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

Discussion Paper

Pillar 2 Liquidity and Funding Risks:

Designing an Internal Liquidity Adequacy Assessment Process for Canadian Deposit-Taking Institutions

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OSFI BSIF

Canada

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1. Introduction

1. In exercising our mandate as prudential supervisors, we strive to protect the rights and interests of depositors and other creditors, while having due regard for institutions' need to compete and take reasonable risks. One of the most prevalent risks facing institutions[1] is liquidity risk, that is, the potential for losses to be incurred from holding insufficient liquidity to survive a stress event. In our industry surveillance, we persistently identify funding and liquidity risks as top risks. Deficiencies in liquidity risk management were prevalent through the 2023 international banking turmoil and since then, we have spent considerable time reflecting on our capabilities to regulate and supervise these risks.

2. The purpose of this discussion paper is to engage institutions and other interested stakeholders in a dialogue on liquidity adequacy, especially focused on Pillar 2, the supervisory review process. While this paper is not an Office of the Superintendent of Financial Institutions (OSFI) guideline, perspectives from institutions and other stakeholders on Pillar 2 liquidity will inform the potential need for guidance relating to these risks. Subsequent consultation(s) will precede any proposed changes to regulatory guidance.

3. As a member of the Basel Committee on Banking Supervision (BCBS), we establish minimum standards for liquidity adequacy in line with international peers. We call the metrics used for these minimum standards Pillar 1 and rely upon them to ensure a level playing field, on which institutions can compete. However, Pillar 1 minimums do not replace the need for effective risk management and supervision, especially considering risks that are not fully captured in their design. We call this assessment and supervisory review of institutions' liquidity risk management Pillar 2.

2. Context for Pillar 2 liquidity in Canada

4. In June 2004, the BCBS issued a revised capital framework, generally known as Basel 2. This framework introduced the concept and rationale for a three-pillar approach to capital measurement and standards. Subsequent updates to the Basel capital framework, including our current implementation of Basel 3, reflect the same three pillars.

- The first pillar – minimum capital requirements
- The second pillar – supervisory review process
- The third pillar – market discipline

[1] In this discussion paper, institutions refer to all deposit-taking institutions regulated by OSFI. This includes banks, federally regulated trust companies, and federally regulated loan companies.

5. For liquidity adequacy, we present the Basel capital framework along the same three pillars. For liquidity risk, Pillar 1 includes tools from the Liquidity Adequacy Requirements (LAR) Guideline such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Under the third pillar, our Pillar 3 disclosure guidance addresses liquidity risk alongside solvency and other risk disclosures. The second pillar is the subject of this discussion paper.

6. Currently in Canada, we rely on judgement-based supervision, supplemented with quantitative supervisory tools such as the Net Cumulative Cash Flow (NCCF), to recognize and provision for Pillar 2 liquidity risks. As part of our new supervisory framework (implemented in 2024), liquidity adequacy, funding risk, and strength of liquidity management are all important considerations for assessing financial resiliency, a primary input for supervisors establishing an overall risk rating. Supervisors use principle-based guidance and various liquidity monitoring tools to monitor and review Pillar 2 liquidity adequacy as part of the framework. Contingency funding plans and the liquidity and funding elements of resolution and recovery plans are also considered in supervisory assessments.

7. The Bank for International Settlements (BIS) published an executive summary on the Pillar 2 framework that describes the four principles of Pillar 2 capital. Although the principles are expressed in relation to capital, we believe they are equally appropriate and applicable to liquidity. To reflect this, we have taken the four principles for Pillar 2 capital and adapted them for Pillar 2 liquidity. In many regards, we feel this is appropriate given how quickly liquidity risks can materialize. The adapted BIS principles, and corresponding supervisory tools or actions, are included with additional detail in Appendix 1.

- **Principle 1:** Institutions should have a process that assesses overall liquidity adequacy in relation to their risk characteristics, as well as a strategy for maintaining their liquidity levels.
- **Principle 2:** Supervisors should review an institution's internal liquidity adequacy assessments and follow up as needed.
- **Principle 3:** Supervisors should specify their expectation for institutions to operate above the minimum regulatory liquidity ratios.

- **Principle 4:** Supervisors should intervene at an early stage to prevent liquidity from falling below the level required to support an institution's risk profile.

Question 1: What are your views on how the four Basel principles of Pillar 2 should apply to liquidity adequacy in Canada?

8. Currently our Pillar 2 supervisory review process is supported by principles-based guidance, various liquidity monitoring tools, and our supervisory framework. Unlike our capital framework, which includes an internal capital adequacy assessment process (ICAAP), our liquidity framework does not have a codified process for institutions to regularly assess their overall liquidity adequacy as part of the supervisory review process.

9. Implementing an internal liquidity adequacy assessment process (ILAAP) entails both costs and benefits. A primary objective of this discussion paper is to consider the costs and invite stakeholder engagement on how to maximize the benefits. Costs include administrative costs that come with new reporting requirements, as described in section 4. We are also considering the possibility that the introduction of an ILAAP leads to higher supervisory expectations for overall liquidity adequacy. That is, larger liquid asset buffers or currency/region-specific minimums to satisfy Pillar 2 needs. Larger liquid asset buffers are costly to institutions but may also be costly to the economy if they reduce willingness to lend. The goal of the ILAAP is to make the process around buffer design more consistent and risk-sensitive, not to bluntly increase buffers. The introduction of an ILAAP will also tailor supervisory actions and support supervisors in cases where buffers should be reduced or used.

3. Pillar 2 liquidity risks and their impacts on institutions

3.1 Pillar 2 liquidity overview

10. An important element of Pillar 2 is the assessment of risks not fully captured by Pillar 1 requirements. Examples in the capital framework include interest rate risk in the banking book, credit concentration risk, and non-financial risks (such as strategic risk, business model risk, and reputational risk). Our ICAAP guidance is explicit about the importance of considering these risks as part of the overall assessment of capital adequacy. Similarly, in liquidity, we have some risks not fully captured by Pillar 1 requirements or captured without full recognition of mitigation

strategies. An ILAAP would offer institutions a mechanism to provide their own assessment of these risks and corresponding risk management capabilities in order to demonstrate overall liquidity adequacy. In this section we highlight prominent Pillar 2 liquidity risks and consider how institutions might incorporate them into an ILAAP.

3.2 Intraday liquidity risk

11. **What it is:** Intraday liquidity risk arises when an institution fails to manage its intraday liquidity needs effectively. This could leave the institution unable to meet a payment or settlement obligation at the time expected, thereby affecting its own liquidity position and that of other parties. Intraday liquidity adequacy assesses the need for liquid assets throughout the day to support these payment and settlement obligations. From a risk management perspective, institutions need to consider the impacts to:

- *balance sheet resilience risk:* where the use of liquid assets for intraday needs may limit their effectiveness in countering a broader run on liabilities or liquidity stress, and
- *payment and settlement risk:* where prolonged balance sheet stress could deplete liquid asset buffers, disrupting critical payment and settlement operations for the institution and for the system.

12. **Current state:** We recently updated Chapter 7 of the Liquidity Adequacy Requirements (LAR) Guideline, which describes expected monitoring tools for intraday liquidity risk. We plan to implement a regulatory return to begin collecting intraday liquidity usage and stress testing data from Lynx participants later this year. To ensure consistent measurement between institutions, management actions such as payment throttling are excluded from stress testing results for regulatory reporting.

13. We also maintain principles-based guidance for intraday liquidity as part of Guideline B-6 Liquidity Principles wherein we expect institutions to actively manage intraday liquidity positions and risks to meet payment and settlement obligations, on a timely basis, under both normal and stressed conditions. Also, as part of the Guideline B-6 principles, institutions are expected to exclude any amounts pledged to settle payments when considering liquidity adequacy. This ensures that internal measures of liquid asset buffers accurately reflect the resources that can be readily deployed in stress scenarios. However, this is not a requirement in any of our Pillar 1 liquidity metrics.

14. In line with the Basel framework, our Pillar 1 liquidity metrics allow institutions to recognize liquid assets used to support payment and settlement activity, provided they are available at the end of the day. Recognition of liquid assets to satisfy both intraday and end of day stress creates a double-duty risk. This may expose institutions to scenarios in which liquidity is tied down by intraday payment needs thus reducing the institutions' ability to meet Pillar 1 outflows, such as deposit withdrawal, facility draw-down, or margin calls. To mitigate this risk, for domestic currencies, central banks have various tools available to smooth payment flows in the settlement systems, and to make additional intraday liquidity available for payment and settlement needs. Double-duty risk for foreign currency payments made through the correspondent banking network is also important, especially considering the risk of intraday credit lines being restricted. Intraday liquidity risk is subject to periodic supervisory review, and we expect it to be recognized in institutions' internal stress testing and risk management.

15. **Potential future state:** As part of the ILAAP, institutions would aggregate their intraday liquidity metrics and provide additional analysis on how stressed intraday liquidity needs may affect overall liquidity adequacy. This would include recognizing management actions (for example, payment throttling) and the various tools used by management (for example, pledging of non-mortgage loan portfolios) to mitigate risk and ensure smooth settlement. Stress scenarios established in Chapter 7 of the LAR Guideline should be considered alongside any other stress scenarios run as part of recovery and resolution planning. Where intraday liquidity needs may jeopardize overall liquidity adequacy, institutions should hold additional Pillar 2 liquidity.

Question 2: How could an ILAAP capture intraday liquidity risk in assessments of overall liquidity adequacy? What methodologies or tools should institutions adopt to enhance the calibration of intraday liquidity metrics and address double-duty risk?

3.3 Pledging risk and adequacy of unencumbered assets

16. **What it is:** Pledging risk and adequacy of unencumbered assets is the risk that the necessary collateral is unavailable when needed. Institutions routinely pledge or encumber assets as collateral to secure payments and settlements (as discussed in section 3.2), to reduce funding costs (such as with covered bonds), or to reduce a counterparty's risk exposures (such as derivative margin). An institution's pledging practices, and the availability of eligible unencumbered assets are integral to its ability to withstand periods of stress. We often refer to the availability of "dry powder" when assessing the adequacy of unencumbered assets, helping institutions maintain access to funding channels and face increasing collateral requirements through stress.

17. **Current state:** Under Guideline B-11 Pledging we expect institutions to establish and implement pledging policies that include various criteria, such as limits for business activities and measures aimed at monitoring the value of assets pledged. We expect that all pledging risk is recognized in an institution's internal stress testing and risk management, which is subject to periodic supervisory reviews. Given the importance of collateral for financial market infrastructure and lending facilities, the Bank of Canada is also engaged in assessing institutions' pledging risk and their adequacy of unencumbered assets.

18. To limit pledging, our covered bond limit caps the amount of assets that can be pledged to support outstanding covered bonds at 5.5% of total on-balance sheet assets. Supervisors may communicate additional supervisory expectations related to pledging. These requirements are often reserved for higher stages of intervention when the future financial viability of an institution is in doubt and decisions to subordinate the interests of unsecured depositors and creditors need to be carefully considered.

19. **Potential future state:** As part of the ILAAP, institutions would incorporate pledging risks and an evaluation of unencumbered asset availability in their overall assessment of liquidity adequacy. This assessment would include a breakdown of assets currently pledged, where they are pledged, and for what purpose (for example, central bank facility, central counterparty margin, covered bonds). Institutions would also consider the liquidity value (after applying a haircut) of all unencumbered assets, with an assessment of where they could be pledged under various stress scenarios involving contingent collateral needs. Stress scenarios used for assessment should align with those used in recovery and resolution planning.

20. Where unencumbered assets are lodged or pre-positioned for future needs, assessment should also consider the timing benefits as well as

potential costs of pre-positioning. Pre-positioning may reduce operational challenges and speed up access to emergency liquidity, but it may also create added frictions if the unencumbered collateral needs to be mobilized and directed towards a different lender or counterparty than expected. Lastly, assessment should consider regular operational testing of collateral use (for example, access to Bank of Canada facilities or the Federal Reserve discount window) as well as any expected challenges to collateral mobility.

21. Where pledging risks may jeopardize overall liquidity adequacy to support recovery and resolution options under stress, additional Pillar 2 liquidity should be held.

Question 3: How could an ILAAP capture pledging risk and adequacy of unencumbered assets in assessments of overall liquidity adequacy? What opportunities or challenges do institutions foresee in monitoring and assessing available unencumbered assets and pledging capacity?

3.4 Foreign currency liquidity risk

22. **What it is:** Foreign currency liquidity risk is the risk associated with mismatches in assets and liabilities denominated in foreign currencies. Managing and monitoring this risk includes evaluating maturity mismatches and foreign exchange (FX) hedging capacity, including the ability to access counterparties during stress, and ensuring adequate liquidity buffers to meet obligations across multiple currencies under both normal and stressed conditions. In some stress scenarios, access to foreign currencies may differ between the parent (foreign branches) and the foreign subsidiaries.

23. **Current state:** Several of the current liquidity monitoring tools provide line of sight into liquidity positions by significant currency. However, the complexity of managing foreign currency funding and the correspondent hedges presents challenges and creates significant noise in liquidity monitoring tools. Existing practices do not fully account for potential market constraints during stress periods, such as reduced access to foreign exchange markets —both in the FX swap and spot markets—or diminished capacity to mobilize Canadian dollar liquidity for foreign currency needs.

24. **Potential future state:** As part of the ILAAP, institutions would incorporate foreign currency liquidity risk in their overall assessment of liquidity adequacy. Where vulnerabilities exist, currency-specific liquidity mismatch limits should be considered for key business activities to reflect market constraints. Institutions should also identify mitigation strategies and contingency actions to manage FX liquidity risks under stress, including potential usage of foreign currency Emergency Lending Assistance (ELA)

from the Bank of Canada. Additionally, as part of their liquidity risk management framework, institutions would be expected to adhere to the FX Global Code, a set of principles and best practices designed to promote transparency, integrity, and efficiency in the foreign exchange market. Where foreign currency liquidity risks may jeopardize overall liquidity adequacy to support recovery and resolution options under stress, additional Pillar 2 liquidity should be held.

Question 4: How could an ILAAP capture foreign currency liquidity risk in assessments of overall liquidity adequacy? What opportunities or challenges do institutions foresee in monitoring and assessing this risk?

Question 5: What are your views on expected adherence to the FX Global Code?

3.5 Solo and intragroup liquidity risk

25. **What it is:** Solo and intragroup liquidity risk refers to the risk associated with liquidity transferred between a parent institution and subsidiaries. The banking turmoil in 2023 reinforced the importance of intragroup liquidity management and the assessment of trapped liquidity.

26. **Current state:** Many of our existing liquidity monitoring tools assess liquidity as fungible across all regions and legal entities unless explicit liquidity transfer restrictions are in place. This is the case for subsidiaries such as retail banks insured by the Federal Deposit Insurance Corporation (FDIC), which need to report most liquidity measures separately, or exclude their excess liquidity from consolidated metrics. At present, we recognize that additional frictions for intragroup liquidity transfer could materialize, requiring supervisors to collect ad hoc data to monitor liquidity needs by legal entity. We also acknowledge there may be practical overlaps between solo and intragroup liquidity supervision and the recently implemented Parental Stand-Alone (Solo) Total Loss Absorbing Capacity (TLAC) framework for domestic systemically important banks.

27. **Potential future state:** As part of the ILAAP, institutions would incorporate liquidity transfer risks and intragroup liquidity management in their overall assessment of liquidity adequacy. Through ongoing work, we expect to learn more about broader liquidity transfer risks facing select branches and foreign subsidiaries that have been fully consolidated in Pillar 1 measures. Overall liquidity adequacy assessment should consider the ongoing feasibility of liquidity transfer across entities, sectors, and countries, even under stress. Where appropriate, legal entity specific minimums, or adjustments to consolidated minimums, should be

considered. In assessments of short-term stress scenarios, institutions should evaluate their liquidity under the most severe assumptions as contemplated in their recovery and resolution plans, such as restricted intragroup credit access or only one way liquidity flows from the parent to the subsidiaries.

Question 6: How should the solo TLAC framework be leveraged for the supervisory review of solo and intragroup liquidity risk?

Question 7: How could an ILAAP capture solo and intragroup liquidity risk in assessments of overall liquidity adequacy? What opportunities or challenges do institutions foresee in monitoring and assessing this risk?

3.6 Franchise viability risk

28. **What it is:** Franchise viability risk refers to the potential liquidity pressures arising from actions taken to preserve an institution's reputation or market access, such as decisions to maintain trading inventories or unplanned debt buybacks during periods of liquidity stress. These actions can reduce the amount of liquidity that an institution can practically use and can also lead to unforeseen liquidity outflows. Both scenarios impact the institution's ability to meet obligations and risk undermining its competitive position if not properly provisioned for.

29. **Current state:** Some franchise viability considerations are factored into the calibration of Pillar 1 metrics. For example, the LCR includes outflows for debt buyback under contingent funding obligations, and the NSFR requires 10% stable funding for reverse repo of level 1 high quality liquid assets. Both assumptions assume actions taken by institutions to preserve their reputation and maintain market access. However, these are the assumptions we made as regulators when calibrating Pillar 1. While we recognize that institutions may have differing views on some aspects of risk, we expect some franchise viability assumptions to be more relaxed and others to be more stringent.

30. **Potential future state:** As part of the ILAAP, institutions would incorporate franchise viability risks into their overall assessment of liquidity adequacy. We expect this to be one of the most significant differentiators between the Pillar 1 results and institutions' own assessments as they consider institution-specific views on liquidity actions taken or removed to preserve their reputation or franchise. Where franchise viability risks may jeopardize overall liquidity adequacy to support recovery and resolution options under stress, additional Pillar 2 liquidity should be held.

Question 8: How could an ILAAP capture franchise viability risk in assessments of overall liquidity adequacy to better address reputational and market access considerations? What opportunities or challenges do institutions foresee in assessing this risk?

3.7 Short-term (5 day) liquidity risk

31. **What it is:** Short-term liquidity risk, as exhibited during the 2023 banking turmoil, usually occurs over a shorter period of time, such as five days. Stressed short-term liquidity metrics aim to estimate the liquidity an institution requires to operate effectively during periods of severe stress lasting a few days, rather than a full month. High velocity of cash outflows enabled by digitization is a key source of liquidity risk in today's world. It challenges an institution's preparedness in responding to rapid unfolding of stress. Having short-term liquidity metrics complements the existing LCR and NCCF measures, which are designed to capture preparedness for longer periods of stress. Short-term (5 day) liquidity adequacy should also be tailored to the institution's specific risk profile given different product and customer exposures and different approaches institutions may take to monetize liquid assets.

32. **Current state:** Supervisors can approximate short-term liquidity needs by conducting sensitivity analysis using existing liquidity monitoring tools such as the NCCF metric, but more bespoke metrics would be needed to guide supervisory actions during stress. These bespoke metrics could include institution-specific measures that account for differences in product structures, customer behaviors, and funding instruments. For example, banks may require customized assumptions on run-off rates, funding costs, and liquidity buffer usability to reflect their specific risk profiles. Developing such metrics would enhance the ability to assess short-term liquidity resilience beyond existing standardized tools.

33. **Potential future state:** As part of the ILAAP, institutions would incorporate short-term (5 day) liquidity adequacy into their assessment of overall liquidity adequacy. Introducing a short-term liquidity metric into the assessment would help us in tailoring liquidity adequacy assessment to institution-specific risks. Additionally, this new metric would enhance alignment with international best practices by ensuring institutions assess near-term liquidity needs under both business-as-usual and stress conditions.

Question 9: How could an ILAAP capture short-term (5 day) liquidity adequacy in assessments of overall liquidity adequacy? What opportunities or challenges do institutions foresee in implementing stressed short-term

liquidity metrics?

3.8 Assessment of product liquidity risk

34. **What it is:** For effective liquidity risk management, institutions should develop their own liquidity risk assessments for all assets, liabilities, and off-balance sheet commitments. While Pillar 1 classifications provide a baseline, institutions should not solely rely on them when making product decisions. Instead, an internal approach to assessing liquidity risk in products ensures that institutions proactively manage liquidity risk.

35. Periodically, we expect institutions' assessment of product liquidity risk to differ from the Pillar 1 treatment or to guide which Pillar 1 category a product falls. As an example, new funding arrangements and financial products such as partnership deposits and tokenized assets or liabilities do not always fit neatly into Pillar 1 liquidity classifications. Where products such as these exhibit risk characteristics that differ from prescribed regulatory treatment the institution's own assessment of product liquidity risk is important.

36. **Current state:** Most institutions reflect their own assessment of a product's liquidity risk in their internal liquidity stress testing and transfer pricing programs. For some new products, we note that many institutions need to rely on expert judgment given the lack of historical data. This can lead to inconsistencies in liquidity treatment, particularly for new products that remain untested in stress scenarios.

37. **Potential future state:** As part of their ILAAP, institutions would develop a structured classification framework that systematically evaluates their own assessment of product liquidity risk. This would include:

- A clear taxonomy for all products, mapping them to traditional liquidity risk categories where applicable and establishing bespoke liquidity treatment where necessary.
- Empirical analysis and scenario testing, incorporating historical market behavior and customer redemption or withdrawal patterns.
- Dynamic stress testing that adjusts liquidity treatment based on evolving market conditions, including changes in investor behavior and macroeconomic factors.
- Internal governance to ensure that new product classifications are validated, monitored, and updated as needed.

38. By adopting this approach, institutions could better anticipate liquidity

risks, strengthen their ILAAP and improve resilience especially when engaging with new financial products. Where an institution's own assessment of liquidity risk may jeopardize overall liquidity adequacy additional Pillar 2 liquidity should be held.

Question 10: How could an ILAAP capture an institution's own assessment of liquidity risk by product? How do you currently classify and assess product-level liquidity risks, irrespective of their treatment in Pillar 1 metrics?

4. Integrating the ILAAP with recovery and resolution planning

39. We believe that the ILAAP would serve as a strong complement to recovery and resolution planning by reinforcing a proactive approach to liquidity risk management, ensuring institutions are prepared for both idiosyncratic and systemic liquidity stress. While resolution planning focuses on maintaining financial stability and protecting depositors in the event of a failure, ILAAP strengthens this by requiring institutions to assess their liquidity adequacy under various stress scenarios, including those that could trigger recovery or resolution. By integrating the ILAAP with recovery and resolution frameworks, institutions could better anticipate and address liquidity shortfalls before they escalate into crises.

40. Seamless integration between the ILAAP and recovery and resolution planning can be achieved by ensuring that institutions' liquidity risk management practices account for resolution-specific funding needs. The ILAAP emphasizes governance, stress testing, and contingency planning, which can be enhanced by incorporating resolution liquidity metrics, such as access to emergency funding mechanisms and pre-positioning of unencumbered liquid assets. Similarly, resolution strategies can benefit from the ILAAP's structured approach to identifying liquidity vulnerabilities early and implementing corrective actions before a crisis materializes. This synergy enables a smooth transition from heightened liquidity monitoring in recovery to structured liquidity execution in resolution, ultimately strengthening financial system resilience and depositor confidence.

Question 11: What are your views on aligning the ILAAP with recovery and resolution planning to ensure sufficient liquidity is available throughout both recovery and resolution phases?

5. Structure of the Internal Liquidity Adequacy Assessment Process

41. The ILAAP, akin to ICAAP, evaluates an institution's internal liquidity risk management, offering a comprehensive approach to measure, monitor, and report liquidity positions and risks while identifying key risk drivers outside of Pillar 1. In developing the ILAAP, we draw inspiration from peer regulators, which have more mature Pillar 2 liquidity frameworks and established ILAAP requirements.

42. Not all elements of Pillar 2 liquidity risk may be applicable to all institutions. The internal risk management assessment should be proportional to the size, complexity, and risk profile of the institution. We may consider further refinement using the categories established in the Small and Medium-Sized Deposit-Taking Institutions (SMSB) Capital and Liquidity Requirements Guideline and developing more streamlined expectations for Category 3 SMSBs. Initially, we would consider application of the ILAAP components as follows:

Risk or gap to address	Application
Intraday liquidity risk	Direct participants of Lynx
Pledging risk and adequacy of unencumbered assets	Systemically important banks (SIBs) and SMSBs
Foreign currency liquidity risk	SIBs
Solo and intragroup liquidity risk	SIBs
Franchise viability risk	SIBs
Short-term (5 day) liquidity risk	SIBs and SMSBs
Assessment of product liquidity risk	SIBs and SMSBs

43. The structure of the ILAAP submission may include liquidity reporting against Pillar 1 requirements, internal liquidity risk assessments (including Pillar 2 risks such as those described in section 3), and an internal risk management assessment against the expectations of Guideline B-6. Institutions' self-assessments of their contingency funding plans may also feature as an important element. These elements would apply to SIBs and

SMSBs.

44. Institutions would be expected to submit an ILAAP submission on a regular basis, with the frequency and scope varying depending on proportionality considerations. Refer to Appendix 2 for the proposed structure and content of ILAAP submissions. Institutions with more complex governance structures or multiple legal entities may require a more detailed or frequent ILAAP submission. Senior management would be responsible for overseeing the design and implementation of the institution's ILAAP.

Question 12: What are your views on proportionality for potential implementation of an ILAAP? How should the categorization of institutions in the SMSB Capital and Liquidity Requirements Guideline be leveraged?

Question 13: What are your views on potential ILAAP reporting requirements? How could they best be aligned with existing practices?

Question 14: What are the current capabilities of your institution with regards to the above proposed ILAAP expectations?

Question 15: What are your views on the costs and benefits of introducing a more structured approach to Pillar 2 liquidity assessment? Do you anticipate any barriers, challenges, or unintended consequences? If so, are these challenges expected to be short-term in nature or ongoing?

6. Next steps

45. We are seeking input and views on the content of this discussion paper including the key features of a potential ILAAP for institutions. We recognize the implementation of an ILAAP would represent a material change in how we supervise liquidity in Canada, and we expect implementation to take time. While we are aiming to closely align the framework with existing capabilities, we acknowledge that many new processes and some new infrastructure may be necessary for institutions and supervisors.

46. Comments received in response to this discussion paper will be used to inform future work on the topic. The questions contained in the sections above are designed to enable OSFI to aggregate stakeholder views. In your submission, please identify the questions you are responding to. You are not required to respond to all questions in your submission. Responses are requested by **August 22, 2025**, and should be sent to Consultations@osfi-bsif.gc.ca.

Appendix 1 – The four principles of Pillar 2[2]

Principles	Objective	Considerations	Supervisory tools/actions
Principle 1 (Institutions' responsibility)	Institutions should have a process that assesses their overall liquidity adequacy in relation to their risk characteristics, as well as a strategy for maintaining their liquidity levels.	Institutions' assessments of their liquidity adequacy should reflect the application of the principle of proportionality, i.e., be appropriate for a institution's size, risk profile and complexity.	• Board and senior management oversight • Sound liquidity assessment • Comprehensive assessment of risks • Monitoring and reporting • Internal control
Principle 2 (supervisory responsibility)	Supervisors should review a institution's internal liquidity adequacy assessments and follow up as needed	Supervision of institutions requires supervisory discretion and involves the application of a variety of tools. This principle can reflect the application of proportionality. The supervisory review should be undertaken in a transparent and accountable manner. Supervisory action should require institutions to address any deficiencies in a timely fashion.	• On-site examinations • Off-site reviews • Reviews of work by external auditors and other parties • Periodic reporting by the institution • Discussions with institution's management
Principle 3 (supervisory responsibility)	Supervisors should specify their expectation for institutions to operate above the minimum regulatory liquidity ratios.	Supervisors must make sure that non-financial risks and risks not fully captured under Pillar 1 are included in the requirement for institutions to operate at liquidity levels above those implied by Pillar 1 minima. This principle can reflect the application of proportionality. The implementation of Pillar 2 does not require a system of automatic liquidity add-ons for all or individual institutions.	• Supervisory authorities need sufficient statutory powers
Principle 4 (supervisory responsibility)	Supervisors should intervene at an early stage to prevent liquidity from falling below the level required to support a institution's risk profile.	This principle reflects the application of proportionality with supervisory actions tailored to a institution's size, risk profile and complexity. Basel III liquidity buffers must be adequately reflected.	• Intensifying the monitoring of the institution • Restricting current business activities • Prohibiting new activities or acquisitions • Restricting or prohibiting dividend payments • Requiring institutions to restore liquidity levels • Requiring institutions to raise additional liquidity

[2] The Basel capital principles are referenced and adapted.

Appendix 2 – Proposed structure and content of ILAAP submission

Heading	Details
Overview	This section is for introductory text describing the business model, the reach and systemic presence of the institution. Institutions should describe any internal and external changes since the last liquidity review. Institutions should include any changes in the scope of the submission since the last review by senior management. Institutions should justify the comprehensiveness and proportionality of their process. (Proportionality may also be addressed under the relevant headings below where this fits better).
Summary conclusions	In this section, institutions should provide the summarized conclusions of their overall liquidity adequacy review, stating how and whether they meet the LAR Guideline. Institutions should discuss any shortcomings and remedial plans. The institution should present its assessment of any additional liquidity it believes it should hold to account for risks not captured in Pillar 1.
Liquidity reporting to support Pillar 1 and other LAR metrics (SIBs and SMSBs)	
LCR reporting	In this section, institutions should discuss their approach to ensure compliance with the LCR.
NSFR reporting	In this section, institutions should discuss their approach to ensure compliance with the NSFR.
NCCF reporting	In this section, institutions should discuss their approach to ensure compliance with the NCCF (comprehensive for SIBs and streamlined for SMSBs).
Intraday liquidity reporting	In this section, institutions should discuss their approach to ensure compliance with the Intraday Liquidity monitoring requirements (comprehensive for SIBs).
OCFS reporting	In this section, institutions (Category 3 institutions) should discuss their approach to ensure compliance with the Operating Cashflow Statement (OCFS).
Other liquidity reporting	In this section, institutions should discuss their approach to ensure compliance with the other regulatory liquidity reporting as outlined in the applicable OSFI guidelines.
Pillar 2 liquidity risk assessment	
Intraday liquidity risk (Direct participants of Lynx)	In this section, institutions should leverage intraday usage and stress testing results to consider impacts of intraday liquidity risk on their assessment of overall liquidity adequacy, recognizing double-duty risks as well as expectations around central bank intervention. From a risk management perspective, institutions should consider the impacts to: 1. Balance sheet resilience risk: where the use of liquid assets for intraday needs may limit their effectiveness in countering a broader run on liabilities or liquidity stress, and 2. Payment and settlement risk: where prolonged balance sheet stress could deplete liquid asset buffers, disrupting critical payment and settlement operations.
Pledging risk and adequacy of unencumbered assets (SIBs and SMSBs)	In this section, institutions should assess the risks associated with their pledging activities by considering: 1. The institution's internal pledging limits and governance policies. 2. Available pledging capacity, including unencumbered asset quality and eligibility for pledging with central banks.

	3. Stress testing framework to determine any additional collateral needed to be pledged under various scenarios. 4. Contractual obligations which may require pledging of additional collateral. 5. Expected access to central bank facilities in a stress environment, including any assumptions made.
Foreign currency liquidity risk (SIBs only)	In this section, institution should incorporate foreign currency liquidity risks in their overall assessment of liquidity adequacy. Where appropriate, currency-specific liquidity mismatch limits would be considered for key business activities to reflect market constraints.
Solo and intragroup liquidity risk (SIBs only)	In this section, institutions should assess liquidity risks by assessing the following liquidity metrics, if applicable, on a standalone basis: LCR, NSFR, NCCF, Intraday Liquidity. Institutions should further evaluate their liquidity through short-term stress scenarios under the assumption of no intragroup credit access.
Franchise viability risk (SIBs only)	In this section, institutions should incorporate franchise viability risks in their overall assessment of liquidity adequacy, as it's one of the most significant differentiators between the Pillar 1 results and the institution's own assessment as they consider institution-specific views on liquidity actions taken or removed to preserve their reputation or franchise.
Short-term (5 day) liquidity risk (SIBs and SMSBs)	In this section, institutions should incorporate short-term (5 day) liquidity adequacy into their assessment of overall liquidity adequacy. Institutions should calibrate the metric for a period of 5 consecutive days of acute stress, incorporating institution-specific risks. Monetization assumptions should align with contingency funding plans and liquidity run-off and draw-down assumptions should reflect past institution and/or industry experience.
Assessment of product liquidity risk (SIBs and SMSBs)	In this section, institutions should provide internal views on product liquidity risk. Institutions should demonstrate that they do not solely rely on regulatory treatments like LCR and NSFR but instead apply robust internal methodologies to evaluate funding stability, redemption behaviors, and stress scenarios. The framework should include a clear taxonomy for classifying new products, empirical analysis to validate assumptions, dynamic stress testing that adapts to market conditions, and governance mechanisms to ensure ongoing reassessment. Additionally, institutions should integrate liquidity risk considerations into product development decisions, ensuring that financial innovation aligns with prudent risk management and regulatory expectations.
Institution's liquidity risk management assessment (SIBs and SMSBs)	
Institutions' assessment of risk strategy and risk appetite	In this section, institutions should describe the risk appetite and strategy, how they were devised, approved, monitored, and reported, and how they are communicated throughout the institution.
Institutions' organizational framework, policies and procedures	In this section, institutions should describe the governance and management arrangements around the ILAAP including the involvement of the governing body. They should also describe the risk framework overall and as it pertains to liquidity and funding risks, the technical and staff resources. The approach to maintaining market access should be included.
Institutions' risk identification,	In this section, institutions should describe the framework and IT systems for identifying, measuring, managing, monitoring and reporting (internal and external) of

measurement, management, monitoring and reporting	liquidity and funding risks, including intraday risk. Institutions should describe the assumptions and methodologies adopted. Institutions should provide evidence of key indicators and a description of internal information flows.
Institutions' liquidity-specific stress testing	In this section, institutions should analyze the internal stress testing framework, including the process and governance of and challenge to scenario design, derivation of assumptions and design of sensitivity analysis, and the process of review and challenge and relevance to the risk appetite. The process by which the stress results are produced, and incorporated into the risk framework and strategic planning, and the liquidity recovery process should be scrutinized. The results and conclusions should be analyzed, with breakdown by each relevant risk driver.
Institutions' liquidity risk internal control framework	In this section, institutions should describe their internal limit and control framework, including the limits and controls around liquid asset buffers, and the appropriateness of the limit structure to the risk appetite. Institutions should describe the transfer pricing framework here, for example how the methodology was developed, the process controlled, monitored, and reviewed, and the results cascaded throughout the institution to drive behaviors and support performance measurement and business incentives.
Funding plans	In this section, institutions should provide the full funding plan to demonstrate how it will support the projected business activities in both businesses as usual and stress, implementing any required improvements in the funding profile and evidencing that the risk appetite and key metrics will not be breached by the planned changes. Institutions should discuss risks to the plan. Where a funding strategy is new, institutions should detail the implementation procedures.