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

# Let there be light:

# How more transparency can promote a safer financial system

**Remarks by Assistant Superintendent Mark Zelmer**
**Office of the Superintendent of Financial Institutions Canada (OSFI)**
**to the**
**BMO First Annual Reserve Management Conference**

**Toronto, Ontario**
**May 7, 2013**

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## Introduction

Thank you for inviting me to speak to you today at this inaugural event. This conference is an excellent forum for showcasing why Canada is both a great and safe place to conduct business. Not surprisingly, given OSFI's mandate, my remarks are mainly focused on the "safe place" aspect of that theme.

The underlying theme of my remarks will be to offer some examples of how more transparency is helping to promote a safe financial system. I will begin with some thoughts on the financial condition of Canadian banks. Specifically why Canadian bank capital ratios are even stronger than you might think, relative to their foreign peers, and the need to shed more light on them to give credit where credit is due.

I will then highlight some new disclosure requirements for the six major banks and how they will provide more information on their liquidity and risk management practices.

I will conclude with some thoughts on the new non-viability contingent capital (NVCC) instruments that are expected to emerge in Canada. I will explain why OSFI believes they need to be transparent contractual instruments. I will also mention how they and the introduction of bail-in debt are expected to help ensure that even domestic systemically important banks (D-SIBs) can be resolved in times of stress without the public purse being the first port of call for new capital.

## Canadian bank capital ratios are stronger than they look

It is a testament to the underlying strength of the Canadian financial system that Basel III capital rules have been fully implemented here from the start. Canadian banks do not need the transition requirement "training wheels" being used by many other jurisdictions. Canadian deposit-taking institutions comfortably meet the seven per cent Common Equity Tier 1 capital requirement on an "all-in" or 2019 basis.[1] Come January 2016, that requirement will increase to eight per cent for the six major banks that have been designated as D-SIBs.

[1] With one temporary exception. Although the new CVA capital charge was included in OSFI's Capital Adequacy Requirement (CAR) Guideline published in December 2012, that charge will not take effect until January 1, 2014, to allow time for the equivalent European and US rules to be finalized. This delay is meant to avoid potentially disrupting the OTC derivatives market. Canadian deposit-taking institutions will continue to be subject to counterparty credit risk requirements and, for those institutions approved to use the Internal Ratings Based approach, the requirements include the increased asset value correlation factor.

As a result, Canadian banks are now publicly reporting Basel III capital ratios on an “all-in” 2019 basis. Let me stress that these are fundamentally strong capital ratios – especially when you compare them to those published by some foreign banks.

Here’s why. First, many foreign banks appear to be reporting Basel III capital ratios on the basis of the rules that allow for the transition measures. So an eight per cent number posted by a Canadian bank is in fact significantly stronger than the same number posted by a bank that is phasing in Basel III over the next six years. Second, different jurisdictions are handling the various options allowed for in Basel III in different ways. One example is how insurance subsidiaries are treated in the definition of capital. And, third, the quality of a bank’s capital ratio will obviously be affected if a jurisdiction has deviated from Basel III in its domestic capital rules.

In Canada, we have faithfully implemented Basel III. And we expect the Basel peer review process will confirm that there are no material deviations in our domestic guidance.

When you analyze the capital ratios of Canadian banks, it is important to bear those differences in mind. The Basel Committee is doing what it can to shed as much light as possible on published capital ratios by introducing a new detailed reporting template later this year. But we are encouraging the Committee to consider whether more steps can be taken to address the reporting differences I just mentioned. After all, banks that report capital ratios to the highest standard deserve some credit.

**Coming soon: more light on bank liquidity and risk management practices**

As you know, there has been a fair amount of concern expressed about the way in which banks compute the risk-weighted assets denominator in their regulatory capital ratios. Some observers claim that allowing banks to use their own internal risk models to measure risk results in asset risk weights that are too complex and difficult to understand. Others argue that this also provides too much flexibility to banks and their supervisors on how risk should be measured, making it difficult to compare risk management practices and reported capital ratios across banks.

A good example of their concern is the risk weights calculated by banks for uninsured mortgages. In Canada, the average model risk weight calculated by banks for such loans is in the mid-teens.

As Julie said last week, some countries are experiencing frothy real estate markets and have introduced floors on risk weights--sometimes around 15 per cent. Given that in Canada uninsured mortgages tend to be of higher quality than the average loan portfolios in other countries (because uninsured loans in Canada have maximum loan-to-value ratios of 80 per cent), OSFI is generally comfortable with the capital held by banks using models. We are also aware that floors can become safe harbours and can lead banks and supervisors to pay less attention to the "appropriate" risk weight, especially when it should be well above the floor for a particular bank. Thus, our focus will continue to be on scrutinizing models currently in use.[2]

Last November, I gave a speech arguing why we cannot turn back the clock and scrap all those fancy risk models in favour of simpler capital tests.[3] Instead, we should consider what steps can be taken to provide you — the investors and other stakeholders — with the information needed to hold banks accountable for the adequacy of their risk management practices and make comparisons across institutions. At the same time, it may also help to rebuild investor confidence in the risk weights used by banks to compute and report their regulatory capital ratios.

OSFI believes Canadian D-SIBs should have public information disclosure practices covering their financial condition and risk management activities that are among the best of their international peers. That is why we announced in our recent D-SIB Advisory that the six major Canadian banks are expected to adopt the recommendations of the Financial Stability Board's Enhanced Disclosure Task Force (EDTF), future disclosure recommendations in the banking arena that are endorsed by international standard setters and the Financial Stability Board, as well as evolving domestic and international bank risk disclosure best practices.[4]

Membership may have its privileges, but it also comes with responsibilities.

The EDTF has provided 32 recommendations on how banks can shed more light on their risk exposures and risk management practices, including their liquidity and funding positions. The report has been welcomed by the FSB, which views it as a valuable step to improving the quality of risk disclosures.

Many of the recommendations are already in place here in Canada given the strong disclosure practices of the six major Canadian banks. And, I am pleased to report that they have agreed to implement the remainder over the course of this year and next.

In the case of risk-weighted assets, the major banks will be enhancing their disclosures to help users understand how bank risk models are influenced by data inputs, modelling assumptions, mathematical formulations, manual overrides and point-in-time versus through-the-cycle assumptions. We should also see more explanations as to how banks assess model performance, including how credit risk models perform relative to actual default and loss experience.

We, at OSFI, also recognize that some investors would welcome more information on the funding and liquidity profiles of the six major Canadian banks. So let me take this opportunity to outline some of the steps that are being taken to address these information needs.

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[2] Dickson, J. 2013. Remarks to the 2013 Financial Services Invitaitonal Forum, Cambridge, Ontario (2 May); available at: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=5492

[3] Zelmer, M. 2012. *Promoting a safe and sound financial system: Lessons from the Goose that Laid the Golden Egg*, remarks to the 2012 Canadian Financial Services Insolvency Protection Forum, Toronto, Ontario (21 November); available at: http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/mz20121121_e.pdf.

[4] OSFI Advisory, Domestic Systemic Importance and Capital Targets – DTIs 2013 (26 March); available at: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=5428

Consistent with EDTF recommendations, the six major banks started producing a contractual maturity table of their financial assets and liabilities, including off-balance-sheet items, when they reported their first quarter results. Later this year, this will be expanded to include more granular details on items with a less than one-year maturity, as well as more details on where liquid assets are held within the banking group and on how encumbered assets impact the pool of liquid assets. You can also expect to see more information emerge over time on bank funding sources and how they are evolving over time.

Before I wrap up my remarks on enhanced disclosures, let me just mention that the EDTF also calls for more disclosure of information on bank trading activities. One example is a more detailed breakdown of trading and non-trading market risk factors beyond interest rate; foreign exchange; commodity and equity measures. Another is a more detailed analysis of a bank's counterparty credit risk exposure from derivatives transactions. The major banks plan to be compliant with most of these requirements within the next 12 months.

Overall, OSFI believes these new disclosures will be useful in assessing Canadian banks and their risk and liquidity management practices. Indeed, we hope it will help to underscore further the strength and stability of the major Canadian banks.

**Why NVCC instruments need to be transparent to qualify as capital**

This brings me to the final topic I want to discuss today – NVCC and bail-in debt – two new types of financial instruments that will emerge in Canada in the not too distant future.

Canadian deposit-taking institutions are no longer able to include new issues of preferred shares and subordinated debt in their Tier 1 and Total Capital ratios unless those instruments carry Non-Viability Contingent Capital (NVCC) conversion triggers. Existing instruments are being phased out of regulatory capital at a rate of 10 per cent per year. Like living wills and other resolution measures, NVCC is an important ingredient in making sure that all deposit-taking institutions, including D-SIBs, can be resolved in an orderly fashion in times of stress without taxpayers being the first port of call for new capital.

But for NVCC instruments to count as regulatory capital, there cannot be any doubt about their ability to either absorb losses directly or be convertible into common equity when a bank is approaching the point of non-viability. Time is of the essence in those situations. Thus, we at OSFI believe that all of the terms and conditions surrounding the conversion process must be clearly spelled out ahead of time in the instrument documentation. That way NVCC investors know when they buy the instruments how their claims will be converted into common equity in the event the Superintendent has to pull the conversion trigger.

Some might argue that this results in more complex instruments that would be more susceptible to market manipulation and death spirals. However, it is important to remember that not defining all of the terms and conditions up front does not make them go away. Sooner or later they will be settled. Leaving some decisions until the time of conversion, when events are stressful and decisions need to be implemented quickly, does not strike us as very prudent.

We also understand the banks have made good progress in thinking about how to handle the risk of market manipulation and death spirals through the terms and conditions of NVCC instruments. So we are confident that they can, with your help, design NVCC instruments that will meet OSFI requirements and not become a source of instability if and when banks come under stress.

Closely related to NVCC is the issue of bail-in debt instruments. These will be debt instruments issued by D-SIBs, where holders of such instruments could also find their claims converted into regulatory capital, in the event the bank needs to be recapitalized. Given this is not a bank capital issue, the design of the bail-in debt framework is being led by the Department of Finance.

Determining how bail-in debt should work is obviously more complex than NVCC. The government announced in its latest budget that it will consult stakeholders on how best to implement a bail-in regime in Canada, and that implementation timelines will allow for a smooth transition for affected institutions, investors and other market participants.

**Conclusion**

Let me end by reiterating my main points.

1. Canadian bank capital ratios are stronger than they look because they are not relying on the transitional arrangements contained in Basel III. We would welcome more light being shone on the differences in reported capital ratios across jurisdictions.

2. OSFI believes that the major Canadian banks should be among the best when it comes to information disclosure practices. This has been reflected in our D-SIB requirements, and will be evident in additional information that these banks will start disclosing over the course of this year. And,

3. OSFI is looking forward to the introduction of NVCC and bail-in debt instruments. Clear terms and conditions for NVCC instruments will help ensure that all banks can be recapitalized in the future without the taxpayer being the first port of call for new capital.

Thank you again for the opportunity to speak with you today. As you can see, OSFI is not resting on its laurels. We continue to work hard to ensure that Canada's financial system continues to be considered among the safest in the world. I hope this conference is the first of many successful such events in the years to come.