Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III regulations – Canada

June 2014

BANK FOR INTERNATIONAL SETTLEMENTS

Note that this report refers to the RCAP grades prior to October 2025. The grade 'materially non-compliant (MNC)', ie one notch above the lowest grade, has since been renamed to 'partially non-compliant (PNC)' for greater clarity

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Glossary

AIRB	Advanced Internal Ratings-Based Approach (credit risk)
AMA	Advanced Measurement Approach (operational risk)
AT1	Additional Tier 1 (capital)
BA	Bank Act
BCBS	Basel Committee on Banking Supervision
BCP	Basel core principles for effective banking supervision
BIS	Bank for International Settlements
C	Compliant (grade)
CAD	Canadian dollar
CAR	Capital adequacy ratio
CAR Guideline	Canadian Capital Adequacy Requirements Guideline
CEM	Current Exposure Method (counterparty credit risk)
CET1	Common Equity Tier 1
CP	Core Principle (Basel Core Principles)
CVA	Credit valuation adjustment
D-SIB	Domestic systemically important bank
DTA	Deferred tax assets
FAQ	Frequently asked question
FSAP	Financial Sector Assessment Program
FIRB	Foundation Internal Ratings-Based Approach (credit risk)
FSSA	Financial System Stability Assessment
GDP	Gross domestic product
G-SIB	Global systemically important bank
ICAAP	Internal Capital Adequacy Assessment Process
IMA	Internal Models Approach (market risk)
IMM	Internal Model Method (counterparty credit risk)
IRB	Internal Ratings-Based Approach (credit risk)
IRC	Incremental risk charge
LC	Largely compliant (grade)
LGD	Loss-given-default
MNC	Materially non-compliant (grade)
N/A	Not applicable
NC	Non-compliant (grade)
NVCC	Non-viability contingent capital (clause)
OSFI	Office of the Superintendent of Financial Institutions
PLA	(A going-concern) Principal Loss Absorption (feature)
PON	Point of non-viability
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted asset
SCVA	Standardised CVA
SIG	Supervision and Implementation Group

Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. The benefits of the agreed global reforms can only accrue if these standards are incorporated into member jurisdictions' regulatory frameworks and applied appropriately. In 2011, the Basel Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework. The assessments under the RCAP aim to ensure that each member jurisdiction adopts the Basel III framework in a manner consistent with the framework's letter and spirit. The intention is that prudential requirements based on a sound, transparent and well defined set of regulations will help strengthen the international banking system, improve market confidence in regulatory ratios, and ensure an international level playing field.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel risk-based capital standards in Canada and their consistency with the Basel III framework.[1] The Assessment Team was led by Mr Ong Chong Tee, Deputy Managing Director of the Monetary Authority of Singapore, and comprised six technical experts. The assessment began in late 2013 and used information available up to 1 May 2014. The counterpart for the assessment was the Office of the Superintendent of Financial Institutions (OSFI), which issued its Basel III risk-based capital rules (primarily the *Capital Adequacy Requirements Guideline*) in December 2012 and brought them into force on 1 January 2013.

The assessment work consisted of three phases: (i) completion of an RCAP Questionnaire (a self-assessment) by OSFI; (ii) an off- and on-site assessment phase; and (iii) a post-assessment review phase. The off- and on-site phase included a visit to Ottawa and Toronto, during which the Assessment Team held discussions with OSFI, the six domestic systemically important Canadian banks (the D-SIBs), one audit firm and three credit rating agencies. These discussions provided the Assessment Team with an overview and a deeper understanding of the implementation of the Basel risk-based capital standards in Canada. The third phase consisted of a two-stage technical review of the assessment findings by a separate RCAP Review Team followed by the RCAP Peer Review Board. This two-step review process is a key instrument of the RCAP for substantive quality control to facilitate the consistency of RCAP assessments. The work of the Assessment Team and its interactions with OSFI were coordinated by the Basel Committee Secretariat.

The scope of the assessment was limited to the consistency and completeness of the domestic regulations in Canada with the Basel framework. Where domestic regulations and provisions were identified to be inconsistent with the Basel framework, those deviations were evaluated for their current and potential impact on the capital ratios for the sample of internationally active banks in Canada. Issues relating to the functioning of the regulatory framework and the integrity of prudential outcomes were not part of the assessment exercise. The Assessment Team did not evaluate the capital levels of individual banks, the adequacy of loan classification practices, the way banks currently calculate risk-weighted assets (RWAs), nor OSFI's supervisory effectiveness.

The Assessment Team sincerely thanks the Superintendent, Ms Julie Dickson, Deputy Superintendent Mr Mark Zelmer, OSFI Managing Director Mr Richard Gresser, OSFI Director Mr Brad

[1] Canada's compliance with other Basel III standards, namely the leverage ratio, the liquidity ratios and the framework for systemically important banks will be assessed at a later date once those standards become effective as per the internationally agreed phase-in arrangements.

Shinn and the staff of OSFI for the professional and efficient cooperation extended to the team throughout the assessment.

Executive summary

OSFI implemented the Basel III risk-based capital regulations in line with the internationally agreed timeline, bringing them into force on 1 January 2013. The Canadian Capital Adequacy Requirements Guideline (CAR Guideline) applies to all 105 locally incorporated banks, trust and loan companies, including those that are not internationally active.[2]

The Assessment Team finds the Canadian prudential regulation to be overall **compliant** with the standards prescribed under the Basel framework. Thirteen of the 14 components assessed are graded as compliant, while one component, namely the definition of capital, is assessed as being largely compliant with the Basel standards. The final assessment recognises the effort made by OSFI to strengthen and align its capital rules to the Basel III framework in the course of the assessment. These amendments (Annex 6) were made public and implemented with effect from 25 April 2014.

The Assessment Team also notes the more rigorous implementation of the Basel framework in several aspects, with the major element being the bringing forward of the 2019 Basel capital ratio requirements to 2013 in the target capital ratios applied to all banks. In addition, OSFI continues to apply the 90% transitional floor to Canadian banks using the Basel advanced approaches. However, these aspects of the Canadian capital rules that are stricter than the Basel minimum requirements are not taken into account for the assessment of compliance under the RCAP methodology.

OSFI's requirements relating to the definition of capital are assessed to be largely compliant with the Basel framework. The Assessment Team found one deviation regarding the treatment of preferred shares to be potentially material. In particular, OSFI does not require preferred shares that are accounted for as liabilities and included in Additional Tier 1 capital to include the automatic conversion trigger required under the Basel framework at the capital ratio of 5.125% of RWAs, although those instruments do include point of non-viability (PON) conversion triggers that are under OSFI's control. That is because OSFI considers those preferred shares to be equity instruments in terms of economic substance; regardless of their accounting classification (instruments accounted for as equity are not required to include any capital ratio triggers under the Basel framework). A less significant deviation relates to the treatment of defined benefit pension fund assets where OSFI excludes certain assets relating to foreign subsidiaries from the deduction requirement under the Basel framework. The assessment also identified two interpretative issues that would benefit from further guidance from the Basel Committee so as to ensure that the Basel III standards are implemented in a consistent way across jurisdictions.

The other components of the Basel framework are assessed as compliant, with only a limited number of non-material differences. For counterparty credit risk, OSFI exempts from market risk capital requirements market risk hedges that are used to mitigate credit valuation adjustment (CVA) risk and that are managed as such. For the Standardised Approach to market risk, OSFI applies the requirements only to internationally active banks and the D-SIBs designated by OSFI with a supervisory option to apply market risk to other locally incorporated banks.[3] The Canadian Pillar 2 (supervisory review process) framework is closely aligned to the Basel standards and consistent with OSFI's principle-based approach

[2] This is with the exception of market risk capital requirements, which apply only to internationally active banks (ie including all institutions designated by OSFI as D-SIBs), and Pillar 3 composition of capital disclosure requirements, which apply fully only to the D-SIBs.

[3] About 70% of the market risk capital charges for the D-SIBs are computed based on internal models, and 30% based on the Standardised Approach.

to regulation. For Pillar 3 (market discipline), OSFI applies the full set of disclosure requirements to the D-SIBs. Non-D-SIBs in Canada are subject to a modified composition of capital disclosure template based on the proportionality principle, which is in line with practices in several other Basel Committee member jurisdictions.

Response from OSFI

OSFI appreciates the detailed assessment conducted through this process. OSFI especially wants to thank the Assessment Team under the leadership of Mr Ong Chong Tee for their insights and professionalism throughout the process.

OSFI has implemented the Basel capital framework with a clearly articulated approach aimed at being conservative where warranted with a focus on choices and approaches to implementation that best reflect the context and risks of banks in Canada. Given the strength of the Canadian system, OSFI chose to apply an “all-in” approach that adopted the 2019 levels of capital in 2013.

We would like to comment on the deviation in the “Definition of capital” section regarding the treatment of preferred shares. In Canada we have had a long-standing preferred share market primarily focused on retail investors. In the wake of Basel III, OSFI requires that, for preferred shares to count towards Tier 1 capital, they must carry contractual PON triggers that would convert the instruments into common shares in the event that the Superintendent declares that the institution is at the point of non-viability. Plain-vanilla preferred shares (eg preferred shares without the contractual PON triggers) have been recognised as equity instruments for accounting purposes. The inclusion of the PON clause can potentially lead to preferred shares being classified as liabilities for accounting purposes even though in practice the PON clauses increase the loss-absorption capacity of preferred shares. For regulatory capital purposes, preferred shares have been clearly recognised as capable of absorbing losses on a going concern basis by the Basel Committee. As OSFI considers preferred shares to fundamentally represent equity claims on banks in economic terms, regardless of their accounting classification, we have not required these instruments to include the 5.125% regulatory capital trigger. OSFI also recognises the need to ensure that this treatment is not used as a lever to inappropriately liberalise the treatment of Additional Tier 1 (AT1) instruments in Canada. As a result, the hurdle for a financial instrument to qualify as AT1 in Canada has been set quite high. Specifically, only non-viability contingent convertible (NVCC) preferred shares and instruments that are classified as equity instruments for accounting purposes will be considered for AT1 recognition in Canada. In this regard, capital recognition will not be automatic; OSFI will continue to reserve the right to refuse any instrument that raises prudential concerns, even if it appears to meet the 14 principles for AT1 eligibility and has been classified by accountants as an equity instrument.

The RCAP process has been helpful in identifying a number of cross-references and editorial adjustments in our domestic guidance that OSFI has used to clarify the alignment of our domestic guidance with the international standards.

The RCAP assessment is a valuable tool that should continue to be used to promote consistency and transparency across jurisdictions. The Basel Committee standards when applied fairly contribute to the overall stability of the global financial system. OSFI supports the assessment programme and will continue to participate with our fellow members in achieving the programme goals.

1. Assessment context and main findings

1.1 Context

Status of implementation

OSFI is the prudential regulator of the banking and insurance sector in Canada. In December 2012, OSFI published a revised, comprehensive version of its *Capital Adequacy Requirements Guideline* (CAR Guideline) which became effective as of 1 January 2013 (in line with the internationally agreed timeline, and subsequently amended on 25 April 2014) and thereby instituted Basel III capital rules in Canada. The Basel II/2.5 standards became effective as of 1 November 2007 and 1 January 2012, respectively, and were implemented based on previous versions of the CAR Guideline (Annex 2). The CAR Guideline, issued by OSFI based on consultation with the industry, applies to all federally incorporated banking institutions active in the country (as of October 2013, see Annex 8) with adaptations for non-internationally active banks.[4]

Implementation context

Structure of the banking system

In October 2013, there were 105 deposit-taking institutions in Canada with total assets amounting to approximately CAD 4.5 trillion (see Annex 8), which corresponds to approximately 250% of the gross domestic product (GDP) of Canada and is about half of the total assets of the financial system.[5] The 105 deposit-taking institutions comprise 25 domestic banks, 23 foreign bank subsidiaries, one cooperative retail association, and 56 trust and loan companies.[6]

The financial system is dominated by six banks classified as D-SIBs,[7] none of which is currently systemically important at a global level (ie G-SIB). Those six banks hold around 93% of Canada's total banking assets. These banks are the only ones that are deemed internationally active by OSFI in a narrower sense, ie those running foreign operations (through branches and subsidiaries) which currently contribute about one quarter of the banks' income. The non-D-SIBs do not currently operate subsidiaries or branches outside the country, and their share of foreign assets and liabilities in terms of their total balance sheet is relatively minor.

Basel standards

The following table provides an overview of the status of adoption of the Basel advanced approaches by the Canadian banks.

4 This is with the exception of market risk capital requirements, which apply only to internationally active banks (ie including all institutions designated by OSFI as D-SIBs), and Pillar 3 composition of capital disclosure requirements, which apply fully only to the D-SIBs.

5 For a recent evaluation of financial stability issues in Canada and macro financial risks confronting banks, see Annex 1 of the IMF's Financial System Stability Assessment (FSSA) report on Canada, which is accessible at www.imf.org/external/pubs/cat/longres.aspx?sk=41299.0

6 When taking ownership into account, there are 70 deposit taking institutions comprising 22 domestic banks, 23 foreign bank subsidiaries, one cooperative retail association and 24 trust and loan companies.

7 See Press release: Canada's domestic systemically important banks identified at www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/DSIB_nr.aspx

Status of approval of the advanced approaches in the Basel framework

Number of deposit taking institutions, end-October 2013 — Table 1

	Standardised Approach	Thereof: Intent to move to advanced approach	Advanced approach approved by OSFI
Credit risk	D-SIBs: 0 Other banks: 62	D-SIBs: N/A Other banks: 3 (AIRB)	D-SIBs: 6 (all AIRB) Other banks: 2 (1 FIRB, 1 AIRB)
Counterparty credit risk	D-SIBs: 6 (CEM, SCVA) Other banks: 64	D-SIBs: 2 Other banks: 0	D-SIBs: 0 Other banks: 0
Market risk	D-SIBs: 0 Other banks: 0[8]	D-SIBs: NA Other banks: 0	D-SIBs: 6 Other banks: 1
Operational risk	D-SIBs: 5 Other banks: 64	D-SIBs: 5 Other banks: 0	D-SIBs: 1 Other banks: 0

Source: OSFI.

Regulatory system and model of supervision

At the federal level, bank regulation is shared among three institutions, which cover about 95% of the assets in the banking system, including the six D-SIBs: (i) The prudential oversight of all federally incorporated banks, insurance companies, trust and loan companies, cooperative credit associations, and fraternal benefit societies in Canada rests with OSFI; (ii) the Bank of Canada assesses financial stability risk, and oversees systemic payment, clearing and settlement systems; (iii) the Department of Finance is responsible for the overall stability of the financial system at the federal government level and federal financial sector legislation, including the governing legislation that establishes the mandates and powers of the federal financial sector regulatory agencies.[9] At the federal level, there are several forums that allow for effective cooperation and sharing of information. The remaining 5% of the assets are held by deposit-taking institutions that are provincially incorporated. None of these deposit-taking institutions are internationally active.

OSFI was established under the *Office of the Superintendent of Financial Institutions Act* (OSFI Act) on 2 July 1987 to regulate and supervise financial institutions and private pension plans subject to federal oversight. It is a de facto independent,[10] self-financing agency that reports to Parliament through the Minister of Finance. As such, OSFI is largely responsible for implementing Basel II, 2.5 and III in Canada.

The previous assessment of OSFI's compliance with the Basel Committee's *Basel core principles for effective supervision* (BCP) was conducted in 2013 as part of the IMF-World Bank Financial Sector Assessment Program (FSAP), the results of which were published in February 2014.[11] That assessment

8 All other banks are currently exempt from market risk charges, but the changes to the OSFI rules (ie application to internationally active banks and D-SIBs) could alter the figures in the table at a later stage.

9 See FSAP BCP assessment, Box 2 of the FSSA, available at www.imf.org/external/pubs/cat/longres.aspx?sk=41299.0

10 See FSAP BCP assessment, available at www.imf.org/external/pubs/cat/longres.aspx?sk=41299.0

11 See www.imf.org/external/pubs/cat/longres.aspx?sk=41407.0

found that Canada has a high level of compliance with the BCP, including in the setting of prudent and appropriate capital adequacy requirements for banks.[12]

Structure of prudential regulations

The relevant hierarchy of prudential rules through which OSFI implements the Basel framework in Canada consists of the following levels:

(i) High-level prudential standards promulgated under the Bank Act (BA);[13]

(ii) Different forms of regulatory instruments which clarify the legislative, regulatory and supervisory frameworks, and articulate OSFI's regulatory and supervisory expectations:

- Guidelines: establish minimum prudential practices not ruled under the BA;
- Advisories: clarify specific policy issues or describe how OSFI administers or interprets provisions of the BA, regulations or guidelines;
- Rulings: interpret provisions of the BA, regulations or guidelines in specific cases;
- Public letters: provide detailed guidance that would not be found in a formal guideline or advisory; and
- Discussion Papers: articulate OSFI's general policy direction in a specific area.

These are supplemented by capital implementation notes to clarify OSFI's expectations on compliance with the technical provisions of the advanced approaches.

Enforceability and binding nature of prudential regulations

As a general principle, RCAP assessments only take into consideration "binding" regulatory documents that implement the Basel framework. This is to ensure that the Basel requirements are set out clearly and that a formal basis exists for supervisors and the industry to ensure compliance with the minimum requirements.

As outlined by OSFI, its main prudential instrument, the CAR Guideline and other regulatory instruments are a means whereby OSFI is able to swiftly, explicitly, and outside the political process, articulate its supervisory expectations. The CAR Guideline explains how the requirements, including adequate prudential standards, of the BA should be met. While the regulatory instruments are not directly enforceable in law, failure to meet them is indicative of failure to meet the underlying legal standard. If OSFI determines that a bank has not met the standard, OSFI has sufficient tools to compel compliance.[14]

[12] Canada was assessed as compliant on CP 16 (capital adequacy), CP 17 (credit risk), CP 22 (market risk), CP 23 (interest rate in the banking book), CP 25 (operational risk), and on CP 28 (disclosure and transparency; related to Pillar 3).

[13] The BA and its supporting regulations provide a comprehensive framework for the setting and enforcing of minimum prudential standards for banks. For example, the BA sets, and empowers the Superintendent to set, minimum prudential standards upon incorporation and on an ongoing basis with respect to, among other things, ownership, governance, capital, liquidity, self-dealing, investments, specialised financing, and borrowing.

[14] Such tools include special examinations, prudential agreements, directions of compliance, application to a court for an order of compliance and ultimately taking control of the bank.

The Assessment Team examined the binding nature of various regulatory documents issued by OSFI using the seven criteria being applied in RCAP assessments.[15] Based on OSFI's evaluation (see Annex 7), the BA is the main instrument via which OSFI prescribes legally enforceable standards. Given OSFI's empowerment at setting and enforcing minimum prudential standards for banks, and validated by the feedback from the Canadian banking industry, the Assessment Team has taken into account the full scope of OSFI's regulatory documents listed in Table 5 of Annex 4. These are all in the public domain, viewed as binding and enforced by OSFI.

Areas where OSFI rules are stricter than the Basel requirement

The Canadian Basel III minimum capital requirements and buffer requirements are being phased in according to the Basel timelines. In addition, OSFI expects all banking institutions to attain so-called "all-in" target capital ratios equal to or greater than the 2019 capital ratios early in the transition period. The D-SIBs are required to meet "all-in" capital targets of 7% for the CET1 ratio by the first quarter of 2013, and 8.5% for the Tier 1 ratio and 10.5% for the Total Capital ratio by the first quarter of 2014. Commencing on 1 January 2016, the "all-in" capital target for CET1 ratio for D-SIBs will be 8%, including a D-SIB buffer of 1 percentage point. The Assessment Team also notes that OSFI continues to apply the 90% transitional floor to Canadian banks using the Basel advanced approaches for credit risk and operational risk. A number of other specific aspects of the Canadian capital rules that are stricter than the Basel minimum requirements are listed in Annex 10.

1.2 Scope of the assessment

Scope

The Assessment Team has considered all documents that implement the Basel framework in Canada as of 1 May 2014, the cut-off date for the assessment.

The assessment focused on two dimensions:

- A comparison of domestic regulations with the capital requirements under the Basel framework to ascertain if all the required provisions have been adopted (completeness of the regulation); and
- Any differences in substance between the domestic regulations and the Basel framework and their significance (consistency of the regulation).

The assessment did not evaluate the adequacy of capital or resilience of the banking system in Canada, or OSFI's overall supervisory effectiveness.

Any identified deviations were assessed for their materiality (current and potential) by using both quantitative and qualitative information. For potential materiality, in addition to the available data the assessment used expert judgement on whether the domestic regulations met the Basel framework in substance and spirit.

[15] The commonly applied RCAP criteria to determine the binding nature of regulatory instruments and documents are: that (i) they are part of a well-defined, clear and transparent hierarchy and regulatory framework; (ii) they are public and freely available; (iii) they are viewed as binding by banks as well as by the supervisors; (iv) they would generally be legally upheld if challenged; (v) they are supported by precedence of enforceability; (vi) they are properly communicated and consequences of failure to comply are properly understood and carry a similar practical effect as for the primary law or regulation; and (vii) the instrument is expressed in clear language that complies with the Basel provision in substance and spirit.

Bank coverage

The coverage focused on the six D-SIBs, as the other Canadian banks' engagement in international banking is very limited. Together, the six largest banks dominate the retail and commercial banking markets, accounting for about 93% of banking assets. For the assessment of materiality of identified deviations, OSFI provided data from banks on a best efforts basis.[16]

The smaller banks do not currently run subsidiaries or branches outside the country, and the share of foreign assets and liabilities (as a percentage of their respective total balance sheets) is negligible, except for two foreign subsidiaries, for which the portions are between 5% and 10% of their respective balance sheets. Foreign bank subsidiaries in Canada are mainly subsidiaries of the G-SIBs, most of which are present in Canada and are small, with total assets below CAD 10 billion.

Overview of the Canadian banking sector

Table 2

	31 October 2013 (CAD billions)	Percentage in terms of Canada GDP (Year to March 2013)
Total assets of all banking institutions	4,592	251%
Total assets of six internationally active D-SIBs	4,295	239%
Market share of six D-SIBs	93%	
Total assets of next largest bank/largest foreign bank subsidiary	86	5%

Note: Not including off-balance sheet assets.

Source: OSFI.

1.3 Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the 15 key components of the Basel framework and for the overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.[17] A regulatory framework is considered:

- *Compliant* with the Basel framework if all minimum provisions of the international framework have been satisfied and if no material differences have been identified that would give rise to prudential concerns or provide a competitive advantage to internationally active banks;
- *Largely compliant* with the Basel framework if only minor provisions of the international framework have not been satisfied and if only differences that have a limited impact on financial stability or the international level playing field have been identified;

[16] Data was collected from the following banks (listed by total assets): Toronto-Dominion Bank, Royal Bank of Canada, Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce and National Bank of Canada.

[17] This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of Basel III that are not relevant to an individual jurisdiction may be assessed as not applicable (N/A).

- *Materially non-compliant* with the Basel framework if key provisions of the framework have not been satisfied or if differences that could materially impact financial stability or the international level playing field have been identified; and
- *Non-compliant* with the Basel framework if the regulation has not been adopted or if differences that could severely impact financial stability or the international level playing field have been identified.

The materiality of the quantifiable findings was assessed in terms of their current or, where applicable, the potential future impact on the capital ratios of banks. The quantification was, for most parts, limited to the agreed population of the D-SIBs. Wherever relevant and feasible, the Assessment Team, together with OSFI, attempted to quantify the impact, both in terms of current materiality and potential materiality. This was done based on data collected by OSFI from the Canadian banks in the agreed sample.[18] Expert judgement was applied where required.

The non-quantifiable gaps were discussed with OSFI, taking into account its regulatory processes, and outcomes were guided by expert judgement based on principles set out in the RCAP assessment methodology.[19]

It was also taken into account that, as a general principle, the burden of proof lies with the assessed jurisdiction to show that a finding is not currently or potentially material.

Further information on the materiality assessment is given in Section 2 and Annex 9.

1.4 Main findings

Overall

The assessment concluded that the prudential regulation in Canada is *compliant* with the Basel framework. Thirteen of the 14 components assessed are graded as *compliant* and one component is assessed as being *largely compliant*. The positive assessment outcome was also the result of a substantial number of edits and rectifications made by OSFI during the RCAP process to further strengthen and align its capital rules with the Basel framework (Annex 6).

OSFI has implemented the Basel framework in a timely and consistent manner. In a few areas, the Canadian rules were found to be stricter than the Basel minimum, such as in the case of OSFI's "all-in" capital target requirements for D-SIBs, and with respect to specific provisions in the areas of: definition of capital, counterparty credit risk and market risk.

The CAR Guideline that implements the Basel framework is applied to all locally incorporated banks. Exceptions, however, were made for the capital requirements for market risk, which only apply to internationally active banks, including all D-SIBs designated by OSFI, and the Pillar 3 capital disclosure requirements, which apply fully only to the D-SIBs, based on the proportionality principle. Specific methods within the standardised approaches to market risk, counterparty credit risk and operational risk

18 Due consideration was given to the number of banks having the relevant exposure, the size of exposures impacted, the range of impact, and the possibility of any rise in the relative proportion of the impacted exposures in the balance sheets of banks in the foreseeable future.

19 This same approach has been followed to assess the materiality of differences for the standardised approaches, since the Canadian banks in the RCAP sample use the advanced approaches. Evidence based on the partial-use exposure of banks in the RCAP sample has also been taken into account. In establishing the gradings for the standardised approaches, the team, in line with the RCAP practices, has taken a conservative approach recognising the relative importance of these approaches for the banks in the RCAP sample for the overall rating.

have not been implemented as OSFI does not deem these relevant at this stage for the Canadian banking sector (see Annex 11 for a list). The Assessment Team does not see a potential for those approaches not allowed by OSFI's regulatory framework to have a material effect on banks' capital ratios.

A summary of the findings is given below. This should be read along with the list of detailed findings in Sections 2.1–2.3. Other observations related to the Canadian system are mentioned in Section 2.4. The issues that were rectified during the assessment period are listed in Annex 6.

Summary assessment grading — Table 3

Key components of the Basel capital framework	**Grade**
Overall grade:	**C**
Scope of application	C
Transitional arrangements	C
Pillar 1: Minimum capital requirements	
Definition of capital	LC
Credit risk: Standardised Approach	C
Credit risk: Internal Ratings-Based Approach	C
Credit risk: Securitisation framework	C
Counterparty credit risk framework	C
Market risk: Standardised Measurement Method	C
Market risk: Internal Models Approach	C
Operational risk: Basic Indicator Approach and Standardised Approach	C
Operational risk: Advanced Measurement Approaches	C
Capital buffers (conservation and countercyclical)	C[20]
G-SIB additional loss absorbency requirements	N/A
Pillar 2: Supervisory review process	
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions	C
Pillar 3: Market discipline	
Disclosure requirements	C

Compliance assessment scale (see Section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant), NC (non-compliant) and N/A (to be assessed after the Basel Committee concludes the final Basel standards).

20 The grading relates only to the capital conservation buffer. Provisions on the countercyclical buffer will be subject to an assessment at a later stage (Annex 12).

Main findings by component

Scope of application

The Basel standards on scope of application relate to requirements for consolidated banking groups and the sub-levels within a group that are required to apply the Basel framework. OSFI's implementation of the scope of application is compliant with the Basel framework.

Definition of capital and transitional arrangements

Transitional arrangements

OSFI's implementation of the transitional arrangements is compliant with the Basel framework. OSFI expects all banking institutions to attain target capital ratios equal to or greater than the 2019 capital ratios from 2013. Specifically, the D-SIBs are required to meet so-called "all-in" capital targets of 7% for the CET1 ratio by the first quarter of 2013, 8.5% for the Tier 1 ratio and 10.5% for the Total Capital ratio by the first quarter of 2014. From 1 January 2016, the "all-in" capital target for CET1 ratio for the D-SIBs will be 8%. In addition, the transitional Basel III minimum capital ratios apply and have to be reported by the banks in parallel. OSFI also continues to apply the 90% transitional floor to Canadian banks using the Basel advanced approaches for credit risk and operational risk.

Definition of capital

A key element of Basel III was the set of changes made to the standards that define the eligible components of regulatory capital. Although the CAR Guideline implements these standards in most areas, the Assessment Team found the treatment of preferred shares and defined benefit pension fund assets to deviate from the Basel requirements (see below for details). Taking account of the materiality of these two issues, the implementation of the definition of capital standards is assessed to be *largely compliant*. In addition, the assessment identified two interpretative issues where the Basel III standards may benefit from further guidance from the Basel Committee, thus improving their consistent implementation across member jurisdictions.

Preferred shares

Additional Tier 1 (AT1) is the next highest-quality component of capital after Common Equity Tier 1. Basel III requires AT1 instruments that are *accounted for as liabilities* to have a going-concern principal loss absorption (PLA) feature. This feature must result in the instrument being automatically written off or converted to common shares when the bank's CET1 ratio falls below 5.125% of RWAs. The CAR Guideline does not apply this requirement to preferred shares, even though they can be accounted for as liabilities.

OSFI has explained the rationale for excluding preferred shares from the PLA feature. In particular, OSFI notes the following:

- Besides the going-concern PLA requirements for AT1 instruments classified as liabilities, Basel III requires all non-common equity instruments to be capable of being written off or converted into common equity at the PON. This may be implemented via either a contractual approach or a statutory approach.
- OSFI has implemented the PON requirements via the contractual approach. That is, all AT1 regulatory capital instruments are required to include a NVCC clause in their terms and conditions that gives effect to the Basel III write-off/conversion requirement at the PON. Plain-vanilla preferred shares (eg preferred shares without the contractual PON triggers) have been recognised as equity instruments in the accounting standards. With the introduction of Basel III, preferred shares with the contractual PON triggers may be classified as liabilities for accounting purposes. For regulatory capital purposes, they have been clearly recognised as capable of

absorbing loss on a going-concern basis by the Basel Committee. In Canada, this is reinforced by their tax treatment, where preferred share dividends are viewed as dividends and thus distributed out of after-tax income; as opposed to interest-bearing debt instruments, where the interest expense is an eligible expense for tax purposes.

- Although the accounting treatment is subject to interpretation, it seems that an unforeseen consequence of adding a NVCC clause to preferred shares is that it can potentially result in them being classified as liabilities for accounting purposes. This classification is not expected to occur in some other jurisdictions that implement the PON requirements through a statutory approach, where preferred shares will continue to be accounted for as equity. On the accounting treatment, OSFI believes that the NVCC clause does not undermine or reduce the loss absorption capacity of the underlying instrument, and thus the differences in the accounting treatment should not impact the inclusion of preferred shares without the PLA feature in AT1.
- Furthermore, the inclusion of the going-concern PLA feature would have a disruptive effect on the well-established market for preferred shares in Canada, which consists mainly of retail investors.

Although the Assessment Team understands the perspective and concerns of OSFI, the Basel III text is clear that *all* AT1 instruments classified as liabilities for accounting purposes are required to have the going-concern PLA feature. This deviation is considered by the Assessment Team to be potentially material given the potential quantity of preferred shares that could be affected by the OSFI approach and the uncertainty over the future accounting treatment of preferred shares with the NVCC clause.

Defined benefit pension fund assets

Basel III requires that a bank must deduct the assets of its defined benefit pension funds from CET1 unless the bank has "unrestricted and unfettered access" to the assets. However, in relation to foreign subsidiaries, the CAR Guideline permits the exclusion of defined benefit pension fund assets from the deduction requirement if the deposit insurance scheme in that foreign jurisdiction (rather than the bank itself, as required by Basel III) has unrestricted and unfettered access to the excess assets of the subsidiary's pension plan in the event of receivership. Based on an assessment of the impact of fully deducting these assets, the Assessment Team deemed that this deviation is not currently or potentially material.

Interpretative issues

The assessment also identified two interpretative issues where the Basel III standards themselves may benefit from further clarification:

- The first is whether and, if so, to what extent "collective allowances" may be eligible for inclusion in Tier 2 capital under the Standardised Approach, given that collective allowances under IFRS represent incurred losses.
- The second is whether there is a common understanding of the requirement to deduct Deferred Tax Assets (DTA) that "rely on the future profitability of the bank to be realised".

  Both issues are outlined in Annex 13.

Capital buffers (conservation and countercyclical)

Basel III established a capital conservation buffer above the minimum capital requirements. The consequence of a bank's CET1 ratio falling into the buffer range is that the bank becomes subject to a restriction on the distribution of future earnings. The Canadian regulation is in line with the Basel standards for the capital conservation buffer and therefore assessed to be compliant.

The countercyclical buffer regime of Basel III works by extending the size of the capital conservation buffer when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk. The details of this regime have not yet been introduced in OSFI's capital requirements, but will be adopted upon full guidance on the regime from the Basel Committee. The implementation of the countercyclical buffer regime in Canada will thus be assessed in follow-up RCAP work.

Credit risk: Standardised Approach

For credit risk, the Basel framework permits banks a choice between the Standardised Approach and the Internal Ratings-Based Approach (IRB). While the six Canadian D-SIBs use Advanced IRB (AIRB), their partial use exposure (ie the exposure that is subject to the Standardised Approach) remains substantial, accounting for 26% of the RWAs for the system overall, and ranging from 7% to 53% for each bank (as of Q3 2013).

OSFI's regulatory requirements for the credit risk Standardised Approach are assessed to be compliant with the Basel standards. The issues identified by the Assessment Team are assessed not to have a material impact on the disclosed capital adequacy ratios of the banks in the RCAP sample:

- For claims secured by residential property, the application of the preferential risk weight of 35% is extended beyond the purpose of housing finance, to collateral mortgages, pass-through type mortgage-backed securities and reverse mortgages. This issue is not assessed as a deviation as the Basel provision on applying the preferential risk weight "restrictively for residential purposes" could be interpreted to refer to the mortgage being extended for financing the property only, or to the residential purpose of the property collateral.
- For exposures to be included in the regulatory retail portfolio, the granularity criterion that must be satisfied is included in the CAR Guideline, but no specific granularity limit is determined, the latter being mentioned in the Basel standards as a measure that may be applied to ensure sufficient granularity. OSFI has implemented the other three criteria for exposure to be included in the regulatory retail portfolio, including the criterion on low values of individual exposures. Taken together, the issue is assessed to be not material.
- A 0% risk weight is applied to unrealised gains and accrued receivables on foreign exchange and interest rate-related off-balance sheet transactions where they have been included in the off-balance sheet calculations, a provision that is not in the Basel standards. The provision in OSFI's CAR Guideline is meant to avoid double-counting of exposures where these are subject to capital requirements for counterparty credit risk and is assessed to be not material.

Credit risk: Internal Ratings-Based Approach

The Canadian IRB for credit risk, which is used by the six D-SIBs (all of which use the AIRB) and five other banks (Table 1), consistently implements the Basel standards.[21] The IRB contributes about half of the D-SIBs' total RWAs, ranging from one third to two thirds for each bank. The IRB has been used by Canadian banks since 2007.

One minor deviation relates to OSFI's CAR Guideline not specifying the calculation method for the concentration limit of 3.5% for purchased receivables. This finding has no material impact on the capital adequacy ratios of Canadian banks.

[21] Note that the BCP assessment (CP16, re Essential Criteria 5) found a "very rigorous process for approval of new models and modifications to existing approved models".

Credit risk: Securitisation framework

The Basel securitisation framework is consistently implemented in the Canadian CAR Guideline. The securitisation exposure of Canadian banks is fairly limited, contributing 2–4% to total RWAs. There are no deviations in OSFI's implementation of the securitisation rules.

Counterparty credit risk framework

The Canadian D-SIBs are using the Current Exposure Method (CEM) to measure counterparty credit risk exposure. Specific D-SIBs might migrate to the Internal Model Method (IMM), subject to OSFI's approval (Table 1). The Standardised Method is not implemented.

OSFI's requirements for counterparty credit risk are assessed to be compliant with the Basel standards. OSFI exempts market risk hedges that are used to mitigate CVA risk and that are managed as such, from market risk capital requirements, although market risk hedges of CVA risk are not recognised as eligible hedges in the CVA capital charge. The impact of this deviation is assessed as not material as data provided by OSFI show a very limited impact on RWA for one D-SIB and zero impact for the other D-SIBs. The potential materiality is also deemed to be low given the domination of the Canadian OTC derivative market by vanilla interest rate and foreign exchange products, which have the highest potential to be cleared via central counterparties, and in view of the regulatory direction towards central clearing of derivative contracts.

OSFI applies scalars to phase in the CVA risk capital charge from 2014 to 2019. This unwinds the effect proportional to the higher "all-in capital targets" that OSFI has imposed from 1 January 2013 (essentially the 2019 Basel capital ratios brought forward to 2013). By 2019, the CVA risk capital charge will be fully phased in so that this effect will be eliminated. For the Basel III transitional minimum capital requirements, which are imposed in parallel, the Canadian banks are subject to the full CVA risk capital charge. Hence, the treatment applied by OSFI is in line with the framework.

OSFI has introduced a 2% risk weight for exposures to unrated counterparties in the Standardised CVA risk capital charge (SCVA) for banks that do not have an approved rating system, as the Basel text does not specify the treatment for such exposures. The Assessment Team considers OSFI's specification as appropriate, as the application of the 2% risk weight is equivalent to treating unrated counterparties as BB-rated counterparties in the SCVA.

Market risk: Standardised Measurement Method

The Standardised Measurement Method for market risk is compliant with the Basel framework. OSFI applies the market risk capital requirements to internationally active banks, ie including all D-SIBs designated by OSFI. This replaces the materiality threshold in place at the onset of the assessment.[22] In terms of total RWAs, the Standardised Measurement Method to market risk contributes about 2% of the D-SIBs' total RWAs (about 30% of the total RWAs for market risk), ranging from 0% to 6% for each bank.

The Assessment Team notes that OSFI has exercised the discretion under the Basel framework not to implement a few of the options within the standardised approaches in its regulation (Annex 11), including the duration method for interest rate risk, the maturity ladder approach for commodities risk, and the delta-plus-method for the price risk of options. This is assessed not to have material implications on banks' capital ratios.

[22] The established rules (ie the limitation to internationally active banks) could preserve the current situation for small and non-internationally active banks, which are not subject to Pillar 1 charges for market risk (see also Table 1) and are outside the scope of this RCAP.

Market risk: Internal Models Approach

The Internal Models Approach (IMA) to market risk is used by the D-SIBs and one of the smaller banks (Table 1). The RWAs based on the IMA contribute about 4% to the D-SIBs' total RWAs (70% of the total RWAs for market risk), ranging from 3% to 6% for each bank. Regarding the scope of incremental risk charge (IRC) models, OSFI currently does not allow banks to include equities and derivatives positions based on listed equities in their IRC models. The Canadian regulation is in line with the Basel standards for the IMA to market risk, and therefore is assessed to be compliant.

Operational risk: Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approaches

The approaches to calculate capital requirements for operational risk included in the Basel framework are: the Basic Indicator Approach, the Standardised Approach or Alternative Standardised Approach, and the Advanced Measurement Approaches (AMA). The Basel standards for operational risk were implemented in Canada in November 2007 and OSFI disallows the use of the Alternative Standardised Approach for any part of an institution incorporated in Canada.

One of the six D-SIBs currently uses the AMA (Table 1). The remaining five use the Standardised Approach. Currently all internationally active banks are on track to implement AMA by 2015 as envisaged by OSFI and their implementation is tracked and communicated internally on at least a quarterly basis. Capital requirements for operational risk contribute 13% to total RWAs at an aggregate level, and range from 11% to 14% for each bank.

OSFI's requirements for operational risk are compliant with the Basel standards, and no deviations were noted.

Supervisory review process (Pillar 2)

The Pillar II framework within the scope of the RCAP methodology has been implemented in close alignment with the Basel standards, and is compliant with Basel standards.

Consistent with OSFI's principle-based approach to regulation and tradition of applying risk-based supervision, OSFI has explicitly included the supervisory review process in its supervisory framework. Discussions with OSFI supervisors and the private sector provided the Assessment Team with an insight on how OSFI's principle-based approach is applied in practice. OSFI arrives at bank-specific minimum capital targets, which are not disclosed to the public, based on its supervisory risk assessment, which explicitly includes Pillar 2 risks. Annex 14 describes OSFI's Pillar 2 supervisory review process.

Disclosure requirements (Pillar 3)

OSFI's implementation of the Pillar 3 disclosure requirements is compliant with the Basel framework.

OSFI has implemented the Pillar 3 disclosure requirements via advisories and public letters. Based on the seven RCAP criteria to assess the binding nature of regulatory instruments issued by OSFI (Annex 7), the Assessment Team concluded that the use of advisories and public letters are eligible for the RCAP assessment. The Assessment Team also understands that OSFI intends to issue its Pillar 3 requirements as a Guideline once the Basel Committee completes its review of Pillar 3.

OSFI requires Canadian D-SIBs to fully implement the Pillar 3 composition of capital disclosure requirements. The non-D-SIBs in Canada are subject to a modified composition of capital disclosure template. OSFI's approach has no material impact on the outcome of the assessment as the Canadian non-D-SIBs are currently not actively engaged in international activities and OSFI will periodically review the designation of D-SIBs in Canada as well as the degree to which the Canadian non-D-SIBs are internationally active over time.

2 Detailed assessment findings

The component-by-component details of the assessment of Canadian's compliance with the risk-based capital standards of the Basel framework are detailed in this part of the report. The focus of Sections 2.1 to 2.3 is on findings that were assessed to be *deviating* from the Basel minimum standards and their materiality.[23] Section 2.4 lists some observations and other findings specific to the implementation practices in Canada.

2.1 Pillar 1: Minimum capital requirements

2.1.1 Definition of capital

Section grade	Largely compliant
Summary	The Assessment Team found that the following two aspects of the CAR Guideline are not fully compliant with the Basel standards, with a potentially material and non-material impact, respectively: (a) The lack of an automatic capital ratio conversion requirement for preferred shares that are accounted for as liabilities and included in AT1. (b) The exclusion of certain defined benefit pension fund assets from the deduction requirement.
Overview of findings by Basel paragraph:	
Basel paragraph no	Basel III paragraph 55 (Criterion 11): Automatic capital ratio conversion requirement for Additional Tier 1 classified as liabilities
Reference in the domestic regulation	CAR Guideline Chapter 2 paragraph 11 criterion 11: principal loss absorption for AT1 instruments
Findings	Paragraph 11 criterion 11 of Chapter 2 of the CAR Guideline addresses the principal loss absorption requirement for AT1 instruments. Paragraph 55 of Basel III requires instruments classified as liabilities for accounting purposes to automatically write down or convert to common equity at a CET1 ratio of 5.125% of RWAs. However, paragraph 11 criterion 11 of the CAR Guideline contains the following text: "Other than preferred shares, instruments included in Additional Tier 1 capital must be classified as equity for accounting purposes." The CAR Guideline does not require preferred shares to have the automatic 5.125% capital ratio conversion. The Assessment Team views the exclusion of preferred shares from the regulatory capital ratio conversion as a clear deviation from the Basel standards, because preferred shares may be classified as liabilities. Section 2 of this report explains OSFI's rationale for adopting this approach, which relates to their requirement for banks to include a NVCC clause in all non-common equity capital instruments, including **preferred** shares, which can result in the shares being classified as liabilities for accounting purposes.
Materiality	Potentially material This assessment reflects the fact that it is uncertain to what extent Canadian banks will choose to issue preferred shares. Furthermore, it reflects ongoing uncertainty on whether all accounting firms will consider preferred shares with the NVCC clause as liabilities.
Basel paragraph no	Basel III paragraphs 76 and 77: Defined benefit pension fund assets

[23] No findings were observed with respect to scope of application, transitional arrangements, credit risk securitisation framework, market risk and operational risk.

Reference in the domestic regulation	CAR Guideline Chapter 2 paragraphs 60 and 61: Treatment of defined benefit pension fund assets of foreign subsidiaries
Findings	Paragraphs 60 and 61 of the CAR Guideline implement the Basel III requirement (paragraph 77) that a bank must deduct the assets of defined benefit pension funds unless the bank has "unrestricted and unfettered access" to the assets. However, paragraph 61 of the CAR Guideline also states: "*In addition, where a Canadian institution has a foreign subsidiary which is insured by a deposit insurance corporation and the regulatory authority in that jurisdiction permits the subsidiary to offset its deduction from CET1 related to defined benefit pension assets on the basis that the insurer has unrestricted and unfettered access to the excess assets of the subsidiary's pension plan in the event of receivership, OSFI will allow the offset to be reflected in the Canadian institution's consolidated regulatory capital, subject to prior OSFI approval.*" This seems to be a deviation from Basel III in respect of (i) the ability for the insurer to have unrestricted and unfettered access, rather than the bank itself; and (ii) the unrestricted and unfettered access to be necessary only in the case of receivership.
Materiality	Not material Based on an assessment of the impact of fully deducting these assets, the Assessment Team deemed that this deviation is not material.

2.1.2 Capital conservation buffer

Section grade	Compliant
Summary	OSFI has implemented the capital conservation buffer requirements in line with the Basel framework. The details of the countercyclical buffer regime have not yet been implemented in the Canadian regulations. Therefore, the implementation of the countercyclical buffer regime in Canada will be assessed at a later date (Annex 12).

2.1.3 Credit risk: Standardised Approach

Section grade	Compliant
Summary	OSFI has generally implemented the Standardised Approach for credit risk in line with the Basel framework. The findings are assessed to have no material impact on the disclosed capital adequacy ratios of Canadian banks. For exposures to be included in the regulatory retail portfolio, the granularity criterion that must be satisfied is included in the CAR Guideline, but no specific granularity limit is determined, the latter being mentioned in the Basel standards as a measure that may be applied to ensure sufficient granularity. A 0% risk weight is applied to unrealised gains and accrued receivables on foreign exchange and interest rate-related off-balance sheet transactions where they have been included in the off-balance sheet calculations, a provision that is not in the Basel standards.
Overview of findings by Basel paragraph:	
Basel paragraph no	Basel II paragraphs 69–71: Claims included in the regulatory retail portfolios
Reference in the domestic regulation	CAR Guideline Chapter 3 paragraphs 24–26
Findings	Basel II paragraph 70 provides four criteria for claims to be included in the regulatory retail portfolio. These include a granularity criterion which requires that supervisors must be satisfied that the regulatory retail portfolio is sufficiently diversified. Paragraph 70 states that one way of achieving the granularity criterion may be "to set a numerical limit that no aggregate exposure to one counterpart can exceed 0.2% of the overall regulatory retail portfolio." The OSFI CAR Guideline implements the

	granularity criterion, but no specific granularity limit is specified. CAR Guideline Chapter 3 paragraph 26 provides that residential construction loans that do not satisfy the four criteria for the regulatory retail portfolio must be treated as a corporate exposure. Paragraph 81 of the Basel text provides that all other assets not covered by the specified asset categories under the Standardised Approach to Credit Risk are risk-weighted as other assets at 100%. Therefore, under the CAR Guideline, residential construction loans to individuals that do not satisfy four criteria are included in corporate exposures, instead of other assets.
Materiality	Not material Given that OSFI has implemented the criteria for exposures to be included in the regulatory retail portfolio, including the criterion on the low value of individual exposures, the potential impact of not having an explicit numerical limit for the granularity criterion is immaterial. The finding on the categorisation of residential construction loans to individuals affects the categorisation of such exposures, but has no material effect on risk weights.
Basel paragraph no	Basel II paragraph 81: Other assets
Reference in the domestic regulation	CAR Guideline Chapter 3 paragraph 50
Findings	A 0% risk weight is applied to unrealised gains and accrued receivables on foreign exchange and interest rate-related off-balance sheet transactions where they have been included in the off balance sheet calculations. This provision is not in the Basel framework. The rationale for this provision is to avoid double-counting of exposures where these are subject to capital requirements for counterparty credit risk.
Materiality	Not material

2.1.4 Credit risk: Internal Ratings-Based Approach

Section grade	Compliant
Summary	OSFI has generally implemented the IRB for credit risk in line with the Basel framework. One deviation identified with respect to the purchase receivables approach is not material.
Overview of findings by Basel paragraph:	
Basel paragraph no	Basel II paragraph 242
Reference in the domestic regulation	CAR guideline Chapter 6 paragraph 48
Findings	Basel II paragraph 242 states that national supervisors must establish concentration limits for purchased corporate receivables above which an institution must calculate capital charges based on the bottom-up approach for corporate exposures. The CAR Guideline specifies a concentration limit of 3.5% but does not specify how the limit should be calculated. OSFI's intent was to place a size limit on the size of any individual exposure at 3.5% of the pool. None of the banks use the purchased receivables approach. OSFI intends to clarify the calculation methodology in the CAR Guideline by the end of 2014, after consultation with the market and taking into account the revisions to the Basel securitisation framework.
Materiality	Not material. None of the banks currently use the purchased receivables approach.

2.1.5 Counterparty Credit Risk Framework

Section grade	Compliant
Summary	Of the available approaches for counterparty credit risk in the Basel framework, OSFI has implemented the IMM and CEM. OSFI's capital requirements are generally in line with the Basel framework for counterparty credit risk and central counterparties. OSFI exempts market risk hedges that are used to mitigate CVA risk, and that are managed as such, from market risk capital requirements. This finding is assessed as not material.
Overview of findings by Basel paragraph:	
Basel paragraph no	Basel II Annex 4 paragraph 103, added by Basel III, paragraph 99
Reference in the domestic regulation	Letter on CVA Grandfathering and Market Risk Hedges (21 Aug 2013)
Findings	OSFI exempts from market risk capital requirements market risk hedges that are used to mitigate CVA risk and that are managed as such, although market risk hedges of CVA are not recognised as eligible hedges in the CVA risk capital charge. (Basel text, Annex 4, para 103 provides only for eligible hedges that are included in the CVA capital charge to be removed from the bank's market risk capital charge calculation.) The Assessment Team concluded that the exemption of market risk hedges of CVA may result in lower market risk capital requirements for Canadian banks. However, data provided by OSFI show a very limited impact on the capital ratio for one D-SIB and no impact on those of the other five D-SIBs. The potential materiality is also deemed to be low. This is because the Canadian OTC derivative market is dominated by vanilla interest rate and foreign exchange products that have a high potential to be cleared via central counterparties. Given the direction towards central clearing, as well as collateralisation and margining of derivative contracts, the need to hedge CVA risks would likely be reduced. For end user counterparty trades which may not be centrally cleared, OSFI provided information that the high correlation between the credit spread movements of the large Canadian banks and the client base (dominated by Canadian federal and provincial governments, supranational entities and large Canadian corporates) provide a natural hedge of CVA risk. These factors taken together would likely reduce the need for market risk hedges of CVA and mitigate the potential materiality of the deviation from the Basel standards.
Materiality	Not material

2.2 Pillar 2

Section grade	Compliant
Summary	The Pillar II framework has been implemented in close alignment with the Basel standards. In line with OSFI's principle-based regulatory approach, certain specific provisions in the Basel text are not transposed in the CAR Guideline. However, OSFI conveys its expectations during interactions with banks, including through the ICAAP review process, as further documented in Annex 14. A quarterly backtesting exercise (economic capital vs regulatory capital) supports OSFI's risk-based supervisory framework and ensures that Pillar 2 risks are sufficiently addressed.
Basel paragraph no	Basel II paragraphs 777(i)–777(xiii), amended by Basel III : Counterparty credit risk
Reference in the domestic regulation	CAR Guideline Chapter 4 paragraphs 52, 62, 70 and 72
Findings	Basel II paragraphs 777(i) to 777(xiii) describe requirements for the management of counterparty credit risk for all banks. These apply to all banks, including those

	adopting the CEM for counterparty credit risks. The OSFI references in CAR Guideline Chapter 4 are applicable only for banks that are using internal models to estimate expected positive exposure. As stated in its published Supervisory Framework, OSFI has adopted the Basel Core Principles for Effective Banking Supervision (BCP) as its source for detailed supervisory standards and criteria. Therefore, OSFI assesses counterparty credit risk management at banks using the BCP as applicable. In addition, OSFI supervisors assess the adequacy with which banks, including less sophisticated and less complex banks, address counterparty credit risk under Pillar 2 ICAAP.
Materiality	Not material
Basel paragraph no	Basel II paragraphs 778(iii)–778(iv), amended by Basel 2.5: Stress testing and specific risk modelling under the IMA for market risk
Reference in the domestic regulation	CAR Guideline Chapter 9 Section 9.11
Findings	Basel II paragraph 778(iii) describes possible supervisory actions in the case that stress test results for market risk exceed the minimum capital requirements for market risk. Basel II paragraph 778(iv) formulates the need for a supervisory review of positions included in the IMA for specific risk. Positions with limited liquidity or price transparency can be excluded upon supervisory request. OSFI's CAR Guideline does not explicitly incorporate these provisions. However, OSFI's ICAAP process shows that stress tests are an integral part of Pillar 2. Also, issues relating to the exclusion of positions with limited liquidity or price transparency forms part of OSFI's supervisory model review.
Materiality	Not material

2.3 Pillar 3

Section grade	Compliant
Summary	OSFI implemented the Pillar 3 disclosure requirements via advisories and public letters. Based on the seven RCAP criteria to assess the binding nature of regulatory instruments issued by OSFI (Annex 7), the Assessment Team concluded that the use of advisories and public letters are eligible for the RCAP assessment. OSFI intends to issue its Pillar 3 requirements as a Guideline once the Basel Committee completes its review of Pillar 3. In terms of scope, OSFI requires D-SIBs in Canada to fully implement the composition of capital disclosure requirements. The non-D-SIBs in Canada are subject to a modified disclosure template. OSFI's approach has no material impact on the outcome of the assessment as the Canadian non-D-SIBs are currently not actively engaged in international activities and OSFI will periodically review the designation of D-SIBs in Canada as well as the degree to which the Canadian non-D-SIBs are internationally active over time.

2.4 List of observations and other findings

Capital conservation

Basel paragraph no	Basel III paragraphs 136–150: Countercyclical buffer
Reference in the domestic regulation	CAR Guideline Chapter 1 paragraphs 41–42
Observation	The CAR Guideline includes two paragraphs stating that OSFI will monitor credit growth and other indicators that may signal a build-up of system-wide risk, and that these may result in the application of higher capital targets and buffers. However, the regulation does not yet implement the details of the Basel III countercyclical buffer regime. Therefore, the implementation of the countercyclical buffer regime in Canada will be assessed at a later date.

Credit risk: Standardised Approach

Basel paragraph no	Basel II paragraphs 66–68: Claims on corporates
Reference in the domestic regulation	CAR Guideline Chapter 3 paragraphs 22–23
Observation	According to Basel II paragraph 67 (which allows national discretion), "Supervisory authorities should increase the standard risk weight for unrated claims where they judge that a higher risk weight is warranted by the overall default experience in their jurisdiction. As part of the supervisory review process, supervisors may also consider whether the credit quality of corporate claims held by individual banks should warrant a standardised risk weight higher than 100%." The CAR Guideline Chapter 3 does not have an explicit provision on this issue, but OSFI does have the authority to require additional capital, both in terms of higher risk weights or through Pillar 2.
Basel paragraph no	Basel II paragraphs 72–73: Claims secured by residential property
Reference in the domestic regulation	CAR Guideline Chapter 3 paragraphs 27–36
Observation	According to Basel II paragraph 72: "In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met." This paragraph states that the 35% risk weight should be applied restrictively for residential purposes. In the definition of qualifying residential mortgages subject to a 35% risk weight in the CAR Guideline, the CAR Guideline applies the 35% risk weight to collateral mortgages and reverse mortgages satisfying certain loan-to-valuation and other prudential criteria, and to pass-through mortgage-backed securities that are fully secured against qualifying residential mortgages. The object of such lending could be for other financing purposes, such as for car and personal loans. OSFI noted that: • the property type criteria is a clear indication that the financing is not for a commercial establishment and is consistent with the intent of the Basel framework. • the reverse mortgage market is dominated by a smaller and non-internationally active deposit-taking institution, and the banks have no exposures to pass-through mortgage-backed securities that receive the 35% risk weight. While it could be argued that the Basel treatment should be for financing the property only, the interpretation that it is the residential purpose of the collateral or property that matters is also valid. This issue has not been assessed as a deviation by

	the Assessment Team as both interpretations of the Basel rule are valid. In addition, Basel II paragraph 73 states that: "National supervisory authorities should evaluate whether the risk weights in paragraph 72 are considered to be too low based on the default experience for these types of exposure in their jurisdictions. Supervisors, therefore, may require banks to increase these risk weights as appropriate." CAR Guideline Chapter 3 does not have an explicit provision on this issue, but OSFI does have the authority to require additional capital, both in terms of higher risk weights or through Pillar 2. Basel II paragraph 73 is a national discretion. While paragraph 73 is not explicitly incorporated, OSFI has the authority to require additional capital, by higher risk weights or via Pillar 2.
Basel paragraph no	Basel II Paragraphs 79–80: Higher risk categories
Reference in the domestic regulation	CAR Guideline Chapter 3, paragraph 50
Observation	Basel II paragraph 80 (which allows for national discretion) states that: "National supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital and private equity investments." CAR Guideline Chapter 3 does not have an explicit provision on this issue, but OSFI does have the authority to require additional capital, both in terms of higher risk weights or through Pillar 2.

Credit risk: Internal Ratings-Based Approach

Basel paragraph no	Basel II paragraph 266
Reference in the domestic regulation	CAR guideline Chapter 6 paragraph 74
Observation	Basel II paragraph 266 defines the loss-given-default (LGD) floor of 10% for residential mortgages for subsegments to which the residential mortgage RWA formula is applicable. Footnote 68 to the paragraph allows subsegments of residential mortgages that are subject to sovereign guarantees to be exempted from the LGD floor. CAR Guideline, Chapter 6 paragraph 74 states that any portion of residential mortgages that are guaranteed or insured by the Government of Canada is exempted from the LGD floor. The paragraph further specifies that residential mortgages that are insured by a private mortgage insurer having a Government of Canada backstop guarantee may be separated into a sovereign-guaranteed exposure and a corporate-guaranteed exposure – the portion with a sovereign guarantee is exempted from the LGD floor. OSFI's treatment is in line with the credit risk mitigation provisions in the Basel framework.
Basel paragraph no	Basel II paragraph 454
Reference in the domestic regulation	CAR guideline Chapter 6 paragraph 280
Observation	Basel II paragraph 454 states that national supervisors will provide appropriate guidance as to how elements on indications of unlikeliness of an obligor to pay must be implemented and monitored. OSFI guidance on the recognition of unlikeliness to pay is implemented through the Implementation Note C-1 on impairment, which refers to accounting standards on impairment. OSFI provides guidance on the monitoring of the triggers of an obligor's unlikeliness to pay in implementation notes: (a) Implementation Note: Risk Quantification at IRB Institutions (b) Implementation Note: Data Maintenance at IRB Institutions (c) Implementation Note: Validating Risk Rating Systems at IRB institutions The Implementation Note on Data Maintenance at IRB Institutions requires banks to maintain comprehensive historical data across legal entities and geography.

	This data will include, but not be limited to, borrower information, credit transaction details, portfolio risk characteristics, ratings, rating migration, default and collateral. Banks are also required to establish clear and comprehensive documentation for data definition, collection and aggregation. These requirements constrain the ability of banks to change the definition of default to manipulate capital requirements or disclosure of credit losses. The Implementation Note on Risk Quantification at IRB Institutions recognises that banks use data from different sources and that these data likely use somewhat different definitions of default. Banks are required to study these differences and make suitable adjustments to achieve consistency. The Implementation Note: Validating Risk Rating Systems at IRB institutions requires banks to confirm the consistency of data used in the definition of default.

Counterparty credit risk framework

Basel paragraph no	Basel II Annex 4, paragraph 97, added by Basel III paragraph 99
Reference in the domestic regulation	CAR Guideline, Chapter 4, paragraph 109; Letter on CVA Grandfathering and Market Risk Hedges (21 Aug 2013)
Observation	For the "all-in" capital targets imposed by OSFI from 1 Jan 2013 (essentially the 2019 Basel capital ratios brought forward to 2013), OSFI applies scalars to phase in the CVA risk capital charge over five years from 1 Jan 2014 to 1 Jan 2019. By 1 Jan 2019, the CVA risk capital charge will be fully phased in. For the Basel III transitional minimum and capital buffer requirements which are imposed by OSFI in parallel, the Canadian banks are subject to the full CVA risk capital charge (ie without application of the scalars). This is clarified in an amendment to OSFI's advisory on "Public Capital Disclosure Requirements related to Basel III Pillar 3". Hence, the treatment applied by OSFI is assessed to be in line with the Basel framework.
Basel paragraph no	Basel II Annex 4 paragraph 104, added by Basel III paragraph 99
Reference in the domestic regulation	CAR Guideline Chapter 4 paragraph 116
Observation	OSFI introduced a 2% weight for exposures to unrated counterparties in the Standardised CVA risk capital charge (SCVA) for banks which do not have an approved rating system, as the Basel rules do not specify the treatment for such exposures. The application of the 2% weight is equivalent to treating unrated counterparties as BB-rated counterparties in the SCVA, which is equivalent to or more conservative than the treatment of unrated counterparties in the Standardised Approach for Credit Risk. Hence, the Assessment Team considers OSFI's specification as appropriate.

Market risk: Standardised Measurement Approach

Basel paragraph no	Basel II paragraphs 709 (i)–709(ii), amended by Basel 2.5
Reference in the domestic regulation	CAR Guideline Chapter 9 paragraph 51
Observation	OSFI's CAR Guideline defines more precisely than the Basel framework the cases in which convertible bonds must be treated as equities for the measurement of interest rate risk. Specifically, the CAR Guideline states that convertible bonds must be treated as equities where: • the first date at which conversion may take place is less than three months ahead, or the next such date (where the first has passed) is less than a year ahead; and

	• the convertible is trading at a premium of less than 10%, where the premium is defined as the current mark-to-market value of the convertible less the mark-to-market value of the underlying equity, expressed as a percentage of the mark-to-market value of the underlying equity. OSFI explained that the guidance was included to provide more consistent interpretation of the Basel requirement, following consultation with banks.

Market risk: Internal Models Approach

Basel paragraph no	Guidelines for Computing Capital for Incremental Risk in the Trading Book, paragraph 9; Basel II paragraph 718(xciii), amended by Basel 2.5
Reference in the domestic regulation	CAR Guideline Chapter 9 paragraphs 231, 232 and 209
Observation	Paragraph 9: "With supervisory approval, a bank can choose consistently to include all listed equity and derivatives positions based on listed equity of a desk in its incremental risk model when such inclusion is consistent with how the bank internally measures and manages this risk at the trading desk level. If equity securities are included in the computation of incremental risk, default is deemed to occur if the related debt defaults (as defined in paragraphs 452 and 453 of the Basel II Framework)." OSFI CAR Guideline Chapter 9 paragraph 231 stipulates that, with OSFI approval, a bank can choose consistently to include all listed equity and derivatives positions based on listed equity of a desk in its incremental risk model. However, the text did not stipulate if such inclusion must be consistent with how the bank internally measures and manages equity risk at the trading desk level. On the same note, the text did not define default as deemed to occur if the related debt defaulted (as defined in paragraphs 452 and 453 of the Basel II Framework). In the following paragraph (paragraph 232 OSFI Note), OSFI explained that at this time it was not confident in the ability of firms to model migration and default risk in equities. In time, as modelling standards evolve, OSFI would revisit this policy. OSFI further explained that in the context of convertible bonds, a bank could achieve partial hedge recognition by including the embedded warrant component of this hybrid instrument in its equity general market risk VaR and equity specific risk VaR models. If a bank elects to do this, at a minimum the remainder of the decomposed convertible bond is still subject to default and migration risk, which should be captured either in an IRC model or through the application of the standardised framework for convertible bonds. In line with this position taken by OSFI, ie equities are not permitted in the IRC model, the corresponding OSFI text for Basel 718(xciii), ie OSFI paragraph 209, did not make reference to the standardised measurement method for equity positions as a fallback measure when a bank did not capture the incremental risks through an internally developed approach.

Operational risk: Introduction, Basic Indicator Approach and Standardised Approach

Basel paragraph no	Basel II paragraph 646
Reference in the domestic regulation	CAR Guideline Chapter 8 paragraph 4
Observation	The Basel text states that banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. OSFI's text is identical to the Basel text. OSFI reported that only one of the six RCAP banks currently uses the AMA. The remaining five use the SA. The Basel standards for operational risk were implemented in Canada in November 2007. OSFI indicated that all internationally active banks are on track to implement AMA

	by 2015 and their implementation is tracked and communicated internally at OSFI and within the banks on at least a quarterly basis.

Operational risk: Advanced Measurement Approach

Basel paragraph no	Basel II paragraph 680
Reference in the domestic regulation	CAR Guideline Chapter 8 paragraphs 68–76
Observation	The Basel text states that a bank may apply partial use of AMA provided, among other conditions, that a significant part of the bank's operational risks are captured by the AMA, and that the bank provides its supervisor with a plan specifying the timetable on which it intends to roll out the AMA across all but an immaterial part of its operations. The plan should be driven by practicality and feasibility of moving to AMA over time, and not for other reasons. OSFI notes provide a definition for "material" and "significant". OSFI has defined "significant" as 75% and "material" as 90% of all bank operations. The Basel text is silent on definitions for these terms. OSFI also states that the bank has five years to roll out the AMA to a "material" part of its operations. OSFI considers the definitions to be appropriate and, in the absence of Basel requirements, sees value in consistent application and expectations across institutions. The five-year requirement to meet the material criteria is intended to set a time limit on banks' plans and to limit partial use.

Pillar 2

Basel paragraph no	Basel II paragraph 738(ii)
Reference in the domestic regulation	Guideline on Internal Capital Adequacy Process (ICAAP) for Deposit-Taking Institutions (E-19), p 9 Corporate Governance Guideline (E-18)
Observation	Basel II paragraph 738(ii) states: "Banks must supplement their VAR model with stress tests (factor shocks or integrated scenarios whether historic or hypothetical) **and other appropriate risk management techniques** … **in particular, it must factor in, where appropriate:** • Illiquidity/gapping of prices; • Concentrated positions (in relation to market turnover); • **One-way markets;** • **Non-linear products/deep out-of-the money positions;** • **Events and jumps-to-defaults;** • **Significant shifts in correlations;** • **Other risks that may not be captured appropriately in VaR (eg recovery rate uncertainty, implied correlations, or skew risk).** The parts in bold highlight are not incorporated in the OSFI CAR Guideline. However, there is related evidence in other parts of the OSFI Guidelines which provides banks with guidance on how to include these factors, if appropriate.
Basel paragraph no	Basel II paragraph 738(v)
Reference in the domestic regulation	Guideline on Internal Capital Adequacy Process (ICAAP) for Deposit-Taking Institutions (E-19), p 9
Observation	Basel II paragraph 738(v) states that banks must demonstrate how they combine their risk management approaches to arrive at internal capital for market risk. The requirement in Basel paragraph 738(v) is not incorporated in the OSFI Guidelines. However, OSFI requires banks to demonstrate or reconcile their use of a variety of

	risk measurement approaches in determining their economic capital.

Pillar 3

Overview of findings by Basel paragraph:	
Basel paragraph no	Composition of capital disclosure requirements paragraphs 1–38 and Basel II paragraphs 808–825
Reference in the domestic regulation	Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013) and Advisory on Pillar 3 Disclosure Requirements (as of September 2006)
Observation	OSFI implemented the Basel Pillar 3 and composition of capital disclosure requirements via advisories. Based on the seven RCAP criteria to assess the binding nature of regulatory instruments issued by OSFI (Annex 7), the Assessment Team concluded that the use of advisories is eligible for the RCAP assessment. OSFI intends to issue its Pillar 3 requirements as a Guideline once the Basel Committee completes its ongoing review on Pillar 3.
Basel paragraph no	Composition of capital disclosure requirements paragraph 3
Reference in the domestic regulation	Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013), Sections 1 and 5
Observation	OSFI requires D-SIBs in Canada to implement the composition of capital disclosure requirements under the Basel framework. Non-D-SIBs in Canada are subject to a modified composition of capital disclosure template as described in Annex 5 of the Advisory on the basis that: (i) the need for the balance sheet reconciliation is less evident given that their balance sheet reconciliations are less complex; (ii) the users of their financial statements are largely domestic investors and consumers arguably focused more on solvency than on detailed calculation of capital; and (iii) they are not likely to be compared to institutions in other jurisdictions. The Assessment Team notes that OSFI's approach has no material impact on Pillar 3 implementation in Canada as the non-D-SIBs are not internationally active currently and OSFI will periodically review the designation of D-SIBs in Canada as well as the degree to which the non-D-SIBs are internationally active over time.
Basel paragraph no	Enhancements to the Basel II framework – Revisions to Pillar 3 (Market discipline) paragraphs 1–6 and Pillar 3 disclosure requirements for remuneration paragraphs 5 – 7
Reference in the domestic regulation	Letter on Implementation of Disclosures for Basel II Pillar 3 Enhancements and Revisions (as of July 2011) and Letter on Implementation of Basel II Pillar 3 Disclosure Requirements for Remuneration (as of December 2011)
Observation	OSFI implemented the Basel disclosure requirements for remuneration and enhancements to Pillar 3 disclosure requirements via public letters. Using the seven RCAP criteria to assess the binding nature of regulatory instruments issued by OSFI (Annex 7), the Assessment Team concluded that the use of public letters is eligible for the RCAP assessment. OSFI intends to issue its Pillar 3 requirements as a Guideline once the Basel Committee completes its review of Pillar 3.

Annexes

Annex 1: RCAP Assessment Team and Review Team

Assessment Team Leader:

Mr Ong Chong Tee	Monetary Authority of Singapore

Assessment Team Members:

Ms Donna Hornig	Office of the Comptroller of the Currency, US
Mr Mahmut Kutlukaya	Banking Regulation and Supervision Agency, Turkey
Mr Timo May-Johann	Deutsche Bundesbank, Germany
Mr Roland Raskopf	Bank for International Settlements, Financial Stability Institute
Mr Noel Reynolds	Bank for International Settlements, Financial Stability Institute
Mr Peter de Rijke	Netherlands Bank, Netherlands

Supporting Members:

Mr Christian Schmieder	Basel Committee Secretariat
Ms Sandy Ho	Monetary Authority of Singapore
Mr Tan Keng Heng	Monetary Authority of Singapore

Review Team Members:[24]

Mr Alwaleed Khaled Alsheikh	SIG member, Saudi Arabian Monetary Agency, Saudi Arabia
Mr Stephen Bland	SIG member, Prudential Regulation Authority, United Kingdom
Mr William Coen	Basel Committee Secretariat
Mr Olof Sandstedt	SIG member, Riksbank, Sweden

[24] The Review Team is distinct from the Assessment Team, and provides an additional level of quality assurance for the report's findings and conclusions. The Assessment Team has also benefited from the feedback of the RCAP Peer Review Board. The Assessment Team has also coordinated closely with Mr Udaibir Das, Head of Basel III Implementation at the Basel Committee Secretariat.

Annex 2: Implementation of the Basel framework as of cut-off date

Overview of adoption of capital standards

Table 4

Basel III Regulation	Date of issuance by BCBS	Transposed in Canadian rule	Date of implementation in Canada	Status
Basel II				
Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	June 2006	*CAR Guidelines, revised version* Advisory on Pillar 3 Disclosure Requirements (as of September 2006)	1 November 2007 1 November 2007	4
Basel 2.5				
Enhancements to the Basel framework Guidelines for computing capital for incremental risk in the trading book Revisions to the Basel II market risk framework	July 2009	*CAR Guidelines, revised version* Advisory on Pillar 3 Disclosure Requirements (as of September 2006) Letter on Implementation of Disclosures for Basel II Pillar 3 Enhancements and Revisions (as of July 2011)	1 January 2012 1 November 2007 First quarter of fiscal 2012	4
Basel III				
Basel III: A global regulatory framework for more resilient banks and banking systems – revised version	June 2011 (Consolidated version)	*CAR Guidelines, revised version*	1 January 2013	4
Pillar 3 disclosure requirements for remuneration	July 2011	Advisory on Pillar 3 Disclosure Requirements (as of September 2006) Letter on Implementation of Basel II Pillar 3 Disclosure Requirements for Remuneration (as of December 2011)	1 November 2007 Fiscal year-end of 2012	4
Treatment of trade finance under the Basel capital framework	October 2011	*CAR Guidelines, revised version*	1 January 2013	4
Composition of capital disclosure	June 2012	Advisory on Pillar 3 Disclosure	1 November 2007	4

requirements		Requirements (as of September 2006) Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013)	July 2013	
Capital requirements for bank exposures to central counterparties	July 2012	*CAR Guidelines, revised version*	1 January 2013	4

Number and colour code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. For rules which are due for implementation as on 30 June 2012**,** the following colour code is used: Green = implementation completed; Yellow = implementation in process; Red = no implementation

Annex 3: List of capital standards under the Basel framework used for the assessment

(i) International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), June 2006

(ii) Enhancements to the Basel II framework, July 2009

(iii) Guidelines for computing capital for incremental risk in the trading book, July 2009

(iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", Basel Committee press release, 13 January 2011

(v) Revisions to the Basel II market risk framework: Updated as of 31 December 2010, February 2011

(vi) Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)

(vii) Pillar 3 disclosure requirements for remuneration, July 2011

(viii) Treatment of trade finance under the Basel capital framework, October 2011

(ix) Interpretive issues with respect to the revisions to the market risk framework, November 2011

(x) Basel III definition of capital – Frequently asked questions, December 2011

(xi) Composition of capital disclosure requirements: Rules text, June 2012

(xii) Capital requirements for bank exposures to central counterparties, July 2012

(xiii) Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee, July 2012

(xiv) Basel III counterparty credit risk – Frequently asked questions, November 2011, July 2012, November 2012

Annex 4: Local regulations issued by OSFI for implementing Basel capital standards

Overview of issuance dates of important Canadian capital rules

Table 5

Domestic regulations	Name of the document, version and date
Domestic regulations implementing Basel II	CAR Guidelines, revised version (as of November 2007) Guideline on Transitional Period Capital Floor Requirement for Institutions using the Internal Ratings-Based Approach to Credit Risk (November 2007) Advisory on Pillar 3 Disclosure Requirements (September 2006)
Domestic regulations implementing Basel 2.5	CAR Guidelines, revised version (December 2011) Advisory on Pillar 3 Disclosure Requirements (September 2006) Letter on Implementation of Disclosures for Basel II Pillar 3 Enhancements and Revisions (July 2011)
Domestic regulations implementing Basel III	CAR Guidelines, revised version (December 2012 and revised April 2014) Letter on CVA Grandfathering and Market Risk Hedges (August 2013) Advisory on Domestic Systemic Importance and Capital Targets (March 2013) Implementation Note on Approval of Regulatory Capital Models for Deposit-Taking Institutions (December 2009) Implementation Notes for IRB Institutions (as of January 2006) Implementation Note on Corporate Governance at Standardised Approach or Advanced Measurement Approach Institutions for Operational Risk (May 2006) Implementation Note on Data Maintenance at Standardised Approach or Advanced Measurement Approach Institutions for Operational Risk (May 2006) Stress Testing Guideline (December 2009) Guideline on Internal Capital Adequacy Assessment Process (ICAAP) for Deposit-Taking Institutions (October 2010) Advisory on Pillar 3 Disclosure Requirements (as of September 2006) Letter on Implementation of Basel II Pillar 3 Disclosure Requirements for Remuneration (December 2011) Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (July 2013)

Hierarchy of Canadian laws and regulatory instruments

Table 6

Level of rules (in legal terms)	Type
Laws	Enacted by the Canadian Parliament
Guidelines	Issued by OSFI
Advisories	Issued by OSFI
Rulings	Issued by OSFI
Public Letters	Issued by OSFI
Implementation Notes	Issued by OSFI
Discussion Papers	Issued by OSFI

Annex 5: Details of the RCAP assessment process

A. Off-site evaluation

(i) Completion of a RCAP questionnaire (self-assessment) by OSFI

(ii) Evaluation of the RCAP questionnaire by the RCAP Assessment Team

(iii) Independent comparison and evaluation of the domestic regulations issued by OSFI with corresponding Basel III standards issued by the BCBS

(iv) Identification of observations

(v) Refinement of the list of observations based on clarifications provided by OSFI

(vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgement

(vii) Forwarding of the list of observations to OSFI

B. On-site assessment

(viii) Discussion of individual observations with OSFI

(ix) Meeting with selected Canadian banks, one audit firm and three credit rating agencies

(x) Discussion with OSFI and revision of findings to reflect additional information received

(xi) Assignment of component grades and overall grade

(xii) Submission of the detailed findings to OSFI with grades

(xiii) Receipt of comments on the detailed findings from OSFI

C. Review and finalisation of the RCAP report

(xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to OSFI for comments

(xv) Review of OSFI's comments by the RCAP Assessment Team

(xvi) Reporting of findings to SIG by the team leader

(xvii) Review and clearance of the draft report by the RCAP Review Team and Peer Review Board

Annex 6: List of items rectified by OSFI during the RCAP assessment

The revised CAR Guideline was published on 25 April 2014.

Basel Paragraph	Reference to OSFI document and paragraph	Brief description of the correction
Scope of Application		
1. Basel II paragraph 24	CAR Guideline Chapter 1 paragraph 4	The CAR Guideline permitted financial entities to be excluded from consolidation if their leverage was "inappropriate for a deposit-taking institution". This exclusion based on leverage, which is not present in the Basel Standards, has been deleted from the updated CAR Guideline.
Definition of Capital		
2. Basel III paragraph 52: Components of Common Equity Tier 1	CAR Guideline Chapter 2 paragraph 3: Other contributed surplus and interim profits and losses	The CAR Guideline included "other contributed surplus" as an element of CET1. The Assessment Team was concerned that this element of reserves could be misinterpreted and could result in banks including in CET1 stock surplus (share premium) related to instruments that are not themselves included in CET1, eg preferred shares. Also, the CAR Guideline was not explicit that interim profit and losses are included in CET1. In the revised CAR Guideline the reference to "other contributed surplus" has been removed and an explicit reference to the inclusion of interim profits and losses has been added.
3. Basel III paragraph 52, footnote 10: Unrealised gains and losses	CAR Guideline Chapter 2 paragraph 50: Reversal of unrealised gains and losses on own use property	Paragraph 50 of the CAR Guideline required revaluation losses and gains with respect to own-use property to be reversed from retained earnings for capital adequacy purposes. This approach contravened footnote 10 of Basel III, which states that there is no adjustment applied to remove from CET1 unrealised gains or losses recognised on the balance sheet. The relevant part of paragraph 50 has been deleted in the CAR Guideline to align it with the Basel III treatment.
4. Basel III paragraph 60 and Basel II paragraph 49(vii): General provisions/loan loss reserves included Tier 2 under the Standardised Approach	CAR Guideline Chapter 2 paragraph 39: Inclusion of collective allowances in Tier 2	The CAR Guideline permitted "collective allowances" for credit risk to be included in Tier 2. Basel II permits the inclusion of "General provisions/general loan-loss reserves" in Tier 2 but not in cases where the reserves are "created against identified losses or in respect of an identified deterioration in the value of any asset or group of subsets of assets". It was unclear to what extent the collective allowances of Canadian banks reflect an identified deterioration in the value of a group of assets. The revised CAR Guideline states that allowances ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded.
5. Basel III paragraph 62: Common shares issued by consolidated subsidiaries and held by third parties	CAR Guideline Chapter 2 paragraph 6b, footnote 11: Calculation of surplus capital of subsidiaries	For consolidated subsidiaries that have issued common equity to third parties, Basel III requires banks to calculate the amount of surplus capital in the subsidiaries that is attributable to the third-party investors. Unlike Basel III, the CAR Guideline did not state that the minimum requirement plus the capital conservation buffer (ie the amount used to calculate the surplus capital) is equal to 7% of RWAs. This created a risk that larger national specific buffers could be

		used to reduce the calculated amount of surplus capital attributable to third parties. Also, the CAR Guideline was unclear on whether the parent's or the subsidiary's calculation of RWAs should be used. Similar issues existed in the CAR Guideline for the calculation of surplus Tier 1 and surplus Total Capital. The revised CAR Guideline includes the relevant percentages stated in Basel III and clarifies the determination of RWAs.
6. Basel III paragraph 67: Goodwill deduction	CAR Guideline Chapter 2 paragraph 51 and footnote 50: Goodwill included in the valuation of significant investments	Paragraph 67 of the Basel III explicitly requires the scope of goodwill deduction to include goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation. In contrast, the CAR Guideline stated in footnote 50 that "Goodwill and intangibles related to significant investments in unconsolidated entities should be deducted as part of the deduction for significant investments outlined in paragraphs 69–76." The revised CAR Guideline amends paragraph 51 and footnote 50 to align it with the Basel III treatment.
7. Basel III paragraphs 69 and 70: Deferred tax assets	CAR Guideline Chapter 2 paragraph 54: Risk weighting of certain DTAs at 100%	Basel III requires all DTAs that "rely on the future profitability of the bank to be realised" to be subject to a deduction treatment. Paragraph 54 of the CAR Guideline permitted DTAs to be risk-weighted at 100% if they arise from a "temporary difference that the institution could realise through loss carrybacks". It was not clear that such DTAs do not rely on the future profitability to be realised. The revised CAR Guideline now includes a condition that DTAs subject to the risk weight treatment do not depend on the future profitability of the bank to be realised.
8. Basel III paragraphs 80–83 and 84–86: Significant investments in financial entities that are outside the scope of consolidation	CAR Guideline Chapter 2 paragraphs 64–69: Threshold for determining a significant investment	Paragraph 84 of Basel III defines a significant investment as occurring where "the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate of the bank". Such investments are subject to the threshold deduction treatment described in Basel III. Footnote 65 of the CAR Guideline defined "significant investment" by reference to Section 10 of the Bank Act or the Trust and Loan Companies Act. Although these include the 10% threshold of Basel III, they do not include the reference to affiliates of the bank. They also include an additional determinant, which is when a bank owns more than 25% of a financial institution's total outstanding Tier 1 capital. The revised CAR Guideline retains the references to the Bank Act and Trust and Loan Companies Act, but adds the requirement to include investments in affiliates and removes the additional determinant.
9. Basel III paragraphs 80–85: Deduction of investments in the capital of financial institutions	CAR Guideline Chapter 2 Section 2.3.1, footnote 62: Netting of long and short positions in the capital of other financial institutions	Paragraphs 80 and 84 of Basel III require the deduction (on a threshold basis) of investments in the capital of financial institutions. These paragraphs permit the netting of long and short positions, subject to certain conditions including a maturity requirement. Footnote 62 of the CAR Guideline permitted an exemption to the maturity requirement in one specific case relating to investments in equities that were held against synthetic short positions. Such an exemption is not permitted in Basel III and has been removed from the revised CAR Guideline.
10. Basel III paragraphs 84–86: Deduction of significant investments in the capital of financial entities	CAR Guideline Chapter 2 paragraph 74: Treatment of investments in the capital of mutual funds	Regarding investments in other financial institutions, Paragraph 74 of the CAR Guideline referred to the Guidance Note Investments by Federally Regulated Financial Institutions in Mutual Fund Entities (December 1999). A paragraph of this Guidance Note could be interpreted as implying that a bank could have a significant investment in the equity of an unleveraged mutual fund and exclude it from the deduction requirement. This would not be compliant with the Basel III requirements which require deduction of significant investments irrespective of their leverage. The revised CAR Guideline deletes the reference to the Guidance Note.
11. Basel III definition of capital FAQ #20 (p 18): Treatment of	CAR Guideline Chapter 2 paragraph 95: Treatment	This issue relates to the deduction requirements that apply to banks investments in the capital of other financial institutions, in the specific case when the capital instruments in question are being phased out from the investee's

investments in the capital of financial institutions that are being phased out	of investments in the capital of financial institutions that are being phased out	capital base. The Basel FAQ states that banks should use the full value of investments in calculating the amount to be subject to the deduction treatment. However, paragraph 95 of the CAR Guideline required banks to deduct the full value of any such investments. The revised CAR Guideline requires banks to use the full value of any such investments, in accordance with the FAQ.
12. Composition of Capital Disclosure Requirements	Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013), Annex 1	Based on the BCBS' Composition of Capital Disclosure templates, the required disclosure in row 7 (ie adjusted against CET1) pertains to prudential valuation adjustments in accordance with paragraphs 698 to 701 of the Basel II text. OSFI had implemented this disclosure under panel 41b of the OSFI template, ie adjusted against AT1 capital. The updated CAR Guideline and OSFI disclosure template applies the prudential valuation adjustment to CET1.
13. BCBS' Minimum Requirements to ensure loss absorbency at the point of non-viability (PON): Paragraphs 1–7	CAR Guideline Chapter 2 paragraph 43, principles #1 and #9	The Basel Committee's PON requirements permit conversion into shares of the parent company when the PON trigger occurs at a subsidiary. The CAR Guideline also permitted conversion into the shares of an affiliate under certain circumstances. This option has been removed in the updated CAR Guideline.
Capital conservation buffer		
14. Basel III paragraph 131: Consequences of breaching the capital conservation buffer	CAR Guideline Chapter 1 paragraph 34: Potential for "other remedial action"	The Basel framework requires that capital distribution constraints be imposed if a bank's CET1 ratio falls into the capital conservation buffer range. However, the CAR Guideline stated that the distribution constraints will be imposed "in the absence of other remedial actions to improve its capital ratios". In Basel III the only permitted exception to the distribution constraints is the bank raising capital in the private sector equal to the amount above the constraint which it wishes to distribute. The updated CAR Guideline removes the reference to "other remedial actions".
15. Basel III paragraph 131: Consequences of breaching the capital conservation buffer	CAR Guideline Chapter 1 paragraph 35: Specific conservation ratios that apply	In describing the conservation ratios that apply, paragraph 131 of Basel III states that the CET1 ratio includes CET1 used to meet the 4.5% minimum CET1 requirement, but excludes any additional CET1 used to meet the 6% minimum Tier 1 and 8% minimum Total Capital requirement. This statement was omitted from the CAR Guideline, but has been included in the updated version.
16. Basel III paragraph 131: Distribution of earnings	CAR Guideline Chapter 1 paragraph 37: Reference to historic earnings	Under Basel III the capital conservation ratios apply on a forward-looking basis, restricting the distribution of earnings in the subsequent financial year following a breach of the buffer. In contrast, paragraph 37 the CAR Guideline defined earnings as "distributable profits for the previous four quarters". The reference to the previous four quarters has been deleted in the updated CAR Guideline.
Credit risk: Standardised Approach		
17. Basel II paragraph 59	CAR Guideline Chapter 3 paragraph 14	The Multilateral Investment Guarantee Agency was not included in the list of multilateral development banks eligible for a 0% risk weight. The revised CAR Guideline includes the Multilateral Investment Guarantee Agency in the list to align with the Basel treatment.
18. Basel II paragraph 68	CAR Guideline Chapter 3 paragraphs 22 and 23	Paragraph 68 of Basel II states that banks should obtain supervisory approval before utilising the option to risk-weight all corporate claims at a flat 100%. CAR Guideline Chapter 3 paragraph 23 is updated so that institutions must seek OSFI's prior approval to apply a 100% risk weight to all corporate exposures.
19. Basel II paragraph 72	CAR Guideline Chapter 3 paragraph 31	According to CAR Guideline Chapter 3 paragraph 31, "Where a mortgage is comprehensively insured by a private sector mortgage insurer that has a backstop guarantee provided by the Government of Canada (for example, a guarantee

		made pursuant to subsection 193(1) of the Budget Implementation Act of 2006), institutions may recognise the risk-mitigating effect of the guarantee by reporting the portion of the exposure that is covered by the Government of Canada backstop as if this portion were directly guaranteed by the Government of Canada." The reference given to the repealed Budget Implementation Act of 2006 is corrected.
20. Basel II paragraphs 82–89	CAR Guideline Chapter 3 paragraphs 51–98	A 100% credit conversion factor is applied in paragraph 83(ii) of Basel II to asset sales with recourse, and in paragraph 84(i) to forward deposits and partly paid shares and securities. Additionally, footnotes 34 and 35 of Basel II require that the off-balance sheet items set out in paragraph 83(ii) and 84(i) are "to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into". These missing Basel II provisions are included in the CAR Guideline.
21. Basel II paragraph 92	CAR Guideline Chapter 3 paragraph 103	Basel II requires that the mapping of eligible ECAI's assessments to the risk weights should cover the full spectrum of risk weights. The mapping table for long-term ratings provided in CAR Guideline Chapter 3 paragraph 103, which did not cover all risk weight categories, was updated.
22. Basel II paragraphs 145(d), 146(b), 151, 153, 171(f)	CAR Guideline Chapter 5 paragraphs 43(d), 45(b), 50, 52, 59(f)	CAR Guideline Chapter 5 paragraphs 43(d), 45(b), 50 and 52 referred to "recognised exchanges" without setting out which exchanges were to be considered "recognised". Similarly, CAR Guideline Chapter 5 paragraph 59(f) referred to "recognised clearing organisations" without specifying which clearing organisations were to be considered recognised. OSFI rectified these paragraphs by defining recognised exchanges as regulated public exchanges and referring to qualifying central counterparties for recognised clearing organisations.
23. Basel II paragraph 186	CAR Guideline Chapter 5 paragraphs 72–73	In the calculation of the counterparty credit risk charge with respect to collateralised OTC derivative transactions, Basel II paragraph 186 requires that the add-on factor for potential future exposure is calculated according to the Basel II CEM under Annex 4, paragraphs 92(i) and 92(ii). In CAR Guideline Chapter 5 paragraphs 72 and 73, which were later rectified, the calculation of the add-on was based on the 1988 Basel Accord.
24. No specific paragraphs	CAR Guideline Chapter 5	Several referencing errors in the CAR Guideline Chapter 5 were rectified.
Credit risk: Internal Ratings -Based Approach		
25. Basel II paragraph 237	CAR Guideline Chapter 6 paragraph 40	Basel II paragraph 237 requires banks to classify debt obligations and other securities with the intent of conveying the economic substance of equity ownership as an equity exposure. OSFI CAR Guideline Chapter 6 paragraph 40 defined which preferred instruments are to be treated as equity based only on redeemability features. OSFI updated paragraph 40 to clarify which preferred instruments are to be treated as debt.
Credit risk: Securitisation Framework		
26. Basel II paragraph 562	CAR Guideline Chapter 7 paragraph 46	CAR Guideline Chapter 7 paragraph 46 (which implemented Basel II paragraph 562) required gain-on-sale to be deducted from Tier 1 capital. This has been superseded by Basel III paragraph 74 which requires gain-on-sale to be derecognised from CET1. OSFI had implemented Basel III paragraph 74 consistently in CAR Guideline Chapter 2 (Definition of Capital), but had not updated Chapter 7 paragraph 46 to be consistent with Chapter 2. OSFI has now amended CAR Guideline Chapter 7.
27. Basel II paragraph 565(b), replaced by Basel III para 120	CAR Guideline Chapter 7 paragraph	CAR Guideline Chapter 7 para 49(b) referenced the eligibility criteria for external credit assessment institution (ECAI) to CAR Guideline Chapter 3 paragraph 102. The eligibility criteria are however located in CAR Guideline Chapter 3

	49(b)	paragraph 101. OSFI has amended the reference.
28. Basel II paragraph 632	CAR Guideline Chapter 7 paragraph 124	CAR Guideline Chapter 7 paragraph 124 referenced the add-ons under the 1988 Accord, instead of the add-ons in the Basel II CEM. OSFI clarified that its Capital Adequacy Reporting Instructions provided the correct reference and that the Canadian banks are applying the correct add-ons. OSFI has amended the reference.
Counterparty credit risk		
29. Basel II Annex 4 paragraph 94	CAR Guideline Chapter 4 paragraph 93	CAR Guideline Chapter 4 paragraph 93 referenced the definition of qualifying asset in Chapter 9 Section 9.10.1.1. In contrast to the Basel rules, it was not required that for debt securities issued by banks to be included in the qualifying category, the issuing banks have to be subject to supervisory and regulatory arrangements comparable to the Basel framework. OSFI has amended the CAR Guideline to add this condition to the definition.
30. BCBS July 2012 document on capital requirements for bank exposures to central counterparties, adding Annex 4 Paragraph 127 to Basel II	CAR Guideline Chapter 4 paragraph 143	The Basel text requires that, where there is a liability for unfunded contributions to non-qualifying central counterparties, the national supervisor should determine in its Pillar 2 assessments the amount of unfunded commitments to which a 1250% risk weight should apply. However, CAR Guideline Chapter 4 paragraph 143 added the text "in the absence of an ability to calculate Kccp" at the rear of the Basel provision. The addition of this text may limit the scope of application of the Basel provision. OSFI has amended the CAR Guideline to delete the additional text.
31. Basel II: Annex 4 paragraph 16	CAR Guideline Chapter 4 paragraph 19	CAR Guideline Chapter 4, paragraph 19 referenced the legal requirements for recognition of bilateral netting of derivatives in Chapter 3. The legal requirements are however located in Chapter 4 (Section 4.1.6.3) instead of in Chapter 3. OSFI has amended the reference.
32. Basel II Annex 4 paragraph 91	CAR Guideline Chapter 4 paragraph 88	CAR Guideline Chapter 4 paragraph 88 omitted the text "or under Part 2, Section II.D of this framework". The omission of this text may have the effect of subjecting securities financing transactions (SFTs) to only the Internal Model Method. The Canadian banks are using the standardised treatment of SFTs. OSFI has amended the CAR Guideline to address the omission.
33. Basel II Annex 4 paragraph 96	CAR Guideline Chapter 4 paragraph 100	CAR Guideline Chapter 4 paragraph 100 referenced the treatment for an nth-to-default transaction to CAR Guideline Chapter 9. The treatment is however located in Chapter 4, paragraph 94 instead of in Chapter 9. OSFI has amended the reference.
34. BCBS July 2012 document on capital requirements for bank exposures to central counterparties, adding Annex 4 Paragraph 112 to Basel II	CAR Guideline Chapter 4 paragraph 127	CAR Guideline Chapter 4 paragraph 127 referenced the conditions for netting to CAR Guideline Chapter 4 paragraph 102. The conditions for netting however, are located in Chapter 4 paragraph 101 to 103, instead of only Chapter 4 paragraph 102. OSFI has amended the reference.
35. Basel III, paragraph 99 (adding	Advisory on "Public	OSFI amended its advisory on "Public Capital Disclosure Requirements related to Basel III Pillar 3" to clarify that

	Annex 4, paragraph 97 to Basel II): CVA risk capital charge	Capital Disclosure Requirements related to Basel III Pillar 3"	Canadian banks are subject to the full CVA risk capital charge (ie without the application of the scalars) for the Basel III transitional minimum capital requirements and buffer requirements.
Market risk: Standardised Measurement Approach			
36.	Basel II paragraphs 701(i)–708(i): Methods of measuring market risk	CAR Guideline Chapter 9 paragraph 28	OSFI allows credit derivatives that are used to hedge counterparty credit risk on other derivatives in the trading book to be exempt from counterparty credit risk capital requirements. However, OSFI does not make clear the condition under the Basel text that the hedged exposure has to be subject to the criteria and general rules for the recognition of credit derivatives. OSFI has made explicit reference to this condition, which is set out in Chapter 4 paragraph 9 of OSFI's CAR Guideline.
37.	Basel II paragraph 710(i)	CAR Guideline Chapter 9 paragraphs 61–62	OSFI has removed instruments that are collateralised by government paper from the "government" category for the computation of specific risk capital requirements for issuer risk.
38.	Basel II paragraphs 710–711(ii): Issuer Risk ("qualifying category")	CAR Guideline Chapter 9 paragraph 63	Unlike in the Basel text, OSFI's CAR Guideline does not require banks to be subject to supervisory and regulatory arrangements comparable to Basel II to be included in the "qualifying" category for the computation of interest rate risk. OSFI has incorporated this condition into its CAR Guideline.
39.	Basel II paragraphs 718(ix)–718(xviii): Interest rate derivatives	CAR Guideline Chapter 9 Appendices 9–5	No specific risk charge for interest rate risk is assigned to derivatives if the underlying security is a government security. Under the Basel framework, a specific risk charge is applied if the underlying government security is rated below AA–. OSFI has amended its CAR Guideline to be in line with the Basel framework.
40.	NA	CAR Guideline Chapter 9 paragraph 2	OSFI sets a materiality threshold before market risk capital requirements would apply. This materiality threshold applies when the value of trading book assets or liabilities whichever is greater: (a) is at least 10% of total assets; and (b) exceeds $1 billion. OSFI has amended its CAR Guideline to apply market risk capital requirements to internationally active institutions and all institutions designated by OSFI as domestic systemically important banks.
41.	NA	CAR Guideline Chapter 9 paragraph 79	OSFI corrected a minor referencing error in its CAR Guideline.
42.	NA	CAR Guideline Chapter 9 footnote 29 of Section 9.10.5.1 Table 1	OSFI corrected a minor referencing error in its CAR Guideline.
43.	Para 2.1 (2) of the "Interpretive issues with respect to the revisions to the market risk framework"	CAR Guideline Chapter 9 paragraph 85	The Basel interpretive document clarifies that a bank must exclude from the correlation trading portfolio any SPV-issued instrument backed, directly or indirectly, by a position that would itself be excluded if held by the bank directly. OSFI has incorporated this clarification into its CAR Guideline.
Market risk: Internal Models Approach			
44.	Basel II paragraph 718(lxxi)	CAR Guideline Chapter 9 paragraph 186	OSFI corrected an error where paragraph 186(d) erroneously referred to Section 9.11.6 of "Backtesting" instead of the correct Section 9.11.7 of "Stress testing".
45.	Basel II paragraph 718(lxxiii)	CAR Guideline Chapter 9 paragraph 188	OSFI omitted the reference to Basel paragraph 718(lxxxvi) of "Combination of internal models and the standardised methodology".

		OSFI amended the text in its CAR Guideline to rectify this issue.
46. Basel II paragraph 718(lxxiv)	CAR Guideline Chapter 9 paragraphs 189, 190	A wrong reference to the unrelated section of "Combination of internal models and the standardised methodology" was replaced by the correct Section 9.11.8 of "Model Validation".
47. Basel II paragraph 718(lxxiv)	CAR Guideline Chapter 9 paragraphs 189, 190	The reference to the document of "Supervisory framework for the use of backtesting in conjunction with the Internal Models Approach to market risk capital requirements" is missing in OSFI's CAR Guideline. OSFI added this reference in its guideline.
48. Guidelines for Computing Capital for Incremental Risk in the Trading Book, paragraph 11	CAR Guideline Chapter 9 paragraph 234	In the definition of "default risk", the statement "as well as the potential for indirect losses that may arise from a default event" was added to OSFI's CAR Guideline.
49. Guidelines for Computing Capital for Incremental Risk in the Trading Book, paragraph 26	CAR Guideline Chapter 9 paragraph 249	An incorrect reference to paragraph 247 was replaced by the correct reference to 246.
50. Interpretive Issues with Respect to the Revisions to The Market Risk Framework – Section 2.2 paragraph 1		Interpretive Issues with Respect to the Revisions to The Market Risk Framework (Section 2.2 paragraph 1) clarifies that banks are not allowed to perform a single calculation covering exposures subject to the IRC and exposures subject to the comprehensive risk measure capital charge and that disallowing a single calculation has the effect of not allowing any diversification between the portfolios. OSFI added such a requirement to its amended CAR Guideline.
51. Interpretive Issues with Respect to the Revisions to The Market Risk Framework – Section 2.2 paragraphs 2 and 11		The Basel text clarifies that, in the instance where multiple models are used to calculate capital charges for different risks in a correlation trading portfolio, a simple sum method is used in the capital computation. OSFI added this requirement to its amended CAR Guideline.
Pillar 3		
52. Composition of capital disclosure requirements: paragraphs 5–7	Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013), Sections 2 and 3	OSFI has included in the respective advisory that the composition of capital must either be included in banks' published financial statements or, at a minimum, these statements must provide a direct link to the completed disclosure on their websites or on publicly available regulatory reports.
53. Composition of capital disclosure requirements: paragraph 16	Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013), Section 4(ii)	OSFI has included in the respective advisory that banks are required to list the legal entities that are included in the regulatory consolidation that are not included in the accounting scope of consolidation.

54.	Composition of capital disclosure requirements: Annex 1	Advisory on Public Capital Disclosure Requirements related to Basel III Pillar 3 (as of July 2013), Annex 1	OSFI has changed the required disclosure in row 7 to relate to prudential valuation adjustments.

Annex 7: Assessment of the binding nature of regulatory instruments issued by OSFI

The following table summarises OSFI's self-assessment of the seven criteria used by the RCAP to determine the eligibility of OSFI's regulatory instruments for the RCAP. The Assessment Team concluded that the regulatory instruments issued and used by OSFI (as set out in Table 5 of Annex 4) are eligible for the RCAP assessment.

Criterion		Assessment (by OSFI)
(i)	The instruments used are part of a well defined, clear and transparent hierarchy and regulatory framework	The Bank Act (BA) and its supporting regulations provide a comprehensive framework for the setting and enforcing of minimum prudential standards for banks. For example, the BA sets, and empowers the Superintendent to set, minimum prudential standards upon incorporation and on an ongoing basis with respect to, among other things, ownership, governance, capital, liquidity, self-dealing, investments, specialised financing, and borrowing. As a complement to this legislative framework, OSFI is administratively empowered to publish several forms of guidance, as described below, which serve to clarify the legislative, regulatory and supervisory frameworks, and to articulate OSFI's regulatory and supervisory expectations and best practices on matters within its discretion. As these forms of guidance are not legislative in nature, and are issued by OSFI at its discretion, they are not subject to direct influence from governmental or other bodies: **Guidelines**, which are used to establish minimum best or prudent practices, set out OSFI's expectations and requirements for banks in order to govern industry activities and behaviour. These include guidelines on the supervisory framework, solvency standards (eg capital adequacy), prudential standards (eg large exposure limits, portfolio mix, liquidity), accounting standards (eg non-accrual loans, impaired loans), and sound business and financial practices (eg corporate governance, legislative compliance); **Advisories**, which clarify the position of OSFI regarding certain policy issues or describe how OSFI generally administers and interprets provisions of the BA, regulations or guidelines. Banks are expected to consider the relevance of these advisories, which are not case-specific, to their own particular circumstances and to take action, if needed; **Rulings**, which describe how OSFI has applied or interpreted provisions of the BA, regulations or guidelines in specific cases; and **Discussion papers & public letters**, which articulate OSFI's general policy direction in a specific area. Guidelines, advisories and public letters are used to establish policy on minimum, best or prudent practices and set out OSFI's expectations and requirements for banks in order to govern industry activities and behaviour. Guidelines, advisories and public letters set standards for industry activities and behaviour, are generally static for a period of time ranging from one to several years, depending upon the need to incorporate revisions to reflect changes in the environment. Guidelines, advisories and public letters generally fit into one of four categories: capital, accounting, prudential limits and restrictions, and sound business and financial practices.
(ii)	They are public and freely available	OSFI publishes all prudential standards, including guidelines, advisories, public letters, and public consultations on its website www.osfi-bsif.gc.ca.
(iii)	They are viewed as binding by banks as well as by the supervisors	The forms of guidance are a means whereby OSFI is able to swiftly, explicitly, and outside the political process, articulate its supervisory expectations and how the requirements, including adequate prudential standards, of the BA should be met. While the guidelines, advisories and public letters are not directly enforceable in law,

	failure to meet them is indicative of failure to meet the underlying legal standard. If OSFI determines that a bank has not met the standard by other means, OSFI has sufficient tools to compel compliance. The guidelines, advisories and public letters are therefore indirectly enforceable under the law. In practice all instruments are viewed as equivalent to regulations by the industry. In order for this approach of indirect enforcement to be effective and lead to desired supervisory outcomes, it is essential for OSFI to closely monitor the industry's compliance with the instruments and to be prepared to increase supervisory pressure as soon as a non-compliant institution is identified.
(iv) They would generally be legally upheld if challenged	Guidelines and other regulatory instruments have been in place since 1987 when OSFI was established. No legal challenge has ever been made as to their enforceability or reasonableness. While guidelines, advisories and public letters are not legally binding, any order issued as a result of failure to comply would be legally binding.
(v) They are supported by precedence of enforceability	The guidelines, advisories and public letters are not legally binding per se, but if an institution were to fail to comply with them, OSFI could, for example, direct the institution, by order, to increase its capital (eg under BA Section 485(3)(a)). Such an order would be legally binding. OSFI could also invoke other supervisory measures. OSFI has used the various tools (see next section) to ensure compliance and thus precedence has been set.
(vi) They are properly communicated and consequences of failure to comply are properly understood and carry a similar practical effect as for the primary law or regulation	As part of the ongoing supervisory process, OSFI employs various tools (eg Supervisory Letters, discussions with management and the board of directors) to encourage companies to address concerns. Should this be insufficient, the BA provides the Superintendent with a wide range of discretionary enforcement powers, which are available in the event that prudential standards are not met. Examples of such powers include: special examinations, prudential agreements, directions of compliance, application to a court for an order of compliance and ultimately the taking control of the bank. In general, non-compliance with the provisions of the BA is also an offence that may be subject to certain sanctions, including criminal sanctions and civil monetary penalties that the Superintendent may impose under the *Administrative Monetary Penalties (OSFI) Regulations.* Enforcement of restrictions and directions of compliance can be pursued through the courts, if necessary. OSFI's legislative framework supports a risk-based approach to supervision. As such, the BA permits the Superintendent to apply quantitative and qualitative judgement when deciding which enforcement and/or corrective measures to use and to what degree. The intensity of supervisory action will depend on, and will be calibrated to, the nature, size, complexity and risk profile of the bank. For example, although OSFI's minimum capital requirements are uniform, the actual capital requirements vary by institution. Each institution is required to hold a unique level of capital, as is determined by the institution's activities, risk profile, and systemic importance.
(vii) The instrument is expressed in clear language that complies with the Basel provision in substance and spirit	All regulatory instruments are written to be clear and concise so as to remove misinterpretation and aid enforcement. OSFI achieves compliance with Basel rules text by using the actual Basel language where it is appropriate. OSFI uses text boxes to elaborate on national discretion areas or to provide greater clarity to address unique circumstances (terminology, or accommodating the harmonisation of requirements across the banking and insurance sectors).

Annex 8: Key financial indicators of the Canadian banking system

Overview of the Canadian banking sector as of 31 October 2013 — Table 7

Size of banking sector (CAD billions)	
Total assets of all banks operating in the jurisdiction (including off-balance sheet assets)	4,592
Total assets of all locally incorporated internationally active banks	4,295
Total assets of locally incorporated banks to which capital standards under the Basel framework are applied (ie excludes foreign bank branches)	4,592
Number of banks	
Number of banks operating in Canada	105
Number of internationally active banks	6
Number of banks required to implement Basel standards (according to domestic rules)	105
Number of global systemically important banks (G-SIBs)	0
Number of domestic systemically important banks (D-SIBs)	6
Capital standards under the Basel framework	
Number of banks required to implement Basel equivalent standards	105
Use of advanced approaches by banks	See Table 1 in the main text
Capital adequacy (internationally active banks) (CAD billions; percent)	
Total capital	180
Total Tier 1 capital	144
Total CET1 capital	118
Total risk-weighted assets	1,290
RWAs for credit risk (percent of total RWAs)	81.1%
RWAs for market risk (percent of total RWAs)	6.3%
RWAs for operational risk (percent of total RWAs)	12.6%
Total off-balance sheet bank assets[25]	748
Capital adequacy ratio (weighted average)	13.96%
Tier 1 Ratio (weighted average)	11.19%
CET1 Ratio (weighted average)	9.14%

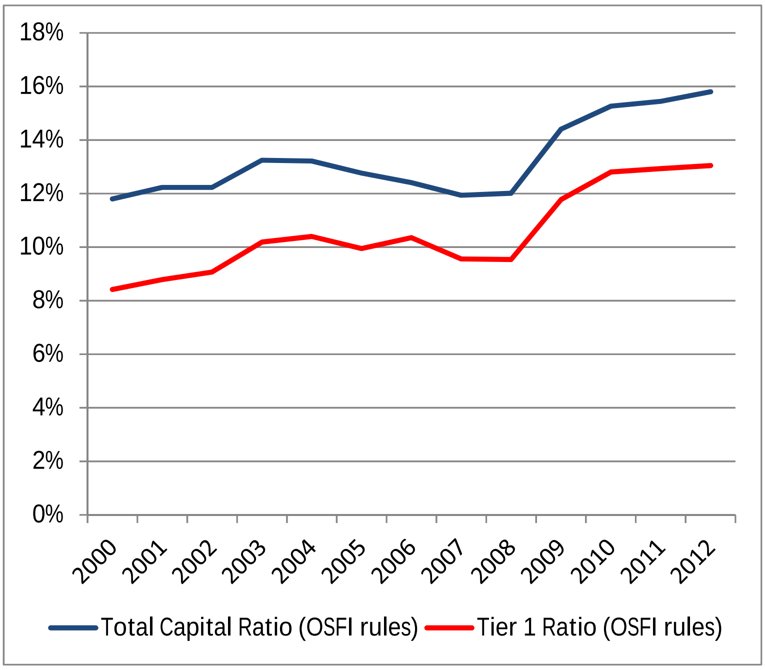
Source: OSFI, data as of October 2013.

25 This includes derivatives at fair value and the credit equivalent amount of non-market-related off-balance sheet exposures.

Evolution of capital ratios of Canadian internationally active banks

Weighted average, in percent

Figure 1



Source: OSFI.

Annex 9: Materiality assessment

The assessment findings (deviations from the Basel minimum) were examined for the materiality of their impact on the capital ratios of the RCAP sample banks in Canada. Both quantifiable and non-quantifiable findings were assessed. The impact of all quantifiable findings for each bank in the RCAP sample was quantified, where data was available. In those cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data were available to quantify a finding, the Assessment Team relied only on expert judgement.

Following this approach, an attempt was made to determine whether the findings are "not material", "material" or "potentially material", as shown below.

Given the more than 50 rectifications that were made during the assessment process (Annex 6), only eight findings remain, of which seven are classified as non-material and one as potentially material. More details of the rationale underlying the materiality analysis are provided in the detailed assessment in Section 2.

Number of assessment findings by component

Table 8

Component	Non-material	Potentially material	Material
Scope of application	0	0	0
Transitional arrangements	0	0	0
Definition of capital	1	1	0
Capital buffers	0	0	0
Pillar 1			
Credit risk: Standardised Approach	2	0	0
Credit risk: IRB	1	0	0
Credit risk: Securitisation	0	0	0
Counterparty credit risk	1	0	0
Market risk: Standardised Measurement Method	0	0	0
Market risk: IMA	0	0	0
OR: Basic Indicator Approach/SA	0	0	0
OR: AMA	0	0	0
Pillar 2	2	0	0
Pillar 3	0	0	0

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgement (for the non-quantifiable gaps). See Section 2 for further information.

Annex 10: Areas where OSFI's rules are stricter than the Basel minimum standards

In several places, OSFI has adopted a stricter approach than the minimum standards prescribed by Basel or has simplified or generalised an approach. In the latter case, the Assessment Team has assessed whether this could result in less rigorous requirements than the Basel standards. The following list, prepared with input from OSFI, provides an overview of the areas where OSFI's rules are considered stricter than the Basel minimum standards. These areas have not been taken into account as mitigants for the overall assessment of compliance.

Definition of capital and transitional arrangements

1. Basel III paragraph 50

OSFI expects all banking institutions to attain target capital ratios equal to or greater than the 2019 capital ratios from 2013. The D-SIB banks are required to meet so-called "all-in" capital targets of 7% for the CET1 ratio by the first quarter of 2013, and 8.5% for the Tier 1 ratio and 10.5% for the Total Capital ratio by the first quarter of 2014. The "all-in" capital target for the CET1 ratio for D-SIBs is 8% commencing 1 January 2016. In addition, the transitional Basel III minimum capital ratios apply and must be reported by the banks in parallel.

2. Basel III paragraph 53

The CAR Guideline requires that any discretionary repurchases of common shares are subject to the prior approval of the Superintendent.

3. Basel III paragraph 55

Paragraphs 16 and 29 of the CAR Guideline require that amendments to the terms and conditions of additional Tier 1 and Tier 2 instruments are subject to the prior approval of the Superintendent.

Counterparty credit risk

4. Basel II Annex 4 paragraphs 42–46

CAR Guideline Chapter 4 paragraph 58 sets out OSFI's expectation that banks will provide documented justification for their use of two different pricing models, in the case where the pricing model used to calculate counterparty credit risk exposure is different to the pricing model used to calculate market risk over a short horizon.

5. Basel II Annex 4 paragraphs 59–68

CAR Guideline Chapter 4 paragraph 78 sets out OSFI's expectation that banks will provide documented justification for their choice of calibration methods, when two different calibration methods are used for different parameters within the effective expected positive exposure model.

Market risk

6. Basel II paragraph 712

Unlike the Basel framework, OSFI does not allow banks using the Standardised Approach to include unrated securities in the “qualifying” category for the computation of interest rate risk.

7. Basel II paragraph 718(xxvi) and 718(xxviii)

Unlike the Basel framework, OSFI does not fully implement the futures-related arbitrage strategies that attract lower market risk capital charges.

Annex 11: List of approaches not allowed by OSFI's regulatory framework

The following list provides an overview of approaches that OSFI has not made available to its banks through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as "not applicable" for the assessment.

Market risk

- Duration Method
- Maturity Ladder Approach
- Delta Plus Method
- Banks are not allowed to include equities in the modelled incremental risk charge

Counterparty credit risk

- Standardised Method

Operational risk

- Alternative Standardised Approach

Annex 12: List of issues for follow-up RCAP assessments

The Assessment Team identified three issues listed below for follow-up and for the future RCAP assessments:

1. Provisions related to the countercyclical buffer (Basel III paragraphs 136–150)
2. Planned issuance of Pillar 3 requirements as a Guideline
3. Clarification of concentration limit for purchased receivables

Annex 13: Areas for further guidance from the Basel Committee

General provisions/general loan loss reserves

Basel III carries forward the Basel II treatment that permits the inclusion of “General provisions/general loan-loss reserves” in Tier 2. However, it clarifies that they should not be included where they have been created “in respect of an identified deterioration in the value of any asset or group of subsets of assets” noting that in such cases “they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital.” OSFI, like other jurisdictions, implements the Basel standards in this area via the inclusion of IFRS “collective allowances” in Tier 2. OSFI’s recently updated guidelines state that collective allowances must not be included if ascribed to an “identified deterioration of particular assets or known liabilities, whether individual or grouped”. The OSFI text, therefore, is judged by the Assessment Team to reflect the Basel standards.

Despite the conclusion that the CAR Guideline is consistent with the Basel standards, the Assessment Team would like to bring a wider issue to the attention of the Basel Committee: the team questions whether any “collective allowances” may be viewed as meeting the Basel standards for inclusion in Tier 2. IFRS adopts an incurred loss model and so this could mean that all collective allowances represent an identified deterioration in the value of a group of assets, making them ineligible for inclusion in Tier 2 under the Basel standards. The Assessment Team sees a risk, therefore, of divergent practices across jurisdictions. Moreover, if collective allowances were deemed to be ineligible as Tier 2 capital, on the basis that IFRS currently adopts an incurred loss model, this would likely have a material impact on the capital ratios of a large number of banks across many jurisdictions. In any case, the Committee will likely need to reconsider the treatment of loan loss allowances, given the initiative of the accounting standard setters to move to an expected loss model.

Deferred tax assets

Under Basel III, DTAs that “rely on the future profitability of the bank to be realised” are required to be subject to a deduction treatment in the calculation of CET1.

The CAR Guideline states that “DTAs arising from temporary differences that the institution could realise through loss carrybacks, that is, they do not depend on the future profitability of the bank to be realised, are not subject to deduction, and instead receive a 100 percent risk weight.” All other DTAs are required by the CAR Guideline to be subject to the Basel III deduction treatment.

The Basel III text does not prescribe how “DTAs arising from temporary difference that the institution could realise though loss carrybacks” should be treated, and, therefore, the Assessment Team did not judge the CAR Guideline to contradict the Basel standards. (*) However, the Assessment Team believes there is potentially a risk that there is not a consistent understanding across jurisdictions of the term “rely on the future profitability of the bank to be realised”. The Basel Committee may wish to consider this issue further.

(*) Paragraph 70 of the Basel III text describes the treatment of “current year tax losses carried back to prior years” when these give rise to “a claim or receivable from the government or local tax authority”. Such amounts are assigned the relevant sovereign risk weighting under paragraph 70. However, while paragraph 70 describes the treatment of the claim or receivable itself, it does not specify the treatment of a DTA that may, at some future time, be carried back to give rise to the claim or receivable.

Provisions based on nominal amounts in EUR and USD

The assessment notes that some provisions in the Basel standards are based on nominal amounts of EUR or USD. Their treatment could be revisited by the Basel Committee.

Annex 14: OSFI's summary of its Pillar 2 supervisory review process[26]

Using the four key principles for supervisory review described in Part 3: The Second Pillar — Supervisory Review Process of the *Basel II: International Convergence of Capital Measurement and Capital Standards*: A Revised Framework – Comprehensive Version – June 2006, OSFI included the Supervisory Review Process for Internal Capital Adequacy Assessment Process (ICAAP) as a key component of its Supervisory Framework. This was achieved by including ICAAP directly in the capital rating that OSFI determines for each bank operating in Canada, excluding foreign bank branches. As a result, OSFI's assessment of ICAAP is included as a component of its regular, ongoing supervisory work and its assessment of the bank's ICAAP can have a direct impact on the Composite Risk Rating and Intervention Rating that OSFI determines and shares with the bank's board and senior management.

Including ICAAP in OSFI's normal supervisory work also results in supervisors being able to easily link the impact of their assessments of inherent risk, controls and oversight of the significant activities (business model) of the bank to the assessment of ICAAP and vice versa. While a bank's ICAAP is frequently subject to a focused, detailed review, the ICAAP is also monitored on an ongoing basis with the completion of the Capital Calculator that OSFI supervisors use to assess the adequacy of the bank's calculations and allocations of capital.

The following description provides a brief summary of how the four principles are addressed in OSFI's supervisory review of ICAAP.

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Guidance to banks for ICAAP requires banks to consider all material risks and to assess the adequacy of their capital to withstand risks not adequately covered by the requirements of Pillar 1. In addition, the guidance requires banks to consider whether minimum regulatory capital requirements fully capture risks, especially when business has been securitised and the risk transfer assumed in the securitisation framework may not be complete. OSFI's Stress Testing Guideline requires banks to consider system-wide interactions and macroeconomic effects. ICAAPs and stress tests help identify capital requirements and provide a basis for supervisory action, if warranted.

OSFI's review of bank ICAAPs includes consideration of external factors including the impact of economic cycles and other external risks and factors (see ICAAP Guideline, p 12).

Banks that operate only domestically or do not have substantial international activity are subject to the same BCBS and OSFI capital requirements as banks that do; specifically the definitions of capital, ACM, and risk ratio calculation methodologies are the same for all banks, regardless of size or country of origin. In addition, OSFI guidelines on stress testing and ICAAP are applicable with standardised scenarios employed as part of the supervisory review process for less complex institutions.

OSFI expects an institution's capital planning to consider the risks of its foreign operations and also the availability of capital and assets in Canada to protect Canadian depositors (see ICAAP, p 3).

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with

[26] The information contained in this Annex has been provided by OSFI.

regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

OSFI has the capacity to evaluate a bank's internal assessment process in order to determine that the relevant qualifying standards are met and that the bank's internal assessments can be relied upon as a reasonable reflection of the risks undertaken. OSFI has a specialist division dedicated to risk measurement and analytics assessment that contains staff with experience in model development at financial institutions. This division reviews and follows up with the banks on anomalies in their reports of model performance quarterly. This division is also responsible for the review, analysis and recommendations on applications to implement/modify models to verify that they meet minimum requirements.

OSFI has the power to impose conditions on its approvals if it considers it prudent to do so. Conditions are frequently applied to approvals. These conditions could include floors or ceiling to inputs or outputs, and requirements to perform and report further work.

OSFI requires banks to adopt a forward-looking approach to capital management through its guidance on the ICAAP and stress testing. The ICAAP process links capital requirements to anticipated risks in a bank and requires stress testing to be an integral part of that process. Likewise, the stress-testing guidance highlights the categories of risk that are to be considered, the reporting of results and the assessment of these programmes by the supervisors.

Both the ICAAP and stress-testing processes and results comprise part of the framework used by OSFI supervisors to assess the capital adequacy of banks. In situations where these processes, results and/or capital adequacy are viewed as inadequate, OSFI can intervene less formally via its intervention ladder or, in more serious situations, Section 485 of the BA allows the Superintendent to require that a bank increase its capital.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

OSFI's minimum capital requirements are stipulated in Chapter 1 Section 1.5 of the CAR Guideline. OSFI expects all institutions to attain target capital ratios equal to or greater than the 2019 minimum capital ratios plus the conservation buffer level early in the transition period. For all institutions, this meant an "all-in" target common equity Tier 1 (CET1) ratio of 7% by the first quarter of 2013. Further, OSFI expects all institutions to attain "all-in" target capital ratios of 8.5% for the Tier 1 ratio and 10.5% for the Total Capital ratio by the first quarter of 2014 (see CAR Guideline, Chapter 1). These "all-in" targets are applicable to all institutions and are triggers for supervisory intervention consistent with the OSFI Guide to Intervention for Federally Regulated Deposit-Taking Institutions ("OFSI's guide"). If an institution is outside the relevant target ratios, supervisory action will be taken proportional to the shortfall and circumstances that caused the shortfall, and may include a range of actions, including restrictions on distributions.

Contingency planning is required to be embedded in the development of realistic capital plans. OSFI explicitly requires banks to "factor in the potential difficulties of raising additional capital during downturns or other times of stress" (ICAAP, p 6) and "develop prudent contingency plans specifying how it would respond to capital pressures that arise when access to securitisation markets is reduced" (ICAAP, p 8).

Subsection 485(1) of the BA requires banks to maintain adequate capital and liquidity in appropriate form. This section specifically provides that:

- Even when a bank complies with formal requirements, the Superintendent may order the bank to increase its capital or to provide more liquidity, and the bank must comply within a time specified by the Superintendent.
- The Superintendent may override the bank's appraisal of asset values.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Required supervisory minimum capital targets are applicable to all institutions and are triggers for supervisory intervention consistent with the OSFI Guide to Intervention for Federally Regulated Deposit-Taking Institutions. If an institution is outside the relevant target ratios, supervisory action will be taken proportional to the shortfall and circumstances that caused the shortfall, and may include a range of actions, including restrictions on distributions. Federally regulated financial institutions understand that if they fall below their minimum capital targets that they can anticipate that they will be moved to Stage "1" because OSFI has staged other financial institutions on that basis.

For example, an institution can be moved from Stage "0", which is normal, to Stage "1" which is described in OSFI's Guide as:

"Stage 1 – Early warning – If an institution is categorised as Stage 1, OSFI has identified deficiencies in the institution's financial condition, policies or procedures or the existence of other practices, conditions and circumstances that could lead to the development of problems described at Stage 2 if they are not promptly addressed."

The following conditions could lead to OSFI categorising an institution as Stage 1:

- The combination of the institution's overall net risk and its capital and earnings compromises the institution's resilience.
- The institution has issues in its risk management or has control deficiencies that, although not serious enough to present a threat to financial viability or solvency, could deteriorate into more serious problems if not addressed.

In addition to its normal activities, at Stage 1 OSFI's activities/responsibilities may involve:

- Formally notifying management, board of directors and external auditor of the institution by way of a supervisory letter that the institution is at Stage 1 and that the institution is required to take measures to mitigate or rectify the identified deficiencies.
- Meeting with management, board of directors (or a committee of the board) and/or the external auditor of the institution to outline concerns and discuss remedial actions.
- Sending a notice of the assessment surcharge to the institution.
- Monitoring the institution on an escalating basis by increasing the frequency of reporting requirements and/or expanding the level of detail of information that the institution is required to submit.
- Conducting enhanced or more frequent supervisory reviews, or directing the institution's internal specialists to conduct reviews that focus on particular areas of concern such as asset or loan security valuations.
- Entering into a prudential agreement with the institution for the purpose of implementing any measure designed to maintain or improve the safety and soundness of the institution.
- Requiring the financial institution to increase its capital.
- Imposing business restrictions on the financial institution in appropriate circumstances and/or issuing a direction of compliance in appropriate circumstances.