BLG 2016 Canadian Financial Institutions Regulatory Outlook

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2016 promises to be another year of significant regulatory activity, both internationally and domestically, of relevance to the Canadian financial sector. Set out below is a summary of some developing areas on our radar that could impact the Canadian financial sector in 2016.

Financial Stability Board (FSB)

FSB's first annual report on implementation of the financial reforms and their effects, issued in November 2015, notes that implementation of bank capital reforms has substantially strengthened the banking system. All 24 FSB jurisdictions have Basel III risk- based capital rules in force. Final rules on liquidity have been issued and are in force in almost all jurisdictions. The FSB report notes that banks have increased their capital ratios mainly through retained earnings rather than by reduced lending. The FSB report also notes that in some policy areas, implementation is less advanced. In particular, substantial work remains at the national level to implement effective resolution regimes. Implementation of over-the-counter derivative reforms, while well underway, is uneven and continues to be well behind schedule. The FSB is currently assessing the financial stability risks of asset management activities which will inform the assessment methodology and will develop activities-based policy recommendations as necessary in the first half of 2016. OSFI is playing a leading role in the FSB asset management review process.

Basel Committee On Banking Supervision

We understand that there are a number of areas of focus for the BCBS in 2016 relevant to deposit-taking institutions. First the Committee is conducting a strategic review of the risk-weighted capital framework to assess whether it strikes the right balance in terms of simplicity, comparability and risk sensitivity. Ongoing reforms are grouped into three broad categories: (i) enhancing the risk sensitivity and robustness of standardised approaches; (ii) reviewing the role of internal models in the capital framework; and (iii) finalizing the design and calibration of the leverage ratio and capital floor possible

modifications to the internal ratings based framework to narrow the modelling choices available to banks, particularly in areas for which the use of models may not be suitable for calculating regulatory capital. Further, the BCBS is finalizing the design and calibration of a Pillar 1 leverage ratio and the use of risk-weighted capital floors based on standardised approaches. Another areas of priority is the review of the regulatory treatment of interest rate risk in the banking book.

The International Association Of Insurance Supervisors (IAIS)

We understand that IAIS is refining the Basic Capital Requirement (BCR) and Higher Loss Absorbency (HLA) requirements for Global Systemically Important Insurers (GSIIs) for implementation in 2019. Work in this area is aimed at mitigating or avoiding risks to the global financial system. To eventually replace the BCR, the IAIS is developing an internationally agreed upon risk based capital test. The insurance capital standard (ICS 1.0) for the broader list of Internationally Active Insurance Groups (IAIG) will be ready by the end of 2016, for implementation in 2019.

Office Of The Superintendent Of Financial Institutions (OSFI)

Continuing priorities for OSFI include anticipating and responding to risks raised by the state of the economy (e.g., decline in oil/commodity prices, high housing prices in certain markets and consumer indebtedness) and adjusting supervision/regulation with a focus on governance, risk management oversight capabilities and cybersecurity. In addition, it is expected that OSFI will be focused on enhancing the supervisory processes, including the application of guidance that is risk-based and scaled to the size and complexity of the federally regulated financial institutions (FRFIs). We also note that OSFI is also engaged in completing the post-crisis reform agenda focused on enhance capital frameworks and support development of resolution framework for D-SIBs (domestically systematically important banks).

A number of new forms of guidance are anticipated for 2016. These include a ruling on conversion by mutual property and casualty companies with non-mutual policy holders and assumption reinsurance transaction instructions. It is also expected that OSFI will issue a deposit-taking institution continuance guide, a federal credit union continuance guide, an updated foreign bank branching guide and substantial investment transaction instructions.

In addition to the ongoing policy work noted above, OSFI is also working on updated guidance for chief agents of insurance branches (Guideline E-4), updating guidance with respect to large exposure limits (Guideline B-2) and guidance for reinsurance security agreements.

Bank Capital

The Operational Risk Management Guideline (E-21) for FRFIs was finalized in December 2015. The Guideline regroups aspects of operational risk that were previously addressed in various guidelines and sets out principles for operational risk management. Operational risk management is to be fully integrated within the institutions overall risk management program and is appropriately documented. As part of this, institutions are required to develop an operational risk appetite statement and ensure effective accountability for operational risk management. Institutions are

required to have a three line of defence approach, or appropriately robust structure, to separate the key practices of operational risk management and provide adequate independent overview and challenge.

OSFI is co-ordinating policy development with the Canadian Securities Administrators work with respect to margin requirements for non-centrally cleared derivatives. This is an FSB initiative, with work conducted through a joint working group of the BCBS and International Organization of Securities Commissions to address systemic risk and to provide more incentive to centrally clear.

For banks using internal capital adequacy models, OSFI has initiated a consultation to establish common best practices, nomenclature and expectations around the enterprise wide model risk management. In addition, while OSFI has traditionally focused on capital adequacy of banks and other deposit-taking institutions on a fully consolidated basis it is examining, as are other jurisdictions, solo capital requirements and the implications of collateralization of bank assets on unsecured creditors.

Insurance Company Capital

On the domestic front, OSFI is on track to implement OSFI's new life insurance regulatory capital framework in 2018 for life insurers. The capital changes in the new framework are explicitly calibrated to a consistent level of conditional tail expectation across the various risks. Actuarial valuation of insurance company liabilities are explicitly intended to include conservative margins with the degree of conservatism varying across risks. To help ensure that this approach results in consistent capital measures across companies, OSFI has asked the Canadian Institute of Actuaries and the Actuarial Standards Board to consider certain issues with a view to updating actuarial standards and /or guidelines if required.

While OSFI is awaiting the results of the Quantitative Impact Study (QIS)7, it is in the process of planning to conduct two framework runs, one in 2016 followed by another one in 2017. These "test drives" will allow OSFI to validate the new capital test and help insurers gear up for the updated regulatory compliance requirements under the new framework. A final guideline is expected to be ready for issue in July 2016, following input from the industry on the draft.

The amended Minimum Capital Test Guideline came into effect on January 1, 2016 for property and casualty companies. The amendments address market risk, capital charges on equity derivatives and equity instruments held short, capital credit for eligible equity hedging and changes to the Branch Adequacy of Assets Test. As regards capital for Mortgage Insurers OSFI is focusing on a new factor-based approach for mortgage insurance risk, with consultations scheduled for 2016.

Canada Deposit Insurance Corporation (CDIC)

In December 2015 CDIC, tabled its five-year corporate plan. The five-year plan identifies CDIC's three strategic objectives: modernize the deposit insurance program; build preparedness to resolve domestic systemically important banks; and foster an environment of innovation and excellence. Modernization of the program will involve rolling out a payout transformation plan with a focus on the latest payment methods and channels, and communications with depositors; updating risk assessment processes;

actively participating in the Government's deposit insurance review; developing intervention plans for selected members; and implementing a new three-year public awareness strategy. As regards resolution, CDIC will, among other things, work closely with banks to develop credible resolution strategies; continue to work with other federal safety net agencies to enhance Canada's resolution framework; augment its internal resources to strengthen D-SIB resolution preparedness and accelerate resolution planning. CDIC indicates that it will also establish an outreach program to engage with key domestic and international resolution authorities and regulators, and establish agreements aimed at information sharing and coordination. We understand that CDIC's objective of fostering an environment of innovation and excellence will involve, among other things, a new talent management strategy, developing CDIC's Emerging Risk function and implementing a new investment management model.

Canadian Payments Association (CPA)

CPA has released its Strategic Plan entitled Modernizing Canadian Payments 2015 – 2020. In line with other countries further along the path to payment system modernisation, the CPA is bringing the ISO 20022 standard for payment messages to Canada and actively promoting harmonisation at the international level. In the third quarter of 2015, it launched a consultation on its ISO 20022 message standard for direct debits and credits. From early 2016, CPA indicates that the new ISO 20022-enabled messages for Automated Funds Transfers will be made available for use in the market. Further, working with McKinsey & Company, the CPA is conducting interviews and interactive workshops with industry participants and stakeholders – another key component of its modernisation initiative. In 2016, once the shared vision has been established, we understand that the CPA will turn its attention to developing proposals for its core clearing and settlement systems to support the vision.

Financial Consumer Agency of Canada (FCAC)

In 2015 FCAC became more proactive and transparent in its supervision of FRFIs, expanded its financial literacy activities and restructured to align internal operations with its priorities in protecting financial consumers' interests. In its most recent annual report, FCAC notes its intent to work diligently to keep pace with the growing number of increasingly complex and often-changing financial products and services on offer to consumers. In addition, FCAC indicates that it is determined to help Canadians improve their financial literacy and awareness of their financial rights and responsibilities, so they can make sound financial decisions suited to their individual circumstances. Further, FRFIs can expect FCAC to continue to be active in monitoring compliance through on-site examinations, industry reviews, and customer complaint monitoring.

Financial Transactions And Reports Analysis Centre Of Canada (FINTRAC)

In 2016 it is expected that FINTRAC will continue to focus its efforts on providing actionable financial intelligence that assists police and national security agencies in protecting Canada and Canadians. The Compliance Program of FINTRAC will continue to ensure the quality, quantity and timeliness of the reporting it receives and ensure that reporting entities have the tools and the guidance they need to comply with their anti-money laundering and anti-terrorism financing legislative obligations. In addition, in 2016 changes to regulations under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTFA), that were published in mid 2015, are expected

to be finalized and promulgated. The amended regulations address such issues as identify verification, use of electronic signatures, an expanded definition of politically exposed persons, and new standards for the reporting of suspicious transactions. Oversight of the implementation of these regulation changes are expected to be another priority for FINTRAC.

Provincial Reforms

L'Autorité des marchés financiers (AMF)

The Québec AMF has a number of important initiatives that are continuing into 2016, including revisions to an *Act respecting financial services cooperatives*, and the *Insurance Act*. AMF has indicated that following earlier study and public consultations work is proceeding on revising an *Act respecting the distribution of financial products and services* and the *Derivatives Act*. It is engaged in a series of reforms aimed at modernizing the regulations of the Québec financial sector. In addition, the AMF has indicated that it will release the results of its most recent measurement of its indices developed to help policy makers identify measures to improve financial literacy.

Ontario

In 2015, Ontario launched a number of reviews relevant to the financial sector. Special panels are reviewing regulations relating to financial advisors and planners and the regulation of payday loans, cheque cashing, money transfer services and debt collection agencies. These public consultations will help inform important work underway on potential amendments to consumer protection legislation, including the *Payday Loans Act* and the *Collection and Debt Settlement Services Act*, all of which are expected to be advanced in 2016.

In addition, a panel reviewing three Ontario regulatory organizations, including the Financial Services Commission of Ontario, which regulates insurers, insurance intermediaries, mortgage brokers and credit unions, is expected to deliver final recommendations on amendments to the Ontario financial services regulatory structure in 2016. The panel released preliminary recommendations in November, 2015, which include establishing an integrated regulator of financial services in Ontario. The panel is currently reviewing the feedback it has received.

Amendments modernizing the life and accident and sickness sections of the *Insurance Act* (Ontario) will come into force July 1, 2016. The amendments are similar to changes already made in the Western Provinces, and, among other things, the amendments stipulate the wording that must be included in insurance policies and certificates, extend the grace period in which an insurance policy may be reinstated for non-payment of premium and generally modernize the legislative provisions applicable to these types of contracts.

Final Comments

We continue to monitor many of the developments noted above for clients and would be happy to share additional information and or insights with readers of this Alert, as requested.

By

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