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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 BCBS discussion paper: The regulatory framework: balancing risk sensitivity, simplicity and comparability

The Canadian Bankers Association (CBA) appreciates the opportunity to comment on this Basel Committee on Banking Supervision (BCBS) discussion paper, which addresses the complexity of the regulatory capital framework, its consequent impact on the comparability of capital adequacy ratios across banks and jurisdictions, and the desire to maintain a risk sensitive capital framework.

The CBA understands that there is currently a vigorous discussion in the international regulatory community over the use of internal models in measuring and managing risk that extends beyond this discussion paper. The CBA wishes to contribute to this discussion by sharing its views in an effort to help the BCBS achieve the appropriate balance between the complementary goals of risk sensitivity, simplicity, and comparability.

Canadian Banks and the Basel Capital Framework

Canadian authorities, and in particular, the Office of the Superintendent of Financial Institutions (OSFI), have historically been strong proponents of the Basel capital frameworks (Basel I, Basel II, Basel 2.5, and Basel III). As a result, Canadian banks were among the first to adopt each iteration of the Basel capital framework.

In turn, CBA members believe that Canadian banks have benefitted greatly from the early adoption and robust application of each successive Basel capital framework. We believe that full adoption of the Basel capital framework, including its “use test” requirements, helped accelerate

[1] The Canadian Bankers Association works on behalf of 57 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.

increased sophistication of our risk management systems and contributed significantly to the high levels of confidence in Canadian banks. We also believe that this played a large role in the strong performance of Canadian banks throughout the global financial crisis.

The CBA believes that the adoption of Basel II was a necessary step forward in managing risk in a modern banking system. While Basel I was a good first step for its time, its simple assessment of risk for capital adequacy purposes was not sufficiently risk sensitive given the development of modern risk management techniques. More importantly, we believe the complexity of the financial services environment demands more sophisticated approaches to the measurement of risk which must be aligned for business and capital adequacy purposes. In an increasingly complex financial system, if capital requirements are determined based on simple measures, capital measurement and its supporting processes will be used strictly for regulation, while banks continue to evolve their risk management practices to maximize their relative performance and increase their understanding and management of risk. This will contradict Basel II's use test requirements and result in a growing divergence between the two forms of "risk" measurement. It will also result in a simpler regulatory system that is unable to evaluate the important differences between financial products and services which may have similar characteristics but have different risk profiles – likely resulting in the overcapitalization of banks and a drag on economic efficiency – but possibly resulting in arbitrage and undercapitalization of banks with the resulting risks to the financial system.

Unlike standardized approaches, the Advanced Internal-Rating Based ("AIRB") approach and modelled market risk approaches do not erroneously assume asset/exposure homogeneity across all banks and jurisdictions. Indeed, internal ratings and parameter estimations function to delineate risk within assets and portfolios which achieves a level playing field between similar banks in the same jurisdiction. The CBA continues to strongly support the use of internal risk models within AIRB and the trading book and opposes any efforts to move away from this risk sensitive approach towards a more simplified approach, which we would view as a dramatic step backwards.

Risk Sensitivity

The CBA recognizes that there is an inevitable trade-off between different objectives of the regulatory capital framework such as risk sensitivity and comparability. The consultation paper correctly notes that "simplicity has not, to date, been recognized as an explicit objective". In our view, as discussed below, simplicity should not be recognized as an objective of the regulatory capital framework except insofar as it is a tool to achieve other objectives such as comparability. Risk sensitivity and accuracy should be the primary objective. This, along with confidence in prudential supervision, is what creates confidence in the integrity of the regulatory capital framework. Without it, comparability and simplicity could create artificial confidence in the robustness of the regulatory system.

CBA members believe that the AIRB approach and advanced approaches to evaluating market risk, which allows banks to delineate risk within portfolios, across banks, products and exposures, and across jurisdictions, continues to be the appropriate approach to managing risks for large, complex banks. In fact, the AIRB and modelled market risk approaches have now become widely accepted as a more sophisticated approach to risk management for large, complex banks, regardless of what approach may be required for regulatory purposes.

A movement to a more simplified approach should not be based on a view that a portfolio should be measured equally across banks and/or jurisdictions, as this view would not appropriately

reflect jurisdictional differences in legality and stability nor would it reward strong risk management in all of its forms, adjudication and structuring, on-going portfolio management, and loan workout and collections efforts. In short, consideration should be made that asset class homogeneity across the globe does not truly exist. This, in turn, reinforces the need to retain national discretion as a necessary part of the framework.

Internal Models vs. Standardized Approach

In line with concepts ascribed to by Basel II, the framework needs to evolve with enhancements in risk measurement. Despite the additional complexity brought about by the use of internal models, the CBA strongly believes that the use of models enables more accurate and refined measures of risk than simpler, standardized models. The only way to measure risk and evaluate the results of risk management practices across banks is through the use of individual models. Extensive use of the standardized approach could introduce capital arbitrage. In Canada, such internal models undergo a significant amount of continuous internal scrutiny within the bank itself (e.g., internal and external audit), as well as by OSFI, our national regulator. It is such scrutiny that ensures the integrity of the models in Canada. Similar scrutiny elsewhere gives us confidence that the spirit of the regulatory capital framework is being respected as well.

It is also worth noting that while banks have discretion in how they model certain parameters within the AIRB approach, many significant capital requirement drivers within the internal models are outside of the banks' control. For example, non-discretionary conservative adjustments are embedded throughout the AIRB regulatory capital models such as adjustments to LGD for economic downturns, PD floors for bank and corporate exposures, and the application of the 1.06 scalar.

The AIRB approach provides banks with appropriate incentives that align risk management and risk appetite with capital usage and enable the development, and refinement of more sensitive measures of risk that should also lead to more accurate usage of capital. Further, it is also worth noting that these internal models do not necessarily yield lower capital requirements compared to a standardized approach, but do so only in cases where the actual risk of a portfolio in a bank in a jurisdiction is less than the global average.

While the CBA believes that the standardized approach to risk management may be adequate for smaller banks with a limited diversity of risks, it does not believe that this approach should be used for large, complex banks. The standardized approach also places a heavy reliance on external ratings, which would be problematic given the shift in many jurisdictions to reduce the reliance on external credit ratings. Since 2008, many authorities have referenced an insufficient understanding of risk and an over reliance on external ratings as the major contributor to the global crisis. The standardized approach can also increase the prevalence of 'cliff effects', where a small ratings downgrade can result in a non-commensurate increase in capital.

Simplicity vs. Complexity

The CBA would agree that the pursuit of increased risk sensitivity over the years has increased the complexity of the capital adequacy framework in some areas, and in particular for the calculation of risk-weighted assets. However, we do not believe that the pursuit of simplicity (or alternatively, the avoidance of complexity) should in itself be a goal that supersedes the need for risk sensitivity and accuracy.

The CBA generally supports the objective of simplicity. However, we do not believe that all risk models should be 'simple' or that risk sensitivity and accuracy should be sacrificed to achieve simplicity. Instead, we believe that risk models should not be unnecessarily complex and that any increased complexity must be justified by a more accurate representation of risk with corresponding risk measurement benefits, such as improvement to the alignment of incentives that encourage and reward reductions in risk.

While the CBA would generally support efforts to simplify the regulatory and capital framework, this must not be done at the expense of the risk sensitivity achieved through the AIRB and other advanced model approaches.

If an additional objective is to be added to counterbalance against complexity, we recommend that it should be "supervisability" – not simplicity. The discussion paper notes correctly that complexity and opacity affect comparability and make it difficult for regulators and other stakeholders to evaluate whether risk sensitivity has been achieved. The goal should not be to recognize "simplicity" as an end in itself, which would limit other objectives. However, improvements which achieve risk sensitivity should be bounded by trade-offs which result in so much complexity that it is not practicable to supervise or compare banks.

Comparability

The CBA believes that capital adequacy ratios should be as comparable as practicable within national boundaries and across borders. However, to do so, the regulatory regime would need to adjust for differences in governing laws, business environments, and business practices, all of which make it difficult distil a complex business into a comparable ratio – particularly if simplicity is an objective and complexity is to be avoided.

The consultative document notes several reasons why these ratios may not be comparable across banks with similar risk profiles; however, more work is required to understand differences in model outcomes from risks perceived to be similar but which are supportable by bank-specific risk management practices and experiences and jurisdictional differences. We believe that a certain level of differentiation among banks can be reasonably justified and that diversity in financial systems (e.g., different opinions on riskiness) is a source of strength. While differences in risk measurement and model validation must be adequately supported and consistently supervised to maintain the broader comparability of risk-based capital adequacy ratios across all banks and jurisdictions, significant systemic risk would be created if homogeneity is required and risk sensitivity is reduced.

The CBA would welcome guidance on AIRB implementation and be supportive of a disclosure framework that would help improve comparability across banks and across jurisdictions. It may also be worth exploring a manner in which national authorities would be required to explain any material cases where they have exercised national discretion.

Finally, as noted in the Basel Committee work on comparability of risk weighted assets, variation in supervisory practices is a significant barrier to comparability. While national discretion to increase capital requirements to address idiosyncratic and local concerns is important, given the need for comparability of ratios across borders, such discretion should be utilized in a way that will maximize comparability. As such, we urge the Basel Committee to reinforce a consistent use of Pillar 1 as the minimum capital requirements, leaving discretion to national regulators and banks to use Pillar 2 so that additional capital may be held without distorting the comparability of capital ratios. Further, while we understand that sovereignty permits national regulators to

reduce capital requirements below Basel Accord requirements, we recommend that national deviations from Basel Committee rules should be transparent. As such, we recommend that banks receiving the benefit of lower national standards should be required to disclose their capital ratios with and without the benefit of such national discretion.

Enhanced Disclosures and Comparison with Standardized Approaches

CBA member banks have recently been devoting large amounts of resources towards meeting new international and domestic disclosure requirements, including those of the Enhanced Disclosure Task Force. As such, we emphasize that what truly matters from a disclosure perspective is the quality of the information (i.e., disclosing the true drivers of risk) rather than the quantity of information that is made publicly available.

The CBA recognizes the value provided by standardized approaches when AIRB or other advanced approaches are not possible due to inadequate data sources, data integrity concerns, etc., which prohibits robust modelling and parameter estimation. However, we would have serious concerns disclosing the results of modelled vs. standardized outcomes, as the results could be misinterpreted by users. For example, users may misinterpret standardized measures of risk to be the “correct” measure of risk, and therefore view lower measures of capital produced by risk models on lower risk portfolios as being “faulty” or overly aggressive.

The CBA believes that standardized approaches are the least accurate in terms of their risk sensitivity, which often results in this approach being used as a “last resort” when other, more risk sensitive, measures are unavailable.

Introduction of the Basel Leverage Ratio

The Basel III framework will include a non-risk-based metric through the ‘leverage ratio’, which is being designed in a way that ensures full comparability internationally, irrespective of accounting standards, or other factors. Leverage comparability across banks and jurisdictions is more easily attainable than standardized risk-based comparability and, in this context, a primary goal of comparability for the leverage ratio appears more appropriate.

The leverage ratio is a natural complement to a risk sensitive capital framework and should be a straightforward, standardized test that permits broad comparability on a fungible basis. The simple assets-to-capital multiple in Canada has worked very effectively. In contrast, the proposed Basel leverage ratio, although simple conceptually, is complex to calibrate and excessively conservative, overstating leverage by over weighting contingent events. Further, while the extent the Basel leverage ratio is aimed at restraining risk during benign periods when risks are hidden, a significant risk exists that it can become the binding constraint under stress – thereby resulting in pro-cyclical deleveraging which can exacerbate a stress.

In order for the Basel risk-based capital framework to continue to be effective, the non-risk-based leverage ratio must be used as a complement to the risk-based capital framework. The Basel leverage ratio would be a much less effective complement to a simplified risk-based capital framework. Once implemented, there should be no need to simplify the framework further.

Principles-Based Regulation & Effective Supervision

The discussion paper requested our views on other approaches that could help balance the competing objectives of the regulatory regime. A significant source of strength in the Canadian

regulatory system is principles-based regulation, supported by clear guidance and effective and consistent supervision. Principles-based regulation supports risk sensitivity and avoids arbitrage provided banks internalize the regulatory objectives enunciated in the principles. Clear rules-based guidance shows how those principles can be achieved – but requires banks to go further if the rules will not achieve the regulatory objectives.

While prescriptive rules can be arbitraged by achieving technical compliance, principles are much more difficult to arbitrage unless they are ignored. Effective supervision can then focus on both compliance with technical guidance and on whether the principles have, in substance, been achieved.

Greater reliance on principles-based regulation, supported by clear guidance and effective supervision, will increase risk sensitivity and comparability of capital ratios. Rather than creating a choice between risk sensitivity (on one hand) and comparability and simplicity (on the other), this regulatory direction recognizes the complexity in modern financial markets and requires banks to address such complexity in a way consistent with fundamental regulatory objectives, including risk sensitivity. Further, unlike the other suggestions in the consultation paper to more fundamentally address complexity, this will not require a disruptive change to banking and is, with the commitment of banks and regulators, achievable through incremental and measured change.

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

Sincerely,