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OSFI Releases Final Liquidity Adequacy Requirements Guideline – and other related developments

I. Introduction

In November 2013, the Office of the Superintendent of Financial Institutions Canada ("**OSFI**") released the draft Liquidity Adequacy Requirements Guideline ("**LAR Guideline**"). The content and requirements of the draft were discussed at length in our January 2014 financial services bulletin. On May 30, 2014 OSFI published the finalized LAR Guideline. This bulletin reviews the differences from the draft and the material points of clarification provided by OSFI, and reviews recent related developments.

The LAR Guideline deviates very little from the draft; no significant modifications to the substantive components were introduced. OSFI responded to particular comments and questions that were proposed during the comment period. To the extent revisions were made, they primarily provide greater clarity and, in the rare case, correct a relatively minor oversight.

II. Overview

As was the case with the draft, a majority of the text in the finalized guideline is drawn directly from *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* ("**Basel III Report**"), a report prepared by the Basel Committee on Banking Supervision ("**BCBS**"). The LAR Guideline includes a chapter on net cumulative cash flow, a Canada-specific metric introduced by OSFI in 2009, which is an exception to OSFI's general practice of adopting standards developed by the BCBS with little or no modification.

This bulletin discusses recent OSFI developments that impact the administration of the LAR Guideline, and in particular, material corrections and clarifications adopted in relation to the following components of the LAR Guideline:

1. Liquidity Coverage Ratio ("**LCR**")
2. Net Stable Funding Ratio ("**NSFR**")
3. Net Cumulative Cash Flow ("**NCCF**")
4. Additional liquidity risk monitoring tools

On July 16, 2014 OSFI issued the reporting requirements and instructions related to the LCR standard, the LCR by significant currency monitoring tool, and the NCCF monitoring tool. Beginning in January 2015 completed returns associated with these metrics are to be filed on a monthly basis by all entities to which the LAR Guideline applies. Although the BCBS is still finalizing the NSFR, this standard is expected to take effect, at least in part, by January 2018. The NCCF, with some revision, has been in effect since 2009.

III. Public Disclosure Requirements for Domestic Systemically Important Banks on LCR

On July 16, 2014 OSFI also issued the final version of Guideline D-11 - Public Disclosure *Requirements for Domestic Systemically Important Banks on Liquidity Coverage Ratio* ("**Guideline D-11**"). Guideline D-11 sets out the public disclosure requirements for internationally active banks (i.e. those institutions that have been designated as domestic systematically important banks ("**D-SIBs**") in Canada). To date, the D-SIB designation has been applied to Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada, and Toronto-Dominion Bank. The release of Guideline D-11 was spurred by the January 2014 publication of BCBS's *Liquidity Coverage Ratio Disclosure Standards* ("**LCR-DS**"), which advocates harmonization with a view to increasing the accuracy, consistency and accessibility of LCR data. Guideline D-11 provides for the wholesale implementation of the LCR-DS, which will apply to all D-SIBs effective Q2 2015.

IV. Liquidity Coverage Ratio

The LAR Guideline aims to ensure that an institution maintains adequate and appropriate forms of liquidity. The LCR aims to ensure that an institution maintains an adequate stock of unencumbered high quality liquid assets ("**HQLA**") that can be converted into cash at little or no loss of value in private markets to meet liquidity needs over a 30 day calendar period.

OSFI clarified that in order to include the surplus HQLA of a subsidiary in the LCR of a consolidated entity, the assets involved must be freely available in times of stress. It is, therefore, important to remain cognizant of any restrictions on repatriating assets to the parent entity. To the extent that any such restrictions exist, the affected assets cannot be included in the consolidated entity's LCR.

In the context of collateral swaps, OSFI clarified that cash outflows occur when (i) collateral borrowed is of a higher quality than the collateral lent, and (ii) the swap matures within the 30 day stress horizon. In these circumstances, the cash outflow amount is the difference between the prescribed outflow and inflow rate of the collateral lent and the non-rehypothecated collateral borrowed, respectively. However, no outflow should be allocated when the collateral involved is of the same LCR type.

OSFI rejected the notion of looking through to the underlying securities in assets such as mutual funds and exchange traded funds in the calculation of HQLA. If an individual security cannot be separately monetised, it cannot be included in the HQLA. Furthermore, OSFI refused to recognize the S&P/TSX Composite Index as the major stock index in Canada (which would mean that HQLA could include common equity shares of issuers included in the S&P/TSX Composite Index) and instead confirmed the S&P/TSX 60 Index as the major stock index in Canada, on the basis that only the most liquid of stocks should qualify as HQLA.

In response to concerns that smaller institutions were unduly penalized by a minimum pool size requirement of $25 million under Bank of Canada guidelines in order to characterize National Housing

Act Mortgage Backed Securities ("**NHA MBS**") and Canada Mortgage Bonds ("**CMBs**") as Level 1 assets, OSFI created an exception. Non-foreign, non-D-SIB institutions may include NHA MBS and CMBs with a pool size of less than $25 million as Level 1 assets.

The draft guideline required that banks subject to prudential supervision assume a 40% drawdown with respect to the undrawn portion of committed credit and liquidity facilities. This was modified to apply to the broader concept of deposit-taking institutions. Absent this modification, certain institutions may have been at a disadvantage when arranging liquidity backstops.

Finally, OSFI stated that it is not contemplating an expansion of the types or categories of assets that can be included under the HQLA definition beyond what is set out in the Basel III Report.

V. Net Cumulative Cash Flow

The NCCF metric measures cash inflows and outflows over various time horizons in a twelve month span. As previously noted, the NCCF is a departure from the BCBS standard. Both tools are designed to identify gaps between cash inflows and outflows; however, the NCCF incorporates a greater level of detail. As with LCR, the final version of the LAR Guideline clarifies potential points of ambiguity and does not substantially modify the substantive rules that govern application of this metric.

Among other modifications, OSFI clarified that the NCCF threshold for small business customer deposits is $5 million on an individual account basis, not $1.5 million as defined under the LCR. In addition, OSFI reassessed the deposit run-off assumptions and adjusted certain run-offs within categories deemed to be core deposits.

VI. Net Stable Funding Ratio

NSFR is a BCBS standard that has not yet been finalized. However, the NSFR will require institutions to maintain a stable funding profile. Under this framework, the amount of funding required is tied directly to the institution's liquidity characteristics and off-balance-sheet exposure.

References to the NSFR in the LAR Guideline are placeholders that will be populated once BCBS finalizes this standard. To this end, BCBS released a draft in January 2014, and solicited feedback until April 11, 2014, when the comment period ended.

VII. Additional Liquidity Risk Monitoring Tools

In addition to the above metrics, OSFI has a number of other liquidity monitoring tools at its disposal. These tools do not define minimum required thresholds. Instead, OSFI gathers data using every available source and approaches entities to discuss concerns as, and if, they arise. If OSFI determines a minimum requirement is required, its implementation will be preceded by advance notice.

Finally, OSFI stressed a preference for automatic data collection where possible but acknowledged that data must still be gathered manually in many instances. Where manual collection is required, OSFI indicated that its preference is that information be provided via a template that will be distributed in mid-2014.

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