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Canada
Deposit Insurance
Corporation

Société
d'assurance-dépôts
du Canada

CDIC Differential Premiums System

July 25, 2022

Canada

Table of Contents

Foreword 4

Background 5

Overview of the Current DPS 5

- Qualitative Criteria 5
- Quantitative Criteria 6
- Premium Category Classification and Calculation of Premiums Payable 6

DPS Objective and Principles 8

Context and Environmental Considerations 9

Summary of the Results of the DPS Review 10

DPS Framework Review: Proposals 14

- Number of Premium Categories 14
- New Member Policy 16
- Frequency of Assessment 16
- Return of Insured Deposits (RID) Filings 17

Regulatory Criteria 18

- OSFI Examiner Rating (25 points) 19
- CDIC Risk and Resolvability Rating (15 points) 19
- CDIC Risk Assessment Methodology 19
- CDIC Rating: Resolvability 20
- CDIC Risk and Resolvability Rating: Scoring Methodology 21

Financial Criteria 23

- Capital Adequacy 23
- Weighting 24
- Criteria 24
- Metrics 24
- Return on Risk-Weighted Assets 26
- Mean Adjusted Net Income Volatility 28

Stress-Tested Net Income 29

Efficiency Ratio 29

Net Impaired Assets to Total Capital 30

Three-Year Moving Average Asset Growth 31

Real Estate Concentration Ratio 31

Asset Encumbrance Measure 31

Aggregate Commercial Loan Concentration Ratio 33

Liquidity and Funding 34

High-Quality Liquid Assets to Short-Term Funding 35

Net Stable Funding Ratio 35

Stable Funding Ratio 37

Brokered Deposits Measure 37

Conclusion and Next Steps 39

Annex A: Changes to the Canadian Resolution Regime 40

Annex B: Summary of Proposals 41

Foreword

The Canada Deposit Insurance Corporation (CDIC) maintains a fund — the *ex ante* fund — to protect depositors and promote financial stability. The *ex ante* fund supports the payout of depositors in the event of a CDIC member institution failure and/or the timely resolution of a member institution.

The *ex ante* fund is funded by premiums paid by CDIC member institutions, which are determined pursuant to the Differential Premiums System (DPS).

CDIC has undertaken a strategic review of the *ex ante* fund and the deposit insurance premium frameworks. The purpose of the review is to ensure that these frameworks remain responsive to developments in the member institution operating environment and support the achievement of CDIC's mandate under section 7 of the *Canada Deposit Insurance Corporation Act*, RSC 1985 c C-3 (CDIC Act). An overview of the review and its findings can be accessed at this **link**.

This document outlines the results of CDIC's comprehensive review of the DPS and describes proposed changes to the framework to improve its efficiency and effectiveness.

Comments are requested from member institutions, their associations, regulators and other interested parties on the proposals set out in this paper. Please direct your written comments by October 21st, 2022 to:

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Background

Pursuant to CDIC's mandate set out in section 7 of the CDIC Act, CDIC provides insurance against the loss of part or all of deposits in the event of a member institution failure, acts as the resolution authority for its members, and promotes and otherwise contributes to the stability of the financial system in Canada. This work is pursued for the benefit of persons having deposits with member institutions and in such a manner as will minimize the exposure of CDIC to loss.

Insurance losses arising from the failure of a member[1] are ultimately borne by the membership through the assessment and collection of premiums that flow into the CDIC *ex ante* fund.

These premiums are assessed commensurate with the financial and resolution-related risks that members pose to CDIC. The DPS (through the Differential Premiums By-law) establishes a system for classifying member institutions into different categories for annual premium rate purposes. The statutory authority for the By-law is section 21(2) of the CDIC Act.

Overview of the Current DPS

CDIC's DPS classifies member institutions into categories for the purpose of risk-based differentiation as it applies to the determination of a deposit insurance premium rate. In accordance with the *CDIC Act* and current *Differential Premiums By-law* (DPB), members are assessed annually and assigned a score from 0 to 100 points. This score aims to signal to the member institution in a timely manner the risk areas of particular importance to CDIC, and what the member should address to improve its score. The score is determined by a scorecard made up of qualitative (40 out of 100 points) and quantitative (60 out of 100 points) factors (**see Table 1**).

Qualitative Criteria

The qualitative criteria allow the DPS to incorporate information not typically captured through (backward-looking) financial metrics, such as quality of risk management and application of risk controls and mitigants by the member. These criteria are better suited to consider how new and evolving risks are measured and effectively managed by the member, as well as the ways in which these risks can impact CDIC's ability to achieve its mandate.

1 Members include Schedule I and II banks, federally regulated credit unions, loan and trust companies, and associations governed by the Cooperative Credit Associations Act that take deposits.

The qualitative criteria are based on knowledge gained by regulators and include current and forward-looking factors. The current criteria consist of the Examiner's Rating (35 out of 40 points), which is assigned by OSFI, and "Other Information" (5 out of 40 points), which is determined by CDIC and takes into consideration circumstances that represent a threat to, or compromise, the safety, soundness, financial condition, or viability of the member.

Quantitative Criteria

The quantitative criteria consist of eleven financial metrics that consider risk factors such as capital adequacy, earnings and asset quality. These metrics reflect the financial condition of a member institution and rely on information derived from financial statements and regulatory returns as required by OSFI.

The current balance between qualitative and quantitative components (i.e., 40/60) aligns with international best practice and supports transparency in scoring. CDIC proposes to maintain the current balance but will henceforth refer to these indicators as "regulatory criteria"[2] and "financial criteria" respectively.

Premium Category Classification and Calculation of Premiums Payable

Based on its score, a member is classified into one of four categories for premium purposes (**see Table 2**). Each category has a corresponding premium rate, with category 1 having the lowest premium rate and category 4 having the highest. While premium rates can vary, they are subject to a maximum of 33 basis points of a member's volume of insured deposits pursuant to section 21(4) of the CDIC Act.

In order for CDIC to determine their final premiums payable, members must estimate their volume of insured deposits by completing the Return of Insured Deposits (RID). Completion of the form results in a determination of a member's volume of insured deposits as at April 30th, which establishes a member's premium assessment base.

Once members have been assigned a score and premium category, and they have submitted their estimate of their volume of insured deposits as at April 30th, their premium payable can be calculated using the following formula, which is set out in the DPB:

2 Regulatory criteria provides a more accurate description of the qualitative indicator as, in addition to expert judgement, quantitative aspects weigh heavily into the analysis undertaken by CDIC and OSFI in determining inputs to the Examiner Rating and Other information scores.

A × B × C, where:

- **A** is the legislated maximum premium rate (33bps of a member's volume of insured deposits),
- **B** is the volume of insured deposits (i.e. current assessment base), as at April 30,
- **C** is the risk-based rate determined pursuant to the Differential Premiums By-law assessment.

Table 1 and 2 summarize the DPS[3] in effect as of this document's publication date.

Table 1: CDIC Differential Premiums System Summary Scorecard

Criteria or Factors	Maximum Score
Qualitative:	
Examiner's Rating	35
Other Information	5
Sub-total: Qualitative Score	**40**
Quantitative:	
Capital Adequacy — Leverage Ratio	10
Capital Adequacy — Tier 1 Capital Ratio	10
Return on Risk-Weighted Assets	5
Mean Adjusted Net Income Volatility	5
Stress-Tested Net Income	5
Efficiency Ratio	5
Net Impaired Assets to Total Capital	5
Three-year Moving Average Asset Growth	5
Real Estate Asset Concentration (Non-D-SIBs only)	5
Asset Encumbrance Measure (D-SIBs only)	5
Aggregate Commercial Loan Concentration Ratio	5
Sub-total: Quantitative Score	**60**
Total Score	**100**

3 Detailed description of the system is available on the CDIC website in the Differential Premiums Manual available at: **Differential Premiums By-law Manual (cdic.ca)**

Table 2: Premium Categories

Score	Premium Category
≥ 80	1
≥ 65 but < 80	2
≥ 50 but < 65	3
< 50	4

DPS Objective and Principles

The core objective of the DPS is *to: send an early warning signal — with financial consequences — to the management and board of directors of a member institution concerning the risk (i.e., likelihood of failure and resolvability*[4]*) the member poses to CDIC*.

The following overarching principles underpin the design of the DPS; the system should:

- define risk-based premium categories that reflect the relative risk posed to CDIC by a member institution,
- differentiate members within categories based on the risk they pose to the *ex ante* fund as well as CDIC's ability to efficiently resolve the member institution,
- provide incentive for member institutions to achieve the best premium classification,
- consider both financial and regulatory factors,
- be transparent in application so that member institutions understand the factors CDIC must apply and the manner in which CDIC administers the DPS. This helps members take the necessary actions to achieve the best premium category and ensures procedural fairness,
- be administratively efficient and minimize burden on the member institutions, and
- be congruent with generally accepted accounting/reporting standards.

The DPS principles are aligned with the ***Core Principles for Effective Deposit Insurance Systems*** (Core Principles) introduced by the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS), and with the updated IADI ***General Guidance for Developing Differential Premium Systems***.

4 Resolvability refers to the effectiveness and efficiency with which the failure of a member institution can be resolved through the use of CDIC's powers, without material impact to depositors and the stability of the financial system.

Context and Environmental Considerations

Commencing with the 1999 premium year, each member institution has paid annual premiums at a rate dependent upon its classification into one of four premium categories under the DPB.[5] Pursuant to the DPB, CDIC classifies members into premium categories based on regulatory and financial risk indicators. A DPS helps to reduce potential cross-subsidization of risk across member institutions that can occur under a flat premium structure and provides incentives to member institutions to achieve a better premium category.

CDIC last conducted a review of the DPS in FY2013/2014, focused on amendments to the DPS' financial criteria. The review assessed the impact on financial statements of initiatives such as Basel II and III, the transition to International Financial Reporting Standards (IFRS) and the designation of certain member institutions as domestic systemically important banks (D-SIBs). The review resulted in adjustments to several metrics that assess risks under financial criteria and the introduction of an asset encumbrance metric.

Since the last review, substantive regulatory framework measures have been implemented to improve the safety and soundness of CDIC member institutions and expand statutory resolution tools and authorities available to CDIC (**please see Annex A**).

Strengthened supervisory measures include the finalization of Basel III regulatory requirements. Basel III places a greater focus on liquidity adequacy and funding stability, measured through metrics such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Liquidity and funding are key factors influencing the risk profiles of member institutions; as such, the introduction of funding and liquidity-related measures into the DPS' financial criteria is under consideration.

As Basel III implementation reaches its final stages, OSFI has begun to tailor capital and liquidity expectations for small- and medium-sized banks (SMSBs).[6] CDIC proposes alternatives to certain DPS financial criteria for those members that may be impacted by these new OSFI requirements.

The pace of change and innovation within the financial sector continues to present new and evolving financial and non-financial risks that will continue to impact the safety and soundness of the membership.

Resolution measures since the last review include the designation of CDIC as the resolution authority for its members (2017), strengthening of member institution recovery and resolution frameworks, and the introduction of new tools for the resolution of systemically important banks (SIBs) and subsequent build-up of loss absorbing capacity for these banks in Canada.

5 Prior to 1999, all member institutions paid the same premium rate (i.e., a flat rate premium structure).

6 **Small and Medium-Sized Deposit-Taking Institutions (SMSBs) Capital and Liquidity Requirements**

Existence of impediments to an orderly resolution in the event of a member failure can lead to an increased loss exposure for CDIC, and thereby increase costs for the surviving members as contributors to the *ex ante* fund, and result in a disruption to depositors and financial sector stakeholders leading to increased risks to the stability of the financial system in Canada.

Several requirements contained in CDIC by-laws are aimed at reducing the resolvability risks. For example, the *Data and System Requirements By-law* (DSRB) support CDIC in ensuring that it can effectively make an insurance determination and execute a payout of insured deposits of a member, as one of the resolution strategies for its members. Given the expansion of CDIC's mandate since the last DPS review to include resolution authority and CDIC's expanded resolution toolkit, CDIC has examined inclusion of resolvability risks into the DPS.

Summary of the Results of the DPS Review

In light of the significant changes in the operating environment and CDIC's experience in the administration of the DPS, CDIC proposes several strategic changes to the DPS framework. CDIC's objective is to ensure that the proposed framework changes and scorecard adjustments make the DPS fit for purpose for the years to come.

CDIC's analysis identified several areas to modernize the DPS to reflect the evolving statutory, supervisory, risk and operating environment for MIs:

(i) Improve the risk sensitivity of score results to improve differentiation and minimize cross-subsidization,

(ii) Adapt metrics to better reflect key financial regulatory and resolvability developments (e.g., Basel III changes, bail-in, liquidity/funding metrics, etc.), and

(iii) Improve the ability of the DPS framework to meet its objective to serve as a timely signal to management and the board of directors of a member institution of heightened member risk to CDIC.

This section provides a summary of the key proposals of the DPS review.

CDIC proposes that the number of premium categories be increased from 4 to 5 to improve the ability of the DPS to differentiate members appropriately and fairly. In order for the DPS to better serve as a timely signal of heightened member risk, CDIC proposes increasing the frequency of classification of members into premium categories from annual to quarterly. With respect to new members, CDIC proposes that new members be placed in category 2 for the first two years of membership, unless staged by OSFI, in which case they would be downgraded commensurate with their risk profile.

The current DPS differentiates members based on regulatory and financial criteria, according to a 40/60 split. The proposed framework will retain this split. Within the Regulatory criteria the current framework allocates 35 points to OSFI as the examiner and 5 points to CDIC. CDIC's proposed framework recommends increasing the CDIC component (i.e., currently called "Other Information") from 5 to 15 points. Going forward, this CDIC component will be referred to as the "CDIC Risk and Resolvability Rating" and expanded to incorporate both CDIC's assessment of factors contributing to the likelihood of failure and the assessment of resolvability challenges for a member institution. The increase in CDIC's component will be offset by an equal reduction in the Examiner Rating component (i.e., from 35 to 25 points).

CDIC proposes to reduce the weight of the capital adequacy components of the Financial Criteria from 20 to 10 points. Proposed adjustments to capital metrics will more clearly differentiate between D-SIBs, Category I/II SMSB or Category III SMSB, and align better with OSFI capital rules. The reduction in weight would be offset by a proposed introduction of funding and liquidity metrics in the Financial Criteria.

With respect to metrics focused on earnings, CDIC proposes to retain the Return on Risk-Weighted Assets metric and Mean Adjusted Net Income Volatility metric, though with some modification. CDIC proposes to remove the Stress Tested Net Income metric due to its correlation with other earnings-related metrics. Similarly, CDIC proposes to eliminate the Efficiency Ratio due to correlation with other profitability metrics and the Regulatory DPS criteria.

CDIC proposes no changes to the Aggregate Commercial Loan Concentration Ratio metric and three-year Moving Average Asset Growth metric. An adjustment to the thresholds for the Net Impaired Assets to Total Capital metric is proposed to improve risk capture and differentiation across the membership. CDIC proposes that the Real Estate Asset Concentration also be applied to D-SIBs going forward with a weight of 5 (out of 100), and that a modified Asset Encumbrance metric be applied to all members under the proposed DPS.

Table 3 and 4 summarize the proposed DPS scorecard as applied to D-SIBs and non-D-SIBs and provides highlights of changes from the current framework.

Proposed framework changes and changes to DPS scorecard are elaborated in detail in the sections that follow.

Table 3: Proposed Differential Premiums System Scorecard

Proposed Non-D-SIB Criteria	Weight	Proposed D-SIB Criteria	Weight
REGULATORY			
• Examiner Rating • CDIC Risk and Resolvability Rating	25 15	• Examiner Rating • CDIC Risk and Resolvability Rating	25 15
Within the Regulatory criteria the current framework allocates 35 points to OSFI as the examiner and 5 points to CDIC's risk rating. CDIC proposes increasing the CDIC Risk and Resolvability Rating component from 5 to 15 points, offset by an equal reduction in the Examiner Rating (i.e., OSFI) component (from 35 to 25 points).			
Sub-total: Regulatory Score	**40**	**Sub-total: Regulatory Score**	**40**
FINANCIAL			
Capital Adequacy[7] • CET-1 and Total Capital Combined Ratio • Leverage Ratio	 5 5	**Total Loss Absorbing Capacity** • CET-1 and Risk-Based TLAC Combined Ratio • TLAC Leverage Ratio	 5 5
CDIC proposes to reduce the weight of the capital adequacy section from 20 to 10 points. Proposed adjustments to capital metrics will also more clearly differentiate between D-SIBs, Category I/II SMSB or Category III SMSB, and align better with OSFI capital rules.			
Earnings • Return on Risk-Weighted Assets • Mean Adjusted Net Income Volatility	 5 5	**Earnings** • Return on Risk-Weighted Assets • Mean Adjusted Net Income Volatility	 5 5
The current DPS includes two additional earnings metrics (the Efficiency Ratio and Stress Tested Net Income metrics). CDIC proposes removing these metrics as the associated risks are captured by other profitability metrics and within the Regulatory DPS criteria. CDIC proposes to alter the scoring thresholds for the Mean Adjusted Net Income Volatility and Return on Risk-Weighted Assets metrics as well.			

7 Category III SMSBs will be scored based on **Simplified Risk-Based Capital Ratios for CET-1 and Total Capital** per OSFI guidelines and will not be subject to Leverage Ratio. Instead, CET-1 and Total Capital Ratios will be worth 10 points for those institutions.

Proposed Non-D-SIB Criteria	Weight	Proposed D-SIB Criteria	Weight
Asset Quality/Concentration • Net Impaired Assets to Total Capital Ratio • Three-Year Moving Average Asset Growth Ratio • Real Estate Asset Concentration Ratio • Aggregate Commercial Loan Concentration Ratio	 5 5 5 5	**Asset Quality/Concentration** • Net Impaired Assets to Total Capital Ratio • Three-Year Moving Average Asset Growth Ratio • Real Estate Asset Concentration Ratio • Aggregate Commercial Loan Concentration Ratio	 5 5 5 5
While these Asset Quality measures remain unchanged from the existing DPS, CDIC proposes that the Real Estate Asset Concentration ratio be introduced for D-SIBS (and continue to apply for non-D-SIBs). The thresholds applied to the Net Impaired Assets to Total Capital ratio are proposed to be altered to more effectively differentiate between CDIC members.			
Encumbrance/Pledging • Asset Encumbrance Measure	 5	**Encumbrance/Pledging** • Asset Encumbrance Measure	 5
The Asset Encumbrance Measure applies to D-SIBs under the existing DPS. CDIC proposes that the Asset Encumbrance Measure now also be applied to non-D-SIBs.			
Liquidity and Funding • HQLA to Short-term Funding Ratio • Stable Funding Ratio • Brokered Deposits Ratio	 5 5 5	**Liquidity and Funding** • HQLA to Short-term Funding Ratio • Net Stable Funding Ratio	 5 10
Liquidity and funding risks are not separately captured under the current DPS scorecard, CDIC is now proposing that 15 points be allocated to criteria measuring risk from both liquidity profile and funding profile dimensions.			
Sub-total: Financial Score	**60**	**Sub-total: Financial Score**	**60**
Total Score	**100**	**Total Score**	**100**

Table 4: New Premium Categories

Score	Premium Category
≥ 90	1
≥ 80 but < 90	2
≥ 65 but < 80	3
≥ 50 but < 65	4
< 50	5

DPS Framework Review: Proposals

This section outlines the detailed proposals to modernize and strengthen the DPS.

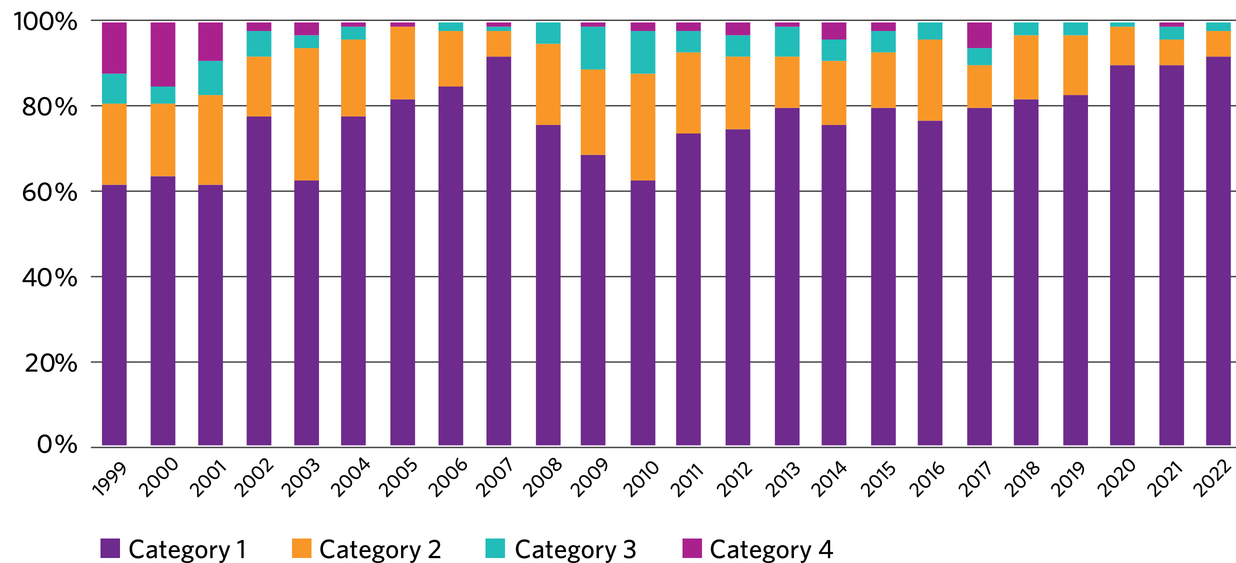
Number of Premium Categories

Since first adopting the DPS in 1999, policy objectives have included differentiation of members based on the relative risks they pose to CDIC. This differentiation into risk-based premium categories is intended to incentivize members to avoid excessive risk-taking. The current DPS contains 4 categories as follows:

Premium Categories	
Score	**Premium Category**
≥ 80	1
≥ 65 but < 80	2
≥ 50 but < 65	3
< 50	4

A large and increasing majority of members have been classified in the best premium category (category 1). For example, in 2021 and 2022, 90% and 92% of members fell in category 1 respectively.

Member Category Distribution



This proportion of members consistently in the best category may be an indication that — among other drivers — four categories may not be enough to adequately differentiate members. If the difference in risk between the least and most risky members in category 1 is too great, it could create issues of fairness and excessive cross-subsidization of risk.

Increasing the number of premium categories would improve the ability of the DPS to appropriately and fairly differentiate members, thereby better reflecting their relative risk in premium scoring. CDIC proposes that the number of premium categories be increased from 4 to 5.

At present, and as set out in Schedule 1 of the Differential Premiums By-law, a move from category 1 to category 2 represents a doubling of premiums, as does a move from category 2 to category 3. As part of this proposal, CDIC will also consider the appropriateness of this current scaling of premiums from one category to the next, and the degree to which a revised approach may continue to meaningfully incentivize members to achieve the best classification while also allowing CDIC to achieve its new *ex ante* fund target. CDIC would welcome views on options to scale premiums amongst categories.

PROPOSAL #1:

CDIC proposes amending the Differential Premiums By-law to increase the number of premium categories from 4 to 5 with the following scoring ranges:

Premium Categories

Score	Premium Category
≥ 90	1
≥ 80 but < 90	2
≥ 65 but < 80	3
≥ 50 but < 65	4
< 50	5

New Member Policy

A member institution that meets the "new member" definition is currently classified into category 1.[8] In practice this means that new members will be classified in the best premium category for a period of 2 years. This policy is premised on vetting that will have taken place as part of OSFI's entry processes for a member to become a federally regulated deposit-taking institution, and assumes a new member belongs in the best premium category. It is also driven by a lack of historical regulatory data necessary to compute several of the scorecard's financial metrics.

The new member policy does not contain a mechanism to reflect changes to an institution's risk profile during the 2 years. As a result, premiums charged may not be commensurate with the risk the member poses to CDIC.

CDIC proposes that new members will be placed in category 2 for the first two years of membership, unless staged by OSFI, in which case they would be downgraded commensurate to their risk profile.

PROPOSAL #2:

CDIC proposes amending the new member policy in the *Differential Premiums By-law*. New members will be placed in category 2 for the first two years of membership, unless staged by OSFI, in which case they would be downgraded commensurate to their risk profile.

Frequency of Assessment

CDIC currently assesses member risk for premium purposes on an annual basis.[9]

As a result, CDIC's classification of member institutions into risk-based categories can be based partially on information that may no longer accurately reflect true member risk over the premium period. The current annual frequency has been reviewed with a view of determining whether a higher frequency could allow CDIC's DPS to better reflect CDIC's risk exposure to members over the premium cycle and send a timelier signal to members with respect to those risks.

8 A member meets the definition of a "new member" if the member institution has been operating as a member institution for less than two fiscal years consisting of at least 12 months each determined as of the end of the fiscal year ending in the year preceding the filing year.

9 Each premium year begins on May 1 and ends on the following April 30. The financial information collected in the Differential Premiums Form is based on the member's annual financial statements preceding the beginning of the premium year, meaning reflecting the member's financial position as at previous October 31st or December 31st depending on the member's fiscal year-end. The regulatory information reflects an as at date of April 30th to align closely with the beginning of the new premium year. A member's final premium classification (based on quantitative and qualitative scores) can be downgraded if, as at April 30th, it is non-compliant with either the *Resolution Planning By-law* (D-SIBs only) or the *Data and System Requirements By-law*.

Under the current annual system, data used to calculate DPS financial metrics in April and determine a member's premium categorization are taken from year-end financial statements from the prior year. However, the risk profile of an MI can change rapidly. Substantial inter-year risk profile changes are currently not captured in the DPS, resulting in some members paying premiums at a level not commensurate with member risk as assessed by CDIC.

In addition to aligning premium and member risk assessment, increased frequency would incent members to correct issues identified earlier and receive the appropriate reduction in premiums on a timelier basis. For example, it would provide an opportunity for members who score below the threshold of a better category to improve their score, and reduce their premiums, within a three-month period as opposed to benefitting from a score improvement only in the following year.

Under the proposed new process, CDIC would classify a member into a premium category every quarter based on a quarterly Differential Premiums form filing. At the end of the premium year, their volume of insured deposits as at April 30th would be multiplied by a weighted average of the four premium rates they were assigned in the four quarters of the prior fiscal year.

The data required to calculate the financial metrics in the DPS scorecard are already available on a quarterly basis through existing regulatory returns. Inputs into the Regulatory criteria section of the scorecard are also available either quarterly or on an ongoing basis. Accordingly, from an operational and administrative standpoint, moving to quarterly premium classification is not expected to have a material impact on regulatory burden.

Return of Insured Deposits (RID) Filings

The Legislation provides that members must estimate the volume of insured deposits once per year (as at April 30 of each year) and provide this figure, by means of the RID, on or before July 15th. To determine the annual premium amount payable, the volume of insured deposits is subsequently multiplied by the premium rate as determined by an institution's differential premiums category.

Given the above proposal to increase the frequency of DPS assessments to quarterly, CDIC would welcome input from members on potential opportunities to create efficiencies related to the RID calculation and RID reporting more generally. Furthermore, CDIC would welcome views as to whether increasing the frequency of such reporting would be advantageous as premiums could then better reflect periodic fluctuations in the volume of insured deposits.

No changes are proposed to the way premiums are collected. Members may either pay the full premium amount for the premium year by July 15th, or pay in two equal installments, the first due by July 15th and the second due by December 15th.

PROPOSAL #3:

CDIC proposes amending the CDIC Act to increase the frequency of classification of members into premium categories from annual to quarterly. Members will continue to estimate their volume of insured deposits on an annual basis and premiums will continue to be collected from members on a semi-annual basis.

Regulatory Criteria

The DPS scorecard's "Regulatory Criteria" component is currently driven by OSFI's Examiner Rating (ER) (35points) and Other Information (5 points). The examiner rating is assigned by OSFI as of April 30 of the filing year and is determined by a combination of the member institution's Composite Risk Rating (CRR) and Stage Rating. The "Other Information" score is determined by CDIC and can factor in any information about circumstances that represent a threat to or compromise the safety, soundness, financial condition or viability of an institution. In practice, a member's "Other Information" score is typically based on its *Internal Member Rating*, which is determined by CDIC using its *Risk Assessment Methodology*. CDIC's IMRs are reviewed on an ongoing basis and are assigned to each member institution by CDIC on a quarterly basis.

The current split between the "Examiner Rating" and "Other Information" does not sufficiently emphasize the importance of CDIC's perspective on member risk in relation to CDIC's role as resolution authority, nor the importance of considerations that may impact CDIC's ability to resolve member institutions. Given these changes, CDIC proposes that the CDIC component of the "Regulatory Criteria" be increased from 5 to 15 points, with a resulting decrease in the "Examiner Rating" from 35 to 25 points.

OSFI Examiner Rating (25 points)

Given OSFI's role as the prudential supervisor and the primary regulator for CDIC member institutions, the Examiner Rating would continue to make up the majority of the "Regulatory Criteria" points. The proposed allocation of points will maintain the same ratios as the current allocation as follows:

Table 5: Examiner Rating Scoring

Composite Risk Rating		Stage Rating		Examiner Rating	DP Score
Low	+	None	=	1	25 points (max)
Moderate	+	None	=	2	22 points
Moderate	+	Staged	=	3	15 points
Above Average	+	Staged or not	=	4	8 points
High	+	Staged or not	=	5	0 points

CDIC Risk and Resolvability Rating (15 points)

CDIC's rating will incorporate two elements:

1. CDIC's assessment of the likelihood of loss for the Corporation stemming from a failure of a member institution guided by CDIC's Risk Assessment Methodology; and
2. CDIC's assessment of resolvability of a member institution.

CDIC Risk Assessment Methodology

CDIC's Risk Assessment Methodology assesses the likelihood of loss for the Corporation stemming from a failure of a member institution, while providing adequate lead time to ensure readiness for an orderly resolution on the part of CDIC and the member.

The methodology focuses on financial risks (e.g., asset quality, capital, earnings, funding structure and liquid resources) and regulatory risks (e.g., compliance, governance, and risk management) and includes a forward-looking component to measuring risk.

The final output of the risk assessment process conducted in accordance with the methodology outlined above is an Internal Member Rating (IMR), which is a key indicator of a member's likelihood of failure from a CDIC-specific lens. A member is assigned one of five possible IMR ratings, with 1 being the best and 5 being the worst:

Table 6: Internal Member Rating Categories

1	Strong
2	Acceptable
3	Potentially Vulnerable
4	Weak
5	Critically Weak

By focusing on members' likelihood of failure, the *Internal Member Rating* (IMR) helps to identify those member institutions that pose a heightened level of risk to CDIC early enough to permit corrective action to be taken to minimize CDIC's exposure to loss.

As detailed further below, introducing and expanding the weighting of a CDIC Risk and Resolvability Rating to replace the "Other Information" score allows the RAM/IMR to better influence members' overall DPS score, which will help ensure the DPS is appropriately differentiating members on the basis of risk to CDIC and the *ex ante* fund. As the resolution authority and the largest expected creditor in the event of failure, it is important that DPS scores and resulting member premiums reflect CDIC's view of risk.

CDIC Rating: Resolvability

Resolvability refers to the readiness of CDIC and its member institutions to implement a resolution strategy in a manner that supports CDIC achieving its mandate. There are multiple factors that affect resolvability of a member institution, including legal structure suitability, loss absorbency, access to liquidity, operational continuity and governance, among others.

CDIC, through resolution planning, preparedness activities and testing, aims to mitigate challenges that may occur during a resolution. Currently, several requirements contained in the CDIC by-laws with which member institutions must comply are aimed at reducing resolvability risks. CDIC proposes that compliance with two CDIC by-laws aimed at mitigating resolvability risks be more prominently[10] factored into the DPS:

- the *Resolution Planning By-Law (RPB),* which establishes a framework for the development, submission, and maintenance of resolution plans by the D-SIBs, and a process for highlighting and addressing deficiencies in those plans.

10 Compliance with these by-laws is already linked to the DPS in several ways today. For example, non-compliance with the DSRB results in a downgrade of premium category, and RPB non-compliance (D-SIBs only) results in a multiplier being applied to premiums payable.

- the *Data and System Requirements By-Law (DSRB),* which sets out the data and system requirements members must have in place to facilitate a fast insurance determination.

CDIC proposes that, in addition to increasing the weight of the CDIC Rating from 5 to 15 points, a new component be added to it to capture resolvability, as it is core to CDIC's resolution object introduced in 2017. The proposed higher weighting reflects the critical importance of resolvability in managing risks to CDIC, and that related compliance carries both financial incentives and consequences. The proposed resolvability metric will replace the mechanism currently embedded in the DPS in respect of compliance with the DSRB and the RPB.

CDIC Risk and Resolvability Rating: Scoring Methodology

The proposed scoring methodology for the CDIC Risk and Resolvability Rating aims to provide an early warning signal with respect to both likelihood of failure (i.e., IMR) and resolvability, and differentiate members on such components. A combination of IMR and resolvability in scoring allows for a dynamic assessment of runway to failure and exposure to loss at failure.

CDIC proposes that a member institution's compliance with the RPB (for D-SIBs only) and DSR will act as a proxy for resolvability. For non-D-SIBs, since the RPB is not applicable, compliance with DSR is the only factor considered, which results in a modified scoring grid. Going forward, CDIC intends to regularly review resolvability factors included in the scoring methodology.

Table 7: CDIC Risk and Resolvability Rating Scoring — D-SIBs

IMR + Compliance	DPS Score
1-3 + Full Compliance RPB and DSR	15
1-3 + Partial Non-Compliance RPB and Full Compliance DSR	8
1-3 + Full Compliance RPB and Non-Compliance DSR	5
1-3 + Material Non-Compliance RPB and Full Compliance DSR	0
1-3 + Partial or Material Non-Compliance RPB and Non-Compliance DSR	0
4 + Full Compliance RPB and DSR	8
4 + Partial Non-Compliance RPB and Full Compliance DSR	5
4 + Material Non-Compliance RPB or Non-Compliance DSR	0
5 + Any Level of Compliance RPB and DSR	0

Table 8: CDIC Risk and Resolvability Rating Scoring — Non-D-SIBs

IMR + Compliance	DPS Score
1-3 + Full Compliance DSR	15
1-3 + Non-Compliance DSR	5
4 + Full Compliance DSR	8
4 + Non-Compliance DSR	0
5 + Any Level of Compliance DSR	0

The proposed CDIC Rating scoring system generally awards full points to members that remain prudentially sound and/or are taking active steps to correct any identified supervisory deficiencies (i.e., IMR is less than 4). In the event of an IMR of 4, members may receive a majority of possible points (8), provided they are fully compliant with the Data and System Requirements By-law and the Resolution Planning By-law as applicable. However, a "critically weak" member (as determined pursuant to the RAM), would score 0 points regardless of compliance with the by-laws.

In order to emphasize the critical importance CDIC places on resolvability, members could lose several points if non-compliant with the RPB or DSR. For example, non-compliance with the DSR will result in a 10-point deduction, even if a member has an IMR of 1-3. For D-SIBs, while partial non-compliance with the RPB will only result in a 7-point deduction, material non-compliance will result in a loss of all 15 points, regardless of IMR.

PROPOSAL #4:

CDIC proposes to reduce the Regulatory criteria's Examiner Rating component from 35 to 25 points, introduce a CDIC Risk and Resolvability Rating to replace the current "Other Information" component, and increase the weight of this component from 5 to 15 points. The CDIC Risk and Resolvability Rating would incorporate both CDIC's assessment of factors contributing to the likelihood of failure of a member institution and the assessment of resolvability challenges for the member.

Financial Criteria

CDIC conducted an extensive analysis to determine whether changes to the DPS financial criteria are warranted.[11] An important objective of the review of the financial criteria was to improve the risk sensitivity of the framework and to ensure that members are being appropriately differentiated, both at the individual metric level and in aggregate.

In analyzing the financial criteria, CDIC performed analysis to determine each metric's value as a predictor of risk from both a forward-looking and contemporaneous perspective and back-tested metrics to determine their performance as a differentiator on the basis of risk. Furthermore, several frameworks containing alternative sets of metrics were tested to determine a framework which aligned best with CDIC's views of risk and best met the objectives of the DPS. CDIC also reviewed whether current scoring thresholds are set appropriately by performing a series of analyses.

In determining the need for new financial metrics, CDIC consulted experts and reviewed domestic and international financial regulatory trends and best practices. Potential new metrics were analyzed and back tested.

Care has been taken during the development of the proposals to ensure CDIC and member institutions can continue to leverage readily available data from existing regulatory returns on a quarterly basis.

Capital Adequacy

The current Capital Adequacy criterion consists of two metrics (leverage ratio and tier 1 capital ratio), each worth a maximum of 10 points, for a total of 20 possible points. The first awards marks to an institution that manages leverage prudently, while the second recognizes higher quality capital and lower risk assets. To achieve full marks, institutions must have a leverage ratio greater than or equal to 110% of the leverage ratio authorized by the regulator and must have a tier 1 capital ratio greater than the "all in" (i.e., including D-SIB capital conservation buffer and D-SIB surcharge) target as set by the regulator.

Capital adequacy is a highly important criterion when considering risk to the *ex ante* fund and potential loss to CDIC in the event of a failure, and therefore has historically been heavily weighted in the DPS. However, current capital metrics and the associated thresholds do not facilitate adequate differentiation. The Capital Adequacy score is also very heavily weighted within the overall DPS scorecard, as it is a cornerstone of both ratings in the Regulatory Component outlined above.

Since the last review of the DPS, Canada's regulatory capital rules have continued to evolve, SMSB proportionality initiatives have been implemented and the bail-in framework for D-SIBs was implemented. CDIC proposes several amendments to the Capital Adequacy criterion, along with changes to the individual capital adequacy component metrics.

11 A detailed explanation of the current formulae for each of the current quantitative measures and its threshold scoring grid is set out in the Differential Premiums Manual available on the CDIC website: **Differential Premiums By-law Manual (cdic.ca)**

Weighting

CDIC proposes reducing the weight of the Capital Adequacy criteria from 20 to 10 total points, and allocating these points to new liquidity and funding metrics given their stronger ability to differentiate member institution risk.

Criteria

The introduction of Canada's bail-in framework has created new requirements for D-SIBs that emphasize their need for total loss absorbing capacity (TLAC), in addition to traditional capital requirements. CDIC proposes a separate scoring criterion for D-SIBs and non-D-SIBs, with the former graded on TLAC levels rather than Capital alone.

In a similar vein, OSFI's work on **SMSB proportionality** will result in changes to certain requirements for smaller, less complex institutions (e.g., leverage ratio). To ensure consistency with these new requirements, CDIC also proposes a separate Capital Adequacy scoring criteria for Category III institutions which will focus on the Simplified Capital Ratio.

Lastly, CDIC has observed some confusion surrounding the use of certain terminology in the Capital Adequacy section of Differential Premiums Manual (e.g., "all in" target). CDIC will adjust terminology to maintain consistency with OSFI usage.

Metrics

D-SIBs — TLAC Leverage Ratio, CET-1 Ratio and Risk-Based TLAC Ratio

The purpose of TLAC requirements is to provide a non-viable D-SIB with sufficient loss absorbing capacity to support its recapitalization. Holding sufficient TLAC is of critical importance to CDIC as it provides a buffer for D-SIBs to absorb losses that can help it avoid non-viability, and in the case that a failure does occur, would facilitate an orderly resolution. The TLAC leverage ratio builds on the existing leverage ratio to provide an overall measure of a D-SIB's TLAC. This ratio will replace the current DPS leverage ratio and have the same scoring thresholds but will be worth a maximum of 5 points rather than 10 (**see Table 9**).

To provide a more meaningful view of the quality and quantity of a D-SIB's capital and TLAC, CDIC is also proposing to replace the Tier 1 Capital Ratio with a metric that combines the Common Equity Tier 1 (CET-1) ratio and the Risk-Based TLAC Ratio. The latter is the primary basis used by OSFI to assess a D-SIB's TLAC and focuses on the risk faced by that institution. Scoring thresholds will be based on a member meeting the Supervisory target[12] and TLAC target as set by the regulator for the CET-1 ratio and Risk-Based TLAC ratio respectively.

12 Supervisory target for D-SIBs includes capital conservation buffer and D-SIB surcharge.

Like the TLAC leverage ratio, the new metric will be worth a maximum of 5 points rather than 10 (see Table 9).

Table 9: Capital Adequacy Criterion — D-SIBS

Metrics	Thresholds			Weight
TLAC Leverage Ratio	< 100% of authorized min = 0 points	100 – 110% of authorized min = 3 points	> 110% of authorized min = 5 points	5
CET-1 and Risk-Based TLAC Ratios	Below Supervisory target (CET-1) and TLAC target = 0 points	At or above Supervisory target (CET-1) or TLAC target (i.e., for 1 of 2 metrics) = 3 points	At or above Supervisory target (CET-1) and TLAC target = 5 points	5

Non-D-SIBs (Category I and II SMSBs) — Leverage Ratio, CET-1 Ratio and Total Capital Ratio

For non-D-SIBs (excluding Category III SMSBs), the leverage ratio will continue to be used in its current form but will be worth a maximum of 5 points rather than 10 (see Table 10).

CDIC is also of the view that CET-1 and Total Capital provide a more meaningful view of the quality and quantity of an institution's capital. To that end, CDIC proposes a metric for non-D-SIBs that combines the CET-1 and Total Capital ratios[13]. Scoring thresholds will be based on the Supervisory target[14] as set by OSFI for both ratios. The new combined metric will be worth a maximum of 5 points rather than 10 (see Table 10).

Table 10: Capital Adequacy Criterion — Non-D-SIBS (Category I and II SMSBs)

Metrics	Thresholds			Weight
Leverage Ratio	< 100% of authorized min = 0 points	100 – 110% of authorized min = 3 points	> 110% of authorized min = 5 points	5
CET-1 and Total Capital Ratios	Below Supervisory target for both = 0 points	At or above Supervisory for 1 of 2 metrics = 3 points	At or above Supervisory target for both ratios = 5 points	5

13 Calculated using Risk-Based Capital Ratios for Category I and II SMSBs.

14 Supervisory target for non-D-SIBs includes capital conservation buffer.

Non-D-SIBs (Category III SMSBs) — CET-1 Ratio and Total Capital Ratio

Category III SMSBs would not be subject to the leverage ratio under OSFI's proposed **SMSB capital requirements**. As a result, the combined CET-1 and Total Capital ratio DPS metric will be worth a maximum of 10 points for these institutions (**see Table 11**).

Table 11: Capital Adequacy Criterion — Non-D-SIBS (Category III SMSBs)

Metrics	Thresholds			Weight
CET-1 and Total Capital Ratios	Below Supervisory target for both = 0 points	At or above Supervisory for 1 of 2 metrics) = 6 points	At or above Supervisory target for both ratios = 10 points	10

PROPOSAL #5:

CDIC proposes to reduce the weight of the capital adequacy section from 20 to 10 points. The criterion and scoring would also differ based on whether the member is a D-SIB, Category I/II SMSB or Category III SMSB.

D-SIB Metrics: TLAC Leverage Ratio (5 pts) and Combined CET-1/Risk-Based TLAC Ratio metric (5 pts)

Cat I and II Non-D-SIBs: Leverage Ratio (5 pts) and Combined CET-1/Total Capital Ratio metric (5 pts)

Cat III Non-D-SIBs: Combined CET-1/Total Capital Ratio metric (10 pts)

Return on Risk-Weighted Assets

The Return on Risk-Weighted Assets metric measures the adequacy of earnings relative to the risk of a member. The criterion is calculated by dividing the current year's net income by the average of the last two years' adjusted risk-weighted assets expressed as a percentage. The criterion provides an indication of the relative returns among member institutions adjusted for their risk profiles.

Currently, an institution scores maximum points (5) if its ratio is ≥ 1.15% and no points if it is < 0.75%, with 3 points for ratios between the two.

CDIC's analysis shows that an increase of the upper limit would provide meaningful risk capture and improved differentiation. As such, CDIC proposes increasing the upper scoring threshold.

The new proposed thresholds would be as follows:

Table 12: Return on Risk-Weighted Assets

	Thresholds			Weight
Current	< 0.75% = 0 points	≥ 0.75% and < 1.15% = 3 points	≥ 1.15% = 5 points	5
Proposed	< 0.75% = 0 points	≥ 0.75% and < 1.75% = 3 points	≥ 1.75% = 5 points	5

In order to align with SMSB proportionality changes, CDIC also proposes an adjustment to the formula for this criterion that will be applicable only to Category III SMSBs. Both instances of "Adjusted risk-weighted assets" will be replaced with "Adjusted Total Assets + Operational RWA". The new formula for Category III SMSBs will be as follows:

$$\frac{\text{Net Income or Loss}}{\left(\left(\begin{array}{c}\text{Adjusted Total Assets + Operational}\\ \text{RWA as of the end of the preceding}\\ \text{fiscal year}\end{array}\right) + \left(\begin{array}{c}\text{Adjusted Total Assets + Operational RWA}\\ \text{as of the end of the fiscal year ending in the}\\ \text{second year preceding the filing year}\end{array}\right)\right)/2} \times 100$$

PROPOSAL #6:

CDIC proposes two changes to the Return on Risk-Weighted Assets criterion: (i) alter the upper scoring threshold (from < 1.15% to < 1.75%); and (ii) for Category III SMSBs, replace "Adjusted Risk-Weighted Assets" in the denominator with "Adjusted Total Assets + Operational RWA".

Mean Adjusted Net Income Volatility

The Mean Adjusted Net Income Volatility ratio[15] presents a volatility-adjusted view of a member's earnings strength. Volatile earnings may pose a relatively higher risk that members' earnings will not be sufficient to cover losses that may occur.

Currently, an institution scores maximum points (5) if its ratio is ≥ 0 and ≤ 0.5 and no points if it is > 1.25 or negative, with 3 points between 0.5 and 1.25.

In order to recognize those members with relatively stable earnings, less stringent thresholds are proposed as CDIC's analysis indicates that the proposed thresholds would continue to identify members that experience greater income volatility and differentiate appropriately on the basis of risk.

The new proposed thresholds would be as follows:

Table 13: Mean Adjusted Net Income Volatility

	Thresholds			Weight
Current	> 1.25 or negative = 0 points	> 0.5 and ≤ 1.25 = 3 points	≥ 0 and ≤ 0.5 = 5 points	5
Proposed	> 1.50 or negative = 0 points	> 0.75 and ≤ 1.50 = 3 points	≥ 0 and ≤ 0.75 = 5 points	5

PROPOSAL #7:

CDIC proposes to alter the upper and lower scoring thresholds of the Mean Adjusted Net Income Volatility ratio metric (from < 0.5 to < 0.75 and from < 1.25 to < 1.5 respectively).

15 The ratio is calculated by dividing the standard deviation of the net income (or loss) by the mean net income (or loss).

Stress-Tested Net Income

The Stress Tested Net Income criterion determines how an institution's earnings will be affected by comparing the current year's income to the standard deviation of historical annual net income of that institution. While this metric provides some differentiation, it is correlated with other earnings-related metrics that sufficiently capture earnings risk.

CDIC proposes to remove the Stress-Tested Net Income measure from the DPS. The 5 points currently allocated to this metric would be assigned to the proposed new metrics (i.e., funding and liquidity).

PROPOSAL #8:

CDIC proposes to remove the Stress-Tested Net Income Criterion from the DPS.

Efficiency Ratio

The Efficiency Ratio represents the non-interest expenses associated with producing a certain level of gross revenue and is viewed as a proxy of management's cost effectiveness in running the institution.

CDIC's analysis indicates that the associated risks are indirectly captured by other profitability measures currently employed elsewhere in the quantitative measures, and that there is correlation between the Efficiency Ratio and other profitability metrics. Further, the regulatory DPS criteria also incorporates a timely and holistic view of management quality from a risk management perspective.

Given the above, CDIC proposes to remove the Efficiency Ratio from the DPS. The 5 points that are currently allocated to this metric would be redistributed to the liquidity and funding metrics.

PROPOSAL #9:

CDIC proposes to remove the Efficiency Ratio from the DPS.

Net Impaired Assets to Total Capital

The Net Impaired Assets to Total Capital Ratio (%)[16] considers net impairments of both on- and off-balance sheet assets. This criterion is an important measure of an institution's asset quality and has proven to be effective at differentiating the risk profile of member institutions.

Currently, an institution scores maximum points (5) if its ratio is < 20% and no points if it is ≥ 40%, with 3 points between 20% and 40%.

CDIC's analysis indicates that more stringent thresholds would provide improved differentiation and risk capture. In order to ensure this metric continues to provide a meaningful view of member asset quality that is aligned to CDIC's internal views, CDIC proposes adjustments to both the upper and lower thresholds.

The new proposed thresholds would be as follows:

Table 14: Net Impaired Assets to Total Capital

	Thresholds			Weight
Current	≥ 40% = 0 points	≥ 20% and < 40% = 3 points	< 20% = 5 points	5
Proposed	≥ 30% = 0 points	≥ 15% and < 30% = 3 points	< 15% = 5 points	5

PROPOSAL #10:

CDIC proposes to alter the scoring thresholds of the Net Impaired Assets to Total Capital metric from < 20%, ≥ 20% and < 40%, and ≥ 40% to < 15%, ≥ 15% and < 30% and ≥ 30% respectively.

16 This ratio represents the sum of net impaired on and off-balance sheet assets as a % of total capital.

Three-Year Moving Average Asset Growth

The Three-Year Moving Average Asset Growth criterion uses a three-year moving average asset growth ratio which has the effect of smoothing out yearly fluctuations and provides a means of comparison that is centred on a member institution's own historical performance.

Members experiencing unusually high rates of asset growth can carry greater risk. Analysis of failures domestically and internationally suggests that aggressive growth, when achieved through a loosening of underwriting standards, competitive pricing or in the context of broader credit-cycle factors, is meaningfully corelated with risk.

CDIC's analysis indicates that this metric continues to appropriately identify those members that carry relatively greater risk in respect of this metric.

No changes are proposed to either the formula itself or the current thresholds.

Real Estate Concentration Ratio

This criterion measures the impact of real estate asset concentration on the risk profile of non-D-SIB institutions. CDIC continues to place significant importance on the impact of real estate asset concentration on the risk profile of its member institutions, views high real estate concentration, all else equal, as unfavorable from a risk perspective for all members. CDIC proposes inclusion of real estate concentration DPS considerations for all members.

No changes are proposed to formulae or current thresholds.

PROPOSAL #11:

CDIC proposes that a Real Estate Concentration Ratio metric be introduced for D-SIBs and that it continue to apply for non-D-SIBs.

Asset Encumbrance Measure

The Asset Encumbrance Measure targets a member's pledging activity and related ability to deal with a liquidity shock. The measure, which combines both a *Domestic Unencumbered Asset Concentration Measure* and a *Pledged Asset Measure*, was introduced following the 2013-14 DPS review and was applied only to D-SIBs.

The criterion addresses associated risk in the following two ways:

- To prevent CDIC from taking a loss in the event of the member's failure, the metric encourages member institutions to have sufficient realizable assets to match unsecured liabilities.
- The criterion encourages member institutions to develop greater flexibility to deal with a liquidity shock.
- While this criterion currently only applies to D-SIBs, the risks it targets are equally important to CDIC in the resolution of a non-D-SIB. As such, CDIC proposes that the Asset Encumbrance Measure be applied to non-D-SIBs in addition to D-SIBs.

CDIC proposes altering thresholds for the Pledged Asset Ratio to levels which CDIC's analysis indicates will provide appropriate identification of member institutions with relatively greater risk in terms of the availability of unencumbered assets to unsecured creditors and the flexibility to deal with liquidity shocks.

CDIC also proposes to amend the definition of the Unencumbered Asset Concentration formula in order to better capture the amount of unencumbered assets expected to be available in the event of a failure. First, derivative liabilities will be subtracted from total liabilities in the numerator, thereby backing out derivative counterparties from the pool of senior unsecured claimants. Second, impairments will be removed from the denominator to avoid double counting, as total assets from the consolidated balance sheet are already presented on a net basis. The proposed formula will be as follows:

$$\frac{\text{Total Liabilities - (Subordinated Debt + Covered Bond Liabilities + Securitization Liabilities + Repos + Shorts + Derivative Liabilities)}}{\text{Total Assets - Total Pledged Assets}} \times 100$$

Currently, an institution scores maximum points (5) if its result on the Unencumbered Asset Concentration formula is ≤ 100%. If the institution's result on that formula is > 100%, the institution will be required to complete the Pledged Asset Ratio. If the Pledged Asset Ratio < 50% the institution would receive 3 points, if ≥ 50% the institution receives no points.

The proposed thresholds for D-SIBs and non-D-SIBs would be as follows:

Table 15: Asset Encumbrance

Thresholds				Weight
Current	> 50% on Pledged Asset Ratio = 0 points	≤ 50% on Pledged Asset Ratio = 3 points	≤ 100% on Unencumbered Asset Concentration = 5 points	5
Proposed	> 40% on Pledged Asset Ratio = 0 points	≤ 40% on Pledged Asset Ratio = 3 points	≤ 80% on Unencumbered Asset Concentration = 5 points	5

PROPOSAL #12:

CDIC proposes that the Asset Encumbrance metric be applied to non-D-SIBs in addition to D-SIBs. Furthermore, Derivative Liabilities would be subtracted from the numerator and Impairment would no longer be subtracted from the denominator of the formula used to calculate the Unencumbered Asset Concentration ratio.

Further, CDIC proposes to alter the scoring threshold of the Unencumbered Asset Concentration Ratio from ≤ 100% to ≤ 80%, and the scoring thresholds of the Pledged Asset Ratio from > 50% to > 40% and from ≤ 50% to ≤ 40%.

Aggregate Commercial Loan Concentration Ratio

The Aggregate Commercial Loan Concentration Ratio measures a member institution's non-mortgage loan concentration across various industry sectors as a percentage of total capital. In the 2013-14 DPS review, CDIC altered the thresholds for this metric in order to better capture those institutions known to CDIC as exhibiting higher concentration risk. CDIC's analysis indicates that these changes have generally achieved their intended result and, as such, are providing appropriate differentiation.

No changes are proposed to either the formula itself or the current thresholds.

Liquidity and Funding

The current DPS does not separately capture liquidity and funding risks. Since the last DPS review in 2014, the regulatory liquidity frameworks have matured and are nearly completely implemented. Liquidity and funding have also become key factors looked at by CDIC as part of its Risk Assessment Methodology.

Liquidity is a key factor influencing the risk exposure of member institutions as sound liquidity mitigates the impact of an unexpected reduction in deposits. There are several examples in past financial crises of institutions failing despite having sufficient capital because of weak liquidity and consequent inability to mitigate the impact of deposit runs.

One potential limitation of having a liquidity and funding criterion as part of the DPS in the past was that when these risks materialize it is often over a relatively short period of time (less than a year), while the DPS was only conducted annually. However, CDIC's proposal to move to quarterly frequency of assessment would allow potential liquidity problems to be captured by the DPS much faster and would further its primary objective of sending members an early warning signal. Given these developments, CDIC is of this view that it is now appropriate to include a series of measures in the DPS that will capture the liquidity risk of member institutions. As a result, CDIC proposes 15 DPS points be allocated to a criterion that measures liquidity risk, with the points derived primarily from the reduction to the weighting of the Capital Adequacy criteria from 20 to 10 total points

Two dimensions to consider in the development of metrics for liquidity risk are the liquidity profile and the funding profile. Measures that address the liquidity profile gauge the amount of contingent liquidity an institution can use to generate cash to meet obligations (particularly during stress). Meanwhile, measures that address the funding profile consider the structure of the liability mix, including sources, counterparties and tenors.

CDIC considered and tested several metrics to determine a set that captured the risk of members' liquidity and funding profiles and appropriately differentiated members on that basis. CDIC proposes 3 new metrics for non-D-SIBs: 1) High Quality Liquid Assets to Short-term Funding, 2) Stable Funding Ratio, and 3) Brokered Deposit Ratio. CDIC proposes 2 new metrics for D-SIBs: 1) Hiqh Quality Liquid Assets to Short-term Funding Ratio, and 2) Net Stable Funding Ratio.

The differing criteria for D-SIBs and non-D-SIBs reflect the differing regulatory requirements and funding structures for larger, more complex banks. The following sections detail these proposed new metrics.

PROPOSAL #13:

CDIC proposes 15 DPS points be allocated to a criterion that measures liquidity risk, from both liquidity profile and funding profile dimensions. Given differing regulatory requirements and funding structures for larger, more complex banks, CDIC proposes separate criteria for D-SIBs and non-D-SIBs.

High-Quality Liquid Assets to Short-Term Funding

CDIC proposes to add a new criterion for both DSIBs and non-DIBs to measure the amount of high-quality liquid assets (HQLA) a member institution has available to cover its short-term obligations. Sufficient HQLA is critical to mitigating unexpected reductions in deposits or a member's other liquidity needs.

The criterion would be worth a maximum of 5 DPS points and be calculated as follows:

$$\frac{\text{High Quality Liquid Assets}}{< 1 \text{ Year Liabilities}}$$

The numerator, HQLA, follows the definition set out in OSFI's Liquidity Adequacy Requirements guideline. The denominator represents a member's short-term funding and is defined as liabilities less than one year.

CDIC's analysis indicates that this metric is a very powerful differentiator of members on the basis of their liquidity risk. Back testing results were closely aligned with CDIC's internal assessment of member liquidity risk. Similar to the process for existing metrics, CDIC conducted analysis to determine thresholds that appropriately differentiate members and provide those with liquidity issues with an early warning signal.

Table 16: High-Quality Liquid Assets to Short-Term Funding

Thresholds			Weight
< 5% = 0 points	≥ 5% and < 10% = 3 points	≥ 10% = 5 points	5

PROPOSAL #14:

CDIC proposes an HQLA to Short-Term Funding criterion that would measure an institution's high-quality liquid assets as a percentage of short-term funding. This criterion would apply to both D-SIBs and non-D-SIBs and would be worth a maximum of 5 points.

Net Stable Funding Ratio

CDIC proposes a net stable funding ratio (NFSR) criterion that would apply to only DSIBs. NFSR is an internationally recognized measure developed as part of the Basel III international liquidity framework. It addresses longer term structural liquidity mismatches by measuring the amount of longer-term stable sources of funding used relative to the liquidity profiles of the assets funded, and the potential for contingent calls on

funding liquidity arising from off-balance sheet commitments and obligations. The NSFR requires a minimum amount of funding that is expected to be stable over a one-year time horizon based on factors assigned to assets and off-balance sheet liquidity exposures.

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

An alternative set of stable funding metrics will apply to non-D-SIBs (see following section). There are many smaller, less complex non-D-SIB members who are not required to report the NSFR.

Per OSFI's LAR guidelines, the NSFR is defined as the amount of available stable funding relative to the amount of required stable funding. This ratio should be equal to at least 100% on an ongoing basis (see formula below). "Available stable funding" is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year. The amount of such stable funding required ("Required stable funding") of a specific institution is a function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its off-balance sheet (OBS) exposures.

Thresholds for the NSFR will be linked to requirements set out in LAR guidelines and the ratio will be worth a maximum of 10 DPS points. A member that is below minimum requirements (100%) will earn 0 points, while a member must have a ratio of 110% or greater to earn maximum points.

Table 17: Net Stable Funding Ratio (D-SIB Only)

Thresholds			Weight
< 100% = 0 points	≥ 100% and < 110% = 6 points	≥ 110% = 10 points	10

PROPOSAL #15:

CDIC proposes that the Net Stable Funding Ratio (NSFR) be applied to D-SIBs to measure their funding stability for DPS purposes, for a maximum of 10 points.

Stable Funding Ratio

A member's funding structure directly affects its liquidity risk as some sources of funding are less reliable than others, making them more difficult to roll over, or in extreme situations subject to run. A member making significant use of less reliable sources of funding increases its risk of illiquidity.

CDIC proposes a Stable Funding Ratio aimed at capturing non-DSIB members' reliance on unstable funding sources. This ratio measures the level of stable funding relative to the tangible banking assets, where stable funding is defined as the portion of capital and liabilities expected to be reliable to the member institution; it includes core deposits, long-term brokered deposits (over 1 year), and tangible shareholders' equity. All else equal, members with a lower ratio are more exposed to risks associated with potentially unstable sources of funding.

The ratio would be calculated as follows:

$$\frac{\text{Stable Funding}}{\text{Tangible Banking Assets}}$$

CDIC conducted analysis to determine thresholds that appropriately differentiate members based on their levels of stable funding. Thresholds would be as follows:

Table 18: Stable Funding Ratio (Non-D-SIB Only)

Thresholds			Weight
< 20% = 0 points	≥ 20% and < 45% = 3 points	≥ 45% = 5 points	5

PROPOSAL #16:

CDIC proposes a simplified funding stability criterion for non-D-SIBs: the Stable Funding Ratio. This criterion would be worth a maximum of 5 points.

Brokered Deposits Measure

CDIC proposes a criterion in the DPS (to be applied only to non-D-SIBs) that measures the risk of reliance on brokered deposits. There have been examples in recent years and in past financial crises that illustrate that funding in the form of brokered deposits can pose a high risk in stress scenarios due to their lack of "stickiness"

relative to other deposits. Tenor of brokered deposits impacts the relative risk of reliance on such deposits; as such, CDIC proposes a two-part criterion that includes a measure of deposit tenor:

The first part measures a member's brokered deposits as a percentage of their total assets:

$$\text{Formula 1:} \quad \frac{\text{Brokered Deposits}}{\text{Total Assets}}$$

If a member's result is < 25%, they will receive maximum points (5).

If it is ≥ 25%, a second formula is introduced measuring the tenor of the member's brokered deposits:

$$\text{Formula 2:} \quad \frac{< 1 \text{ Year Brokered Deposits}}{\text{Total Brokered Deposits}}$$

If the member's result for formula 1 is ≥ 25% and < 50% OR the result of formula 2 is < 40%, they receive 3 points. If a member's result for formula 1 is ≥ 50% AND the result of formula 2 is ≥ 40%, they receive 0 points. In combination, the two formulae assess the overall reliance on, and the contractual tenor of, brokered deposits. The thresholds are summarized in Table 19 below:

Table 19: Brokered Deposit Ratio (Non-D-SIB Only)

Thresholds			Weight
Formula 1 is ≥ 50% AND Formula 2 is ≥ 40% = 0 points	Formula 1 is ≥ 25% and < 50% OR Formula 2 is < 40% = 3 points	Formula 1 is < 25% = 5 points	5

PROPOSAL #17:

CDIC proposes a criterion that will apply to non-D-SIBs that will measure an institution's reliance on brokered deposits as a proportion of total assets, as well as the tenor of those deposits. This criterion would be worth a maximum of 5 points.

Conclusion and Next Steps

This Consultation Paper has proposed a number of strategic framework changes and other enhancements to the DPS to make it more effective, fair, and better able to meet its core objective to send an early warning signal — with financial consequences — to the management and board of directors of member institutions concerning the risk (i.e., likelihood of failure and resolvability) the member poses to CDIC. The proposals are summarized in **Annex B**.

CDIC is available to meet with stakeholders to discuss the review and the proposals. Should you wish to meet with CDIC staff, please contact us at your earliest convenience for scheduling.

Comments on the Consultation Paper proposals are requested by October 21st, 2022 and should be sent to **consultation@cdic.ca**. Feedback received in response to this paper will be summarized and shared publicly on a no-names basis.[17]

Stakeholder input will inform CDIC's final directions on the DPS framework, which may include legislative amendments and operational changes to support framework implementation.

17 Submissions received could be subject to an access to information (ATI) request. Where a submission is captured by an ATI request, CDIC will determine the extent to which parts of the submission should be redacted based on the Access To Information Act. Where CDIC is required disclose unredacted parts of a submission, it will consult with the affected respondent prior to disclosing this information.

Annex A: Changes to the Canadian Resolution Regime

Following the financial crisis in 2008-2009, the G20 committed to fundamental reform of the global financial system and called on the Financial Stability Board (FSB) to develop and coordinate an enhanced framework for global regulation and oversight.

Among other policy responses, a comprehensive resolution framework was designed to address the systemic risks (and the moral hazard) associated with failure of a large financial institution. Since the financial crisis, multiple changes have been introduced to the Canadian resolution regime, which provides CDIC a broad set of tools to resolve its member institutions and is consistent with the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions.*

The six largest banks were designated by the Superintendent of Financial Institutions as Domestically Important Banks (D-SIBs), of which two were designated as globally systemic banks (G-SIBs) by the FSB.

In 2018, Canada's bail-in regime came into force, giving CDIC the power to undertake a bail-in conversion of specified debt of a D-SIB into common shares to recapitalize the D-SIB and allow it to remain open and operating, upon determination of non-viability by the Superintendent of Financial Institutions. The Canadian bail-in regime requires D-SIBs to maintain sufficient regulatory capital and total loss absorbing capacity (i.e., TLAC) that can be used in the event of a failure to absorb severe, but plausible, losses and be restored to viability. The bail-in framework and associated loss absorbing capacity requirements are critical to ensuring D-SIBs' resolvability and mitigating the risk they pose to CDIC.

To support effective implementation of resolution strategies for the D-SIBs, the CDIC *Resolution Planning By-law* (RPB) came into force in 2019 to set out the statutory requirements for development and maintenance of resolution plans.

Annex B: Summary of Proposals

<table>
<tr><th>#</th><th>Proposal</th></tr>
<tr><td>1</td><td>CDIC proposes increasing the number of premium categories from 4 to 5 with the following scoring ranges:
<table>
<tr><th colspan="2">Premium Category Scoring Ranges</th></tr>
<tr><th>Score</th><th>Premium Category</th></tr>
<tr><td>≥ 90</td><td>1</td></tr>
<tr><td>≥ 80 but < 90</td><td>2</td></tr>
<tr><td>≥ 65 but < 80</td><td>3</td></tr>
<tr><td>≥ 50 but < 65</td><td>4</td></tr>
<tr><td>< 50</td><td>5</td></tr>
</table></td></tr>
<tr><td>2</td><td>CDIC proposes that new members will be placed in category 2 for the first two years of membership, unless staged by OSFI, in which case they would be downgraded commensurate to their risk profile.</td></tr>
<tr><td>3</td><td>CDIC proposes increasing the frequency of classification of members into premium categories from annual to quarterly. Members will continue to estimate their volume of insured deposits on an annual basis and premiums will continue to be collected from members on a semi-annual basis.</td></tr>
<tr><td>4</td><td>CDIC proposes to reduce the Regulatory criteria's Examiner Rating component from 35 to 25 points, introduce a CDIC Risk and Resolvability Rating to replace the current "Other Information" component, and increase the weight of this component from 5 to 15 points. The CDIC Risk and Resolvability Rating would incorporate both CDIC's assessment of factors contributing to the likelihood of failure of a member institution and the assessment of resolvability challenges for the member.</td></tr>
<tr><td>5</td><td>CDIC proposes to reduce the weighting of the capital adequacy section from 20 to 10 points. The capital criterion and scoring would also differ based on whether the member is a D-SIB, Category I/II SMSB or Category III SMSB, as listed below.
• D-SIB Metrics: TLAC Leverage Ratio (5 pts) and Combined CET-1/Risk-Based TLAC Ratio metric (5 pts)
• Category I and II Non-D-SIBs: Leverage Ratio (5 pts) and Combined CET-1/Total Capital Ratio metric (5 pts)
• Category III Non-D-SIBs: Combined CET-1/Total Capital Ratio metric (10 pts)</td></tr>
</table>

#	Proposal
6	CDIC proposes two changes to the Return on Risk-Weighted Assets metric: (i) alter the upper scoring threshold (from < 1.15% to < 1.75%); and (ii) for Category III SMSBs, replace “Adjusted Risk-Weighted Assets” in the denominator with “Adjusted Total Assets + Operational RWA”.
7	CDIC proposes to alter the upper and lower scoring thresholds of the Mean Adjusted Net Income Volatility metric (from < 0.5 to < 0.75 and from < 1.25 to < 1.5 respectively).
8	CDIC proposes that the Stress-Tested Net Income criterion be removed from the DPS.
9	CDIC proposes that the Efficiency Ratio be removed from the DPS.
10	CDIC proposes to alter the scoring thresholds for the Net Impaired Assets to Total Capital metric from <20%, ≥ 20% and < 40%, and ≥ 40% to <15%, ≥ 15% and < 30% and ≥ 30% respectively.
11	CDIC proposes that the Real Estate Asset Concentration Ratio metric be introduced for the D-SIBs and that it continues to apply for non-DSIBs.
12	CDIC proposes that the Asset Encumbrance Measure be applied to non-DSIBs and that it continues to apply for D-SIBs. Furthermore, derivative liabilities would be subtracted from the numerator and impairment would no longer be subtracted from the denominator. Further, CDIC proposes to alter the scoring threshold of the Unencumbered Asset Concentration Ratio from ≤ 100% to ≤ 80%, and the scoring thresholds of the Pledged Asset Ratio from > 50% to > 40% and from ≤ 50% to ≤ 40%.
13	CDIC proposes that 15 DPS points be allocated to criteria measuring liquidity risk, with separate criteria for D-SIBs and non-DSIBs as described in proposals 14-17.
14	CDIC proposes a criterion that would measure an institution’s high quality liquid assets as a percentage of short-term funding. This criterion would apply to both D-SIBs and non-D-SIBs and would be worth a maximum of 5 points.
15	CDIC proposes that the Net Stable Funding Ratio (NSFR) be used for D-SIBs to measure their funding stability for DPS purposes. This criterion would be worth a maximum of 10 points.
16	CDIC proposes a simplified funding stability criterion for non-D-SIBs: the Stable Funding Ratio. This criterion would be worth a maximum of 5 points.
17	CDIC proposes a criterion for non-D-SIBs that will measure an institution’s reliance on brokered deposits as a proportion of total assets, as well as the tenor of those deposits. This criterion would be worth a maximum of 5 points.