Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel large exposures regulations – Canada

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BANK FOR INTERNATIONAL SETTLEMENTS

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Contents

Glossary

BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
C	Compliant (grade)
CAD	Canadian dollars
CAR	Capital Adequacy Requirements
D-SIB	Domestic systemically important bank
DTI	Deposit-Taking Institution
Fannie Mae	Federal National Mortgage Association
FAQs	Frequently asked questions
Freddie Mac	Federal Home Loan Mortgage Corporation
G-SIB	Global systemically important bank
GSE	Government-sponsored entity
LC	Largely compliant (grade)
LCR	Liquidity Coverage Ratio
LEX	Large exposures
MNC	Materially non-compliant (grade)
NC	Non-compliant (grade)
OSFI	Office of the Superintendent of Financial Institutions
RCAP	Regulatory Consistency Assessment Programme
SCCL	Single-Counterparty Credit Limits
SIG	Supervision and Implementation Group

Preface

The Basel Committee on Banking Supervision (Basel Committee) places a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits from adopting Basel standards can only fully accrue if these are implemented fully, consistently and in a timely manner by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework.

This report presents the findings of an RCAP Assessment Team on the domestic adoption of the Basel large exposures (LEX) framework in Canada. The assessment focused on the completeness and consistency of the domestic regulations published on 10 April 2019 and effective 1 November 2019, as applied to domestically systemically important banks (D-SIBs) in Canada, with the Basel LEX framework. Issues related to prudential outcomes, the resilience of the banking system or the supervisory effectiveness of the Canadian authorities were not in the scope of this assessment. The assessment relied on regulations, other information and explanations provided by the Canadian authorities and ultimately reflects the view of the Basel Committee.

The RCAP Assessment Team was led by Ms Kerstin af Jochnick, First Deputy Governor of the Riksbank, Sweden. It comprised four technical experts, from Australia, the European Union, the United Kingdom, and the Basel Committee Secretariat (see Annex 1). The main counterpart for the assessment was the Office of the Superintendent of Financial Institutions (OSFI), Canada. The work was coordinated by the Basel Committee Secretariat with support from staff from Sveriges Riksbank.

The assessment began in the middle of 2018 and comprised three phases: (i) self-assessment by the assessed jurisdiction's authorities (September to November 2018); (ii) an assessment phase (November 2018 to April 2019), including an on-site assessment involving discussions with the Canadian authorities and representatives from Canadian banks; and (iii) a review phase (April to June 2019), including a technical review of the Assessment Team's findings by a separate RCAP Review Team, the Committee's Supervision and Implementation Group, the RCAP Peer Review Board and the Basel Committee. More information on the RCAP assessment process is available on the Committee's website.[1]

The RCAP Assessment Team acknowledges the cooperation received from OSFI counterparts throughout the assessment process. In particular, the team thanks the staff of OSFI for playing an instrumental role in coordinating the assessment exercise.

[1] See www.bis.org/OSFIs/implementation.htm.

Executive summary

In Canada, the large exposures (LEX) framework applies to all domestic systemically important banks (D-SIBs) on a consolidated basis. The framework was implemented by way of a Large Exposure guideline issued on 10 April 2019 and will become effective on 1 November 2019.

Overall, as of 15 April 2019, the large exposures regulations in Canada are assessed as compliant with the Basel LEX framework. This is the highest grade. Each component is also assessed as compliant.

No findings were identified. The Assessment Team noted that the OSFI LEX framework is super-equivalent to the Basel LEX framework in several areas (see Annex 4). These include a tighter limit for exposures to systemically important banks (SIBs). In accordance with the methodology and guidance provided in the RCAP Handbook for jurisdictional assessments, the stricter rules have not been taken into account as a mitigant for the overall or component-level assessment of compliance.

The Assessment Team recognises the efforts made by OSFI to improve the consistency of its LEX regulation throughout the assessment process. These amendments were included in the final guidance issued by OSFI on 10 April 2019 and effective 1 November 2019 (see Annex 3 for a complete list of the amendments).

Response from OSFI

OSFI would like to express our sincerest thanks to Ms Kerstin af Jochnick and to all the members of the Assessment Team and the Secretariat for their professionalism and openness during the review process. Their expertise and integrity throughout the assessment led to productive and insightful discussions on the Canadian Large Exposure framework.

OSFI welcomes and shares the overall rating of highest with the Basel Large Exposure standards, both for the individual components and the overall rating. This reflects our decisions to incorporate the Basel standard both in substance and in form into our framework for domestic systemically important banks.

OSFI is committed to the RCAP process and we believe it provides everyone with the opportunity to implement the global standards agreed to at the Basel Committee in the manner intended. It provides the opportunity to assess our own implementation and benchmark ourselves against our peers.

1 Assessment context

1.1 Status of implementation of the large exposures framework

OSFI first introduced the Large Exposure Limits Guideline ("Current Guideline B-2") for federally regulated Deposit-Taking Institutions ("DTIs") over two decades ago, in 1994. The Current Guideline B-2 restricts the aggregate exposure of an institution to any single counterparty or a group of connected counterparties to 25% of the institution's eligible capital base. This Guideline has been complemented with a guidance note on the application of the guideline issued in 2001.

OSFI issued an updated large exposure guideline which underwent public consultation in December 2018, and published final guidance in April 2019. The final guideline ("D-SIB Guideline B-2") is effective 1 November 2019 and applies to all Canadian D-SIBs on a consolidated basis. The D-SIB Guideline B-2 combines the requirements of the Current Guideline B-2 and the Basel Committee's Supervisory Framework for Controlling and Measuring Large Exposures (April 2014) as well as the relevant Frequently Asked Questions published by the Committee (September 2016).

All other DTIs[2] continue to be subject to the Current Guideline B-2 until OSFI has the opportunity to review the guideline for this subset of institutions.

1.2 Regulatory system

OSFI was established as the sole prudential regulator in Canada, under the Office of the Superintendent of Financial Institutions Act (OSFI Act) on 2 July 1987. This grants OSFI the power to issue guidance in the form of Guidelines, Advisories and public letters. These documents are used to establish policy on minimum, best or prudent practices and to set out OSFI's expectations and requirements for banks.

OSFI is an independent government agency, funded by levies on the institutions that it regulates. It reports to Parliament through the Minister of Finance. OSFI is responsible for banking regulation and supervision. The Bank of Canada, Canada Deposit Insurance Corporation, and the Department of Finance each have complementary responsibilities for financial stability.

1.3 Structure of the banking sector

In September 2018, there were 72 banks operating in Canada, with assets and off-balance sheet exposures of around CAD 6.0 trillion. The financial system is dominated by the six largest banks, one of which has been designated as a G-SIB and the others as D-SIBs. These banks comprise more than 90% of the exposures of the Canadian banking system and all of the exposures of the Canadian internationally active banks. The RCAP Assessment Team focused on these banks in evaluating the materiality of its findings.

1.4 Scope of the assessment

The Assessment Team considered the large exposure limits applicable to Canadian D-SIBs, which were published on 10 April 2019 and will be effective 1 November 2019. The assessment had two dimensions:

- a comparison of domestic regulations with the Basel large exposures framework to ascertain that all the required provisions have been adopted (*completeness* of the regulations); and

[2] This excludes subsidiaries of the Canadian D-SIBs that are incorporated under the *Bank Act* and the *Trust and Loan Companies Act*.

- whether there are any differences in substance between the domestic regulations and the Basel large exposures framework and, if so, their significance (*consistency* of the regulations).

In its assessment, the RCAP Assessment Team considered all binding documents that effectively implement the Basel large exposures framework in Canada. Annex 2 lists the Basel standards used as the basis for the assessment. The Assessment Team also discussed the binding nature of the guidelines with OSFI and the sample banks and it was clear that the guidelines have a binding nature despite the use of the terminology guideline, which in other jurisdictions would not necessarily be interpreted as such. Note that the assessment did not evaluate the resilience of the banking system in Canada or the supervisory effectiveness of OSFI.

As set out in the RCAP methodology, the Assessment Team evaluated the materiality and potential materiality of identified deviations between the Basel large exposures framework and the local regulations. The quantification was limited to a sample of banks. In addition, the Assessment Team reviewed the non-quantifiable aspects of identified deviations and applied expert judgment as to whether the domestic regulations meet the Basel framework in letter and in spirit.

The Assessment Team noted that, in some areas, the assessed jurisdiction's rules go beyond the minimum Basel standards. Although these elements (listed in Annex 4) provide for a more rigorous implementation of the Basel framework, they have not been taken into account for the assessment of compliance.

The outcome of the assessment is summarised using a four-grade scale, both at the level of each of the three key components of the Basel large exposures framework and the overall assessment of compliance. The four grades are: compliant, largely compliant, materially non-compliant and non-compliant.

2 Assessment findings

2.1 Assessment grades and summary of findings

Overall, the Assessment Team finds the implementation of the large exposures framework in Canada to be compliant with the Basel standards. This grade takes into account the rectifications issued by OSFI up to April 2019, as described in Annex 3.

Assessment grades

Table 1

Component of the Basel LEX framework	Grade
Overall grade	C
Scope and definitions	C
Minimum requirements and transitional arrangements	C
Value of exposures	C

Assessment scale: C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant).

2.1.1 Scope and definitions

The Canadian regulation on the scope and definition requirements is compliant with the Basel LEX framework. No findings were identified.

2.1.2 Minimum requirements and transitional arrangements

The Canadian regulation on the minimum requirements and transitional arrangements is compliant with the Basel LEX framework. No findings were identified. The Assessment Team noted as an observation a delay in the implementation of the Basel LEX framework by Canada.

2.1.3 Value of exposures

The Canadian regulation on the value of exposures is compliant with the Basel LEX framework. No findings were identified.

2.2 Detailed assessment findings

2.2.1 Scope and definitions

The component is judged to be compliant with the Basel LEX framework. No findings were identified.

2.2.2 Minimum requirements and transitional arrangements

The component is judged to be compliant with the Basel LEX framework. No findings were identified.

2.2.3 Value of exposures

The component is judged to be compliant with the Basel LEX framework. No findings were identified.

2.3 Observations on the implementation of the large exposures framework in Canada

The following observations highlight certain special features of the regulatory implementation of the Basel large exposures framework in Canada. These are presented to provide additional context and information. Observations do not have a bearing on the assessment outcome.

2.3.1 Scope and definitions

Basel paragraph number	10-12: Scope and level of application
Reference in the domestic regulation	Paragraph 1 of OSFI's D-SIB Guideline B-2
Observation	The Basel LEX framework is applicable to all internationally active banks on a consolidated basis. In Canada, the LEX framework applies to Canadian D-SIBs only. Currently, these are the only internationally active banks in Canada. Therefore, at the current time, the scope of application is the same in substance as that required under the Basel standard. A bank seeking to start international operations may require regulatory approval under the Bank Act, depending on the nature and structure of the operations. OSFI would be aware of any material changes to a bank's business model given its supervision of the institution. Should a non D-SIB become internationally active, OSFI could determine that the D-SIB Guideline B-2 would be applied to that bank. Meanwhile, OSFI continues to apply the 1994 version of Guideline B-2 to non D-SIBs for their single-name concentration risk.

2.3.2 Minimum requirements and transitional arrangements

Basel paragraph number	93: Implementation Date
Reference in the domestic regulation	Page 1 of OSFI's D-SIB Guideline B-2
Observation	The Basel LEX framework notes that all aspects of the framework must be fully implemented by January 2019. OSFI's guideline will come into force on 1 November 2019.

2.3.3 Value of exposures

Basel paragraph number	61: Sovereign entities and entities connected with sovereigns
Reference in the domestic regulation	Paragraph 14(f)(2) and footnote 11 on OFSI's D-SIB Guideline B-2
Observation	The Basel LEX framework exempts banks' exposures to sovereigns and their central banks. This also applies to public sector entities treated as sovereigns according to the risk-based capital requirement and any portion of exposure guaranteed by, or secured by, financial instruments issued by, sovereigns. OSFI recognises the financial support provided by the US government to certain US government-sponsored entities (GSEs) – the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for which a conditional exemption exists under the US Single-Counterparty Credit Limits (SCCL) rule. OSFI included a conditional exemption for exposure to these two entities so long they are under conservatorship or receivership of the US government. This treatment broadly aligns with the US Federal Reserve under its SCCL rule and is consistent with the observation made in the US RCAP Liquidity Coverage Ratio (LCR) report.[3]

3 www.bis.org/bcbs/publ/d409.pdf

Annexes

Annex 1: RCAP Assessment Team and Review Team

Assessment Team Leader

Ms Kerstin af Jochnick	Sveriges Riksbank, Sweden

Assessment Team members

Mr Paul Veerhuis	Australian Prudential Regulation Authority
Ms Lynnette Withfield	Bank of England
Mr Luis Del Olmo	European Banking Authority
Mr Puneet Pancholy	Basel Committee Secretariat

Supporting members

Ms Amelie Stierna	Sveriges Riksbank, Sweden
Mr Olivier Prato	Basel Committee Secretariat
Mr Masaya Hatoma	Basel Committee Secretariat

Review Team members

Mr Neil Esho	Basel Committee Secretariat
Mr Ko Nishiuchi	Financial Services Agency, Japan
Mr Sang Don Lee	Financial Supervisory Service of Korea
Mr Stefan Hohl	Bank for International Settlements, Financial Stability Institute

Annex 2: List of Basel standards and implementing regulations issued by the Canadian authorities

The following Basel standards were used as the basis of this RCAP assessment:

- *Supervisory framework for measuring and controlling large exposures*, September 2016
- *Frequently asked questions on the supervisory framework for measuring and controlling large exposures*, September 2016

Table A.1 lists the regulations issued by OSFI to implement the large exposures framework in Canada. Previous RCAP assessments of Canadian implementation of the Basel standards considered the binding nature of regulatory documents in Canada.[4] This RCAP Assessment Team also concluded that the guidelines described in Table A.1 could be considered as binding on banks and supervisors for the purposes of an RCAP assessment.

Overview of relevant regulations on large exposures — Table A.1

Domestic regulations	Type, version and date
Large Exposure Limits (D-SIBs)	Guideline April 2019, effective 1 November 2019
Large Exposure Limits (all other banks)	Guideline December 1994

Source: OSFI.

[4] See Annex 7 of the RCAP assessment of the Basel III risk-based capital regulations in Canada, published in June 2014 and available at www.bis.org/OSFIs/publ/d320.htm.

Annex 3: Rectifications made by OSFI

List of rectifications by the OSFI — Table A.2

Basel paragraph	Reference in Canadian regulations	Description of the rectification
65	Paragraph 14(k) and footnote 12	The Basel framework allows for the exclusion of intra-day interbank exposures. In addition to intra-day interbank exposures, OSFI's draft guideline had included an exemption of intraday exposures with non-banks as well as daylight overdrafts. OSFI removed the exemption in the final guideline.
68	Footnote 16	The Basel framework includes a definition of covered bonds which is then relevant to the treatment of covered bonds as outlined in paragraphs 69 to 71. In the final guideline, OSFI added a cross-reference to a definition of covered bonds in OSFI's Liquidity Adequacy Requirements Guideline. This covered bond definition is consistent with the definition used by Basel in paragraph 68.

Source: OSFI.

Annex 4: Areas where the Canadian rules are stricter than the Basel standards

In four areas, the Canadian authorities have adopted a stricter approach than the minimum standards prescribed by the Basel Committee. These are listed below for information. The stricter rules have not been taken into account as mitigants for the overall or component-level assessment of compliance.

Basel paragraph number	13: Scope of counterparties and exemptions
Reference in the domestic regulation	Paragraph 1 14(d), and 14 (f)(3) of OSFI's D-SIB Guideline B-2
Description	OSFI provides a narrower exemption than Basel for exposures to sovereigns and central banks. OSFI's exemption is provided for these exposures where they are (i) subject to 0% risk weight under OSFI's Capital Adequacy Requirements (CAR) Guideline and (ii) denominated and funded in the domestic currency of the sovereign.
Basel paragraph number	31: General measurement principles
Reference in the domestic regulation	Paragraph 14 (a) and footnote 10 of OSFI's D-SIB Guideline B-2
Description	The Basel LEX framework specifies that all amounts deducted from capital (not including amounts that are risk-weighted at 1250%) are excluded from the LEX limit. OSFI includes the amounts deducted for investments in banking, financial or insurance entities in the calculation of exposures.
Basel paragraph number	69: Covered bonds
Reference in the domestic regulation	Paragraph 26 of OSFI's D-SIB Guideline B-2
Description	The Basel LEX framework allows banks to assign an exposure value of no less than 20% of the nominal value of the bank's covered bond holding. OSFI allows banks to assign an exposure value of no less than 25% of the nominal value of qualifying covered bonds that meet the criteria set out in the Guideline.
Basel paragraph number	16 and 91: Large exposures rules for global systemically important banks
Reference in the domestic regulation	Paragraph 7 of OSFI's D-SIB Guideline B-2
Description	Under the Basel LEX standard, jurisdictions are encouraged to consider applying stricter limits to exposures between D-SIBs and to exposures of smaller banks to G-SIBs. OSFI sets the limit for a Canadian G-SIB's exposure to a Canadian D-SIB at 20% of Tier 1 capital. As well, the exposure of a Canadian D-SIB (that is not a G-SIB) to either another Canadian D-SIB or any G-SIB is limited to 20% of its Tier 1 capital.