Intelligence MEMOS

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From: Mark Zelmer

To: Office of the Superintendent of Financial Institutions

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Re: **Let's Not Rush New Bank Rules on Capital and Lending**

Canada's financial regulator is in a ticklish situation. On March 6, Federal Reserve Chairman Jerome Powell signalled that US regulators are reconsidering their plans to hike capital requirements for large banks in accordance with what is commonly referred to as the "international Basel III endgame agreement."

The obvious question? Should Canada's counterpart, the Office of the Superintendent of Financial Institutions (OFSI), follow suit? The obvious answer? In my view, yes, OSFI should suspend its plans to implement similar changes for the six major Canadian banks until it is clear whether the US and other major jurisdictions actually proceed.

The Basel III endgame agreement is the final chapter of a suite of changes to bank capital requirements that were designed to foster a safer, more resilient global banking system in the wake of the 2007-2008 global financial crisis. This last chapter will limit banks' ability to use their own risk management models to compute their regulatory capital requirements and instead impose standardized models on them that typically generate more stringent requirements.

Quick off the mark, OSFI has moved faster on the endgame agreement than major jurisdictions, including the US, EU, and UK. It has already implemented key changes to the measurement of risk, whether credit, market or operational.

The final and most contentious changes are the introduction of a capital floor and the constraint on banks' use of their own risk models. When fully implemented by OSFI in 2026, the capital floor will prevent bank capital requirements from falling below 72.5 percent of those calculated using a standardized capital framework that uses internationally agreed supervisory parameters. By contrast, before Powell's latest announcement, the US had been planning to implement its changes by 2028, while the EU and UK are targeting 2030.

An analysis of the capital changes published by Scotiabank's equity research team suggests the main impact in Canada will be higher capital requirements related to loans to large corporations and to lending secured by real estate, including residential mortgages and income-producing real estate. This is because banks' risk models produce lower capital requirements for these types of loans than those emerging from the standardized framework.

Because greater capital requirements would raise loan costs, some have argued OSFI should delay its phasing-in of the capital floor so as not to discourage investments needed to enhance productivity and expand housing stock in a time of shortage.

That alone doesn't justify a pause, however. However worthy the goals of enhancing Canada's productivity and expanding housing, using bank regulation as an instrument to promote lending to specific economic sectors is a bad idea – tantamount to asking bank depositors and creditors to subsidize the costs and risks associated with such lending in an opaque manner.

On the other hand, a couple of prudential points do argue in favour of OSFI pushing pause on its endgame implementation.

First, are current bank capital levels adequate or not? If they are adequate, then higher requirements are unnecessary. Alternatively, OSFI could continue with the endgame but allow the impact of the new requirements to be neutralized by some offsetting measures. Total regulatory capital requirements could remain unchanged through some combination of adjustments to the capital buffers contained in bank capital plans and/or reducing the size of OSFI's "domestic stability capital buffer" applied to the six major banks. Lowering it reduces the amount of capital banks must hold.

Second, Powell's announcement also suggested the new US rules could change, along with being delayed. If so, the EU, UK and others may follow that lead, in which case, for all intents and purposes the endgame agreement collapses. OSFI shouldn't impose a new regulatory floor on our banks when the world's leading banking markets are opting out.

Events in the US have given the rest of us an opportunity to pause and see if and when other jurisdictions actually implement the endgame agreement. If OSFI wants to carry on with its current implementation plans, it should explain why Canada's six big banks should have to meet tough new requirements before their international competitors.

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