Implementation of Basel III Reforms and Guideline B-20 in Canada and their Impact on Business Choices for Banks

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Basel III Overview - Background

- In late 2010/early 2011, the Basel Committee announced its new Basel III framework, many of the changes to be implemented over time.

- These reforms included:
  - higher minimum capital requirements,
  - new capital conservation and countercyclical buffers,
  - revised risk based capital measures,
  - a new leverage ratio, and
  - two liquidity standards.

- The Office of the Superintendent of Financial Institutions (OSFI) on February 1, 2011 issued its action plan for the Canadian implementation of Basel III including, in particular, capital adequacy and liquidity requirements.

Basel III Overview - Background (Cont'd)

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Annex 1

Calibration of the Capital Framework Capital requirements and buffers (all numbers in percent)			
	Common Equity (after deductions)	**Tier 1 Capital**	**Total Capital**
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

* Common equity or other fully loss absorbing capital

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Basel III Overview - Background (Cont'd)

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Annex 2: Phase-in arrangements (shading indicates transition periods)

(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

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Basel III Overview - Capital

- Basel III increases the quantity, quality and transparency of capital.
- Required minimum common equity (or core capital) will increase in steps from 2% measured before the application of deductions to 4.5% of risk weighted assets measured after the application of the stricter capital deductions under Basel III.
- Required tier 1 capital will increase from 4% to 6%. Examples of what is included in tier 1 capital in addition to common equity are contributed surplus for instruments included in CET1 and retained earnings.
- The required minimum total capital ratio (that is tier 1 and tier 2 capital to risk weighted assets) is set at 8%.

Basel III Overview - Capital (Cont'd)

- Risk weighting definitions are tightened in relation to trading derivative and securitization activities in particular thereby indirectly imposing higher capital requirements.
- Introduces the concept of a capital conservation buffer to ensure banks maintain a buffer of capital in the form of common equity to absorb losses during financial and economic stress periods, eventually 2.5% of risk weighted assets.
- OSFI could in addition impose a counter-cyclical buffer of up to 2.5% of common equity or other fully loss absorbing capital if it felt that at the macro level there was a build-up of excess credit growth in Canada. No such buffer has been imposed by OSFI to date.

Basel III Overview - Capital (Cont'd)

- On August 7, 2012, OSFI released a draft revised capital adequacy requirements (CAR) guideline which reflects the capital changes brought about by Basel III.

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Basel III Overview - Capital (Cont'd)

- The below table sets out OSFI's expectations for "all-in" target capital ratios (i.e. including the capital conservation buffer) and is applicable to all banks.
- Whereas Basell III contemplates a phase-in of its minimum capital requirements by 2019, OSFI expects Canadian banks to be fully compliant on January 1, 2014.

"All-in" Capital targets (including capital conservation buffer) - effective Q1 each year							
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Common equity tier 1 (CET1)	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Tier 1 capital		8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
Total capital		10.5%	10.5%	10.5%	10.5%	10.5%	10.5%

Basel III Overview - NVCC

- Post-financial crisis, international regulators concluded that the forms of tier 1 capital (other than common shares) which had been issued globally did not - as designed - adequately absorb losses before taxpayers.
- In January 2011, requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability were issued by the Basel Committee.
- Specifically, all non-common tier 1 and tier 2 instruments to be included for purposes of regulatory capital are to either contractually or statutorily include a provision whereby the instrument is either written off or converted into common equity at the point of non-viability.
- In February 2011, OSFI published a draft advisory which discussed its expectations in respect of NVCC. OSFI subsequently published a final NVCC advisory in August, 2011.

Basel III Overview - NVCC (Cont'd)

- Effective January 1, 2013 (the cut-off date) to satisfy OSFI's NVCC requirements, a capital instrument of a Canadian bank (including a Canadian subsidiary of a foreign bank) must:
  - have a clause requiring a full and permanent conversion into common shares of the bank upon a trigger event,
  - meet all other criteria for inclusion as tier capital as specified by Basel III,

Basel III Overview - NVCC (Cont'd)

- include a trigger event either where OSFI advises the bank in writing that in the Superintendent's view the bank has ceased or is about to cease to be viable and that after conversion of all contingent capital instruments and taking into account whatever the Superintendent considers relevant it is reasonably likely that the viability of the bank will be restored or maintained <u>or</u> a federal or provincial government in Canada publicly announces that the bank has accepted a capital injection or equivalent support from the government or a political subdivision or agent without which the bank would have been determined by the Superintendent to be non-viable (the draft policy includes a list of criteria to be considered by the Superintendent when determining if the bank has ceased being viable and it is reasonably likely that the viability will be restored),

Basel III Overview - NVCC (Cont'd)

- have a conversion mechanism that ensures that the NVCC investors receive commensurate voting rights,
- have conversion mechanism methodology reflecting the hierarchy of claims in liquidation,
- have no impediments to conversion, which is automatic and immediate on the happening of a trigger event,
- provide that the conversion does not constitute an event of default under the non-capital instrument and, applying a commercially reasonable efforts test, the conversion must not constitute an event of default under any agreement of the bank, and
- include a trust arrangement to hold shares that are issued on conversion to non-common share investors who are legally prohibited from owning common shares such as governments and their agencies.

Basel III Overview - NVCC (Cont’d)

- The determination of non-viability of a bank will be made by the Financial Institutions Supervisory Committee comprised of OSFI, CDIC, Finance, Bank of Canada and FCAC.
- The deliverables required for purposes of confirming the NVCC status of capital instruments are set out in the final advisory on NVCC.
- OSFI prefers NVCC where the obligation to convert is contractual whereas the industry prefers that the obligation to convert be statutory.
- To date there has not been a NVCC capital instrument issue by a bank and it is quite possible, given the new emphasis on CET1, large offerings will be unlikely.

Basel III Overview - Phase-out of Non-Compliant Capital

- In February 2011, when publishing its draft NVCC advisory OSFI also published an advisory relating to the transition and phase out of capital instruments that do not meet the Basel III requirements.
- The aggregate amount of a bank's outstanding non-qualifying capital instruments will be determined as at January 1, 2013.
- Recognition of these instruments for capital purposes will be capped at 90% from that date with the cap reducing by a further 10% of the original base in each subsequent year.

Basel III Overview - Phase-out of Non-Compliant Capital (Cont'd)

- The following table sets out the time line for the phase out of disqualified capital instruments.

Fiscal reporting period	Applicable cap
Q1 2013	90%
Q1 2014	80%
Q1 2015	70%
Q1 2016	60%
Q1 2017	50%
Q1 2018	40%
Q1 2019	30%
Q1 2020	20%
Q1 2021	10%
Q1 2022	0%

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Basel III Overview - Phase-out of Non-Compliant Capital (Cont'd)

- The cap is determined separately for tier 1 and tier 2 instruments and will impact banks' innovative tier 1 capital, preferred shares (including interest shares), and subordinated debt (both step-up and NVCC concerns).
- When complying with the requirements concerning phase out, banks are at the same time to maximize the amount of available regulatory capital and give effect to the legitimate expectations of the holders of the capital instruments.
- Banks, to the maximum extent possible, are to redeem instruments at their regular par redemption date and minimize reliance on redemption due to a regulatory event.

Basel III Overview - Phase-out of Non-Compliant Capital (Cont'd)

- The cap on non-compliant capital may be met in part by the voluntary exclusion by a bank of an amount of non-qualifying instruments from available regulatory capital.
- Canadian banks have indicated that, with two exceptions, they will be able solely through par redemptions to reduce their non-qualifying capital in compliance with the Basel phase out schedule.
- Two banks have stated that in each case a relatively recent offering whose par redemption date is long dated past 2022 will be redeemed in 2022 pursuant to a regulatory event redemption.

Basel III Overview - D-SIBs

- In November 2011, Basel released a framework related to global systemically important banks (G-SIBs).
- To date, no Canadian domestic banks have been identified as a G-SIB and it is unlikely that this will occur at this time.
- On October 11, 2012, Basel finalized twelve principles for the assessment methodology and higher loss absorbency (HLA) for domestic systemically important banks (D-SIBs).
- Banks identified as D-SIBs may be required to increase their capital buffers beyond the level required by their non-D-SIB competitors, thereby increasing their relative cost of doing business.

Basel III Overview - D-SIBs (Cont'd)

- Basel grants discretion to national regulators with respect to the designation within their jurisdiction of D-SIBs.
- Basel has promulgated 12 principles, 7 dealing with assessment methodology (to be applied by regulators when determining if a particular institution is a D-SIB) and the remaining 5 which deal with HLA.
- The principles are to be applied at both a consolidated group and subsidiary level and thus could apply to domestic systemically important branches or subsidiaries of international banks.

Basel III Overview - D-SIBs (Cont'd)

- All of Canada's six largest domestic banks have been categorized as D-SIBs by OSFI.
- The D-SIB framework may have relevance for the largest Canadian banks not just on a domestic level but also in respect of their locally significant banking operations in other jurisdictions if those operations are determined by local regulators to be D-SIBs.
- D-SIB rules to be phased in over three years beginning in 2016.

Basel III Overview - Leverage

- Critics of Basel III capital ratios (e.g. Andrew Haldane of the Bank of England) have argued that their emphasis on risk-weighting is an unreliable indicator of bank solvency and that regulators should focus on a simpler ratio of equity to total assets.
- The Basel Committee is in the process of finalizing a leverage ratio requirement for purposes of implementation in early 2018 whereby tier 1 capital must equal at least 3% of on and off balance sheet exposures.

Basel III Overview - Leverage (Cont'd)

- Canada in the form of an assets to capital multiple (ACM) is one of a limited number of jurisdictions to have had a leverage constraint. For many years, Canadian banks have been required to limit all on and off balance sheet assets (not just risk weighted assets) to 20 times capital (or in certain cases up to 23 times capital - with OSFI approval).
- Changes to Canada's ACM will be made, if necessary, after the Basel III leverage ratio has been substantially finalized. In the meantime banks are expected to meet the ACM test and to operate at or below their authorized multiple on a continuous basis.

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Basel III Overview - Liquidity

- Basel III imposes liquidity requirements on banks in the form of two new ratios:
  - a liquidity coverage ratio (LCR), and
  - a net stable funding ratio (NSFR),

  and imposes new liquidity reporting requirements.
- LCR:
  - A short term 30 day test designed to strengthen the ability of banks to withstand adverse shocks.
  - Requires banks to maintain high quality liquid assets to cover 100% of net cash outflows that could be encountered under certain stress scenarios.

Basel III Overview - Liquidity (Cont'd)

- NSFR:
  - A longer term structural ratio designed to address liquidity mismatches.
  - Requires banks to maintain a minimum amount of secure medium and long term funding based on the liquidity characteristics of its assets over a one year period.
- While in February 2012, OSFI released the final version of *Guideline B6 - Liquidity Principles* which incorporates the Basel Principles for Sound Liquidity Risk Management and Supervision, at this time Guideline B-6 does not introduce an LCR or an NSFR.

Basel III Overview - Disclosure

- In June 2012, the Basel Committee noted that the financial crisis revealed that the level of the disclosure of the capital positions of banks and the lack of consistency in the way these positions were reported made assessments and comparisons difficult and arguably led to market uncertainty.
- Accordingly, on August 13, 2012, OSFI announced that it expects all banks to fully implement the Basel III disclosure rules in Q3 of 2013. Until such time, all banks in Canada, regardless of size, are required to make modified minimum composition of capital disclosures commencing in Q1 and Q2 of 2013.

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Impact of Regulatory Reforms - Financial Metrics

- Increased and a better quality of capital will negatively impact ROE.
- Pressure on dividend growth as a result of the need for a greater re-investment of earnings, investors look to stable growth in dividends when determining value of bank shares.
- Fewer buy backs of bank common shares as banks need to preserve common equity tier 1 capital.
- Banks may, due to the increased emphasis on CET1 under Basel III and the diminished emphasis on total capital, focus on assets to common equity capital and deleverage insofar as preferred shares and subordinated debt (although, viewed positively, such issuances are not dilutive insofar as bank EPS).
- D-SIB designation may result in even higher common equity tier 1 capital and total capital which would put even more pressure on ROE.

Impact of Regulatory Reforms - Financial Metrics (Cont'd)

- Enhanced capital requirements under Basel III magnified by transition to IFRS including in particular impacts resulting from the treatment of securitizations and shareholder equity (even after OSFI’s transitional relief in both cases).
- Potential growing divergence between economic capital and regulatory capital may be a continuing source of tension between banks and their regulators.
- Liquidity coverage ratios will impact costs.
- Increased pressure on margins and profitability generally.
- Query whether stock prices could suffer as investors look for businesses with greater margins, lower capital requirements, reduced regulation and greater dividend returns.

Impact of Regulatory Reforms - Strategies and Business Plans

- Greater focus on return on capital in terms of business lines, products and acquisitions.
- Emphasis on capital re-allocation based on revised risk weighting and risk assessment concerns (e.g. geographic, business, product, counterparty, customer, etc.).
- The nature of acquisitions/dispositions by banks will likely change with increased appetite for investments in less capital-intensive, more liquid, and/or more profitable business lines and possible dispositions of certain capital-intensive, less liquid and/or less profitable business lines although significant dispositions by Canadian banks is unlikely.
- Less interest in businesses that are not banking related (e.g. insurance) as full deduction from CET1.

Impact of Regulatory Reforms - Strategies and Business Plans (Cont'd)

- The obligation of non-Canadian global banks to cull certain of their activities (including, but not limited to, their Canadian activities) for capital, liquidity and leverage reasons stated above will provide Canadian banks potential acquisition opportunities.
- Possible exits from certain foreign jurisdictions which are potential “capital traps” (i.e. reallocation of capital among jurisdictions in which a bank operates).
- The relative competitive position of Canadian banks who are regulated by OSFI may be adversely impacted in situations where foreign regulators regulating foreign banks either interpret Basel III more liberally than OSFI or do not adopt Basel III.

Impact of Regulatory Reforms - Strategies and Business Plans (Cont'd)

- NVCC may be perceived as higher risk by fixed-income investors resulting in lower demand and requiring higher and more costly dividend/interest yields and may engender significant concerns for common share investors who risk significant dilution should a conversion event occur.
- Liquidity costs/requirements will reduce profits and therefore will be increasingly factored into the pricing of products and result in increasing loan spreads (to the extent commercially feasible).

Impact of Regulatory Reforms - Strategies and Business Plans (Cont'd)

- Greater emphasis on improving liquidity models and stress testing which will require significant investments in newer and more sophisticated tools required for the better modeling, measuring and managing of liquidity risk.
- Emphasis on retail banking and the necessary incentivizing of longer-term deposits will assist with liquidity requirements and long-term funding issues (e.g. GICs versus deposits).
- Managing liquidity risk may even be a greater challenge for banks than managing capital, significantly impacted as well by non-Basel III considerations such as Dodd-Frank and Volcker in the US.

Impact of Regulatory Reforms - Strategies and Business Plans (Cont'd)

- Greater business line and administrative integration.
- Simplifying/collapsing legal structures and considering branch alternatives in order to ease capital strain.
- Increased complexity (e.g. capital buffers, counter-cyclical buffers, etc.) of Basel III coupled with a lack of international regulatory consistency (e.g. Dodd-Frank, the Volcker Rule, whether Basel III will be adopted in the US, higher capital rules in Switzerland and Sweden, etc.) will require significant investments to be made in the tools and personnel necessary to effectively manage the changes brought about by Basel III. Capital concerns will also consume an increased amount of board and senior management time.

Impact of Regulatory Reforms - Strategies and Business Plans (Cont'd)

- Greater premium on appropriate governance and risk management, and increased regulatory importance of the role of the Chief Risk Officer.
- Better data management will become a critical component of a bank’s operations, requiring new and better IT systems (which may, or may not, be able to take advantage of new IT capabilities (e.g. cloud computing)) and highly trained personnel.
- Reduction in head-count and overhead generally.
- Streamlining of reporting both up and across banks.
- Increased emphasis on timely and accurate disclosure resulting in greater transparency, with the focus being on tier 1 capital and, less so than is currently the case, on tier 2 capital.

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Guideline B-20 - Introduction

- In response to the Financial Stability Board's *Principles for Sound Residential Mortgage Underwriting Practices*, the OSFI has released Guideline B-20.
- B-20 purports to implement principles which will assist in managing the risk associated with a residential mortgage crisis.
- Largely a reaction to the bubble and subsequent collapse in the United States housing market.

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Guideline B-20 - Scope

- Applies to all federally-regulated financial institutions (FRFI).
  - Arguably, applies even to institutions not regulated by OSFI.
  - For example, monoline lenders may be forced into *de facto* compliance if they sell loans to FRFIs.
- Applies to *any loan* secured by residential property.
  - Residential property is defined as a property with one to four unit dwellings.
  - Includes Home Equity Lines of Credit (HELOCs), equity loans, etc.
- At this point, all FRFIs are expected to have implemented the B-20 Principles and should be actively complying with relevant disclosure requirements.
- B-20 does *not* apply retroactively to in-force residential mortgages.

Guideline B-20 - Five Principles
Principle 1 - the RMUP Requirement

- The substance of B-20 is contained in its five principles designed to provide a sound underpinning for residential mortgage underwriting.

- **Principle 1:** FRFIs that are engaged in residential mortgage underwriting and/or the acquisition of residential mortgage loan assets should have a comprehensive Residential Mortgage Underwriting Policy (RMUP). Residential mortgage practices and procedures of FRFIs should comply with their established RMUP.

Guideline B-20 - Principle 1 (Cont'd)

- It is incumbent upon senior management to develop and implement the RMUP, while the board of the FRFI should review and provide guidance and oversight.
- The RMUP should be based on a board approved risk appetite framework establishing the level of risk the FRFI is willing to tolerate.
  - The RMUP also ought to align with the FRFI’s enterprise-wide strategy and their risk management framework.
- FRFIs need to develop and implement control, monitoring and reporting systems to ensure compliance with the RMUP.
- A senior officer of the FRFI should make annual declarations to the board confirming compliance with the RMUP.
  - Any deviation should be disclosed to the board and OSFI.

Guideline B-20 - Principle 2 - Do Your Due Diligence

- **Principle 2:** FRFIs should perform reasonable due diligence to record and assess the borrower's identity, background and demonstrated willingness to service his/her debt obligations on a timely basis.

Guideline B-20 - Principle 2 (Cont'd)

- Compliance with Principle 2 involves the following:
  - Performing a “reasonable enquiry” into the background, credit history and borrowing behavior of a prospective borrower in order to assess their reliability to repay.
  - Fully documenting the loan process and maintaining the information that led to mortgage approval.
    - As a general principle, an independent third party should be able to arrive at the same credit decision as the FRFI based on the FRFI’s documentation.
  - Documentation should be performed with a view to the FRFI’s obligations under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* and the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations.*
    - In particular, FRFIs must comply with customer identification and record keeping requirements, and ensure enough information about a borrower is obtained for the FRFI to determine if the borrower is a “higher risk customer”.

Guideline B-20 - Principle 3 - ABC = Assess Borrower’s Capacity

- **Principle 3:** FRFIs should adequately assess the borrower’s capacity to service his/her debt obligations on a timely basis.

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Guideline B-20 - Principle 3 (Cont'd)

- FRFIs will be expected to do the following per Principle 3:
  - Make reasonable inquiries to verify the borrower's income, including employment status and income history.
    - This applies equally to guarantors and co-signatories.
  - Develop debt serviceability metrics, incorporate them into the FRFI's RMUP, and apply them to each borrower for the purpose of assessing affordability.
    - Average scores (e.g. Gross Debt Service (GDS) ratio or Total Debt Service (TDS) ratio) for all mortgages underwritten should be less than the FRFI's stated maximums and calculated conservatively.
  - FRFI should consider factors not otherwise captured in the metrics, e.g. savings, living expenses, recurring payments, etc.
  - FRFIs should have a maximum amortization period and the average of all mortgages underwritten should be less than this.

Guideline B-20 - Principle 4 - Know Your Worth

- **Principle 4:** FRFIs should have sound collateral management and appraisal processes for the underlying mortgage properties.

Guideline B-20 - Principle 4 (Cont'd)

- The previous three principles focus on ensuring the borrower can and will repay their loan. Principles 4 and 5 deals with preparation in the event of a default.
- Principle 4 states FRFIs will be expected to have clear and transparent property valuation policies and procedures in place which utilize tools such as on-site inspection, third-party appraisal, or automated valuation tools.
  - However, no single tool or method should be relied upon.

Guideline B-20 - Principle 4 (Cont'd)

- A Loan-to-Value (LTV) ratio determined by law or market conditions should be used to evaluate risk both for traditional mortgages and HELOCs.
  - The LTV ratio for non-conforming mortgages must be less than or equal to 65%.
  - The FRFI should determine whether a down payment is produced from the borrowers own resources, or is a gift, rebate, etc.
    - Incentive and rebate payments should *NOT* be considered part of the down payment.
  - The non-amortizing HELOC component of a residential mortgage must not exceed an LTV ratio of 65%.

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Guideline B-20 - Principle 5 - Expect the Best, Prepare for the Worst

- **Principle 5:** FRFIs should have effective credit and counterparty risk management practices and procedures that support residential mortgage underwriting and loan asset portfolio management, including, as appropriate, mortgage insurance.

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Guideline B-20 - Principle 5 (Cont'd)

- As part of a risk management strategy, FRFIs should:
  - Where appropriate, obtain mortgage insurance from CMHC or a private provider and evaluate of each insurer continually throughout the life of the insurance contract.
  - Where acquiring a residential mortgage from a third-party, ensure the underwriting standards of the third-party are B-20 compliant.
  - Obtain independent valuation of any models used to make underwriting or mortgage acquisition decisions and regularly review and recalibrate them.
  - Utilize a stress-testing regime on an ongoing basis to validate any models used.
  - Underwrite or acquire heightened-risk mortgages only when accompanied with increased prudence.
  - Ensure sufficient regulatory capital exists to reflect risks taken.

Guideline B-20 - Disclosure

- B-20 requires that FRFIs publicly disclose sufficient information regarding their residential mortgage portfolios to market participants so the latter can perform an evaluation of the FRFIs' soundness of operation.
- This disclosure should include, but is not limited to, quarterly publications including information regarding:
  - the percentage of mortgage loans and HELOCs that are insured vs. uninsured;
  - a breakdown of mortgages by amortization period;
  - the LTV ratio for any new or acquired uninsured mortgage loans and HELOCs; and
  - a discussion of the potential impact on mortgage loans and HELOCs in the event of an economic downturn.

Guideline B-20 - Supervision of FRFIs

- The FRFI must provide its RMUP to OSFI on request.
- The FRFI should immediately inform OSFI of any mortgage underwriting issues that could materially impact its financial condition.
- OSFI supervises FRFIs and can take, or require the board and/or senior management to take any necessary corrective measures to deal with issues of soundness.
- Where an FRFI does not adequately account and control for the risks of underwriting or acquiring residential mortgages, OSFI can take or require the FRFI to take corrective measures including:
  - heightened supervisory activities; and
  - adjustment of capital requirements or asset-to-capital multiple.

Guideline B-20 - B-20’s Impact - Mortgages and HELOCs

- For lenders and brokers dealing with “A” clients, not much will have changed.
- More difficulty dealing with “B” clients.
  - Meeting the requirements of Principle 3 will be more difficult for business-for-self (BFS) clients.
  - Principle 4 requires that non-conforming mortgages have their LTV ratio limited to 65%.
    - Also requires LTV ratios be recalculated upon refinancing.
    - “Free Down Payments” are no longer possible - rebates and cash-back are no longer considered part of a down payment.
  - While the LTV ratio of HELOCs has also been limited to 65%, 80% options can still be created by combining the 65% HELOC with a 15% mortgage.

Guideline B-20 - B-20's Impact - Disclosure and Supervision

- Though OSFI has the power to supervise and take, or require a board to make changes, it is unclear how this supervision will be handled.
  - FRFI boards should ensure they adequately document interactions with senior management.
  - Lenders should ensure their brokers have done their due diligence and provide as much additional information as possible in the event OSFI exercises its supervisory power.
- Increased OSFI oversight through more extensive on-site OSFI audits is increasingly likely.

Guideline B-20 - Conclusions

- Despite all of the above, year-over-year sales in Toronto were up 16% in July 2013. In Vancouver, sales were up 40.4% in the same period.
- Credit Unions will remain unaffected to the extent that:
  - they do not apply for federal charter;
  - do not accept funding from an FRFI; and
  - the province in which they operate does not impose requirements akin to B-20.

Basel III and Guideline B-20 – Conclusions (Cont'd)

- Canadian banks are in a good position to adopt Basel III (they are strongly capitalized and have existing and sophisticated liquidity and leverage models as well as excellent risk management capabilities, advanced and very good compliance, well developed recovery plans, etc.).
- Historical emphasis on retail banking will assist Canadian banks in dealing with liquidity requirements.
- Basel III, its requirements insofar as capital, liquidity, leverage and governance and its implications, both intended and unintended, represents one of the most significant regulatory developments affecting the banking industry in recent memory. It is and will dramatically impact the ways in which banks in Canada are managed and carry on business.

Basel III and Guideline B-20 - Conclusions (Cont'd)

- B-20 imposes some significant new responsibilities on lenders and brokers and some difficulties on borrowers.
- The exact details of how OSFI will exercise its supervisory powers are unclear, but FRFIs and those selling loans to them should take steps to ensure they are B-20 compliant.
- B-20 is not the end of the world; year-over-year sales increases prove the challenges are surmountable.

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