ISSUE 4 | VOLUME 4 | WINTER 2011

OSFI BSIF

The OSFI *Pillar*

FROM THE OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS CANADA (OSFI)

Basel III Implementation, Non-Qualifying Capital, and Non-Viability Contingent Capital

As a result of recent international developments in revising and creating global banking requirements for capital and liquidity, OSFI issued a number of documents that describe the interpretation of these requirements in Canada and the timeline for implementation.

February 1, 2011

Letter to Deposit-taking Institutions regarding the interpretation and implementation of Basel III requirements

This letter to all deposit-taking institutions (DTIs) set out OSFI's action plan for consulting and revising capital guidance in Canada and to ensure that Basel III requirements are met within the internationally agreed timelines.

To view this letter or advisory, visit the OSFI web site at www.osfi-bsif.gc.ca.

February 4, 2011

Advisory regarding the Treatment of Non-Qualifying Capital Instruments

The Basel III rules affect the eligibility of instruments for inclusion in regulatory capital and provide for a transition and phase-out for instruments that do not meet the Basel III requirements. OSFI intends to adopt the Basel III changes in its domestic capital guidance for DTIs. This Advisory clarifies OSFI's expectations with respect to rights of redemption under regulatory event clauses and applies to all DTIs.

As a result of the changes to the qualifying criteria for Tier 1 and Tier 2 instruments under Basel III, DTIs may have capital instruments that are in excess of the "cap" on non-qualifying instruments set forth in the Basel III rules text. As such, DTIs may cease to receive the expected capital benefit of such instruments beginning January 31, 2013. (continued…/2)

OSFI releases Market Risk - QIS 2 Results

On March 3, 2011, OSFI issued its Market Risk - QIS 2 Results, which is a high-level summary of the results and findings of the second Quantitative Impact Study relating to market risk. This study is being used in the development of a new standardized approach for determining the market risk solvency buffer for the Minimum Continuing Capital and Surplus Requirements Guideline.

The report concludes that work will continue in order to refine and calibrate the new methods. It has not been determined yet whether another QIS is required. It is likely that an integrated QIS for credit, market and insurance risk components will be performed to permit better calibration of the solvency buffers for all risks. Although, as the report explains, more work is required on certain aspects of market risk, the work is nearing completion and some of the issues can only be resolved at a later stage.

For a copy of the report, visit the OSFI web site at www.osfi-bsif.gc.ca.

Basel III Implementation, Non-Qualifying Capital, and NVCC (cont. p.1)

February 4, 2011

Draft Advisory regarding Non-Viability Contingent Capital (NVCC)

The objective of these additional Basel III requirements (the NVCC requirements) is to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. More specifically, to meet the NVCC requirements, the terms and conditions of all non-common tier 1 and tier 2 instruments must include a provision whereby the instrument is either written off or converted into common equity upon the occurrence of the trigger event at the point of non-viability.

The Basel Committee on Banking Supervision also agreed, subject to strict conditions, that the objective of the NVCC requirements could alternatively be met through a statutory resolution regime where it requires equivalent outcomes to the contractual approach.

This draft advisory outlines OSFI's expectations in respect of the issuance of NVCC by DTIs. Section 1 specifies the principles governing inclusion of NVCC instruments in regulatory capital. Section 2 provides an overview of the process by which OSFI would confirm that such instruments qualify as Additional Tier 1 or Tier 2 capital. Section 3 outlines the treatment of capital instruments issued after the release of this Advisory and prior to January 1, 2013. Finally, Section 4 provides an overview of the criteria the Superintendent will consider prior to triggering the conversion of NVCC.

To view the draft advisory, visit the OSFI web site at: www.osfi-bsif.gc.ca.

OSFI releases Consultation Findings - Financial Institutions

On February 3, 2011, OSFI released the findings of the most recent consultation with financial institutions.

Since 1998, OSFI has commissioned consultations with senior members of the financial community and their professional advisors to obtain their assessment of its effectiveness as a supervisor and regulator. The primary objective of these consultations is to explore impressions of OSFI in the discharge of a number of key elements of its mandate as a regulator of financial institutions, including regulations and guidance, supervisory activities and the approvals process.

In early 2010, OSFI commissioned The Strategic Counsel, an independent research firm, to conduct a confidential survey with executives of the financial institutions that OSFI regulates.

Despite challenging times as a result of the current financial environment, overall impressions of OSFI are positive in all areas. Most of the results from the 2010-11 survey are consistent with those of the previous survey, conducted in 2007-08. The highest positive ratings in 2010-11 are evident on the issue of contributing to public confidence; these ratings have increased since the previous survey.

To view the complete report, visit the OSFI web site at www.osfi-bsif.gc.ca.

Intervention Guide for Federally Regulated Private Pension Plans

On January 21, 2011, OSFI issued a new Guide to Intervention for Federally Regulated Private Pension Plans. The objective of the Guide is to promote awareness and enhance transparency of the intervention process used by OSFI for federally regulated private pension plans.

The Guide outlines the types of involvement that a federally regulated plan administrator and employer can expect from OSFI and summarizes the circumstances under which certain intervention measures may be taken.

To view the complete guide, visit the OSFI web site at www.osfi-bsif.gc.ca.

OSFI releases enhancements to the Supervisory Framework

On February 24, 2011, OSFI posted an updated Supervisory Framework for Federally Regulated Financial Institutions. This revised framework will reinforce OSFI's ability to continue to provide a world-class, risk-based supervisory methodology for the foreseeable future.

OSFI's Supervisory Framework, first issued in 1999, has proven to be an effective approach to meeting OSFI's mandate to contribute to the safety and soundness of Canadian financial institutions. However, developing and maintaining a risk-based supervisory methodology is a dynamic process that requires periodic review to ensure that practices remain relevant and effective.

Over the past decade there have been changes in the nature of risks and their management by financial institutions. In addition, there have been significant developments in international regulation and supervision, including: the revision and introduction of the core (supervisory) principles of the Basel Committee on Banking Supervision (Basel) and the International Association of Insurance Supervisors (IAIS), respectively; the Financial Stability Board's recommendations for enhancing the supervision of systemically important financial institutions; upgrades to capital rules and expectations (as per the Basel II Accord and the Basel III reforms); and heightened requirements for liquidity, risk management and corporate governance in general.

Recently, OSFI conducted a thorough review of its Supervisory Framework in light of these developments as well as OSFI's "lessons learned" through day-to-day experience applying the Framework over the past decade. This review has resulted in a number of enhancements to the Framework.

- The Framework now makes specific reference and linkage to the Basel and IAIS core principles, to reflect OSFI's adoption of these;
- Assessment of liquidity at federally regulated financial institutions (FRFIs) has been enhanced by requiring an assessment of liquidity for the FRFI as a whole;
- Approval of a FRFI's overall risk appetite and oversight of its corporate compensation systems and practices have been explicitly included as part of the Board of Directors' responsibilities; and
- Actuarial has been added as a new oversight function to recognize its important role in the oversight of risk in financial institutions with insurance business.

To view the updated framework, visit the OSFI web site at www.osfi-bsif.gc.ca.

Trade-offs: Basel III, Competitive Equity, Systemically Important Financial Institutions, and Stress Tests

The following is an excerpt from remarks by Superintendent Julie Dickson to the RiskMinds conference in Geneva, Switzerland, December 8, 2010.

No matter how you say it, moving to a tighter regulatory environment entails costs and trade-offs. Today I will talk about trade-offs in four areas: Basel III, competitive equity among financial institutions during the implementation of Basel III, Systemically Important Financial Institutions, or SIFIs, and the publicizing of bank stress test results. To assess trade-offs in these areas you have to make judgements about costs and benefits. By their nature, such judgements are not black and white. This also means that it is not possible to have everyone agree on everything.

Basel III

In the months leading up to the finalization of Basel III, there was considerable debate about the costs versus the benefits of increasing global regulatory requirements.

Coming from a country that was relatively resilient, we think that Basel III was a reasonable compromise with positive results. While it is a substantial increase in the minimum capital required, we think it is one that can be justified based on what we saw during the crisis.

(continued …/4)

Trade-offs: Basel III, Competitive Equity, Systemically Important Financial Institutions, and Stress Tests

(continued from page 3)

In conclusion, let me reinforce a few of the messages I have talked about today:

1. The Basel III agreement is a big step forward, but we cannot be complacent. We need to be on high alert as Basel III is implemented and we all need to be ready to respond to developments in a timely way. Changes in capital rules and liquidity can have huge impacts and we cannot allow the rules to atrophy.

2. In terms of competitive equity, the uneven implementation of the Basel III agreement is contemplated. Over time, level playing field issues may arise if there is to be a regulatory race to the top, as endorsed by the G-20.

3. Getting international agreement on SIFIs is difficult in part because of the social costs that are involved. There are many different views on whether lists of SIFIs should be drawn up and publicized and whether a Pigouvan surcharge should be adopted. On the bright side, much has already been done to deal with moral hazard, such as living wills, and we have also seen movement on contingent capital and its close cousin bail-in debt. It is encouraging that many countries are reforming their bank resolution regimes and core market infrastructure.

4. Publicizing bank stress tests with the government's or regulator's seal of approval could create adverse outcomes by merely shifting moral hazard from one authority to another without the investors bearing the consequences of the risks they take.

5. While economic growth is the ultimate driver of almost everything, including the health of banks, robust bank regulation and supervision are prerequisites for long-term growth and stability; these should not be traded for short-term benefits.

To read the complete speech, visit the OSFI web site at: www.osfi-bsif.gc.ca

What's New On Line (www.osfi-bsif.gc.ca)

Presentation by Jean-Claude Ménard, Chief Actuary, to the Society of Actuary's "Living to 100" International Symposium

"For a pension plan actuary, the future challenge is not so much to project how many people will still be alive at 100, but more so at age 85."

To view the complete presentation, visit the OSFI web site at: www.osfi-bsif.gc.ca.

SUBSCRIBER NOTIFICATION

Would you like to be notified when notices or items of interest are posted to the OSFI web site? Then on your next visit to our site, sign up for notifications at the Subscription Centre located on the home page.

Just select your areas of interest, and when something is posted in that area, you will receive an email with a link to the relevant information.

The OSFI *Pillar*

The *Pillar* is published by the Communications and Consultations Division of the Office of the Superintendent of Financial Institutions Canada.

For a free subscription, or to provide feedback, please email OSFI Communications and Consultations at: thepillar@osfi-bsif.gc.ca

OSFI BSIF

255 Albert Street
Ottawa, Ontario K1A 0H2