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Returning to Normalcy: The Unwinding of Financial Sector COVID-19 Measures in Canada

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In the early days of the COVID-19 pandemic, uncertainty and volatility ran rampant in the world, including in its financial markets. Implemented with the goal of ensuring sufficient capital and liquidity in the financial markets, a wave of measures were taken by Canada's principal financial industry regulators, the Office of the Superintendent of Financial Institutions ("OSFI"), the Department of Finance Canada and the Bank of Canada. With vaccinations now well underway in Canada and the macro economy stabilizing and showing signs of a recovery, despite continued struggles for some and a very virulent "third wave" of the coronavirus, it is inevitable that a number of these measures will phase out as economic conditions continue to improve and markets stabilize.

Unwinding of measures by OSFI and Bank of Canada

With the lockdown implemented at the start of the pandemic in 2020 resulting in a slowdown of the overall economy, OSFI and the Bank of Canada were tasked with the purpose of maintaining resiliency of financial institutions during a period of stress. This required ensuring that banks were still able to make loans and credit through a period of economic disruption. As a result, OSFI and the Bank of Canada implemented various measures which relaxed capital requirements for banks, allowing them to lend more with the goal of ensuring strong liquidity in the markets (please see our April 2020 blog post for more information on these measures). However, OSFI and the Bank of Canada have maintained that they will continue to monitor the economy and adjust their measures appropriately. Accordingly, as sectors of the market steadied and started to improve, OSFI and the Bank of Canada began the process of phasing out certain relief measures which were no longer required.

For example, on March 16, 2021, OSFI announced the unwinding of various regulatory adjustments made to the market risk capital requirements for banks. In particular, effective May 1, 2021, the level of Stressed Value at Risk ("SVaR") multipliers used by banks will return to their pre-pandemic levels. OSFI also recently announced the unwinding of the temporary increase to the covered bond limit. The usual issuance limit of covered bonds at 5.5% of a bank's total assets was temporarily increased to 10% last year to facilitate greater access to a stable source of funding through the Bank of Canada's facilities. OSFI is now unwinding this increase as it believes it is no longer necessary. The announcement stated that, effective immediately, institutions which exceed the normal 5.5% limit will be expected to return below this threshold as soon as market conditions permit and provide a plan to OSFI outlining their approach as to how they will achieve this. The reversal of the above measures by OSFI are in addition to the phasing out of certain measures in the fall of 2020 relating to the special capital treatment of loan and insurance premium payment deferrals (see our previous blog post for more information).

Given a significant decline in the use of its market functioning programs introduced in 2020, the Bank of Canada is also confident that Canada's financial markets will continue to recover. In particular, the Bank of Canada recently announced the discontinuation of its Commercial Paper Purchase Program, Provincial Bond Purchase Program and Corporate Bond Purchase Program. These programs were implemented during April and May of 2020 to help support the flow of credit to the economy as well as the liquidity and proper functioning of the corporate debt and provincial government funding markets. However, the Bank of Canada appears to believe that these markets are functioning properly now without the Bank's assistance and accordingly these programs are being discontinued.

As we monitor the recovery and regulatory updates, we will be watching closely the Bank of Canada's policy developments. For example, a relaunch of the Bank's Commercial Paper Purchase Program, Provincial Bond Purchase Program or Corporate Bond Purchase Program may suggest that these markets are not as liquid or as available as the Bank previously thought, and that further support may be needed. We note that certain other countries' central banks are getting more involved in parts of the economy which they used to avoid – such as the move by New Zealand's government to force its central bank to include housing prices in setting interest rates – and any future evolution by the Bank of Canada into this new policy role will have downstream effects on the economy.

Key Capital Requirements Relaxation Measures Still in Place

There are some key capital requirement relief measures which are still in place and financial institutions and their observers should be monitoring for when they will be phased out. For example, in March 2020, OSFI lowered the Domestic Stability Buffer ("DSB") applicable to lenders. This capital requirement is designed to serve as a "rainy day" stabilizer that is increased during a good economy and may be decreased during challenging economic times. OSFI

lowered the DSB from 2.25% of each bank's risk-weighted assets to 1%, freeing up approximately $300 billion in additional lending capacity to support Canadian businesses and households during the pandemic. At that time, OSFI made a commitment not to increase the DSB buffer for at least 18 months, meaning that the DSB level may start to return to its pre-pandemic levels as early as September of this year. While OSFI has given no expectation to the market of its plans to cause lenders to rebuild their buffers, its actions in this area will give the market a good indication of where OSFI and its fellow Canadian regulators think that the economy is and where it is headed. It is noteworthy that September 2021 is also the target of the federal government for when a majority of Canadians will have received vaccinations.

In April 2020, OSFI had also allowed banks to temporarily exclude central bank reserves and sovereign-issued securities from their leverage ratio exposure measures calculation in order to free up capital for lending and financial intermediation activities. This measure was initially to be in place until April 2021, but in November 2020, OSFI extended this by eight months, meaning these exposures will be exempted from the leverage ratio until December 31, 2021.

In contrast, the US Federal Reserve announced last month that it would not be extending temporary relief on a similar regulation known as the supplementary leverage ratio ("SLR"), which requires the largest US banks to hold a minimum level of capital. The relief to the SLR allowed US banks to exclude Treasuries and deposits with Fed banks from their calculations of the leverage ratio. This relief expired at the end of March 2021 and with only two weeks' notice this program was not extended, as the US Federal Reserve noted that the Treasury market had stabilized. However, the Fed's confidence in the markets was not consistent with that of the banks, as the US banking industry lobbied to extend the SLR relief throughout 2021.

We will be watching to see whether Canada's government and financial regulators take an approach similar to that of the US Fed in the upcoming months. Given the recent enhanced lockdown measures taken in Ontario and the fact that the country's vaccine rollout has been significantly slower than that of the US, Canadian regulators may take a more cautious approach to unwinding COVID-19 relief measures which relaxed banks' capital requirements.

Inflation Concerns

Hundreds of billions of dollars in Canadian government relief and stimulus spending, generationally-low interest rates, repeated supply-chain disruptions (including resulting from the recent blockage of the Suez Canal) and an expected sharp increase in consumer demand as Canadians get vaccinated in the upcoming months are all prompting inflation concerns in a post-pandemic world. Canadians have saved up an unprecedented amount of money during the pandemic and are believed to be waiting to unleash it as the economy opens up. The real estate market has ballooned significantly in many parts of the country, and the latest Canada's Food Price Report has indicated an increase in grocery prices at a rate faster than ever predicted by an annual food price report.

Given that the inflation rate doubled from 1.1% in February to 2.2% in March, the Bank of Canada recently announced that effective next week, it will be scaling back on purchases of government bonds and indicated a possible interest rate hike as early as next year. The swift action by the Bank of Canada was due to stronger than estimated growth in the first quarter of 2021, as economic activity proved to be more resilient than expected. In contrast the US Federal Reserve said it will not begin scaling back on government bond purchases until it sees "substantial further progress" on employment and inflation. While the Bank of Canada held its benchmark interest rate at 0.25%, we will be closely watching to see whether pent-up consumer demand will outpace supply in the upcoming months, causing the Bank to take further appropriate measures in response, including potentially increasing interest rates.

Resuming Regulatory Consultations and New Requirements

Another anticipated shift in the upcoming months is the resumption of various regulatory consultations and new regulatory requirements which were suspended or delayed due to the pandemic. For example, OSFI recently announced that it has resumed its consultation on the minimum qualifying rate for uninsured mortgages as it recognizes the current Canadian housing market has the potential to put lenders at increased financial risk. Furthermore, while the Canadian Securities Administrators ("CSA") had delayed the implementation of its conflicts of interest Client Focused Reforms ("CFRs"), initially scheduled for the end of 2020, registrants will now have to comply with these CFRs by June 31, 2021 (please refer to our previous blog post for more information on the CSA's CFRs).

In the Canadian federal budget released on April 19, the government signalled its intention to delay the mandatory review of the federal *Bank Act*, *Insurance Companies Act*, and *Trust and Loan Companies Act*, and extend their sunset dates by two years, to 2025. In the government's view, this will allow for full consideration of the effects of the pandemic on the financial sector.

As regulatory consultations and implementations resume, financial institutions will not only have to return to pre-pandemic requirements, but also comply with newly implemented measures, and potentially provide input to regulators who are undertaking industry consultations. Organizations should be proactive and keep an eye on directions that regulators take, including decisions they make, in the upcoming months to ease the transition into normalcy.

With strategic leveraging of deep industry expertise, McCarthy Tétrault can help you navigate the transition to a post-pandemic economy. Please contact Hartley Lefton if you have any questions or for assistance.