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

Risk and Resilience – Preparing for the Unforeseen

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to the
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Introduction

Thank you to Risk Canada for inviting me here to help kick off this second annual Risk Conference.

Risk is inherent in the provision of financial services, and as everyone in this room knows, risks change over time. They change as institutions progress, as economies evolve, and as operating environments transform. Volatility is a natural state for this industry, and preparing for the unforeseen is a continual process.

Financial institutions are faced with a number of new and emerging risks — high consumer debt, record low interest rates, cyber threats, housing market uncertainties and geopolitical pressures, to name a few. In this environment, it is increasingly important for financial institutions to demonstrate that they have the necessary controls in place to manage the unexpected, and that they are well equipped with strong capital and liquidity shock absorbers to withstand a variety of stressed conditions.

This morning, I would like to share how OSFI evaluates the response of federally regulated financial institutions (FRFIs) to emerging risks, and then provide an update on some of the work being done in the areas of capital and liquidity to further bolster the safety and soundness of the Canadian financial system.

OSFI's role

OSFI devotes much of its effort to implementing its core mandate in a way that contributes to public confidence in the Canadian financial system. We do this through developing guidance on risk management and mitigation, assessing the safety and soundness of financial institutions, and intervening promptly when corrective actions need to be taken.

Our role as Canada's prudential regulator requires an ongoing balance between restraining excessive risk-taking while allowing financial institutions to take reasonable risks and compete effectively, both at home and abroad.

In order to do our job well, it is critical for OSFI both to have a clear understanding of the existing and emerging risk factors facing the industry, and to ensure that institutions have sufficient capital and liquidity available to respond to a range of unforeseen shocks.

Evaluating FRFIs' response to emerging risks

As part of our mandate, OSFI closely monitors and evaluates system-wide or sectoral developments that could have a negative impact on the financial conditions of the institutions we regulate.

When we look at emerging risks, we begin with a market surveillance of the financial industries we regulate, the markets and industries that Canadian financial institutions are most exposed to, and the broader economy outside these markets and sectors.

In the course of our surveillance work, OSFI collects data and analytics from a number of different sources, including the institutions themselves, our fellow regulatory partners in government, and other international regulators and agencies. The scope of the data collected gives our supervisors and risk specialists a unique and relatively broad cross-sector perspective when analyzing and identifying potential risks that could have a material impact on Canadian financial institutions.

Once we classify an emerging risk issue, we identify how, specifically, the financial institutions we regulate may be vulnerable. This means we look at, for example —

- The different types of direct and indirect exposures;
- Potential changes in the nature of the exposures;
- The size of the exposures relative to historic levels;
- Whether new or evolving practices or products may be making the institutions more vulnerable; and
- Whether the risk issue is isolated to a specific sector or institution or if it is more systemic.

We then look at how institutions are responding to these risks, and ask questions such as —

- Do they understand their exposures and are they operating within their board-approved risk appetites?
- Are there appropriate limits and controls in place?
- Have they done stress-testing or used other methods to quantify the potential risks?
- Are there appropriate capital and contingent liquidity levels in place?

Of course, financial institutions are on the front lines and are best equipped to deal with these risk issues, but it is our job to weigh the effectiveness of their control functions and ensure that those controls appropriately correspond to the risks.

So when, for example, oil prices started declining in 2014, we watched the institutions' responses very closely. In this case, we noted that they were monitoring their direct and indirect exposures, stress-testing their related portfolios and taking prudent measures in their underwriting and loan management.

This is the type of risk management reaction we expect, and responses to emerging risks are generally adequate — requiring little OSFI response beyond monitoring. There are, however, times when we notice trends or common changes in vulnerabilities across the industry that are not always apparent to individual institutions.

If OSFI identifies a broad, pervasive risk issue, or even one isolated to a few specific institutions, we will act. We can either take regulatory action — through industry letters or by revising OSFI guidance — or we can take targeted supervisory action — through institution-specific supervisory recommendations, changes to risk ratings or broad cross-sectoral review work.

In terms of how we are structured to deal with emerging risks, OSFI's supervision and risk specialist groups work together to closely monitor this area. We also have a dedicated Risk Surveillance and Analytics team that aggregates information and coordinates the analysis of emerging risks.

We try very hard to discipline ourselves — to be focused on what *could* happen. Emerging risks and the triggers for disturbances and shocks to the financial system are not always easy to identify. However, if controls and risk management in institutions are robust and strong capital and liquidity shock absorbers are in place, the ability to deal with such events is greatly improved.

On that note, I would like to turn to some of the work being done in capital and liquidity.

Capital and liquidity

Understanding an institution's capital and liquidity position is central to understanding the risks financial institutions take — and by extension the best way for both the institution and regulators to mitigate those risks.

The global financial crisis was a powerful demonstration of how instability can result from insufficient financial resources in capital or liquidity.

Despite the relative stability of the Canadian financial system during the financial crisis, we know the next crisis will not be identical to that scenario. And the success of Canada's regime nearly ten years ago does not guarantee future success. With that in mind, we will continue to improve our capital and liquidity standards to better position institutions to withstand a variety of stressed conditions.

Capital standards

One of OSFI's most important responsibilities is keeping Canada's capital regime effective and up-to-date. When OSFI sets out to adjust or improve its capital regime, the main objective is always to bolster its safety and soundness, not to target an increase or decrease in capital levels. Proportionality, and a risk-based approach, will always be the lenses through which we look at our capital standards.

In terms of shaping Canada's capital regime, OSFI has taken an approach that implements international agreements — such as those made at the Basel Committee on Banking Supervision — with consideration of the Canadian context, potential regulatory burden, and the importance of maintaining a level playing field.

Until recently, the Basel Committee had been working to complete the international post-crisis banking reform agenda known as Basel III. OSFI's preference is for the Basel Committee to move forward soon on an agreement that all member jurisdictions will support. However, if it becomes clear to us that the Basel process is stalled indefinitely, we will move ahead on addressing the outstanding issues in Basel III and develop a plan that works for Canada.

The top priority for OSFI's Canada-specific plan would be making the current domestic capital regime more risk-sensitive by better aligning risk weights with underlying risks.

More specifically, OSFI would work to —

- Address issues in the current standardized risk weight framework used by Canada's smaller banks by paying special attention to circumstances where the assets that pose different risks are given the same risk weight.
- Examine the variation in risk weights across Canada's larger banks using the internal ratings-based approach.

OSFI is also working toward building a clear plan for the use of capital buffers by Canadian institutions. Currently, that means looking at the purpose of capital buffers and how we expect to see them used with our regulatory partners and financial institutions.

We hope this work will foster a better understanding of the intended role of capital buffers and strengthen the system's overall response to potential economic weakness. Our goal is to set out a framework that encourages institutions to use their capital buffers as the normal first step in the process of recapitalization. Part of our work will be to ensure that banks, regulators and market participants understand our expectations for buffer use.

Liquidity standards

Like capital standards, liquidity standards are set with a view to better position institutions to withstand stressed conditions rather than normal operating environments. During the early liquidity phase of the financial crisis, many financial institutions — despite having adequate capital levels — still experienced difficulties because they did not manage their liquidity in a prudent manner. The crisis drove home the significance of liquidity to the proper functioning of financial markets and the financial sector.

Since the crisis, the Basel Committee has strengthened its liquidity framework by developing two minimum standards for funding and liquidity. These are designed to achieve two separate, but complementary, objectives.

The first — the liquidity coverage ratio, or LCR — promotes the short-term resilience of an institution's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for 30 days.

The second objective — the net stable funding ratio, or NSFR — reduces funding risk over a longer time horizon by requiring institutions to fund their activities with sufficiently stable sources in order to mitigate the risk of future funding stress.

OSFI has had the liquidity coverage ratio in place since 2015, and will implement the net stable funding ratio in the future.

In March 2017, OSFI issued a letter stating its intent to delay domestic implementation of the net stable funding ratio to January 2019. This is to align with the implementation delays seen in other key foreign markets.

OSFI remains committed to implementing the net stable funding ratio standard in its *Liquidity Adequacy Requirements (LAR) Guideline*. We believe that it will complement the current shorter-term liquidity metrics that OSFI currently has in place by focusing on a longer-term view of liquidity and funding risk.

That said, OSFI has already taken a longer-term perspective on liquidity risk beyond the liquidity coverage ratio's 30-day horizon through its domestic Net Cumulative Cash Flow (NCCF) metric. This mechanism, along with other liquidity monitoring tools and the forthcoming net stable funding ratio, will work in conjunction to effectively assess the liquidity risk of institutions.

Conclusion

As I mentioned at the outset, risk management and preparing for the unforeseen is a continual process. And as the nature of risks change rapidly, it is increasingly important for financial institutions and regulators to be proactive and vigilant.

OSFI is paying close attention to the risks — both current and emerging — facing Canada's regulated financial institutions. And through our regulatory and supervisory functions, we are working with the industry to bolster the safety and soundness of the Canadian financial system.

It is not always certain which emerging risks or triggers will create substantial disturbances and shocks to the financial system. What is relatively certain, however, is that if controls and risk management in institutions are robust, and strong capital and liquidity shock absorbers are in place, the ability to deal with such events is greatly improved.

Thank you for your time. I would be happy to address your questions.