

June 23, 2016

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

Dear Sir/Madam:

Re: CBA¹ Comments on the BCBS consultative document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*

We thank you for the opportunity to provide comments on the BCBS's consultative document, *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* ("consultative document"). We note that the proposed changes are being advanced shortly after the BCBS's second consultative document on *Revisions to the Standardised Approach for credit risk*. Furthermore, we understand that the Committee is still considering the design and calibration of capital floors based on standardized approaches.

We highlight the importance of evaluating all of the many proposed regulatory changes holistically to ensure that the Committee's objective of not significantly increasing overall capital requirements is met. To this end, we stress the importance of ensuring that internal ratings based (IRB) approaches retain a prominent position within the updated Basel III capital framework. In our view, this could be accomplished by making the current proposal part of a Pillar 2 approach, supported by Pillar 3 disclosure.

To the extent a Pillar 1 approach is decided, the comprehensive quantitative impact study that is planned to inform the final design and calibration of floors along with the work to consider the interactions of input floors, output floors, and the leverage ratio will be very important. We urge the Committee to take the necessary time to evaluate and assess the impacts of the proposed requirements, to consider whether input floors are necessary once aggregate minimum requirements (e.g. leverage ratio) are known, and to provide industry with sufficient time to implement any changes that are deemed necessary and regulators with sufficient national discretion (subject to peer review) to be responsive to local circumstances.

In this letter, we provide overall comments on some key issues with more detailed comments included in the attached appendix.

¹ The Canadian Bankers Association works on behalf of 59 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.

Variation in Risk-Weighted Assets (RWA)

A common theme in the consultative document is the application of floors, either on the inputs or the outputs to the RWA calculation. While an effective application of these floors would reduce variability, we note that it would be overly punitive to DTI's with a lower risk profile and/or more rigorous credit risk management practices, and we are concerned with the incentives that would create. For example, we would highlight the potential negative consequences of driving Canadian banks further out on the risk curve to seek acceptable returns when faced with an increase in capital.

Banks under Basel III are constrained by Common Equity Tier 1 (CET1) ratio requirements. Given the increased focus on this metric by the market, it is more important than ever to ensure that RWA measurement accurately reflects the amount of risk undertaken by each bank. RWAs have become a binding constraint that affects banks' business strategies, and we would urge the Committee to consider the implications of any changes that would distort RWA estimates in relation to the corresponding transaction risk.

The Committee also does not appear to consider jurisdiction-and bank portfolio-specific characteristics and lending practices. Risks vary materially for different markets, customers and products. Unless suitable national discretion is permitted, an unintended consequence of the proposed changes is that, through capital requirements diversification, a bank with a risk profile above the new minimum requirements will have a competitive capital advantage when they enter a low risk market to compete with bank's who are naturally below the minimum requirements. We do not believe that lack of comparability in RWA is an indication that our IRB models are not sound but rather indicates that they reflect differences in business strategy.

Overall, we believe that banks are consistent in their rank ordering of obligors' by credit quality. We believe that differences in the interpretation of definitions represent a key source of variation in RWA. The consultative document does not address the wide interpretation of definitions that affect parameter estimates. More guidance on definitions such as recognition of default, length of LGD recovery periods, LGD discount rates, and required conservatism for sources of uncertainty in combination with well-informed floors would reduce RWA variability, thereby supporting the retention of the A-IRB approach for most risk classes.

By proposing punitive and one-size-fits-all floors, variation in RWA is reduced at the expense of risk sensitivity; instead, to achieve better transparency and comparability of RWA across banks, we believe that Committee should pay greater attention to:

- the standardization of definitions;
- disclosure requirements;
- instituting incentives that encourage banks to gather default/loss data; and
- prescribing criteria for banks and supervisors to determine whether an additional requirement is applicable or not.

This way, rather than pushing banks to take on aggressive risk, it encourages banks to continue their internal credit risk analysis and leverage their A-IRB infrastructure where important investments have been made to advance risk management capabilities.

We would stress that there are several fundamental reasons for variation in RWA - differences in modelling choices and data inputs, supervisory guidance across jurisdictions, and differences in business strategy, systemic risk, products, transaction/customer risk and risk management practices. In our view, the Committee's objective must be to minimize variation in the factors that

should be consistent only, and not in those where variation between banks is justified. Moreover, some divergence in practices in measuring RWA should be reasonably expected as homogeneous risk weights could result in even greater and undesirable systemic risk.

Risk Sensitivity

The foundation of IRB approaches is risk sensitivity, and we believe that this proposal fails to recognize that banks have made significant investments since the inception of Basel II in developing risk sensitive models and rating systems that have been fully integrated into overall risk management processes. This has allowed for improved risk assessment and capital determination that is commensurate with risk. The proposal to remove the option to use IRB approaches or constrain modelling of parameters for certain exposures could reduce banks' incentives to continually invest in the enhancement of risk sensitive rating systems. This can lead to undesirable consequences as the relative risk of assets will not be well differentiated resulting in the potential for banks to take on higher risk assets given more favourable returns for the same level of capital required as highlighted earlier.

The benefits from the accumulated knowledge and process investments would also be lost. Moving back to a quasi-standardized approach will have undesirable consequences in terms of the potential for misalignment on internal risk assessment and external risk reporting as reflected in the risk weights or capital ratios. We strongly believe that the models/parameters can be enhanced and alternatives, as suggested above, should be pursued to maintain a risk sensitive framework with fewer and better understood variations. We believe these alternatives should be considered first before requiring the standardized approach for certain portfolios of IRB banks as discussed below.

Finally, where the use of risk sensitive models or inputs thereto are restricted, to minimize unintended consequences (e.g. distortions in pricing and resource allocation) and to give continuing effect to the "use test", the rules should provide that advanced approach banks should use unrestricted risk-sensitive models to determine relative riskiness and impose the restriction at the highest aggregate level practicable (e.g. total credit risk RWA).

Retention of IRB approaches

Exposures to banks, other financial institutions and corporates

We believe that the A-IRB approach should be retained for banks, other financial institutions, and large corporates even though they are low default portfolios. In our modeling approach, we use internal as well as external data sources from either rating agencies or consortium data from banks globally to evaluate PD and LGD parameters. We believe that our models which have been governed under robust model risk management frameworks properly quantify credit risk.

We note that mandatory application of the standardized approach to banks and large corporates would also likely result in inappropriate pricing across risk classes/segments. Furthermore, capital requirements for low-risk regulated institutions relative to higher-risk assets would increase because the proposal is not risk sensitive. At the same time, non-regulated competitors would gain an unfair advantage by being able to price their loans at better rates because they would not be subject to the same framework. We believe there is significant potential for this to create increased risk in the industry overall.

For the above reasons, we strongly believe that IRB approaches should be retained for banks, other financial institutions, and corporates. Rather than removing the A-IRB approaches for banks and large corporates, we would suggest establishing certain qualifying criteria (e.g.

requirement for a certain number of observations or data years and a minimum number of defaults).

In the event, however, that the Committee proceeds with its proposal to require the standardized approach for these exposures, we would stress that more granularity is needed in the risk-weight buckets than is currently proposed in the revisions to the standardized approach for credit risk. More granular risk weights could also be mapped to the Bank's internal ratings under the current A-IRB approach as opposed to qualitative descriptions that are proposed in the consultative document. We would also like to ensure that the proposed thresholds of EUR50bn in total assets and EUR200m in annual revenues for Corporates will be open to further calibration based on the QIS results. In particular, we believe that the EUR200m threshold is set too low and will capture a large number of Corporates where data for modelling, including number of defaults, is readily available both internally and externally.

Specialized lending

We believe that the current A-IRB approach measures credit risk better than either a supervisory slotting criteria (SSC) approach or the revised standardized approach for credit risk. Under the SSC approach, banks are required to map their internal grades to five supervisory categories. We note, however, that the current slotting approach lacks the robustness of an effective risk rating system to meet the objectives of risk sensitivity, consistency, and transparency. We believe that the current qualitative criteria established for the five supervisory categories would be open to significant interpretation and, therefore, would not meet the stated objective of improved comparability.

Regarding the revised standardized approach for credit risk, we believe that the definitions of specialized lending and IPRE are vague and too general, and similar issues noted for the SSC approach apply. Additionally, the proposed option to apply either the Standardised or SSC approaches, which are very different in terms of assessment criteria and corresponding risk weights, would create further variation in RWA.

When Build-to-Hold and Build-to-Sell fall under the SSC or standardized approach, there would also need to be a far more granular risk-based differentiation than is currently allowable.

Furthermore, we note that the amount of available data for modelling these exposures has increased significantly in recent years. In particular for project financing, it has become more prevalent for government-sponsored financing of major infrastructure or power/renewable energy projects on a global basis. As an example, there is global consortium data comprised of thousands of projects and including several hundred cases of default over the past twenty plus years.

For the above reasons, we believe that the IRB approaches should be retained for exposures classified as specialized lending. In the event, however, that the Committee proceeds with its proposal to require the standardized approach for these exposures, similar to banks and financial institutions, we recommend more granularity in the risk weight buckets than is proposed in the Revised Standardised approach. Risk weights could also be mapped to the Bank's internal ratings, that are based on more comprehensive risk assessments, as opposed to the use of qualitative descriptions as proposed in the consultative document.

On removal of IMA-CVA

The CBA appreciates that, while variability in IMA-CVA results can always be an underlying concern, the primary concern expressed by the Committee on this issue relates to the overall

complexity of an IMA-CVA model and the reservation as to whether such models can adequately capture risk. We agree that the additional complexity of IMA-CVA may not be warranted in the event that CVA risk is significantly reduced by greater use of central clearing and margining for non-centrally cleared transactions. However, despite those advances, there will still be parts of the portfolio where CVA risk will be quite significant. For instance, positions with Sovereigns and Corporates will not include the benefits of margining and will, therefore, contribute the vast majority of CVA risk while constituting a smaller portion of the portfolio's overall positions. Moreover, these sub-portfolios are usually simpler to model as they are often one-directional and contain more of the plain-vanilla derivatives which will reduce the complexity of IMA-CVA calculations. We therefore recommend that the IMA-CVA option be retained and, if used, be subject to satisfying local regulatory model validation requirements pertaining to P&L attribution and backtesting.

In this case, we envision banks having a hierarchy of CVA approaches that can be tailored to different parts of their portfolio. For instance, counterparties having a majority of complex derivatives which are difficult to value could be handled under the BA-CVA approach. Financial counterparties which will have their CVA risk significantly reduced through margining could be handled under the SA-CVA approach. Corporates and Sovereigns which will constitute the majority of CVA risk, and which will continue to be actively managed, could be handled through IMA-CVA.

Allowing this hierarchy of approaches offers many tangible benefits. First, it addresses the Committee's concerns regarding the complexity of IMA-CVA approaches by relegating this approach to simpler sub-sets of the overall portfolio. Second, it promotes consistency with FRTB in recognizing that one particular modeling approach may not be suitable across all parts of a bank's portfolios. Third, it would allow for a better risk-sensitive approach. Allowing firms to focus computational power in areas where it matters the most to their portfolio will result in a better representation of CVA risks overall. Fourth, such an approach would provide an incentive for firms to continually improve their risk management as it relates to CVA. Having a better understanding of the key drivers of CVA and how to manage and hedge those drivers will help reduce CVA and default risks in the next crisis. Fifth, without a suitable internal understanding of risks, eventual calibration of regulatory-standard models becomes difficult. Risk-sensitive models have often acted as the benchmark for regulatory calibration exercises. Without the existence of internal approaches, it becomes difficult to gauge what reasonable regulatory parameters should look like.

Retail and smaller Corporate exposures

For the Retail classes, we appreciate the Committee's decision to separate QRRE transactors from QRRE revolvers. Nevertheless, we recommend that the distinction between transactors and revolvers be made on the basis of not having any interest charged on the facility (e.g. credit card) within the last 6 months on a rolling basis, as opposed to the current proposal. We have provided some suggested wording on p. 7-8 of our attached appendix.

Parameter floors

We believe that setting parameter floors will be a crude fix to solve RWA variability and it disregards the extensive work and effort that the industry has made in establishing modelling practices and governance processes that ensure that our models perform well in managing risk.

Instead of setting floors at the parameter level, the Committee should consider establishing further standards in modelling and validation practices, as well as regulatory oversight, to ensure consistency in approaches as highlighted in our earlier comments. Where parameter floors are

deemed necessary, they should be set by national regulators, based on agreed international principles, to reflect local business, product, transaction and customer risks and subjected to international peer review. Finally, as mentioned above, parameter floors will create unintended consequences (e.g. economic distortion), are contrary to the use test and should be avoided where a higher minimum level of capital at an aggregate level will have a similar overall impact.

Exposure at Default (EAD) for Non-retail Unconditionally Cancellable Commitments

We also believe that the range of 50 – 75% for non-retail Unconditionally Cancellable Commitments (UCC) is overly conservative as it does not reflect the actual usage ratios of these credit lines and would adversely affect lending and economic growth. Furthermore, the introduction of this approach would mean that there is little to no difference in capital requirements between the cancellable and non-cancellable commitments and the banks will receive very little capital relief from making a commitment cancellable. We would argue that there are good reasons why a commitment is judged to be unconditionally cancellable as it puts the bank in a better position to manage its risks which should be recognized in reduced capital requirements.

For product types that truly allow the bank to cancel uncommitted facilities at any time in practice, we believe that it is reasonable to apply the lower CCF proposed for Retail UCC of between 10% to 20% to non-Retail exposures where there are demonstrated controls and legal rights, monitored with robust internal bank governance processes.

We also note that extensive data exists for the behaviour of revolving credit facilities to model UGD and is a viable approach to estimating EAD. Static and punitive CCFs to address undrawn amounts simply do not capture the actual behavioural experience and demonstrable ability to cap or reduce available amounts and limit access to deteriorating credits. For example, where available lines are based on A/R and Inventory margining, it is clearly the case that such undrawn amounts are not fully available and are managed on a monthly basis.

Removal of the 6% scaling factor for IRB exposures

The 1.06x IRB scaling factor was introduced by the Committee in 2003 as a temporary measure aimed at maintaining the overall capital level in the system after transitioning to the IRB approach at a level slightly lower than under the Basel I regime. This multiplier was calibrated based on the results of QIS 3 in the second half of 2002, which noted materially lower expected levels of RWA under the proposed IRB approach for some portfolios (notably mortgages) in certain jurisdictions, and therefore for the overall system.

We believe that this concern has now been fully mitigated by the accumulation of empirical data for the banks' credit portfolios since 2002, which included mortgage default rates and LGD observed during the recent financial crisis, and has resulted in materially higher input parameters than those contemplated back in 2002. This is irrespective of whether the changes in the consultative document are adopted. Therefore, we believe that the rationale for maintaining the 1.06x multiplicative factor for IRB RWA no longer exists, on either a conceptual or quantitative basis. Having the 1.06 scaling factor hampers comparability between the IRB and standardized RWA. We suggest that the Committee remove the 1.06 scaling factor on IRB exposures.

Output floor

The leverage ratio already establishes a risk-insensitive minimum capital requirement and the establishment of a floor for IRB banks based on the standardized approach capital requirements is something the CBA continues to disagree with. While we acknowledge that the existing IRB floor, based on Basel I, needs to be replaced as the framework is substantially different from

Basel III, we believe that simply imposing a floor based on the standardized approach, which is in itself inferior in risk sensitivity compared to the IRB approaches, will not accomplish the Committee's stated objectives and is unnecessary given the leverage ratio. Application of a floor above 60% will also significantly reduce the risk sensitivity reflected within the A-IRB modeled portfolios (retail, small corporate/commercial) which are subject to very little granularity within the Standardized Approach. To the extent an output floor is required, to reflect local business, product, transaction and customer risks, the floor should be determined by national regulators based on agreed principles and subjected to international peer review. We look forward to the opportunity to review and comment on future proposals on the capital floor framework.

Implementation

We also highlight that there would be a considerable number of systems, process, and methodology changes required to implement the proposed changes. In particular, this would involve changes to credit risk management practices and processes with respect to specific requirements on due diligence, assessment of exposures under different approaches and changes in rating systems, and model modifications given the proposed constraints on IRB. These negative implications can be minimized by using capital requirements at an aggregate level wherever practicable, rather than micro-managing business, information and modelling practices through input or parameter restrictions. We also believe that the new requirements related to collateral and commitments are too restrictive, and would negatively impact our business and operations.

There are also underlying levels of granularity in the proposal that are not easy to operationalize (i.e. separating banks and other financial institutions, parameter floors at the sub-asset class level). Given the inter-linkages and evolving requirements, the banks will need to be provided with sufficient lead time to fully implement the final changes. We suggest that it could take as many as three years to implement the changes in the consultative document. We would request clarification from the Committee as to when they expect banks to operationalize the changes under this consultative document and other related proposals. We would also stress the importance of internationally consistent implementation timing.

We thank you in advance for your consideration of our comments, and we would be pleased to discuss our submission at your convenience.

Sincerely,



cc: Richard Gresser, Senior Director, Capital Banking, OSFI
Brad Shinn, Managing Director, Bank Capital, OSFI
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CBA Comments on BCBS's Consultative Document
'Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches'

CBA Members' Comments and Requests for Clarification

Overall Comments and Key Issues

Another approach to reduce undue and excessive variability in RWA would be to apply a floor to the ratio of Basel Expected Loss (EL) to actual historical loss rates (BEL/AL), averaged over the time period covered by internal data. Moreover, the floor could be adjusted for the historical length of the data, and the default rates. These floors would be most effectively applied at the most granular asset class level. As an illustrative example, a Bank's portfolio of large corporates, with 10 years of data and an average default rate of 0.75%, may require a BEL/AL ratio of 1.25. Another Bank's large corporate class, with 5 years of data and an average default rate of 0.50%, may require a BEL/AL ratio of 1.5. This approach would reward DTI's with a history of prudent credit risk management and more internal history to draw upon. It may not reduce the variability in risk weights to the same degree as the current proposal. However, the differences among DTIs would be more intuitive and transparent.

1. Introduction (p. 1)

Summary of proposals (p. 1)

The Committee states that "Regarding the use of internal models for calculating regulatory capital, jurisdictions will be considered compliant with the Basel framework if they do not implement any of the internally modelled approaches (i.e. they allow use of the standardised approaches only)." Could the Committee please provide guidance on how the treatment of portfolios mandated to be under the Standardized Approach (Banks, large Corporates, Equities) would be reflected in the determination of A-IRB compliance requirements around Partial Use. The Partial Use test as defined by the BCBS are exposures of banks using the IRB approaches which remain under the standardized approach either due to roll-out plans or permanent partial use. Will the Committee be incorporating appropriate wording in the Basel III framework to provide guidance given the recommended treatment for certain IRB portfolios is now the Standardized Approach?

Output floors (p. 1-2)

A-IRB banks in Canada have expended commendable efforts and resources to develop robust and risk sensitive rating systems that align with Basel standards and it would be several steps backwards if a floor that is based on less risk sensitive measures were to be imposed on A-IRB capital requirements. The floor would effectively penalize the higher quality or lower risk exposures, resulting in undesired consequences in lending practices and portfolio compositions as banks may gravitate towards the higher returns from riskier assets where capital requirements may be the same as lower risk assets.

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We are quite concerned with how much higher the required capital under the proposed standardized approach could be vs. our current capital requirements, the majority of which are calculated under advanced approaches. We find it difficult to project how an application of a floor, even at a reduced percentage, based on the proposed standardized risk weights would not result in a material increase in required capital for the Canadian banks. This would contravene the Committee's stated position from the standardized approach for credit risk consultative document that "increasing overall capital requirements under the Standardized Approach for credit risk is not an objective of the Committee; rather, capital requirements should be commensurate with the underlying risk." It would also be an unreasonable outcome if a group of banks that collectively are afforded some of the highest credit ratings globally, were required to hold materially higher capital due to a floor based on risk insensitive standardized risk weights.

We are concerned about the potential negative consequences of driving Canadian banks further out on the risk curve to seek acceptable returns when faced with an increase in capital. This would not be a desired outcome from a regulatory perspective.

There are also a number of additional shortcomings to the use of floors based on standardized approaches:

- 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.

If an aggregate output floor is set too high, this also penalizes banks that conduct due diligence to establish good credit quality and low risk portfolios. With the capital floor requirement, we believe that regulators are trying to prevent banks that take on excessive risk from reporting lower capital. The question then becomes how to differentiate banks that are truly managing good quality/low risk portfolios from banks that take aggressive positions but under-estimate the risk.

We believe that enhanced disclosure, such as the revised Pillar 3 disclosure requirements, which are 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.

Banks that have sufficient historical data, sound validation practices, and that incorporate a conservative buffer in capital or parameter estimates should not be subject to a capital floor. As noted in our cover letter, regulators should first consider other options to minimize variation in RWA including: (a) more guidance on definitions; (b) further standards in modelling and validation practices including

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regulatory oversight to ensure consistency in approaches; and (c) steps to minimize variation due to modelling choices.

If the Committee decides to proceed with both output and input floors, regulators should consider prescribing a set of criteria that banks can use to demonstrate whether a capital floor is required. For example, if the number of years' historical data and number of obligors meet the criteria, validation practices meet certain requirements, or a conservative buffer has been added to address specific model weakness, the capital floor would not be necessary.

2. Scope of use of internal models (p. 2)

2.1 Summary of proposals (p. 2–3)

No comments

2.2 Exposures to banks, other financial institutions and corporates (p. 3-4)

Exposures to banks and other financial institutions

For financial institutions with low leverage, we believe this should be reflected in the standardized approach risk weights.

In terms of modeling techniques used, based on scorecards or rating replication, all of our current modeling approaches are deemed robust, generally accepted in the industry, used by major rating agencies, and capable of validation. As such, our quarterly back-testing reports and rating migration demonstrate stability and adequate risk quantification of all parameters.

Exposures to Corporates

We are of the view that removing the A-IRB approach for certain large corporates is too punitive, as it may deter a bank from practicing sound collateral and loan management as they can no longer benefit from a lower LGD compared to their peers. Under the F-IRB approach, we note that the LGD is based on a supervisory prescribed rate. Under the A-IRB approach, banks with good collateral management/better-structured loans usually have a lower LGD assigned to the same exposures compared to their peers, as this can be factored into the LGD modelling. As a result, banks with better lending practices are usually rewarded with a lower risk weight, which we believe is the appropriate outcome. Banks with good lending practices or good collateral management are likely to suffer smaller losses compared to their peers in the event of default of the same counterparty, and hence this should be reflected in the risk weighting of the exposures. The "variability" that the Committee noted may not be solely due to a lack of observable data, but in reality, a reflection of different banks' lending practices. We also note that an LGD estimate is collateral specific. The loss data is segregated by collateral type and corresponding LGD values are estimated accordingly. A rating bucket with few defaults (i.e. "low default exposures") does not imply that LGD cannot be estimated. For example, Large Corporate loans that fall in the AAA category may have few defaults given good

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credit quality associated with the AAA obligors; LGD can still be estimated when there are defaulted loans observed in the rating bucket with poor credit quality obligors.

In the event that the Committee proceeds with its proposals, we offer the following comments below on Corporate exposures.

- The size threshold for A-IRB eligibility should be increased based on the availability of data to model the risk parameters. In addition to QIS data, other alternative sources should also be considered (i.e. Global Data Consortium (GDC) or other consortium).
- With respect to the revenue and asset figures being based on audited financial statements for the application of the threshold amounts, we request flexibility based on the banks internal review processes for each of their counterparties but note that the timing of such reviews would not exceed three years. The suggested proposal of an average of the previous three years may also not be reflective of the current financial circumstances of the counterparty. Corporates belonging to a consolidated group may have different operations and risk characteristics where the risk is independently assessed by the bank. For these corporates, the classification for capital assessment should be separated from the Consolidated group. We would recommend clarifying the definition to "corporates belonging to consolidated groups whose risk cannot be independently assessed".

Specialized lending and Real Estate

In the event that the Committee proceeds with its proposals, we offer the following comments below.

- The proposal does not refer to the new Real Estate asset class that is introduced in the revised standardized approach for credit risk. If the aggregate floor is based on the revised standardized approach, there would be misalignment that could further add to comparability and implementation challenges.
- Under the proposed changes to the specialized lending criteria, all IPRE will be subject to the standardized calculation. Furthermore, according to the revised taxonomy of the standardized approach, IPRE exposures will be categorized in the real estate exposure class and risk weighted according to LTV ratios. The revised standardized taxonomy divides IPRE into retail (IP-RRE) and commercial (IP-CRE). Given that retail exposures are allowed to continue to apply A-IRB rules under these new proposals, we would request that the BCBS clarify whether the expectation is that retail IPRE are expected to follow the standardized approach or whether they are allowed to continue to utilize A-IRB parameters.
- IPRE and some segments of Acquisition Development Construction (ADC) are key sectors that banks lend to and there should be sufficient empirical data to support the use of models for risk ratings, PDs and LGDs. At a minimum, these segments should be permitted to apply the F-IRB approach. Variation in parameters and RWs observed by the Committee could be rightfully attributed to differences in local markets and economic environment in which the exposures reside.
- The split approach creates confusion regarding the appropriate treatment for IPRE. For borrowers renting out residential properties, the existing treatment is commercial IPRE. However, under the new taxonomy, these commercial exposures would then be reported under the real estate IP-RRE approach, which is considered to be retail. In these cases, what would be the

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annual review and account management requirements? If risk weights are no longer driven by internal A-IRB estimates for these borrowers, what is the BCBS's expectation on the frequency with which banks are expected to refresh the customer's information? There are currently no requirements to refresh data/ratings under the standardized approach.

- If the supervisory slotting approach is retained as an option, we believe that the Committee should review the current qualitative criteria with a view to augmenting them with more quantitative measures and other elements of rigor, where appropriate, to allow for consistency of mapping internal grades to their respective supervisory categories.

For example, a holding company generating cash flows from multiple businesses has a 'global' PD. This company's next project – with recourse to the holding company – may be, for example, land development. While this facility will certainly have a facility-specific LGD, the last project may or may not change the holding company's global PD and therefore the obligor should not be classified based on the last facility, but instead in accordance with its 'global' business.

2.3 Equities (p. 4)

Given the diverse nature, and inherent risk of unexpected loss of the securities that DTI's hold in their banking books, a more granular set of risk weights that recognize these differences should be considered.

We also believe harmonization between regulations is required. The finalization of the FRTB rules in January stipulates that listed equities must be considered part of the Trading Book (par 16) regardless of whether they sit in the Banking Book and therefore, must be considered under the new market risk regime. As part of the new market risk regime, equities must now be included in the Jump-to-Default Charge in the Standardized Model (par 144 & 147) and the Default Risk Charge in the Internal Model (par 186). So the current regulatory proposals to reduce variation in RWA should only apply to unlisted equities in the banking book. Clarity is requested in the FIRB rules as well.

The major argument put forward by the Committee for removing AIRB is to ensure consistency in RWA measures for public equities across banks as all banks are deemed to be making the same risk assessments based on the same public data. As this argument no longer holds (i.e. only unlisted equities in the Banking Book would have AIRB applied), we request that the Committee reconsider the allowance of the AIRB approach for the remaining unlisted equities that sit in the banking book.

2.4 Counterparty credit risk and CVA (p. 4 -5)

Counterparty credit risk

- We request clarification on whether the applicable floor to the IMM-CCR would be applicable to overall CCR or by product type (i.e. derivatives and SFTs distinctly).

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- We also seek clarification on how the floor for derivatives will be determined using SA-CCR. For example, if part of the entity's derivatives RWA is determined using IMM approach, and part is determined using SA-CCR approach, will the floor be based on the SA-CCR number of the whole derivative portfolio? Or will it just be based on the population under SA-CCR?
- It would be beneficial to have more details on the floor proposal. However, if a floor is required, a floor at the entire EAD level can be more consistently calibrated than attempting a counterparty level application.

3. Parameter floors (p. 5-7)

We disagree with a model parameter floor approach for smaller Corporates and Retail classes. Such an approach tends to distort differentiation in quantified risk. Banks have seen in the past how the 3 basis points floor on PD calibrations for AAA and AA rated borrowers would impact on the credit adjudication results regarding these categories of borrowers. In addition to not being able to calibrate the PD easily on AAA and AA rated borrowers, it is important to recognize that there are differences in risk levels between such borrowers.

We also note that significant variation in model parameters does not necessarily translate to excessive variation in RWAs. Parameter variation may offset with each other depending on how specific credit risk factors (including qualitative considerations) are taken into account in PD, LGD and EAD estimates (given a specific firm, a higher PD estimate may be associated with lower LGD or EAD). As such, the RWA impact may be much less than individual parameter variation. Imposing parameter floors may amplify RWA variation.

A-IRB floors may also discourage banks from adopting the IRB approaches and the associated risk management standards. Banks may be incentivized to shift their exposures to higher risk exposures to avoid the effect of the parameter floors.

We also note that while floors have been proposed for PD/LGD, there is no comment on the definition of default (90 days vs 180 days for QRRE). We would also seek clarification on whether the floors apply before or after credit risk mitigation.

In the event that the Committee proceeds with its proposals, we provide further comments and questions below with respect to the proposed PD, LGD, and EAD floors for the smaller Corporates and Retail classes.

LGD

Corporate

- The proposal to have LGD floors of 25% for unsecured, 15% for A/R and Real Estate, and 20% for other physical assets, and a high 50% haircut will increase the amount of capital carried against over collateralized loans.

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Mortgages

- In a downturn scenario, we would expect some variance by the type of residence, and their relative marketability in the event of an extreme stress scenario. The consultative document does not go beyond commercial vs. residential in segmenting real estate.

Other types of security

- The collateral types are not sufficiently granular as there should be differentiation in LGDs such as for certain sectors and collateral subject margining.
 - For real estate collateral, there should be separate residential vs commercial types as recognized in the Revised standardized approach for credit risk. The residential haircut or LGD should be lower than the commercial.
 - For loans secured by collateral with frequent revaluation and margining requirements, e.g. in Asset-Based Lending or Exploration and Production, the loan exposure will be well covered at all times. Hence, haircuts should be substantially lower.
 - Other physical collateral should include inventory, fixed assets/equipment, oil and gas reserves. We seek clarification on the definition of both other physical and financial collateral.
 - The floors are only 5% lower than the LGDs under the F-IRB approach which does not provide sufficient differentiation or incentive for banks to maintain A-IRB approaches.
 - For loans that are over-collateralized, providing for real economic value, a lesser floor should be applied.

EAD

We are concerned that the floor is not properly communicated and we request greater clarity. We understand the floor to mean the on balance sheet exposures plus 50% of the off Balance Sheet exposure using the applicable CCF in the SA. Is the 50% referring to the floor? If so, we request clarification if this floor should only be applied if the banks calculated CCF is lower than 50%? We note that the reasonability assessment is also subject to the standardized CCF level. If these CCFs are set at too high a level to reduce variability, there will not be an incentive for banks to model EAD.

Corporate

The proposal appears to be a “one size fits all” floor without recognizing that further drawdowns under uncommitted lines could be lower. The proposed 25% to 37.5% factor on the undrawn portion for uncommitted lines (accounting for the majority of certain bank portfolios) is not appropriate given:

- Exposures benefit from meaningful financial covenants as well as a rigorous risk assessment process allowing for early reduction in uncommitted lines (well in advance of a payment default).
- In the majority of cases, uncommitted lines are margined, thus providing a natural governor to UGD in advance of a payment

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default.

- Increasing the capital on demand loans universally could provide the incorrect incentive to provide committed lines (to charge a standby fee) which would increase risk in aggregate.
- Increasing the capital could decrease systemic willingness to provide demand loan liquidity to the SME market place.

Definition of QRRE transactors (Footnote 12)

We note that the Revolver/Transactor definition used does not address inactive accounts or lines of credit. The definition is restrictive since the client must have been a transactor throughout the life of the facility in order to be considered a transactor.

The definition of QRRE transactors as those "where the balance has always been repaid at each scheduled repayment date" is also not consistent with the industry definition. It would be difficult to operationalize as it would require banks to track customers' payments since each account's origination, which may be over many years and would vary across accounts, rather than over a recent fixed observation period. Experience also shows that occasional missed payments on credit cards years ago are not indicative of increased risk if the customer has met their scheduled payments over a sufficiently long recent period. Therefore we suggest to reword the second sentence in footnote 12 (before the brackets) as follows: "QRRE transactors are facilities such as credit cards and charge cards where at least 6 months have passed since the facility was first used as a means of payment and the balance has been repaid at each scheduled repayment date over the last 6 months".

4. Parameter estimation practices and fixed supervisory parameters (p. 7)

4.1 Probability of default (p. 7)

Under the proposed requirements for the modelling of PD under the F-IRB and A-IRB approaches, we note that the data used to calculate PDs "should be based on the observed historical average one-year default rate, which must include a representative mix of good and bad years, with a minimum weighting of data from downturn years of one in ten". Could the Committee please confirm whether the PD downturn should be based on our own historical data in the last 10 years only?

In section 4.1, we also note the comments that "Currently banks must adjust PD estimates upwards for anticipated seasoning effects. However, the Committee believes that instead of encouraging banks to adjust estimated PDs, they should instead be required to take account of seasoning as a risk factor in their models". For banks using a Through The Cycle (TTC) modelling approach, rating changes are not due to business cycle. We think including seasoning as a risk factor in the models will increase variability in estimates and RWA and generate opposite results to what the Committee is trying to achieve. For banks using a Point-In-Time modelling approach, account

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age is also not considered and the proposal would require changes to models.

4.2 Loss given default (p. 7)

4.2.1 F-IRB: Unsecured exposures (only relevant for exposures to corporates) (p. 8)

No comments

4.2.2 F-IRB: fully and partially secured exposures (only relevant for exposures to corporates) (p. 10)

The same comments on haircuts being too high and insufficient granularity in collateral categories in section 3 – Parameter Floor apply.

We also foresee a material impact on any business in core commercial Canada where we take as security a General Charge on assets, whether it is via a General Security Agreement or Debenture charge (or equivalent). Under the terms of the general charge documentation, the bank has a legally enforceable lien on all current and after acquired assets (no matter where they are located). The documentation will not meet the requirements to specifically identify the assets nor locations (especially for the after acquired assets), and this will not be eligible for inclusion into the LGD calculation. This will impact a material volume of our customers (and there will be recoveries associated with these now LGD in-eligible assets)

These items represent a material change for core commercial Canada as well as the US and implementation will have both procedural and system implications, and result in a material change in LGD.

4.2.3 A-IRB: unsecured exposures (corporate and retail) (p. 10)

We disagree with the Committee's proposal in section 4.2.3 that for A-IRB unsecured exposures (corporate and retail) the banks must separately estimate (1) a long-run average LGD and (2) an add-on to reflect the impact of downturn conditions. The long run average may already be heavily weighted towards the downturn period when the majority of historical defaults occur. This would result in the downturn LGD not being materially higher than the long run average, and would make a supervisory prescribed add-on unnecessary.

In the case of retail exposures, A-IRB banks have tens of thousands of defaulted unsecured exposures, such as credit cards, even when

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the observation time period is limited to a commonly recognized severe downturn such as that in 2008 – 2010. This allows directly modelling downturn LGD for unsecured retail exposures using A-IRB banks' internal historically observed LGD for such exposures during a commonly recognized economic downturn period. A prescribed floor should not be required if the bank has sufficient empirical data to support the calibration. Splitting the calculation between a long-run average LGD and an add-on for downturn conditions is therefore not required and would introduce unnecessary complexity.

4.2.4 A-IRB: fully and partially secured exposures (corporate and retail) (p. 10)

The Committee proposes that banks be permitted to directly estimate their downturn LGDs for fully and partially secured exposures, but that this estimate be subject to a floor calculating using the following formula:

$$\text{Floor} = \text{LGD}_{u \text{ floor}} * E_u / E + \text{LGD}_{s \text{ floor}} * E_s / E$$

We have the following questions:

- The products in Retail are either secured or unsecured. The formula may not be feasible for Retail. Could the Committee please provide clarification.
- The Committee noted that the formula above does not apply to exposures in the residential mortgages portfolio. Will there be a separate formula for residential mortgages?
- What formula should we apply for secured exposures (i.e. other products that are secured by financial papers, real estate, etc.)?

4.2.5 Exposure A-IRB modelled and collateral not modelled (p. 10)

No comments

4.3 Exposure at default and credit conversion factors (p. 10-12)

We appreciate the guidance provided related to EAD modelling. We note that where EAD modelling continues to be permitted, it will be subject to certain constraints on EAD estimation practices. Could the Committee please provide further insights on the following:

- item ii) "Banks should ensure that their EAD/CCF estimates are effectively quarantined from the potential effects of this region of

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instability". Could the Committee further clarify what is meant by 'region of instability'?

- item v) EAD estimates must use a 12-month fixed horizon estimation approach. The mandatory use of the fixed horizon estimation approach is not consistent with most retail estimation where the cohort approach is used extensively and is not consistent with the application of the estimates. When applying an EAD model to a current portfolio, the portfolio contains loans that will never default, loans that will default in 12 months, but also loans that will default in 1 or 2 months. The approach we use for modeling EAD takes into account that diversity (we look at the current portfolio at time T and look at the EAD at default, no matter when the default happens in the 12 months following T (and it will sometimes happen 1 or 2 months after T)). We do not believe this approach should be prohibited as data used for modeling reflect the same diversity as the portfolio on which the model will be applied.

A key change to the proposed definition of commitments is around the acceptance of the offer by the client. Additional clarification is needed on the definition of acceptance, and depending on the clarification, process and system changes will be required to capture this data as it is not currently tracked centrally. Significant technology investment may be required to ensure client acceptance is recorded correctly on bank systems. Furthermore, the expanded definition of commitments to include any offer that is still subject to conditions is likely to have material capital implications.

4.4 Maturity (p. 12)

No comments

4.5 Credit risk mitigation (p. 12-13)

It is not reasonable to remove the double default treatment due to the lack of evidence of its use. Some Canadian banks have applied double default in their RWA measurement and believe it actually provides reasonable risk sensitivity for situations that warrant double default treatment. We suggest instead better disclosure of banks using the double default treatment for certain portfolios. Alternatively, if the Committee remains convinced that it must be removed, we suggest that it be grandfathered for the institutions that have already implemented the double default treatment.

5. Other issues (p. 13)

We request that the Committee provide a glossary of definitions to assist in the understanding of the Basel III framework. In addition, a summary annex which would highlight the capital formulas related to credit risk, counterparty credit risk, and operational risk in the

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banking book would prove very helpful similar to the current Annex mapping IRB exposures to the new standardized approach categories.

6% scaling factor on IRB exposures

The application of the scaling factor introduces additional inconsistency between the IRB and Standardized approaches, where the 1.06 scaling factor has never been applied. It would be particularly difficult to justify under the current proposal in which large portions of the banks' credit portfolios such as banks and large corporates would in fact be using the Standardized RWA. An alternative approach of selectively applying the 1.06x multiplier to RWA for the remaining credit portfolios (such as Retail and SME) but not to RWA for banks and large corporates is also hard to justify. Either way, using the multiplier results in a lack of consistency, and is particularly hard to justify now that the initial concerns that led to its introduction in 2003 have been addressed.

Annex: Mapping of IRB exposures to new standardised approach categories (p. 14-15)

Based on the second consultative document on the revisions to the standardized approach for credit risk, the new Real Estate category is composed of 3 segments which are General Treatment, Income-Producing Real Estate (IPRE), and Land Acquisition, Development, and Construction (ADC). The Real Estate exposures would therefore not be considered in the Specialized Lending category under the new SA. The mapping shows different proposed treatments for the Real Estate category based on the existing IRB category. While the IPRE is mapped from Specialized lending to the Real Estate category with a proposed treatment of SA or slotting, it remains unclear what would be the proposed treatment for the General Treatment and the ADC. Since the ADC portfolio is considerably large for certain Canadian Banks and future RWA treatment could impact today's business decisions, we believe that the proposed treatment of the General Treatment and the ADC exposures should be clarified.