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IACPM Response to OSFI Consultation on CAR 2027

The **International Association of Credit Portfolio Managers** (IACPM) is a global industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. The IACPM's institutional member firms comprise the world's largest financial institutions, and as such overlap the membership of several other financial industry associations. Our perspective is different, however, in that the IACPM represents the teams within those institutions who have responsibility for managing credit portfolios, including actively controlling concentrations, adding diversification, managing the return of the portfolio relative to the risk and applying capital to new lending. In carrying out these responsibilities successfully, credit portfolio managers contribute to maintaining the safety and soundness of their respective financial institutions. Effective credit portfolio management is critically important to our prudential supervisors and to policy makers more broadly because of its role in supporting financial institutions' ability to lend.

IACPM members welcome the opportunity to respond to OSFI's proposed amendments to the Draft Capital Adequacy Requirements Guideline (2027). In this response we focus on two topics: (i) securitization and (ii) the use of credit insurance and export credit agencies.

Securitization

Notification of synthetic securitization transactions

We note the proposal in paragraph 5 of CAR Chapter 6 to require institutions to notify OSFI of all synthetic securitizations within 30 days of the transaction being executed, together with details of the information and documentation to be included in that notification set out in Appendix 6-4. We also note that this requirement is broadly consistent with similar requirements which apply to the execution of significant risk transfer (SRT) securitization in both the EU and UK.

IACPM members have the following observations in relation to these proposals:

- First, the proposals state that where OSFI determines that the securitization transaction should not be subject to the securitization framework for regulatory capital purposes, the institution is required to hold capital against the securitized exposures as if they had not been securitized. IACPM members consider that it should be made clear that OSFI would only make such a determination where either (i) the securitization does not comply with the relevant requirements set out in CAR or (ii) OSFI determines that the securitization contains features or the nature of the securitized exposures is such that the securitization creates risks for the originator which are not properly taken into account in the securitization framework. It should also be understood that that this later circumstance would be expected to arise only in exceptional cases. This is important in

giving institutions certainty that, so long as they comply with the requirements set out in CAR, they can expect to be able to recognize the regulatory capital benefits provided for under the securitization framework.

- Secondly, in relation to the requirement to notify details of lending arrangements with investors, IACPM members understand that this is intended to be limited to repo (or similar) financing provided by the originator (or its affiliates) in connection with the securitisation in question. It would be helpful if this could be clarified, so that it is clear that originators are not also required to provide information about third party financing that may be provided to investors. We note, however, that the Notes issued to investors in SRT securitizations are generally freely transferable through the clearing systems, so the actual investors can change over time.

We feel comfortable that banks will provide OSFI with synthetic securitization details to assist OSFI's determination. IACPM members are willing to continue discussions and would find it helpful to hear from OSFI on the scope of information and OSFI's process for capital treatment determination.

CET deduction for tranches risk-weighted 1250%

IACPM members welcome the proposal to permit the exposure amount of a securitization position bearing a risk weight of 1250% to be deducted from CET 1 as an alternative to applying at 1250% risk weight. We would, however, suggest a slight tweak to this proposal to provide that where the detachment point of the tranche is higher than K_{IRB} or K_{SA} (as applicable), for this purpose the institution is permitted to divide the tranche into a portion below K_{IRB}/K_{SA}, which would be deducted from CET 1, and a portion attaching above K_{IRB}/K_{SA}, to which the applicable tranche risk-weight could be applied. In the context of SRT securitisation, this is most likely to be a point which arises in context of the output floor, where a thicker first loss tranche may be needed for SEC-SA purposes, that would benefit from being split into two separate purposes for SEC-IRBA purposes.

Suggested further amendments to the securitization framework

IACPM members also wish to take this opportunity to invite OSFI to consider some further amendments to the securitization framework which we believe would result in the framework better reflecting the actual risk associated with securitization exposures *and* would bring the Canadian regulations more in line with comparable jurisdictions.

We note that the current CAR remains very faithful to the Basel 3 framework. However, while IACPM members are broadly in favour of the application of common global standards, the reality is that the regulations in the most significant comparable jurisdictions (the EU, UK and US) now deviate from the Basel 3 standards, in some cases in quite significant ways. In our view, these deviations are justified given that the Basel 3 framework was calibrated following the global financial crises of 2008–09 and reflects the loss experience primarily seen in US sub-prime mortgage securitization. This has resulted in a securitization framework which is much more conservative than is warranted given the actual performance of SRT securitization across the EU, UK, Canadian and even US markets in the now almost 20 years since the crisis.

There are three areas in particular where we consider targeted amendments to the securitization framework could make securitization a much more effective tool for Canadian banks to manage

their credit risk and capital requirements. These are: (i) the p-factor used in the SEC-SA framework, (ii) the risk weight floor which applies to securitization positions, and (iii) the introduction of a framework to extend the benefits of STC framework to certain synthetic securitizations. We consider each of these in turn.

p-factor

Consistent with the Basel 3 framework, the CAR applies a p-factor of 1 for the purposes of the SEC-SA methodology. This has the effect of *doubling* the already conservative capital requirements which apply to portfolio of exposures under the Standardized Approach (ie, K_{SA}), distributed across all the tranches in the securitization. In practical terms, this means that the required thickness of the placed tranches(s) of the securitization in order for the risk weight of the senior tranche to reach the floor, is much larger than would otherwise be the case, leading to the cost of a securitization (ie, the coupon payable to investors) being much greater than it would otherwise be.

The effect of this p-factor is particularly significant when a bank is constrained by the output floor (ie, where paragraph 31 of Chapter 1 of CAR applies). This is because, when a securitization is tranched using the SEC-IRBA approach, the combination of K_{IRB} generally being lower than K_{SA} for the same portfolio and the p-factor under the SEC-IRBA generally being significantly lower than 1 means that the attachment point necessary to achieve the risk weight floor under the SEC-IRBA is much lower than that required to achieve the risk weight floor under the SEC-SA. Consequently, when the SEC-SA is applied to the tranches of that same securitization, the resulting risk weights will be much higher, in many cases resulting in the securitization achieving no capital benefit, particularly after the cost of the credit protection is taken into account.

Each of the EU, UK and US approach this issue in different ways:

- In the EU, the SEC-SA methodology is adjusted so that the p-factor applied for the purposes of the output floor calculation is reduced to 0.5, or 0.25 in the case of a STS (ie, STC) securitization.

- In the UK, the PRA will shortly introduce a formulaic p-factor for the SEC-SA generally which is modelled on the SEC-IRBA p-factor formula, subject to a floor of 0.5. UK banks anticipate that in most cases this will result in a SEC-SA p-factor of 0.5.

- The US has still not fully implemented Basel 2, let alone Basel 3, and continues to operate under the old supervisory formula (SSFA) approach. This effectively continues to apply a p-factor of 0.5. It remains to be seen whether the US will adopt any changes to their securitization rules. Although a proposal was introduced in 2023 which would have seen the US move to a p-factor of 1 under the SEC-SA, that proposal was subsequently dropped, and it is not currently expected to be reintroduced in that format.

Thus, in all of the major comparable jurisdictions to Canada, banks are (or soon will be) able to apply a p-factor for the purposes of the SEC-SA methodology which is much lower than that which applies for Canadian banks, placing Canadian banks at a significant competitive disadvantage to their main competitors and increasing the costs of financing the Canadian economy.

IACPM members therefore urge OSFI to amend paragraph 132 of CAR Chapter 6 to change the p-factor to 0.5 for the SEC-SA formula.

Risk weight floor

Under the Basel 3 framework, as reflected in CAR, a risk-weight floor of 15% applies to the risk weight of a securitization position under both the SEC-IRBA and SEC-SA methodologies. This risk weight floor is not risk-sensitive, in the sense the floor is the same, regardless of the attachment point of the tranche and regardless of the level of K_{IRB}/K_{SA}. In our view, this is both overly conservative and creates a disincentive for banks to securitize high-quality (ie, low risk-weight) portfolios. Instead, there is an incentive to securitize higher risk portfolios where the perceived risks associated with securitization may be harder to address.

In recognition of this, reforms are currently being negotiated in the EU which are expected to lead to the introduction of a risk-sensitive risk weight floor for the senior tranche, coupled with different absolute floor levels for different types of securitizations. The risk-sensitive floor calculation essentially works by multiplying K_{IRB}/K_{SA} (as applicable) * 12.5 * 15% (or 10% for an STS securitization). Thus, where K_{IRB}/K_{SA} (as applicable) is less than 100%, the resulting floor will be lower than the existing 15% that applies for non-STS securitizations and 10% that applies for STS securitizations, and for some portfolios could be as low as 5%. To guard against the attachment point for the senior tranche being too low to provide meaningful protection, this is coupled with certain "resilience" requirements, of which the two most important are a minimum granularity requirement (N not less than 50) and a minimum senior attachment point, although it should be stressed that the SEC-IRBA/SEC-SA formulae themselves will largely self-correct for that anyway. That is, the risk-weight floor only applies where the SEC-IRBA/SEC-SA would otherwise produce a *lower* risk weight anyway, which will not be the case if the attachment point is too low.

IACPM members consider that these changes are an appropriate way of reflecting the risk associated with the underlying portfolio in the resulting securitization capital requirements and we encourage OSFI to consider adopting a similar approach in Canada.

STC framework

The STC framework set out in Section 6.10 of CAR currently only applies to traditional securitizations. One of the most significant, and beneficial, reforms to the securitization framework in the EU was the extension of the STC framework (referred to as "STS" in EU regulation) to synthetic securitizations in 2021. This occurred after many years of careful consideration and industry engagement and has proven to be extremely effective at opening the benefits of securitization up to banks applying the Standardised Approach, as well as improving the economic viability for securitization of higher quality assets for IRB Banks.

It is not actually necessary to extend the entirety of the STC framework to synthetic securitization to realize much of the benefit. Although they do value the increased standardization that comes from the STS framework un the EU, investors in SRT securitizations generally do not place much weight on whether or not the securitization is STS when making their investment decision. This is due to the fact that they are investing in the risky first loss and lower mezzanine tranches of the securitization, unlike investors in traditional STS securitizations, who are usually investing in the senior, highly-rated tranches. The benefit from the STS framework for synthetic securitization in the EU comes from the fact that the originator

is permitted to halve the p-factor used in the SEC-SA and SEC-IRBA methodologies and apply a risk-weight floor of 10% to the retained senior tranche. The lower p-factor allows for a lower attachment point for the senior tranche (and thus a lower cost transaction), while the lower risk weight floor reduces the resulting capital cost of the securitization by as much as a third.

IACPM members consider that the more favourable treatment which the originator is permitted to accord to an STS securitization under the EU framework ultimately derives from a small sub-set of the STS criteria which do minimize the already remote risk of losses being applied to the senior tranche. These include:

- Only allowing securitization of exposures which are held on the balance sheet of the originator.
- A requirement for the originator to retain a material net economic interest in the securitization of not less than 5%
- A minimum granularity requirement (eg., N not less than 50).
- Capping the risk weights of the underlying exposures which can be included in the securitization.
- Prohibiting active portfolio management (ie, no removal of securitized exposures where the exposure has not been reduced/removed).
- No resecuritization.
- Where pro-rata amortization applies, the inclusion of triggers to switch to sequential amortization where the portfolio is deteriorating.
- Restricting investor early termination rights.

As it happens, in the case of EU, the STS requirements on these points reflect common market practice in both the EU and Canada. This is not an accident, as it shows that most synthetic securitizations in the EU and Canada (and the UK, for that matter) are already being structured in a prudent manner.

IACPM members therefore encourage OSFI to consider allowing the originator of a synthetic securitization which satisfies the above requirements to apply a more favourable p-factor and risk-weight floor for the purposes of its capital calculations than is the case for other securitizations.

Application

Each of these above changes could be applied to the securitization framework generally or could be applied solely for the purposes of the originator of the securitization. As the impact of these points primarily affects the originator, even if OSFI does not consider it appropriate to make these changes generally, we still urge it to consider making these changes for the originator.

Credit Insurance

In accordance with paragraph 104 of CAR Chapter 5, where an institution purchases unfunded credit protection in the form of a guarantee (which would include credit insurance), the adjusted risk weight for the protected exposure should not be less than that of a comparable unsecured direct exposure to the protection provider. This involves applying the LGD which applies to an unsecured exposure to the protection provider which, in the case of an insurance company, will be 45% (see paragraph 87 of CAR Chapter 5).

[As we have previously mentioned,] IACPM members consider that a LGD of 45% in this context is too high, and does not properly reflect the reduced risk associated with the use of this form of credit risk mitigation and, in most cases it will mean the bank receives little or no regulatory capital benefit from the credit protection at all. This is for the following reasons.

- First, insurers are almost always subject to prudential regulation (whether by OSFI or in their home jurisdictions), which is intended to ensure that the have the resources necessary to meet their policy commitments. Thus, an exposure to an insurer is very different from an exposure to an unregulated corporate entity.

- Secondly, and following from the previous point, in many jurisdictions (including Canada), claims of policyholders rank ahead of other creditors of the insurer, resulting in an insurer's financial strength rating often being higher than its senior unsecured debt rating. Thus, applying the same LGD for *all* exposures to an insurer does not accurately reflect the higher recovery that may be expected in respect of those different types of insurance claims.

- Thirdly, the nature of unfunded credit protection is that it provides a second level of protection for the lending institution. That is, the institution will have a claim for the same exposure amount against *both* the underlying borrower *and* the insurer, and its actual exposure to the insurer is therefore net of any recovery which it obtains from the underlying borrower. This is quite different from a non-insurance exposure to the same insurer (eg., a loan), where the institution's recourse is solely to the insurer. While we acknowledge that removal of the so-called "double default" methodology was a key change in the Basel 3 framework, we think that in the specific context of credit protection provided by financial institutions subject to prudential regulation (such as insurers), it is nevertheless appropriate to adjust the LGD which is used for the purposes of calculating the effect of unfunded credit risk mitigation provided by a prudentially regulated entity.

Importantly, data which has been compiled by various third-party institutions shows that the actual recovery rates from credit insurance over many years has been close to 100%. Recent analysis commissioned by the International Trade & Forfaiting Association (ITFA) from Global Credit Data (GCD) compares the observed riskiness of insured exposures to own funds requirements. It calculates a conservative combined LGD for insured exposures, ranging from 6.4% to 7.3%, incorporating unresolved cases, margins of conservatism, and downturn effects. Using borrower ratings and Basel formulas, the capital requirement based on this LGD is found to be less than half the own funds requirements calculated under the substitution approach, which uses a 45% LGD. Considering losses on defaulted insurers, an LGD range of 19% to 22% was observed.

In light of the above, before the implementation of Basel IV, most Canadian banks were modelling a LGD for credit insurance well below 20% and the subsequent amendment by OSFI to 45% for such exposures resulted in this type of unfunded credit protection achieving much less capital benefit.

Taking the above into account, IACPM members submit that it would be more appropriate to apply a LGD of 22.5% specifically in the context of calculating the risk-weight of an exposure which benefits from unfunded credit protection where: (i) the protection provider is a regulated

insurer and (ii) the insurer has either an issuer credit rating or a financial strength rating not lower than A- at inception.

This change would increase the usage of credit insurance, which would in turn increase credit & capital availability in the Canadian economy, without unduly increasing risk in the insurance sector. Furthermore, the revised LGD would support Canadian banks with their prudent risk taking decision making in Canada and when competing to support the banking sectors' activities abroad.

Export Development Canada

Finally, Export Development Canada (EDC) is Canada's export credit agency, mandated to support and develop Canada's export trade and the capacity of Canadian companies to compete internationally, in alignment with the Government of Canada's economic and trade priorities. EDC works alongside private sector financial institutions and insurance partners to provide risk sharing solutions—such as financing, guarantees, insurance, and other credit risk mitigation tools—that help sustain the flow of financing to Canadian exporters and investors, particularly during periods of economic stress or heightened uncertainty.

IACPM members recognize the importance of effective partnerships with public entities such as EDC, in supporting the resilience of the Canadian financial system. In particular, members highlight the benefit of a capital framework that is able to reflect, where applicable, the risk mitigating features of public entity offerings such as the EDC-backed products, where these meet the operational and risk transfer requirements set out in the CAR Guideline. In this context, members are aware that EDC will separately provide feedback to support clarity and transparency regarding the capital treatment of its product offerings, where OSFI deems it appropriate. Clear, consistent, and transparent regulatory capital treatment of such structures has the potential to enhance regulatory certainty, strengthen the effectiveness of these partnerships, and support banks' capacity to extend credit to the real economy, in alignment with the broader objectives of the draft CAR Guideline (2027) to maintain a risk sensitive and proportionate capital framework that supports financial stability and can help drive sustainable economic growth. We therefore encourage OSFI to consider including recognition of such schemes either in the CAR or through ancillary public guidance.

We are available to discuss any aspect of this response at your best convenience.

Sincerely,

Som-lok Leung

Executive Director

IACPM