Guideline

Title	Pledging
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I. Introduction

This Guideline is intended to assist federally regulated financial institutionsBanks, trust and loan companies, co-operative credit associations, Canadian insurance companies, and fraternal benefit societies. (FRFIs) in establishing, as required by the relevant provisions of FRFI legislation,The provisions are found in the *Financial Consumer Agency of Canada Act* (S.C. 2001, c.9). The legislative references are sections 419 to 419.2 of the *Bank Act,* sections 383 to 383.2 of the *Cooperative Credit Associations Act,* sections 470 to 470.2, sections 542.07 and 542.071 of *the Insurance Companies Act* and sections 419 to 419.2 of the *Trust and Loan Companies Act*. policies regarding the creation of security interests in their propertyProperty includes the segregated fund assets of federally incorporated life insurance companies and fraternal benefit societies. and the acquisition of beneficial interests in property that is subject to security interests, hereafter referred to as “pledging.” This is not a Guideline pursuant to statutory

authority found in FRFI legislation; therefore, it does not have force of law.

The Guideline outlines factors that OSFI expects the FRFI to consider when establishing pledging policies. These factors are aimed at ensuring that a FRFI's policies reflect its business operations and associated risks and that the policies are implemented effectively.

OSFI expects that FRFIs will also develop pledging policies on an enterprise-wide basis, in a manner consistent with their overall liquidity and other risk management practices.

The Guideline will be applied when the new legislative provisions on pledging come into force. These provisions will require that the directors of a FRFI establish pledging policies, and that the FRFI adheres to those policies. However, the requirements will not apply in respect of pledging by an insurance company or deposit-taking FRFI to secure an obligation to the Bank of Canada or, in the case of a deposit-taking FRFI, to the Canada Deposit Insurance Corporation.

II. Definition

FRFI legislation defines "security interest" as an interest in or charge on property by way of mortgage, lien, pledge or otherwise taken by a creditor or guarantor to secure the payment or performance of an obligation. Although certain activities, such as securities lending, may result in the creation of security interests, actually determining whether a specific activity or transaction results in pledging rests on the particulars of the transaction.

III. Background

OSFI recognizes that pledging is an integral part of a number of activities or transactions that are important to FRFIs' operations. Some of those activities or transactions, such as liquidity management, use of derivatives and securities lending, may themselves be subject to other OSFI guidelines. The objective of pledging by a FRFI is generally to secure its own financial obligations. However, pledging is also part of a number of activities that reduce risk to the FRFI and to the financial system. For example, pledging may be used in support of a FRFI's derivative contracts to hedge interest, currency or other market risks. As well, pledging requirements associated with participation in

certain systems, such as clearing houses and payment systems, can help contribute to reducing systemic risk.

Pledging can affect a FRFI's ability to meet its liquidity requirements. For example, in the event of a liquidity crisis, a FRFI's ability to borrow money may hinge upon the availability of unencumbered assetsFor example, the Bank of Canada, as lender of last resort, lends only on a fully secured basis.. Therefore, OSFI expects FRFIs to consider liquidity risk in establishing their pledging policies. Pledging policies can also affect unsecured creditors, because the higher the proportion of pledged property, the fewer the assets available for unsecured creditors (i.e., depositors, policyholders and other creditors) in the event of a FRFI's insolvency.

OSFI expects FRFIs' pledging policies to reflect an appropriate balance between the need to conduct their business and compete, the responsibility to effectively manage the risks related to their operations, and the interests of their unsecured creditors. In this context, information relating to pledged assets is important from a liquidity management standpoint and, in the event of insolvency, becomes critical for depositors, policyholders and other unsecured creditors. Identifying business activity categories that require pledging and reporting pledged assets are key elements of a FRFI's pledging policies.

IV. Pledging Policies

OSFI expects FRFIs to establish and implement pledging policies that establish the framework within which pledging can occur in relation to various business activities. Where it is appropriate to do so, the policies may specify the parameters for delegation of certain responsibilities and functions necessary to the implementation of some of the elements set out below.

A FRFI's pledging policies should encompass the following elements:

1. An outline of the FRFI's objectives when engaging in activities that require pledging, having regard to the FRFI's policy towards risk and risk management, including its tolerance of risk.

2. A description of the business reasons (e.g., hedging, liquidity management, access to markets, support for its core operations) for the activities or transactions that require pledging. Examples of such activities or

transactions include:

- participation in securities depositories and various clearing and settlement systems (including systems for payments and foreign exchange);
- derivatives operations (e.g., pledging to counterparties in respect of over the counter derivatives operations);
- borrowing on a secured basis (e.g., mortgaging of property);
- securities borrowing/lending;
- reinsurance; and
- capital equivalency deposits (e.g., to satisfy the requirements of a foreign government).

3. Appropriate limits on pledging for particular business activities, having regard to whether the value of the assets pledged is reasonable in relation to the benefits that the FRFI can expect to derive from the activity or transaction that requires pledging. Such limits are particularly important when the activity does not involve risk mitigation. The level of pledging for particular activities and the aggregate level of pledging for the institution, and on an enterprise-wide basis, should be assessed with respect to their significance to the FRFI's liquidity requirements and policies, the strength of its capital and its ability to absorb losses, and to the potential effect that the pledging may have on unsecured creditors, including depositors and policyholders.

4. Quantitative limits on an individual officer's ability to execute agreements or approve transactions that require pledging, taking into account the standards that the FRFI has in place (see item 3). Each FRFI should determine the circumstances where individual (per officer) transaction limits as well as aggregate limits would be appropriate.

5. Measures aimed at monitoring the value of assets pledged in various activities or transactions, as well as the aggregate value of assets pledged, and the performance of appropriate stress tests to determine any additional collateral the FRFI may have to pledge under various scenarios (e.g., market movements or triggers such as rating downgrades).

6. The basis on which reporting and monitoring of pledging should be performed, having regard to the type and nature of the operation and including other factors such as whether contracts are subject to novation or other legally valid forms of netting. Reporting should include information relating to pledged assets and unencumbered assets.

7. The frequency and format of internal reporting for monitoring adherence to the policies.

8. Appropriate practices and procedures to ensure that the policies are respected. For instance, although individual departments engaging in activities or transactions that require pledging are expected to have proper controls in place for these operations, ultimate responsibility for the oversight of all such operations is expected to reside in a single, clearly defined department or individual that is independent of the departments where the operations originate.

Where FRFIs have other internal policies in relation to activities or transactions that require pledging, these policies should be included (or referred to) in their pledging policies.

Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations of FRFI Boards of Directors in regards to operational, business, risk and crisis management policies.