Bank of Canada Emergency Lending Policies

A consultation paper by the Bank of Canada
5 May 2015

The Bank of Canada is updating its emergency lending policies to reflect the evolution of the Canadian financial system and lessons learned globally during the 2007–09 financial crisis. This paper sets out proposed updates to the Bank of Canada's Emergency Lending Assistance (ELA) policies and is being issued for public consultation. Comments should be addressed to

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All comments on this consultation paper should be received by 4 July 2015.

Policy Objectives

This consultation paper sets out proposed changes to the Bank of Canada's Emergency Lending Assistance (ELA) policies. Background information on Emergency Lending Assistance is provided in an appendix at the end of this paper. The motivating factors behind the review of the ELA policy framework are to

- **reflect lessons from the global financial crisis.** The Bank has sought to incorporate observations from the experience in Canada as well as in other jurisdictions during the recent crisis. The 2007–09 financial crisis provided useful insights into the policies and frameworks of different national authorities that were used to respond to stress at individual financial institutions and financial markets.
- **clarify the scope of lending policies**. The scale of the financial crisis forced central banks to re-examine whether the scope of their lending policies was appropriate. In light of this, the Bank will articulate its ELA policies for provincially regulated deposit-taking institutions and financial market infrastructures (FMIs).[1]
- **strengthen the resilience of the Canadian financial system**. Since the financial crisis, regulatory reforms have been developed at the global level and implemented in Canada to improve the resilience of financial institutions and FMIs and reduce systemic risk. In particular, these reforms help to ensure that such entities can be resolved in an orderly manner when the firm's own recovery actions are insufficient and the firm is no longer viable. National authorities are working to ensure that effective recovery and resolution frameworks are in place that eliminate the need for taxpayer bailouts and reduce the systemic impact of non-viable institutions or FMIs.[2] The Bank will improve the flexibility and capacity of ELA so that it can be used to effectively support financial institutions or FMIs in recovery or resolution.

The Bank's liquidity facilities are carefully designed to ensure that they are flexible and effective tools to promote financial stability and, at the same time, have appropriate safeguards to protect the Bank from financial risk and to mitigate moral hazard on the part of potential borrowers.[3]

It is important to note that central bank lending cannot recapitalize a financial institution or an FMI or address the underlying problems that lead to liquidity shortfalls. Accordingly, the deployment of the Bank's liquidity facilities is just one component of a larger set of coordinated actions that authorities can take to support the stability of the Canadian financial system.

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[1] FMIs are payment clearing and settlement companies that channel the vast majority of financial transactions within financial markets. For more information, please refer to http://www.bankofcanada.ca/core-functions/financial-system/oversight-designated-clearing-settlement-systems/oversight-and-legislation/guideline-related-oversight-activities.

[2] See Financial Stability Board (2014), "Key Attributes of Effective Resolution Regimes for Financial Institutions," at http://www.financialstabilityboard.org/2014/10/r_141015/.

[3] Moral hazard arises when potential borrowers engage in excessive risk taking because a liquidity backstop exists.

Key Updates to the Bank of Canada's Emergency Lending Assistance Policies

This section of the consultation paper outlines the key proposed updates to the Bank's ELA policies. They relate to the following areas: (i) the role of ELA in the effective recovery or orderly resolution of a financial institution; (ii) ELA eligibility criteria for provincially regulated deposit-taking institutions; (iii) acceptance of mortgages as collateral for ELA; and (iv) the provision of ELA to FMIs.

(i) The role of Emergency Lending Assistance in the effective recovery or orderly resolution of a financial institution

The Bank of Canada will eliminate its requirement for a solvency opinion as a condition for the provision of Emergency Lending Assistance (ELA). Instead, a new requirement for a credible recovery and resolution framework will be established.

A financial institution under stress can trigger a process known as recovery, whereby the institution takes actions (e.g., raising capital or funding or restructuring business lines) to restore the market's confidence in its financial soundness.

The Bank's ELA has traditionally been positioned as a tool to provide temporary liquidity to a viable firm that is experiencing persistent liquidity problems. In other words, ELA can support the recovery of a distressed financial institution, and this will continue to be an important aspect of ELA.

Should recovery actions be insufficient to mitigate the stresses faced by a financial institution, the firm's resolution authority could place the financial institution into resolution.[4] Through this resolution process, the resolution authority would seek to, (i) maintain operations that are critical to the economy and return the firm to viability, either through a sale to or merger with a healthy firm or a bail-in of senior debt holders; or (ii) liquidate the firm in an orderly fashion. In instances where the resolution authority is aiming to return the financial institution to viability, authorities may need to provide temporary public sector liquidity to support the firm until it is able to regain access to market funding.[5, 6]

The Bank plans to make ELA available as a potential source of liquidity support in resolution, in addition to other available sources of temporary public sector liquidity, such as the financial institution's resolution authority.[7] ELA would play a role in ensuring that obligations that come due during resolution are met in a manner consistent with the ultimate objective of restoring a financial

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[4] The resolution authority for federally regulated deposit-taking institutions is the Canada Deposit Insurance Corporation (CDIC).Work is currently under way to establish a resolution authority in Canada for FMIs.

[5] Under a bail-in framework, a failed institution may be recapitalized by having its creditors' claims upon the firm converted into equity shares in the firm. For more information on the proposed bail-in process in Canada, please refer to http://www.fin.gc.ca/activty/consult/tpbrr-rpcrb-eng.asp.

[6] This is recognized in Section 6 of the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions."

[7] For more information on CDIC's role as Canada's resolution authority, please refer to http://www.cdic.ca/CDIC/Media/Documents/Speech_MBourque_CDHowe_jun2014.pdf.

institution to viability or facilitating its orderly liquidation. In this context, ELA has the following advantages: ELA is timely since the Bank can instantaneously create Canadian-dollar liquidity; ELA loans can be sizable, if required, and are limited only by the amount of acceptable collateral that can be provided to the Bank; and ELA is designed to mitigate credit risk and moral hazard.

Existing ELA policies require that the applicant be assessed as solvent in order to be eligible for ELA. In practice, however, the benefits of a solvency opinion have been limited: insolvency and illiquidity are difficult to differentiate, since these issues are typically interrelated for financial institutions. Furthermore, solvency represents a point-in-time assessment of a firm's financial health and does not necessarily reflect long-term viability.

The Bank views the provision of emergency loans as supporting a distressed financial institution's return to long-term viability, either through the firm's own recovery actions or as part of coordinated efforts by the public sector if the firm's recovery actions prove to be inadequate. A credible recovery and resolution framework supports the long-term viability of a firm by ensuring that the firm has recovery actions designed to improve its liquidity and capital positions while under stress or, if the firm fails to achieve a recovery, that the resolution authority has a credible strategy that can maintain the firm's critical functions and eventually return it to viability or liquidate it in an orderly manner.

To ensure that the Bank has the flexibility to provide ELA in support of a credible resolution, the Bank's ELA solvency requirement will be replaced by a requirement for the applicant firm to have a credible recovery and resolution framework in place.

(ii) Emergency Lending Assistance eligibility criteria for provincially regulated deposit-taking institutions

For a provincially regulated credit union, caisse populaire or central to be eligible for Emergency Lending Assistance (ELA), the Bank would require (i) the firm to be a member of the Canadian Payments Association (CPA); (ii) a provincial indemnity against losses incurred by the Bank; (iii) that ELA be necessary to support the stability of the Canadian financial system; and (iv) the firm to have a credible recovery and resolution framework.

Provincially regulated credit unions and caisses populaires would not generally be eligible for ELA, since, in most cases, these institutions receive liquidity assistance from provincial centrals. In extraordinary cases, the Bank will consider providing ELA to a provincially regulated credit union, caisse populaire or central provided that the following eligibility criteria are met:[8]

[8] Federal credit unions would be subject to the same eligibility criteria as other federally regulated deposit-taking institutions.

(i) **CPA membership.** The Bank of Canada Act provides the Bank with the power to make secured loans or advances to members of the CPA. Therefore, ELA can be provided only to CPA members.[9]

(ii) **Provincial indemnity.** Provinces that have responsibility for the prudential oversight of the institutions will need to indemnify the Bank from any losses if the borrower were to default on its ELA loan. The indemnity would only cover any residual amount should the value of the collateral provided, as well as any guarantees by other institutions, prove insufficient.[10] Note that provincial indemnification is not required for access to the Bank's Standing Liquidity Facility (SLF) or market-wide liquidity facilities.

(iii) **Financial stability.** Bank of Canada ELA would be available only if it is deemed, in the judgment of the Bank, to be important for the stability of the broader Canadian financial system. The Bank must be of the opinion that the distress or disorderly failure of the potential ELA recipient would have systemic implications for the Canadian financial system.

(iv) **Credible recovery and resolution framework.** At the time that ELA is requested, an appropriate recovery framework (for viable institutions) or resolution framework (for non-viable institutions) would need to be in place for the relevant credit unions, caisses populaires and centrals, and these frameworks would need to be judged as credible by the Bank.

The indemnity agreement will be a legal requirement once recent amendments to the Bank of Canada Act come into effect. The three conditions largely formalize and clarify existing policies. These conditions do not reflect any specific concerns about the provincial credit union or caisse populaire systems. Provincial authorities remain responsible for ensuring that the institutions they supervise have appropriate liquidity arrangements in place. The conditions are also consistent with broader efforts to clarify the roles and responsibilities of federal and provincial financial authorities with respect to credit unions, caisses populaires and centrals, in order to promote a strong and resilient financial system.[11]

The Bank is committed to working with the provinces and financial institutions to address any operational barriers and prepare the legal documentation necessary to ensure that if it decides to grant ELA access, funds may be provided to provincial entities on a timely basis.

[9] If the other eligibility requirements are met, the Bank may choose to provide ELA to a credit union central that is a CPA member. The central would then pass on the liquidity to individual credit unions or caisses populaires that are not themselves CPA members.

[10] This condition establishes symmetry between the provincial and federal frameworks, since any residual loss suffered by the Bank when providing ELA to a federally regulated institution would ultimately be absorbed by the federal government.

[11] See page 132 of the Government of Canada's 2014 budget, "The Road to Balance: Creating Jobs and Opportunities."

(iii) Acceptance of mortgages as collateral for Emergency Lending Assistance

The Bank of Canada will, at its discretion, take mortgages as eligible collateral for Emergency Lending Assistance (ELA): first, indirectly through the pledging of private-label mortgage-backed securities, then, directly by taking assignments of the mortgages, but only as a last resort to maintain financial stability.

For ELA, the Bank is willing to accept a broader range of collateral than that approved for credit under the SLF.[12] In practice, this has traditionally meant the Bank would largely rely on a financial institution's Canadian-dollar non-mortgage loan portfolio. Under existing policies, articulated in 2004, the Bank would not provide liquidity against mortgage loans.

Under its updated policies, the Bank will accept mortgages as collateral for ELA, but only as a last resort when other sources of collateral have been exhausted. This should translate into a significantly larger capacity for eligible financial institutions to draw on ELA. It would also provide the Bank with greater flexibility in the types of collateral it may choose to accept, which could be particularly helpful during a period of financial stress.

While there are benefits to expanding the list of eligible ELA collateral to include mortgages, this also poses some legal and operational challenges for the Bank.[13] As a result, the Bank proposes (before accepting assignments of mortgages) to first accept private-label residential mortgage-backed securities (RMBS), including those that do not meet the SLF collateral eligibility requirements such as securitizations of mortgages originated by the pledgor ("own-name" RMBS).[14, 15] Direct assignments of mortgages would be taken only in extreme circumstances when financial stability is threatened and other viable sources of collateral (including private-label RMBS) have been exhausted.

[12] The Bank's SLF collateral policy is described in "Assets Eligible as Collateral under the Bank of Canada's Standing Liquidity Facility" at www.bankofcanada.ca/wp-content/uploads/2011/08/slf_131213.pdf.

[13] First, to perfect its security in the mortgages, the Bank would need to register the assignments of *individual* mortgages in the land registry or land titles office in the county or municipality where the mortgages are located. In contrast, the Bank can perfect its security in a *portfolio* of non-mortgage loans by registering its interest in the entire portfolio through a single personal property security registration at the provincial level. Second, the Bank could incur an extensive administrative burden related to servicing the mortgages if an institution receiving ELA were to default on the advance and be placed into liquidation.

[14] Only uninsured mortgages would be securitized in this context, given the legislative ban on securitizing insured mortgages in private securitization programs that are not supported by the Canada Mortgage and Housing Corporation (CMHC).

[15] The creation and perfection of security in RMBS is subject to a much less onerous legal regime than that for mortgage loans. The Bank would perfect its security interest in the RMBS simply by taking delivery of the securities in the CDSX securities settlement system.

Questions for Consultation

1. How would financial institutions use their non-mortgage loan portfolio, private-label mortgage-backed securities and individual mortgage loans as collateral for ELA under this proposal? In particular, what is the likely order in which these assets will be pledged?
2. What technical or operational challenges would financial institutions encounter in pledging private-label RMBS (e.g., capacity and time needed to securitize) and in directly assigning mortgages to the Bank? To mitigate these challenges, would financial institutions look to pre-position such collateral in advance with the Bank?

(iv) The provision of Emergency Lending Assistance to financial market infrastructures

The Bank of Canada could provide Emergency Lending Assistance (ELA) to designated financial market infrastructures (FMIs) in support of credible recovery and resolution actions. The minimum rate charged would be the Bank Rate, and the Bank would be willing to accept a broad range of collateral at its discretion (and subject to operational constraints).

The Bank has the legal authority to lend on a fully collateralized basis to the operator of a clearing and settlement system that has been designated under the Payment Clearing and Settlement Act (PCSA).[16] This section proposes clarifications to the policy framework that would guide such lending.

The Bank could provide ELA to support the effective recovery and/or orderly resolution of an FMI.[17] Eligibility for ELA will remain limited to designated systems, with ELA being available to Canadian-domiciled FMIs at the Bank's discretion.[18, 19] Lead central banks overseeing foreign-domiciled FMIs are responsible for ensuring that emergency liquidity is available for those systems.[20] However, the Bank of Canada could facilitate the lead central bank's provision of Canadian-dollar liquidity should the lead central bank choose to do so.

In exercising its discretion to provide ELA, the Bank would take into account concerns about systemic risk, such as the potential for the system's critical functions to become impaired,

[16] The Governor may designate an eligible FMI for Bank oversight when of the opinion that it may be operated in a manner that poses systemic risk or payments system risk. For designation to take effect, the Minister of Finance must be of the opinion that designation is in the public interest.
[17] The Bank could also provide liquidity support as part of an FMI's orderly wind-down, if applicable.
[18] Current Canadian-domiciled systems designated by the Bank of Canada under the PCSA are the Large Value Transfer System (LVTS), CDSX and the Canadian Derivatives Clearing Service (CDCS).
[19] Consistent with the Financial Stability Board's call to remove any technical obstacles that would prevent central banks from providing emergency liquidity in all relevant currencies to central counterparties, the Bank is exploring the operational feasibility of providing foreign-currency ELA if needed to prevent a Canadian-domiciled designated FMI from failing to meet its obligations to a foreign FMI.
[20] Current foreign-domiciled systems designated by the Bank of Canada under the PCSA are the Continuous Linked Settlement Bank (CLS Bank) and LCH.Clearnet Limited's SwapClear Service. The lead foreign central banks overseeing each of them are the Federal Reserve Board and the Bank of England, respectively.

materially disrupting the well-functioning of the Canadian financial system. The objective would be to sustain the FMI's critical services and promote market confidence in the system. If the FMI operator remains viable, the Bank could provide ELA, as a last resort, to support the FMI's recovery from severe stress. If a designated system is non-viable (i.e., in resolution), the Bank could provide ELA in support of the resolution process. Moral hazard and other risks associated with ELA to a non-viable institution would be addressed as part of credible FMI resolution actions.

The minimum rate that the Bank would charge on ELA to FMIs is the Bank Rate, with the discretion to charge a higher interest rate if deemed appropriate. The Bank would be willing to accept a broad range of collateral, at its discretion. To ensure that sufficient ELA can be provided if and when the Bank chooses to do so, the Bank will work with designated systems to minimize any technical constraints to the range of collateral it could accept, such as timely collateral pricing, as well as pledging and delivery to the Bank.

Next Steps

The Bank of Canada welcomes feedback from all interested parties regarding the proposed policy changes and clarifications in this paper. In particular, we invite responses to the questions related to the taking of mortgages as collateral (page 6). Individual responses received by the Bank will be treated as confidential and will not be published. However, the Bank may choose to issue a summary of the responses received after the consultation period has ended.

Following the conclusion of the consultation period, the Bank will finalize the updates to its ELA policies and post them on its website. We will also engage relevant authorities and financial institutions to ensure smooth implementation of the updated policies.

Appendix: Bank of Canada Emergency Lending Assistance

This appendix describes the purpose, terms and conditions, decision-making process for granting access to, and the mechanics of distributing the Bank of Canada's Emergency Lending Assistance (ELA), incorporating the changes proposed in this consultation paper.

Purpose of Emergency Lending Assistance

The provision of ELA is extraordinary and designed to provide lender-of-last-resort liquidity to individual financial institutions (FIs) or financial market infrastructures (FMIs) that are facing serious funding or liquidity problems. ELA is not intended to address illiquid markets and is distinct from other extraordinary liquidity facilities (e.g., term purchase and resale agreements) that may be activated during times of market stress and made available to a broad set of participants.

ELA can be provided to two types of financial entities—FIs and FMIs—and can play a role in both their recovery and resolution:

- **Recovery:** An FI or FMI under extreme stress can trigger a process known as recovery, whereby the entity takes actions to restore the market's confidence in its financial soundness. Bank of Canada ELA has historically played a role in the recovery of FIs by providing liquidity in support of recovery actions.[21]
- **Resolution:** Should recovery actions be insufficient to mitigate stress faced by an FI or FMI, the firm's resolution authority could place the FI or FMI into resolution. Through this resolution process, the resolution authority would seek to maintain functions that are critical to the economy and return the firm to viability, or liquidate the firm in an orderly fashion.[22] ELA could serve as a source of temporary public sector liquidity to support the broader efforts of authorities to conduct an orderly resolution of the firm.

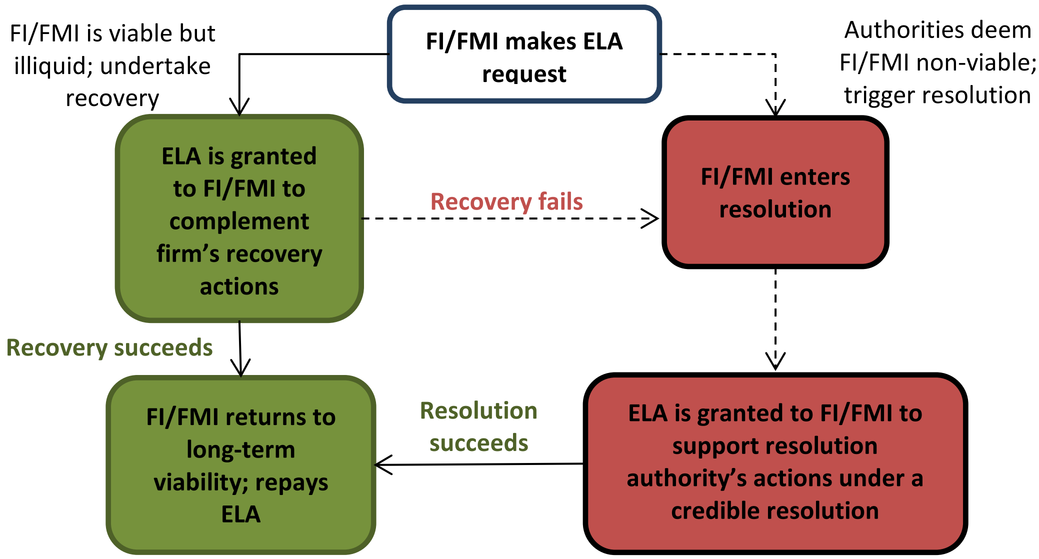
In both recovery and resolution, however, the Bank retains its discretion to provide ELA.

[21] Deposit-taking institutions are susceptible to "bank runs," where a large and sudden increase in the redemption of deposits or a refusal by wholesale funding providers to continue lending can lead to liquidity shortages and potential insolvency. Examples of recovery actions that a financial institution could take are restructuring business lines and raising capital or funding.

[22] Examples of resolution actions with respect to an FI or FMI include recapitalization and restructuring. The resolution authority could also choose to wind down the firm in an orderly fashion.

Figure 1 illustrates how ELA may support an FI or FMI's return to long-term viability, highlighting important differences between the role of ELA in recovery and in resolution.

Figure 1: Scenario analysis—providing Emergency Lending Assistance to a financial institution or a financial market infrastructure



The following assumptions apply:

1. **Eligibility criteria for ELA are satisfied:** Eligibility criteria depend on the type of entity making the ELA request (see Table 1).
2. **The Bank decides to offer ELA**: The provision of ELA complements either the recovery actions of the entity under distress or the resolution actions of the resolution authority.

Terms and Conditions of Emergency Lending Assistance

The terms and conditions of ELA loans are determined by the Bank of Canada Act, the Payment Clearing and Settlement Act (PCSA), the Bank's lending policies and its loan and security agreements.[23] They are designed to provide the appropriate safeguards to protect the Bank from financial and legal risk and to mitigate moral hazard.

CPA membership or designated FMI: The Bank of Canada Act provides the Bank with the power to make secured loans or advances to members of the Canadian Payments Association (CPA), while the PCSA provides the Bank with the power to lend to FMIs designated as subject to the Bank's oversight (designated FMIs).[24,25] Therefore, only CPA members or designated FMIs are eligible for ELA.

[23] See the Bank of Canada Rules Governing Advances to Financial Institutions at http://www.bankofcanada.ca/wp-content/uploads/2010/04/rules_08.pdf.
[24] For CPA members, see paragraph 18(h) of the Bank of Canada Act.

Interest rate: The minimum rate that the Bank charges on ELA loans is the Bank Rate, which is the rate of interest that the Bank charges on one-day loans to major financial institutions. While the Bank has the discretion to charge an interest rate higher than the Bank Rate, historically, the Bank has charged the Bank Rate for ELA.

Term: Under the Bank of Canada Act, the Bank can provide ELA for a maximum term to maturity of six months. The loans can be renewed for a period of up to six months, at the Bank's discretion. In practice, ELA loans would typically be structured as one-day loans, to be rolled over daily.

Collateral: The Bank of Canada Act requires that all Bank lending be secured by collateral pledged by the borrowing institution. Collateral that is acceptable under the Standing Liquidity Facility (SLF) will also be accepted for ELA. The haircuts applied to collateral accepted under SLF are determined by the Bank's SLF collateral policy.[26] For ELA, the Bank is also willing to accept a broader range of collateral, subject to the appropriate haircuts, than that approved under the SLF.

Decision-Making Process for Granting Emergency Lending Assistance

Assessment against eligibility criteria

The Bank's Governing Council would assess an entity's ELA request to determine whether the entity meets the eligibility criteria under the ELA framework. The eligibility criteria depend on the type of financial entity. Table 1 lists the eligibility criteria for three types of entities that are eligible for ELA.

Table 1: Eligibility criteria for access to Emergency Lending Assistance

Type of financial entity	Eligibility criteria
Federally regulated financial institution	1. Member of the Canadian Payments Association (CPA) 2. Credible recovery and resolution framework
Provincially regulated deposit-taking institution[27]	1. CPA member[28] 2. Provincial indemnity 3. Important to the stability of the Canadian financial system 4. Credible recovery and resolution framework
Financial market infrastructure (FMI)	Domestic FMI designated for Bank of Canada oversight[29]

25 For designated FMIs, see paragraph 7(b) of the PCSA.

26 For more information on the Bank's SLF collateral policy, see http://www.bankofcanada.ca/wp-content/uploads/2014/03/SLF-Policy.pdf.

27 A deposit-taking institution is a type of financial institution that accepts deposits, which are fixed-value promises to pay, often redeemable at short notice.

28 For a provincially regulated deposit-taking institution, this would typically be the provincial central. The central may then pass on the liquidity to individual credit unions and caisses populaires that may not themselves be CPA members.

29 Lead central banks overseeing foreign-domiciled FMIs are responsible for ensuring that emergency liquidity is available to those systems. However, the Bank of Canada could facilitate the lead central bank's provision of Canadian-dollar liquidity should the lead central bank choose to do so.

Coordination with relevant authorities

For federally regulated FIs, the Financial Institutions Supervisory Committee (FISC) is the primary forum of exchange for coordinating strategies, such as those for contingency planning, among federal authorities when dealing with troubled institutions that are still viable.[30] Relatedly, federal authorities would primarily coordinate resolution strategies for non-viable firms through CDIC's Board of Directors. The Bank would keep federal authorities informed of prospective ELA situations and would notify them immediately when it provided ELA to an institution.

For provincially regulated deposit-taking institutions, formal arrangements for communication with provincial authorities need to be established. The Bank is starting discussions on this with relevant provincial authorities.

For FMIs who are also overseen by other regulatory authorities, the Bank establishes co-operative arrangements with those authorities to facilitate communication and coordination.

Mechanics of Emergency Lending Assistance Distribution

For FIs, ELA funds are disbursed through the LVTS, the large-value payments system operated by the Canadian Payments Association (CPA). Consequently, to receive ELA funds an ELA recipient must have direct access to the LVTS or indirect access through a CPA member. For domestic FMIs, ELA funds can be provided to the FMI through a deposit into an account at the Bank of Canada.

[30] For the legislative basis underpinning FISC, see Section 18 of the Office of the Superintendent of Financial Institutions Act at http://laws-lois.justice.gc.ca/eng/acts/o-2.7/page-6.html#h-12.