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

Dear Basel Committee members:

**Re: CBA¹ Comments on the Basel Committee consultative document:
“Capital floors: the design of a framework based on standardised approaches”**

We appreciate the opportunity to provide comments on the consultative document, “*Capital floors: the design of a framework based on standardised approaches*”. While we agree that a capital floor is an important element of any capital framework, and we support the Committee’s goal of ensuring an adequate amount of capital exists across banking systems, we have serious reservations about the proposed capital floors framework and its reliance on the proposed standardized approach (SA) for credit risk. We also acknowledge that the existing AIRB floor, based on Basel I, needs to be replaced as the framework is substantially different from Basel III. This has resulted in banks maintaining a Basel I legacy system that is not used internally for any other purposes. However, we note that the current Basel III SA could be used to provide floors and that it is unnecessary to introduce the new proposed SA for the purpose of providing a calculation for capital floors.

We have concerns related to the roles and objectives of capital floors, the introduction of floors to internal models based on standardised approaches, and implementation including the inter-relationship with the proposed revisions to the standardized approaches for credit, market, and operational risk. We have provided our comments on these issues below. Detailed comments are included in the attached appendix including our responses to the questions posed in the consultative document.

Roles and objectives of capital floors

We note that the Committee views the role of a capital floor as complementing the leverage ratio and acknowledges that each measure addresses different issues and offsets shortcomings of the other. The use of Basel I as a floor was appropriate as banks’ transitioned to Basel II. However, given that all Canadian banks have implemented Basel III, we believe that continued use of a standardized based capital floor reduces the benefit realized by banks that have implemented good risk management infrastructure. We believe the proposals may undermine the risk sensitivity measures that are fundamental to the AIRB approach. We strongly believe that the role of a capital floor must be clarified as being a back-stop measure to the risk-sensitive calculation of capital requirements.

¹ The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 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.

The Basel III leverage ratio already provides an effective and relatively straightforward capital floor. At the current time, given that the leverage ratio is just coming into force, we do not see the need for another capital floor and recommend that the current AIRB capital floor should be withdrawn, pending continuing study of the leverage ratio and AIRB interaction.

Should the Basel Committee determine that a SA capital floor is required in addition to the leverage ratio, we do have several concerns over the claims that are presented in the consultative document to justify their use, and we offer some further insights below.

Binding constraint vs. back-stop measure

A standardized floor on low risk portfolios reduces risk sensitivity by making it a binding constraint and may encourage banks to manage risk poorly or move up the risk curve. We believe that a SA capital floor should be a transitional provision and not a permanent constraint as this would provide little incentive to develop more advanced approaches and promote advances in risk measurement and management practices. A standardized floor should be positioned as a backstop measure and not a binding constraint to AIRB models.

Comparability

While we concede that, by definition, a SA provides more comparable and consistent RWA, we challenge the underlying assumption that a standardized framework provides a more consistent and comparable assessment of risks. Certain risks are overstated/ understated in standardized approaches but would be correctly reflected in more risk sensitive internal approaches. In other words, banks with very different risk profiles may have similar standardized measures due to the non-risk sensitive nature of those measures. This undermines the proposed comparability of capital objective as capital ratios will be less comparable and meaningful, even though their RWA denominator may be more consistent. Furthermore, the standardized approach focuses on inherent risk while AIRB approaches recognize residual risk as well by considering risk management practices and collateral.

The disclosure of standardized capital requirements would allow for comparability without the need for the implementation of a floor. This would permit the marketplace to use the Basel III capital information and disclosures to query whether a bank's AIRB-based RWA and capital ratios are reliable.

The Basel Committee's own work has cited the use of national supervisory discretion as a significant cause of non-comparable RWAs and capital ratios. We recommend that the Basel Committee should remove national discretion for internationally active banks so that their RWAs and capital ratios would be made more comparable. While national discretion does not have a role in Pillar 1 capital, supervisors would be free to use Pillar 2 capital requirements where they believe a risk is undercapitalized. This would result in much greater comparability of capital ratios.

RWA inconsistency and dispersion

RWA inconsistency for the same exposure is largely driven by underlying definitions, exclusions, calculation assumptions, and model inputs that include macro-economic as well as borrower-specific factors. Therefore, differences in RWA do not create an un-level playing field as some suggest but rather maintain a level playing field because they adjust weights for risk. Diversity of views on credit-worthiness of obligors and industries is a source of strength in an economy. Furthermore, we note that while the input parameters PD, LGD, EAD, and expected maturity are estimated using internal models, their transformation to regulatory capital or RWA are done using the Basel II IRB risk weight functions which are prescribed and therefore external. This regulatory capital estimation function has known shortcomings, most notably the inability to capture concentration and diversification effects and mis-specified asset correlations – but there is evidence to suggest that a properly developed,

executed, and supervised advanced approach calculation of RWA is far superior to a calculation under a SA.

A reduction of variation in supervisory approaches may also be difficult to meet due to different standardized approaches that are implemented (e.g. Basel II vs. Basel III etc.). We would urge the Basel Committee to require all Basel Accord countries to apply a consistent SA to their internationally active banks that does not differ due to the application of national discretion.

Efforts can be made to ensure that advanced approaches are well-developed, executed, and supervised in accordance with the Basel Accord and the standards prescribed therein. Further, differences can be better understood and minimized to still permit risk sensitive approaches to flourish within agreed boundaries. For example, an understanding of differences could be gained through industry-wide standardization of base model definitions, assumptions, and more frequent international benchmarking of internal model approaches, quantitative impact studies, and comparison of best modeling practices.

Low levels of models-based RWAs

There is an underlying assumption that lower RWAs based on model-based approaches are wrong. However, risk weights may be lower but still accurately represent the appropriate amount of risk in portfolios. Certain exposure measures by design have lower RWA's due to credit mitigation (e.g. presence of collateral). Exposures in different markets and industries may naturally have different risk profiles due to different laws, industries, business models/practices and volatilities. We also note that prudent lending practices, or more intensive problem credit management which can be supported by empirical evidence, are also taken into account in the AIRB calculation. The introduction of the leverage ratio also represents a form of floor for these exposures and is completely independent of risk-weighting. Therefore, we do not believe that additional floors at granular levels are required.

Concerns about low or inconsistent levels of capital can be addressed more constructively. For example, we note that the revised Pillar 3 disclosure requirements include qualitative disclosures related to IRB models (Table CRE), that require banks to describe the main characteristics of models used at the group-wide level on an annual basis. Explainable differences caused by risk insensitivity of standardized approaches should not lead to a floor for the modelled approach; for example, the overstatements of the current standardized capital for market risk compared to more accurate and risk sensitive internal approaches. Explanations will inform regulators and other stakeholders (e.g. analysts) about shortcomings in either standardized or modelled approaches and lead to potential future improvements to regulations. Transparency should be the objective so that different risk weights for similar exposures would be revealed and would need to be defended. Requiring the same risk weights due to a superficial similarity would result in a misallocation of economic resources and cause a loss of diversity in our economy.

Horizontal inequity in risk-weighted capital requirements

Standardized banks generally have higher risk weights as they do not invest as heavily in risk models/systems as banks using internal models which have a better understanding of their own risk profile. We do not believe that a "level playing field" should mean more similar risk weights between standardized banks and AIRB banks. The fact that every bank will apply the same risk weight for each asset class under standardized approaches may result in the unintended consequence of having more risk concentration towards whichever asset class provides the lowest risk weight. In fact, reducing differences between institutions on standardized vs. modelled approaches should not be desired unless it is shown that those differences are not risk-based. First, more sophisticated and accurate modelling and risk management practices, which likely result in lower residual risk, should be incentivized and rewarded through more accurate and lower capital. Secondly, standardized approaches do not capture diversification and do not scale well with the size of portfolios. However such diversification should be captured in capital requirements to enable economies of scale. Finally,

based on the information available to Canadian AIRB banks, if standardized risk weights and AIRB risk weights are to be made more similar in Canada, that should be by reducing the standardized risk weights so that they more closely approximate the advanced approach outcomes.

We also note that floors are already established through certain specific constraints to modelling choices or parameters (e.g. alpha parameter in counterparty credit risk). There is also limited diversification proposed in the Fundamental Review of the Trading Book. Currently, the BCBS has introduced the leverage ratio and scaling factor to mitigate AIRB model risk.

Surcharges and buffers

Several national regulators have also introduced capital buffers (above the D-SIB charges) to address unexpected losses and market downturns. Implementing a capital floor based on a standardized approach in addition to these measures seems excessive.

Introduction of floors to internal models based on standardised approaches

The introduction of floors based on standardized approaches has the following shortcomings:

- Internal model approaches are generally more risk sensitive and tailored to the actual risks that an institution may take. Imposing a standardized floor negates that risk sensitivity and leads to a misrepresentation of the actual risk institutions take.
- We appreciate that the Committee is working on more risk sensitive approaches for standardized capital for almost all risk categories. Shortcomings of each proposed standardized approach will become more apparent as regulators try to develop and implement different approaches. While the new proposed SA to credit risk seeks to be more risk sensitive, its risk drivers will provide more granularity but will not accurately portray relative or absolute risks with the result that the capital for certain risks will be over/understated. When such a SA becomes the binding constraint, this introduces the potential for regulatory capital arbitrage – e.g. for banks that are less risky than the SA, they will have an incentive to take on more risk; for banks that are more risky than the SA, they will have no incentive to reduce their risk profile.
- There is operational burden for maintaining standardized approaches for each risk category for daily and monthly calculations/analysis on top of modelled approaches. Incentives for more accurate modelled approaches will be significantly lowered. At a minimum, banks should be required to only calculate one SA to credit risk capital.
- The introduction of a floor that may be significantly higher than the more risk sensitive internal models may discourage newer model development in more developed markets and for banks dealing with less risky exposures. It would be harder to justify that Risk Management units of banks make investments in regulatory models as they may become irrelevant due to floors. This would also stifle the growth and continued improvements in the regulatory risk models we have observed in the industry in the last 15 years.
- A capital floor has limited informational value from an investor perspective, if all regulatory capital requirements are based on a floor calculation that does not accurately portray risks. A capital floor will not tell the investor how far short the actual capital is against a floor and most likely may not enhance transparency and investor confidence. In fact, basing capital requirements and ratios on a binding SA floor will obscure valuable information currently available to stakeholders.

We believe that the revised Pillar 3 disclosure requirements, which will be required for internationally active banks, provide opportunities for disclosure of modeling practices under both standardized (i.e.

Table CRD) and IRB (i.e. Table CRE) approaches, which would alleviate the need for capital floors as comparability can be achieved through disclosure.

Type of floor

Bearing in mind our recommendations for not adopting a capital floor other than the leverage ratio, we prefer an aggregate RWA-based floor over a risk category-based floor, if adopted. We believe that such a floor would be easier to implement, more readily explainable to stakeholders (i.e. through disclosure), and would be better suited to the variety of business models that banks may adopt and to the many different markets that banks operate in around the world.

Implementation

We are concerned that the timeline for having a final capital floors document, including calibration, by the end of 2015 is unrealistic and aggressive. The concern is that decisions on calibration may not reflect QIS impacts and other issues on the new proposed standardised approaches as discussions on these are taking place in parallel. The capital floor calculation for the most part will be driven by the revised guidance around standardized approaches to credit risk, market risk, and operational risk. It would be difficult for the banks to opine upon the capital floors without the final guidance on the standardized framework, and for regulators to assess the overall effect for their jurisdictions. In fact, capital floors based on new SA should only be considered once the SA has been fully implemented and experience has been gained to compare the outputs from such an SA to outputs from more risk sensitive (and less risk sensitive – e.g. the leverage ratio) approaches. Therefore, it would be prudent to only attempt to finalize the floor guidance after sufficient input and feedback from these other consultations and an opportunity to run the new SAs in parallel with other approaches. Moreover, in addition to IT related concerns, banks will also need sufficient time from a capital planning perspective to reflect the different risk-weighted assets. Finally, as capital floors based on new SA may have material macro-economic impacts on markets where the cost of credit will have to be increased, such new measures should not be introduced until the consequences can be evaluated and trade-offs can be evaluated.

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

Sincerely,



Attachment

cc: Catherine Girouard, Director, Bank Capital, OSFI
Mary Thomas, Senior Analyst, OSFI

**CBA Comments on BCBS Consultative Document
'Capital floors: the design of a framework based on standardised approaches'**

CBA Members' Comments and Requests for Clarification

I. Executive Summary (p. 1)

Please refer to our accompanying letter for our overall comments on key issues. Additional comments are also provided below.

- One of the primary objectives of the original Basel II Accord was to promote and provide incentives to adopt more advanced and risk-sensitive approaches. Requiring the implementation of an alternative standardized approach for banks already under the advanced approaches defeats this purpose.
- We feel the objectives can be more effectively achieved through Pillars II and III of the Basel Framework. These are designed to ensure capital adequacy is maintained, an adequate supervisory review process exists, and the transparency necessary to ensure comparability is achieved. In fact, a key goal of the revised Pillar III disclosures (with phase two upcoming) is to improve comparability and consistency.
- The Committee notes that one of its objectives is to mitigate model risk and measurement errors stemming from internal model approaches. The leverage ratio and capital buffers do address some of these issues and hence floor calibration should ensure that additional conservatism is not built into capital.
- We recommend incorporating national discretion within the design construct of the capital floor as this will likely overcome the differences in corporate laws and tax structures. A one-size-fits-all concept, absent national discretion, would be unadvisable.
- It would be prudent to finalize guidance on other technical papers, e.g. TLAC, before finalizing guidance and calibration of the capital floor. The paper does not provide a clear view of the end game on capital including TLAC.
- Given the complexity and significant technology changes required for implementation, and dependencies on other ongoing proposals on Standardized Approaches on credit, market, and operational risks, what is the overall timeline?

II. Introduction (p. 2)

- The document does not mention IRRBB which may have an impact on the floor. A decision on whether IRRBB is Pillar 1 or 2 has to be made and this impacts the floor. This is another moving part to be resolved before finalization of the floor. CSRBB is also not mentioned. We would encourage the Committee to clarify its position.
- The introduction of a standardized capital floor using the new revised standardized methodology will most likely result in significant increases in capital levels along with operational challenges for advanced approach banks that do not calculate or have processes built to calculate standardized RWA.
- The intent of the current floor was meant to be temporary to ensure capital levels within the system do not fall readily, offer incentives to develop more advanced approaches, promote advances in risk measurement and management practices, and allow time for regulators to gain comfort with institutions processes and models. These should continue to be objectives.

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- By making the floor permanent, it appears the benefit of Basel II/III and the extensive work completed by institutions could potentially be negated. The introduction of a capital floor based on a standardized approach to a certain extent fails to differentiate the risk-sensitive nature of the RWA calculations under the advanced approaches and the impact of model risk.

III. Roles and objectives of capital floors (p. 4)

Please refer to our accompanying letter for our comments.

IV. Design of capital floor framework (p. 6)

The final calibration of the floor is dependent on the level of granularity or portfolio to which the floor is being linked even though the document states that the calibration of the floor is independent of the design. However, there is a sequence to be followed: the design has to be determined before the final calibration.

Q1. Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class? (p. 6)

While we generally oppose the institution of a floor based on standardized approaches, we prefer floors applied at the aggregate level. We have the following comments:

Comments in favour of aggregate floors:

- Aggregate floors can be more easily managed compared to risk-category based floors. An aggregate floor will provide fewer constraints and allow institutions to balance capital requirements between risk classes.
- An aggregate floor would offer banks some diversification benefit between risk types and exposure classes.
- Would be easy to explain capital changes to external stakeholders.
- Adopts similar methodology to the existing Basel I transitional floor.

Comments against risk-category based base floors:

- We believe that risk category based floors would have a negative binding effect on banking operations. Risk categories already feature constraints through certain specific modelling choices or parameters constraints. E.g. alpha for CCR, floor for AIRB parameters, diversification parameters in FRTB for market risk. Imposing additional floors to provide further limits to risk sensitivity would not be necessary.

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- Specific, more granular floors, would allow for a fine-tuning of calibrations based on level of confidence in the internal models for risk and/or exposure types. However this will add a level of complexity to the floor concept. A more granular capital floor may also distort the accurate measurement and monitoring of risk necessary to manage risks at the business line, asset class, and risk class levels, especially when results are based on arbitrary minimums.
- Floors based on exposure class would be difficult to manage since asset class definitions differ between standardized and AIRB. They would also be operationally difficult to manage to internally. Internal capital allocations will become more complicated by adopting floors at exposure or portfolio levels. The permutations of binding constraints under risk category floors could be overwhelming and may create significant challenges in allocating capital. We believe that risk category floors will likely work only if national discretion is permitted.
- By using granular floors, the banking system would be more likely confronted with potential discrepancies between an international calibration (80% of the internationally calibrated standardized approach), and local specificities as regards some asset classes. For instance, in Canada, AIRB CHT-insured mortgages would certainly be constrained by a floor defined at the mortgage asset class level but this would be less likely if the floor is defined Total Bank (or at least at the retail/wholesale level).

Q2. What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk? (p. 9)

It would appear that Option 1 is preferable, especially if a bank has a shortfall in allowances being deducted from CET1 capital. However, it would not benefit banks that have excess provisions as the RWA is not adjusted for the CET 1 ratio.

We would like the example to include a scenario where the bank has a shortfall in allowances deducted from CET 1 capital. This is to establish that the option 1 of reversing out provisions in either case will be considered consistently.

Merits of Option 1:

- Easier to understand and implement.
- Currently under Basel III, the shortfall in allowances is an adjustment to the numerator. Therefore, reversal of adjustment to the numerator is logical.
- A different multiplier might be required to convert capital to an RWA equivalent depending on the capital level of banks.
- Differences in the treatment of provisions vs EL should be adjusted through capital ratios and not RWA. Thus option 1 is the best option. This will dissuade optimistic model design and benefit institutions that take a more conservative approach to provisioning.
- We believe that option 1, is more theoretically accurate as it adjusts the capital at the appropriate tier. Option 2, since it adjusts RWA will impact all three capital ratios (CET1, Tier 1 and Tier 2) regardless of if the AIRB capital adjustment is made to CET1 or Tier 2.
- More in line with an IRB approach.

CBA Members' Comments and Requests for Clarification

Merits of Option 2:

- We do not see the logic for making the adjustments to RWA, given that the original adjustments were to the numerator.

Both options appear to have certain shortcomings:

- Likely to involve cumbersome calculations, as advanced approach banks may have a certain proportion of their portfolios that are still under the standardized approach.
- Likely to result in carryover of the flaws of the standardized approach (i.e. 1.25% of credit risk RWA seems like a very blunt measure).

The Committee also seems to have ignored several other differences in standardized and advanced approaches and solely focused on the provisioning for credit risk as an item that requires resolution. The two options cited in the consultative document also ignore IFRS 9 developments that are expected to overhaul the expected loss calculations. We note that the BCBS consultative document *Guidance on accounting for expected credit losses* has now been issued to provide additional guidance on IFRS 9. Changes to the provisioning framework should be considered prior to deciding on the treatment.

Q3. Do you have any other comments regarding the design of the capital floor? (p. 9)

The primary objective of this regulation should be to enhance international standardization, consistency of regulation between different jurisdictions, and ensure a level playing field internationally across all jurisdictions.

We have the following comments:

- Allowing differentiation by jurisdiction would undermine the above objective. If jurisdictions do not implement the newly proposed standardized approaches or are lagging this should be considered non-compliance with newly established Basel rules.
- Discrepancies between jurisdictions are challenging for banks operating in multiple jurisdictions.
- Different floors by supervisory jurisdiction will negate the benefit of comparison across financial institutions globally.
- Paragraph #25-26 – includes discussion on the Choice of the standardized approach. By stating that the Standardized Approach for the floor represents "the one implemented by the jurisdiction in which it operates...." this is likely to continue the un-level playing field among banks.

We would appreciate if the Committee is able to provide clarification on the following matters:

- Under Option 1, will a bank be required to make the Provision adjustment, even if it was not subject to the floor threshold?
- With reference to provisioning adjustment under Option 2 (Box 2) – is 12.5x RWA multiple expected to be static? Is the intent to take a multiple based on existing capital levels?

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- It's unclear whether the Committee intends for a Capital floor based on a Standardized Approach RWA (i.e. paragraphs 17 and 18) or based on a Standardized Approach capital ratio (i.e. paragraph 22). If the Capital floor is based on a Standardized Approach RWA (i.e. the denominator of the ratio), what is the rationale for analyzing the treatment of allowances in the capital number (i.e. the numerator)?
- With the implementation of the standardized floor, does the Committee intend to remove the 6% scaling factor on the risk-weighted asset amounts for credit risk under the IRB approach as the intent of the scaling factor was to maintain the overall level of minimum capital requirements?

We understand that the calibration of the floor is currently outside the scope of this consultative document. However, we wish to highlight that if the final outcome of the calibration is similar to the current situation (where we do not trigger it on an all-in basis), this will result in significant effort for implementation and on-going reporting with limited or no benefit as the floor may not be triggered.

We encourage the Committee to undertake further consultation on the capital floor only after the standardized approach guidance on Credit risk, Market Risk and Operational Risk has been finalized.