November 18, 2005

To: Deposit-Taking Institutions

Subject: Implementation of the Advanced Internal Ratings Based Approach (AIRB) for Credit Risk under the New Basel Capital Framework

The four U.S. Federal banking agencies recently announced revised plans for the U.S. implementation of the New Basel Capital Framework[1]. Canadian banks have asked whether the U.S. announcement impacts OSFI's current plans for implementing the New Basel Capital Framework in Canada.

OSFI believes that the Basel II implementation date should not change in Canada. This conclusion reflects key differences between Canada's approach and the U.S. approach to implementation. The U.S. proposal has only allowed one advanced option for their banks; they must use AIRB for credit risk and AMA for operational risk. Canada does not require AMA and has also indicated that FIRB and standardized approaches for credit risk will be available if banks fail to achieve the advanced approach. Contrary to the U.S., Canada has provided more flexibility via a waiver mechanism that facilitates an orderly migration of bank loan portfolios to the advanced approaches. OSFI draft capital rules, implementation process and other tools, provide a number of additional alternatives that may be used to address shortfalls in implementation. The alternatives include the use of simpler more conservative assumptions under the new capital framework and possibly the requirement for disclosure to shareholders.

Similarly, given the strong risk management systems promoted by Basel II, it continues to be OSFI's expectation that large domestic banks[2] implement AIRB for all "material" portfolios and credit businesses in Canada and the U.S. by fiscal year-end 2007. OSFI will continue to monitor ongoing implementation efforts against agreed rollout plans and in this context will review the results of the parallel run reports with individual institutions. Depending on the results of these efforts, OSFI may need to explore alternatives within our implementation approach for addressing any individual bank concerns prior to the implementation date. In addition, the review of the asset to capital multiple for individual banks is linked to the bank's readiness for implementation of the AIRB on the implementation date.

[1] Joint press release of September 30, 2005 by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

[2] Large domestic banks are those that have total capital (after deductions) in excess of $5 billion Canadian, or that have greater than 10 per cent of total assets or greater than 10 per cent of total liabilities that are international (i.e., asset/liabilities booked outside Canada plus assets/liabilities to non-residents booked in Canada).

OSFI believes that information obtained during the parallel reporting period will be essential to the evaluation of the progress that banks are making towards internal implementation of the framework. Thus for banks adopting the AIRB approaches parallel reporting continues to be required for five quarters, beginning with data for the fourth quarter of fiscal year 2006 and ending with the fourth quarter of fiscal year 2007. Concerning floors, OSFI continues to expect banks applying an IRB approach for credit risk and/or an AMA for operational risk to apply a capital floor of 90% and 80% of the current capital adequacy requirements in the fiscal years 2008 and 2009 respectively.