Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Discussion Paper

Advancing Proportionality:

Tailoring Capital and Liquidity Requirements for Small and Medium-Sized Deposit-Taking Institutions

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OSFI
BSIF

Canada

I. Introduction

OSFI's mandate is to protect depositors, policyholders and creditors by developing a regulatory framework to manage and mitigate risk, assessing the safety and soundness of financial institutions and intervening promptly when corrective actions are needed. OSFI recognizes the importance of allowing financial institutions to compete and take reasonable risks and holds boards and senior management ultimately responsible for the viability of their institutions.

As noted in its strategic plan[1] for 2019-2022, OSFI is looking at ways to further adapt its regulatory and supervisory approaches to the size, complexity and risk profile of financial institutions. OSFI's initiative to develop a more tailored set of capital and liquidity requirements for small and medium-sized deposit-taking institutions (SMSBs)[2] relates to OSFI's strategic goal of improving institutions' preparedness and resilience to financial risks while enhancing the effectiveness of the frameworks.

As a member of the Basel Committee on Banking Supervision (BCBS), OSFI participates in the development of global standards with a focus on internationally active banks. Although the scope of the Basel framework is limited to internationally active banks, there is a degree of proportionality built into the framework. OSFI, like regulators in other jurisdictions, has adopted various Basel standards and applied them to systemically important banks as well as to smaller, non-internationally active banks. As new standards are developed or existing standards revised, jurisdictions have been taking measures to ensure the requirements remain relevant and appropriate for smaller institutions.

As announced in our discussion paper[3] released in July 2018, OSFI is in the process of implementing the final Basel III reforms domestically with expected implementation by Q1 2022. The domestic implementation of the final Basel III reforms provides a natural opportunity for OSFI to revisit the capital and liquidity regime for SMSBs.

Through the issuance of this discussion paper, we are aiming to enhance OSFI's accountability to external stakeholders by improving stakeholders' understanding of our objectives and soliciting input early on in the policy development process. As such, we are seeking comments on the proposed segmentation and the tailored capital and liquidity requirements for SMSBs set out in this paper.

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[1] OSFI Strategic Plan 2019-2022, April 2019

[2] For purposes of this discussion paper, SMSBs refers to all deposit-taking institutions regulated by OSFI that are not designated as domestic systemically important banks (DSIBs) and that are not subsidiaries of DSIBs or foreign bank branches.

[3] OSFI discussion paper: Implementation of the final Basel III reforms in Canada, July 2018

II. Guiding principles for this initiative

OSFI's review of the capital and liquidity frameworks for SMSBs is guided by the following principles.

1. The capital and liquidity frameworks applied to SMSBs should reflect the nature, size, complexity and business activities of these institutions.
2. Capital and liquidity requirements should contribute to the protection of depositors and creditors and allow institutions to compete and take reasonable risks.
3. The revisions to the frameworks should strike the right balance between improving the risk sensitivity of the requirements for SMSBs and reducing the complexity of the frameworks to make them more fit for purpose.

III. Scope of the initiative

OSFI's current capital and liquidity regimes consist of three pillars. Pillar 1 requirements refer to OSFI's guidelines that outline the minimum requirements related to capital and liquidity and their corresponding regulatory reporting requirements. Pillar 2 requirements refer to OSFI's guidance that outlines prudential and risk management expectations related to capital and liquidity as well as associated supervisory oversight. Pillar 3 requirements refer to OSFI's guidance on public disclosure requirements related to capital and liquidity.

The first phase of this initiative will focus on the Pillar 1 requirements while subsequent phases will include a comprehensive review of the Pillar 2 and Pillar 3 capital and liquidity related guidelines applicable to SMSBs.

Pillar 1 requirements include the Capital Adequacy Requirements (CAR) Guideline, the Leverage Requirements (LR) Guideline and the Liquidity Adequacy Requirements (LAR) Guideline. These guidelines are more rules-based in nature which allows comparability and ensures consistent application across DTIs. However, given the varying nature and complexity of DTIs, the ratios produced by these requirements (e.g. risk-based capital ratios, leverage ratio, liquidity coverage ratio) may not be the best measure of the risks faced by all SMSBs. To address this concern, OSFI is assessing how the existing capital and liquidity requirements can be modified for some SMSBs and is exploring alternative measures to assess the adequacy of capital and liquidity.

The current frameworks already incorporate some simpler options for smaller, less complex institutions (e.g. flat risk weights which can be applied to determine the credit risk capital held against certain assets). However, there may be a need to develop additional, simpler approaches for use by smaller SMSBs or by SMSBs for which a particular activity or risk is immaterial. In addition, the standardized approaches may not be sufficiently risk sensitive to capture the risks associated with exposures in certain asset classes (e.g. real estate). In these instances, OSFI will look at developing more risk sensitive approaches that can be used by SMSBs to better capture the risk to which they are exposed.

To promote consistent reporting across institutions, OSFI currently has in place a set of regulatory returns (e.g. Basel Capital Adequacy Return (BCAR), Leverage Requirements Return (LRR), the Liquidity Coverage Ratio (LCR) return and the Net Cumulative Cash Flow (NCCF) return) which are used to assess an institution's compliance with OSFI's capital and liquidity requirements. Part of the work to assess the Pillar 1 requirements for SMSBs will involve the assessment of the current regulatory reporting regime including the content and frequency of regulatory reporting.

IV. Segmentation of SMSBs

OSFI currently regulates a total of 72[4] DTIs, including six DSIBs and 66 SMSBs. Included in the SMSBs are a wide range of domestic banks (including federal credit unions), foreign bank subsidiaries and trust and loan companies.

SMSBs vary significantly in terms of their mix of geography, customers, and business (e.g. commercial lending, real estate lending, credit card lending, and trust and custody activities). They also range from relatively large, complex, and diversified institutions to smaller institutions with a single business activity. As such, SMSBs face different types and levels of risks based on their nature, size, complexity and business activities.

To address the variation across the wide range of SMSBs, OSFI is proposing to establish criteria to segment these institutions into distinct categories. This segmentation will allow for more tailoring of the requirements in line with the guiding principles set out above. Such an approach is also broadly consistent with methods being considered by regulators in other jurisdictions[5] with similar objectives related to proportionality.

The segmentation of SMSBs will be based on a combination of qualitative and quantitative criteria to categorize institutions based on their nature, size, complexity and sophistication. The four criteria being considered by OSFI include: (i) the approach used to calculate Pillar 1 capital requirements for credit risk; (ii) the size of an institution's on-balance sheet assets; (iii) the amounts of assets under administration / management; and (iv) supervisory judgment.

The first criterion that would be used to segment SMSBs is whether an institution has been approved to use the internal-ratings based (IRB) approach for credit risk. To obtain IRB approval, institutions need to demonstrate to OSFI that their corporate governance, internal controls and use of credit risk ratings are sufficiently advanced and sophisticated to be commensurate with the nature, scope, complexity and risk profile of the institution. SMSBs with IRB approval will be grouped into one category and expected to meet the highest standards under the capital and liquidity frameworks.

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[4] This figure does not include foreign bank branches, DTIs in liquidation or subsidiaries of OSFI-regulated DTIs.

[5] For more information please refer to the report published by the BCBS in March 2019 which summarizes the responses from member jurisdictions on proportionality practices in bank regulation and supervision: *Proportionality in bank regulation and supervision – a survey on current practices*.

The next criterion for segmenting SMSBs should consider the size and business activities of the institution. OSFI is considering the following measures to assess this: (i) on-balance sheet assets (ii) deposits and (iii) regulatory capital. On-balance sheet assets is viewed as a more intuitive and comprehensive measure than regulatory capital and deposits to determine the relative size of SMSBs as it captures many of the activities undertaken by institutions (e.g. lending activities). As well, on-balance sheet assets and deposits provide similar results with respect to the ranking of SMSBs by size.

While on-balance sheet assets is a good proxy for the size of institutions involved in financial intermediation, some SMSBs undertake business activities that result in relatively small amounts of on-balance sheet assets but comparatively larger amounts of assets under administration / management (AUA/AUM). As such, the level of AUA/AUM will be used as an additional factor to further segment SMSBs. These two measures capture a range of different activities engaged in by SMSBs (e.g. on-balance sheet lending as well as off-balance sheet activities such as trust and custody business). In addition, these measures can be used to assess the complexity of an institution as complexity is generally correlated with size.

Finally, OSFI will retain supervisory discretion to place an SMSB in the most suitable category based on the nature of its business.

Table 1 provides a summary of the four categories of SMSBs including the criteria for segmentation and characteristics of institutions that will fall into each category.

Table 1. Segmentation of SMSBs

Category and current composition	Criteria	Characteristics
Category 1 (1 institution representing 30% of total SMSB assets)	Approved to use IRB approach for credit risk	Large SMSBs with diverse operations (e.g. multiple business lines, multiple distribution channels).
Category 2 (6 institutions representing 46% of total SMSB assets)	SMSBs > $10B in assets	Large SMSBs with operations ranging from diverse (e.g. multiple business lines, multiple distribution channels) to relatively less complex and less diversified.
Category 3 (37 institutions representing 23% of total SMSB assets)	SMSBs with Assets of $0.5B to $10B or >$20B in AUA/AUM	Smaller and generally less complex institutions with fewer business activities.
Category 4 (22 institutions representing 1% of total SMSB assets)	SMSBs with ≤ $0.5B in Assets and ≤ $20B in AUA/AUM	Smallest and generally least complex institutions.

V. Key features of OSFI's tailored SMSB capital and liquidity requirements

In line with the principles outlined above, OSFI is proposing to design its capital and liquidity requirements for SMSBs based on the segmentation of institutions. The proposed requirements by SMSB category are summarized in the table in Appendix 1 and described in more detail below.

Capital

Currently all SMSBs are required to calculate risk-based capital ratios and a leverage ratio as set out in OSFI guidance. Together, these two sets of requirements provide a framework for assessing an institution's capital adequacy. The risk-based capital ratios are a measure of capital available as a percentage of risk-weighted assets (RWA). For the majority of SMSBs, risk-weighted assets are composed of credit risk RWA and RWA related to operational risk. The leverage ratio is a measure of capital available as a percentage of total exposures.

Credit risk

Currently, to determine the capital required for credit risk, SMSBs can either use a simpler approach, called the Standardized Approach, or a modelled approach, called the IRB approach. As noted earlier, use of the IRB approach is subject to OSFI's approval and requires an institution to have more sophisticated risk management and measurement processes in place.

Under the current standardized approach, institutions determine the applicable risk weight using either the external rating of the obligor or by applying a flat risk weight which varies by asset class. The final Basel III reforms include additional risk sensitivity for certain asset classes (e.g. real estate) and allow for more granular risk weights for unrated exposures (e.g. banks and corporates).

Under OSFI's domestic implementation of these reforms, institutions will be permitted to use these more granular risk weights, subject to meeting certain requirements, or may continue to use a flat risk weight for certain asset classes. In this way, the Basel III standardized approach provides a good starting point for OSFI to improve the risk sensitivity and simplicity of the standardized approach.

In the discussion paper on OSFI's domestic implementation of the final Basel III reforms released in July of 2018, OSFI outlined several areas where domestic modifications to the framework are being considered to better reflect the Canadian market. Through this discussion paper on the SMSB initiative, OSFI is seeking views on ways in which the standardized approach can be further tailored to increase the risk sensitivity in some areas and provide more simple options in other areas.

Consistent with the principles outlined above, the resulting SMSB capital framework will aim to better capture the risks faced by SMSBs while reducing complexity. This framework could include a revised standardized approach, while maintaining a simpler standardized approach. Category 2 institutions would be subject to the revised standardized approach with the possible option of using the more simpler standardized approach. Category 3 institutions would be subject to the simplified standardized approach but may be given the option to apply to use the revised standardized approach. As discussed further below, under the revised capital framework for SMSBs, Category 4 SMSBs would not be subject to risk-based capital requirements.

Operational risk

For operational risk, SMSBs currently use one of two approaches to calculate capital requirements, the Basic Indicator Approach and the Standardized Approach, both of which use gross income as a proxy for the size of the institution. Under the Basic Indicator Approach, a single factor is applied to the institution's gross income to determine the capital charge. The Standardized Approach is more granular with three different factors applied to defined business lines.

The final Basel III reforms replace these two approaches with a single standardized approach. Rather than using gross income as the indicator, this new approach uses a financial statement based proxy as the business indicator component and allows for the use of historical loss data when calculating required capital.

Given the additional complexity inherent in the revised standardized approach for operational risk compared to the existing two approaches, OSFI is considering only requiring Category 1 and 2 SMSBs to use this approach.

Category 3 SMSBs would continue to use a simple approach to calculate operational risk capital requirements. This simple flat rate charge could either take the form of the existing Basic Indicator Approach or could be based on another measure (e.g. assets or AUA/AUM) to determine the flat RWA add-on for operational risk. As noted above, Category 4 SMSBs would not be subject to risk-based capital requirements.

Leverage ratio

Currently, all SMSBs are subject to the leverage requirements set out in OSFI's LR Guideline. Under the leverage requirements, institutions calculate their total exposures (both on- and off- balance sheet) and compare this amount to capital available. The final Basel III reforms include minimal changes to the leverage ratio and, therefore, this ratio will continue to apply to all SMSBs.

OSFI is considering no longer requiring Category 4 SMSBs to calculate risk-based capital ratios given their relative size and complexity. Instead, they will be subject to a higher minimum leverage ratio, in the range of 8% to 12%, rather than the current minimum of 3%. The elimination of the risk-based capital requirements will reduce the complexity of the framework for these institutions while ensuring that they continue to hold adequate capital as determined by the leverage ratio.

Liquidity

SMSBs are currently required to calculate a Liquidity Coverage Ratio (LCR), based on the Basel III framework, and a Net Cumulative Cash Flow (NCCF) metric, a measure developed by OSFI. These two measures, along with a suite of assessment tools, are used to evaluate the liquidity adequacy of an institution.

The LCR aims to ensure that an institution has a sufficient stock of liquid assets to withstand a 30-day period of stress. The NCCF is used to gain a perspective on an institution’s cash flow profile over a longer time horizon. These two measures use similar assumptions and, taken together, provide a broader picture of the institution’s liquidity profile.

Given the fundamental role these measures play in the liquidity adequacy framework, OSFI will require SMSBs in Categories 1 and 2 to continue to calculate the LCR and NCCF. In addition, OSFI will look at revisions to the NCCF to improve the utility of this measure. This could take the form of modifications to increase risk capture (e.g. incorporate cash outflows related to commitments and operational expenses) and/or other modifications to existing cash flow assumptions (e.g. incorporate additional cash inflows related to residential mortgages).

For Category 3 and 4 institutions, OSFI is considering simpler liquidity metrics that are more in line with the liquidity risks faced by these institutions. Category 3 SMSBs would continue to be subject to the LCR requirement, as a base measure of liquidity, that is comparable across institutions. However, the LCR would no longer be a requirement for Category 4 institutions. The NCCF would also no longer apply to institutions in Categories 3 and 4. Instead, OSFI will explore the development of other liquidity metrics that could take the form of a minimum liquid asset holding requirement (e.g. as a percentage of assets) or a simplified cash flow metric and would depend on the nature of an SMSB’s activities. This approach will ensure that the smallest SMSBs remain subject to adequate minimum liquidity requirements appropriate to their liquidity needs and generally less complex funding structure, while reducing the complexity of the framework.

Finally, beginning in Q1 2020, OSFI will implement a third measure as part of the LAR Guideline called the Net Stable Funding Ratio (NSFR), which will be applicable to the D-SIBs. The NSFR, a Basel III standard, requires institutions to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. Given the level of sophistication needed to meet the IRB requirements for credit risk, Category 1 SMSBs will also be subject to the NSFR requirements.

VI. Process and next steps

Consistent with the guiding principles set out above, OSFI is proposing to achieve greater proportionality through a combination of SMSB segmentation and more selective use of capital and liquidity measures. In this discussion paper, OSFI has proposed illustrations of how this might work and is seeking comments on these proposals.

Comments received in response to this discussion paper will be used to further develop the segmentation approach, including the process for the migration of SMSBs between categories. This feedback will also be used to inform the finalization of a revised set of Pillar 1 capital and liquidity requirements for SMSBs, effective in Q1 2022. To meet this implementation date, OSFI is targeting publication of a final set of rules by December 2020.

As noted earlier, revisions to the Pillar 2 and Pillar 3 requirements will take place in subsequent phases of this initiative. Further consultations on these phases will begin by mid-2020.

VII. Questions for stakeholders

OSFI is seeking input and views on the content of this discussion paper including the segmentation of SMSBs and the tailored Pillar 1 capital and liquidity requirements. In addition, interested stakeholders are requested to provide responses to the following questions:

1. Do you agree that segmenting SMSBs into separate categories is a beneficial step towards achieving the guiding principles of this initiative?
2. Do you have any comments on the criteria used to segment SMSBs into the four categories? Do you have suggestions for other criteria that could be used or other ways of segmenting these institutions?
3. What are your views on the tailored Pillar 1 capital and liquidity requirements applicable to each category of SMSBs?
4. Do you have any suggestions on areas of the capital regime that could be made more risk sensitive and/or areas that could be simplified or made less costly to administer?
5. Do you have any suggestions on revisions to the NCCF metric or proposals for simplified liquidity metrics?
6. Do you have views on how capital and liquidity reporting requirements (e.g. frequency and content) could be tailored for SMSBs to further the objectives of this initiative?
7. Do you anticipate any barriers, challenges or unintended consequences to implementing the changes to the capital and liquidity frameworks? If so, are these challenges expected to be short-term in nature or ongoing?

Comments on the discussion paper and responses to the above questions are requested by **September 27, 2019** and should be sent to SMSB.Proportionality@osfi-bsif.gc.ca.

Appendix 1 – SMSB Pillar 1 capital and liquidity requirement*

	Capital			Liquidity		
	Risk-based Capital Ratios		Leverage Ratio (LR)	Liquidity Coverage Ratio (LCR)	Net Cumulative Cash Flow (NCCF)	Net Stable Funding Ratio (NSFR)
	Credit Risk	Operational Risk				
Category 1: IRB approved SMSBs	**Internal-Ratings Based Approach**	**Standardized Approach**	**LR**	**LCR**	**Revised NCCF**	**NSFR**
Category 2: SMSBs >$10B assets	**Standardized Approach**	**Standardized Approach**	**LR**	**LCR**	**Revised NCCF**	**No NSFR**
Category 3: SMSBs with $0.5B < Assets ≤ $10B or >$20B in AUM/AUA	**Simplified Standardized Approach**	**Flat rate capital add-on**	**LR**	**LCR**	**No NCCF** **Simplified liquidity metrics**	**No NSFR**
Category 4: SMSBs with ≤$0.5B assets and ≤$20B in AUM/ AUA	**No Risk-based Capital Ratios**		**A higher minimum LR**	**No LCR**	**No NCCF** **Simplified liquidity metrics**	**No NSFR**

*The Internal Ratings Based Approach, Standardized Approach (Credit and Operational risk), LR, LCR and NSFR are based on Basel III. The Simplified Standardized Approach for credit risk is based on Basel II.