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CRISIS MANAGEMENT AND BANK RESOLUTION FRAMEWORK—TECHNICAL NOTE

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CRISIS MANAGEMENT AND BANK RESOLUTION FRAMEWORK

AD REFERENDUM

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Canada. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations.

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ABCP	Asset Backed Commercial Paper
AMF	Autorité des Marchés Financiers
BCPS	Basel Core Principles for Effective Supervision
BCBS	Basel Committee for Banking Supervision
BIS	Bank for International Settlements
BOC	Bank of Canada
Can$	Canadian Dollar
CAR	Capital Adequacy Ratio
CBCM	Cross-Border Crisis Management
CDIC	Canada Deposit Insurance Corporation
CMG	Crisis Management Group
CMHC	Canada Mortgage and Housing Corporation
CSA	Canadian Securities Administrators
DIS	Deposit Insurance System
DOF	Department of Finance
D-SIB	Domestic Systemically Important Bank
EFF	Extraordinary Financing Framework
ELA	Emergency Liquidity Assistance
FISC	Financial Institutions Supervisory Committee
FIRP	Financial Institution Restructuring Provisions
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FCAC	Financial Consumer Agency of Canada
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
HOA	Heads of the Agencies
IMPP	Insured Mortgage Purchase Program
Key Attributes	Key Attributes of Effective Resolution Regimes for Financial Institutions
MOF	Minister of Finance
MOU	Memoranda of Understanding
NVCC	Non-viability Contingent Capital
OSFI	Office of the Superintendent of Financial Institutions
OBA	Open Bank Assistance
PRA	Purchase and Sale Agreements
RRP	Recovery and Resolution Plan
SAC	Senior Advisory Committee
SLF	Standard Liquidity Facility
SRC	Systemic Risk Council

EXECUTIVE SUMMARY[1]

This note elaborates on the main recommendations made in the Financial Sector Assessment Program (FSAP) Update for Canada in the areas of crisis management and bank resolution. It summarizes the findings of the FSAP Update missions undertaken during June 19–23, 2013 and September 9–20, 2013 and is based upon the analysis of the relevant legal and policy documents and intensive discussions with federal authorities, the Autorité des Marchés Financiers (AMF), and private sector representatives. The key findings and recommendations of this technical note are summarized below.

The resilience of the Canadian financial system is a testimony to strong prevention policies. The country's longstanding financial stability was underpinned by traditionally strong prudential supervision and regulation, conservative financial sector policies and business models of banks, as well as sound economic fundamentals. The authorities continuously improved and adapted the legal and institutional arrangements to reflect evolving market conditions and risks. Canada was consistently a frontrunner in implementing the key elements of the global financial reforms before and following the recent crisis.

The Canadian safety net is complex well established, and enjoys a high level of credibility. A substantial part of the financial sector is covered by the federal safety net, while each of the ten provinces has functionally-independent crisis management arrangements. At the federal level, the Minister of Finance (MOF) is legally and operationally the financial stability "gatekeeper". The government has broad intervention powers and can supersede certain decisions of both the Office of the Superintendent of Financial Institutions (OSFI) and Canada Deposit Insurance Corporation (CDIC) based on financial stability grounds. The OSFI, CDIC, and Bank of Canada (BOC) have each established leading practices in their areas of responsibilities. The provincial deposit insurance systems (DIS) and resolution frameworks are highly heterogeneous and the FSAP's analysis, based on extensive discussions with the AMF and publicly available information, suggests that the preparedness to overcome financial stress should be enhanced.

The federal legal and institutional arrangements for resolving individual financial institutions are robust. The intervention framework is well articulated, underpinned by strong legal powers, and transparently communicated to the industry in the form of a joint OSFI-CDIC "Guide to Intervention." CDIC has a broad resolution toolkit, although some important tools (i.e. those provided under the Financial Institution Restructuring Provisions—FIRP from the *CDIC Act*) can only be activated based on a decision of the Governor in Council following a recommendation from the MOF. The CDIC has developed a detailed operational framework for resolution and has recently introduced a single depositor view system. BOC has a strong emergency liquidity framework. A set of committees brings together the main regulatory authorities at federal level and provides a strong level of coordination and communication. The well-known mandates of participating agencies

[1] Prepared by Oana Nedelescu (MCM).

facilitate clarity of responsibility; and a high degree of informality permits flexible operation and a nimble response to arising issues.

However, the lack of a mandate in some specific areas means there is a risk of gaps in coverage, which could weaken the ability of the authorities to spot emerging problems and to respond in the most effective manner. The BOC conducts regular assessments of the stability of the financial sector, but this exercise is hindered by data gaps and lack of access to some important information. No-one has a mandate to collect and analyze data for the financial system as a whole—federally and provincially regulated entities, unregulated entities, and markets. In the absence of such a mandate, a complete set of information is not collected on a systematic and regular basis and the policy actions to the buildup of systemic risks may be delayed. Moreover, an overarching policy and operational guidance to respond to a system-wide crisis is missing. Coordination failures could be accentuated by shortfalls in communication between federal and provincial authorities.

Clear mandates should be assigned (i) to monitor systemic risk in order to facilitate macroprudential oversight, and (ii) to carry out system-wide crisis preparedness. For performing the macroprudential oversight, such entity should have participation broad enough to allow a complete view of systemic risks, and powers to collect all necessary data for systemic risk analysis. For crisis preparedness purposes, such entity should operationalize a coordination framework composed of policies, procedures, and operational guidance to support timely and effective decision making in a crisis situation. Comprehensive simulations to test the capacity of the authorities (federal and provincial) to respond to broad and severe scenarios should be performed on a periodic basis. The cross-sectoral resolution frameworks should also be better articulated.

The CDIC's autonomy in activating resolution tools needs to be improved and its resolution powers further strengthened. The CDIC should have greater independence in activating various resolution tools (including those provided in the FIRP of the *CDIC Act*), while governmental approval would be maintained in situations which may involve public funds or ownership (e.g. bridge banks). The CDIC should be empowered to require companies in the same group to ensure continuity of essential services in a resolution and be equipped with explicit powers to terminate contracts. Furthermore, its power to temporarily stay the exercise of early termination rights should be enhanced, in line with the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes. The merits of introducing some form of depositor preference should be considered, which could mitigate legal risks during a resolution and better protect the resources of CDIC.

The ex-ante funding of CDIC should continue to be bolstered. To achieve the targeted 100 basis points coverage of the insured deposits (from the current 39 basis points), an increase of the premiums paid by financial institutions will be necessary. Enhanced data collection on depositors would ensure that the coverage limit and the target ex-ante financing strike the right balance between depositor protection, financial stability, and market discipline. The proposed simplification of the rules for eligibility for deposit insurance of complex deposit products is welcome.

The provincial arrangements for crisis management and the cooperation with federal authorities need to be enhanced. The provincial safety nets should be reinforced to ensure:

(i) enhanced supervision of provincial institutions that may be deemed to be systemically important; (ii) well-funded and prepared deposit insurance systems; (iii) comprehensive resolution frameworks; and (iv) clear policies and operational guidance for crisis management. The longer-term objective should be to introduce more uniformity across the operating standards of the provincial safety nets and convergence towards leading practices. A more integrated communication on financial stability issues at both provincial and federal levels is recommended, while active cooperation on systemically important financial institutions should be a priority.

Table 1. Main Recommendations for the Crisis Management and Bank Resolution Framework

Coordination	**Priority**
➢ Provide a clear mandate to an entity (i) to carry out macro-prudential oversight with participation broad enough to allow a complete view of systemic risks, and with powers to collect all necessary data for systemic risk analysis and (ii) to carry out system-wide crisis preparedness	High
➢ Perform regular system-wide crisis simulation exercises	Medium
➢ Enhance cross-sectoral coordination in the supervision and resolution of groups which span over both federal and provincially regulated areas; give priority to communication and cooperation on systemically important institutions (federal and provincial)	High
Provincial safety nets	
➢ AMF: Enhance early intervention powers; increase ex-ante funding of deposit insurance fund and introduce a capitalization target and a single customer view system; establish a crisis intervention framework	High
➢ Other provincial authorities: Undertake a self-assessment of the adequacy of safety nets and pursue necessary enhancements to ensure: well funded local deposit insurance schemes, broad resolution frameworks, and operationalized contingency planning	High
➢ All: Review and update, where necessary, cooperation agreements and contingent operational arrangements with federal authorities	Medium
➢ All: Introduce a more uniform approach on coverage levels of provincial deposit insurance schemes	Medium
Resolution powers	
➢ Improve autonomy of CDIC in activating a broader range of resolution tools	Medium
➢ Enhance the CDIC's resolution powers in line with the Key Attributes, including the power to bail-in for D-SIBs	Medium
➢ Introduce legal requirements for the preparation of recovery and resolution plans and powers to change a firm's structure in order to enhance resolvability	Medium
➢ Consider introducing some form of depositor preference	Medium
Deposit insurance	

➢ Bolster the ex-ante resources of CDIC	Medium
➢ Improve data collection on depositors' profiles	Medium
➢ Simplify the rules for complex deposit products	Medium
Emergency Liquidity Assistance	
➢ Remove the legal restriction which prohibits the BOC from taking mortgages as collateral when providing liquidity assistance	Medium

INTRODUCTION[2]

1. The financial system weathered exceptionally well the recent global financial crisis. Due to its openness and strong ties with the United States, the economy was hit by slumping external demand while the core funding markets were affected by the global financial shocks. However, the impact was relatively mild and the economy experienced a short and shallow recession, while risks to financial stability were contained by decisive policy action. No financial institution failed or had to be rescued by the government and conditions in the financial system have relatively quickly normalized. Banks continue to report solid earnings in 2013 and the average capital adequacy ratio for domestic banks is above 13 percent.

2. The framework for dealing with systemic risk and systemic crises has been continuously improved. In the aftermath of the Global Financial Crisis, many reforms have been introduced to strengthen the intervention powers of the authorities to deal with bank failures, including a recapitalization tool by the government and a bridge bank instrument. CDIC has significantly enhanced its operational resolution procedures and its capacity to promptly reimburse deposits. A more stringent regime was established for federally chartered domestic systemically important banks (D-SIBs), while some provincial authorities have also initiated similar policies.

3. In hindsight, the policy framework has not been tested by systemic risks and the crisis management experience is inherently limited. OSFI was established in 1987 in the wake of bank failures earlier in that decade, but has not experienced any episodes of systemic concern since its inception. Throughout its history, CDIC has generally resolved small and medium-sized banks, with the most recent bank failure dating back to 1996. Therefore, the objective of the present note is not only to describe what policy elements have contributed to the longstanding stability of the Canadian financial system, but also to test the existing framework in terms of preparedness to respond to potentially greater financial turmoil.

4. This note is structured as follows. Chapter II summarizes the existing institutional framework and coordination arrangements for crisis management. Chapter III discusses the federal crisis preparedness and management tools, covering early supervisory intervention, official financial

[2] Prepared by Oana Nedelescu (MCM) as part of the 2013 FSAP Update of Canada. The mission would like to thank the Canadian authorities and market participants for their excellent cooperation and open dialogue.

support, orderly and effective resolution, and the federal deposit guarantee scheme. Chapter IV discusses elements related to the improvement of resolvability of D-SIBs. Chapter V provides reflections with regard to provincial crisis management arrangements and outlines the links between the federal and the provincial safety nets. Finally, Chapter VI outlines issues related to cross-border coordination and exchange of information.

INSTITUTIONAL ARRANGEMENTS, COORDINATION, AND PREPAREDNESS

A. Features of Effective Crisis Management Frameworks

5. **The past has shown us that every financial crisis is different in terms of source of stress, manifestation, and intensity**. Since it is hard to anticipate the conditions in which a crisis occurs, the best remedy is prevention. Good preemptive policies are efficient in mitigating the risks of crises, but do not eliminate them completely. In a highly globalized financial system and fluid market conditions, preventive policies need to be complemented by effective crisis management arrangements, which allow for timely policy actions and preserve financial stability when the unexpected happens.

6. **An effective crisis management framework entails both institutional and operational components**. Indeed, the foundation of an effective crisis management framework is provided by a sound and comprehensive legal and institutional setup. Such arrangements are reflected in a broad range of legal powers and tools in the areas of systemic risk detection, early intervention, official liquidity assistance, resolution, and deposit insurance. The safety net institutions (the supervisory agency, the central bank, the deposit insurance agency, and the resolution authority) should have independent but mutually reinforcing mandates, and cooperation and exchange of information should be possible both during the normal course of business and during crises. They should also allow for cooperation and exchange of information internationally.

7. **A well articulated operational intervention mechanism is needed to enable timely and effective decision making**. The operational mechanism should be set in policies, procedures, operational guidance, including pre-drafted documentation, as well as coordination mechanisms to support timely and best possible decision-making in a crisis situation. The early detection of financial system risks allows more time for contingency planning to analyze the different courses of action in the event of a crisis and to plan for implementation measures. Once risks materialize, the authorities' response needs to be decisively implemented and communicated in a way that preserves confidence. Such operational mechanisms need to be periodically tested and reviewed to ensure suitability to new conditions and emerging risks.

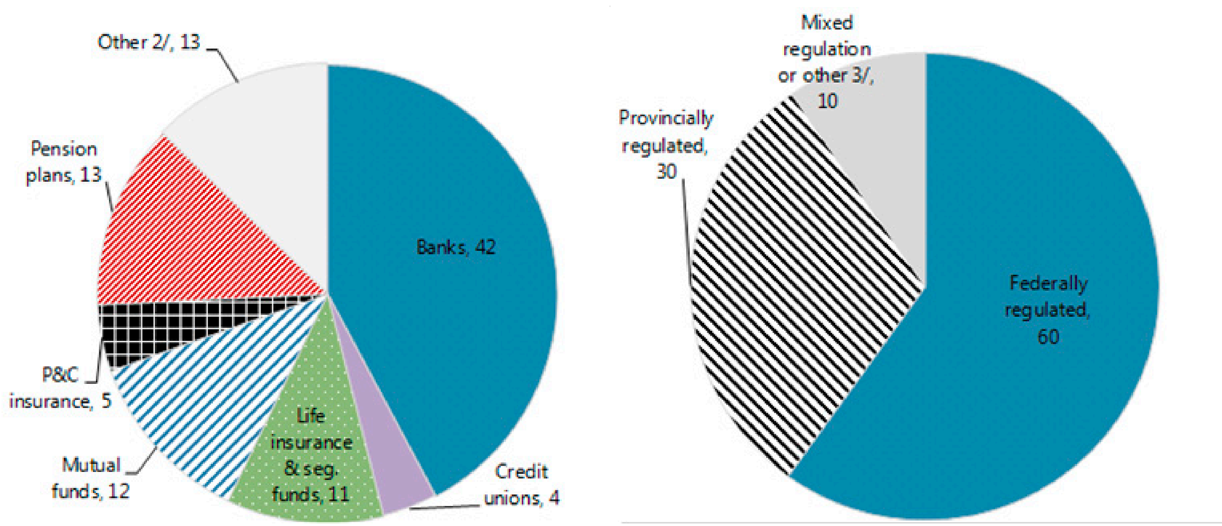
B. Domestic Safety Nets

8. **The Canadian financial system is large, relatively complex, and concentrated.** The financial system accounts for almost 500 percent of the GDP and is composed of a large spectrum

of federally and provincially regulated institutions. The six domestic systemically important banks[3] (D-SIBs) and one large provincially incorporated credit cooperative network[4] hold almost half of the financial sector assets. The financial system was exceptionally resilient during the global financial crisis and no financial institution had to be closed or rescued.

9. Financial sector oversight responsibilities are shared by several federal and provincial authorities. The largest part of the financial sector, including all banks, trust and loan companies, and insurance companies is under federal prudential supervision, while the ten Canadian provinces oversee most of the credit unions and credit cooperatives, as well as security markets and other market conduct elements (Figure 1).

Figure 1. Financial Sector Structure



(Percent of total assets; consolidated balance sheet accounts)

Sources: Bank of Canada; OSFI; Statistics Canada; Canadian Council of Insurance Regulators; company reports; and IMF staff calculations.

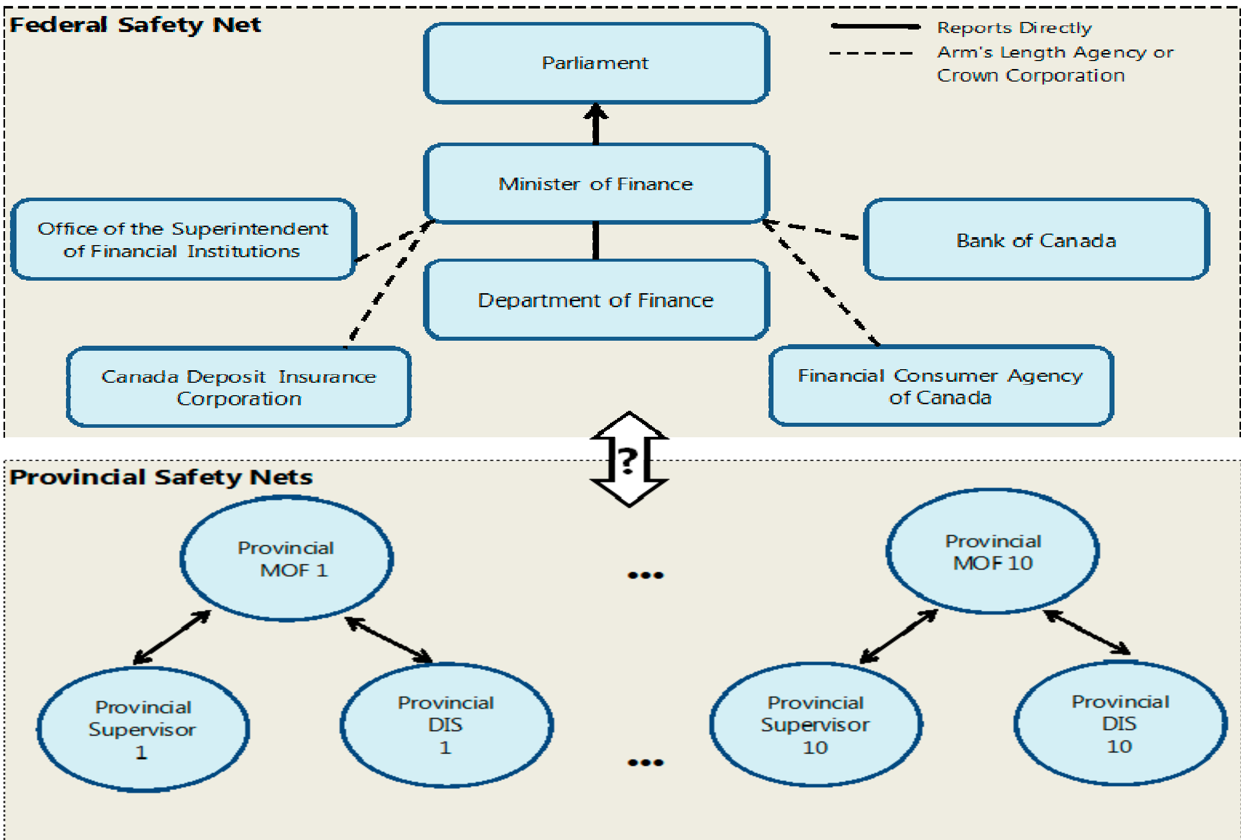
10. The safety net is consequently complex and organized separately at the federal and provincial levels. The federal safety net is composed of the Department of Finance (DOF), the BOC, the OSFI, the CDIC, and the Financial Consumer Agency of Canada (FCAC), each with specific, yet mutually reinforcing policy mandates. The provincial safety nets are, by institutional and political design, operationally independent from the federal safety net. The ten Canadian provinces have

[3] In March 2013, OSFI designated six federally regulated banks as D-SIBs: Royal Bank of Canada, Toronto Dominion Bank, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Bank of Montreal, National Bank of Canada.

[4] Desjardins is a provincially incorporated group, which was designated by the Québec supervisor (Autorité des Marchés Financiers) as systemically important.

distinct authorities overseeing provincially incorporated institutions, some of which are domiciled in the local Ministries of Finance, and separate provincial deposit insurance systems (Figure 2).

Figure 2. Federal and Provincial Safety Nets



Note: DIS= Deposit Insurance System.

11. The federal authorities function under the auspices of the Minister of Finance (MoF), although their operational independence is generally high. According to the *Financial Administration Act,* the MoF is charged with the "supervision, control and direction of all matters relating to the financial affairs of Canada not by law assigned to the Treasury Board or to any other minister" (Article 15), thus being the "gatekeeper" of financial stability for federally regulated entities.

- **DOF:** is the operational arm supporting the MoF in fulfilling his financial stability mandate. The MoF has broad powers, including entering into any contracts and/or providing credit that are necessary to promote the stability or maintain the efficiency of the financial system. The MoF also has overarching authority over federal financial sector legislation and has the ability to direct other authorities to take specific action to prevent adverse effects on financial stability.

- **BOC**: is Canada's central bank. The BOC does not have an explicit statutory mandate for promoting financial stability, although through its roles provided by the *Bank of Canada Act* contributes to the stability and efficiency of the Canadian financial system by providing liquidity; overseeing key domestic payment, clearing and settlement systems (per the *Payment, Clearing and Settlement Act*); and participating in the development of financial system policies in Canada and globally.

- **OSFI**: is the federal prudential supervisory agency. The OSFI supervises and regulates all banks and federally regulated life and property and casualty insurers, federally regulated trust and loan companies, cooperative credit associations, and fraternal benefit societies, as well as private pension plans subject to federal oversight.[5] OSFI does not have an explicit financial stability mandate, although it contributes to financial stability directly by virtue of its micro-prudential supervisory role.

- **CDIC**: is the federal deposit insurer and the main federal resolution authority. The CDIC reports to Parliament through the MOF and is governed by a Board of Directors. Its authority extends over federally-regulated deposit-taking institutions. The CDIC has an explicit statutory mandate to "promote and otherwise contribute to the stability of the financial system" (*Canada Deposit Insurance Corporation Act)*. The CDIC's operational independence in activating some of its main resolution tools is constrained (see Chapter III, Section D).

- **FCAC**: is a federal regulatory body working to protect and inform consumers of financial products and services. Its activities consist of supervision of compliance by federally incorporated financial institutions with consumer protection legislation, financial education and literacy outreach, as well as research in the two previously mentioned areas. Given its preventive mandates, FCAC is considered a partner in the safety net.

12. Furthermore, there are a few interagency arrangements designed to reinforce cooperation on financial sector issues of broader concern (Table 2):

- **The Financial Institutions Supervisory Committee (FISC)**: established in 1987, is mandated in the *Office of the Superintendent of Financial Institutions Act* to facilitate consultation and the exchange of information on matters relating to the supervision of federal financial institutions between OSFI, CDIC, BOC, FCAC, and the DOF. FISC is also responsible for coordination and communication among federal agencies with respect to strategies and action plans for addressing individual problem financial institutions. Members exchange freely any information on matters relating directly to the supervision of financial institutions, bank holding companies or insurance holding companies that is in the

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[5] OSFI is also responsible for reviewing and monitoring the safety and soundness of Canada Mortgage and Housing Corporation's (CMHC) commercial activities. CMHC is a Crown corporation that offers mortgage insurance and securitization options to Canadian lenders. The CMHC has a legislative objective to promote and contribute to the stability of the financial system, including the housing market.

possession of any other member. The FISC is chaired by the Superintendent of Financial Institutions.

- **The Senior Advisory Committee (SAC)**: has the same membership as FISC, but is chaired by the Deputy MOF. SAC is a discussion forum for financial sector policy issues, including financial stability and systemic vulnerabilities in order to inform the advice provided to the MoF. Other government agencies can be invited to this discussion forum, if relevant. Each SAC member formulates policies to address identified vulnerabilities consistent with their individual mandates. Policy issues are discussed at SAC to ensure coordination and assess how such policies may affect the banks and the financial system. SAC is a non-statutory body and it does not have well defined terms of reference.

- **The Heads of Agencies (HOA) Committee**: chaired by the Governor of the BOC and includes the DOF, OSFI, and four provincial Securities Regulators (the Ontario Securities Commission, Autorité des Marchés Financiers (AMF), Alberta Securities Commission, and British Columbia Securities Commission). This forum allows federal authorities and provincial securities market regulators to exchange information, and to coordinate actions on issues of mutual concern such as hedge funds and OTC derivatives.

- **The Systemic Risk Committee (SRC) established by the members of the Canadian Securities Administrators (CSA):** started operating in October 2009 and is tasked to develop a process to identify and analyze systemic risks in the Canadian capital markets. The Committee works with other CSA committees, as well as with other domestic regulators or agencies on systemic risks related to securities markets. Recently, an agreement has been made among the provinces of Ontario and British Columbia and the federal authorities in Canada to establish a cooperative capital markets regulator.

Table 2. Overview of Inter-agency Committees

Committees	FISC	SAC	HOA	SRC
Members	OSFI, CDIC, BOC DOF, FCAC	OSFI, CDIC, BOC, DOF, FCAC (other governmental institutions can be invited)	OSFI, BOC, DOF 4 Provincial Securities Regulators	Members of the Canadian Securities Administrator (CSA)
Chair	Superintendent of Financial Institutions (OSFI secretariat)	Deputy Minister of Finance (DOF secretariat)	Governor of BOC (BOC secretariat)	Collegial structure (SRC reporting to the Chairs of CSA)
Mandate	Facilitate the exchange of information on matters relating to the supervision of federally regulated financial institutions	Overall financial sector policies	Exchange information and coordinate on issues of mutual concern (e.g. hedge funds and OTC derivatives)	Identify and analyze systemic risks in the capital markets
Frequency	Quarterly (or as frequent as necessary)	Quarterly (or as frequent as necessary)	Quarterly (or as frequent as necessary)	Semiannually (conference calls every two weeks)
Legal form	Statutory	Non-statutory	Non-statutory	Non-statutory

13. **Canada has a comprehensive special resolution regime for federally regulated financial institutions which includes significant powers of intervention**. The main resolution authority for federal deposit taking institutions is the CDIC, but some resolution powers are also held by OSFI and MOF. The private policyholder protection schemes for life insurance (Assuris[6]) and P&C insurance (PACICC[7]) play important roles in the resolution of insurance companies. All federally regulated

[6] Assuris is the private not-for-profit organization that guarantees continuation, up to specified limits, of benefits to Canadian policyholders of member life insurance companies that become insolvent. Assuris is designated by the Minister of Finance under the *Insurance Companies Act* as a compensation association for life insurance and accident and sickness insurance. Assuris may assist a solvent troubled member financially before a wind-up order has been issued. With certain constraints, Assuris may facilitate the transfer of business to another owner if this is the most cost-effective solution. Assuris works closely with OSFI .

[7] PACICC is the industry-funded non-profit Property and Casualty Insurance Compensation Corporation. It is a private organization that responds to claims of policyholders under most policies issued by Property and Casualty (P&C) insurance companies and oversees the liquidation of insolvent member companies. Provincial and territorial authorities have designated PACICC as the compensation association for the P&C insurance class. PACICC has a compensation fund that is designed to bridge the period between the wind-up order and when the funds from the general assessments are collected. The trigger for PACICC involvement / payout in a distressed institution is a wind-up order. PACICC does not provide "open firm" financial assistance to insurers.

financial institutions are liquidated under the *Winding-up and Restructuring Act*, rather than the bankruptcy law applicable to most ordinary business enterprises, the *Bankruptcy and Insolvency Act*.

14. The authorities continue to develop their approach to the "too big to fail" Financial institutions. The six largest banks dominate the banking sector. Their size implies that, in the event of a major bank failure, the impact on the financial system and the economy as a whole would be potentially massive. A comprehensive risk management framework for Canada's systemically important banks that includes a higher capital requirement, implementation of a bail-in regime, as well as enhanced supervision and recovery and resolution plans for these institutions was announced in March 2013, although some of these measures have been implemented by the authorities for several years already (i.e. recovery, and more recently, resolution planning). Such measures are aimed at ensuring that the resolution of a systemically important financial institution could be handled in an orderly manner, while minimizing broader financial stability risks and tax payer contribution.

15. The provincially regulated institutions follow different resolution regimes. Securities and investment firms are regulated at the provincial level and are subject to the same regime as applies to the liquidation of ordinary business enterprises, while customers of securities broker/dealers are protected against loss by the Canadian Investor Protection Fund, which does not have any statutory powers of intervention. Credit cooperatives are resolved and liquidated under specific provincial legislation. The provincial institutional arrangements for crisis management are generally self-contained, but provincial-federal financial stability ties exist (see Chapter V).

16. Preliminary discussions have begun to develop a policy framework for the recovery and resolution of financial market infrastructures (FMIs). At present, privately owned FMIs would follow the ordinary corporate insolvency regime. The BOC has articulated an oversight framework for FMIs[8], requires all designated FMIs to observe the Principles for Financial Market Infrastructures, and regularly conducts assessments of designated FMIs' observance of these standards.

C. Coordination and Cooperation Before and During Crises

17. There is evidence of good cooperation among authorities both inside and outside the existing federal committees. Some intrinsic features of the institutional construct facilitate such cooperation. One example is the cross-agency participation in the decision making bodies.[9]

[8] For more information see the "Guideline Related to Bank of Canada Oversight Activities under the Payment Clearing and Settlement Act."

[9] The board of the CDIC includes the Deputy MoF, the Governor of the BOC, the Superintendent of Financial Institutions, a Deputy Superintendent of Financial Institutions, and the Commissioner of the FCA. The MoF is the Head of OSFI (while the Superintendent is the Deputy Head of OSFI), however OSFI does not have a separate "governing body" (board of directors) and the Superintendent has sole power to appoint the executive management team. The Deputy MoF is an ex officio non-voting member of the board of BOC.

Furthermore, Canada has a long practice of rotating senior civil servants across public authorities. While informal, this allows different institutional cultures to blend.

18. There are no legal impediments which prevent the sharing of information among federal agencies. The *Office of the Superintendent of Financial Institutions Act* (section 18) provides that every member of FISC "is entitled to any information on matters relating directly to the supervision of financial institutions, bank holding companies or insurance holding companies that is in the possession or under the control of any other member." The federal authorities freely exchange confidential information, as necessary. For example, CDIC receives all OSFI examination information every year along with statutory requirements and other materials.

19. However, communication between federal and provincial authorities is less well articulated. Regulators of provincial deposit taking institutions, or other provincially incorporated and regulated financial institutions are not represented on the FISC or the SAC, although the four largest provincial securities regulators participate in the HOA discussions on capital markets issues. Prudential information is not exchanged with the relevant provincial regulators in respect of entities where either OSFI or the provincial regulator is the consolidated group supervisor (e.g. regarding security dealers which are provincially-regulated subsidiaries of major banks, or on banks which are federally regulated, but are subsidiaries of provincially regulated groups). Some ad-hoc communication between OSFI and provincial regulators nevertheless exists and there are meetings at the provincial level where OSFI provides updates on its activities.

20. There are data gaps which hamper the collection and analysis for the financial system as a whole.[10] Therefore, a complete set of information is not collected on a systematic and regular basis, and there are gaps in understanding e.g. relating to holding company credit intermediation, some pension fund activities, securities markets, and the interconnectedness through markets of different areas of the financial universe.

21. No single committee has an explicit mandate for systemic risk monitoring or for crisis management. The current inter-agency arrangements for cooperation cover a broad range of financial stability issues, but there is no single forum where systemic risks emerging from various parts of the financial sector—banks, insurance and securities firms; federally and provincially incorporated financial institutions; unregulated entities; and markets—are raised and discussed in a structured way so that authorities have at all times a high level view of risks and can decide on coordinating policy actions, as necessary (Figure 3). Moreover, no single committee has an explicit crisis preparedness and management role, although both FISC and SAC have been actively involved during the recent financial turmoil. So far, no system-wide crises simulation exercises have been performed to test the responsiveness of the existing coordination mechanisms. Situations may arise where there is a need for the determination of whether a situation has arisen which justifies the

[10] The BOC undertakes extensive financial stability monitoring and vulnerability assessments, and publishes its findings in its biannual Financial System Reviews. However, the BOC lacks a specific mandate for system-wide monitoring and does not have access to a broader range of data and information.

triggering of crisis actions or powers. Without the appropriate mandate, no agency or committee is accountable for this.

Figure 3. Inter-agency Committees' Coverage of Financial Sector Areas

	Banks	Insurance comp.	Securities markets	Market Infrastr.	Shadow banking	Provincial credit unions	Pension funds
FISC (supervisory focus)							
SAC (policy focus)							
HOA (policy focus)							
CSA (supervisory focus)							

Dark blue = primary area of discussion; light blue = other areas of discussion; white = not covered

22. The existing interagency arrangements functioned well during the crisis, although some blind spots have been revealed. The authorities' reaction to contain spillovers of the global crisis was prompt and decisive and consisted of massive liquidity support and fiscal stimulus (Chapter III, Section B). However, Canada's own domestic isolated episode of financial turmoil, closely related to the global financial crisis, supports the argument that while tough prudential regulations and oversight help, effectively tackling emerging systemic risks requires a multi-sectoral policy approach (Box 1).

Box 1. Lessons from the ABCP Market Turmoil

In August 2007, the non-bank Asset-Backed Commercial Paper (ABCP) market in Canada experienced significant turmoil. The ABCP issuers were unable to roll over their maturing paper as investors became increasingly concerned that the underlying collateral was exposed to CDOs backed by U.S. subprime mortgages (lack of disclosure meant this information was not readily available). As backstop liquidity providers refused to advance funds, a third of the non-bank ABCP market (Can$ 35 billion) froze. Privately negotiated restructuring entailed the conversion of the frozen short-term paper into medium-term notes. The federal government together with the three provincial governments involved (Ontario, Québec, and Alberta) provided a senior funding facility to help this restructuring (completed in January 2009).

A few important issues emerged from a crisis prevention and management perspective:

Tougher bank prudential standards help protect banks… The more conservative prudential capital treatment of unconditional liquidity facilities (introduced by OSFI's Regulation B-5 in 2004) reduced the incentives of local banks to commit liquidity support to such third party conduits. In most cases where local banks provided liquidity lines to the conduits, the execution of the agreements was conditional on a "general market disruption" determination; but no such determination was made. Therefore, prima facie, local banks were to a large extent shielded from the ABCP market turmoil.[11] However, in the midst of the crisis, some banks which sponsored such conduits became concerned about reputational risks and decided to provide support exceeding contractual obligations.

… but effectively tackling emerging systemic risks requires a multi-sectoral policy approach. Although OSFI's supervisory concerns regarding unconditional liquidity lines did materialize in policy action, a more comprehensive policy approach would have likely been more effective. The ABCP market expansion was aggressive over 2003-2006, but the broader implications for overall financial stability were not clearly assessed despite the fragile business operating model of the conduits. It was also relatively late in the process when the authorities became aware that retail investors were holding ABCP paper. To a large extent, this was related to the limited data that was at the time available on such financial entities, a problem which was common not only in Canada. It remains unclear the degree to which the HOA monitored the developments and risks related to the ABCP market.[12] When the ABCP turmoil started unfolding, the BOC was able to gather information through market contacts, on an ad-hoc basis. At the peak of the crisis, frequent discussions were held in the FISC given concerns that the turmoil may affect banks. The provincial securities supervisors were not involved at any stage during the assessment of the problem or the design of the response. Post-crisis, the level of disclosure and transparency were substantially improved, including for bank-sponsored ABCP programs, and reforms were promoted to enhance the reliability of the credit ratings process. Furthermore, the SRC of the CSA was established in 2009 to serve as a mechanism for the identification and monitoring of systemic risk from the securities markets.[13]

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[11] In contrast, U.S. banks which backstopped the commercial paper programs took substantial losses and required subsequent government intervention.

[12] See "The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets. A Research Study Prepared for the Expert Panel on Securities Regulation" by John Chant.

[13] The assessment against the IOSCO principles performed as part of the FSAP Update underlines that the mechanisms for coordination need to be strengthened, both in connection with risk identification and regarding crisis management and resolution of large investment dealers.

23. The mandates should be clearly assigned to an entity 1) to carry out macro-prudential oversight, and 2) to carry out system-wide crisis preparedness. For performing the macroprudential oversight, the designated entity should have participation broad enough to allow a complete view of systemic risks and powers to collect all necessary data for systemic risk analysis. For crisis preparedness purposes, the designated entity should establish a coordination framework composed of policies, procedures, and operational guidance to support timely and effective decision making in a crisis situation. A clear allocation of responsibilities would improve accountability and visibility and would mitigate the risks of coordination failures in identifying systemic risks or in responding to systemic crises. The mandates should preferably be in the form of legislation, but could be specified in the terms of reference of the entity or in an inter-agency MOU.

24. For crisis preparedness and management purposes, the committee should:

- ***Agree on a road map for crisis management.*** The roadmap should clearly spell out the individual roles and responsibilities for each agency in a crisis situation. The authorities could start by performing a "gap" analysis which should map the existing powers of the authorities to intervene, exchange information, and cooperate, against the desired features necessary to enable prompt coordination **and decision making in maintaining financial stability.**

- ***Develop a contingency plan designed to manage a systemic crisis*. The scope of the contingency** plan should be broad to include all relevant financial subsectors (banking, insurance, securities, including relevant provincially regulated entities). The plan should identify the necessary human resources, legal basis, lines of communication with other institutions and action plans for failure of a systemically important financial institution or a systemic crisis. Such a plan should also include formal communication channels with other supervisory agencies federal and provincial, as well as with foreign supervisors. The contingency plans should be updated regularly.

- ***Perform regular crisis simulation exercises***. The committee should organize comprehensive simulations to test the capacity of the authorities to respond to broad and severe scenarios on a periodic basis (e.g. with a two year frequency), while more targeted exercises could be conducted more frequently.[14]

- ***Establish a communication strategy***. The strategy should aim at building a relationship with the media representatives and identify one spokesperson to carefully coordinate and manage information on behalf of all the authorities represented in the committee.

- ***Clear all legal and operational hurdles for information exchange***. Consideration should be given to establishing joint databases to facilitate the sharing of information, possibly based on the existing Tri-Agency Data System (BOC-OSFI-CDIC). The committee should

[14] Australia conducts under the coordination of the Council of Financial Regulators comprehensive crisis simulation exercises every two years. In the U.S., the FDIC and Fed conduct several targeted crisis simulation exercises yearly.

review and propose measures to address the existing information sharing restrictions between federal and provincial authorities.

FEDERAL CRISIS PREVENTION AND MANAGEMENT FRAMEWORK

A. Early Supervisory Intervention

25. OSFI has an excellent track record of delivering high quality supervision. The supervisory approach has been traditionally intrusive and maintained a "close touch" with the regulated industry. This helped underpin OSFI's ability to articulate and reinforce its supervisory expectations. The supervisory processes are well established and effectively support the analysis of risks from multiple perspectives, while incorporating a forward looking time dimension.[15] Furthermore, the supervisor is proactive in adapting the supervisory standards and practices so as to effectively reflect market developments.

26. The early intervention framework is well articulated and transparently communicated to the industry. OSFI has a legal mandate which requires that it intervenes early so that institutions are encouraged to respond expeditiously to address concerns.[16] The Supervisory Framework and Guide to Intervention (designed in cooperation with the CDIC in respect of CDIC member institutions) are structured to support OSFI's mandate and outline the range of supervisory powers, tools, and measures that can be used to effectively pursue this mandate. The Guide to Intervention is publicly disclosed and there is a high level of awareness among market participants about the course of supervisory actions should circumstances so require.

27. The intervention ladder is underpinned by strong legal powers. OSFI's operational intervention ladder ("staging") entails four stages, which, supported by legislative authorities, allow OSFI to apply restrictions and requirements commensurate with the gravity of the situation: Early warning (Stage 1); Risk to financial viability or solvency (Stage 2); Future financial viability in serious doubt (Stage 3); and Non-viability/ insolvency imminent (Stage 4). Actions range from limitations on business, higher prudential requirements, removing or restricting managers, limiting acquisitions, to withdrawing the license (Appendix I). The staging also exerts a discipline on chief executives who must report to their boards that they have been staged.

28. OSFI rarely uses its formal intervention powers, although "staging" is a powerful instrument. OSFI's practice indicates a strong preference for exercising moral suasion to trigger

[15] For more details, see the Detailed Assessment Report of the Basel Core Principles for Effective Supervision.

[16] The subsection 4(2) of the *OSFI Act* requires that it "promptly advise the management and board of a financial institution in the event the institution is not in sound financial condition or is not complying with its governing statute law or supervisory requirements under that law and, in such a case, to take, or require the management or board to take, the necessary corrective measures or series of measures to deal with the situation in an expeditious manner."

institution self-corrective actions, rather than formal enforcement. No official (i.e. formal) corrective measures have been taken on supervised institutions or their management over the past decade. Nonetheless, OSFI confirmed that it carries out its intervention mindful of its legal case at each stage in the event it has recourse to the use of its powers. Backed by intense and intrusive supervision, the approach has enabled timely and preemptive voluntary actions taken by the firms (frequently under strong supervisory guidance), that avoided the need for official (i.e. formal) intervention.

29. OSFI's approach has proved successful, amid many recent failures elsewhere of supervisory practices which relied on "bona fide" compliance by the industry. The recent history of financial turmoil has been partly attributed to the lax oversight by many supervisory agencies across the globe, including overreliance on moral suasion and a "light touch" approach. A few factors may have contributed to the success of the (different) supervisory approach in Canada. First, OSFI had a hands-on approach and made its presence constantly felt in the banks though intense onsite and offsite supervisory reviews and has a well-established practice of intense communication with the boards and managements of the banks. Second, supervisory expectations ("rules of the game") were clearly communicated to the banking industry and supported by a conservative prudential framework. Third, OSFI has built a reputation of high professionalism which gained the respect of the market players and instilled strong market discipline.

30. However, OSFI needs to remain vigilant on a few challenges. The current approach to corrective actions requires the early identification of likeliness of failure to meet minimum standards, therefore often relying on the timely and honest communication from the financial institutions to the supervisor. The approach could also be challenged in an environment of rapid changes to the financial system. The BCP assessment identified at least one occasion on which an institution had not communicated to OSFI in advance. Therefore, it recommended that this discipline be enforced through an amendment to the *Bank Act*, to avoid any doubt on the obligations of the firm to report to the OSFI.

31. The "Guide to Intervention" spells out the gradual switch of action from OSFI to CDIC, depending on the severity of the situation. The cooperation between OSFI and CDIC is grounded in their "Strategic Alliance Agreement", which provides a framework to coordinate their activities, to promote consultation, and to facilitate the exchange of information. The "Guide to Intervention for Federally Regulated Deposit-Taking Institutions" outlines the types of escalating involvement and coordination that banks can expect from OSFI and CDIC, and summarizes the circumstances when resolution may be triggered. It also makes clear upfront that the authorities retain the flexibility to adapt their course of action depending on circumstances. As the gravity of the situation increases and resolution actions are likely to become necessary, the CDIC becomes more intensively involved, while meetings of the FISC and of the CDIC Board of Directors increase in frequency and focus on coordinating the implementation of intervention and resolution measures (Table 3).

Table 3. Summary of the Guide to Intervention

	OSFI Actions	Inter-Agency Cooperation	CDIC Actions
No Staging *No significant problems / normal activities*	Ongoing supervision Composite risk ratings provided to the institution	Regular exchange of relevant information between OSFI and CDIC Regular meetings between OSFI and CDIC to discuss an individual institution.	Ongoing monitoring to ensure compliance with CDIC Act and by laws
Stage 1 *Early Warning*	Formal notification of management, board of directors and external auditor; meetings with stakeholders. Increase frequency, scope, and level of detail of reports and supervisory reviews. Enter into a prudential agreement. Impose corrective actions.	OSFI informs CDIC about staging and sends intervention reports. CDIC informs OSFI when institution is placed on its watch list. More frequent meetings between OSFI and CDIC. OSFI and CDIC update FISC.	Request additional information from OSFI. Conduct a special examination. Lay a premium surcharge after consultation with OSFI.
Stage 2 *Risk to financial viability or solvency*	Enhanced monitoring and supervisory reviews. Impose deadline on implementing remedial actions. Can require a special audit. Develop a contingency plan to enable OSFI to take control.	OSFI and CDIC inform each other on information received and analyses performed. OSFI and CDIC start contingency planning. CDIC informs MOF of lack of progress in addressing situation and requests advice on deposit insurance termination.	Formal report sent to the CEO / Chairperson of bank signaling non-compliance with CDIC Act. Can terminate deposit insurance unless the Minister of Finance advises that it is not in the public interest to do so. Conduct a preparatory examination. Apply to Court for order to comply with CDIC Act.
Stage 3 *Future financial viability in serious doubt*	Enhance scope of business restrictions. OSFI staff permanent onsite. Expand contingency planning. Ask management and board to consider resolution options.	CDIC and OSFI conduct more in depth and more frequent discussions. Regular meetings of sub-FISC and FISC as required.	CDIC may take measures to support a restructuring transaction: acquire assets, make or guarantee loans, make or guarantee deposits.
Stage 4 *Non-viability/ insolvency imminent*	Assume temporary control of the assets of the bank (if MOF advises that it is not against the public interest). Request the Attorney General for a winding-up order.	Regular FISC meetings. Initiate FIRP if conditions are met and MOF advice is favorable.	Cancel deposit insurance. Initiate a FIRP. Apply for a winding-up order. Can act as liquidator or receiver if appointed as such.

Note: The Guide has not been updated to reflect more recent powers such as recapitalization and bridge institutions.

32. OSFI has documented an internal crisis management guidance, which is set out in a "Problem Situation Binder." This includes crisis checklists, communication plans, information gathering, resolution options, holding company issues, and discusses the lender of last resort and payment systems. The problem situation binder is currently being updated to reflect recent recovery planning experiences and changes to the resolution framework, such as the introduction of the bridge bank tool. OSFI and CDIC are also closely working together in developing recovery and resolution plans for the D-SIBs (Chapter IV).

33. OSFI has the authority to determine when and how to start the orderly resolution process or to take control of a problem bank. OSFI decides when an institution reaches the point of non-viability (for example, in situations where the institution may still be solvent, but the business model is no longer viable, also see Table 5), thus triggering resolution actions by CDIC. It can also assume the temporary (less than 16 days) control of the assets of the bank; or take control of the assets of the bank for a period exceeding 16 days; or take control of the bank and apply for a winding-up order. In general, once OSFI takes control of a financial institution's assets, it intends to liquidate the institution; at this point CDIC may decide on the appropriate resolution tool (e.g. a bridge institution) or a deposit payout. Under section 648(1)(b) of the *Bank Act* the Minister may prevent the supervisory intervention of taking control of the assets of the bank for a period exceeding 16 days, or taking control of the bank if it is deemed necessary to do so in the public interest. Owing to the coordination between the authorities through the FISC and the CDIC Board of Directors, the Superintendent would—in practice—be exercising her or his powers from a position of consensus support.

34. A number of legal provisions create room for "constructive tensions" between the OSFI and CDIC, at which point their actions should be closely coordinated. For example, CDIC can terminate deposit insurance, even if the institution is still solvent (Section 30 of the *CDIC Act*). In the past, the CDIC has terminated deposit insurance as an enforcement action against two solvent members. Such powers were used by the CDIC when it was responsible for the administration of the Standards of Sound Financial and Business Practices. The CDIC has to be concerned about minimizing the exposure of the insurance fund to loss from failing institutions. This could create an incentive to resolve an institution sooner rather than later—for instance, to lean against perceived regulatory forbearance—but may conflict with supervisory interests. Such risks call for close bilateral coordination between the OSFI and CDIC, as well as though the FISC cooperation.

B. Official Financial Support

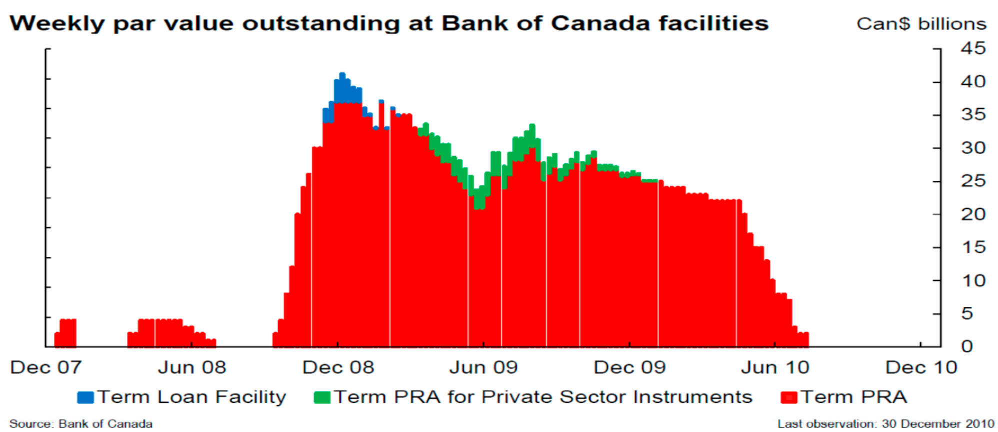
35. Canada has a broad range of official support instruments. Official support can be provided by BOC (under the *Bank of Canada Act*), the MOF (under the *Financial Administration Act,* and the CDIC (under the *Canada Deposit Insurance Corporation Act)*. Measures can range from direct and indirect liquidity assistance (BOC, MOF, or the CDIC), to recapitalization (MOF, CDIC), and/or nationalization (MOF, CDIC).

Emergency Liquidity Assistance (ELA)

36. The BOC has a well articulated framework for providing liquidity support. Under Section 18(h) of the *Bank of Canada Act,* the BOC can make loans or advances to a financial institution, subject to the following conditions: a) the loan must be collateralized; b) the loan or advance must be made to a deposit-taking institution that is a member of the Canadian Payments Association; and, c) the duration of the loan or advance must not exceed 6 months (although loans can be renewed). The BOC has a Standing Liquidity Facility (SLF) which supports the payments system[17] and a special last-resort lending tool (ELA).

37. During the recent crisis, BOC provided prompt and ample liquidity support. As liquidity conditions in the core funding markets became very tight, BOC made available substantial liquidity support to the financial system, mainly in the form of term purchase and sale agreements (PRAs). The terms for the liquidity support were appropriately expanded in four dimensions: maturities, amounts, counterparties, and collateral. By spring 2009, participation in liquidity operations diminished (Figure 4). The process was smoothly guided by BOC which transparently provided advance notices regarding the gradual reduction in the frequency and amounts of auctions.

Figure 4. Use of Bank of Canada Liquidity Facilities



38. The operational framework for Emergency Liquidity Assistance (ELA) is sound. The BOC publicly discloses its policies for lender-of-last-resort[18] which describe the conditions and circumstances for providing ELA and has internal guidelines which detail the decision-making process, collateral acceptance and valuation, and other terms and conditions (Box 2). In addition to the legal requirements under the *Bank of Canada Act* highlighted above, BOC policy imposes additional requirements for ELA: the institution must be judged to be solvent by the prudential

[17] The SLF supports settlement in the payments system by providing collateralized, overnight loans to direct participants in the Large Value Transfer System who are experiencing temporary shortfalls in their settlement balances. Under the *Bank of Canada Act* lending has to be collateralized and the Bank Rate charged.

[18] See http://www.bankofcanada.ca/financial-system/lender-of-last-resort/

supervisor, and a business plan to address deficiencies (including by introducing restrictions to activities or distribution of dividends) must be sent to OSFI and discussed within FISC, together with other corrective measures proposed. The potential range of eligible collateral and of beneficiary institutions under ELA is broader than under SLF. However, the range of eligible collateral is constrained by a legal restriction on the BOC with respect to taking mortgages as collateral.[19]

Box 2. The BOC's Policy Statement on ELA

The following principles and conditions guide the BOC's ELA policy:

Primary objective: To address market failures associated with persistent liquidity problems in institutions judged to be solvent.

Eligible institutions: Federally chartered banks (including foreign banks' subsidiaries) and federally incorporated trust and loan corporations. Although not normally eligible, in the case of a widespread event, BOC can also consider providing ELA to a provincial credit union central or a caisse populaire system. Foreign banks' branches are not normally eligible for ELA, but in exceptional circumstances, where the home central bank temporarily could not provide liquidity, the BOC could provide interim lending. All the lending is against eligible collateral.

Liquidity support only: In order for an illiquid institution to qualify for ELA, it must continue to be solvent. The government and CDIC are expected to deal with an insolvent institution.

Collateral requirements: In a crisis situation, the BOC can consider accepting a broader range of collateral than that accepted under the SLF. In practice, this would typically mean permitting an institution to pledge a greater proportion of its collateral in the form of non-mortgage loan portfolio, as well as accepting additional types of collateral.

Interest rate: The interest rate on the ELA is determined case by case. The minimum rate that the BOC can charge on ELA loans is the Bank Rate. While the Bank has discretion to charge a higher interest rate if it sees fit, in its limited experience with the ELA, it has charged the Bank Rate.

Transparency: Although ELA provided by BOC would not be announced publically, some high frequency high granularity statistics published by BOC could help determine such support.

Foreign currency lending: The BOC does not provide ELA in foreign currency. **Under extreme conditions, the BOC can provide liquidity to any firm**. The BOC has the power to buy and sell securities, including equities, to the extent determined necessary by the Governor under Section 18 (g)(ii) of the *Bank of Canada Act*, if the Governor is of the opinion that there is severe and unusual stress on a financial market or the financial system. All such transactions would be fully disclosed and justified in the BOC's public statements. The BOC would also need to publish in the Canada Gazette notice that it believes that there is a situation of severe and unusual stress on the financial system—but only once the Governor is of the opinion that such publication will not itself contribute to the situation of stress. The BOC may also at any time buy or sell any debt securities from an institution, and such action is not required to be published (Section 18(g) (i)).

[19]The *Bank of Canada Act* restricts the BOC from taking real estate as a collateral (mortgages are considered to be a conveyance of real property). In cases where the primary assets available to an institution to secure BOC lending are mortgages, the security interest would have to be structured as an assignment of the mortgage receivables only, and not as an assignment of the mortgages themselves.

39. The BOC has limited experience with providing ELA support. During the recent financial crisis, no banks made use of the ELA facility. However, in 1985, the BOC provided ELA to two small Canadian banks that eventually became insolvent, at which time the BOC withdrew its liquidity support. Subsequently, the BOC was named in litigation by the estates of the banks, although the litigation against the BOC was eventually settled in BOC's favor. The episode revealed weaknesses of prudential supervision at that time (pre-OSFI) and also that it would be important to consider how the liquidity assistance should be handled if the institution receiving this assistance later becomes insolvent or in some way no longer meets the requirements for assistance.

40. BOC is in the process of reviewing the liquidity framework, including its ELA procedures. As part of this process, which is aimed at ensuring that the lender of last resort policy remains appropriate, it is recommended that the following improvements are taken into consideration:

- Remove the legal provision which restricts the BOC from taking mortgages as collateral when providing liquidity assistance;
- Consider the scope for and the conditions of liquidity support by BOC necessary under the new resolution framework (i.e. access by bridge banks, security dealers, or provincially regulated FMIs);
- Consider allowing the provision of ELA in foreign currency under exceptional circumstances and with adequate safeguards.
- Clarify the BOC's scope for providing ELA relative to other official assistance provided by MOF and/or CDIC in systemic situations.

Official assistance provided by MOF

41. The crisis led to a strengthening of the legal powers of the MOF in the areas of decision making and crisis intervention. As a result of amendments made in 2009 to the *Financial Administration Act* and to the *Bank Act*, the MOF, with Governor in Council authorization, can enter into any contracts and/or provide credit that in the Minister's opinion is necessary to promote the stability or maintain the efficiency of the financial system in Canada (*Financial Administration Act* (section 60.2). The MOF is also empowered to acquire securities in one or more federally regulated financial institutions, where this would promote the stability of the financial system in Canada (provisions stipulated including the *Bank Act*). The DOF confirms that such powers are meant to be used only in exceptional circumstances.

42. To soften the impact of the crisis, the Government took action through the Extraordinary Financing Framework (EFF). In particular, the support provided by the Government to financial institutions was aimed at complementing the short-term liquidity provision by BOC with longer-term financing. The most important component of the EFF was the Insured Mortgage Purchase Program (IMPP), launched in October 2008, through which the government committed to purchase up to a total of $125 billion in insured residential mortgage pools from eligible financial institutions. In addition to the IMPP, the government also offered various assurance facilities (guarantees) to eligible financial institutions, which were not in the event used (Box 3).

Box 3. Government Support Programs During the Crisis

Under the IMPP, National Housing Act Mortgage-Backed Securities (NHA MBS) were purchased by the Government through the Canada Mortgage and Housing Corporation (CMHC) to provide term funding to eligible financial institutions and maintain the availability of longer-term credit in Canada. The window for purchases under this program ran from the fall of 2008 through March 2010.

Minimum pricing was set at 20 bps over Canada Mortgage Bonds (CMBs) to create a disincentive to use this as a funding source. The IMPP functioned in line with its policy objectives during the initial operations, with high demand and pricing well above the minimum. Demand tapered off and pricing fell to its minimum, as the supply of credit returned to more normal levels. Overall, around Can$ 70 billion was utilized and the IMPP was recognized by lenders as being successful in improving liquidity conditions for longer-term funding. The Government expects that the IMPP will generate an estimated $2.5 billion in net revenues by the time it ends in 2014–2015.

The Canadian Lenders Assurance Facility and the Canadian Life Insurers Assurance Facility were offered to Canada's deposit taking institutions and life insurers in order to permit these eligible financial institutions to access additional funding through the issuance of Government-guaranteed term debt of up to 3 years maturity in exchange for paying a market-based guarantee fee to the Government. These facilities, which ran from late 2008 and early 2009 (respectively) until the end of 2009, were put in place to ensure that Canadian financial institutions were not put at a competitive disadvantage when raising funds in wholesale markets. Neither facility was used.

43. The MOF can also acquire shares in a bank, although the power has not been used so far. The *Bank Act* provides the ability for the Governor-in-Council to issue an order, on the recommendation of the MOF, to acquire shares of a bank. The Minister must consult with the OSFI, the BOC, and CDIC in making the recommendation that the order will promote the stability of the financial system in Canada. In recapitalizing an institution, the MOF can set terms and conditions, which can include imposing limits to executive compensation, appointing or removing executives, prohibiting the payment of dividends, and imposing requirements on the lending practices of the institution.

44. A governmental systemic risk override needs to be balanced against moral hazard risks. The Governor in Council, upon recommendation by the MOF, can exempt CDIC from the requirement that it pursue its mandate in a manner that will minimize its exposure to loss where circumstances are such that adherence to this requirement might have an adverse effect on financial stability. Many countries have systemic risk exceptions embedded in their legislation (U.S., Japan, New Zealand, Hong Kong), including in relation to the application of the least cost test. However, a systemic risk override to the requirement to minimize the exposure to loss (or more narrowly to apply the least cost test) may be more problematic in countries with concentrated banking systems, such as Canada. To counterbalance possible moral hazard risks, the government and the CDIC should continue developing resolution options which would credibly put the burden on the private sector. Furthermore, it would be advisable to consider introducing more clarity in the conditions under which systemic risk overrides would operate,[20] by possibly subjecting the override powers to a stricter test.

C. Orderly and Effective Resolution

45. The CDIC performs a dual role as a resolution authority and deposit insurance agency for federally registered deposit taking institutions.[21] Its mandates are clearly prescribed in the *CDIC Act*: 1) to provide insurance against the loss of part or all of deposits; 2) to promote and otherwise contribute to the stability of the financial system in Canada; and 3) to pursue the two objectives set out above for the benefit of persons having deposits with member institutions and in such a manner as will minimize the exposure of the Corporation to loss. Therefore, when deciding whether to take a particular course of action, the CDIC is required to equally consider how the decision would achieve the three statutory objectives. The CDIC puts great emphasis on the preemptive action component of its mandate, which seamlessly complements the prudential supervisory process of OSFI.

Governance

46. The *CDIC Act* sets out generally sound governance principles. The CDIC is governed by the *CDIC Act*, but certain general obligations of CDIC as a Crown corporation are set out in the *Financial Administration Act*. The board of directors is composed of five members from the other federal safety net participants[22] as well as five directors and a Chairperson, all from the private sector. The directors are subject to the disqualification criteria spelled out in the *CDIC Act* which include a prohibition from being active bankers, and are subject to the *Conflicts of Interest Act*, which applies to public office holders. There are no prescribed selection criteria, except that the Chairperson must be "a person of proven financial ability." There is no specified term for the

[20] In the U.S., Section 141 of the *Federal Deposit Insurance Corporation Improvement Act* of 1991 specifies two criteria for invoking the systemic risk override: first, compliance with the least cost test must have serious adverse effects on economic conditions or financial stability; and second, a non least cost test resolution must avoid or mitigate such adverse effects. Therefore, there are two cumulative conditions: a systemic situation must exist and the non least cost test actions must have reasonable chances of success.

[21] Banks, federally and provincially regulated trust and loan companies, federally regulated retail cooperative credit associations, and federal credit unions.

[22] The Deputy Minister of Finance, the Governor of the BOC, the Superintendent of Financial Institutions, a deputy Superintendent of Financial Institutions or an officer of this office, and the Commissioner of the FCAC.

Chairperson, who can be dismissed at any time "for cause" by an order of the Governor in Council.[23] The CDIC publishes an annual report and quarterly financial statements, and it is ultimately accountable to the Parliament.

47. However, the operational independence of CDIC in activating various resolution tools is relatively limited. The most important resolution tools, including those provided under the Financial Institution Restructuring Provisions (FIRP) can only be triggered based on a decision of the Governor in Council following a recommendation from the MoF (Table 5). The CDIC retains discretion only in activating assisted transactions and open bank assistance (OBA), the use of which should be limited to avoid moral hazard risks. In practice, the legal requirements impose a governmental approval for deploying even simple resolution actions which imply taking control of the institution and effecting a forced sale under the FIRP, which are the prerogative of resolution authorities in most countries (e.g. U.S., U.K, etc.).

Resolution triggers, powers, and toolkit

48. A prudential determination by OSFI is generally, but not always, the trigger for the resolution of a bank. OSFI's determination of "non-viability" is flexible and launches the resolution of an institution (under a FIRP and a bridge bank tool) before reaching the point of insolvency (Table 3). However, the CDIC can provide OBA and resolve a member institution through an assisted purchase and assumption transaction without a formal non-viability opinion, although this measure would be discussed in FISC. OSFI can take control of the assets and / or of the financial institution itself, although it cannot take over the powers of the shareholders (i.e. cannot force a merger or a sale). Therefore, OSFI's takeover is likely to result in a winding-up order.

[23] The other private sector directors are appointed by an order of the Governor in Council (on the recommendation of the Minister of Finance) for a defined term not exceeding four years. The private sector directors can be dismissed by order of the federal Cabinet without cause.

<table>
<tr><th colspan="2">Table 4.Triggers for Resolution and Winding-Up</th></tr>
<tr><th>Triggers</th><th>Actions</th></tr>
<tr><td>RESOLUTION

A. Non-viability determination by OSFI

Inter alia:

(a) a federal member institution has ceased, or is about to cease, to be viable, and the bank:
➢ is dependent to an excessive extent on loans, advances, guarantees or other financial assistance to sustain its operations;
➢ has lost the confidence of depositors and the public;
➢ has a level of the regulatory capital which is or is about to become substantially deficient; or
➢ failed to pay any liability that become due and payable or will not be able to pay its liabilities as they become due and payable.

(b) the viability of the bank cannot be restored or preserved by the exercise of the Superintendent’s powers.

B. Non-viability determination by CDIC

When necessary to pursue the mandate of CDIC.</td><td>CDIC Act, Subsection 39.1

✓ OSFI provides the bank with a reasonable time to make representation.
✓ OSFI reports to the CDIC.
✓ CDIC initiates resolution under CDIC Act. Some resolution tools require an order of the Governor in Council on the recommendation of the Minister of Finance.

CDIC Act
Decision by CDIC Board.</td></tr>
<tr><td>WINDING-UP (determination by OSFI)

➢ failure or likeliness of failure to pay its liabilities as they become due and payable;
➢ the assets of the bank are not sufficient to give adequate protection to the bank’s depositors and creditors;
➢ any asset appearing on the books or records of the bank or held under its administration is not satisfactorily accounted for;
➢ regulatory capital of the bank reached a level or is eroding in a manner that may detrimentally affect its depositors or creditors;
➢ the bank has failed to comply with an order to increase capital;
➢ the bank’s deposit insurance has been terminated by CDIC; or
➢ any or other state of affairs exists in respect of the bank that may be materially prejudicial to the interests of the bank’s depositors or creditors or the owners of any assets under the bank’s administration.</td><td>Bank Act, Subsection 648(1.1)

✓ OSFI can take control, for a period exceeding 16 days, of the assets of the bank.
✓ OSFI can take control of the bank.
✓ Attorney General initiates winding-up under the Winding Up and Restructuring Act
✓ CDIC pays out deposits.
✓ CDIC can act as liquidator.</td></tr>
</table>

49. The resolution toolkit is vast and continues to be improved following the crisis. The full range of resolution tools can be utilized by CDIC to resolve a failing member institution, from purchase and assumption transactions to bridge banks (Table 6). CDIC has also been empowered to hold shares in its member institutions, subject to the MOF's approval. When acting as a receiver, or in forced sale or bridge transactions, the CDIC removes and replaces a failing institution's board of directors and senior management and the powers of shareholders are suspended. In 2012, legislative amendments came into force strengthening the provisions related to temporary stays on early termination rights of counterparties in the context of a bridge bank resolution, although some exemptions apply. The power to terminate contracts is indirect.[24]

Table 5. Resolution Tools Available to CDIC

Resolution tools	Circumstances of use	Trigger	Decision making
Assisted Purchase and Assumption or Whole Bank Acquisition	This tool can be used when an acquirer for the troubled institution is available and the institution's **shareholders agree to the sale**, but some financial assistance from CDIC is needed to facilitate it.	CDIC decision	Voluntary agreement of shareholders. CDIC Board for financial assistance. OSFI approval of transaction for acquiring bank
Forced sale (shares or assets)	Under the Financial Institution Restructuring Provisions (FIRP), the CDIC can take **control of the institution** in order to complete a restructuring transaction, which could include: the sale of all/part of the institution's shares and subordinated debt, an amalgamation with another financial institution or the sale of all/part of the institution's assets/liabilities.[25]	OSFI "non-viability" determination	Governor in Council on the recommendation of the Minister of Finance.

[24] Currently, the CDIC can, as a receiver, assign all the eligible financial contracts to a third party as part of a restructuring transaction or to a bridge bank and leave others behind in the stub of the failing member institution.

[25] In an Asset FIRP, CDIC can temporarily take possession and control of the assets, sell assets, arrange for liabilities to be assumed and carry on the business of the financial institution. The powers and duties of directors and officers of the financial institution are also suspended and CDIC, as receiver could exercise these powers. In a Share FIRP, CDIC would have temporary share ownership (e.g. 60 days, renewable up to three times for a total of 180 days) and control of the institution to transfer the shares to an acquirer, which could also be accompanied by a restructuring, removal of problem assets, replacement of management or any other measure to put the entity on a sound footing

(continued)

Table 5. Resolution Tools Available to CDIC (Continued)			
Bridge bank	Under this approach, an order is made by the **Governor–in-Council** to incorporate a bridge bank for the resolution of the failing institution. CDIC would be appointed as the receiver of the institution and then decide which assets and liabilities should be passed to the newly established (CDIC-owned) bridge bank. This would include all insured deposits at a minimum. The assets not acquired by the bridge institution would remain in the failed bank which would be placed into liquidation.[26]	OSFI "non-viability" determination.	Governor in Council on the recommendation of the Minister of Finance.
Open bank assistance	Not a primary resolution tool. Would typically only be used as a last resort and in conjunction with another resolution tool in situations where: • the failure and closure of an institution is undesirable, • an acquirer has not readily emerged; and, • other options such as bridging the member institution are not possible. Assistance can range from a one-time, finite loan to a blanket guarantee for all creditors of the institution. CDIC can also acquire problem assets, make a deposit or facilitate a managed liquidation.	CDIC decision.	CDIC Board.
Liquidation and payout	Under this resolution tool, a member institution is wound-up under court-supervised liquidation and CDIC makes a payment to insured deposits.	OSFI's application for a winding-up order.	Court.

for future viability.

[26] Creditors and shareholders of the failed institution whose claims are not assumed by the bridge bank would thus retain a claim in the insolvency proceedings of the failed member. They would be entitled to receive no less than they would recover in conventional liquidation. The bridge bank can operate for 2 years (with possible 1-year extensions for a total of up to 5 years) and would be terminated through a sale of assets / shares or through an orderly wind-down of business.

Table 5. Resolution Tools Available to CDIC (Concluded)			
Agency agreement	Managed liquidation by a third party, acting as an agent of CDIC, whereby an agent, on a fee basis, will dispose of the assets and honour deposits and other liabilities as they come due.	OSFI's application for a winding-up order (in agreement with the bank).	Court.

Operational capacity

50. The operational capacity of CDIC is well developed. CDIC has a number of teams dedicated to collecting and reviewing member information, analyzing and monitoring risk, preparing for small and large bank resolutions and implementing CDIC's resolution powers. The Complex Resolution Division works to ensure that the Corporation has the operational capacity to effectively implement resolution methods for large complex members, focusing on three main areas:

- development and maintenance of resolution plans for large complex member institutions;
- enhancing CDIC preparedness for large bank resolution (including coordination of communication, funding and capacity enhancements and development of appropriate strategies based on CDIC's resolution tools and powers); and
- advancing crisis management co-ordination activities with international resolution counterparts and liaising with important domestic resolution entities that may be impacted in resolution activities.

51. CDIC has prepared extensive failure resolution guidelines and operational plans. The CDIC developed a comprehensive bridge bank manual and step-by-step process for forced sales, as well as template agreements for member institutions based on past experiences, lessons learned in past domestic failures and recent international experiences. These materials have been updated over the years to support CDIC readiness. A communication plan is being developed specific to large banks, and CDIC is implementing stand-by arrangements that can be leveraged for D-SIB resolution. Moreover, the CDIC has completed a first iteration of resolution plans for each Canadian D-SIB and plans to extend the process to a foreign bank subsidiary.

Experience with bank failures

52. There is no recent experience with bank failures, but past bank failures have been dealt with by liquidation or assisted transactions. Owing to the longstanding history of financial stability, no bank has failed since 1996. In the past, the CDIC has dealt with 43 bank failures, involving about Can$26 billion of insured deposits. Most of these failures have been related to small institutions (30 failures with insured deposits of less the Can$0.5 billion), while the largest failure had insured deposits close to Can$10 billion.[27] About three quarters of the failed banks have been liquidated and CDIC has reimbursed the insured deposits. In one quarter of the cases CDIC has facilitated assisted transactions. Furthermore, in one instance the CDIC also provided temporary liquidity assistance to a former member, although this form of support was considered exceptional.

53. CDIC has established a process for determining the preferred resolution option. As a member institution approaches non-viability, CDIC undertakes a two-track analysis to determine what intervention options may exist, including the associated cost and impact on financial stability, in comparison to CDIC's total deposit insurance exposure with respect to eligible deposits. For example, CDIC would consider the cost associated with an assisted purchase if an acquirer was potentially available for the institution and could also absorb potential losses associated with an insured deposit payment and liquidation.

54. The assisted transactions performed in the past imposed losses on shareholders and unsecured creditors. CDIC triggered a competitive bidding process around the assisted transaction, taking into consideration the objective to minimize losses. While assisted transactions can be quickly agreed upon by both the acquiring and the acquired banks when the failed bank is small and market conditions are favorable, they are more difficult to perform in the case of institutions with more diversified ownership and complex structures. The experience with the largest transaction of this form (Central Guarantee Trust Company) suggests that the resolution process can be very lengthy and the legal complications around it burdensome. As the resolution toolkit has in the meantime evolved substantially, it would be desirable that the CDIC is able to supplely use the full range of resolution options available in a way that balances its objectives.

55. The CDIC continues to be involved in the liquidation of an institution. The liquidation takes place according to the *Winding-up and Restructuring Act* and is a court-supervised process. In most cases, CDIC nominates experienced liquidators to perform liquidations as court-appointed liquidators and thereafter recommends adjustments to the size of the effort as the liquidation proceeds. The liquidator has broad powers to liquidate the assets of the failed institution and to challenge transactions in the period just before liquidation that prejudice creditors generally (e.g. preferential payments). Throughout liquidation, CDIC ensures that depositors receive prompt settlement of their full entitlement with respect to their insured deposits in failed institutions. The liquidator is also free to consult with OSFI regarding the exercise of its powers, providing OSFI with an opportunity to influence the winding-up process.

56. Currently there is no depositor preference, which has the effect of decreasing the recoveries of depositors and CDIC in liquidation. Currently, depositors are ranked on the same level as unsecured creditors. However, loans made by CDIC have a higher priority (afforded to

[27] In the early 1990s CDIC resolved Central Guarantee Trust Company with assets of $12 billion through an assisted sale (acquisition by the Toronto Dominion Bank) and partial liquidation and wind-up.

Crown claims[28]) than general unsecured creditors and shareholders in any liquidation proceeding for the failed institution. In the past, depositors of certain failed member institutions have been paid additional compensation. Funding for the additional compensation has come from provincial and/or federal government agencies rather than from CDIC.[29] With some form of depositor preference in place, the costs to depositors, CDIC, and the government would likely be reduced. Depositor preference could also assist in applying certain resolution tools such as bridge institutions, in terms of providing for the ability to more clearly carve out depositors as a class from other creditors.

57. Past liquidations have been relatively lengthy, but the bulk of liquidation has taken place in the first two to three years. The length of liquidation has varied considerably and the average liquidation period has varied between 10 to 15 years. Longer liquidations reflect complex litigation and claims issues which require considerable time and effort to resolve. Although no recent experience with bank liquidations exists, one insurance company (Union of Canada) was liquidated under the *Winding Up and Restructuring Act* (also applicable to banks) over about a one year period (February 2012–May 2013).

58. The process of collaboration with other participants of the federal safety net is solid. The partnership between CDIC and OSFI is institutionalized in the "Strategic Alliance Agreement" which lays out the terms of cooperation and sharing of information between the two federal institutions. There is evidence of close interaction and consultation between CDIC and OSFI, both formal and informal, throughout the life cycle of federal deposit taking institutions. The CDIC is also interacting with other federal safety net providers through its participation in the FISC and SAC Committees, while the broad composition of the CDIC board reinforces coherence in decision making and actions.

Recommendations for the resolution framework

Strengthen the operational independence of CDIC

59. To improve the credibility of the resolution framework and the timeliness of resolution actions, CDIC's operational independence should be strengthened. The Key Attributes require that the resolution authority enjoys adequate operational independence. A requirement to obtain governmental approval for certain resolution actions, for example those which have implications for public funds or ownership (e.g. the establishment of a bridge bank) is justified. Nevertheless, it is neither desirable nor practical to subject simple resolution actions (for

[28] Upon insolvency, the creditor ranking is as follows: 1) Secured creditors [*s. 79 WURA*]; 2) Liquidator's fees and costs [*s. 94 WURA*]; 3) Priority payment items [*s. 31 CPA*]; 4) Amounts owing to the Federal Crown (except if under 8 or 9 below) [*s. 369 Bank Act*]; 5) Amounts owing to any Provincial Crown (except if under 8 or 9 below) [*s. 369 Bank Act*]; 6) Arrears of wages [*s. 72 WURA*]; 7) Ordinary unsecured claims – including deposits [*s. 369 Bank Act*]; 8) Subordinated debts [*s. 369 Bank Act*]; 9) Fines and penalties [*s. 369 Bank Act*]; 10) Shareholders [*s. 95 WURA*].

[29] For example, in 1985 uninsured deposits at Northland Bank and Canadian Commercial Bank were covered by the Government of Canada under the *Financial Institutions Depositors Compensation Act*. There were a number of reasons behind the government extended protection including participation in a support rescue package.

example purchase and assumptions in the case of small banks or other actions under forced sale provisions of FIRP) to a complicated approval process of approval by the CDIC board, further recommendation by MOF, and final stamp of approval by the Governor in Council. As the authorities are working on improving the effectiveness and credibility of the resolution framework, it would be important for the government to take one step back from its involvement in approving resolution actions, allowing the resolution authority to have greater weight in deciding on the application of various resolution tools within its mandate. It is therefore recommended that CDIC is provided more legal powers to activate resolution actions, in particular those related to the FIRP.

Enhance the scope the CDIC's powers in resolution

60. The resolution powers of CDIC should be extended to other relevant non-regulated entities which are part of the group. In particular, the CDIC should have powers over the holding companies of a member institution to which the resolution regime applies, as well as over the non-regulated operational entities within a financial group or conglomerate that are significant to the financial activities of the group or conglomerate (i.e. provide services that are necessary for the continuity of systemically important functions carried out within the group). Such powers are justified insofar as they are necessary to support the orderly resolution of the financial institution or the group.

61. Other improvements to the resolution powers of CDIC should be contemplated, in line with the FSB Key Attributes. In particular, the following improvements would be important to consider:

- CDIC should have an explicit power to terminate contracts;
- CDIC should have the power to carry out bail-in within resolution. A bail-in regime for D-SIBs, which the government has already committed to implement, would allow for the recapitalization and return to viability through the rapid conversion of certain bank liabilities into regulatory capital in the event that a systemically important bank depletes its capital. This would ensure that private creditors will bear a greater share of the resolution costs (see Chapter IV, Section II);
- CDIC should have a broader power of automatic temporary stay on early termination rights applicable to eligible financial contracts (EFCs) in a resolution, including those effected under a FIRP tool,[30] while giving careful consideration to the potential implications for central counterparties and other financial sector counterparties.

[30] According to the Key Attributes (EC 3.3.4.), the legal framework ensures that any transfer of assets or liabilities (including holdings of client assets) by the resolution authority using that power does not trigger rights of early termination in relation to any obligation relating to the assets and liabilities transferred or under any contract to which the firm in resolution is a party.

62. **CDIC should develop mechanisms of cooperation in resolution with non-bank resolution authorities**. Taking into consideration the current structure of Canadian financial groups (in which banks dominate), CDIC is most likely to act as a lead resolution authority in the case of a group-wide resolution. It would be therefore appropriate to establish a more coordinated process for the resolution of banking groups with other relevant resolution authorities. In such cases, a broader cooperation between CDIC, OSFI, and relevant provincial supervisors (i.e. of large security dealers) would be necessary.

Work on mitigating moral hazard risks

63. The CDIC should take into account resolution options which place a greater burden on the private creditors. To mitigate moral hazard and to protect the resources of the CDIC, the mission recommends that it adopts a stricter loss minimization test that 1) considers only the cost of the payout of the failure of the bank and not the impact on other banks, unless the failure of the relevant bank would severely endanger financial stability[31] and 2) the costs of resolution are to a more substantial degree shifted to the private creditors.

64. CDIC should clearly signal that OBA is only an exceptional measure, to be used only in cases of a systemic threat. If the CDIC is to provide funding beyond least cost assistance in a FIRP or a bridge-bank transaction, i.e. loans to purchasers, capital injections, etc. such assistance should be restricted only to situations where there are threats to financial stability.[32] The determination of whether such a threat exists should involve a very high level involvement with other safety net providers, including the government. [33] In such situations, the CDIC or another agency should be required to prepare a systemic impact analysis of the different options which could be applied in resolution to inform the high level decision. Further, any OBA should be capped as a percent of the CDIC's cash (or cash equivalent) resources. Finally, as outlined above, it is advisable to eliminate the possibility for open bank assistance from the Guide to Intervention, to clearly signal the commitment of deploying such tool only in exceptional circumstances.

[31] In cases where the marginal impact of the funding of all the other banks in the system, of not providing OBA to a failing bank is considered, the results may be skewed in favor of providing assistance. OBA should only be provided if there is a severe systemic risk not a marginal system wide impact on bank funding costs.

[32] Experience indicates that open bank assistance can never pass the "least cost" test as it is by definition open-ended and loss estimations of problem banks are virtually always underestimated; it also increases moral hazard as ailing banks may use the open bank assistance to engage in ever more risky activities in an effort to restore profitability; is susceptible to political pressure that could cloud good business decisions; and could lead to psychological entrapment, as the authorities' desire to protect the investment could give rise to further support if the bank's condition continues to deteriorate, driving up the total resolution costs (See Parker, D. (2011), "Closing a failed bank: resolution practices and procedures", IMF).

[33] This role could be played by the entity assigned with the mandate of crisis preparedness and management. Staff does not propose that this assessment should immediately be made public. For example, information could be released on a delayed basis only, when it would not endanger the resolution or financial stability. This would still allow for ex-post accountability and review, for example, by parliament.

Introduce some form of depositor preference

65. The authorities should consider introducing some form of depositor preference. Depositor preference not only mitigates the risk of depositor runs, it can also improve recoveries for depositors, the deposit insurance agencies, and the government in the case of a bank's failure. In the context of the proposal to introduce bail-in powers, the introduction of depositor preference is all the more important as unsecured creditors will need to be written-down or have their debts converted into equity. If depositors are ranked equally with unsecured creditors, a bail-in cannot be effected without discriminating within the class of creditors. Depositor preference could be tailored to take different forms (although national depositor preference should be avoided as it could hamper cross-border resolution), based on a rigorous analysis of the desired impact and interaction with other features of the existing bank operating and resolution framework (Appendix II).

D. Federal Deposit Insurance

66. The CDIC has worked proactively to improve its deposit insurance function. There have been no deposit payouts since the failure of Security Home Mortgage Corporation in 1996.[34] Since then, several modifications have been made to the *CDIC Act,* to by-laws, and to CDIC's processes and guidelines to improve the deposit insurance function, including the capacity to reimburse depositors much faster, as well as rebuilding the ex-ante funding of the CDIC. Given its dual capacity of deposit insurer and resolution authority for the member institutions, the CDIC is ensuring that operationally, the deposit insurance and the resolution functions work cohesively.

General features of CDIC coverage

67. The federal deposit insurance scheme provides protection for eligible deposits in member institutions.[35] The deposit insurance covers eligible deposits held in each member institution up to a maximum Can $100,000 (principal and interest combined) per depositor, per institution, and per category of deposits.[36] Furthermore, to be eligible for deposit insurance protection, deposits must be made in Canada and in Canadian currency, while term deposits must be repayable no later than five years after the date of deposit (Appendix III). No exclusions apply in respect to certain categories of depositors (e.g. deposits made by directors of the bank, managers, and related parties), which would be advisable to prevent moral hazard. The current deposit limit is estimated to cover fully about 97 percent of the deposits of individuals and about 31 percent of the value of deposits in the system. The current data collection does not allow for a clear determination

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[34] From 1991 to 1996 (the last five-year payout activity), there were 11 cases where CDIC paid insured depositors.

[35] Banks, trust and loan companies, as well as federally-regulated cooperative credit associations and federal credit unions.

[36] The following seven categories of deposits can be insured separately by the CDIC: in one name; in more than one name (joint deposits); in trust for another person; in Registered Retirement Savings Plans; in Registered Retirement Income Funds; in paying realty taxes on mortgage property; in tax-free savings accounts.

of the specific coverage of categories of other small-scale depositors (i.e. small and medium-sized enterprises and corporates).

68. The definition of eligible deposits under the *CDIC Act* is relatively difficult to understand for the public. Although the CDIC made efforts to present the coverage of insurance in an accessible and easily understandable format, ambiguities linger regarding the eligibility of some complex deposit products. Therefore, it might be difficult to quickly determine the level of a depositor's coverage, which would be necessary to perform a timely payout and preserve public confidence. In order to provide clarity on coverage eligibility for both depositors and member institutions, the CDIC has issued Information Bulletins. Relevant by-laws (e.g. Joint and Trust Disclosure) are also regularly reviewed by the CDIC Board to ensure they remain relevant and up-to-date.

Funding mechanisms and coverage

69. The CDIC is ex-ante funded and reviews its target funding level regularly. CDIC currently has funding of Can$2.6 billion representing an estimated 39 basis points of insured deposits. The existing resources are sufficient to repay insured deposits in all small banks individually, or concurrently in a number of small banks, but would not be sufficient to cover insured deposits in a medium-sized institution. The relatively low level of ex-ante coverage reflects a long period of time in which the corporation had to recover from substantial losses incurred in the mid eighties and early nineties. The CDIC plans to achieve a minimum target ex ante funding of 100 basis points of insured deposits (currently equivalent to Can$6.5 billion), over the coming ten years.

70. In addition, CDIC may also borrow from the federal government or in the capital markets, or a combination of the two. The current borrowing limit (Can$19 billion, which grows in step with the insured deposits) combined with the ex-ante funding would ensure a coverage of 325 bps of insured deposits. Beyond the line with the government, CDIC could seek additional funding through a Parliamentary Appropriation Act, although the process of accessing such funds would be potentially protracted and requires approval of Parliament.

71. CDIC utilizes a differential premiums structure. The Corporation is funded by premiums that are assessed on the insured deposits of member institutions each year. There are four premium categories which are set in the CDIC's Differential Premiums Bylaw Manual, updated and distributed to member institutions each year. Repayment of ex post liquidity funding would be through recoveries from failed member estates and annual premiums levied on member institutions. Premiums are limited to 33 1/3 basis points of insured deposits and currently average approximately 3 basis points of insured deposits.

72. The investment policies of CDIC are conservative. CDIC invests almost exclusively in government securities and government-backed securities. It does not invest in its member institutions. The CDIC's financial risk is monitored by a risk management unit and an asset liability management committee. The CDIC Board undertakes a comprehensive review of its financial risks (treasury) policies every three years.

Corrective actions by CDIC

73. To manage its insurance risks, CDIC conducts regular risk assessments of its members and monitors their financial performance. CDIC relies on OSFI and the supervisors of provincially incorporated members to conduct annual examinations of member institutions on its behalf. CDIC works closely with these supervisors—for example, in addressing member institutions that pose unacceptably higher risk to CDIC. However, in certain circumstances, CDIC conducts special and preparatory examinations to assess its risk and exposure in a troubled member institution.

74. CDIC has the power to assess deposit insurance premium surcharges. CDIC may assess and collect a premium surcharge after consultation with OSFI or the provincial supervisor. Circumstances for the use of premium surcharges include failure to comply with the provisions of the CDIC Prescribed Practices Premium Surcharge By-law and Deposit Insurance Policy By-law or failure to fulfill the terms of an Undertaking to CDIC. To date, there have been no instances where CDIC has ever charged a premium surcharge under the Premiums Surcharge By-law.

75. In addition, CDIC can terminate deposit insurance (as per Section 30 Report). The basis for termination can be evidence of unsound standards of prudent business financial practices (e.g. unsound capital management). The issuance of a Section 30 report is typically preceded by the conduct of a special examination, following which the institution has to rectify the situation. A copy of the Section 30 report shall be provided to the MOF (or provincial Minister if provincial member) and indicates that a failure to remedy the situation could lead to the termination of the deposit insurance policy. The MOF has the power to override such decision based on public interest grounds.

76. The termination of deposit insurance triggers the taking control of the supervised institution by OSFI.[37] The existing eligible deposits would continue to be insured for two years from the termination date (or for term deposits with a longer term, until the maturity date of the term deposit). Alternatively, CDIC has the discretionary authority to make an immediate deposit insurance payment for all eligible deposits. In its history, CDIC has terminated the deposit insurance policy of three member institutions through the Section 30 process and has immediately reimbursed deposits in all the three cases.

Reimbursement of deposits

77. In general, the CDIC deposit repayment is triggered by OSFI's actions. Typically, the taking control and the application for winding-up follow closely and therefore the taking control by

[37] However, if the CDIC terminates the deposit insurance policy on request by the member (because it stops taking deposits) and if otherwise the institution would want to remain a bank, OSFI would not take control.

OSFI would trigger the payment of insured deposits. CDIC may also make a payment of insured deposits if the member is unable to make any payment in respect of a deposit because of an order of the court or any action taken by a supervisory or regulatory body.

78. The CDIC has substantially improved its IT collection system to ensure quick pay-outs. The CDIC's Data and System Requirements By-law came into effect January 1, 2011. Member institutions are required to implement and maintain certain capabilities in support of a faster insurance determination to effect the timely payment of amounts owing to depositors should a member institution fail. CDIC insurance determination rules are such that payments to depositors are calculated based on a depositor view of their account holding (equivalent to the single customer view). At present, 96 percent of member institutions complied within the two and half year implementation period. The remaining members plan to be compliant within the next year.

79. CDIC has established performance targets for payment to insured depositors. There is no target maximum pay-out period to depositors, although CDIC has a legal obligation to make deposit insurance payments "as soon as possible." Where the deposit records are presented in a format usable for CDIC to make an insurance determination, CDIC can make a payment available to depositors in five days or less, as confirmed by recent payout simulations. However, certain exceptions to making a payment in this time are required for tax-efficient deposits and trust deposits, as they involve information/approval from third parties.

Activities to increase public awareness

80. CDIC and its member institutions conduct extensive public awareness activities. CDIC uses multiple public educational channels (i.e. corporate website, toll-free call centre, media, paid advertising, speeches, etc.) to improve public knowledge of the deposit insurance system. Internal surveys show that CDIC consistently exceeds its public awareness targets. Under CDIC's Information By-law, the CDIC decal must be posted on the door of each retail branch of each CDIC member institution and on each member's website; branches also must provide customers with the CDIC "Protecting Your Deposits" brochure.

Recommendations for improving the deposit insurance function

81. The ex-ante funding of CDIC should continue to be increased. To achieve the targeted minimum coverage of 100 basis points of the insured deposits (from the current 39 basis points) within a reasonable timeframe, an increase of the premiums paid by financial institutions will be necessary. An increase in the ex-ante funding of the CDIC is desirable in the current environment of financial stability (i.e. that buffers are built during "good times").

82. Enhanced data collection on depositors would ensure that the coverage limit and the target ex-ante financing strike the right balance between depositor protection, financial stability, and market discipline. Following the crisis, a more nuanced view of deposit insurance coverage emerged, where the predominant function of coverage is to promote confidence, financial stability, and prevent chaotic depositor runs.[38] The goal would therefore be to set coverage so that the majority of depositors, both small-scale individuals and corporate depositors, are sufficiently protected and do not have an incentive to preemptively run the bank, while keeping a meaningful percentage of the value of deposits uninsured, so that the relatively few large-scale depositors would have an incentive to exercise market discipline. From this perspective, it would be useful for CDIC to be able to gather a broader range of information on the profile of depositors, which could also usefully inform broader financial stability analyses. Furthermore, certain categories of deposits (i.e. deposits made by the directors of the bank in the respective institutions, as well as by managers and related parties) should be excluded from coverage, to help prevent moral hazard.

83. The proposed simplification of the rules for eligibility for deposit insurance of complex deposit products is welcome. The depositors should have clarity on the types of products which are insured by CDIC, while the latter should be able to quickly determine the eligibility of deposits in order to effect a payout. The pending efforts of the authorities in the direction of clarifying the definition of deposits should continue and be transparently communicated to the public.

IMPROVING THE RESOLVABILITY OF D-SIFIS

A. Recovery and Resolution Planning

84. Canada has recently established a more stringent regime applicable to D-SIBs. The six federally-designated D-SIBs will be subject to continued supervisory intensity (including recovery and resolution planning), enhanced disclosure, and a one per cent risk weighted capital surcharge (by January 1, 2016). Subsequently, the authorities have also stated their intention to introduce a bail-in tool to support the resolution of the D-SIBs. Besides the federally incorporated D-SIBs, the Québec-headquartered group, Desjardins, has also been designated as a D-SIFI (in June 2013) by the provincial supervisor (Chapter V).

85. Notably, Canada has established a practice of recovery and resolution planning even before the formal D-SIBs regime was announced. In particular, the first recovery and resolution plan pilots were done in 2010, and recovery plans have been prepared by the six largest domestic banks for three years already (since 2011), based on the direction and administrative guidance provided by OSFI. Furthermore, recovery planning for the two large insurance companies is at its second iteration. CDIC, on the other hand, has prepared a first generation of resolution plans in December 2012. There are plans to extend recovery and resolution planning to a larger spectrum of institutions. The Québec supervisor AMF has also announced that Desjardins will be subject to recovery and resolution planning.

[38] See International Association of Deposit Insurers "Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage", Guidance Paper, March 2013.

86. OSFI and CDIC cooperate closely in preparing the recovery and resolution plans and, where necessary, with relevant foreign authorities. OSFI provides the institutions' recovery plans and all other necessary firm information to CDIC for the purpose of assisting CDIC with preparing the resolution plans. Other domestic authorities, such as the BOC and the DOF, are also engaged in recovery and resolution planning (RRP) though participation in RRP working groups, information sharing, and Crisis Management Groups (CMGs). Additionally, the CDIC collects information directly from firms in developing resolution plans and shares this information and analysis with OSFI. Internationally, where a bank with cross-border operations takes recovery actions (or contemplates recovery actions), OSFI will liaise, share information, and discuss supervisory actions/interventions with the relevant foreign supervisors pursuant to the MoUs. CDIC has recently obtained the legislative authority under the *CDIC Act* to share member institution-specific information obtained from OSFI with relevant foreign authorities subject to a condition that the Superintendent and the CDIC Board agree with the release of the member-specific information that was provided to CDIC by OSFI.

Box 4. Canada's Experience with Recovery and Resolution Plans (RRPs)

Recovery Plans are implemented and approved by the firm's senior management and identify options for restoring the firm's financial strength and viability when faced with severe stress. Overall, the process is guided by OSFI's industry-wide recommendations, Recovery Plan Principles, and technical notes. OSFI provides direction, analyzes the submissions and provides regular feedback to the individual firms. In addition, OSFI facilitates discussions of the recovery plans with CDIC, BOC, DOF and relevant U.S. and U.K. regulatory authorities within the annual Crisis Management Groups (CMGs) that are set up for each D-SIB. The focus at these discussions depends on crisis management priorities, regulatory concerns, and maturity of the recovery plans. For example, the topic of the 2012 CMGs was Funding and Liquidity, and the topic of the 2013 CMGs was Recovery Actions.

Recovery planning has been an iterative process, whereby the scope and the depth of each iteration have been gradually increased. OSFI considers that following these iterations, the discussions with the firms have significantly evolved and firms have gradually become more receptive to the recovery planning expectations and are in the process of integrating recovery plans into existing strategic business and risk management decision-making processes.

Resolution Plans are prepared by the resolution authorities, based on information provided by the firm. CDIC's resolution planning work in 2012 focused on identifying those functions and activities performed by D-SIBs (including participation in key FMIs) for which continuity in resolution is critical to maintaining financial stability. Additionally, CDIC identified the separability challenges that could occur as a result of operational, financial and legal dependencies within the firms. Work in 2013 has expanded to consider challenges associated with resolution in greater detail. The banks have been engaged in analyzing resolution challenges and identifying mitigating strategies, where possible. The CDIC is also planning an annual tabletop exercise of a large bank failure which will begin in 2014. Following this exercise, further improvements would be made for future iterations of the resolution plans.

Similar to the OSFI's findings, CDIC has indicated that in the early stages banks experienced some difficulty in engaging in the process, while subsequently confirming that it facilitated self-discovery and raised awareness of the suitability of their internal "defense" mechanisms to intensified financial distress. Both authorities involved frequently commented that implementation of the RRP expectations had provided new information to assist with supervisory work.

87. A few elements would further reinforce the implementation of the RRP framework:

- **First, it would be useful to create a legal requirement for the formulation of RRPs for all Canadian financial firms that are of systemic importance**. The requirement should apply to deposit takers, insurance companies, and financial market infrastructures which could be systemically significant or critical if they fail.[39]

- **Second, introducing resolvability assessments could prove to be a beneficial addition to the domestic resolution framework.** Resolvability assessments, as envisaged in the Key Attributes, are designed to evaluate the feasibility of resolution strategies for the institution and their credibility in light of the likely impact of the firm's failure on the financial system and overall economy.[40] If a firm is assessed to be insufficiently resolvable, the firm should be encouraged through the supervisory process to take voluntary measures to improve its resolvability.

- **Third, the authorities should have legal powers to impose changes to the firms' structures so as to improve resolvability**. At present, the supervisory and resolution authorities do not have the direct power to require a bank to restructure with the purpose of improving resolvability. In line with the Key Attributes, to ensure that the authorities are able to effectively improve a firm's resolvability, the resolution legal framework should provide clear powers to improve resolvability by requiring changes to firms' business practices, structures or organization. Such actions should be justifiable under the legal framework on public interest grounds, provided that the effect on the soundness and stability of the on-going (domestic and foreign) operations of the firm is duly taken into account.

- **Fourth, recovery and resolution planning across sectors needs to be better articulated.** The supervisory mandate of OSFI in respect to banks and insurance companies facilitates coordination of recovery and resolution planning of groups involved in both these sectors. Furthermore, some of the largest securities firms are subsidiaries of major Canadian banks and play important roles in the securities markets, which are provincially regulated. Therefore, a comprehensive protocol to deal with the insolvency of large investment dealers would be needed, of which OSFI and relevant provincial supervisors should be an integral part.[41]

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[39] In October 2013, the CDIC Board authorized the pre-publication (for public comments) of a by-law to enable the CDIC to be provided with the necessary information and analysis to assist it in preparing resolution plans.

[40] In particular, the Key Attribute 10 suggests that authorities assess: (i) the extent to which critical financial services, and payment, clearing and settlement functions can continue to be performed; (ii) the nature and extent of intra-group exposures and their impact on resolution if they need to be unwound;(iii) the capacity of the firm to deliver sufficiently detailed accurate and timely information to support resolution; and (iv) the robustness of cross-border cooperation and information sharing arrangements. The CDIC is in the process of developing a framework for conducting resolvability assessments, which should be finalized in early 2014.

[41] The recent insolvency of MF Global showed the importance that coordination arrangements are in place. Although the constitution of a working group list and a crisis management group go in the right direction, the recent IOSCO assessment underlined that such arrangements should become more institutionalized.

B. The Non-Viability Contingent Capital Framework

88. The crisis made a case for improving the range of instruments that can be used to support the resolution of financial institutions while minimizing costs for taxpayers. OSFI's Non-Viability Contingent Capital (NVCC) framework represents one of the international early regulatory responses in this regard.[42] The NVCC framework has been incorporated into OSFI's Capital Adequacy Requirements (CAR) Guideline (section 2.2).[43] The guideline specifies that effective January 1, 2013, all non-common Tier 1 and Tier 2 capital instruments (i.e. preferred stock or subordinated debt) issued by an institution must comply with the NVCC requirements.

89. The NVCC is a gone-concern contingent instrument. The NVCC aims to ensure that investors in non-common Tier 1 and Tier 2 regulatory capital instruments bear losses before taxpayers where the government determines it is in the public interest to rescue a non-viable bank, based on clearly specified trigger events.[44] The NVCC triggers are very late and very remote and the Canadian authorities confirm that they would only elect to trigger the NVCC where there is a high level of confidence that the conversion accompanied by additional measures (i.e. liquidity assistance provided by BOC, liquidity assistance provided by CDIC, change in management, change in business plan, public or private capital injection) would restore the viability of the failed financial institution. The NVCC instruments are not contingent convertible instruments (Co-Cos), the key distinction being the timing and nature of the NVCC triggers, which can be exercised only at the discretion of the authorities at the point of non-viability.

90. The NVCC is just an option in the resolution toolkit. The decision to maintain an institution as a going concern where it would otherwise become non-viable will be informed by OSFI's interaction with the FISC and on the CDIC Board of Directors. However, the Canadian authorities will retain full discretion to choose not to trigger NVCC notwithstanding a determination by the Superintendent that an institution ceased, or is about to cease, to be viable. Therefore, other resolution options, including the creation of a bridge bank, could be used to resolve a failing institution either as an alternative to NVCC or in conjunction with or following an NVCC conversion, and could also subject capital providers to loss.

[42] The NVCC Advisory was published in 2011, following the principles released by the Basel Committee on Banking Supervision (BCBS) Point of Non-Viability Requirements (January, 2011) and the Financial Stability Board (FSB) Consultative Document on Resolution (July 2011).

[43] See http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=5050 for the most recent update of the CAR Guideline.

[44] The earlier of:1) the announcement by the Superintendent that the deposit-taking institution (DTI) has been advised, in writing, that the Superintendent is of the opinion that the DTI has ceased, or is about to cease, to be viable and that, after the conversion of all contingent instruments and taking into account any other factors or circumstances considered relevant or appropriate, it is reasonably likely that the viability of the DTI would be restored or maintained; or 2) a federal or provincial government in Canada publicly announces that the DTI has accepted or agreed to accept a capital injection, or equivalent support, from the federal government or any provincial government or political subdivision or agent or agency thereof without which the DTI would have been determined by the Superintendent to be non-viable.

91. To the date when the FSAP was conducted, none of the major banks had issued a de novo NVCC instrument, although the first issuance was expected soon. CIBC did, however, amend via a deed poll the terms of three series of its preferred shares to make them NVCC-compliant. A number of smaller, closely-held banks have issued NVCC or modified instruments to make them NVCC-compliant. For these banks, OSFI has permitted alternatives to the market-based conversion required under the CAR Guideline to accommodate the unlisted nature of their common shares or intercompany issuances where all of the capital has been issued to the parent or affiliates. Under the CAR Guideline, each instrument must have a formula governing the conversion mechanism that references the market value of equity when OSFI determines the institution is no longer available. OSFI expects good demand from institutional fixed income and other investors for NVCC.

C. Bail-in

92. Canadian authorities are preparing a bail-in regime applicable to systemically important banks. Similar to NVCC instrument, bail-in supports the resolution of a failing bank by providing sources of capital when the institution is unable to raise capital through private markets and ensures that major creditors of banks, together with equity holders and other providers of regulatory capital, face the risk of loss, even if the troubled bank is not closed or liquidated. The DOF is working closely with relevant authorities with the aim of preparing the legal and operational regime for bail-in.

93. Introducing the power to bail-in creditors in failing financial entities is consistent with the Key Attributes and recent international developments. Indeed, Key Attributes list the bail-in as one of the instruments that effective resolution regimes should have available. At the same time, the Key Attributes clearly indicate that bail-in should be deployed in conjunction with other resolution powers (removal of problem assets, replacement of management, preparation of a viable business plan etc), which would ensure that the underlying problems which caused its failure are addressed. The U.S. has introduced the bail-in power in its 2010 Dodd-Frank Act. In the U.K, the bail-in powers for banking groups were proposed by the Vickers Report, while the European Union is more broadly preparing a recovery and resolution directive framing up a regime for statutory bail-in.

94. The bail-in framework needs to be carefully designed to ensure its effective implementation. In particular, the bail-in regime should be articulated so that will work alongside the existing NVCC framework and other capital rules (i.e. the triggers for bail-in power should be consistent with those used for other resolution tools). Likewise, the legal framework needs to be designed to establish an appropriate balance between the rights of private stakeholders and the public policy interest in preserving financial stability (Appendix IV).

95. Furthermore, the bail-in regime needs to be consistent with other financial stability objectives. Several long-term aspects will need to be carefully taken into consideration when introducing the new regime. The introduction of bail-in could increase the funding costs for unsecured debt and which may, in turn, trigger shifts in banks' liability structure towards other forms of funding (i.e. secured) which are outside the scope of the bail-in regime. Such arbitrage incentives would be countered, however, by other regulatory measures including the Basel III Net Stable Funding Ratio which will incentivize banks to hold higher levels of stable, long-term funding; and asset encumbrance limits that restrain banks' reliance on secured debt funding.[45] It would be also useful to consider requiring the D-SIBs to hold a minimum amount of capital instruments and senior, unsecured debt in conjunction with the bail-in regime to ensure a minimum amount of gone-concern loss-absorption capacity. Last, when deploying bail-in, authorities should be mindful of cross-sector contagion in crisis times,[46] as for example insurance companies are major investors in banks' debt instruments.

PROVINCIAL ARRANGEMENTS FOR CRISIS MANAGEMENT

A. Characteristics of the Provincial Safety Nets[47]

96. The provincial safety nets are operationally independent from the federal safety net. They are designed to tackle financial stability concerns related to the provincially regulated deposit taking institutions,[48] which have small operations, generally limited[49] to serving members of local communities (credit cooperatives) or of certain professional affiliations (credit unions). In principle, the provinces are equipped with the classic elements of a safety net, including financial supervision, deposit insurance—often empowered to offer liquidity and solvency support—and bank resolution.

97. There is high heterogeneity across the individual provincial arrangements for crisis prevention and management. Responsibilities are spread between distinct provincial supervisory authorities, local governments, as well as separate deposit insurance schemes (DIS). In smaller provinces, the supervision of deposit taking institutions is allocated to the local governments, while larger provinces (i.e. Québec and Ontario) have autonomous supervisory agencies (Table 6).Each province has its own deposit insurance scheme (DIS), while the resolution and liquidation of deposit taking institutions is handled according to provincially-applicable laws.

[45] Canada's banking regulator limits a deposit taking institution's covered bond issuance to 4 percent of total assets.

[46] For more details see Jassaud and Le Lesle, "Bail-in Proposals: What is the Future of Bank Debt in Europe?" The Geneva Association of Risk and Insurance Economists, Progress Newsletter no. 55, 2012.

[47] The analysis of the provincial safety nets is based on extensive discussions with the AMF (in the case of Québec) and publicly available information in the case of the rest of the provincial arrangements.

[48] Deposits taking institutions are restricted to operating within their province. Provincially chartered credit unions cannot become members of CDIC.

[49] In Québec, credit cooperatives are empowered to pursue their activities outside Québec.

Table 6. Provincial Allocation of Prudential Supervision and Deposit Insurance Functions

Province	Prudential Supervision	Deposit Insurance Scheme
British Columbia	Province of British Columbia Financial Institutions Commission	Credit Union Deposit Insurance Corporation of British Columbia
Alberta	Province of Alberta Treasury Department	Alberta Credit Union Deposit Guarantee Corporation
Saskatchewan	Province of Saskatchewan Financial Services Commission	Saskatchewan Credit Union Deposit Guarantee Corporation
Manitoba	Province of Manitoba Consumer and Corporate Affairs	Credit Union Deposit Guarantee Corporation of Manitoba
Ontario	Deposit Insurance Corporation of Ontario	Deposit Insurance Corporation of Ontario
Québec	Autorité des Marchés Financiers	Autorité des Marchés Financiers
Nova Scotia	Provincial Government of Nova Scotia	Nova Scotia Credit Union Deposit Insurance Corporation
Prince Edward Island	Provincial Government of Prince Edward Island	Prince Edward Island Credit Union Deposit Insurance Corporation
Newfoundland and Labrador	Provincial Government of Newfoundland and Labrador	Newfoundland and Labrador Credit Union Deposit Guarantee Corporation
New Brunswick	Provincial Government of New Brunswick	New Brunswick Credit Union Deposit Insurance Corporation

98. **Particularly, the local deposit insurance schemes display very uneven characteristics, some of which are problematic.** First, the ten DISs have different levels of coverage, ranging from Can$ 100,000 (similar to the coverage offered by CDIC) to unlimited deposit insurance in four of the ten provinces (Table 7). Such variation in coverage raises level playing field concerns in relation to the federally chartered deposit taking institutions,[50] while the unlimited insurance coverage creates moral hazard risks. From the depositors' perspective, the heterogeneity of deposit insurance coverage levels may create uncertainty and confusion. Second, the funding mechanisms are also uneven, with some provinces still reliant on ex-post financing (New Brunswick), while it remains unclear whether provincial governments' backstopping is explicitly provided in all cases. Furthermore, evidence suggests that funding of some DISs needs to be improved (Table 7). In some cases, the resolution powers are incomplete.

[50] Deposits in federal institutions are covered up to Can$ 100,000 (per depositor, per type of product, per institution), while in some provinces, deposit insurance can range from Can$ 250,000 to unlimited coverage.

Table 7. Characteristics of Provincial Deposit Insurance Systems

Deposit Insurance Scheme	Institutions Covered	Coverage Limit	Coverage Ratio	Target Ratio	Type of Funding	Authority to Act as Receiver	Resolution Governed by
Autorité des Marchés Financiers (Quebec)	421	Can$ 100,000 per person per institution; separate coverage for registered accounts.	0.58	No target	Ex-ante	Yes	Bankruptcy/Insolvency laws and Deposit Insurance Act
Credit Union Deposit Guarantee Corporation (Alberta)	34	No limit	1	1.5	Ex-ante	Yes	Bankruptcy/Insolvency laws and special resolution regime
Credit Union Deposit Guarantee Corporation (Manitoba)	38	No limit (including foreign currency deposits)	1	No target	Ex-ante	Yes	The Manitoba Credit Unions and Caisses Populaires Act
Credit Union Deposit Insurance Corporation (British Columbia)	45	No limit	0.8	0.8	Ex-ante	Yes	Financial Institutions Act
Deposit Insurance Corporation (Ontario)	152	Can$ 100,000; 100% coverage for registered savings plans	0.6	Under review	Ex-ante	Yes	Credit Unions and Caisses Populaires Act
Credit Union Deposit Insurance Corporation (New Brunswick)	34	Can$ 250,000 per member	N/A	N/A	Primarily Ex-Post	No	Bankruptcy Insolvency laws
Credit Union Deposit Guarantee Corporation (Newfoundland and Labrador)	10	Can$ 250,000 per type of deposit	0.6	N/A	Ex-ante	Yes	Credit Union Act
Deposit Insurance Corporation (Nova Scotia)	31	Can$ 250,000	N/A	N/A	Ex-ante	Yes	Other
Credit Union Deposit Insurance Corporation (Prince Edward Island)	10	CAD $125,000; 100 % for registered plans	1.5*	N/A	Ex-ante	Yes	Other
Credit Union Deposit Guarantee Corporation (Saskatchewan)	61	No limit	1.58	1.6	Ex-ante	Yes	The Credit Union Act

Source :FSB,"Thematic Review on Deposit Insurance Systems, Peer Review Report" ; various provincial authorities websites; staff estimates.
* based on best available information.

Reference date for the information is end 2012 (or most recent publicly available).

99. **A deeper analysis of the crisis management arrangements was performed in relation to the Québec province.**[51] Québec's provincial financial system is the largest in Canada and is the host of the country's sixth most important financial group—Desjardins. The *Autorité des Marchés Financiers* (AMF) plays a multiple role in the province as a supervisor, deposit insurance agency, and resolution authority.[52] Over the past years, the agency has engaged in several ambitious reforms aimed at enhancing its supervisory capacity, as well as its deposit insurance function, all framed in the agency's Work Plan for 2012–2017. The AMF has also announced that the systemically important

[51] The mission enjoyed close cooperation from the AMF which kindly made available a wide range of documents and information about its supervisory and deposit insurance functions.

[52] The powers and responsibilities of the AMF are enshrined in the *Act on Financial Services Cooperatives (AFSC)*, the *Act on Deposit Insurance (ADI)*, and in the *Act on the AMF*.

financial institution —Desjardins Group—will be subject to additional capitalization and disclosure requirements, as well as enhanced supervision.[53]

100. From a crisis management perspective, the credit cooperatives networks in Québec have the particularity of having internal first line defense arrangements. First, the networks of credit cooperatives are organized under the umbrella of a Federation[54] which acts as an internal supervisory body with broad correction action powers. Therefore, the federation becomes the first layer of supervision and an important partner of the AMF in performing the overall oversight. Second, there are several intra-network support mechanisms which can be activated when liquidity or solvency pressures materialize. The "security funds" are fed by contributions of the individual credit cooperatives into a separate legal entity, while "liquidity funds" are set up at the individual cooperative level, but can be mobilized across the network should security funds be exhausted.

101. The AMF has wide intervention authority. The AMF can order a credit cooperative to cease a course of action or to implement specified measures (article 567 of the AFSC) and can suspend the powers of the board of directors and appoint a provisional administrator (article 403 of the AFSC). Furthermore, the AMF can act as a receiver (article 40 of ADI), although only upon receiving the approval of the Superior Court (article 19.1 of the Act on the AMF) and can suspend or cancel the permit of a supervised institution (article 31 of ADI). Access to supervisory information is broad (article 556 of the AFSC), although the information received on federally chartered institutions which are part of the same group is limited. The legislation provides for rather discretionary open bank assistance powers, although the authorities confirm that such prerogatives have not been used in the past. However, in the past, OBA was provided by the predecessor of the AMF as well as by other provincial authorities. As outlined before, the use of open bank assistance is strongly discouraged (footnote 32 above) except when needed to mitigate systemic risks.

102. The AMF is putting in place a wide reform of its deposit insurance function. Similarly to the federal arrangements, the insured amount per depositor is Can$100,000 which covers around 95 percent of depositors and 65 percent of the deposits of participating institutions. The AMF has an ex-ante financing system with a uniform premium system, but plans to introduce differentiated contributions. At March 31, 2012 the net resources of AMF for deposit insurance purposes were Can$505 million (equivalent to 0.58 percent of insured deposits); AMF has unrestricted borrowing capacity from the Government of Québec.[55]

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[53] For more information see http://www.lautorite.qc.ca/en/press-releases-2013-corpo.html_2013_desjardinsgroup-systemically-important.html . The Desjardins Group includes a network of 376 credit cooperatives and credit unions operating in Québec and Ontario, as well as a large number of ancillary services entities, some of which are federally supervised by OSFI or chartered by other provincial authorities. It has a dominant market position in Québec.

[54] The Federation of the Caisses Desjardins du Québec (FCDQ) acts as a supervisory body for all member credit cooperatives (377) and has a dedicated structure (Bureau de la Surveillance) which performs this function.

[55] The AMF's borrowing capacity from the Government has been increased at different stages (up to Can$ 700 million in 1981), however in 2009 the borrowing limit was abolished (i.e. can borrow any amounts "necessary if the resources of AMF are insufficient").

103. The following recommendations are made in respect to the improvement of the early intervention, resolution, and deposit insurance functions of the AMF:

- **Some of the internal safeguards need to be better articulated so as to effectively support the official safety net arrangements**. At present, the Federation is required to notify the AMF within ten days about corrective actions imposed on individual credit cooperatives.[56] Such notification period should be significantly shortened to allow the AMF to react promptly to important developments affecting individual credit cooperatives. Furthermore, it remains unclear whether the security funds are required to (as opposed to "can" as stipulated presently in the law[57]) provide support when an individual credit cooperative is under stress. This aspect is even more important as at present the security funds are larger (Can$757 million) than the funds available to AMF to reimburse depositors.

- **The AMF ex-ante funding should be improved, while other desirable improvements should include the introduction of a single customer view recordkeeping.** The AMF is encouraged to finalize the process of deciding on a long-term capitalization target and of improving governance of its deposit insurance function in line with the IADI Core Principles. The AMF is closely following the CDIC's steps about the introduction of a single customer view recordkeeping. This process would greatly enhance the capacity to ensure a prompt depositor repayment (i.e. five to seven days).

- **Finally, clear crisis intervention policies and procedures need to be put in place**. The AMF should document the policies and the operational procedures that would be executed in a crisis situation. Such procedures should include clear conditions and steps for the activation of intra-network support, the AMF intervention, as well as the recourse to the federal safety net, if necessary. As a prerequisite for the latter, cooperation arrangements with other relevant federal authorities should be reviewed and updated. Once the overall crisis management approach is designed, it should be tested periodically through crisis simulation exercises and improved as needed.

B. Provincial-federal safety net interaction

104. Financial problems are handled locally in a first instance, but depending on circumstances, there may be ways to access federal support. The province of New Brunswick tackled, in 2007, problems in one of its important players—Shippagan Credit Cooperative—by introducing a support package of Can$ 60 million of which Can$ 40 million were contributed to recapitalize the institution, while the rest was used to enhance general deposit protection.[58] Earlier in 1981, financial distress affecting one of the Québec incorporated credit cooperatives prompted the

[56] See articles 377-380 of the AFSC.

[57] See articles 487 of the AFSC.

[58] For more details, see http://www.gnb.ca/cnb/news/jus/2007e0373ju.htm .

provincial deposit insurance scheme (the predecessor of the AMF) to enter into a loan agreement with the CDIC, which was necessary for providing liquidity support. The liquidity line was partly used and repaid quickly thereafter.

105. During the recent financial crisis, both federal and provincial authorities intervened. Fiscal stimulus was introduced at the federal and provincial levels. In the midst of the crisis, one province has introduced full deposit insurance coverage (British Columbia).[59] Furthermore, in late 2008, the Caisse Centrale Desjardins, which is a provincially incorporated institution, was provided the ability to access the Canadian Lenders Assurance Facility (initially announced to cover only federally regulated institutions), although the facility was never accessed. Notably, the facility was made available based on the guarantee from the Government of Québec for any potential losses incurred by the Government of Canada in respect of insurance on debt issued by the Caisse Centrale Desjardins.[60]

106. There are several points in which provincial and federal safety nets interconnect. As outlined above, the provincial safety nets are, by institutional and political design, operationally independent from the federal safety net. Therefore, the responsibility of managing financial distress at the provincial level falls on individual provincial safety nets, which should ensure that locally incorporated institutions are well supervised and that adequate arrangements are in place to contain any financial distress arising regionally. However, there are ties which argue for close cooperation between relevant provincial and federal authorities:

- First, on the supervisory plan, some provincial groups or entities are the ultimate parents of entities which fall under federal realm (for both supervisory and deposit insurance purposes).[61] To facilitate an overall view on the activities and the risks of the group, such cases demand close cooperation and exchange of information between provincial and federal supervisors, preferably formalized in cooperation agreements (MOUs).

- Second, as outlined above, emergency liquidity assistance may (but does not have to) be provided by BOC to a broad range of institutions, including provincially incorporated ones, under strict conditions related to eligibility of access (namely a timely and accurate opinion from the responsible supervisory authority[62] regarding the solvency of the institution) and

[59] Before the crisis, three other Western Provinces benefited from blanket deposit insurance guarantees: Alberta, Manitoba and Saskatchewan. Interestingly, the blanket deposit guarantee introduced in British Columbia was not justified by runs in local institutions, but rather by concerns that the volatile market conditions might direct some deposits into those neighboring provinces which offered full deposit guarantees.

[60] For more details see http://www.fin.gc.ca/n08/08-083-eng.asp .

[61] For example, Desjardins Group in Québec is the ultimate parent of Bank West and Desjardins Trust, both federally supervised; CS Alterna Co-op in Ontario is the parent of CS Alterna Bank which is federally supervised; the Credit Union Central of Saskatchewan, and other credit unions own Concentra Financial Services Association and its subsidiary Concentra Trust, both federally supervised.

[62] According to the BOC's criteria, the central bank has to be reassured of the "soundness of the supervisory framework".

collateral availability. Provincial authorities should proactively engage with BOC in discussing conditionality for federal ELA support and ensuring that they can be promptly demonstrated should such emergency situations arise. Furthermore, provincial authorities should ensure that adequate legal arrangements are preemptively in place for mobilizing guarantees at the network level for the purpose of accessing ELA from the BOC.

- Third, there are several instances where CDIC shares responsibilities for deposit insurance with provincial authorities or can provide liquidity assistance to various provincial entities (Box 5).

Box 5. CDIC's Provincial Links

The CDIC shares responsibilities for deposit insurance with the AMF. Under the terms of an agreement between CDIC and AMF, deposits made in Québec with provincially incorporated members are insured by the AMF, and deposits made outside Québec with such AMF members are insured by the CDIC. The shared responsibility requires close cooperation between the two agencies, as well as clear common procedures for depositor reimbursement in case such instances would arise.

Under section 17.1 of the *CDIC Act*, provincially incorporated financial institutions may apply for CDIC membership (currently, CDIC has one provincially-regulated CDIC member).[63]

Furthermore, CDIC may, with federal Governor in Council approval, enter into an agreement with provincial authorities to restructure the financial institution (*CDIC Act*, Section 39.38).

The CDIC can enter into liquidity arrangements with provincial deposit insurance schemes or other entities (Section 39 of the *CDIC Act*). According to Sections 482 and 483 of the *Federal Cooperatives Credit Associations Act*, CDIC—as an agent of the government—can make short-term (e.g. six month) loans for liquidity purposes to cooperative credit societies and to provincially created corporations that provide or administer stabilization or liquidity funds for the benefit of credit unions and their members provided that certain conditions are met. At present, such arrangements are in place with British Columbia and Alberta, but no funds to date have ever been advanced through CDIC under these provisions.

107. In 2012, federal legislation came into force to allow for federally regulated credit unions to operate across provincial boundaries. According to such provisions, credit unions can apply under the *Bank Act* to operate federally, becoming supervised by OSFI, and become members of the CDIC (as sole deposit insurer). Clear transitional arrangements for deposit insurance are also outlined in the law.[64] So far, no institution has applied to use the federal framework, although in

[63] National Bank Trust Inc is a Québec-based subsidiary of National Bank.

[64] Deposit insurance coverage is available for demand deposits (transaction accounts) over Can$100,000 for six months provided these deposits were made before CDIC assumed role of insurer. Furthermore, pre-existing term

(continued)

practice, the federal credit union option would allow credit unions to expand their activities across all Canadian provinces and be part of the federal safety net.

C. Recommendations

108. It would be useful if the provincial authorities would undergo a self-assessment of the adequacy of their safety nets. The Québec AMF's thorough analysis of its supervisory and deposit insurance arrangements proved useful at revealing the concrete areas where improvements are needed and firming up a long-term action plan. Such an exercise could be usefully replicated by other provincial authorities with a view of reinforcing their local safety nets. Federal authorities could support this process by actively sharing their experience and expertise in relevant areas. The longer-term objective should be to introduce more uniformity across the operating standards of the provincial safety nets and more convergence towards best practices.

109. The provincial arrangements for crisis management should be strengthened as necessary. In particular, the provincial authorities should ensure that the locally systemic important financial institutions are subject to enhanced oversight (in line with the requirements for D-SIFIs), while recovery and resolution plans are put in place. The provincial DISs need to be reinforced to ensure adequate funding of the insured deposit exposure, timely repayment of insured deposits, and sound governance arrangements. A more uniform approach on the coverage levels of various provincial schemes would also enhance their credibility and the transparency. Finally, clear policies, procedures, and operational guidance for crisis management need to be established and regularly tested, if necessary in conjunction with other relevant provincial and federal authorities.

110. The cooperation between the provincial and federal authorities needs to be improved. Where relevant, provincial authorities should have a more frequent and comprehensive exchange of supervisory information with OSFI regarding financial groups which span federal and provincial boundaries; update their cooperation agreements with CDIC; and step up communication with other federal authorities, as necessary. Enhanced cooperation with the federal authorities should not be regarded as a substitute, but rather as a complement for the provincial safety nets, which should continue to be reinforced in a manner that would ensure self-sufficiency in handling a provincial crisis. More intense communication on financial stability issues at both provincial and federal level should ensure that the Canadian authorities have the information to identify and assess overall risks in the financial sector preemptively and comprehensively and to proportionally respond in addressing such risks ("comprehensiveness in prevention, proportionality in intervention"). Lastly, crisis simulation exercises could be organized to include a range of relevant federal and provincial authorities.

deposits will be covered to the maturity of the term, while any new money deposited with federal credit unions after becoming members of CDIC would be subject to current CDIC coverage rules and limits. At the end of 6 months, transaction accounts would no longer be eligible for transition coverage.

CROSS-BORDER COORDINATION AND EXCHANGE OF INFORMATION

111. Both OSFI and CDIC can share confidential information with their international counterparts throughout the life cycle of banks. By law, OSFI and CDIC can share member specific information with their international counterparts in certain circumstances where they are satisfied that the information will be treated as confidential. OSFI has entered into formal information sharing and supervisory cooperation arrangements (Memoranda of Understanding) with over 30 foreign supervisory authorities and routinely exchanges information with foreign home and host regulators. The CDIC has signed two cross-border MOUs with the Instituto para la Protección al Ahorro Bancario from Mexico (2012)[65] and with the Federal Deposit Insurance Corporation from the United States (2013) to strengthen the cross-border cooperation in the areas of bank resolution and deposit insurance. CDIC also participates in the supervisory colleges held by OSFI.

112. CDIC is also actively strengthening relationships with relevant foreign authorities. Through its resolution planning work, CDIC determines with which additional authorities it may be helpful to establish MOUs in order to facilitate resolution. Legislation introduced in 2012 allows the CDIC to share certain institution-specific information it receives from OSFI with its international counterparts when it is satisfied that the information will be treated as confidential and based on the agreement of the Superintendent and of the CDIC Board.

113. The CDIC resolution powers do not differentiate between domestic and foreign owned deposit takers, but do not apply to branches of foreign banks. CDIC's resolution powers have no application to branches of foreign financial institutions: branches of foreign banks operating in Canada are prohibited from taking retail deposits (i.e. deposits of less than Can$150,000)[66] and are not eligible to become CDIC members. To take retail deposits, a foreign bank must establish a regulated subsidiary. The branching option therefore provides foreign banks that are primarily interesting in commercial banking with a less intrusive alternative for conducting more limited activities in Canada.[67]

114. There is no legal obligation to take into account the possible effects in other jurisdictions resulting from resolution actions by the CDIC. However, they are not prevented from doing so and, in their determination respecting a resolution option, Canadian authorities would, in practice, seek to understand and take into account any impacts that a resolution option may have on a foreign jurisdiction and appropriately discuss such impacts with foreign authorities, insofar as this was expected to enable them to achieve their objects. Canadian authorities will be

[65] The MOU with Mexico is an agreement limited to sharing best practices between the Canadian and the Mexican authorities. This may evolve into a more structured resolution supporting elements once legal hurdles are clarified.

[66] Note that the maximum protection level offered by CDIC is Can$ 100,000.

[67] There are 28 foreign bank branches operating in Canada (full-service branches and lending branches).

aided in carrying out such evaluation by respecting the terms of cross-border MOUs. There are no laws that discriminate against creditors based upon nationality or location.

115. The practice of recovery and resolution planning has also reinforced the cooperation with foreign authorities. Since 2011, when the practice of submitting recovery plans was formally extended to all large banks, OSFI and CDIC have hosted annual and semi-annual crisis management groups (CMGs) with the participation of relevant foreign authorities (i.e. regulators from the U.K. and the U.S.). OSFI and CDIC have also attended one CMG as a host regulator with generally good experience. In addition, in the fall of 2013, CDIC, in collaboration with OSFI, hosted CMGs with all the six D-SIBs which focused on resolution related issues and involved the major cross-border supervisory agencies of each of the big six banks (i.e. the U.K. and U.S.).

116. The Canadian authorities are closely involved in the international policy debates on cross-border bank supervision and resolution. OSFI and CDIC have played an active role representing Canada in FSB Cross Border Crisis Management (CBCM) initiatives, including the input of guidance on recovery triggers, stress scenarios, operationalizing recovery and resolution plans and developing assessment methodology and Peer Reviews. OSFI currently participates in the CBCM work stream on loss absorbency capacity whereas CDIC currently participates in three CBCM work streams on loss absorbing capacity, data templates (which it chairs), and funding in resolution. The CDIC is also an active member in IADI and chairs the IADI regional committee of North America and the guidance group. In addition to the CMGs, OSFI participates in other relevant international crisis management work and engages in outreach activities with relevant non-CMGs host authorities.

Appendix I. OSFI'S Intervention Powers

According to the *Bank Act*, OSFI is equipped with a broad range of intervention powers:

Restricting the current activities of the bank

The Superintendent may restrict the activities of a bank by: varying its Order to Commence and Carry on Business (section 54); issuing a Direction of Compliance (section 645); requiring an Undertaking related to an approval (section 973.02) or an investment (section 470); or entering into a Prudential Agreement (section 644.1).

Imposing more stringent prudential limits and requirements

The Superintendent may impose more stringent prudential limits and requirements by: issuing a Capital/Liquidity Order (section 485); issuing a Direction of Compliance (section 645); requiring an Undertaking related to an approval (section 973.02) or an investment (section 470); entering into a Prudential Agreement (section 644.1); or placing a limit on the assets held by a bank (section 54.1).

Withholding approval of new activities or acquisitions

The Superintendent may prevent a bank from undertaking a new activity if the new activity would: require an approval to amend the bank's license (section 54); or constitute an unsafe or unsound practice in conducting the business of the bank (section 645).

Restricting or suspending payments to shareholders or share repurchases

The Superintendent may restrict the payment of dividends to shareholders or share repurchases by way of a Capital Order (subsections 79(4) and 485(4)). The Superintendent may also issue a Direction of Compliance (section 645) to direct the bank not to pay a dividend.

Restricting asset transfers

The Superintendent may restrict asset transfers by: denying approval where a bank seeks to acquire or transfer assets that comprise more than 10 per cent of the bank's total assets (section 482); or issuing a Direction of Compliance (section 645); entering into a Prudential Agreement (section 644.1); or securing an Undertaking related to an approval (section 973.02) or an investment (section 470).

Barring individuals from the banking sector

The Superintendent may: remove a director or senior officer of a bank if the Superintendent is of the opinion that the person is not qualified based on specific considerations (section 647.1); or veto the appointment of a director or senior officer of a "problem" bank if the Superintendent is of the opinion that the person is not qualified based on specific considerations (section 647).

Replacing or restricting the powers of managers and Board members

The Superintendent may revoke, suspend, or amend an approval and in doing so take into account any relevant prudential considerations. Where the Superintendent takes control of the bank itself, the powers, duties, functions, rights, and privileges of directors and officers are suspended, and the Superintendent assumes those powers, duties, functions, rights, and privileges (section 649). However, OSFI cannot take decisions which require the approval of the general assembly of shareholders (i.e. a merger).

Facilitating a takeover by or merger with a healthier institution

The Superintendent may encourage a failing bank to seek a substitute bank to assume its obligations on a voluntary basis (typically this would be when a bank was at stage 3 or 4). In the event that the Superintendent takes control of the bank under section 648, the Superintendent must, pursuant to section 649, manage the business and affairs of the bank with a statutory objective of doing all things necessary or expedient to protect the rights and interests of the depositors, which may include seeking to transfer the failing bank's obligations to a healthier institution.

Providing for the interim management of the bank

Section 649 provides that: where the Superintendent takes control of the bank itself, the powers, duties, functions, rights, and privileges of directors and officers are suspended which are assumed by the Superintendent. The Superintendent may elect to appoint one or more persons to assist in the management of the company.

Revoking the banking license

Pursuant to section 54, the Superintendent may revoke a bank's Order to Commerce and Carry on Business (i.e. a bank's license).

Appendix II. Considerations in Introducing Depositor Preference

Advantages

Reducing resolution costs incurred by the deposit insurance scheme (DIS), and in a systemic crisis, by the State. Via subrogation of insured depositors' preferential rights to the DIS upon a payout of insured deposits or by giving to the DIS an equivalent right upon financing of a resolution, DP allows the DIS to maximize its recoveries on the assets of the failed bank. Moreover, in order to perform its role, the DIS may have to borrow from the State, which is likely the case in a systemic crisis. In this event, the State could then have recourse over the failed bank by enjoying the same preferential right: this would reduce public exposure in resolution.[68]

Enhancing depositor confidence. DP (particularly in combination with a DIS, funded ex-ante) can help mitigate the likelihood of bank runs by depositors, by providing them with confidence of higher recovery of their claims upon the possible insolvency of a bank.

Facilitating resolution. DP can help reduce legal challenges from other unsecured creditors (for example, on grounds of discriminatory treatment) in case of a transfer of deposits to another institution or the bail-in of certain creditors as bank resolution techniques, as the DP provides clear legal grounds for the preferential treatment of depositors. Where DIS funds are also used to finance resolution rather than a direct pay-out, DP also simplifies the performance of the DIS mandate, aimed at protecting insured deposits, as well as reducing potential claims and therefore the cost for the DIS / the State under the "no creditor worse off" safeguard.

Maximizing market discipline. By de facto increasing the potential loss exposure of unsecured creditors, DP provides strong incentives for creditors to monitor banks' risk-taking behavior more closely, and price this accordingly. At the same time, banks choosing to sustain meaningful levels of non-deposit, unsecured funding will need to provide higher transparency and show sufficient capital and available, non-collateralized assets.

Disadvantages

Wholesale funding costs. By tilting the balance in favor of depositors—whose protection in case of a bank's failure contributes to maintaining depositor confidence—DP inherently increases the potential loss exposure of other unsecured creditors. This could (i) increase unsecured funding costs or their re-profiling (such as through shortening of maturities); and (ii) increase the encumbrance of assets on bank balance sheets.

Broadly, the following approaches to DP can be distinguished (see table):

[68] Empirical evidence is mixed on whether the introduction of DP in the U.S. in 1993 reduced subsequent resolution costs for the FDIC, in part because of the lumpiness and heterogeneity of failures.

- ***Insured depositor preference* (second column)** ranks all unsecured creditors including depositors pari passu, but gives the DIGS preferred status in liquidation. By providing a preference to the DIS only, a preferential treatment of depositors in other resolution tools (e.g. bail in) is not explicitly provided for. This ranks uninsured depositors equally with other senior unsecured creditors, failing to capture all the benefits of DP noted above. It also assumes that eligible depositors with large balances have the same capacity as wholesale creditors in monitoring risk.

- ***Depositor preference* (third column)** ranks all eligible deposits pari passu (with the DIS subrogated for insured depositors), but higher than other senior unsecured creditors. This approach captures the benefits of DP and shares resolution costs equally between the DIS and uninsured depositors.

- ***Tiered depositor preference* (fourth column)** prefers insured deposits (and the DIS) over uninsured deposits, but prefers both over other senior unsecured (bondholders). This approach affords greater protection to depositors, while still minimizing costs to the DIS.

<table>
<tr><th>Pari Passu</th><th>Insured DP</th><th>DP</th><th>Tiered approach</th></tr>
<tr><td rowspan="3">All eligible deposits (and subrogated DGS) and other senior unsecured creditors rank pari passu</td><td>DGS (subrogated for insured deposits)</td><td rowspan="2">All eligible deposits (and DGS subrogated for insured deposits)</td><td>DGS (subrogated for insured deposits)</td></tr>
<tr><td rowspan="2">Retail deposits over deposit insurance limit and other senior unsecured</td><td>Eligible deposits (i.e. retail) over deposit insurance limit</td></tr>
<tr><td>Other senior unsecured</td><td>Other senior unsecured</td></tr>
</table>

Appendix III. Observations on the Federal Deposit Guarantee Scheme

In June 2009, the Basel Committee on Banking Supervision and the International Association of Deposit Insurers (IADI) issued the Core Principles for Effective Deposit Insurance Systems in June 2009.[69] Without conducting a formal assessment of observance, the mission has compared the federal Canadian DIS, as well as the applicable laws, regulations and information provided with the principles embedded in this international standard. The main observations are found below.

Core Principle	**Comments**
Principle 1: Public Policy Objectives	✓ The two principal objectives of a deposit insurance system are clearly set out in the *CDIC Act*: *a. to provide insurance against the loss of part or all of deposits; and* *b. to promote and otherwise contribute to the stability of the financial system in Canada.* ✓ All financial sector legislation, including CDIC's governing legislation, the *CDIC Act*, is reviewed publically every five years.
Principle 2: Moral Hazard	✓ The federal deposit insurance system in Canada incorporates features to reduce moral hazard through prudential supervision and regulation, effective resolution and various design features (e.g. limited coverage, use of differential premiums). ✓ The coverage is limited to $100,000 per depositor, per institution. The coverage limit fully protects about 97 percent of the deposits of individuals in Canadian dollars, but only about 31 percent of the value of total deposit liabilities in the system.
Principle 3: Mandate	✓ CDIC's mandate is clearly set out in legislation and consistent with its public policy objectives. Its powers are consistent with its mandate.
Principle 4: Powers	✓ CDIC has all necessary powers to fulfil its deposit insurance mandate. ✓ Some of the resolution powers of the CDIC are constrained by the need of a government approval.
Principle 5: Governance	✓ CDIC is able to use the powers and means assigned to it without undue influence from external parties. There is in practice no significant evidence of government or industry interference in the operational independence of CDIC and its ability to obtain and deploy the resources needed to carry out its deposit insurance function. ✓ However, the government does have the authority to remove some directors of the board without cause in law, which is

[69] See the Core Principles for Effective Deposit Insurance Systems, July 2009 and the Core Principles for Effective Deposit Insurance Systems: A Proposed Methodology for Compliance Assessment, December 8, 2010 at http://www.bis.org.

	inconsistent with the Core Principles. ✓ CDIC is financed in a manner that does not undermine its autonomy or independence and permits it to fulfill its mandate.
Principle 6: Relationships with other Safety-Net Players	✓ CDIC is part of a broad framework for sharing information on deposit-taking institutions and is able to get information on troubled institutions in advance from the supervisor or directly from its members through special and preparatory examinations. This information is subject to confidentiality provisions that apply to all safety-net participants. ✓ In order to make a fast insurance determination, CDIC has introduced standardized data extracts and systems requirements on its member institutions.
Principle 7: Cross-Border Issues	✓ CDIC does not insure any banks in jurisdictions outside Canada, nor does any foreign deposit insurer insure any banks in Canada. ✓ Branches of foreign-owned banks are not permitted to take insurable retail deposits in Canada. Foreign-owned banks wishing to take such deposits in Canada must incorporate as separate Canadian subsidiaries.
Principle 8: Compulsory Membership	✓ Membership in CDIC is compulsory for all banks, federally and provincially chartered trusts and loan companies, federal credit unions, and cooperative credit associations. Membership in the deposit insurance system is determined by OSFI, but all CDIC members must follow CDIC's *Deposit Insurance Policy Bylaw*.
Principle 9: Coverage	✓ Coverage is defined in law, credible, limited and meets the public policy objectives of the system. ✓ However, in the case of some complex deposit products, ambiguities linger regarding eligibility for deposit insurance. ✓ Based on more granular information about the profile of depositors, consideration should be given to reviewing the limits and coverage to ensure that they strike the right balance between small depositor protection, financial stability, and ensuring market discipline.
Principle 10: Transitioning from a Blanket Guarantee to a Limited Coverage Deposit Insurance System	N/A
Principle 11: Funding	✓ CDIC's funding arrangements are clearly set out in legislation. CDIC assesses *ex-ante* premiums on a differentiated basis. It has an established fund, which is invested conservatively with an emphasis on safety and liquidity, and has pre-established access to backup funding. ✓ CDIC has a target coverage level of ex-ante funding which is revised regularly. ✓ Management is currently reviewing its fund adequacy in light of its work on recovery and resolution planning for large complex member institutions.
Principle 12: Public	✓ CDIC has a robust public awareness program. It is responsible for

Awareness	promoting public awareness of the deposit insurance system on an ongoing basis. The objectives of the public awareness program are clearly defined and consistent with its public policy objectives. ✓ CDIC works with member institutions and other safety-net organizations to ensure the consistency of its messaging and reviews its public awareness program on a regular basis.
Principle 13: Legal Protection	✓ CDIC and the directors, officers, and employees of CDIC and others working on behalf of CDIC are protected against legal action for actions taken in good faith while discharging CDIC's mandate. They are similarly indemnified from any related legal costs.
Principle 14: Dealing with Parties at Fault in a Bank Failure	✓ CDIC has the authority to seek legal redress against parties at fault in a bank failure. It must do this by establishing that the directors, officers, managers or auditors of a failed institution acted in a personal capacity rather than in that of the failed institution
Principle 15: Early Detection and Timely Intervention and Resolution	✓ CDIC is part of a framework within the financial system safety net that provides for the effective early detection and timely intervention into troubled institutions. CDIC and OSFI follow the *OSFI-CDIC Guide to Intervention for Federally Regulated Financial Institutions*, which is public and clearly sets out what intervention tools CDIC and/or OSFI may use and when a financial institution could expect those tools to be used. ✓ The safety-net participants have generally adequate operational independence and necessary powers to act in a timely manner.
Principle 16: Effective Resolution Processes	✓ CDIC is part of an effective failure resolution process. The authority for OSFI to determine that an institution is no longer viable and to trigger resolution actions of CDIC (bridge banks or FIRP) is clearly set out in legislation. ✓ CDIC has a suite of tools to resolve the institution—including but not limited to depositor payout. However, some of the most important resolution tools can only be activated based on governmental approval. ✓ CDIC is called upon to resolve the institution in a manner that minimizes its exposure to loss. ✓ The basis for CDIC to terminate its policy of deposit insurance is also clearly stated in the legislation.
Principle 17: Reimbursing Depositors	✓ CDIC has the necessary legal, technological and human resources infrastructure to reimburse depositors promptly after a failure, in compliance with the *CDIC Act*.
Principle 18: Recoveries	✓ CDIC shares in the proceeds of recoveries from the estates of failed member institutions. The claims of the insured depositors of the failed institution are subrogated to CDIC. There is no depositor preference. ✓ The recoveries process is guided by commercial considerations, which balance the need to minimize the costs of a lengthy liquidation with achieving the highest gross realizations from the assets.

Appendix IV. Bail-in within Resolution

Bail-in encompasses the power to write down equity and unsecured and uninsured creditor claim to absorb losses, convert unsecured and uninsured creditor claims into equity, and convert or write-down any outstanding contingent capital instruments that have not already been triggered according to their terms.

Bail-in must respect the hierarchy of claims in liquidation. Equity should absorb losses first, then subordinated debt (including all regulatory capital instruments), and finally senior unsecured debt. Creditors should have the right to compensation where they do not receive at least the amount they would have received in a liquidation of the ailing financial institution (the "no creditor worse off" principle).

There are several additional design elements that need to be addressed by the legal framework to make bail-in an effective resolution tool:

- **Triggers for bail-in** —Generally, the triggers should be consistent with those used for other resolution tools—for example, where a financial institution is no longer viable or is likely to be no longer viable and has no reasonable prospect of becoming so. This threshold should be before the institution is balance-sheet insolvent and before all equity has been wiped out.
- **Scope of Application**—Certain types of liabilities should not be subject to bail-in. While equity and subordinated debt should first absorb losses, the *Key Attributes* exclude secured creditor claims and insured deposits and leave open the possibility of excluding other liabilities that are of systemic or strategic importance (e.g. inter-bank deposits, payment and settlement obligations, and trade-finance obligations).
- **Effect on Financial Contracts**—Bail-in should not trigger contractual rights of acceleration, termination, or set-off as long as the substantive obligations under the relevant contracts continue to be performed, subject to the creditor safeguards regarding respect for the hierarchy of claims and the "no creditor worse off" principle.
- **Safeguards and Judicial Review**—As is the case with other resolution powers and in the interests of financial stability, it would be preferable if, subject to a country's own constitutional framework, bail-in can be exercised as part of an administrative (as opposed to judicial) process that is subject to ex-post judicial review to ensure that the authorities act within the scope of their legal powers.