

March 27, 2015

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

Dear Basel Committee members:

**Comments on the Basel Committee consultative document:
“Capital Floors: the Design of a Framework Based on Standardized Approaches”**

Canadian Western Bank¹ (CWB) appreciates the opportunity to provide comments on the consultative document, “Capital Floors: the Design of a Framework Based on Standardized 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.

CWB also participated in and supports the submission by the Canadian Bankers’ Association.

CWB currently uses the SA approach for credit risk and are enhancing our risk management practices to support an eventual move towards the Advanced Internal Rating Based approach (AIRB). As an institution currently using the Basel III SA approach for credit risk but working on a transition to the advanced methodology, we recognize that the existing AIRB floor, based on Basel I, needs to be replaced as the framework is substantially different from Basel III and is no longer relevant. As a result, the capital floor proposal will impact our business case to support and move forward with the AIRB project. However, we note that the current Basel III SA could be used to provide floors and believe it is unnecessary to introduce the new proposed SA for the purpose of providing a calculation for capital floors.

The Canadian banks have undertaken extensive efforts and devoted significant resources to develop and maintain robust models, processes and systems to measure and manage credit risk, thereby ensuring capital commensurate with risks in our portfolios are adequately captured in compliance with the AIRB framework. Under the prudential supervision of the Office of the Superintendent of Financial Institutions, we believe that Canada has established more than adequate internal and external governance processes overseeing AIRB implementation. In fact, the two largest Canadian banks currently using the SA, including CWB, have projects currently underway to enhance risk management practices and move towards AIRB. We therefore do not

¹ Canadian Western Bank is a mid-sized Canadian bank offering a full range of business and personal banking services across the four western provinces, and is the largest publicly traded Canadian bank headquartered in Western Canada. CWB, along with its operating affiliates (National Leasing, Canadian Western Trust, Valiant Trust, Canadian Direct Insurance, Canadian Western Financial, Adroit Investment Management, and McLean & Partners Wealth Management) collectively offer a diversified range of financial services across Canada.

believe that the contemplated revisions to the SA framework, including capital floors, should significantly increase Canadian banks' existing capital requirements without due consideration and evidence that such risks are not properly capitalized under current methodologies.

We have concerns related to the roles and objectives of capital floors, the introduction of floors to internal models based on standardized approaches, and implementation including the inter-relationship with the proposed revisions to the standardized approaches for credit, market, and operational risk. We provide our comments on these issues below.

Credit capital floors

We expect overall risk weights under the revised SA should continue to be more conservative relative to the AIRB framework as the latter is intended to encourage and reward banks for developing more sophisticated processes and systems to assess credit risk and effectively manage capital required for the banks' exposure.

However, the current proposal seems to be built on the concept that a bank may use risk sensitive internal models only if they lead to results higher than an identified capital floor. From a more theoretical viewpoint this implies that banks are encouraged to improve their risk management only until they reach that floor. Once operating at the floor or below all incentives to further improve would disappear and at that stage a bank could rightly question the added value of internal models. The floor de facto introduces another undesired cliff effect: full recognition of internal models and risk management incentives above the floor, but no recognition at all below.

Application of floors to internal models based on standardized approaches

The application of floors based on SA 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 develop and implement different approaches. While the new proposed SA for 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 may 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 to maintain 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 for credit risk.

- The introduction of a floor that may be significantly higher than the more risk sensitive internal models may discourage new model development in more developed markets and for banks dealing with less risky exposures. It would be harder to justify the business imperative for Risk Management units of banks to make investments in regulatory models if they may become irrelevant due to floors. This would also stifle the continued enhancement in the regulatory risk models and associated risk management processes we have observed in the Canadian 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 may not enhance transparency and investor confidence. In fact, basing capital requirements and ratios on a binding SA floor could obscure valuable information currently available to stakeholders.

Consistency and comparability

It has been suggested that the variation in risk weights for similar exposures under AIRB approaches continues to be a major issue in respect of consistency and comparability.

- While RWAs differ, it has not been shown, once national supervisory discretion is removed, that the differences are unjustifiable and due to inaccurate risk assessments or the improper use of internal models – to the contrary, with closely supervised AIRB models, the likelihood is that differences in RWA are due to differences in risk profiles, diversity in models, and choices in risk management.
- Even if the differences in RWA are ultimately determined to be unjustified this should not be dealt with simply by imposing higher floors as this will effectively eliminate AIRB banks' extensive efforts to differentiate credit risk at the higher quality end of the risk spectrum. We believe that the minimum risk weights in the proposed SA imply floors for risk weights which are too high for some high quality counterparties. For example, the minimum risk weights of 60% for corporate exposures and 30% for bank exposures are too high based on Canadian experience and we believe that the corresponding grids should be re-calibrated. In fact, the Canadian experience suggests that existing SA RWA's are too high and should, in fact, be re-calibrated lower.

Implementing non-risk sensitive, higher credit risk capital floors may adversely impact lending activity as exposures to a higher quality obligor that otherwise would have attracted lower capital will be risk weighted the same as a relatively riskier obligor. Further, if the SA becomes the binding constraint through capital floors, banks will be incented to focus their business based on the relative RWA intensity of different businesses in an attempt to earn better returns. If so, lending and economic activity can become distorted.

Type of floor

Bearing in mind our recommendation for not adopting a capital floor other than the leverage ratio, we prefer an aggregate RWA-based floor over a risk category based floor. 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 the final capital floor determined and calibrated by the end of 2015 is unrealistic and aggressive. One concern is that decisions on calibration may not reflect results from the Quantitative Impact Study and issues identified through discussions of the proposed standardized approaches. 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 floor proposals and calibration without the final guidance on the standardized framework, and for regulators to assess the proposed overall effect on their jurisdictions.

We recommend that 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 the new SA to outputs from more risk sensitive (and less risk sensitive – e.g. the leverage ratio) approaches. Therefore, it would be prudent to finalize the capital 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 changes in risk weighted assets.

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

Sincerely,



Carolyn J. Graham, FCA
Executive Vice President and
Chief Financial Officer



Bogie Ozdemir
Executive Vice President and
Chief Risk Officer

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