INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

11 King Street West, Suite 1600, Toronto ON M5H 4C7
T 416.364.2754 | F 416.364.4861

www.iiac.ca

May 27, 2019

Brian Rumas
Director – Bank Capital, Capital Division
Office of the Superintendent of Financial Institutions Canada
255 Albert Street
Ottawa, Canada
K1A 0H2

Via email: Brian.Rumas@osfi-bsif.gc.ca

Dear Brian,

RE: Treatment of Provincial Bonds within Canada's FRTB Framework

The Investment Industry Association of Canada (the "IIAC") often reviews regulatory or policy reforms to determine what impact, if any, such reforms would have on the functioning of domestic capital markets. The IIAC relies extensively on the experience and deep market knowledge of its Members to help form industry positions. Recently, IIAC Members considered the potential impact domestic implementation of the Fundamental Review of the Trading Book ("FRTB") could have on our provincial bond market, and our capital markets broadly. Our review has prompted this request for confirmation from OSFI that Canadian provincial bonds will not be subject to any credit spread charge within OSFI's FRTB framework.

Background

Provincial governments are among the largest, and most frequent, issuers of debt in Canada. Since the 2007–09 global financial crisis, the total value of Canadian provincial bonds outstanding has more than doubled. At the end of the second quarter of 2018, provincial bonds made up 24 per cent of the total outstanding bonds denominated in Canadian dollars[1]. There are now more provincial bonds outstanding than Government of Canada (GOC) bonds (See Chart 1).

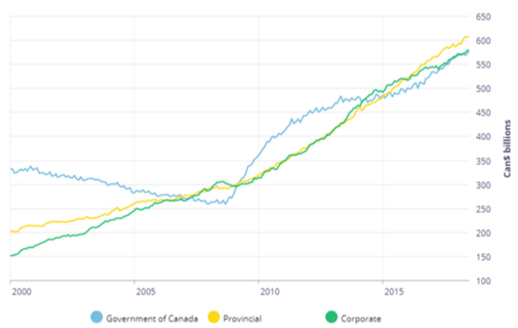
Provincial bonds are also considered some of the safest and most liquid bonds in Canada evidenced by their volume of trading (See Chart 2). Furthermore, Canadian provinces have their own taxing authority

[1] Bank of Canada Staff Analytical Note 2018-30

and an economic base that is stronger than that of some sovereign jurisdictions, which has allowed for provincial debt securities to be treated as HQLA L1 outside of Canada.

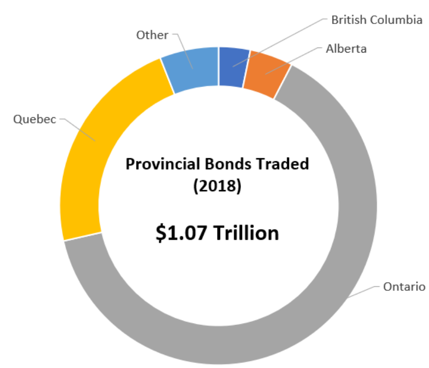
Chart 1: Total Value of Bonds Outstanding

Canadian-dollar-denominated bonds, outstanding amount by category



Source: Bank of Canada Staff Analytical Note 2018-30

Chart 2: Trading in Provincial Bonds (2018)



Source: IIROC Market Trading Reporting System, IIAC

Industry Concerns

Canadian Banks and Dealers are among the largest holders of provincial bonds. We remain concerned that there has yet to be confirmation from OSFI that provincial bonds will be treated as obligations of the sovereign, with a corresponding 0% risk-weight, as currently exists in the OSFI Capital Adequacy Requirements (CAR) guideline[2]. Provincial bonds are underwritten and marketed by Canadian banks, and this relationship represents an important source of liquidity to the provincial debt markets in Canada.

Should a risk-weight be levied on provincial bonds as part of Canada's FRTB framework, the higher cost associated with holding these securities would lead dealers to reduce their provincial bond inventories. The diminished demand for provincial securities from banks and dealers could impair market functioning through less (or more costly) market intermediation activities (ie. market making, hedging, underwriting, etc) provided by these financial institutions. Market liquidity will suffer as a result.

Reduced demand for provincial bonds from banks and dealers could also result in upward pressure on provincial credit spreads. Any upward pressure on provincial credit spreads could impact market participant behaviour which could also hurt market functioning. From a fiscal perspective, a sustained widening in provincial credit spreads could lead to increased debt servicing costs for provincial governments.

---

[2] See OSFI CAR, Chapter 9, section 9.10.11.1 Specific Risk, para. 56: "The treatment of a sovereign asset under the standardized approach to specific risk is based on its rating. Obligations of Canadian provinces are treated as obligations of the government of Canada for the purpose of specific risk factors in the framework."

Members have also noted concern that there has yet to be confirmation that under the FRTB Internal model approach, for the DRC model, the probability of default (PD) for Canadian provinces exposures, as well as for Canadian Government exposures, will not be subject to a floor of 0.03% as proposed by the BCBS[3] consistent with the actual OSFI Capital Adequacy Requirements (CAR) guidelines IRB approach for credit risk[4].

Recommendation

While FRTB is an agreed international standard, its implementation will rest in various regional and national rules. OSFI can calibrate FRTB in order to better smooth its effects on Canadian markets. Recent consultations and discussions with OSFI and the Bank of Canada on the topic of the Net Stable Funding Ratio (NSFR), recognized the importance of Provincial bonds, with OSFI amending the Required Stable Funding (RSF) factor of all Level 1 assets (government of Canada bonds, provincial bonds, NHA MBS and CMB) to 0%.

We request confirmation that OSFI will continue this approach and align provincial bonds with sovereign treatment in the upcoming draft of the FRTB framework for Canada.

Sincerely,

Jack Rando
Managing Director
Investment Industry Association of Canada

[3] BCBS, January 2019, Minimum capital requirements for market risk, para. 33.24
[4] OSFI CAR, Chapter 6, section 6.2.1 Specific Risk, para. 27

IIACACCVM
11 King Street West, Suite 1600, Toronto ON M5H 4C7 | T 416.364.2754 | F 416.364.4861 | www.iiac.ca