Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Industry Consultation on OSFI's Review of the *Assessment of Financial Institutions Regulations, 2001* for Banks, Authorized Foreign Banks, Trust and Loan Companies, and Cooperative Credit Associations

Office of the Superintendent of Financial Institutions (OSFI)
October 2013

255 Albert Street
Ottawa, Canada
K1A 0H2

www.osfi-bsif.gc.ca

Table of Contents

A. PURPOSE

OSFI has undertaken a review of the *Assessment of Financial Institutions Regulations, 2001* (the Regulations) for banks, authorized foreign banks, trust and loan companies, and cooperative credit associations (collectively referred to as “federally regulated entities” or “FREs”)[1] to ensure that the distribution of OSFI’s expenses through assessments appropriately reflects the time and resources that OSFI devotes to supervising and regulating (hereinafter referred to as “supervising” or “supervision” of) individual FREs. This consultation paper:

- provides a brief overview of the current assessment methodology for FREs;
- identifies and discusses key considerations in developing a new assessment methodology;
- proposes new measures on which to base assessments;
- proposes updates to the minimum assessment methodology; and,
- summarizes the aggregate impact of the proposed changes on FREs.

This consultation process is an essential part of how OSFI ensures transparency in the regulatory development process and identifies issues or unintended consequences that may result from proposed regulatory changes. OSFI looks forward to receiving and considering industry feedback on the proposed amendments.

B. CURRENT ASSESSMENT METHODOLOGY

Section 23 of the *Office of the Superintendent of Financial Institutions Act* (the OSFI Act) provides that before the end of each calendar year, the Superintendent shall ascertain the total amount of expenses incurred during the immediately preceding fiscal year in connection with the administration of the *Bank Act* (the BA), *Trust and Loan Companies Act* (the TLCA), *Cooperative Credit Associations Act* (the CCAA) and the *Insurance Companies Act*. The OSFI Act also provides that the Governor-in-Council may make regulations prescribing the assessment methodology for each type of financial institution, and that each financial institution shall be assessed in accordance with the methodology prescribed by the Regulations, which is summarized below.

1. Base Assessments

Paragraphs 2(*a*) through (*c*) of the Regulations provide that the basis of calculation will be:

- banks and trust and loan companies – the average total assets during the fiscal year ending on March 31 of that year;

[1] OSFI recently consulted separately on proposed changes to the assessment methodology for federally regulated insurers: http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/notices/osfi/inscnsregs_e.pdf

- authorized foreign banks – the average total assets in Canada during the fiscal year ending on March 31 of that year; and,
- cooperative credit associations – the average total assets during the immediately preceding calendar year.

Sections 4 and 5 of the Regulations prescribe the formulae to be used to determine the base assessments under each of the BA, TLCA, and CCAA. FREs subject to the BA and TLCA are grouped together, and those FREs subject to the CCAA are addressed separately.

More specifically, the formulae require the Superintendent to determine the combined expenses incurred in connection with the administration of both the BA and TLCA, and to separately determine the expenses incurred in connection with the administration of the CCAA. After having regard for minimum assessments (discussed in the following section), assessment surcharges, service charges, and other revenues relating to the administration of these statutes, the formulae calculate each FRE's share of the remaining expenses based on its pro-rata share of average total assets.

Section 4 of the Regulations does, however, limit the base assessment to $10,000 for a loan company and for an authorized foreign bank that is subject to the restrictions and requirements referred to in subsection 524(2) of the BA (referred to as a "lending branch").

2. *Minimum Assessments*

Section 4 of the Regulations also prescribes the methodology for determining the applicable minimum assessment for FREs subject to the BA and TLCA[2], whereby one of ten different minimum assessments is applied in accordance with specified classes of average total assets. These minimum assessments range from $10,000 for a FRE with average total assets equal to or less than $50 million to as much as $275,000 for a FRE with average total assets greater than $50 billion.[3]

Section 5 of the Regulations prescribes a minimum assessment of $10,000 for FREs subject to the CCAA.

Subject to the exception noted in footnote 2, a FRE's fixed minimum assessment is added to the variable assessment to arrive at a FRE's base assessment for a fiscal year.

---

[2] A lending branch is not charged a minimum assessment since its base assessment is capped at $10,000.

[3] The Regulations provide that, regardless of its size, a loan company that is a subsidiary of a bank is charged a minimum assessment of $10,000.

C. KEY CONSIDERATIONS IN DEVELOPING A NEW METHODOLOGY

OSFI has identified three key considerations that should drive the design of an updated assessment methodology.

1. Best Proxy of OSFI Time and Resources

The policy objective supporting the design of the existing assessment methodology is to allocate OSFI expenses among FREs in a way that most accurately reflects the time and resources OSFI spends supervising individual FREs. When reviewing the Regulations in 2001, OSFI viewed "average total assets" to be the best unit of measure on which to base assessments for FREs because this figure generally reflected the size of a FRE, and the size of a FRE was viewed as a sound proxy for the time and resources OSFI spent supervising individual FREs.

While the original policy objective has not changed, OSFI is considering whether "average total assets" (i.e., FRE size) continues to be the best proxy for the time and resources OSFI devotes to supervising individual FREs. During the recent financial crisis, for example, OSFI found that the risk profile of a FRE was also a significant driver of OSFI's resources. Further, any new methodology should consider the implications of post-crisis reforms, such as the greater level, extent, and intensity of supervision of domestic systemically important banks (DSIBs).[4] As such, OSFI is proposing an assessment methodology that is aligned with OSFI's risk-based supervisory framework, the latter of which drives OSFI's supervisory planning processes and resource allocation decisions.

2. Implications of the International Financial Reporting Standards

The International Accounting Standards Board develops International Financial Reporting Standards (IFRS) that many countries have chosen to adopt, including Canada. For annual periods beginning on or after January 1, 2011, in Canada, publicly accountable entities were required to adopt IFRS, including all FREs.

International Accounting Standard (IAS) *27, Consolidated and Separate Financial Statements* and *Standing Interpretations Committee (SIC) 12, Consolidated – Special Purpose Entities* require that many Canadian securitizations and off-balance sheet structures be reported on the balance sheets of FREs. Further, *IAS 39 Financial Instruments: Recognition and Measurement* permits fewer assets to be derecognized in comparison to those permitted previously under Canadian Generally Accepted Accounting Principles (CGAAP).

While the impact of moving from CGAAP to IFRS will vary depending on the activities and investments of each FRE, the above-noted accounting changes have the greatest

[4] In March 2013, OSFI published an *Advisory – Domestic Systemically Importance and Capital Targets – DTIs* to identify DSIBs and to address a number of the principles in the Basel Committee on Banking Supervision's October 2012 *framework for dealing with domestic systemically important banks*.

potential to significantly affect reported assets, the basis of the current assessment methodology, potentially affecting the distribution of OSFI's expenses across FREs relative to the actual time and resources OSFI devotes to supervising these FREs.

3. Simplicity and Flexibility

OSFI believes that the assessment methodology should be both simple and flexible. A straightforward assessment methodology will facilitate OSFI's calculation of assessments, maintaining regulatory transparency.

Although a single assessment methodology would ideally be applied across all financial institution sectors, the methodology would have to be sufficiently flexible to accommodate the differences between different types of institutions. Further, any new methodology should be sufficiently flexible to remain up-to-date over time, and not be materially and adversely impacted by accounting and other changes to international standards.

D. PROPOSED ASSESSMENT METHODOLOGY

OSFI is proposing to make two changes to its current assessment methodology. The first change would amend the basis on which minimum and base assessments are currently calculated (i.e., "average total assets"). The second proposed change updates the minimum amount assessed and proposes a methodology to help these minimum charges keep pace with growth in base assessments over time.

1. Capital Adequacy Requirements / Capital Equivalency Deposit

While OSFI considered and analysed different assessment options, it proposes to base its new assessment methodology on the capital adequacy requirements for Schedule I and Schedule II Banks[5], trust and loan companies, and cooperative credit associations, and on the capital equivalency deposit for Schedule III Banks[6], as defined in OSFI's capital adequacy and capital equivalency guidelines.[7] More specifically, OSFI proposes to amend the Regulations to provide that the basis for calculating assessments will be:

a) ***risk-weighted assets*** for Schedule I and Schedule II Banks, and for trust and loan companies;

[5] Schedule I Banks are listed in Schedule I of the BA and include Canadian owned and incorporated banks. Schedule II Banks are listed in Schedule II of the BA and include Canadian incorporated subsidiaries of foreign banks.

[6] Schedule III banks are listed in Schedule III of the BA and include foreign bank branches registered in Canada – both full-service branches and lending branches.

[7] http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=527

b) ***total borrowings divided by the borrowing multiple*** for cooperative credit associations (subsequently referred to as "the borrowing multiple calculation");[8] and,

c) the ***capital equivalency deposit*** for Schedule III Banks.[9]

OSFI has concluded that using the capital adequacy requirements[10] and capital equivalency deposit offer a number of benefits relative to the three key considerations that OSFI determined should drive the design of an updated assessment methodology:

- OSFI's capital adequacy and capital equivalency requirements are aligned with OSFI's risk-based approach to supervision:
    - risk-weighted assets is a risk-sensitive measure and therefore serves as a strong proxy for the time and resources OSFI spends supervising individual FREs, including DSIBs;
    - the borrowing multiple calculation and capital equivalency deposit are liability-based measures that will grow or contract concurrent with changes in liabilities.
- OSFI has well-established capital adequacy and capital equivalency frameworks – any future adjustments to these frameworks would only serve to better refine the allocation of OSFI's expenses and the accuracy of assessments.
- The assessment base under the proposed methodology will be less prone to major impacts resulting solely from future accounting changes.
- The proposed measures are simple in that each is obtained from a single item on the quarterly and annual returns.
- The base assessment calculation is simplified by relying on a point-in-time, year-end data point instead of an average.
- The minimum assessment calculation is simplified by eliminating the ten different minimum assessment categories.

2. Minimum Assessments

In addition to modifying the basis for calculating assessments, OSFI also proposes to update and simplify the minimum assessment methodology and the minimum amounts assessed. Although minimum assessment charges represent a small percentage of total assessments, they have not been updated in more than ten years, and have not kept pace with increases in base assessments.

8 A cooperative credit association's total borrowings would be divided by 20 (the borrowing multiple/limit) to determine the institution's capital adequacy requirement.

9 A lending branch is required to maintain a capital equivalency deposit of $100,000. A full-service foreign bank branch is required to maintain a capital equivalency deposit equal to the greater of $5.0 million or 5 per cent of Canadian liabilities.

10 Pursuant to the structure of OSFI's Guidelines the term "capital adequacy requirements" refers to both risk-weighted assets and borrowing multiple calculation.

As shown in Table 1, the total value of assessments for all FREs has increased by approximately 157 per cent from 2000 to 2010, while the total value of minimum assessments has increased by approximately 29 per cent. These results reflect the fact that OSFI's costs have increased significantly while the minimum assessment has been held constant.

Table 1 – All FREs

	Final 1999-2000	Final 2009-2010	Change
Total Assessments	19,256,211	49,445,148	157%
Sum of Minimum Assessments	5,190,000	6,695,000	29%

Regardless of a FRE's size, OSFI performs a minimum amount of supervision for each FRE. OSFI has determined that it spends a minimum of thirty to thirty-five days per year supervising small FREs other than lending branches and cooperative credit associations, and fifteen to twenty days per year on lending branches and cooperative credit associations. Using a conservative rate of $1,000 per day, this would equate to a cost of $30,000 - $35,000 and $15,000 - $20,000, respectively.

In light of the foregoing, OSFI proposes to simplify the current assessment methodology by replacing the current multi-minimum approach with a single minimum assessment of $30,000 for all FREs other than lending branches and cooperative credit associations, and a single minimum assessment of $15,000 for lending branches[11] and cooperative credit associations. OSFI also proposes to annually index, based on the Consumer Price Index, minimum assessments to help minimum charges keep pace with growth in base assessments.

3. *Calculation Methodology*

The proposed assessment methodology would be calculated in accordance with the following steps:

(a) Apply the appropriate minimum assessment to each FRE.
(b) Determine the FRE's pro-rated share of expenses (using the appropriate capital adequacy and capital equivalency measure) without considering the applicable minimum assessment.
(c) **If the pro-rated share is less than** the applicable minimum assessment, the FRE is only assessed the applicable minimum amount.
(d) **If the FRE's pro-rated share is greater than** the applicable minimum assessment, the FRE is also assessed a residual amount:
   (i) The total expenses allocated to a sector less the sum of all minimum assessments (i.e., the sum of (a) for all FREs) applicable to that sector.

[11] OSFI is also proposing to remove the existing $10,000 cap on lending branches' base assessments. Going forward, it is proposed that lending branches be charged both a minimum assessment a base assessment.

(ii) The amount determined in (i) is then pro-rated over the expenses allocated to the FREs whose share of expenses is greater than the minimum (i.e., those FREs to whom (d) applies).

Please refer to Appendix 1 for a detailed summary of the proposed assessment methodology and for example calculations.

E. IMPACT OF PROPOSED CHANGES

It is important to reiterate that the changes to the assessment formula impact only the allocation of OSFI's expenses across FREs and not the total amount assessed by OSFI. As such, the proposed amendments do not generate additional revenue for OSFI.

The results that follow separately illustrate the impact of implementing the proposed change in assessment methodology (i.e., using risk-weighted assets, the borrowing multiple calculation, and capital equivalency deposit, as the basis for the assessment methodology), and the proposed changes to the minimum assessment charged.

OSFI has modeled the impact of the proposed changes using 2008 and 2009 data; this data is not affected by changes to IFRS. It should also be noted and understood that the total number of FREs may vary each year as FREs enter and exit from federal jurisdiction.

1. Base Assessments

Table 2 illustrates the impact of a change from the current average total assets calculation to the proposed capital adequacy and capital equivalency measures using past assessment periods, excluding FREs assessed the minimum under the new methodology.

Table 2 – All FRE (Excluding Minimum Assessed FREs)

	# of FREs	Change in Assessment from Asset Method		
		< 15% change	Between 15% and 50% change	Greater than 50% change
2008				
Increase	14	4	7	3
Decrease	34	6	15	13
2009				
Increase	19	8	7	4
Decrease	34	4	13	17

Table 2 illustrates that a change to the proposed measures would benefit the majority of FREs, with approximately two-thirds experiencing decreases in their assessments. OSFI believes that this outcome better reflects the distribution of time and resources among these institutions.

2. *Minimum Assessment*

Table 3 uses 2009 assessment data to illustrate the impact of the proposed changes to the minimum assessment methodology. Total expenses recovered through minimum assessments would decrease by 40 per cent. This decrease is the result of moving from the current multi-minimum approach that can require minimum assessments as high as $275,000, to a minimum assessment of $15,000 for lending branches and cooperative credit associations and $30,000 for all other FREs.

Table 3 – All FREs

2009-10	Minimum			
	Current Assessment Methodology (scaled amounts)		Proposed Assessment $30,000 / $15,000	
	Total Minimum Assessments	% of FRE Assessment	Total Minimum Assessments	% of FRE Assessment
Banks	3,560,000	7.20%	1,350,000	2.73%
AFB	1,120,000	2.27%	795,000	1.61%
T&L	1,955,000	3.95%	1,800,000	3.64%
Coops	60,000	0.12%	90,000	0.18%
Total	**6,695,000**	**13.54%**	**4,035,000**	**8.16%**

As previously discussed, there is a minimum amount of time that OSFI spends supervising any FRE. The proposed minimum assessment methodology would better reflect this minimum amount of time, and would provide for the allocation of any residual expenses based on the capital adequacy and capital equivalency frameworks. OSFI believes that this outcome would better reflect the distribution of time and resources among these FREs.

F. OTHER CONSIDERATIONS

The current Regulations not only address the minimum and base assessments of financial institutions, they also prescribe the assessment surcharge methodology for OSFI to recover additional expenditures associated with supervising FREs that have been staged by OSFI. Accordingly, OSFI also reviewed whether the surcharge calculation should be amended.

OSFI concluded that no change to the current surcharge methodology would be required.

G. CONCLUSIONS

OSFI has concluded that the proposed assessment methodology, based on capital adequacy requirements and capital equivalency deposit, would permit the allocation of OSFI expenses in a manner that more closely reflects the actual time and resources spent regulating and supervising individual FREs, including DSIBs. It is a simplified approach as well as a methodology that better reflects OSFI's regulatory and supervisory practices and resource allocation decisions. In addition, the proposed methodology would be less prone to major impacts resulting solely from future accounting changes.

Finally, OSFI believes that the proposed minimum assessment amounts, and subsequent annual indexing, would help minimum charges keep pace with growth in base assessments.

H. INDUSTRY CONSULTATION

OSFI invites all FREs and industry associations to participate in this consultation process by submitting comments to:

Philipe-A. Sarrazin
Managing Director, Legislation and Policy Initiatives
255 Albert St
Ottawa ON K1A 0H2
philipe.sarrazin@osfi-bsif.gc.ca

The consultation will be conducted for a period of 45 days from the publication of this document.

OSFI will review all comments received and report back to industry on the outcome of this consultation and next steps.

Proposed Calculation Methodology for FREs

Given a Minimum Assessment (A) = $15,000 (Restricted Foreign Bank Branches or Coops) or $30,000 (all other FREs)

the base assessment of a financial institution that is a FRE will be equal to:

a) A, if A > H

where

H = G/D*B, and represents the initial cost allocated to the institution for each Sector
G = Institution Risk Weighted Assets (RWA), Capital Equivalency Deposit (CED), or Borrowing Multiple Calculation (BMC)
D = Sum of RWA, CED, and BCM for all institutions
B = OSFI's costs to be recovered for each Sector

or

b) A,

plus, an amount determined by

C/E*(B-F)

where

C = H-A
E = Sum of C for all institutions in each Sector
B = OSFI's costs to be recovered for each Sector
F = Sum of the minimum assessments for each Sector

this amount to be indexed annually

CALCULATION EXAMPLES

	(G) RWA, CED or BMC
Institution 123 with a reported Risk Weighted Capital of:	2,000,000
Institution 234 with a reported Required Capital of:	5,000

where

Minimum assessment* **(A)**:	$30,000
OSFI's costs to be recovered **(B)**:	$43,908,064
Sum of RWA, CED, and BMC (**D**):	$1,248,198,802
Sum of C **(E)**:	$42,000,918
Sum of minimum assessments **(F)**:	$3,945,000

	A = Minimum Assessment	**Residual Assessment**	**Total Assessment**
Institution 123	30,000	38,396	68,396
Institution 234	30,000	0	30,000

* in this example a bank is modelled