

October 15, 2008

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sir/Madam:

**Re: Comments on Guidelines for Computing Capital
for Incremental Risk in the Trading Book**

The Canadian Bankers Association¹ would like to thank the Basel Committee for the opportunity to comment on the Guidelines for Computing Capital for Incremental Risk in the Trading Book. Given the recent financial market turmoil, members acknowledge the importance of ensuring that capital is held commensurate with the risks in the trading book. In particular, the scale of recent losses experienced by many banking organizations would seem to justify some expansion in the scope of the capital charge to capture price changes not only due to defaults, but also other sources of price risk including credit migrations and significant moves of credit spreads and equity prices. However, in calibrating appropriate incremental capital charges, it will be important to keep in mind a reasonable balance relative to the potential impacts on capital markets, pro-cyclicality and how capital for such risks may be addressed under Pillar 2. Moreover, accurately modeling all these risks is a challenging and complex process and we would therefore like to offer our comments on the draft Guidelines.

Given that events like the current credit crisis are rarely predictable in advance, more emphasis should be put on principles and risk management processes, as opposed to prescriptive capital charges. In addition, better exposition of the principles underlying the capital charges is necessary for banks to be able to meaningfully apply them in their particular context.

There seems to be confusion between risk measurement, as quantified in the capital charges, versus stress-testing and Pillar 2 considerations. Generally it seems that the proposed guidelines are trying to roll the second into the first, which is the source of ambiguity and duplication.

¹ The Canadian Bankers Association works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 249,000 employees to advocate for efficient and effective public policies governing banks and to promote an understanding of the banking industry and its importance to Canadians and the Canadian economy.

There is tremendous scope for double-counting between the IRC and the existing market risk measures. To have a coherent, meaningful capital regime it is crucial that this be recognised and allowed for in the final capital charges.

Further detailed comments are provided in the attached chart.

Overall, and as an overarching theme which we have not specifically articulated in our comment chart, our members express their general support for the comments provided in the joint submission by ISDA, the IIF and LIBA.

Thank you for considering our comments and suggestions.

Sincerely,

A handwritten signature in black ink, appearing to read "Mitchell", written in a cursive style.

Attachment

Member Bank Comments on the Basel Committee's Guidelines for Computing Capital for Incremental Risk in the Trading Book (July 2008)

Issue	Member Bank Comments/Questions
1. Scope & Coverage <i>Under the proposal, the incremental risk charge (IRC) would reflect all price risks except those directly attributable to movements in commodity prices, foreign exchange rates, or the term structure of default-free interest rates ("non-IRB market factors").</i> <i>(a) Would it be preferable for supervisors to list specific types of events that must be captured (e.g. defaults, migrations, and only certain types of movements in credit spreads and equity prices)? What should be the basis for determining which types of events would be included, and how could the Committee ensure that the framework was not largely backward looking?</i> <i>(b) Would it be worthwhile to expand the scope and coverage of the IRC to capture price risks associated with commodity prices, foreign exchange rates and the term structure of default-free interest rates?</i>	(a) Listing/Types of Events to be Captured in IRC Members agree that capital should be held for all price risks in the portfolio but believe that a principles-based approach would provide the best guidance regarding the types of events that should be captured. Members also feel that a better understanding is required as to what risks the regulators believe are missing from the current capital calculation. Members also believe that materiality should be considered; regulators should understand that as the scope of applicable risks is increased so is the scope of affected transactions. A strict reading of the new guidelines would entail simulating every derivative in the trading book (since they all reference the non-treasury based interest rate curves.) This would be an enormous increase in scope with arguably little marginal benefit, so flexibility on this point is important. Members are also of the opinion that each bank should be able to set the liquidity horizon based on their own assessments, subject to review and approval. (b) Scope and Coverage of IRC We do not believe that it is useful to extend the scope to include these additional risks. Any concern with larger than expected price movements is covered by stress testing requirements under Pillar 2. Members question why this question is being asked at all. Are regulators looking for banks to hold capital against more than price risk?
2. General versus Specific Risk <i>For covered IRC positions, Pillar 1 charges would depend in various ways on three types of risks: general market risks and specific risks, as defined under the current MRA, and IRC covered risks. Are the differences among these types of risks clear and measurable?</i>	Members believe that the differences are definitely not clear, which is why the regulators should be flexible regarding the recognition of double-counting among the three. Overall, members believe that a principles-based approach would provide individual institutions with the clarity and flexibility they need to capture the risks appropriately.

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3. Double-Counting Adjustments <i>While the capital horizons and confidence levels underlying the IRC and the 10-day VaR charge would differ, the risk factors captured by these risk measures would overlap to a significant degree. However, any adjustments to offset double-counting would complicate the framework and diminish the Pillar 1 importance of the 10-day VaR calculations including incentives to estimate the 10-day VaR as accurately as possible. Is it possible to provide double-counting adjustments that do not raise such concerns? How?</i>	This question is due to lack of clarity of what the capital number is supposed to represent. Clearly there will be tremendous overlap and it is essential to remove double-counting. If the regulators are concerned about a drop in the relative importance of the 10-day VaR calculations, they should consider allowing the IRC to be diminished when correcting for double-counting. In any event, general market risk VaR remains a key internal risk control and its accurate determination will always be important, regardless of its relative magnitude compared to other capital charges.
4. Capital Horizon and Confidence Level <i>The proposal stipulates that an IRC model incorporate a one-year capital horizon, a 99.9 percent confidence level, and a liquidity horizon appropriate for each trading position. The Committee recognises that such an approach could present considerable practical challenges, including the need for data to calibrate key parameters.</i> <i>(a) What alternative guidelines would achieve the Committee's objectives, but in a manner that would be less costly or difficult to implement?</i> <i>(b) Given the current state of risk modelling, is it feasible to estimate the portfolio loss distribution (excluding non-IRC market factors) over a one-year capital horizon at a 99.9 percent confidence level?</i> <i>(c) Would it be worthwhile to allow banks to use a single horizon for all covered positions (e.g. three months) and a lower confidence level (e.g. 99 percent), together with a supervisory scaling factor that was calibrated to achieve broad comparability with the IRB Framework for the banking book? Would such an approach be as useful for internal risk management purposes as the proposed IRC?</i>	(a) Alternative Guidelines The framework should be simplified/clarified so that the industry concentrates its resources on measuring risks that have a good chance of being modeled. A better understanding of what the current regulatory framework achieves is needed. It may turn out to be much easier than expected to include the risks that we believe need to be included, explicitly or implicitly. (b) Estimating the Portfolio Loss Distribution This is difficult to with any statistical reliability. We will never have enough historical data and therefore we need to rely on models including a great number of assumptions and judgements. Regulators should approve the models/approach rather than the output/numbers. Further, losses at a 99.9 percent confidence level and one-year horizon cannot be calculated/interpreted in a meaningful way. This represents events whose frequency should be about once every 1000 years. We do not believe we can model financial market behaviour at this level of confidence and time horizon. (c) Using a Single Horizon for all Covered Positions We endorse this idea and remark that the current treatment of general market risk VaR, with its factor of three multiple, is a precedent. Determination of the scaling factor should be determined via a consultative exercise with industry.

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5. Validation <i>Given the IRC soundness standard of a one-year time horizon and 99.9th percentile loss, the Committee seeks comment on how the resulting risk measure might be validated quantitatively. For example, would it be reasonable to validate the underlying model at shorter horizons and/or at lower percentiles? If so, how might one ensure that the validation exercise is relevant for the one-year 99.9th percentile standard? Also, would different aspects of the model likely require different validation approaches?</i>	Our members do not feel that the 99.9 percent one year measure can be validated via back testing. It is not possible to back test something that occurs every 1000 years, so lowering the percentiles and the time period will be necessary. Back-testing methodology should be model-specific and left to the individual banks.
6. Validation <i>The flexibility built into the proposed IRC potentially could make Pillar 1 charges for trading positions less comparable across banks. How might the framework ensure greater comparability without unduly limiting firms modelling choices? In particular, would it be productive to require banks to calculate risk measures for standardised test decks of trading portfolios, which could be used to compare model results across banks.</i>	We are in favour of the idea of banks comparing risk results for standardized test decks of positions; however, we believe this should be performed through industry surveys where the identities of individual banks are confidential. Banks could then study the range of results with their peers and gain a better understanding of their own assumptions. There is a concern regarding the survey contributions of banks for whom a given risk is immaterial. They will tend to treat that risk in a very conservative manner (since the impact of that conservatism will be immaterial at an enterprise level.) This could complicate interpretation of survey results and in particular skew the results upwards, giving regulators a misleading impression of best practices among banks.
7. Implementation Timeline <i>Is the proposed implementation schedule feasible? If not, which IRC guidelines, and what specific types of positions or risk factors, are most problematic?</i>	The proposed implementation schedules are very aggressive. While we have known of the default risk requirement for 1 January 2010 for some time, banks will now want to take a holistic view. We do not want to build a model for default risk in isolation of understanding how we are going to model all risks that need to be taken into account under this paper. Therefore, the 2010 deadline for default is now insufficient, let alone accommodating migration risk in the same timeframe. The 1 January 2011 deadline requires capture of all remaining price risks other than default and migration events. Specification of these events by the Basel Committee on Banking Supervision is not even scheduled to be available before the end of 2008. Furthermore, not only is the scope of risk modelling greatly expanded but so is the number of transactions which need to be modelled. This adds to the systems and implementation issues.

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8. Disclosures <i>What additional Pillar 3 disclosures related to the IRC, or the trading book more broadly, would be helpful to market participants and contribute to market discipline?</i>	A high level description of how it is done at the institution, similar to what is currently done for general market risk VaR, would be helpful. Care should be taken not to confuse the market. Increased disclosure does not necessarily mean increased transparency.
9. Interim Treatment for Re-Securitisations <i>Paragraph 50 requires a capital charge for re-securitisations that are cash or derivative credit positions, as set out in paragraph 615 of the Basel II Framework. This would start on 1 January 2009 and last until the IRC has been implemented for these positions. Would it be worthwhile to expand the scope of these positions to all securitisations?</i>	Many details have yet to be decided, including the definition of "re-securitisation". Therefore, we believe that banks should be allowed to focus on the enhancement of IRC for these positions rather than implement a short-term solution.
10. Other Paragraph 30 <i>A bank's IRC model must appropriately reflect issuer and market concentrations. Thus, other things being equal, a concentrated portfolio should attract a higher capital charge than a more granular portfolio (see also paragraph 28). Concentrations that can arise within and across product classes under stressed conditions must also be reflected. For example, holdings of asset-backed securities where the underlyings are not correlated under normal conditions can become concentrated exposures when correlations increase under stress.</i> Paragraph 36 <i>While the risk factors incorporated into a bank's IRC and 10-day VaR calculations generally will overlap to some degree, the Committee has not yet determined how any double-counting adjustments should be computed. Offsets for any double-counting (for example, reducing the IRC by the amount that shared</i>	Issues of concentration and excessive correlation are best captured in stress testing and not in the primary capital calculation. We expect flexibility on this point since there is potential for substantial double-counting under the proposed guidelines, as per our comments under #3 above.

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<i>risk factors contribute to 10-day VaR capital) could diminish the prominence of the 10-day VaR calculation in Pillar 1 and weaken incentives for banks to measure normal day-to-day trading risks as accurately as possible. On the other hand, providing only limited recognition of double-counting could distort incentives to hedge trading risks effectively.</i> Paragraph 45 <i>A bank would calculate the IRC at least weekly, or more frequently as directed by its supervisor. The IRC for a given reporting period would equal the average charge over the reporting period.</i> General	This may be onerous. We would like flexibility to calculate IRC with a frequency related to how stable it is. There is little value in determining IRC weekly if it moves very little from week to week, for instance. In fact, since the motivation is to capture less liquid risks, by definition it should be stable over relatively long time frames. This paper appears to contradict a basic principle embedded in the Basel II Framework. Specifically, the Framework is very specific with respect to the characteristics of an exposure subject to trading book treatment. This paper suggests that illiquid positions can be subject to trading book treatment.