ASSOCIATION DES BANQUIERS CANADIENS
CANADIAN BANKERS ASSOCIATION

Box 348, Commerce Court West
199 Bay Street, 30th Floor
Toronto, Ontario, Canada M5L 1G2
www.cba.ca

Nancy Fung
Vice-President, Banking Operations
Tel: (416) 362-6093 Ext. 335
Fax: (416) 362-8288
nfung@cba.ca

May 31, 2010

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

Dear Sirs/Madams:

Re: CBA Comments on the Basel Committee's consultative document
Sound practices for backtesting counterparty credit risk models

The Canadian Bankers Association[1] would like to thank the Basel Committee for the opportunity to comment on the April 2010 consultation paper entitled *Sound practices for backtesting counterparty credit risk models*, and for its ongoing willingness to discuss and respond to industry concerns.

We agree with the Basel Committee's goal of promoting a more resilient banking sector with an improved ability to absorb shocks arising from financial and economic stresses, such as those experienced in the 2007-2009 crisis. We are generally supportive of the consultation paper, as it laudably presents a principles-based approach to the backtesting of counterparty credit risk.

However, we would like to bring to your attention a fundamental methodological issue in the proposed guidance regarding the difficulty in backtesting counterparty credit risk models. Over time, probability distributions differ, and backtesting regime-switching takes place. Therefore, banks are faced with differing historical volatility levels. These varying volatility levels decrease the reliability of predicted values, therefore making comparison of a single predicted value against the realized value at a point in time challenging for banks.

Also of note, in Canada, our regulator will not be permitting banks to use an Internal Modeling Method (IMM) until possibly 2012. These proposals will not apply to banks in our country until IMM adoption.

Our more detailed, paragraph-specific comments can be found in the attached Appendix 1 ("CBA Comments").

Thank you for considering our comments and suggestions.

Yours truly,

Nancy Fung

Attachment

---

[1] The Canadian Bankers Association works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 263,400 employees to advocate for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions.

Appendix 1 - CBA Comments on the Basel Committee's Consultative Draft *Sound practices for backtesting counterparty credit risk models* (April 2010)

CBA Members' Comments and Requests for Clarification
I. General
▪ Para 8 - Since IMM is based on a bulk measure (expected value of the positive exposure) as opposed to a tail measure, the backtesting should also focus on that. The document refers to the need to demonstrate goodness of fit over the entire range of percentiles. However, just as how we focus on the statistic of relevance (99th loss) for market risk VaR, so here the focus should be on the expected positive exposure. ▪ The consultative document is generally silent on one of the main conceptual difficulties associated with backtesting one-year exposure distributions. Namely, if we look back one year, we will typically only have a singe one-year observation point against which to measure the theoretical distribution. One can make qualitative statements about the consistency of the observation with the purported distribution but cannot make any meaningful statistical conclusion.
II. Aggregation of Data
▪ Para 22 - The statement that the backtesting "*...must be able to identify poor performance in individual risk factors*" makes sense. However, it should be buffered by the statement that poor performance of a single risk factor does not invalidate the model if that particular risk factor is not particularly important for the firm in question. It may often arise that a firm implements different risk factors with varying degrees of sophistication: modelling of interest rate curves will typically receive far more focus than base metal futures prices, for example. (The same principle is already embedded in paragraph 24.) Also, we suggest that the phrase be changed from "individual risk factors" to "individual **material** risk factors".
III. Frequency of Backtesting Analysis
▪ Para 26 - There may be markets for which it would be difficult to find data for "a wide range of market periods". New markets may not have a history for all types of economic environments, and this should be reflected in the language. We also question

CBA Members' Comments and Requests for Clarification

the meaningfulness of the results so obtained. The backtesting, as we argue above, should be on the expected bulk behaviour. Comparing expected behaviours to historical tail events seems tailor-made to produce failure and we are uncertain what can be meaningfully inferred from such a comparison.

IV. Time Horizons

- Para 40 - The requirement to backtest out to time horizons commensurate with the maturity of the trades covered is problematic. It is not uncommon for interest rate swaps to extend out to 30 years or more and it is simply not feasible to undertake a backtesting over that time horizon. In particular, thirty years ago there essentially was no interest rate swap market so it is essentially impossible.

  In addition, backtesting beyond a one-year horizon is very problematic. The historical data to be relied upon may be inconsistent (e.g., due to changing interest rates), and calibration will not be in tune with the length of the longer (beyond one year) time horizon.

  In particular, this paragraph seems to contradict paragraph 27, which states that validation should "be based on a comparison of recent forecasts to their realised values".

  Furthermore, backtesting beyond a one-year horizon is not necessary. In the capital calculation, the exposure modelling enters into two quantities: EAD and M. Of these, EAD is the more numerically important, while M is responsible for an adjustment to the final value. EAD is defined over just a one-year time horizon. Therefore backtesting to one year should be enough to validate EAD (and partially validate M) and covers the majority of the capital calculation.