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Chapter – 9 Risk Management in Canadian Banking

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Chapter - 9 Risk Management in Canadian Banks

Introduction

The recent global financial crisis impacted the banking industry on a very large scale. There was significant chaos and downfall in the global financial system and a number of banks became insolvent. Some failed and those which managed to survive were able to do so because they received tax-payer funded bailout assistance. This brought about a major focus on risk management in banks and the regulatory changes to the banking sector worldwide in order to prevent another such crises. Significant regulatory changes are still underway in many parts of the world and most banks are now adopting a stricter risk management framework.

Most of the changes with regards to aspects such as capital, liquidity and systemic risk come from the Basel III rules agreed upon by the Basel Committee members on matters of Banking Supervision.

The Financial Stability Board, working under the supervision of the G20, lays out the policy direction for these changes and the Basel Committee turns that direction into regulation.

Learning Objective

At the end of this chapter, you would have learnt about:

- Risk management in banks in general
- Risk management by banking industry in Canada
- International regulations that impact risk management in Canada

9.1 Risk Management in Banks and Regulatory Reforms

What is risk and the types of risk?

There are many definitions of risk. Some of the commonly termed definitions of risk are as defined by GARP as below:

- The likelihood an undesirable event will occur
- The magnitude of loss from an unexpected event
- The probability that "things won't go right"
- The effects of an adverse outcome

There are many types of risks faced by the banks. Some examples of the different types of risks faced by a bank are:

- Submission of payments by borrowers may get delayed or they mail fail to make the payment altogether.
- The customers who have deposited their money with the bank may demand their money much before in time than the bank has reserved for.
- Interest rates in the market may change and alter or lower the value of the loans of the bank
- The value of the bank's investments in securities and private companies may go down partially or completely in value.
- Losses may occur both due to human error or any error or fraudulent activity done in the computer systems etc.

Therefore to keep a tab, assess and manage these risks, banks actively engage in risk management.

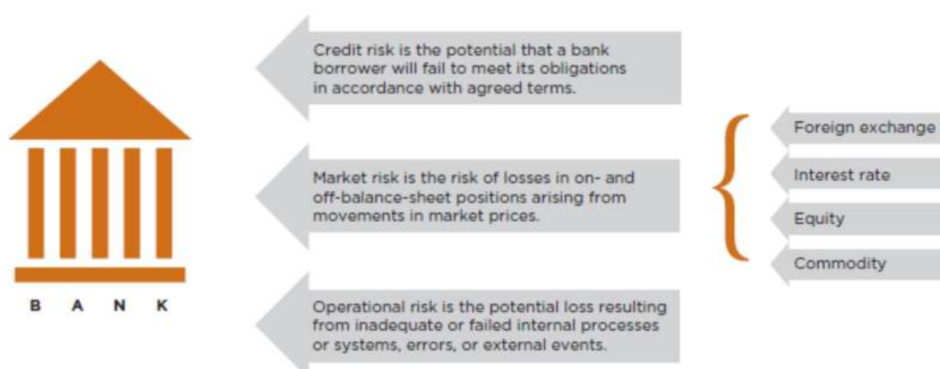
With regards to a bank, risk management would mean management of the risks faced by the bank while measuring the risk of the current portfolio of assets and other risky exposures continuously. Then this is followed by communication of the risk profile of the bank to other functions of the bank by taking measures either directly or in collaboration with the other functions of the bank to bring down the possibility of loss or to lessen the extent of the expected loss to the bank.

From the perspective of regulations, the size and risk attached to a bank's assets are the most significant determinants of how much "regulatory reserve capital" is required by a bank to hold. A bank holding high risk assets may encounter a situation where the assets may quickly lose their value. If the market views the bank as unstable the depositors may panic and withdraw their deposits with the bank for fear of losses. These withdrawals may send wrong signals to the other depositors that the bank may run out of funds if most depositors remove their money they have deposited with the bank. When withdrawals start to spread across the bank the bank is under tremendous pressure to start selling all its assets. In order to avoid such a situation, regulators require banks with high risk assets to have more reserves available which serve as a backup. Therefore financial risk management and banking regulation go hand in hand to keep banks safe.

The types of risks identified by the Basel Accord, which is a result of a collaborative attempt by banking regulators from major developed nations all over the world to constitute a globally acceptable and widely applicable framework for banks and bank risk management are:

- Credit Risk
- Market Risk and
- Operational Risk

There are also other risks that the Basel Accord recognizes that may be a part of the above core risk types as shown below:



(Source: garp.org)

The effects of the global financial crises were felt the most by banks. Some of the big banks around the globe failed and others were bailed by the governments. This happened due to insufficient risk management, undercapitalization and illiquidity apart from so many other factors. But the experience of the Canadian banks was quite different. As compared to their counterparts across the world, they fared much better and did not struggle to stand up. This is because Canadian banks are well managed and regulated well and have been equipped with the required risk management strategies and governance approach. The "big six" of Canada are among some of the largest financial institutions in the world.

9.1.1 Scenario in Canada

Financial markets are globally integrated. So in the end, the aim is that consistent implementation of these regulatory changes in countries around the world will result in a better functioning global financial system.

Entering the global financial crisis Canada's banks were well capitalized, well managed and well regulated, and they remain so to this day. No Canadian bank was in danger of failing or needed a government bailout. And while this turmoil did not originate in Canada, it did have an impact on banks in Canada.

There are many important participants – including Canadian policymakers and regulatory officials – involved in shaping and adapting these regulatory changes for Canada's financial system. Canada's banks – through and with the Canadian Banker's Association are working closely with domestic and global regulatory organizations to implement all of the international regulatory changes.

9.1.2 OSFI and Risk Management

In response to changes in banking laws and international standards (e.g., the Basel Capital Framework), and changing market conditions (e.g., the introduction of new products such as synthetic collateralized loans, derivatives), the Office of the Superintendent of Financial Institutions (OSFI) frequently issues new and updated guidelines impacting Canadian banks' risk management practices and capital adequacy standards. The industry's aim is to ensure these guidelines and standards promote safety and soundness, without impairing the global competitiveness of the Canadian banking industry.

9.1.3 What is Basel III?

Basel III is a framework that sets out global regulatory rules for bank capital and liquidity. These rules were originally published in December 2010 in response to the global financial crisis and are subject to ongoing review and updates. The phase-in of Basel III capital rules began in 2013. Canada implemented these changes in January 2013, well ahead of many other countries and well ahead of the Basel III timeline. The phase-in of Basel III's liquidity rules begins in 2015.

Basel III was developed and agreed to by members of the Basel Committee on Banking Supervision – commonly called "the Basel Committee". This is a longstanding committee of the Bank for International Settlements (BIS) that is mandated to review and develop banking guidelines and supervisory standards at a global level.

9.1.4 Regulatory Reforms

While several regulatory changes are underway, there are three important areas where rules have been set: capital, liquidity and systemic risk. Regulators in Canada implement these international rules and apply them domestically as part of their ongoing oversight of the Canadian financial system.

9.1.4.1 Capital

A bank holds capital so that the public will have confidence in it to help protect depositors and other stakeholders against losses in the event of a default. Capital is a cushion against bank-specific and market-related activities that could have negative impacts on a bank's ability to stay solvent.

Basel III capital rules

- There are several categories of rules related to capital under Basel III. Taken together, these rules require banks to hold enough capital to equal at least 10.5% of their total risk-weighted assets by 2019.
    - ❖ Banks that are determined to be global systemically important banks (G-SIBs) and/or domestic systemically important banks (D-SIBs) have to hold additional capital. Canadian D-SIBs (i.e. the six largest banks in the country) will have to hold additional capital by January 2016.
    - ❖ G-SIBs and D-SIBs are treated differently under Basel III given the potential impacts that a failure of any one of them would have on global and domestic economies.

Systemically important banks are those whose failure can impact the orderly functioning of the financial system and impact the economy and result in another global financial crisis.

Basel III capital rules as they relate to banks in Canada

- In December 2012, OSFI issued the final version of the revised Capital Adequacy Requirements (CAR) Guideline. This is how Canadian regulators are implementing the Basel III capital rules in Canada.
- Under the CAR Guideline, OSFI expected banks to meet target capital levels that equal or exceed the 2019 Basel III minimum capital requirements in 2013, well before that 2019 deadline.

Latest on Capital Adequacy Requirements (CAR)

OSFI issued the final revised version of the Capital Adequacy Requirements Guideline that will be effective for the first quarter of fiscal 2013. The guideline has been revised as a result of the Basel Committee on Banking Supervision reforms to strengthen global capital rules with the goal of promoting a more resilient banking sector, commonly referred to as Basel III.

Canada's banks are among the best capitalized banks in the world in terms of both the quality and quantity of capital, and have been judged the soundest in the world by the World Economic Forum for the last five years. Banks in Canada did not receive nor need a government bail-out during the global financial crisis.

9.1.4.2 Liquidity

"Liquidity" refers to the ease with which assets can be converted into cash (i.e., liquidated) and sold. For banks, good liquidity is important because it bolsters their resilience to internal and external shocks.

Basel III liquidity rules

- The Basel Committee has developed two minimum rules for liquidity – the Liquidity Coverage Ratio (LCR) that has a 30-day horizon, and the Net Stable Funding Ratio (NSFR) that has a time horizon of one year.

- LCR requirements were confirmed as of January 2013 and will be phased in between 2015 and 2019. Details of the NSFR are still being worked out, but it will be in force by 2018.

- These rules are meant to ensure banks have sufficient, high-quality liquid assets to withstand a period of economic stress.

Methodology used by OSFI in implementing liquidity rules for banks in Canada

- OSFI issued a revised "Liquidity Principles B6 Guideline" in February 2012. This describes how the regulator assesses the strength of a bank's liquidity risk management framework and whether the bank would have adequate liquidity under stressed conditions.

- OSFI's approach is consistent with the Basel Committee's September 2008 *Principles for Sound Liquidity Risk Management and Supervision.*

Liquidity Principles B6 Guideline

This guideline sets out prudential considerations relating to the liquidity risk management programs of federally regulated deposit-taking institutions and bank holding companies. In this Guideline, the term "institution " means banks ,and all federally regulated trust and loan companies , and bank holding companies.

9.1.4.3 Management of Systemic Risk

In the financial world, "Systemic risk" refers to elements of risk within the global financial system and the likelihood that those elements could lead to another global financial crisis for instance, along the lines of the crisis in 2008. Managing systemic risk helps maintain economic stability as well as the resiliency and soundness of individual financial institutions.

Regulatory requirements to address systemic risk

- Regulatory changes are being made to help manage systemic risk by strengthening capital, liquidity and leverage requirements for all banks

- Banks that are determined to be global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs) have to hold additional capital. Rules applying to these institutions will go into effect in January 2016

- These rules for G-SIBs and D-SIBs are meant to address concerns stemming from banks whose collapse would cause significant global and/or domestic economic damage.
- Moves to ensure that these institutions have adequate recovery and resolution plans are part of this overall reform. These plans are road maps to facilitate either the recovery of an institution or its orderly wind-down in the event of failure. Both recovery and resolution can be caused by severe financial stress.

Regulatory requirements to address systemic risk as they relate to banks in Canada

- There are currently no banks designated as G-SIBs in Canada.
- In March 2013, OSFI named the six largest banks in Canada as D-SIBs. As a result, these banks will be required to hold an additional one per cent of capital and will be subject to more intense supervision and enhanced disclosure.

Banks in Canada are extremely unlikely to fail. However, there are mechanisms in place to help bring about an orderly resolution in the very unlikely event of a Canadian bank failure.

9.1.4.4 Regulatory changes coming out of the United States that will impact Canadian banks

Policymakers in the United States are taking their own approach to prudential regulation that differs in some ways from the harmonized approach being taken globally. A number of these measures have extraterritorial effects on Canada.

The American approach is contained in *The Dodd-Frank Wall Street Reform and Consumer Protection Act* – known generally as *The Dodd-Frank Act* – which passed in 2010. This act covers a very wide policy spectrum and touches banks in Canada in many significant ways, as highlighted below.

9.1.4.5 The Volcker Rule

- The "Volcker Rule" is part of *The Dodd-Frank Act*
  - The Rule, named after former Federal Reserve Chairman Paul Volcker, is intended to restrict banks operating in the United States from making certain types of

investments – on the bank's own behalf and not on behalf of customers – because such investments are considered to be potentially high risk

- The Rule, in its draft version, was so broad that it captured domestic operations of Canadian-based banks with U.S. operations as well as other foreign banks that have U.S. subsidiaries, and would restrict Canadian banks from undertaking activities in Canada that are permitted by the Canadian government
- The final version of the Volcker Rule was issued in December 2013.
- As per press release by Federal Reserve, Five federal agencies on December 10th, issued final rules developed jointly to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker rule").
- The final rules prohibit insured depository institutions and companies affiliated with insured depository institutions ("banking entities") from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. The final rules also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds (Source:federalreserve.gov)

9.1.4.6 Treatment of Foreign Banking Organizations (FBOs)

- The U.S. Federal Reserve is considering whether to require FBOs – including Canadian banks operating in the U.S. – to incorporate under a bank holding company structure to which Basel III capital, liquidity, stress testing, and other requirements would apply.
- In this case, capital and liquidity will be trapped in U.S. operations, thus causing the Canadian consolidated entity to hold capital levels that far exceed prudent Basel III levels.

(Source: cba.ca)

9.1.4.7 Latest on risk mgmt in Canada

The Economic Action Plan 2013 has taken a decision to implement a comprehensive risk management framework for Canada's systemically important banks. Large Canadian banks are a source of strength and stability to Canada's economy and are successful in the international and domestic markets.

The Canadian government realizes the need to manage risks that are associated with systemically significant banks whose fall and failure may cause a disturbance in the financial system which in turn will impact the economy. This requires strong federal and prudential oversight with a back up of alternatives for these financial institutions without the use of taxpayer funds in the unlikely case that any institution runs into trouble.

The framework will be in line with other reforms and standards, implemented by other countries worldwide such as the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions, and will function alongside the existing regulatory capital regime in Canada. It will include the following elements:

- As laid out by the Superintendent of financial institutions, "systemically important" banks will face higher capital requirement.
- The Canadian government proposes to execute a "bail-in" regime for systemically important banks.
- The regime will make sure that a bank can be recapitalized and returned to viability through the very rapid conversion of certain bank liabilities into regulatory capital in the unlikely event that a systemically important bank depletes its capital.
- The stake holders will b consulted by the government on which is the best way to execute a bail-in-regime in Canada with implementation timelines allowing a smooth transition for institutions that are affected.
- Systemically important banks will continue to be subject to existing risk management requirements, including enhanced supervision and recovery and resolution plans.
- This risk management framework will curtail the unfair and undue advantage that may be gained by Canada's systemically important banks through the misplaced belief by investors and other market participants that these institutions are "too big to fail".

Summary

- There are many definitions of risk. Some of the commonly termed definitions of risk are as defined by GARP as the likelihood an undesirable event will occur, the magnitude of loss from an unexpected event, the probability that "things won't go right", the effects of an adverse outcome
- The types of risks identified by the Basel Accord, which is a result of a collaborative attempt by banking regulators from major developed nations all over the world to constitute a globally acceptable and widely applicable framework for banks and bank risk management are:
    - Credit Risk
    - Market Risk and
    - Operational Risk
- Basel III is a framework that sets out global regulatory rules for bank capital and liquidity
- Policymakers in the United States are taking their own approach to prudential regulation that differs in some ways from the harmonized approach being taken globally. A number of these measures have extraterritorial effects on Canada
- The Economic Action Plan 2013 has taken a decision to implement a comprehensive risk management framework for Canada's systemically important banks

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