alpha to equal 1.4. The CBA understands the difficultly in determining the appropriate value of alpha, as a range of values could be supported. However, we note that since IMM and NIMM are not fully comparable, consistency in the alpha value should not be an indispensable condition. Consequently, the CBA suggests that the BCBS determine the ultimate value of alpha after reviewing the results of the QIS.

We also question whether alpha should be applied to the replacement cost as well as to the add-on component of the calculation. There is nothing uncertain regarding current exposure so it seems incorrect to scale that term as well.

We thank you for taking our comments into consideration and would be pleased to discuss these issues further at your convenience.

Sincerely,