



# OSFI's Annual Risk Outlook - Semi-annual update

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## Introduction

The risk landscape has evolved since our release of the spring [2023 Annual Risk Outlook \(/en/about-osfi/reports-publications/osfis-annual-risk-outlook-fiscal-year-2023-2024\)](/en/about-osfi/reports-publications/osfis-annual-risk-outlook-fiscal-year-2023-2024) (ARO). While the nine financial system risks remain, we have noted a continuing shift in the risk environment. The most significant developments are a domestic inflation rate that remains above the Bank of Canada's target rate, the resulting monetary policy tightening and elevated interest rate environment, and signs of weakening credit quality, particularly in the commercial real estate (CRE) market.

This update provides an overview of what has changed in our assessment of financial system risks and provides an updated view that includes key environmental factors and our planned actions to address these risks. We also outline when to expect the release of policies, some of which have been affected by evolving environmental factors and shifting risk priorities.

## OSFI mandate update

On June 22, 2023, Parliament passed Bill C-47, the *Budget Implementation Act*, expanding our mandate and powers to include supervising federally regulated financial institutions (FRFIs) to determine whether they have adequate polices and procedures to protect

themselves against threats to their integrity or security, including foreign interference. These changes will enhance the strong oversight of FRFIs that supports a stable Canadian financial system.

FRFIs will be required to establish and adhere to such policies and procedures by January 1, 2024. To effect these changes, we will develop regulatory guidance and set expectations for FRFIs. Given the intersections between integrity and security and broader non-financial risks, such as culture and behaviour risk and operational risk and resilience, we will defer certain non-financial risk policy decisions until integrity and security guidance is released.

We will examine FRFIs at least yearly to determine whether these policies and procedures are adequate and report the results to the Minister of Finance.

## **Overview of environmental changes**

### **Higher interest rate environment**

Although the rate of inflation has slowed in 2023, a prolonged period of inflation remaining above the Bank of Canada's target range has led to a sustained increase in interest rates over the past 18 months. This has put pressure on retail, corporate, and commercial borrowers' ability to service debt. For example, we have observed a deterioration in the credit quality of variable-rate, fixed payment mortgages. When interest rates rise, these VFM loans reach a "trigger rate" when the fixed payment only covers the interest but none of the principal. If rates rise beyond the trigger rate, the fixed payments do not cover the interest payments and mortgage principal outstanding grows. There is a common misperception that these mortgages' amortization period extends, largely because monthly mortgage statements calculate a transient amortization period based on the amount of principal paid down in that month.

In fact, the contractual amortization period does not change. And mortgagors will have to make up the deferred principal paydowns when they renew. This means they are at risk of suffering a significant payment shock.

Lending institutions are currently well-capitalized and have proven to be financially resilient in previous downturns. However, as the impact of higher rates continues to be absorbed, the ability of consumers and businesses to adapt to the current rate environment will be tested as loans mature over the next few years in residential real estate secured lending (RESL), CRE, and corporate loan markets. We remain vigilant and continue to monitor for indications of increased borrower defaults, increased fraud, credit losses, and any broader credit led softening of the economic environment.

## **More difficult CRE environment**

While office, and construction and development are the riskiest CRE segments, all commercial property types are facing increased risks due to higher interest rates. Construction markets show signs of a slowdown. Office CRE valuations have come under pressure as the industry grapples with rising vacancies. The outlook remains difficult as seen through an increasing number of strategic defaults in the office space, falling real estate investment trust values relative to their historical net asset value estimates, and rising U.S. commercial mortgage-backed securities delinquency and special servicing rates, especially in the office segment. In addition, negative rating migration seems to be lagging changes to the risk environment. This indicates that risk assessments, risk rating models, and collateral valuations may not appropriately reflect the risk environment.

We have noticed evolving practices in the CRE market. In particular, an increase in the use of “participation” agreements and other co-lending arrangements such as layering in other subordinated debt arrangements whereby the risk is tranching between multiple lenders and entities. These agreements don’t always have standardized contractual language and therefore can present additional risk to lenders based on legal, operational, and structural complexities. They can affect lenders’ rights and remedies thereby impacting the probability of default and level of recovery values. Within this context, we now consider CRE to be a higher risk item than was reflected in the April ARO as conditions remain challenging.

## **Overview of our actions**

### **CRE**

We continue to supervise CRE risk management practices to ensure our expectations of prudent account and portfolio management are met. The intention of our supervisory work is to ensure that FRFIs are capturing the increase in CRE-related risk in their rating updates, collateral valuations, and in their provisioning levels. Institutions should expect further engagement on topics such as collateral valuation, particularly in subsegments that may be subject to a more meaningful decline in property valuation. We are currently engaged with industry to enhance CRE-related data collection to increase reporting granularity. This will improve tracking of CRE, including monitoring of ratings, forbearance actions, and collateral valuation.

In response to what we've observed, we released interim regulatory guidance on September 29, 2023 to reinforce CRE supervisory expectations. In February 2023, we updated our capital requirements to incorporate Basel III reforms. These updates included detailed capital requirements for CRE lending. We will monitor the implementation, as well as evolutions in the current environment, and will make adjustments and issue clarifications to the framework as needed.

## **Residential Mortgage Lending**

In RESL our supervisory work includes ensuring that FRFI risk management practices are responsive to changing market conditions, and lending standards are aligned with the expectations of Guideline B-20, Residential Mortgage Underwriting Practices and Procedures.

On July 11, 2023, we began a public consultation to obtain feedback on proposed revisions to the Capital Adequacy Requirements (for deposit-taking institutions) and the Mortgage Insurer Capital Adequacy Test guidelines to address risks related to mortgages with growing balances. This situation, referred to as negative amortization, may occur in an increasing interest rate environment when fixed payments on a variable interest rate mortgage are insufficient to cover the increased interest component. The proposed changes would become effective in fiscal Q1 2024.

On October 16, 2023, we will publish the results of our initial public consultation on Guideline B-20 on debt serviceability measures. One option we explored in our consultation is a potential role for loan-to-income (LTI) thresholds to help financial institutions better manage the risks associated with significant buildups of household debt in their loan books.

While other jurisdictions have incorporated LTI thresholds into their regulatory frameworks, Canada's mortgage market is different from that in other countries. In fact, different Canadian lenders have different risk appetites borne of bespoke business models in a highly competitive mortgage market. Therefore, a simple, macroprudential LTI measure may not be fit-for-purpose in Canada.

OSFI seeks an integrated set of common-sense protections that work effectively both in a high interest rate environment like today, and when interest rates are low as they were during the pandemic. Our primary aim is to ensure that Canadian homeowners can afford to service their mortgages in good times and hard times. As a secondary goal, we aim to ensure that OSFI's measures impact our regulated constituents proportionately such that all lenders in the federal financial system, regardless of size, can compete and take reasonable risks. We will continue to advance our review of expectations relating to RESL through 2023 to 2024.

As we do every year, we are reviewing the level of the minimum qualifying rate (MQR) stress test in the context of increasing interest rates and mortgage rates. The next planned MQR announcement is December 12, 2023.

# Annex

## Guidance priorities

This annex updates our near-term plan of guidance priorities for FRFIs and federally regulated pension plans (FRPPs). The references below reflect calendar quarters and cover the periods from Q4 2023 to Q2 2024. The Annex does not include guidance released since the April ARO or guidance no longer planned for release before Q2 2024.

Our guidance priorities are divided into three streams: (i) risk management guidance for FRFIs, (ii) capital and accounting guidance for FRFIs, and (iii) guidance for FRPPs.

The timelines indicated below reflect our current strategic plans and risk priorities and could change due to external factors.

## I. Risk management guidance for FRFIs

### Deposit-taking institutions and insurance companies

Calendar quarter	Guidance initiative	Purpose	Status
Q4 2023	Draft <u><a href="#">guideline E-21 on Operational Resilience and Operational Risk Management</a></u> ( <u><a href="#">/en/guidance/guidance-library/operational-resilience-operational-risk-management-draft-guideline-2023</a></u> ) for consultation	Sets out expectations on operational resilience, while continuing to reinforce expectations for operational risk management	Revised from Q3 2023
Q4 2023	Results of initial Guideline B-20: Residential Mortgage Underwriting Practices and Procedures consultation	Presents a summary of stakeholder feedback on the initial Guideline B-20 consultation	Revised from Q3 2023

<b>Calendar quarter</b>	<b>Guidance initiative</b>	<b>Purpose</b>	<b>Status</b>
Q4 2023	Draft guideline on Integrity and Security	Sets out proposed expectations for FRFIs to address risks and threats to their integrity and security. This follows the passage of Bill C-47, which expanded OSFI's mandate	New
Q1 2024	Draft guidance on fiat-referenced crypto-asset	Sets out proposed expectations for FRFIs engaged in fiat-reference crypto-asset arrangement and activities	New
Q1 2024	Final guideline on Integrity and Security	Sets our final expectations for FRFIs to address risks and threats to their integrity and security. Bill C-47 comes into force on January 1, 2024	New

## II. Capital and accounting guidance for FRFIs

### Deposit-taking institutions and insurance companies

Calendar quarter	Guidance initiative	Purpose	Status
Q4 2023	Revised Guideline E-23: Draft Model Risk Management Guideline	Public consultation on proposed expectations related to sound policies and practices for enterprise-wide model risk management	Revised from Q2 2023
Q4 2023	Revised Pillar 3 Disclosure Guideline, incorporating Market Risk and Credit Valuation Adjustments risk disclosures	Finalizes expectations on Market Risk and Credit Valuation Adjustments Risk Pillar 3 disclosures for banks	On track

Calendar quarter	Guidance initiative	Purpose	Status
Q4 2023	<p>Updates to capital frameworks for deposit-taking institutions (Capital Adequacy Requirements guideline) life insurers (Life Insurance Capital Adequacy Test guideline), mortgage insurers (Mortgage Insurer Capital Adequacy Test guideline) and property and casualty insurers (Minimum Capital Test guideline)</p>	<p>Incorporate minor revisions into the banking and insurance capital frameworks</p>	<p>On track</p>

Calendar quarter	Guidance initiative	Purpose	Status
Q4 2023	Consultation document on public disclosure of crypto-assets	Consultation on public disclosure of exposures to crypto-assets. In response to the <b><u>2023 Federal Budget</u></b> ( <a href="https://www.budget.canada.ca/2023/home-accueil-en.html">https://www.budget.canada.ca/2023/home-accueil-en.html</a> ) announcement	New
Q4 2023	Outcome of OSFI's review of wholesale funding sources with retail-like characteristics	Finalize changes, if any, to Liquidity Adequacy Requirement guideline for wholesale funding sources with retail-like characteristics	New
Q1 2024	Updates to interim approach for the capital and liquidity treatment of crypto-asset exposures	Finalize guidance on updates to capital and liquidity treatment of crypto-asset exposures	New
Q1 2024	Draft approach for determining capital requirements for segregated fund guarantee risk	Public consultation on the draft capital approach, along with accompanying forms	On track

<b>Calendar quarter</b>	<b>Guidance initiative</b>	<b>Purpose</b>	<b>Status</b>
Q1 2024	Revised Draft Guideline B-11: Pledging and the Covered Bond Limit Framework	Public consultation on revisions to expectations on pledging, as well as the framework around the covered bond limit	On track
Q2 2024	Consultation document on the Minimum Capital Test	Public consultation on potential future Minimum Capital Test framework updates	On track
Q2 2024	Consultation on the MICAT Guideline	Public consultation on changes to determining capital requirements for multi-unit residential mortgage insurance.	New

### III. Guidance for FRPPs

#### Private pension plans

<b>Calendar quarter</b>	<b>Guidance initiative</b>	<b>Purpose</b>	<b>Status</b>
Q4 2023	Technology and cyber incident reporting advisory and reporting form for FRPPs	Provides information to assist administrators of FRPPs to report technology and cyber incidents to OSFI	Revised from Q2 2023

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