



Remarks by Ben Gully Assistant Superintendent, Regulation Sector to the Global Risk Institute

April 27, 2021

Introduction

Good afternoon.

I'd like to start off by thanking the Global Risk Institute for hosting my remarks today.

The word "global" is in your name given the scope of your horizons and having Bruce and his colleagues based in Canada is testament to the longstanding strengths of Canada's financial system.

The domestic and global dimensions of your work mirror, in some ways, the subject of my speech.

That is, I'll talk about how the internationally agreed upon Basel III reforms are providing a foundation for a resilient banking system, and how our domestic implementation of these reforms will improve the existing regulatory framework and overall safety and soundness of Canadian banks.

And in case there is any doubt, this final phase of Basel III is indeed coming to an end even if it may not have felt like it over recent years.

Resiliency in the banking system

A few months ago, Superintendent Jeremy Rudin, spoke about the ongoing strength of Canada's banks in the face of a pandemic. As he said at the time, "the Canadian banking system continues to demonstrate the resilience for which it is known around the world. Of course, this is no reason for complacency, whether in the industry or at OSFI."^{[Footnote1](#)}

Today, even as more Canadians get vaccinated every day, there is still a lot of uncertainty about the road ahead. We must also consider the risks that already required our attention before the pandemic, such as those stemming from household and institutional indebtedness. Therefore, we all have to stay ever vigilant, especially on what appears to be a slow and tentative journey towards a post-pandemic Canada.

Banks in this country have risen to the multiple and fluid challenges brought on by the pandemic, and Canada is stronger for it. Having a firm foundation within our banking sector continues to provide benefits to the financial system as the economy from coast-to-coast-to-coast acts and reacts to a range of unprecedented pressures.

As well, by the time the pandemic began to take hold just over a year ago, OSFI's pursuit of post-Global Financial Crisis (GFC) enhancements to Canada's regulatory regime meant we were already well prepared. We were ready to take on the then-unknown challenges ahead of us from a position of relative strength, the sheer scale and overlapping nature of those challenges notwithstanding.

This approach reflects our view that adherence to well-designed international standards is in Canada's national interest, as well as that of Federally Regulated Financial Institutions. This is because the domestic implementation of global standards contributes to the strong reputation of our financial system, and it helps Canada's banks to attract capital and funding both domestically as well as from investors around the world.

Capital markets are both confidence-sensitive and global in nature, so it is vital that OSFI's ruleset maintains credibility on an international stage. This is accomplished by implementing rules that are consistent with internationally agreed-upon frameworks, and which are applied to internationally-active banks from other jurisdictions. Moreover, Canada's commitment to these standards puts the country in a position where it is able to influence international dialogue, something that is important given the broader economic benefits for trade, investment, and international cooperation.^{Footnote2}

And this brings me back to my main topic today—how OSFI's finalization of the Basel III framework is creating conditions for an even stronger and resilient banking system.

Basel III endgame

The ongoing resilience of the banking sector underscores the need to stay focused on the appropriate design of prudential regulation. The Basel III reforms highlight the importance of capital and liquidity to a bank's viability. Of course, capital being the measure of the capacity that a bank has to absorb losses, while liquidity is a measure of a bank's ability to make good on its obligations, such as deposits, as they come due.

The Basel III reforms are a consolidation of recently agreed and previously announced enhancements to international standards that have occurred during the post-GFC period from 2009 onwards.

Developed by the Basel Committee on Banking Supervision (BCBS), the Basel framework is a consolidated set of standards for bank capital, leverage, and liquidity that has evolved over time in response to changing market conditions.

Basel III was built on the foundations and limitations of two preceding frameworks.

The Basel Capital Accord, or Basel I, gave financial regulators a global standard to use in thinking about capital adequacy. And Basel II improved the way regulatory capital requirements reflected underlying risks and reinforced the role of supervision and market discipline in achieving sound prudential outcomes.^{Footnote3}

With over 10, long years of developments and improvements in Basel standards post-GFC, we are now finally able to draw a line in the sand and complete these changes as part of the consolidated package of Basel III reforms.

And while COVID-19 has provided for a brief pause in global implementation to allow the financial system to focus on the pandemic, our attention now returns to the final rollout of these reforms ahead of the domestic start date in Canada of fiscal year 2023. We think this is critical to preserving resilience in the financial system by acting on the lessons of the GFC, while also allowing standard setters to move forward and focus on future threats and vulnerabilities.

Three key principles for implementation

OSFI's implementation of the Basel III reforms reflects three key principles:

1. Fit for Canada
2. Setting the right incentives through improved consistency and risk sensitivity;
and
3. Enhanced proportionality.

Principle 1: Fit for Canada

Let us turn to the first principle: fit for Canada.

OSFI has a long tradition of being an active member of the BCBS. We are committed to the development and implementation of global standards for international active banks, and our engagement is critical to ensuring good outcomes for Canada as part of a well-functioning global financial system.

At the same time, the finalisation of global standards is only the first step towards domestic implementation of rules for capital and liquidity adequacy. These standards only serve as a minimum upon which to develop domestic rules. There remain areas of interpretation and optionality that require clarity for domestic purposes, which in turn require robust public consultation to ensure our approach remains well tested and understood.

As well, while public regulation is a good starting point to determine capital and liquidity adequacy, there also remain important differences in business models and risk management practices at individual banks that can't be easily captured by a single rule. As such, we consider supervision—the review and risk assessment of financial institutions' safety and soundness—as a critical part of the overall capital and liquidity adequacy regime.

As part of this effective supervisory regime, we also believe that strong financial reporting is critical. Transparency demonstrates adherence to our prudential requirements and, supported by high quality audits, reinforces the strength and resiliency of the Canadian system. We also recognize that the complexity of regulatory reporting continues to increase due in part to impacts like the Basel III reforms.

We are working to address this through a recently released OSFI consultation paper—entitled *Assurance on Capital, Leverage and Liquidity Returns*—that proposes enhancements to align assurance expectations and seeks feedback to help us create future guidance for external auditors and banks.

Principle 2: Setting the right incentives through improved consistency and risk sensitivity

Now onto our second principle for implementation.

Key changes to the domestic capital framework aim to improve the risk sensitivity of the capital rules and provide the right incentive structures to banks.

The final Basel III reforms improve the risk sensitivity of the framework by removing or limiting the use of models in areas where the range of outcomes produced by the models led to unwarranted variability across institutions and potentially inappropriate changes in capital requirements.

For example, under the internal ratings-based approach to credit risk we have removed the ability for banks to estimate certain parameters for low-default portfolios such as exposures to financial institutions and large corporates. We have also introduced minimum floor levels on certain input parameters used in the calculation of credit risk capital requirements for retail exposures.

Additionally, Basel III is better aligning the capital with the risk under the Standardized Approach to credit risk by having more risk-sensitive rules, such as more varied risk weights for different asset classes like residential and commercial real estate, rather than a flat risk charge.

We believe this approach allows banks to make lending decisions that are more in line with their risk appetite. To confirm this, and as part of the current consultation phase, we are conducting a quantitative impact study to assess the impact of the proposed changes on our domestic institutions.

Principle 3: Enhanced proportionality

Of course, Basel III was developed with large, internationally active banks in mind. But many of the key tenets within that framework aimed at enhancing resiliency— like improving risk sensitivity and incentives to support resiliency—can be applied to banks of any size through enhanced proportionality, our third principle.

Other jurisdictions, such as the U.S., have had a tradition of more clearly distinguishing expectations for banks, based on their size and complexity. Our work in preparing for the implementation of Basel III provided us with a natural opportunity to review our overall banking framework and revisit the capital and liquidity regime for smaller, non-internationally active banks as well.

Using the Basel III reforms as a starting point, we developed unique, 'made-in-Canada' proposals tailored more appropriately to the risks of our smaller institutions. The proposals aim to strike a balance between improving the risk sensitivity of the requirements for small banks and helping to address rising complexity of the frameworks to make them more effective and thereby fit for purpose.

Just over a month ago, we outlined these proposals in a new draft *SMSB Capital and Liquidity Guideline*.

The new draft guideline serves as a reference tool for stakeholders to help them understand which parts of our capital, leverage and liquidity guidelines are applicable to SMSBs and, as such, acts as a complement to those guidelines.

Moreover, we have introduced a number of Canadian innovations within the Pillar 1 capital and liquidity requirements to help reduce the complexity of the frameworks for smaller institutions.^{Footnote4}

The value of public consultations to implementation

The three principles governing OSFI's approach to domestic implementation of Basel III are critical for Canada.

At the same time, we also recognise that intent and execution may not always align as closely as we might wish, which is why we began extensive public consultations on our Basel III and SMSB proposals as well as our revised Pillar 3 disclosure requirements for systemically important banks last month.^{Footnote5} The window will be open until June 4 of this year, with consultation on changes to Pillar 3 open until July 2. We will publish a summary of comments with the release of our final guidance in late 2021.

I'd like to stress that we believe that now is the right time to move forward on these changes. We believe that full and consistent implementation of Basel III is an essential part of preserving resilience in the global financial system, and is integral to OSFI's regulation in Canada.

As well, timely implementation also gets us ahead of the new risks, allows us to say "it's done", and thereby helps us focus forward on the new normal and on being prepared for the unexpected.

In short, we've spent enough time on post-GFC regulatory reforms. Let's get them in place and focus on lessons from the pandemic and beyond.

The future of regulatory reform

While we remain focused on concluding the round of Basel III reforms and managing pre-pandemic financial risks and vulnerabilities, the impact of COVID-19, coupled with broader developments in the risk environment, also pose new challenges to the future design of bank regulation. As well, OSFI's vision is a reminder of the importance of continuous improvement in prudential regulation: *preserving confidence, ever vigilant, always improving*.

What, then, lies ahead in the evolution of prudential risk oversight?

I see two key things to think carefully about.

1. Flexibility in the new normal

The Basel III framework is just that, a framework. It sets out a minimum international standard whereby national regulators can build their domestic rules for capital, leverage, and liquidity requirements while also recognising that national implementation may differ in some limited instances.

Flexibility is a desirable—indeed, a necessary—component of that framework, particularly in dealing with an increasing volatile, uncertain world. Now, more than ever, we need rules that can adapt effectively to changing conditions while at the same time not undermining the credibility of prudential regulation.

We have seen the need for, and benefits of, more dynamic regulatory design frameworks, especially throughout the last year. This is part of the reason we developed overarching principles for regulatory changes during the pandemic to ensure that changes could occur that were credible, consistent, necessary and fit for purpose.

At the onset of COVID-19, we took a decisive and precautionary step to reinforce the financial resilience of banks and insurance companies by introducing a number of temporary restrictions on capital distributions. These included prohibitions on share buybacks and increases to regular dividends and executive compensation.

Now, slightly more than a year following the introduction of these measures, we continue to monitor the overall conditions triggered by the pandemic to determine when it will be appropriate to unwind these restrictions.

OSFI is acting prudently in the context of continued uncertainty related to COVID-19, and will maintain the restrictions until they are no longer fit for purpose and once we have greater clarity on the path forward out of the pandemic. Our review of our expectations related to capital distributions remains ongoing, and any decisions related to the unwinding of these restrictions will be communicated quickly, transparently and well in advance.

When it comes to the Basel III reforms and OSFI's approach, there is also flexibility in how requirements for capital and liquidity buffers operate, depending on conditions and capital levels. Such flexibility was particularly important given what we have all experienced over the last 14 months.

Our approach was a nod to the fact that we did need more flexibility in the application of rules than perhaps we envisioned before 2020. And I suspect that this more flexible approach to regulatory and policy design will need to follow us into the future if we are to respond effectively to the demands of the risk environment.

2. Responding to new and evolving risks

While the Basel III reforms promote resilience, they cannot be addressed in isolation to other factors impacting institutional and systemic resilience. Pre-pandemic financial risks haven't somehow quietly retreated off the global stage under the cover of COVID-19. Indeed, some existing risks are increasingly prominent, while some newer risks are revealing themselves.

Technology risks and risks stemming from environmental, social and governance (ESG) impacts could manifest into financial risks if left unchecked. Similarly, the features and risk characteristics of new asset classes, such as crypto-assets, need assessment to determine the design of an appropriate prudential treatment for banks' exposures to them.

By extension, OSFI may incorporate these risks into regulation and/or supervision depending on the prudential risks and our understanding of them, as well as our own evolving approach to risk management expectations for financial institutions.

Therefore, in keeping with our mandate, we are promoting broader engagement with stakeholders on these evolving families of risks, with wider and more open public consultations on technology risk and climate change^{Footnote6} informing our path forward in dealing prudently with these risks.

On the global stage, the Basel Committee is also focused on these non-financial risks. At the end of last month it released principles for operational resilience and operational risk management, which aim to make banks better able to withstand, adapt to, and recover from severe adverse events.^{Footnote7} It also recently issued analytical reports on these risks that examines the transmission channels of climate-related risks to the banking system, and reviews the measurement methodologies of climate-related financial risks.^{Footnote8}

Going forward, the Basel Committee's 2021-2022 work programme outlines key priorities along a number of critical fronts, including COVID-19 resilience and recovery, horizontal scanning and mitigation of risks, strengthening supervisory coordination and practices, and evaluating Basel III implementation.^{Footnote9} OSFI supports these priorities, knowing they will serve us well as we respond to an increasingly diverse and uncertain risk environment.

No time to waste

Complacency is our greatest risk to financial resilience, and we must therefore remain vigilant.

In concluding, I want to reiterate that timely implementation of the Basel III reforms is central to OSFI's prudential priorities. The innovations related to capital, leverage, and liquidity regulation are essential to preserving financial resilience.

At the same time, sound regulation needs to continue to be backed by strong supervision and appropriate public disclosures.

As a consequence, there is quite simply no time to waste in completing Canada's implementation of this last phase of the Basel III reforms. The GFC has lessons for us to memorialise, and the risk environment poses risks that are not going to wait for us.

We welcome your feedback on Basel III, and we look forward to a broader discussion of the future of bank capital regulation to address the various and accelerating forms of innovation in the financial industry.

Thank you again for joining me today. I look forward to any questions you may have.

Footnotes

Footnote 1 Jeremy Rudin, "Passion, Persistence and Effective Regulation Supervision", Remarks to the 2021 RBC Capital Markets Canadian Bank Conference, January 11, 2021, www.osfi-bsif.gc.ca.

Footnote 2 Mark Zelmer and Jeremy Kronick, "International Prudential Standards in a World of Growing Nationalism and Protectionism", *Commentary No. 517*, CD Howe Institute, July 2018, www.cdhowe.org.

Footnote 3 "Basel III: international regulatory framework for banks", www.bis.org.

Footnote 4 These include the introduction of a Simplified Standardized Approach for credit risk, a Simplified Standardized Approach for operational risk, a Simplified Risk-Based Capital Requirement, a Streamlined version of the Net Cumulative Cash Flow return, and a new Operating Cash Flow Statement return. The applicability of these requirements is outlined within the guidelines.

Footnote 5 "Advancing a more resilient and proportional banking regulatory framework in Canada", March 11, 2021, www.osfi-bsif.gc.ca.

Footnote 6 For information on these two consultations, see "OSFI launches consultation on technology risks in the financial sector", September 15, 2020, and "OSFI launches consultation on climate-related risks in the financial sector", January 11, 2021, www.osfi-bsif.gc.ca.

Footnote 7 "Principles for operational resilience", March 31, 2021, www.bis.org.

Footnote 8 "Climate-related risk drivers and their transmission channels" and "Climate-related financial risks – measurement methodologies", April 14, 2021, www.bis.org.

Footnote 9 "Basel Committee work programme and strategic priorities for 2021/22", April 16, 2021, www.bis.org.