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Consultative Paper on the New Basel II Framework

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Canada

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1. Introduction

The Basel Committee on Banking Supervision (BCBS) has been working for several years to develop a new regulatory capital framework that recognizes the increasingly more complex risk activities of internationally active DTIs. On June 26, 2004, the BCBS released a document entitled "International Convergence of Capital Measurement and Capital Standards" – A Revised Framework (the new Basel framework) that sets forth proposed revisions to the 1988 Accord that more precisely assesses capital charges in relation to risk. The new Basel framework responds to new developments in financial products, advances in risk measurement and management practices.

The new Basel framework encompasses three pillars: minimum regulatory capital requirements, supervisory review, and market discipline. Under the first pillar, a deposit-taking institution (DTI) must calculate capital requirements for exposure to both credit risk and operational risk (and market risk for institutions with significant trading activity). The new Basel framework does not change the definition of what qualifies as regulatory capital, the minimum risk-based capital ratio, or the methodology for determining capital charges for market risk. The new Basel framework provides several methodologies for determining capital requirements for both credit and operational risk.

For credit risk there are two approaches: Standardized Approach and the Internal Ratings-Based (IRB) approach. Within the IRB approach there is a foundation methodology (FIRB), in which supervisors provide certain risk component inputs and others are supplied by deposit-taking institutions (DTIs), and an advanced methodology (AIRB), where DTIs provide more risk inputs.

For operational risk, three principal methods are described: Basic Indicator Approach (BIA), Standardized Approach, and Advanced Measurement Approach (AMA). Under the first two methodologies, capital requirements for operational risk are fixed percentages of operational risk proxies. The AMA provides the flexibility for a DTI to develop its own individualized approach for measuring operational risk, subject to supervisory review and approval. Alternative Standardized Approach, a hybrid of the Standardized Approach, is also available for a subset of DTIs that would be subject to the new Basel framework.

The second pillar of the new framework, supervisory review, highlights the need for DTIs to assess their capital adequacy positions relative to risk (rather than solely to the minimum capital requirement), and the need for supervisors to review and take appropriate actions in response to those assessments.

The third pillar of the new framework imposes public disclosure standards on DTIs that are intended to allow market participants to assess key information about a DTI's risk profile and its associated level of capital.

2. Overview

This Consultative Paper sets out OSFI's proposed approach on national discretion items identified by OSFI, the Accord Implementation Group (AIG) and the Canadian Bankers Association (CBA). It also clarifies key aspects of timing/reporting requirements and parallel-run periods for implementation for both credit and operational risk approaches.

Our proposals are based on the BCBS's new framework for regulatory capital and risk management, published at the end of June 2004. Wherever possible, relevant paragraph references [shown in square brackets] to the text in the new framework have been included. We have focused on issues that industry pre-consultation have suggested would be most helpful for DTIs to have our views on at this stage to help prepare for implementation.

OSFI proposes to engage the industry in the development of templates for disclosure standards that are tailored for Canadian circumstances under Pillar 3.

This paper contains our detailed proposals for the following:

- Availability of approaches – sets out OSFI's expectations for the use of credit and operational risk methodologies for DTIs incorporated in Canada;
- Timing of implementation and reporting periods – sets out the implementation dates and the parallel run periods required by OSFI for compliance purposes;
- Scope of application – outlines OSFI's approach to the following:
    - threshold above which investments would be deemed significant minority equity investments in non-insurance financial entities;
    - prorata consolidation for joint ventures under GAAP;
    - stand alone capital;
    - recognition of surplus capital in insurance entities;
    - applicability of the deduction approach for: significant minority and majority investments in commercial entities, majority-owned securities dealers and other financial subsidiaries, investments in insurance subsidiaries;
- Standardized Approach to credit risk – sets out in detail OSFI's approach to risk weighting of claims, definitions of public sector entity (PSE), and qualifying external credit assessments;
- Internal Ratings Based Approach to credit risk – provides clarification of portfolio definitions, IRB mechanics and OSFI's approach to the treatment of general allowances in hybrid (Standardized & IRB) DTIs;
- Credit risk mitigation – discusses OSFI's intent to limit the range of options for calculating the effect of financial collateral in the Standardized and FIRB approaches to the simple approach and the comprehensive approach using

supervisory haircuts; own estimates of haircuts for financial collateral or repos would be available for the AIRB approach;

- Banking book equity minimum requirements – sets out OSFI's requirement to use the Market Based Approach only, exemptions and transitional arrangement available for DTIs, and definition of equity – proposed treatment of mezzanine debt and preferred shares;
- Operational risk minimum requirements – outlines OSFI's approach to the following:
  - partial use arrangements;
  - AMA specific issues:
    - recognition of insurance
    - recognition of correlations
    - calculation of operational risk capital to UL only
  - other national discretion issues;
- Pillar 2 – sets out OSFI approach to the supervisory review process, including:
  - DTI internal targets
  - substantial compliance with Pillar 2
  - assessment criteria for capital and possible improvements needed

OSFI has established a joint working group on Basel implementation with the CBA. We propose to obtain the main feedback from DTIs, through that working group and its technical sub-groups, no later than September 30, 2004. That feedback would be considered for incorporation in OSFI's first draft of a revised Capital Adequacy (CAR) Guideline, to be issued early 2005.

3. Availability of Approaches

OSFI proposes to apply the new Basel framework to all DTIs incorporated in Canada.

3.1. Credit risk

OSFI would expect domestic DTIs that have total regulatory capital (net of deductions) in excess of $5 billion Canadian, or that have greater than 10 percent of total assets or greater than 10 percent of total liabilities that are international (i.e., assets/liabilities booked outside of Canada plus assets/liabilities to non-residents booked in Canada) to implement an AIRB approach for all "material" portfolios and credit businesses in Canada and in the U.S. from Q4[1] 2007.

OSFI proposes to make available the IRB and Standardized Approaches to all other DTIs incorporated in Canada. OSFI anticipates, however, that the majority of other DTIs incorporated in Canada would implement the Standardized Approach for measuring credit risk. OSFI considered the possibility of introducing two distinct simpler approaches for credit risk, the "full" Standardized Approach and the Simplified Standardized Approach, which is a collection of the 'simplest' options available under the "full" Standardized Approach. However, after comparing the two approaches, OSFI determined that it would be more efficient for the industry and for OSFI to develop only one Standardized Approach for measuring credit risk under the new Basel framework. This single approach would be rolled out in a flexible manner such that DTIs wishing to implement the simplest, most basic elements of the approach could do so. At the same time, DTIs that would like to take advantage of the more complex options permitted within the Standardized Approach and are able to meet any corresponding criteria, would have that opportunity.

The capital adequacy guideline and reporting forms would be developed in such a way that smaller DTIs with less complex operations and products would easily be able to identify and adopt the simplest, most basic elements of the Standardized Approach. For example, this may be achieved by attaching an appendix to the capital adequacy guideline that would highlight the simplest options under the Standardized Approach for credit risk and provide a quick reference for these institutions.

A Canadian subsidiary of a foreign or domestic DTI may be permitted to use its parent's IRB methodology subject to OSFI approval. OSFI approval would consider, among other things, the appropriateness for the Canadian marketplace of the data and experience used to calculate the subsidiary's IRB capital requirement.

3.2. Operational Risk

OSFI proposes to permit a DTI incorporated in Canada to implement any one of the following three approaches for measuring operational risk: the Basic Indicator Approach, the Standardized Approach or an AMA. OSFI does not propose to allow a DTI to use the Alternative Standardized Approach. This approach was developed for those institutions

[1] Refers to fiscal quarter end of the reporting DTI.

operating in non G-10 countries and thus is not appropriate for institutions incorporated in Canada.

[663, footnote 101] The new Basel framework sets out qualifying criteria for internationally active DTIs using the Standardized Approach for operational risk. OSFI proposes to apply these criteria to all DTIs implementing the Standardized Approach. In assessing the compliance of such DTIs with these criteria, OSFI would take into consideration the risk profile and complexity of an institution on a case-by-case basis.

[647] The new Basel framework states that internationally active DTIs and DTIs with significant operational risk exposures are expected to use an approach that is more sophisticated than the Basic Indicator Approach and that is appropriate for the risk profile of the institution. OSFI supports this approach and strongly encourages such DTIs in Canada to implement either the Standardized Approach or an AMA. OSFI encourages DTIs that plan to implement an IRB approach for credit risk to also, over time, implement an AMA for operational risk as they improve their systems and processes to the point where they are able to meet the qualifying criteria. However, given potential resource limitations, we would encourage DTIs to first adopt an IRB approach before implementing an AMA. Other DTIs that are able to meet the minimum requirements for the AMA can also apply to OSFI to use this approach.

[656] Subject to the conditions outlined in the new Basel framework, OSFI proposes to allow a Canadian subsidiary of a foreign bank to use an allocated amount from its parent's AMA capital to determine its operational risk capital requirements. The same flexibility would be available to the domestic DTI subsidiaries of a Canadian DTI.

[657] OSFI will work with individual banks and their respective home supervisors in those limited instances, if any, where it may be determined, in accordance with the conditions outlined in the new Basel framework, that a Canadian subsidiary of a foreign bank should calculate stand-alone AMA capital requirements.

4. Implementation Dates and Parallel Run Periods

[258] The new Basel framework requires a DTI to produce a formal IRB rollout plan for review and approval by the supervisor. The rollout plan would set out a detailed proposal for implementation of the IRB approaches, specifying to what extent and when it intends to roll out IRB approaches across all significant asset classes and business units over time. Pursuant to these requirements, OSFI expects any DTIs that are working towards IRB status to submit such a roll out plan by November 30, 2004.

OSFI proposes to implement these time lines:

- DTIs planning to use the AIRB approach to credit risk may use Basel 1[2] up to and including Q4[3] 2007;
- DTIs using the AIRB approach to credit risk and any of the permitted operational risk approaches would be expected to submit capital calculations that are compliant with the new Basel framework on Q4 2007;
- DTIs planning to use the AIRB approach together with any of the permitted operational risk approaches would be expected to collect parallel run information, for a two-year period, on Q1, Q2, Q3 and Q4, 2006-2007;
- OSFI expects different data quality standards for the 2006 parallel run compared to the 2007 parallel run; DTIs would provide information during the first year of the parallel run, on a best efforts basis; during the second year of the parallel run, information should be of sufficient quality to represent a meaningful dress rehearsal of the DTIs' AIRB approaches;
- Following Q4 2007 up to and including Q4 2008, capital requirements for DTIs using the AIRB credit risk or AMA operational risk would be subject to a floor set at 90 percent of Basel 1; following Q4 2008 up to and including Q4 2009, capital requirements would be subject to a floor set at 80 percent of Basel 1;
- The BCBS confirmed in its press release on May 11, 2004 that the Standardized and FIRB Approaches to credit risk would be available as of year-end 2006. OSFI will communicate its position regarding the timing for implementation of the Standardised and FIRB Approaches after further discussions with other major jurisdictions regarding their implementation plans;
- Pillar III will apply consistent with the timing of DTIs' implementation of the new Basel framework. For greater certainty, this means that AIRB and AMA bankDTIs' Pillar III public disclosure requirements will commence for 2008.

OSFI recognises that domestic DTIs that are internationally active or significant may have material portfolios and credit businesses *outside* of Canada and the U.S that would not meet the minimum requirements for AIRB on Q4 2007. As a consequence, OSFI

[2] Calculation of capital required will be based on current rules i.e. CAR Parts 1&2
[3] Refers to fiscal quarter of the reporting DTI.

proposes the use of the Standardized Approach or FIRB Approach for these portfolios and credit businesses until Q4 2009.

OSFI recognizes that there may also be some limited circumstances where certain exclusions from IRB rollout continue to be warranted. For example, where it can be demonstrated that for asset classes and/or business units operating in jurisdictions where the reliability of the legal framework for collection of defaulted debts does not support the development of robust data for credit risk estimates, OSFI would consider these exemptions. Consequently, OSFI would create a "limited waiver mechanism" to permit DTIs to come forward with proposed exceptions of this type, which would then be considered on a case-by-case basis, including an assessment of materiality, with OSFI retaining the right to approve or decline such waivers in its sole discretion.

5. Scope of Application

5.1. Significant minority equity investments in non-insurance financial entities

[28] The new Basel framework requires that significant minority investments in financial entities, where control does not exist, be excluded from a DTI's capital by deduction of the equity and other regulatory investments <u>or</u> under certain conditions, that they be consolidated on a pro rata basis. National accounting and/or regulatory practices would determine the threshold above which minority investments will be deemed significant and be therefore either deducted or consolidated on a pro rata basis.

OSFI proposes to retain the current requirement that all investments in entities that exceed 10% of the outstanding equity shares of an entity or a substantial investment are to be deducted 50 percent from Tier 1 capital and 50 percent from Tier 2 capital. In the past, deductions of unconsolidated investments were dependent on whether the investments were recorded using the equity method of accounting. This requirement was replaced with the definition of a substantial investment used in the *Bank Act*. OSFI proposes to permit pro rata consolidation for joint ventures for capital adequacy assessment purposes, where those entities are pro rata consolidated under GAAP.

5.2. Significant investments in commercial entities

[35] The new Basel framework provides that significant minority and majority investments in commercial entities, which exceed certain materiality levels, are to be deducted from DTIs' capital. Under OSFI's current capital requirements, investments in unconsolidated commercial entities are deducted from total capital if the DTI's interest represents a substantial investment. This treatment is linked to the Bank Act, i.e. the deduction from capital applies to equity investments that meet the Bank Act definition of a substantial investment (10% of voting rights or 25% of shareholders' equity). OSFI proposes to maintain the current threshold but the deduction would be 50 percent from Tier 1 capital and 50 percent from Tier 2 capital.

5.3. Stand alone capital

[23] The new Basel framework highlights the need for supervisors to test that individual DTIs are adequately capitalized on a stand-alone basis. OSFI recognizes that some DTIs are currently in the process of designing the information system architecture required to support the new Basel framework, therefore, a timely decision on OSFI's part on the approach to stand alone capital is needed. DTIs are, therefore, encouraged to develop such internal systems that would enable them to provide an internal assessment of their stand alone capital position on a legal entity (FRFI) basis if that information were to be requested by the Relationship Manager. These internal systems should be designed to allow the Board, at a minimum, to have an informed view on the adequacy of capital on a legal entity (FRFI) basis as well as in each of the DTI's major jurisdictions. OSFI proposes to consult with industry about the development of a framework for the supervisory review of a DTI's internal assessment of its stand-alone capital adequacy, in the interim.

5.4. Recognition of surplus capital in insurance entities

[33] The new Basel framework allows supervisors, under limited circumstances, to recognize surplus capital in a majority-owned or controlled insurance entity in calculating a DTI's capital adequacy. OSFI is prepared to consult with the industry on an approach that would recognize surplus capital above the level needed to support the operations in insurance subsidiaries that are subject to actuarial, accounting and capital regimes that are equivalent to Canadian practices, but only at the bank holding company level. OSFI's mandate is to ensure that capital recognized in capital adequacy measures is available to protect depositors and policyholders from loss. There can be considerable uncertainty as to what constitutes surplus capital in a regulated unconsolidated entity. Accordingly, OSFI would want to proceed cautiously in developing conditions for defining and recognizing surplus capital. OSFI proposes to recognize surplus capital at the bank holding company level since holding companies do not have depositors or policyholders.

5.5. Other discretionary items

i. **[22, footnote 4]** The new Basel framework provides for the application of the framework to the stand-alone bank as an alternative to full sub-consolidation. OSFI's current practice is to require all DTIs to establish capital adequacy requirements on a consolidated basis (with the exception of insurance subsidiaries and other entities that are subject to a deduction approach). An approach of deducting all equity investments in subsidiaries as provided for in footnote 3 would not be meaningful for Canadian DTIs nor would it be in the spirit of OSFI's consolidated supervisory approach. OSFI proposes to continue with the current practice.

ii. **[26]** The new Basel framework permits a deduction approach for majority-owned securities and other financial subsidiaries instead of requiring consolidation. Under OSFI's current requirements, securities firms and other like financial subsidiaries are fully consolidated, with few exceptions. OSFI proposes to continue with the fully consolidated approach

iii. **[30]** The new Basel framework permits a group-wide method that avoids double counting of capital (rather than a deduction approach) for the treatment of insurance subsidiaries/significant investments in insurance entities. OSFI's current approach of deducting investments in insurance subsidiaries is a sound method of eliminating double counting of capital. OSFI proposes to continue with this deduction method, while at the same time permitting the recognition of surplus capital in insurance subsidiaries, at the holding company level, and under certain conditions to be developed.

Summary

Discretion to	**OSFI proposes to**
[22, footnote 4] Apply new Basel framework to the stand-alone DTI as an alternative to full sub-consolidation	Not use this discretion

Discretion to	OSFI proposes to
[23] Test that individual DTIs are adequately capitalized on a stand-alone basis	Consult with the industry about the development of acceptable standards for a DTIs internal assessment of its stand-alone capital adequacy
[26] Deduct majority-owned securities and other financial subsidiaries rather than to require consolidation	Not use this discretion
[28] Use national accounting and/or regulatory practices to define the threshold for "significant" minority investments	Retain the current threshold i.e. substantial investment - deduction of 50 percent from Tier 1 capital and 50 percent from Tier 2 capital Permit pro rata consolidation for joint ventures where those entities are pro rata consolidated under GAAP
[30] Use a group-wide method that avoids double counting of capital (rather than a deduction approach) for the treatment of insurance subsidiaries/significant investments in insurance entities	Deduct substantial investments in insurance entities and subsidiaries i.e. 50 percent from Tier 1 capital and 50 percent form Tier 2 capital
[33] Recognize surplus capital in a majority-owned or controlled insurance entity in calculating a DTI's capital adequacy	Use this discretion for insurance subsidiaries of bank holding companies where those subsidiaries are subject to Canadian-equivalent actuarial, accounting and capital regimes
[35] Define materiality levels for significant minority and majority investments in commercial entities	Maintain the threshold i.e. substantial investment - deduction of 50 percent from Tier 1 capital and 50 percent from Tier 2 capital

6. Standardized Approach to Credit Risk

6.1. Risk-weighting individual claims

6.1.1. Claims on sovereigns

[54] Under the Standardized Approach, the applicable risk weight for claims on sovereigns is based on the rating assigned to the sovereign by a recognized External Credit Assessment Institution (ECAI), such as a rating agency. A national supervisory authority may apply a lower risk weight to its DTIs' exposures to their own sovereign when the exposures are denominated in the local currency and funded in the local currency. Other national supervisory authorities may also permit their DTIs to apply the same risk weight to domestic currency exposures to this sovereign. In these instances, there is no trans-border risk. Thus, OSFI proposes to continue with its current approach and allow DTIs that have exposures to these sovereigns meeting the above criteria to use the preferential risk weight assigned to the sovereign by the relevant national supervisory authority.

[55] Risk weights for claims on sovereigns can also be determined using the country risk scores assigned by Export Credit Agencies (ECAs). To qualify as a recognized ECA, an agency must publish its risk scores and subscribe to the Organization of Economic Co-operation and Development (OECD) methodology. Institutions may use either the risk scores published by individual ECAs that are recognized by their national supervisory authority, or the consensus risk scores of ECAs participating in the "Arrangement on Officially Supported Export Credits" through the OECD.

OSFI proposes to allow this treatment only for claims on sovereigns that do not receive an ECAI rating. Under these circumstances, DTIs would be permitted to use the consensus risk scores that are available on the OECD website. OSFI expects the use of these risk scores to be infrequent as most material exposures are to rated sovereigns.

6.1.2. Claims on DTIs and securities firms

[60-63] The new Basel framework allows national supervisory authorities to implement one of two options for risk-weighting claims on DTIs and securities firms. Under option 1, the risk weight is one category less favourable than that assigned to claims on the sovereign of the country of incorporation. Under option 2, the risk weight is based on the external rating of the DTI by a recognized ECAI.

OSFI proposes to implement option 1, under which all DTIs would receive the same risk weight. As a result, a DTI's funding ability would not be affected by the steep increase in risk weights between the limited number of risk weight buckets. Currently, all Canadian incorporated DTIs would receive a risk weight at 20 percent, which is one category less favourable than that of the Government of Canada.

[64] National supervisory authorities, who choose to allow preferential treatment for claims on sovereigns as described in paragraph 54, may also allow preferential treatment for certain short term claims on DTIs. To be eligible for this treatment, these exposures must be denominated and funded in the local currency and have an original maturity of three months or less. These exposures may receive a risk weight that is one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20 percent.

This option is only applicable to national supervisory authorities who choose to adopt option 2 for risk-weighting claims on DTIs. Since OSFI proposes to adopt option 1, all claims on DTIs would receive a risk weight that is one category less favourable than the risk weight corresponding to the external rating of the sovereign, regardless of the maturity of the exposure.

6.1.3. Claims on public sector entities (PSEs)

OSFI proposes to continue with the current definition of PSEs as specified in the Capital Adequacy Requirements (CAR) guideline.

[57, 58] The new Basel framework allows claims on (PSEs) to be risk weighted using either option 1 or option 2 for claims on DTIs. OSFI proposes to allow the use of option 1 for claims on DTIs to determine the risk weight for PSEs. Thus, claims on PSEs would receive a risk weight that is one category less favourable than that assigned to claims on the sovereign of incorporation. Based on the current rating of the Government of Canada, all Canadian PSEs would be risk weighted at 20 percent.

OSFI proposes two exceptions to the treatment of PSEs under option 1:

i. Claims on Canadian provinces or territorial governments

The new Basel framework allows national supervisory authorities to treat certain PSEs (e.g., regional governments and local authorities) as sovereigns if these governments have specific revenue raising powers or specific institutional arrangements that reduce the risk of default. Under the current CAR guideline, Canadian provinces and territories are treated as sovereigns given their constitutional powers, taxing authority, and shared cost programs with the federal government. OSFI proposes to continue this treatment. Thus, all direct obligations and obligations unconditionally and irrevocably guaranteed by a Canadian province or territorial government would be treated the same as claims on the Government of Canada (i.e. risk weighted at 0 percent).

ii. PSEs in competition with the private sector

OSFI proposes to treat PSEs that are, in the judgement of the host government, significantly in competition with the private sector as corporate exposures. The current CAR guideline contains a list of PSEs that fall into this category. This list (last updated in 1991) was based on information supplied by the provinces and federal government. OSFI proposes to no longer include this list in the CAR guideline due to the resources required to maintain it. DTIs would continue to look to the host province to confirm whether an entity is a PSE in competition with the private sector.

6.1.4. Claims on corporates

[68] Under the new Basel framework, the risk weight for corporate exposures is determined using the rating assigned by a recognized ECAI. However, national supervisory authorities may allow institutions to use the 100 percent risk weight for all corporate exposures in lieu of using external ratings. OSFI proposes to limit the flexibility to choose this option to DTIs that OSFI would not expect to implement an IRB Approach. However, if a DTI chooses to adopt this option, it must use the 100 percent risk weight for all of its corporate exposures. It cannot use external ratings for a portion of its corporate exposures and a 100 percent risk weight for the balance. This is to ensure that DTIs do not "cherry-pick" external ratings.

[67] The risk weight for all unrated corporate exposures is 100 percent. However, national supervisory authorities have discretion to increase the risk weight for unrated claims above 100 percent if it is felt that a higher risk weight is necessary based on the overall default experience in their jurisdiction. In addition, national supervisory authorities may impose a risk weight greater than 100 percent against individual claims where it is judged that a higher risk weight is warranted based on the credit quality of the exposure.

These options were included in the new Basel framework to accommodate concerns of some countries who believe that a 8 percent minimum capital requirement may be insufficient. OSFI proposes not to introduce a higher risk weight category for unrated corporate exposures in Pillar 1. OSFI will address concentrations of lending to sectors or businesses that have systematically higher risk profiles through its supervisory review process.

6.1.5. Claims included in the regulatory non-mortgage retail portfolios

[69, 70] The new Basel framework specifies qualifying criteria for claims that may be treated as retail claims for regulatory capital purposes and included in a regulatory retail portfolio. These criteria include a granularity criterion which requires that the portfolio be sufficiently diversified to reduce the risk to a level warranting the 75 percent risk weight. National supervisory authorities have the option of setting a numerical limit on the amount of aggregated exposure (i.e. gross exposures before taking into account credit risk mitigation) to one counterparty. For example, this limit could be set at 0.2 percent of the total retail portfolio as proposed in the framework. OSFI proposes not to impose a hard granularity requirement on exposures included in the regulatory retail portfolio under the Standardized Approach.

6.1.6. Claims secured by residential mortgages

[72] The new Basel framework allows claims secured by residential mortgages to receive a risk weight of 35 percent. OSFI proposes to modify the current definition of a qualifying residential mortgage in the CAR guideline to include condominium residences and to require that the mortgage loan be to a person(s) or guaranteed by a person(s). Investments in hotel properties and time-share properties would be excluded from the definition of residential mortgage property. In addition, OSFI proposes to apply the 75 percent retail risk weight to uninsured collateral mortgages that would otherwise qualify as residential mortgages except that their loan-to-value ratio exceeds 75 percent.

[73] National supervisory authorities should determine whether the 35 percent risk weight for residential mortgages is appropriate for circumstances in their jurisdictions. In the event that the risk weight is not appropriate, DTIs may be required by their national supervisory authority to increase the risk weight above 35 percent.

OSFI does not propose to include in the Pillar 1 minimum capital requirements a risk weight greater than 35 percent for qualifying residential mortgages. OSFI believes it would be more appropriate to take lending risk concentrations and the conservatism of loan origination for residential mortgages into account through the supervisory review process.

6.1.7. Claims secured by commercial real estate

[74] Under the new Basel framework, mortgages on commercial real estate are risk weighted at 100 percent. Given the experience with commercial property lending in various jurisdictions over the past few decades, the BCBS feels that this risk weight is appropriate. However, national supervisory authorities may apply a preferential risk weight of 50 percent to parts of commercial real estate loans under exceptional circumstances. OSFI does not propose to allow this preferential treatment given the history of commercial real estate lending in Canada.

6.1.8. Past due loans

[75, footnote 26] The new Basel framework establishes criteria by which net non-mortgage loans 90 days past due shall be risk-weighted at 150 percent or 100 percent depending upon the level of provisioning. Where the level of provisioning is 50 percent or more, a national supervisory authority may permit its DTIS to decrease the risk weight on non-performing loans to 50 percent. OSFI does not propose to allow this treatment as there is no justification in applying a lower risk to an exposure where there is clear indication that the exposure is of higher risk.

National supervisory authorities may also permit DTIs to apply the same treatment to non-past due loans that are risk weighted at 150 percent. Under Canadian GAAP, a discussion of provisions in the context of a performing loan is irrelevant. Thus, OSFI does not propose to allow this treatment.

[76, footnote 27] For the purposes of defining the secured portion of a past due loan, eligible collateral and guarantees would be the same as allowed for credit risk mitigation purposes. The new Basel framework expands the range of eligible collateral beyond the current definition. However, national supervisory authorities may allow a transitional period of three years during which the range of eligible collateral may be extended beyond that which is allowed in the new Basel framework.

Due to the costs involved in developing operational criteria, as well as monitoring for compliance for a temporary period of time, OSFI does not propose to allow the widening of the definition of eligible collateral on a transitional basis. In addition, this temporary concession would likely divert scarce resources away from the development of the AIRB Approaches for credit risk.

[77] National supervisory authorities may allow a 100 percent risk weight to be applied to a past due loan that is fully secured by forms of collateral that are not recognized in the framework, where the provisions are at least 15 percent.

OSFI does not propose to recognize forms of collateral outside of the range of allowable collateral specified in the new Basel framework. The resources needed to design strict operational criteria to ensure the quality of the collateral not recognized in the framework, as well as to monitor and audit compliance would likely outweigh the potential benefits.

6.1.9. Other assets

[80] National supervisory authorities have the discretion to require an institution to apply a risk weight of 150 percent or greater to assets that represent higher risk. OSFI does not propose to require standardized risk weights above 150 percent under Pillar 1 or to expand the types of exposures that receive a 150 percent risk weight under paragraph 78. However, under Pillar 2, OSFI would review a DTI's portfolio and determine if its calculations reflect the true risk of the exposures.

[81, footnote 28] The new Basel framework allows national supervisory authorities to treat gold bullion held in vaults, or on an allocated basis to the extent backed by bullion liabilities, as cash and thus receive a 0 percent risk weight. Consistent with OSFI's current framework, OSFI proposes to permit this treatment as gold bullion is considered to be equivalent to cash.

6.2. Domestic and foreign currency assessments

[102, footnote 31] Under the new Basel framework, where unrated exposures are risk-weighted based on the rating of an equivalent exposure to the borrower, generally foreign currency ratings would be used for exposures denominated in foreign currency and domestic currency ratings would only be used for exposures denominated in the domestic currency. However, national supervisory authorities may permit the use of a borrower's domestic currency rating for exposures denominated in a foreign currency where (i) the bank participated in a loan extended by a qualifying multilateral development bank (MDB) or (ii) the trans-border risk of a loan extended by the bank is guaranteed by a qualifying MDB.

OSFI proposes to allow this treatment and will consult with the industry to determine the nature of Canadian DTIs' participation in these types of transactions.

6.3. Qualifying external credit assessments

6.3.1. Eligible ECAIs and the mapping process

[90, 92] National supervisory authorities are responsible for determining whether an ECAI meets the qualifying criteria specified in the new Basel framework. National supervisory authorities must also assign eligible ECAI assessments to the applicable risk weights available under the Standardized Approach.

OSFI proposes to develop a template for self-assessment against the eligibility criteria which would be completed by identified rating agencies. OSFI will work with eligible rating agencies to develop a mapping process for mapping their agency grades to the risk weights of the Standardized Approach. As much as possible, OSFI will work with other supervisors to leverage off work they may have already commenced with rating agencies.

6.3.2. Use of unsolicited ratings

[108] As a general rule, DTIs should use solicited ratings from eligible ECAIs. However, the new Basel framework allows national supervisory authorities to permit the use of unsolicited ratings. OSFI proposes not to allow DTIs to use unsolicited ratings as the use and recognition of solicited ratings is well established domestically.

Summary

Discretion to	OSFI proposes to
[54] Apply the preferential risk weight assigned to the sovereign by the relevant	Exercise this discretion

Discretion to	OSFI proposes to
national supervisory authority to domestic sovereign exposures that are: • denominated in the local currency, and • funded in the local currency	
[55] Use consensus risk scores of ECAs participating in the "Arrangement on Officially Supported Export Credits" to assign a risk weight to a sovereign exposure	Use the consensus risk scores that are available on the OECD website only for claims that do not receive an external rating from a recognized ECAI
[60-63] Use a risk weight for DTIs that is • one category less favourable than that assigned to claims on the sovereign of the country of incorporation, or • determined based on rating	Use a risk weight one category less favourable than that assigned to claims on the sovereign of the DTI's country of incorporation
[64] Allow preferential treatment for short term claims on DTIs if the exposures • have an original maturity of three months or less, • are denominated in the local currency, and • are funded in the local currency These exposures may receive a risk weight that is one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20%	Not exercise this discretion.
[57, 58] Use a risk weight for PSEs that is • one category less favourable than that assigned to claims on the sovereign of the country of incorporation, or • determined based on ECAI rating of the PSE	Use a risk weight one category less favourable than that assigned to claims on the sovereign of the country of incorporation except: • treat all direct obligations and obligations that are unconditionally and irrevocably guaranteed by a Canadian Province or Territorial Government the same as claims on the Government of Canada (i.e. risk weighted at 0%) • give corporate exposure treatment to PSEs that are, in the judgement of the host government, significantly in competition with the private sector
[68] Allow DTIs to use the 100% risk weight for all corporate exposures in lieu of using external ratings	Allow some DTIs to choose this option
[67] Increase risk weight for all unrated claims and individual claims above 100%	Not exercise this discretion in Pillar 1

Discretion to	OSFI proposes to
if warranted because of the credit quality of the exposure(s)	
[69, 70] Define retail non-mortgage exposures by setting a limit on the amount of aggregated gross exposure to one counterparty	Not impose a specific limit
[72] Allow a risk weight of 35% for claims secured by residential mortgages	Modify current definition of a qualifying residential mortgage to: • include condominium residences • require that the mortgage loan be to a person(s) or guaranteed by a person(s) • continue to exclude investments in hotels and time-shares Apply the 75% retail risk weight to uninsured collateral mortgages where the loan-to-value ratio exceeds 75%
[73] Increase the risk weight for qualifying residential mortgages above 35%	Not exercise this discretion
[74] Apply a preferential risk weight of 50% to commercial real estate under exceptional circumstances	Not exercise this discretion
[75] Where the level of provisioning is 50% or more, decrease the risk weight on non-performing loans to 50%	Not exercise this discretion
[75] Apply the risk weights for non-performing loans to performing loans risk-weighted at 150% where provisions are held	Not exercise this discretion
[76] Allow, temporarily, a wider definition of eligible collateral for determining the secured portion of a past due loan	Not exercise this discretion
[77] Apply 100% risk weight to past due loans that are fully secured by forms of collateral that are not recognized in the framework where the provisions are at least 15%	Not exercise this discretion
[80] Apply a risk weight of 150% or more to assets that represent higher risk (e.g., venture capital and private equity investments)	Not exercise this discretion
[81] Assign a 0% risk weight (i.e., same as cash) to gold bullion held in vaults, or on an allocated basis to the extent backed by bullion liabilities	Permit this treatment

Discretion to	OSFI proposes to
[102] Use borrower's domestic currency rating for an exposure denominated in a foreign currency where the loan is extended by an MDB	Allow this treatment
[90, 92] Determine whether an ECAI meets the qualifying criteria specified in the new framework Assign risk weights based on ECAI ratings	Develop a template for self-assessment against the eligibility criteria to be completed by identified rating agencies Work with the rating agencies to develop a mapping process
[108] Use unsolicited ratings	Not use unsolicited ratings

7. Internal Ratings Based Approach to Credit Risk

Under the AIRB Approach for credit risk, a DTI's internal assessment of key risk drivers (Probability of Default (PD), Loss Given Default (LGD), Exposure At Default (EAD), Maturity) for a particular exposure (or pool of exposures) would be the primary inputs in the calculation of the minimum capital requirements for credit risk. Risk weight functions specified in the new Basel framework would use a DTI's estimated inputs to derive a dollar amount capital requirement for each exposure (or pool of exposures). This dollar capital requirement would be converted into risk-weighted assets equivalent by multiplying the dollar amount of the capital requirement by 12.5 – the reciprocal of the 8 percent minimum capital requirement. Generally, DTIs using the AIRB Approach must first assign assets and off-balance-sheet exposures into one of three portfolios: wholesale (corporate, interbank, and sovereign), retail (residential mortgages, qualifying revolving, and other), and equities. There also are specific treatments for securitization exposures and purchased receivables. Certain assets that do not constitute a direct credit exposure (for example, premises, or equipment) would continue to be subject to the general risk-based capital rules and risk weighted at 100 percent.

7.1. Portfolio Definitions

7.1.1. Sovereign exposures

[229] The definition of sovereign exposure is important for IRB Approaches because, unlike corporate bank or retail exposures, the PD risk driver estimated for sovereign exposures is not subject to a 0.03 percent floor. In the Standardized Approach, the highest quality sovereign exposures and sovereign guaranteed exposures receive a 0 percent risk weight.

OSFI proposes to maintain some consistency between the treatment of high quality sovereign exposures in the Standardized and IRB Approaches by using the same portfolio definition. This means that claims on or directly guaranteed by the Government of Canada, the Bank of Canada, a Canadian province, a Canadian territorial government, foreign central governments, foreign central banks, or qualifying Multilateral Development Banks would not be subject to the 0.03 percent floor on PDs estimated by a DTI.

7.1.2. Corporate Exposures

[218] Corporate exposures would include debt obligations and obligations under derivatives contracts of corporations, partnerships, limited liability companies, proprietorships, and special-purpose entities (including those created specifically to finance and/or operate physical assets).

Loans to or derivative contracts with a pension fund, mutual fund, or similar counterparty are treated as corporate unless the DTI is able to use a look through approach. Pension/mutual/hedge funds and income trusts contracts would also be treated as corporate exposures.

7.1.3. Small and Medium-sized Enterprises

[274] The new Basel framework gives national discretion to use a borrower's total assets instead of total sales to determine the Small and Medium Enterprise (SME) risk weight adjustment. This provision is used only on a case-by-case basis as a fallback to circumstances where sales are not a valid indicator of borrower size.

The calibration of corporate SME risk weight adjustments was based on sales as a measure of borrower size and its relationship to asset correlations. Historically, DTI's own segmentation of small business lending has used a range of segmentation criteria, including loan size, asset size and annual sales.

OSFI believes the measure of borrower size should be based on annual sales (rather than total assets), unless in individual circumstances the DTI can demonstrate that it would be more appropriate to use the total assets of the borrower as its measure of borrower size.

The maximum reduction in the risk weight for SMEs is achieved when borrower size is CAD $5 million. For all borrower sizes below CAD $5 million, borrower size would be set equal to CAD $5 million. The adjustment shrinks to zero as borrower size approaches CAD $50 million. The broad rationale for this adjustment is the view that the credit condition of SMEs would be influenced relatively more by idiosyncratic factors than is the case for larger firms, and, thus, SMEs would be less likely to deteriorate simultaneously with other exposures.

7.2. Specialized Lending

[220-227] Specialized lending (SL) encompasses exposures for which the primary source of repayment is the income generated by the specific asset(s) being financed, rather than the financial capacity of a broader commercial enterprise. Within the corporate exposure category, the new Basel framework has four sub-categories of specialized lending. These are project finance (PF), object finance (OF), commodities finance (CF), and commercial real estate (CRE). CRE is further subdivided into low asset correlation CRE, and high-volatility CRE (HVCRE).

A major reason for establishing the SL sub-category is that the risk factors influencing actual default rates are likely to influence LGDs as well. This is because *both* the borrower's ability to repay an exposure *and* the DTI's recovery on an exposure in the event of default are likely to depend on the same underlying factors, such as the net cash flows of the property being financed. This suggests a positive correlation between observed default frequencies and observed loss rates on defaulted loans, with both declining during periods of favourable economic conditions and both increasing during unfavourable economic periods.

Given that cyclicality is likely to be the norm for SL exposures, the new Basel framework offers a Supervisory Slotting Criteria (SSC) approach as a fallback for DTIs that may not be able to provide sufficiently reliable estimates of PD, LGD, and M for each SL exposure.

7.3. High Volatility Commercial Real Estate (HVCRE)

[227,228] The new Basel framework allows national supervisors to designate certain types of property financing in their jurisdiction as exhibiting higher loss rate volatility and hence requiring separate risk weights associated with HVCRE. Other supervisors would need to ensure that their own DTIs apply the HVCRE risk weights to financing of commercial real estate in such jurisdictions.

Canadian DTIs have indicated that their commercial real estate lending can be assigned borrower PD and LGDs that meet the requirements for these inputs in the corporate risk weight curve.

Accordingly, OSFI does not propose to designate the specific property types in Canada as HVCRE. This means that the optional risk weight choices in paragraphs 280, 282 and 283 would not be relevant for financing commercial real estate in Canada.

However, the HVCRE risk weights would apply to Canadian DTI foreign operations' loans on properties in jurisdictions where the national supervisory authority has designated specific property types as HVCRE. In these cases, OSFI proposes to permit DTIs to use the risk weight alternatives allowed by foreign supervisors when calculating capital requirements for loans secured by these properties.

7.4. Acquisition, Development and Construction (ADC) financing

[227] The new Basel framework indicates that loans financing acquisition, development or construction phases of non-designated properties must have their risk weights determined using a risk weight function specified in paragraph 283. This risk weight function for ADC finance assumes a higher asset correlation than the corporate risk weight function that would otherwise apply.

An exception is made for ADC financing where the borrower has "substantial equity at risk" or the future sale of the property is certain.

OSFI proposes to explicitly exclude loans financing the construction of pre-sold one- to four-family residential properties from the ADC category. In addition, OSFI proposes to address the risk of ADC finance in Canada using Pillar 2 until the supervisory review process begins to identify the volume and underwriting standards for ADC finance as material risks to DTIs.

7.5. IRB Retail other than Qualifying Revolving Exposure and Residential Mortgages

[232] National supervisory authorities have the option of setting a minimum number of exposures for a pool of loans to be classified as retail. The Standardized

Approach addresses the same issue by suggesting a possible limit on single counterpart exposures of 0.2 percent of the total retail portfolio.

OSFI proposes not to impose a floor on the number of exposures included in a portfolio in order for it to be classified as a retail portfolio.

7.6. IRB Mechanics

7.6.1. Definition of Subordination

[288] At national discretion, national supervisory authorities may choose to employ a wider definition of subordination when implementing the FIRB Approach. This might include economic subordination, such as cases where the facility is unsecured and the bulk of the borrower's assets are used to secure other loans.

A DTI's credit risk exposure can be elevated due to its interest being junior to another creditor's interest regardless of whether the loan agreement explicitly states that the loan is subordinate to the interest to another creditor. A senior secured / senior unsecured structure can achieve the same level of subordination as a senior unsecured / subordinated debt structure.

In the QIS3 survey OSFI allowed DTIs to use a wider definition to allow credits that are not expressly subordinated to another facility to be reported in the 75 percent LGD category.

The Canadian DTIs have asked that OSFI not use the wider definition of subordination as a practical matter, given the difficulties in applying the broader definition consistently.

OSFI proposes to retain the legal definition of subordination for the purpose of applying the 75 percent supervisory LGD in the FIRB Approach.

7.6.2. Explicit M

[318,321,322] The FIRB approach prescribes an assumed effective maturity of 2.5 years for purposes of calculating the maturity adjustment to the credit risk weights. However it allows national supervisory authorities to require all DTIs using the FIRB Approach to calculate an actual "explicit" M adjustment. The QIS3 revealed average maturities of less than 2.5 years for Canadian DTIs.

The new Basel framework also provides for an exemption from the 1-year floor on explicit maturities calculated under the IRB Approaches for short-term transactions with defined qualities. The new Basel framework leaves it up to national supervisory authorities to generate lists of transaction types that meet the criteria and provides a list of possible examples.

OSFI seeks industry views on the practicality of requiring FIRB DTIs to calculate an explicit maturity given the state of current and planned systems.

OSFI proposes to exempt from the 1-year floor on maturity adjustments, the following types of transactions:

- Repo-style transactions and short-term loans and deposits;

- Exposures arising from securities lending transactions;
- Short-term self-liquidating trade transactions. Import and export letters of credit and similar transactions could be accounted for at their actual remaining maturity;
- Exposures arising from settling securities purchases and sales. This could also include overdrafts arising from failed securities settlements provided that such overdrafts do not continue more than a short, fixed number of business days;
- Exposures arising from cash settlements by wire transfer, including overdrafts arising from failed transfers provided that such overdrafts do not continue more than a short, fixed number of business days; and
- Exposures to DTIs arising from foreign exchange settlements.

7.6.3. External Audit of Rating Assignment

[443] OSFI does not propose to mandate external audits of DTIs' internal rating assignment processes or of their estimation of loss characteristics. The additional cost of a routine audit of this nature would likely out weigh the benefits given OSFI's on-site role in the approval of internal rating systems for capital adequacy reporting, and given the use test imposes a self discipline on DTIs to maintain the accuracy and integrity of the rating processes used to manage business.

7.6.4. Re-aging

[458] The new Basel framework requires DTIs to have clearly articulated and documented policies on the counting of days past due and in particular in respect of re-aging accounts. It also provides that national supervisors may establish more specific requirements for re-aging.

In some countries an established practice in revolving consumer credit is called re-aging (also known as curing and rollback). Re-aging involves changing the delinquency status of an account.

The practice of bringing a delinquent account current originated to acknowledge and assist customers who corrected previous, usually one-time, cash flow problems. To prevent the accounts from showing perpetually delinquent, the DTI would re-age them to show current. An improperly managed re-aging program can lead to pools of problem receivables, and also understate delinquency and write-off figures, thereby impeding accurate analysis of risk. This is one reason why the new Basel framework acknowledges explicitly the Supervisory option to provide greater restrictions on re-aging policies.

However, in the on-site phase of the QIS3, Canadian DTIs indicated that they either prohibited the practice of re-aging, or had conservative policies that gave some accommodation to the practice.

Accordingly, OSFI does not propose to establish more specific requirements for re-aging than those detailed in the new framework. This policy could be reconsidered in the future if OSFI discovers deterioration in the conservatism of the re-aging practices of Canadian DTIs.

7.6.5. Definition of default- QRR exposures

[452, footnote 82] A national supervisory authority has the option of substituting the 90 days past due trigger in the definition of default with a higher number (up to 180 days) in the case of retail exposures and PSEs.

In Canada, the practice for credit card portfolios is to move directly to a write-off after a maximum of 180 days past due. Some DTIs in Canada would like OSFI to consider allowing individual DTIs in their estimation of PDs and LGDs to use an earlier definition of default for credit cards than is the practice for accounting purposes. Other DTIs prefer to continue to use 180 days.

Given the effect of a change in PDs is non-linear, while changes in LGDs are linear, OSFI would want to establish with Canadian DTIs:

- How allowing some DTIs to use a 90 day rather than an 180 day definition of default for credit card portfolios could produce closely equivalent outcomes in the IRB framework for portfolios that have very similar risk profiles; and
- The implications of using 90 days for default for provisioning practice as it relates to the requirement to make adjustments to capital based on a comparison of provisioning level with estimated Expected Loss.

7.7. Treatment of general allowances in hybrid (Standardized & IRB) DTIs

7.7.1. Clarification on definition of Provisions or Allowances

The new Basel framework proposes to adjust capital for excess/shortfall in provisions compared to EL. Use of the term provisions can lead to some misinterpretation because Canadian GAAP refers to allowances for impairment. It is important, from both a theoretical and level playing field perspective, that all allowances for credit losses available to the DTI for offsetting EL are recognised regardless of terminology used in the new Basel framework.

OSFI proposes to recognise the terminology appropriate to Canadian GAAP. Wherever the new Basel framework refers to provisions, this would be interpreted to mean allowances for credit losses, either specific or general, for Canadian DTIs.

7.7.2. Allocation of general allowances

[382, 383] OSFI recognizes that clarification is needed to determine allocation of general allowances given that it is likely that there would be several institutions that would partially implement the IRB Approach while, at least initially, maintaining a portion of their portfolio on the Standardized Approach.

The new Basel framework proposes three methods for allocating general allowances:

i. General provisions would be split proportionately based on credit risk weighted assets calculated under the Standardized Approach (or Basel I) and IRB Approach;

ii. If both the choice of approach for calculating credit risk and the establishment of general provisions are on an entity-by-entity basis, the booking location of general provisions should be used; and

iii. If DTIs had a transparent internal allocation methodology that met transparent supervisory standards that are determined at national discretion, the DTIs may be allowed to apply such internal methodology in lieu of the proportional risk weighted asset approach.

OSFI proposes to use the proportional split method since it is simple, transparent and can be applied consistently. The use of this method is seen as a temporary measure, as OSFI fully expects DTIs' material portfolios to adopt the IRB Approach.

Once the allocation of the general provisions has been determined, the amount of the general provisions that can be included in Tier 2 capital for the portion of the institution on the Standardized Approach would be limited to 1.25 percent of the risk weighted assets that were calculated under the Standardized Approach.

Provisioning shortfall or excess for the portion of the DTI under the IRB Approach would be calculated as (1) the general provisions allocated to that portion of the DTI, plus (2) all other provisions established within that portion of the DTI, minus (3) the EL charge for the IRB portion of the institution. The amount of excess provisions included in Tier 2 capital for the part of the DTI on the IRB Approach should not exceed 0.6 percent of IRB credit risk weighted assets.

Summary

Discretion to	OSFI proposes to
[229] Define sovereign exposures	Use the same portfolio definition in the Standardized and IRB Approaches
[218] Define corporate exposure	OSFI definition includes: • Debt obligations and obligations under derivatives contracts of corporations, partnerships, limited liability companies, proprietorships, and special-purpose entities (including those created specifically to finance and/or operate physical assets) • Loans to, or derivative contracts with, a pension fund, mutual fund, or similar counterparty are treated as corporate unless the DTI is able to use a look through approach • Pension/mutual/hedge funds and income trusts contracts
[274] To use total assets instead of total sales to determine the SME risk weight	Require borrower size to be measured based on annual sales, unless a DTI can

Discretion to	OSFI proposes to
adjustment when total sales are not a valid indicator of borrower size	demonstrate that total assets are more appropriate
[227-28] Designate certain types of property financing as HVCRE requiring separate risk weights	Not exercise this discretion
[227] Exclude from ADC treatment, financing where: • The borrower has substantial equity at risk • The future sale of the property is certain, or • Source of repayment is substantially certain	• Exclude loans financing the construction of pre-sold one- to four – unit family residential properties from ADC treatment • Use Pillar 2 to address the risk of ADC finance
[232] Define a retail exposures by placing a floor on the number of exposures	Not impose floors on the number of exposures included in the IRB retail portfolio
[288] Use a wider definition of subordination	Retain the legal definition of subordination in applying the 75 percent supervisory LGD in the FIRB Approach
[318, 321-322] Require all DTIs using FIRB to calculate an explicit M adjustment	Seek industry views on the practicality of calculating an explicit M given the state of current and planned systems
[318, 321-322] Determine the types of transactions that may be exempted from the one year floor on M	Exempt from the one year floor on maturity adjustments the following types of transactions: • Repo-style transactions and short-term loans and deposits • Exposures arising from securities lending transactions • Short-term self-liquidating trade transactions. Import and export letters of credit and similar transactions could be accounted for at their actual remaining maturity • Exposures arising from settling securities purchases and sales. This could also include overdrafts arising from failed securities settlements provided that such overdrafts do not continue more than a short, fixed number of business days • Exposures arising from cash

Discretion to	OSFI proposes to
	settlements by wire transfer, including overdrafts arising from failed transfers provided that such overdrafts do not continue more than a short, fixed number of business days • Exposures to DTIs arising from foreign exchange settlements
[443] Require external audits of the processes to assign internal ratings and estimates of loss ratings	Not exercise this discretion
[458] Establish more specific requirements for re-aging retail revolving exposures	Not exercise this discretion
[452] Substitute the 90 days past due trigger in the definition of default for retail exposures and PSEs with a trigger of up to 180 days	Seek industry input on the impact
[382, 383] Apply one, or a combination, of three methods for allocating general allowances: • Proportional split based on credit risk-weighted assets calculated under the Standardized Approach (or Basel 1) and the IRB Approach • Allocation by booking location • Internal methodology	Use the proportional split method and limit • The portion of general provisions allocated to the Standardized Approach and included in Tier 2 capital to 1.25% of the risk-weighted assets calculated under that approach • The amount of excess provisions included in Tier 2 capital, calculated after allocating the general allowance to the IRB Approach, to 0.6% of IRB credit risk-weighted assets

8. Credit Risk Mitigation

8.1. Collateral Management – Standardized & FIRB Approaches for Credit Risk

The new Basel framework identifies two primary types of credit risk mitigation (CRM): guarantees and collateral.

Guarantees are legally binding promises from a third party that the loan obligations of the borrower would be met. The conditions for a guarantee to be eligible are the same as those in current CAR requiring that they are direct, explicit, irrevocable and unconditional. Under the new Basel framework, eligible guarantees would also include additional operational requirements and a treatment for maturity mismatches. The principle of substitution has been retained from current requirements.

Collateral, on the other hand, can be thought of as using financial assets to secure a loan. With collateral there is the chance that under certain circumstances risk can be eliminated. However, since the financial collateral is subject to valuation changes due to market prices additional criteria (over collateralization) has been introduced to account for these changes in value.

The options in the new Basel framework for recognizing financial collateral are:

i. Simple Approach: This method requires the collateral to be pledged for at least the life of the exposure and that it is marked to market and revalued at least every six months. The collateralized portion of the loan is subject to the risk weight of the collateral, with a floor on the risk-weighting of 20 percent. Certain exceptions to this floor are presented in the new Basel framework. Notable exceptions are cash on deposit, sovereign or provincial/territorial government public sector entity securities.

ii. Comprehensive Approach: This approach relies on giving the DTIs the option to use one of three methods to discount the value of the collateral: Supervisory specified haircuts, own estimate haircuts, and a Value at Risk (VaR) model available only for repo-style transactions at national discretion.

   a. Supervisory supplied haircuts

      - Assume daily mark-to-market, daily remargining and a 10-business day holding period.
      - When the frequency of remargining or revaluation is longer than the minimum, the minimum haircut numbers will be scaled up depending on the actual number of days between remargining or revaluation using the square root of time formula in paragraph 139.

   b. Own estimate haircuts

      - This option allows the DTIs to develop their own haircuts to be applied to the collateral they have against loans.
      - This option would be available only to DTIs that satisfy minimum qualitative and quantitative standards.
      - Some of the criteria include a 99th percentile one-tailed confidence interval as well as minimum data observations of one year.

   c. VaR modelling

      - VaR is an estimate of the maximum potential loss expected at a 1 percent confidence interval.
      - VaR models aggregate several components of price risk into a single measure of the potential for loss.

- This approach would only be available for repo-style transactions.

[121] OSFI proposes to limit the range of options for calculating the effect of financial collateral in the Standardized and FIRB Approaches to (i) the simple approach and (ii) the comprehensive approach using supervisory haircuts. This means that a DTI would not be allowed to use its own estimates of haircuts for financial collateral or repos, unless it is approved for use of the AIRB Approach. OSFI believes that limiting the collateral valuation options for DTIs under the Standardized and FIRB Approaches would provide greater incentives for DTIs to develop their own estimates of PD, LGD and EAD. At the same time, this constraint on Standardized and FIRB Approaches would simplify the suite of options for credit risk under Pillar 1.

8.2. Other national discretion issues related to CRM

[170] The new Basel framework provides an option to allow for a zero-haircut for certain types of repo-style transactions at national discretion. OSFI proposes to apply the carve out for repo of Government of Canada securities and securities issued by Canadian provinces and territories subject to confirmation that criteria are met by the DTI.

[171] The new Basel framework defines core market participants for inclusion in the carve-out of collateral requirements for repo-style transactions. OSFI proposes to recognise entities that qualify as a core market participant as identified in the new Basel framework.

[172] The new Basel framework allows each supervisor to adopt another supervisor's choice of a repo carve out for domestic government securities. OSFI proposes to extend the same option for central government securities that other G-10 supervisors have designated as eligible for the carve out option.

While there would not necessarily be a full VaR review and application process for AIRB DTIs on secured lending and borrowing and repo transactions, OSFI is likely to review the changes to the parameters required under the new Basel framework (i.e. holding periods). AIRB DTIs would likely be allowed to use VaR modelling provided the DTI meets the conditions of already having an approved market risk VaR model.

[509] For the purpose of recognising commercial and residential real estate as collateral for FIRB Approach DTIs, the focus of recognition would be assurance that the claim is considered a first lien and that there is no more senior or intervening claim. Junior liens would be accepted where the DTI holds the senior lien and there is no prior claim by another party. This is consistent with the criteria used in the CAR guideline for the preferential treatment given to collateral mortgages (see CAR page 3-1-2).

Summary

Discretion to	OSFI proposes to
[121] Specify methods that may be used to recognize financial collateral for Standardized and FIRB Approaches	Limit options to: • The simple approach • The comprehensive approach using

	supervisory haircuts
[170] Allow a zero-haircut for certain repo-style transactions	Apply the carve out for repos of Government of Canada securities and securities issued by Canadian provinces and territories
[171] Define core market participants for inclusion in the carve-out of repo-style transactions	Recognize all entities listed except regulated mutual funds that are subject to capital or leverage requirements
[172] Adopt other supervisors' carve outs of repo transactions	Follow the lead of other G-10 supervisors with respect to repos of central government securities
[509] Recognize second liens on property pledged as collateral for corporate claims under certain conditions	Only recognize second liens if the DTI also holds first and any other prior liens

9. Banking Book Equity

9.1. Definition of equity exposures

[235] In general, equity exposures are distinguished from other types of exposures based on the economic substance of the exposure. Equity exposures would include both direct and indirect ownership interests, whether voting or non-voting, in the assets or income of a commercial enterprise or financial institution that are not consolidated or deducted for regulatory capital purposes. An instrument generally would be considered to be an equity exposure if it (1) qualifies as Tier 1 capital; (2) is irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or in the event of the liquidation of the issuer; (3) conveys a residual claim on the assets or income of the issuer; and (4) does not embody an obligation on the part of the issuer.

[236] An instrument that embodies an obligation of the issuer is considered an equity exposure if the instrument meets <u>any</u> of the following conditions: (1) the issuer may defer indefinitely the settlement of the obligation; (2) the obligations requires, or permits at the issuer's discretion, settlement by issuance of a fixed number of the issuer's equity interests; (3) the obligation requires, or permits at the issuer's discretion, settlement by the issuance of a variable number of the issuer's equity interests, and all things being equal, any change in the value of the obligation is attributable to, and in the same direction as, the change in the value of a fixed number of the issuer's equity shares; or (4) the holder has the option to require that the obligation be settled by issuance of the issuer's equity interests.

[237] Debt obligations and other securities, derivatives, or other instruments structured with the intent of conveying the economic substance of equity ownership would be considered equity exposures for purposes of the AIRB capital requirements. Equity instruments that are structured with the intent of conveying the economic substance of debt holdings would not be considered an equity exposure.

DTIs have expressed concerns that the definition of an equity exposure may not be sufficiently clear to allow them to make an appropriate characterization of their mezzanine debt and preferred stock portfolios. OSFI proposes the following:

i. Mezzanine debt

   a. without warrants to convert into common shares should be treated as debt;

   b. with warrants to convert into common shares – warrant[4] should be treated as equity; loan agreement should be treated as debt

ii. Preferred shares[5]

   a. convertible preferreds with or without a redeemable feature should be treated as equity;

   b. perpetual preferreds with a redeemable feature at holder's option should be treated as debt; and

   c. term preferreds should be treated as debt.

OSFI proposes to review specific files at each institution to "field test" these proposals. Since OSFI has not clarified the treatment of perpetual preferreds without a redeemable feature and perpetual preferreds with a redeemable feature at issuer's option, special attention would be focused during the review to establishing whether there are clear criteria to operationalize paragraph 237.

[238] In all cases, OSFI would have the discretion to recharacterize debt holdings as equity exposures or equity holdings as debt for regulatory capital purposes.

9.2. Market-based Approach (MBA)

[341] Supervisors may choose which of the two AIRB Approaches - MBA or a PD/LGD Approach - would be used by a DTI to calculate risk-weighted assets for equity exposures not held in the trading book. The PD/LGD Approach is designed to capture risks from credit-related losses only; this approach is more suited for use in cases where credit-related issues are seen as the main focus. The MBA is designed to capture a wide range of risks (e.g., interest rates, general market movements, etc), in addition to credit-related losses. OSFI proposes that the MBA should be used for determining capital requirements for equity exposures in the banking book. Under the MBA, a DTI would calculate the minimum capital requirements for their banking book equity holdings using one or both of two separate and distinct methods: a simple risk weight method or an internal models method. If an internal model is used, minimum quantitative and qualitative requirements would have to be met on an ongoing basis. Certain equity

[4] Should be detachable and separate from the loan agreement, and can be valued i.e. there is a valuation mechanism.

[5] As a result of the recent revisions to Section 3860, OSFI has determined that preferred shares accounted for as liabilities do not meet the conditions for non-innovative (or "core") Tier 1 treatment. OSFI confirms that any such preferred shares outstanding as of January 31, 2004 will continue to be eligible for core Tier 1 treatment for as long as they remain outstanding. However, no such preferred shares issued after January 31, 2004, will be afforded core Tier 1 treatment.

holdings would be excluded as defined in paragraphs 357 and 358 (see Exclusions to the MBA).

9.3. Exclusions to the MBA

i. Nationally legislated programmes

[357] Supervisors may exclude from the AIRB capital charge certain equity exposures made under legislated programs. These equity holdings can only be excluded from the AIRB Approach up to an aggregate of 10 percent of Tier 1 plus Tier 2 capital. In Canada, equity investments made pursuant to the *Specialized Financing (Banks) Regulations*, of the *Bank Act* would qualify for this exclusion. Equity exposures that qualify for this exclusion would be risk weighted at 100 percent.

ii. Materiality

[358] Supervisors may exclude equity exposures of a DTI from AIRB treatment based on materiality. OSFI proposes that a DTI would not be required to use the AIRB Approach if the aggregate carrying value, including holdings subject to exclusions and transitional provisions (see transitional arrangement), is less than or equal to 10 percent of Tier 1 and Tier 2 capital. A DTI would risk weight at a 100 percent equity exposures that qualify for this exclusion. A DTI qualifying for this exemption would not be eligible for the transitional arrangement.

9.4. Transitional arrangement

[267] Supervisors may exempt from AIRB treatment for a maximum of ten years, particular equity investments held at the time of the publication of the new Basel framework. OSFI proposes that equity investments acquired prior to July 1, 2004, would be exempt from the AIRB equity capital charge for a period of ten years commencing Q4 2007 and end in Q4 2017. During that time, these holdings would be risk weighted at 100 percent. The investments that would be considered grandfathered would be equal to the number of shares acquired prior to July 1, 2004, plus any shares that the holder acquires directly as a result of owning those shares, provided that any additional shares do not increase the holder's proportional ownership share in the company. Equity investments acquired on or after July 1, 2004, would be subject to AIRB treatment. In addition, OSFI proposes to exempt commitments to invest in private equity funds, that were entered into before July 1, 2004, that have not been funded yet.

Summary

Discretion to	OSFI proposes to
[238] Re-characterize debt holdings as equities for regulatory purposes and to otherwise ensure the proper treatment of holdings under Pillar 2	Exercise this discretion
[267] Exempt from AIRB treatment, for up	• Exempt equity investments and

Discretion to	**OSFI proposes to**
to10 years, equity investments held at the time of publication of new Basel framework	commitments to invest in private equity funds held prior to July 1, 2004 for 10 years starting with Q4 2007, • Risk weight exempted equity investments at 100%
[341] Decide whether to use the MBA or PD/LGD Approach for calculating risk-weighted assets for equity exposures not held in the trading book	• Use the MBA for equities
[357] Exclude equity holdings made under certain legislated programmes	• Exercise this discretion for equity investments that meet the constraints set out in the *Specialized Financing (Banks) Regulations* • Risk weight excluded equity holdings at 100%
[358] Exclude equity holdings that are not material	• Exercise this discretion • Define materiality at 10% of Tier 1 plus Tier 2 capital • Risk weight excluded equity holdings at 100% • Not permit DTIs using the materiality exclusion to subsequently apply the transitional provision described in paragraph 267

10. Operational Risk Minimum Requirements

10.1. Partial Use

[680-683] The new Basel framework permits a DTI to use an AMA for some parts of its operations and the Basic Indicator Approach or Standardized Approach for the balance ("partial use"), on both a transitional and permanent basis, subject to certain conditions.

These conditions include:

i. on implementation date, a significant part of the DTI's operational risk should be captured by the AMA, and

ii. the DTI must provide a timetable outlining how it intends to roll out the AMA across all but an immaterial part of its operations. A DTI may determine which parts of its operations would use an AMA on the basis of a business line, legal entity, geographical or other internally determined basis.

10.1.1. Basis for determining partial use

DTIs generally tend to manage operational risk on a business line basis. The business line management approach lends itself to a business line approach for partial use purposes. However, there may be valid reasons, such as the cost associated with implementing an AMA relative to the materiality of the risk, to exclude a legal entity that engages in two of the DTI's business lines but represents only a small part of each business line. Therefore, OSFI proposes to permit domestic DTIs to determine partial use on a business line or legal entity basis, or a combination of the two. Any activity that is excluded from the AMA calculation could not be included in the determination of group-wide diversification benefits within the AMA. For simplicity and ease of implementation, OSFI does not propose to make available other bases for determining partial use.

10.1.2. Definition of "significance" and "material" for partial use purposes

The operational risk section of the new Basel framework does not define the terms significant and material. It is left to national supervisory authorities to define these terms for their DTIs.

The CBA has submitted a proposal that would define "significant" as that part of a DTI's operations that represents 75 percent of the DTI's operational risk and "material" as that part representing 90 percent. The CBA proposes that a DTI should have five years from its implementation of an AMA to reach the 90 percent threshold and that it should demonstrate progress in moving from 75 percent to 90 percent during that period. A DTI's operational risk and these thresholds would be measured in terms of the minimum regulatory capital calculated using the Standardized Approach. This proposal would require an AMA DTI to continue calculating capital using the Standardized Approach for up to 5 years post-implementation. OSFI accepts this proposal as both a practical and reasonable approach to the definition of "significant" and "material" for this section of the new Basel framework.

10.1.3. Partial use for Standardized DTIs

The new Basel framework permits the partial use of operational risk approaches only for DTIs implementing an AMA. However, the BCBS recognizes that there may be instances where a DTI that chooses to adopt the Standardized Approach for its global, consolidated operations is required to implement an AMA for a subsidiary operating in another jurisdiction. In these cases, a DTI would be permitted to incorporate that AMA capital amount in its global consolidated capital calculation, with supervisory approval. OSFI proposes to make this flexibility available to its domestic DTIs, subject to any conditions laid out in the new Basel framework.

Apart from these instances, OSFI proposes to permit a Standardized DTI to use the Basic Indicator Approach for parts of its operations on a transitional basis only, for a period not exceeding 3 years. OSFI would need to consider the definition of an acceptable threshold for determining the amount of a DTI's operations to be covered by the Standardized Approach on implementation date. OSFI would permit partial use only where the DTI can demonstrate that it is not being implemented for capital arbitrage purposes.

10.1.4. Available approaches for partial use

The new Basel framework allows a DTI to adopt partial use between an AMA and the Standardized Approach or an AMA and the Basic Indicator Approach. However, OSFI proposes to permit a DTI to choose either the Basic Indicator Approach or the Standardized Approach for a given part of the DTI not using the AMA, and would not restrict a DTI to only one of these approaches. This would be subject to the condition that the DTI is able to demonstrate that this partial use is not intended for capital arbitrage.

The new Basel framework does not specify whether the Alternative Standardized Approach can be used for partial use purposes. For greater clarity, OSFI does not propose to allow any DTI incorporated in Canada to use the Alternative Standardized Approach for any part of its operations in calculating its global, consolidated operational risk capital requirement.

10.2. AMA specific issues

10.2.1. Recognition of insurance

[677-679] Consistent with the new Basel framework, OSFI proposes to permit a DTI using an AMA to recognize the risk mitigating impacts of insurance against operational risk. This amount is limited to 20 percent of the total AMA operational risk capital charge. A DTI should meet the conditions stated in the new Basel framework to be eligible to use insurance as a risk mitigant. OSFI will work with Canadian DTIs in the lead-up to implementation of the new Basel framework to refine these conditions and determine whether additional conditions are warranted.

10.2.2. Recognition of internally determined correlations

[669] The new Basel framework allows a national supervisory authority to decide whether to permit a DTI to recognize diversification benefits (less than perfect correlation) across individual operational risk estimates within the DTI group. The DTI must be able to prove to the supervisor that its systems for determining correlations are sound, implemented with integrity, and take into account the uncertainty surrounding any such correlation estimate (particularly in periods of stress). The DTI should also validate its assumptions using appropriate quantitative and qualitative techniques.

OSFI proposes to allow a DTI to use internally determined correlations across individual operational risk estimates provided that the DTI meets certain conditions. These conditions would be developed at a future date, in consultation with the industry.

10.2.3. Calculation of operational risk capital to UL only

[669] The new Basel framework requires a DTI to calculate its regulatory capital requirement as the sum of expected loss (EL) and unexpected loss (UL), unless the DTI can demonstrate to the satisfaction of its national supervisory authority that it has measured and accounted for its EL exposure.

OSFI proposes to permit a DTI to hold capital against UL only provided that the DTI can demonstrate to OSFI that it has accounted for its EL exposure. OSFI will work with

Canadian DTIs in the lead-up to implementation of the new Basel framework to develop guidance on this issue.

10.3. Other operational risk national discretion issues

There are other areas of national discretion related to operational risk in the new Basel framework. OSFI will work with the industry to develop guidance on these issues in due course.

Summary

Discretion to	OSFI proposes to
[680-683] Permit DTIs to determine which parts of their operations will use an AMA on the basis of business line, legal structure, geography, or other internally determined basis	Permit DTIs to determine partial use of AMA on a business line or legal entity basis, or a combination of the two
[680-683] Define "significant" and "material	• Accept the CBA proposal that defines "significant" as that part of a DTI's operations that represents 75% of the DTI's operational risk and as "material" that part representing 90% • Allow DTIs five years from implementation of AMA to reach the 90% threshold • Require DTIs to demonstrate progress over the five years
[680-683] Permit DTIs using a Standardized Approach to incorporate an AMA amount for subsidiaries operating in jurisdictions that require AMA	• Exercise this discretion • Permit DTIs using a Standardized Approach to use the Basic Indicator Approach for parts of their operations on a transitional basis for three years
[680-683] Allow DTIs that make partial use of an AMA to use either the Standardized Approach or the Basic Indicator Approach for specific business lines or legal entities not included in the AMA	• Will exercise this discretion without restricting a DTI to only one of these approaches • Not permit the use of the Alternative Standardized Approach for partial use
[677-679] Recognize insurance up to 20% of total AMA operational risk capital	Permit AMA DTIs meeting the conditions set out in the new Basel framework to recognize the risk mitigating impacts of insurance
[669] Permit AMA DTIs to recognize diversification benefits across individual operational risk estimates if certain conditions are met	Exercise this discretion and develop requisite conditions in consultation with the industry
[669] Allow DTIs to calculate their capital	Exercise this discretion and work with

Discretion to	OSFI proposes to
requirements only for UL, if DTIs can satisfy their supervisors that they have measured and accounted for their EL exposures	DTIs to develop the necessary guidance

11. Pillar 2

11.1. Supervisory Review Process

The underlying intent of the Supervisory Review Process in Pillar 2 of the new Basel Framework was to promote and support a more rigorous process at internationally active DTIs for determining the adequacy of the actual capital held and to make this process subject to a somewhat more focused supervisory review than may have been the case. Pillar 2 then puts the onus on Supervisors to satisfy themselves as to the appropriateness of DTIs' capital adequacy assessment processes and the adequacy of capital and to intervene, as appropriate, under the authority of supporting legislation. Where supervisors determine there are weaknesses in the DTI's internal capital adequacy assessment processes and strategies, supervisors will require that they be remedied. Supervisors will not necessarily require additional capital; however increased capital might be used as an interim measure while other measures to improve the DTI's position are being put into place.

Pillar 1 defines the minimum capital requirements for DTIs incorporated in Canada. DTIs face risks not explicitly included under Pillar 1 and many DTIs choose to operate at capital levels above those implied by Pillar 1 minimums. Pillar 2 thus expresses an expectation that internationally active DTIs should operate above the Pillar 1 minimum.

11.1.1. DTI internal targets

Internationally active DTIs are expected to conduct their own internal capital adequacy assessment process and establish their own internal target capital levels taking account of their risk profile and capital strategy. In a manner consistent with OSFI's current risk-based approach to supervision, OSFI supervisory staff will assess whether such capital adequacy assessment processes and internal target capital levels are commensurate with the companies' risk profiles.

There is no single correct approach to a capital adequacy assessment process; the expectation is that a DTI conduct its assessment in a comprehensive, well thought out manner. An economic capital model is not required, however, it is one option available to help more complex DTIs develop their judgement in support of their capital adequacy assessment process. Judgement continues to be important in this process and DTIs are expected to ensure that its use is adequately recorded and documented. While the approaches may vary from DTI to DTI , OSFI expects all material risks to the DTI and its subsidiaries, including insurance risks, would be considered and that the approach would have integrity. OSFI anticipates initially that internal DTI practices, procedures and systems to establish an internal target would vary depending on the complexity and range of business. OSFI expects DTIs would use appropriate stress and scenario testing to determine for them the level of capital necessary to mitigate the risk. While a DTI may employ an economic capital model to set its own internal target, OSFI does not expect to employ an explicit model approval process under pillar 2.

The level of sophistication in internal assessments of target capital levels for non-internationally active domestic DTIs should be commensurate with the more focused and less complex nature of their business. Many of these institutions will likely continue to be constrained by the assets-to-capital multiple. Therefore their internal capital assessments may be materially simpler although they will need to demonstrate that they have analyzed the risks not covered by Pillar 1 and those risks are adequately covered by a reasonable cushion above the minimum.

A foreign bank subsidiary may be able to employ the methodology used by its parent bank. However, the foreign bank subsidiary would be responsible for explaining how the data and methodology have been modified to reflect its business strategy and the risks to which it is exposed in Canada.

11.1.2. Substantial compliance with Pillar 2

OSFI already substantially complies with the principles of Pillar 2 because of its practice of communicating industry-wide target capital ratios, its implementation of a risk assessment process that assesses capital and earnings in arriving at an institution specific composite risk rating, and the legislated powers of intervention at OSFI's disposal.

Since 1999 OSFI has expected all Canadian DTIs to attain a risk-based tier 1 capital ratio of at least 7 percent and a total capital ratio of at least 10 percent, as compared to international minimums of 4 percent and 8 percent respectively. For some institutions, however, higher target levels have been appropriate from time to time. Upon initial implementation of the advanced approaches to credit and operational risk, OSFI expects system-wide target risk ratios to remain at the 7 percent and 10 percent levels.

OSFI's risk assessment process begins with an evaluation of the inherent risk within each significant activity of a financial institution. OSFI then examines the quality of risk management applied to mitigate these risks. Then, taking into account the materiality of each of the significant activities of a company, OSFI arrives at an overall net risk rating and its direction, i.e., whether it is decreasing, stable or increasing. Up to this point in the assessment, the financial condition of the company has not been considered. However, OSFI then develops a composite risk rating (and direction) for the financial institution, taking into account both our assessment of the overall net risk (which includes an assessment of the adequacy of risk management processes) and our assessment of financial factors, such as capital and earnings. Capital is assessed in the context of the risk profile of the institution and can be rated as "strong", "acceptable", "needs improvement" or "weak".

11.1.3. Assessment criteria for capital and possible improvements needed

The capital ratio itself is an important factor in the OSFI assessment of capital, but it is not the only factor. Assessment criteria include, for example: the quality of capital; the adequacy of capital to support the company's business plans and risk profile; the ability to access capital at reasonable rates to meet projected needs; and the strength of the DTI's capital management processes. Trends and the outlook regarding a company's capital and earnings are also relevant in assessing the adequacy of a company's current capital position. The various factors should all be considered in the context of the nature, scope, complexity and risk profile of the particular DTI.

The OSFI supervisory framework already encompasses all major inherent risks and the related risk mitigants that are needed to form an evaluation of an appropriate target capital level or range for a DTI. The framework looks at capital as a consideration in arriving at the composite risk rating. Thus OSFI would need to consider how to refine the application of the OSFI supervisory framework to help evaluate or set the target capital level for a DTI under pillar 2 of the new Basel framework. OSFI will move cautiously over the implementation phase of the supervisory framework to further develop the application of capital assessment rating criteria to, among other things:

- Consider further use of the supervisory framework assessments to inform supervisory judgment on an acceptable target capital level;
- More formally consider information from a DTI's own internal assessments of risk or individual risks in the assessment of target capital levels;
- More rigorously incorporate indicators of concentration risk into the target capital assessment (this may be assisted by international efforts in this area);
- Incorporate a measure to identify any interest rate risk outliers into the capital target; and
- Evaluate how relevant and comprehensive a DTI's internal stress testing is based on the nature of its risk taking activities.

OSFI expects the rating criteria will not become a formula-driven process of add-ons. Expert judgement will continue to be necessary to operationalizing the assessment of criteria and integrate those results into the overall assessment. Once these criteria are more fully developed and experience is gained from a reasonable period of implementation, the Supervisory assessment of the internal target capital for some DTIs with low risk could fall below industry wide targets of 7 percent and 10 percent. Equally, a DTI with capital well above industry targets might not be considered to have strong capital based on its risk profile.