

June 26, 2016

William Coen
Secretary of the Basel Committee on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

Via Email

Dear Bill:

Re: Comments on the BCBS consultative document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*

Thank you for kicking-off the meeting with industry representatives on June 23 to discuss the BCBS's March 2016 consultative document, *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* ("consultation paper") and for inviting us to send in over the weekend any additional comments we may have as a result of meeting.

While I am sure that the RMG, SIGBB and Secretariat members will update you and the BCBS on our rich discussions of the industry proposals¹, given my former BCBS role and my current position as a risk manager, I hope I can provide unique perspective on four key take-aways from Thursday's meeting which may not otherwise be apparent².

1. RCAP Indicates Credit Internal Ratings Based (IRB) Approaches Are Conservative:

While there has been suspicion that banks use IRB models to artificially lower RWA, the April 2016 RCAP report overwhelming shows that IRB banks are conservative in estimating retail and SME corporate AIRB parameters when compared to actual outcomes. While the RCAP results do not have a long time series and the data is uneven among participating banks, all four asset classes have data before the 2008-09 financial crisis and therefore consider a stress period. These results reflect that a combination of supervisory influences and bank conservatism result in prudent IRB parameters (i.e. actual results for the industry are consistently, and generally materially, below estimated defaults and losses). As with other studies, while there is variation in among banks, much of it can be explained by supervisory requirements and local market differences and there is no evidence to support the conclusion that there is widespread use of IRB to game the system. Further, when the RCAP results are considered in the context that some banks experienced severe stress in the data period, the few instances where industry average results exceed estimates appear reasonable. In the remaining paragraphs I address the question of whether individual bank variability is evidence of unacceptable practices³ and how that can be controlled.

2. Supervisors Have The Ability To Address IRB Variability: As you noted in your opening remarks, BCBS has made significant strides post-crisis in creating more consistent

¹ See the proposals set out in the IIF letter of June 3, 2016.

² These 4 points are supplementary to the IIF June 3 and Canadian Bankers Association June 23 comment letters, which I support and endorse for your consideration

³ Note that mortgage variability in the April RCAP paper is materially overstated since 3 participating Canadian bank estimates included the benefit of guarantees and the actuals did not. Correcting this moved BMO from a notable outlier, with estimated PD well below actual PD, to being near the mean with estimated PDs being well below actual.

supervisory standards and more effective peer reviews to identify divergences, and in understanding bank practices through tools such as RCAP. As Thursday's discussion revealed, supervisors have the ability to create tools and collect data that will identify unacceptable IRB practices and enable supervisors to correct them. With respect to bank and large corporate exposures, given the BCBS conclusion that these credits can be evaluated by public data, the BCBS can sponsor a model which supervisors can use to assess individual bank model outputs – and which BCBS may, during peer reviews, use to assess supervisory performance⁴. Further, for retail and lower end commercial IRB models, the April 2016 RCAP shows that it is easy to identify banks and jurisdictions with models that under-predict defaults and losses so that national supervisors can hone in on outlier banks and BCBS peer reviews can assess national supervisors. With these modest advances and supporting BCBS guidance, undesirable model-driven RWA variability can be effectively identified and targeted, without restricting IRB modelling or causing unintended consequences (such as those I discuss in the next paragraph).

3. **Use Test & Parameter Discovery:** As you noted in your remarks, the “use test” was at the core of Basel II advanced approach: it was the hallmark of readiness for IRB and evidence that the models reflect how risk is managed. Thursday's discussion revealed that the BCBS proposal would weaken the use test and that the industry is seeking to renew the use test⁵. IRB banks understand and manage risks through the process of discovering IRB parameters and determining risk ratings. For advanced approach banks, our IRB processes have, as desired by the use test, become inextricably linked to our risk management processes. The consultation paper proposes to provide minimum or mandatory parameters for some asset classes and to require banks to use a standardized approach for others. Even where this will not increase capital, IRB banks believe this interference with core elements of our risk management processes will have undesirable consequences. This is a key reason why the industry generally prefers model restrictions that do not interfere with risk management practices – e.g. if LGDs for an asset class are considered too variable and some banks appear to have unreasonably low LGDs, rather than flooring LGDs, the better intervention is to require a minimum RWA as it will better support the continuation of existing risk management and parameter discovery practices⁶. Further, a bank's data has been formed by those linked risk management and IRB processes and it may not be practicable to restate historical data. Finally, differences in risk management and risk assessments create the diversity that underpins efficient resource allocation and strengthens systemic resilience to risk. As such, more is at stake than an abstract trade-off between more risk-sensitive models and comparable or equivalent RWA calculations.
4. **Local Markets Require Local Solutions:** On Thursday it became apparent from the comments of different industry representatives that the more local the market, the more variable RWA should be for an asset class. Variation of RWA to reflect differences in risks from local markets and products is desirable and should be encouraged. Leaving aside exposures to multinational banks and corporations, the risks to smaller businesses and consumers can only be properly evaluated in the context of the local market. At BMO we

⁴ In the US CCAR process, the Federal Reserve uses its internally developed stress loss model to evaluate and benchmark bank models – the BCBS and national supervisors can create similar tools to evaluate IRB models.

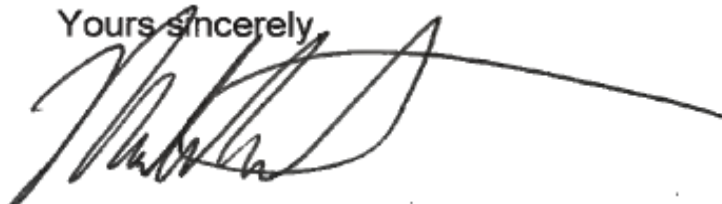
⁵ In particular, with a more granular slotting based approach for banks which relies on a bank's internal model and by continuing to use internal models for large corporates, specialized finance, SME corporate and retail asset classes, the industry seeks to maintain the linkage between risk management and internal models.

⁶ For example, in certain asset classes, a bank may record defaults before peers, which causes higher PDs and, as more of the defaults are resolved without material loss, lower LGDs. If the LGD is floored, such a bank will be strongly incented to change its preferred risk management practice so it can reduce its PD and increase its LGD.

know that even apparently similar customers and products in different markets can have important underlying differences⁷. As such, it is not practicable to develop internationally binding minimum IRB parameters for assets that can only be evaluated in a local context⁸. It should be the role of national authorities to determine appropriate local requirements and it is the role of BCBS to develop principles to guide banks and supervisors and, through peer reviews, to consider whether jurisdictions are Basel Accord-compliant. Considering the objective of comparability, capital ratios will not be meaningful or comparable if international rules mandate the same RWA calculations for asset classes in different circumstances.

Thank you for your continued thoughtful leadership and for seeking to find a balance between many competing demands. Please let me know if you would like to discuss my comments.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark E. White', with a long horizontal flourish extending to the right.

Mark E. White,
Senior Vice President & Head Enterprise Risk,
Bank of Montreal

cc: Mark Zelmer, Deputy Superintendent, OSFI
Richard Gresser, Senior Director, Capital Banking, OSFI
Guiseppe Siani, Chair RMG
Noel Reynolds, BCBS Secretariat
Brad Carr & Andres Portilla, Institute of International Finance
Darren Hannah, Vice President, Canadian Bankers Association
Surjit Rajpal, CRO, Bank of Montreal
Tom Flynn, CFO, Bank of Montreal

⁷ For example, despite the apparent similarity in US and Canadian economies, neighbourhoods and customers, fundamental underlying differences in the residential real estate markets cause the risks to not be comparable.

⁸ For example: residential mortgages are driven by a complex interaction of local characteristics such as taxation, creditor/consumer rights, mortgage insurance, unemployment support and other national factors; credit card risks are determined by customer behaviours (e.g. revolvers vs transactors), bank lending and enforcement practices and the legal and consumer finance framework in which they operate.