Recent Changes to the Bank of Canada’s Emergency Lending Assistance Policy

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- Emergency Lending Assistance (ELA) is a last-resort collateralized loan or advance provided by the Bank of Canada, at its discretion, to eligible financial institutions (FIs) and financial market infrastructures (FMIs) that are facing serious liquidity problems.

- After consulting with relevant stakeholders, the Bank revised its ELA policy in December 2015. The revisions aim to ensure the policy remains effective given ongoing changes in the Canadian financial system and lessons learned from the 2007–09 global financial crisis.

- The updated ELA policy clarifies the role that ELA can play as a temporary source of liquidity in supporting the recovery and resolution of eligible FIs. It also expands the list of eligible collateral to include mortgages, which can significantly increase an eligible institution’s capacity to borrow under ELA. Recent revisions also provide greater clarity for the eligibility criteria and conditions for the provision of ELA to provincially regulated deposit-taking institutions and FMIs.

Similar to central banks in other jurisdictions, the Bank of Canada acts as a “backstop” provider of liquidity to the Canadian financial system. This “lender-of-last-resort” (LLR) function has been a fundamental role of central banks since the 19th century. It aims to prevent or mitigate financial instability by providing liquidity support, either to particular financial institutions (FIs) and financial market infrastructures (FMIs) or to financial market participants more broadly.¹

FIs that fund illiquid loans with redeemable deposits or short-term wholesale funds can face liquidity risks, and even a well-managed, solvent bank could suffer an unexpected liquidity shortage. FMIs also face liquidity risk, notably in the event that one of their participants defaults, requiring them to convert securities received as collateral into cash to meet the defaulter’s payment obligations. While FMIs must have adequate financial resources and arrangements to manage extreme but plausible scenarios, these may not be sufficient in every eventuality. For example, the FMI’s private liquidity facilities may prove insufficient in the most extreme cases or the providers of such facilities may be unable or unwilling to meet their commitments.

¹ The Bank of Canada Act and the Payment, Clearing and Settlement Act (PCSA) together give the Bank the power to make secured loans or advances to members of Payments Canada (formerly the Canadian Payments Association) and operators of FMIs designated for oversight under the PCSA. See paragraph 18(h) of the Bank of Canada Act; section 7 of the PCSA.
Emergency Lending Assistance (ELA) represents one element in the Bank of Canada’s LLR tool kit. Through ELA, the Bank has the discretion to provide a loan or advance to eligible individual FIs and FMIs that are facing serious liquidity problems. ELA is intended to be drawn on an extraordinary basis; the last time it was provided was to Continental Bank in 1986.

In December 2015, the Bank of Canada revised its ELA policy, which had been in place since 2004, incorporating four main updates. The revised policy (i) replaced the requirement for a financial institution’s solvency with the requirement for a credible recovery and resolution framework, (ii) expanded the range of eligible collateral to include mortgages, (iii) clarified the eligibility requirements for provincially regulated financial institutions, and (iv) clarified the conditions for ELA provision to FMIs.

This article discusses each of these updates in turn, with a focus on the factors that motivated them.

### Key Updates to the Bank’s ELA Policy

#### Credible recovery and resolution framework

Under the former policy, only FIs that were judged to be solvent were eligible for an ELA loan. The Bank’s updated policy now requires that FIs have a credible recovery and resolution framework in place. This change reflects the evolution of the Canadian financial system in the wake of the 2007–09 financial crisis.

Given the interconnected nature of the financial system, stress or disorderly failure of certain FIs can lead to contagion to other FIs, with potentially destabilizing effects on the broader financial system. In Canada, this led the Office of the Superintendent of Financial Institutions (OSFI) to identify the six major Canadian banks as systemically important. The financial crisis demonstrated that in the absence of effective resolution regimes for these systemically important FIs, authorities would be expected to bail out failing banks—potentially at great expense to taxpayers—to mitigate the disruptive impact of their failure.

Since the crisis, jurisdictions around the globe, including Canada, have taken important steps to establish effective regimes that can help a distressed institution return to viability or support its orderly liquidation. Authorities have been working to ensure that FIs consider, in advance, recovery actions they could take (e.g., raising capital or funding or restructuring business lines) if they were under stress to restore the market’s confidence in the firm’s financial soundness. However, under extreme shocks, FIs could still fail to recover on their own. In this case, the appropriate authority could place the institution into resolution. Through the resolution process, authorities seek to maintain operations that are critical to the functioning of the real economy and for financial stability while undertaking actions to restore the firm’s capital adequacy and return the FI to viability. For example, resolution of a systemically important FI could be achieved through a “bail-in” of senior debt holders.

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2 For a description of other LLR tool kit elements, see the article entitled, “Market Operations and Liquidity Provision at the Bank of Canada” in this issue of the Bank of Canada Review.


5 Resolution involves any action taken by a national authority, with or without private sector involvement, that is intended to address serious problems in an FI that imperil its viability (BCBS 2010).
restructuring and/or sale of businesses.\(^6\) Examples of resolution tools for non-systemically important firms could include a merger, a bridge bank or an orderly, court-supervised liquidation process.\(^7\)

In Canada, the Canada Deposit Insurance Corporation (CDIC) is the resolution authority for federally regulated deposit-taking financial institutions.\(^8\) The federal government has recently strengthened CDIC’s resolution tool kit with the introduction of a bail-in regime. Financial safety net authorities have also collaborated to establish and enhance recovery and resolution planning for FIs.\(^9\) In this context, Canadian safety net agencies agree that there is a role for Bank of Canada ELA to support effective recovery and resolution. Under the Bank’s updated policy, ELA will continue to support FI recovery. If a firm’s recovery actions should ultimately be unsuccessful, however, there is also a role for ELA in supporting the FI resolution process (i.e., return to viability or orderly liquidation).

Although the provision of ELA to a firm in resolution (including firms that may be temporarily insolvent) is a departure from the previous approach,\(^10\) recent international guidance from the Financial Stability Board supports a role for central bank liquidity as one of several possible mechanisms for funding an orderly resolution process.\(^11\) While private sources of funding are preferred, temporary public sector backstop funding may be needed. The existence of public sector backstop funding can also promote market confidence and support the broader efforts of authorities to resolve the FI in an orderly fashion.

In addition to ELA, temporary public sector funding for a firm in resolution may be drawn from alternative sources, such as a resolution fund, deposit insurance fund or other funding managed by the resolution authority or finance ministry. For example, in Canada, CDIC can provide financial assistance to federally regulated deposit-taking institutions using its investment portfolio and/or its borrowing authority with the Government of Canada or capital markets, subject to approval by the Minister of Finance. Taken together, ELA and these alternative sources of funding complement each other and form a tool kit for temporary public sector funding assistance for an FI in resolution. ELA brings the following advantages to this tool kit:

- **ELA is timely.** The Bank can create Canadian-dollar liquidity instantaneously and has established mechanisms to take and price the necessary collateral and deliver funds to the receiving FI through the Large Value Transfer System (LVTS). Other funding tools may take additional time to deploy. For instance, other authorities may require time to borrow the necessary funds through financial markets.

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\(^6\) A bail-in allows authorities to recapitalize a failing systemically important bank by converting eligible long-term debt of the bank into common shares.

\(^7\) Authorities can transfer all or part of the failing FI’s business to a bridge bank until a buyer can be found.

\(^8\) For more detail on the tools CDIC can use to facilitate resolution, see [http://www.cdic.ca/en/about-cdic/resolution/Pages/tools.aspx](http://www.cdic.ca/en/about-cdic/resolution/Pages/tools.aspx).


\(^10\) Traditionally, ELA has been positioned as a tool to provide temporary liquidity to a solvent firm that is experiencing persistent liquidity problems. This is a common view of the role of the central bank as lender of last resort, tracing its roots to Walter Bagehot in the 19th century.

- **ELA capacity is sizable.** ELA capacity is based on the FI’s eligible collateral, and the Bank of Canada has considerable discretion concerning the assets it can choose to accept (e.g., a non-mortgage loan portfolio). Other public sector funding sources may be more limited in the amount of funds they can raise in a short period of time.

- **ELA is designed to mitigate credit risk and moral hazard** (i.e., the risk that potential borrowers engage in excessive risk taking because a liquidity backstop exists). ELA is fully collateralized, with appropriate haircuts imposed on the value of assets pledged. This helps protect the Bank from credit risk. ELA is also priced at a penalty interest rate that is higher than the rate that would be charged in the market in normal times. Taken together, these factors introduce a disincentive to use ELA for an extended period. This encourages the firm to return to private funding sources when available. Although they may have other means to mitigate credit risk, alternative public sector funding sources may not be fully collateralized and may expose the government to credit risk.

Given these benefits, ELA is well suited to play an important role in a coordinated public sector approach to funding a Canadian FI in resolution. In this context, it is important to note that ELA is a means for the Bank to provide temporary liquidity support. It is impossible to use ELA to recapitalize an FI because ELA is a loan, creating both an asset (the proceeds from the loan) and a liability (the obligation to repay the loan) on the borrower’s balance sheet. ELA therefore does not provide additional equity or capital to the FI.

To ensure that ELA supports either an FI’s return to viability or its orderly liquidation, the Bank of Canada requires that borrowers have a credible recovery and resolution framework (RRF). Broadly speaking, an RRF is credible if it provides the relevant authorities, including the Bank of Canada, with a high degree of confidence that a troubled institution can be returned to long-term viability or be resolved in an orderly manner, without systemic disruption.

This new requirement for a credible RRF and the elimination of the previous solvency requirement both reflect the possible need to provide ELA temporarily to insolvent institutions to support an effective resolution process (Dobler et al. 2016). For example, providing ELA to an insolvent FI could allow the time needed for authorities to recapitalize the institution as part of the broader resolution process. Requiring solvency in this situation could delay or prevent ELA from being provided. If alternative sources of temporary public sector liquidity assistance are limited in the amount of funds they can raise in a short period, the FI in resolution may not have enough liquidity to pay its obligations. This could potentially place orderly resolution and broader financial system stability at risk.

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12 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 FIs. 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.

13 ELA provides liquidity in the form of a loan that is secured by eligible collateral. In terms of the balance sheet, this creates a liability for the borrowing institution. It does not create capital, which requires an entirely different type of transaction: the issuance and purchase of equity or other forms of regulatory capital from the borrower. As such, while ELA can provide liquidity support, recapitalization of a distressed FI would either take place in private markets or be done by public authorities such as the government or resolution authority. A strategy for recapitalization would be one part of a broader credible recovery and resolution strategy.

Removing the solvency requirement also recognizes that solvency and illiquidity are closely linked and, in periods of stress, authorities can have difficulty differentiating between the two (Nyberg 2000). Moreover, solvency represents an assessment of a firm’s financial health at a specific point in time and does not necessarily reflect its long-term viability.

Acceptance of mortgage collateral

Given that the provision of ELA is extraordinary and designed to provide last-resort liquidity, it is possible that the institution requesting ELA will have already liquidated a significant proportion of its holdings of marketable securities. Accordingly, ELA loans may be made against collateral that is less liquid and more difficult to value. Recent revisions to the Bank’s ELA policy clarify that, in addition to the Canadian-dollar non-mortgage loan portfolio (NMLP) and less-liquid securities such as collateralized own-name securities (e.g., self-securitized loans), the Bank of Canada, as a last resort, is willing to accept Canadian-dollar mortgages as collateral for ELA loans.¹⁵

This policy change further expands the range of acceptable collateral for ELA loans beyond that eligible for the Standing Liquidity Facility (SLF).¹⁶ Furthermore, the acceptance of mortgages significantly increases an eligible FI’s capacity to borrow under ELA. Consider, for example, eligible collateral for Canada’s six major banks. Assuming these FIs had already liquidated a significant proportion of their holdings of marketable securities, their combined ELA capacity before the 2015 policy update would have been largely represented by the value of their NMLPs less an appropriate haircut. Based on August 2016 figures, this notional amount (before haircut) would have been approximately $587 billion. Following the 2015 ELA policy update, the acceptance of mortgage loan collateral represents an additional notional capacity (before haircut) of approximately $590 billion, for a total notional capacity (mortgage and non-mortgage loans, both before haircut) of close to $1.2 trillion.¹⁷

This additional capacity may become necessary in extreme stress—for example, when an FI’s funding needs are large and ELA is provided as a source of temporary public sector liquidity to support the broader efforts of authorities to conduct an orderly resolution. Accepting mortgages as collateral also helps the Bank protect itself from credit risk since mortgages can be of comparatively good quality relative to some other assets. Including mortgages in the list of eligible collateral for ELA is also consistent with the International Monetary Fund’s recommendation in the Financial Sector Assessment Program (FSAP) for Canada (IMF 2014).

The Bank is legally required to lend on a secured basis; thus, it must obtain a valid first-priority security interest in any collateral that is pledged or assigned for ELA. However, the legal process for perfecting the Bank’s first-priority security interest in collateral backed by real property, such as mortgages and home equity lines of credit, is substantially more complicated than that for non-mortgage loans. The Bank must take transfer of legal title and then register this title in the land registry or title office where each individual mortgage is located, making the process extremely time-consuming.¹⁸

¹⁵ The Bank of Canada Act requires that all lending by the Bank be on a secured basis.
¹⁷ These figures exclude loans that have been securitized.
¹⁸ The process for perfecting a first-priority interest in loans that are not backed by real property requires filing a single financial statement in the personal property registry of the relevant province, making it relatively quick and simple.
Collateralized lending protects the Bank because the Bank can sell or retain the collateral to compensate against losses it may incur if the FI fails to repay the ELA loan. In the case of mortgages, however, both selling and retaining the collateral in the event of a default is likely more costly for the Bank than other types of eligible collateral. While there is a market for buying and selling mortgage portfolios among banks and mortgage brokers, it is much less deep and liquid than the market for tradeable securities. As a result, market prices are either unavailable or unreliable, making the process for valuing this collateral more complex. Furthermore, the administration of mortgage loans would be operationally burdensome.

Given these challenges, the Bank retains the right to accept only those mortgages for which it can adequately manage the associated financial, legal and operational risks. Furthermore, the haircuts for mortgages will be set on a case-by-case basis to reflect their particular risk characteristics. Pre-positioning collateral allows more time to examine documentation and conduct any necessary valuations before the collateral is accepted.

Clarification of eligibility requirements for provincially regulated financial institutions

The Bank has authority, under the Bank of Canada Act, to make collateralized loans to members of Payments Canada (formerly the Canadian Payments Association), including provincially regulated FIs, credit union centrals and Caisse centrale Desjardins. The provincial centrals can then pass on the liquidity to individual co-operatives that are not members of Payments Canada but meet all other eligibility criteria.

As of 2015, the Canadian co-operative system included 694 credit unions and caisses populaires, which accounted for 9.6 per cent of Canadian financial system assets and 12 per cent of total deposits (Canadian Credit Union Association 2015). Co-operatives generally operate within their home provinces and are regulated by provincial authorities. Their business models typically focus on loan and mortgage activity, with their funding mostly generated through member deposits.

Recent revisions to the Bank’s ELA policy clarify the criteria for providing ELA to these provincially regulated deposit-taking institutions. These criteria reflect the fact that provinces are responsible for the stability of their own financial institutions. They also reflect differences in the provincial regulatory frameworks and seek to mitigate moral hazard, while taking the unique features of the Canadian co-operative system into account. The criteria also reinforce

19 A credible recovery and resolution framework should significantly mitigate the likelihood that a borrower will default on an ELA loan.
20 If the defaulting institution is wound up under the Winding-up and Restructuring Act, a liquidator will have the option of allowing the Bank to realize on its collateral or require that the collateral be transferred to the liquidator for realization.
21 Administering a mortgage involves various functions, including, but not limited to, monitoring and processing mortgage payments, selling the underlying property, discharging mortgages and ensuring that the underlying properties have adequate insurance.
22 The Bank’s haircut policy protects the Bank against valuation risk and potential further declines in collateral value.
23 Pre-positioning collateral entails reaching agreement on the terms of all necessary legal and financial documentation, without necessarily executing the legal agreements required to secure the Bank’s prospective advance.
24 Co-operative centrals provide trade association services, financial services, IT services and liquidity to their member co-operatives.
25 Federal credit unions are subject to the same eligibility criteria as other federally regulated deposit-taking institutions.
that ELA is the last line of liquidity defence; the provincial co-operative systems should have sufficient liquidity contingency arrangements in place without planning to rely on ELA.

These arrangements, which fall under the responsibility of provincial authorities, include the co-operatives' individual liquidity contingency planning as well as liquidity from their provincial centrals and any other inter-central liquidity arrangements that may be in place. If these arrangements are insufficient, ELA can provide a last resort liquidity backstop if all eligibility criteria are met.

The eligibility criteria for provincially regulated financial institutions are as follows:

- **Indemnity requirement.** Bank of Canada policy requires that the province with responsibility for the prudential oversight of the provincial institution indemnify the Bank for any residual losses resulting from default if the value of the collateral or guarantees from other institutions prove insufficient. This requirement reflects the fact that provincial authorities have the legislative powers to regulate local co-operatives and therefore are responsible for the stability of the provincial financial sector.

- **Credible recovery and resolution framework.** Before providing ELA, the Bank of Canada must have a high degree of confidence that a troubled provincially regulated FI can be returned to long-term viability or resolved in an orderly manner. This is similar to the new requirement for eligible federally regulated FIs to have a credible recovery and resolution framework in place and helps to ensure that the provision of ELA is consistent with recovery and resolution actions taken by the FI or provincial authorities. Additionally, a credible recovery and resolution framework enhances the resilience of the Canadian co-operative system, thereby reducing vulnerabilities in the broader financial system.

- **Importance to the stability of the financial system.** The Bank of Canada would provide ELA to a provincially regulated FI only if the distress or disorderly failure of the institution would have significant adverse consequences for the broader financial system or economy. This criterion clarifies that the Bank’s ELA would be provided only in extreme scenarios and reflects the responsibility of provincial authorities and centrals to establish liquidity support mechanisms for co-operatives in their jurisdictions, under most circumstances.

In determining the importance of an institution’s distress or failure to broader financial stability, the Bank will consider the potential for distress in a provincial or regional co-operative system to severely impair financial conditions or regional economic activity or to spread through national co-operative frameworks and infrastructures. For example, distress of one large co-operative or a number of smaller co-operatives simultaneously could have large adverse economic effects on a regional basis that could, in turn, pose risks to the broader financial system.

Before providing ELA to a provincially regulated FI, the Bank requires information and institution-specific data from the relevant provincial supervisors and resolution authorities to make an informed judgment about the credibility of the institution’s recovery and resolution framework as well as the importance of the FI to the stability of the broader financial system. The Bank is currently negotiating with provincial authorities to establish such information-sharing arrangements. These arrangements would also help the
Bank share information of mutual interest—including the Bank’s assessment of financial system vulnerabilities and risks—with provincial regulators on a regular basis.

Clarification of conditions for ELA provision to FMIs

FMIs facilitate the clearing, settling and recording of payments, securities, derivatives and other financial transactions, which in turn enable consumers and firms to safely and efficiently purchase goods and services, make financial investments and transfer funds. By legislation, the Bank of Canada oversees FMIs that have the potential to pose either systemic risk to the financial system or payments system risk as defined by the Payment Clearing and Settlement Act (PCSA). Currently, the Bank has designated five FMIs as系统ically important, with one additional FMI designated as having the potential to pose payments system risk. The Bank’s risk-management standards for designated FMIs minimize the likelihood that those FMIs would ever require ELA. Nonetheless, even in the presence of stringent standards, FMIs may experience a liquidity shortfall in extraordinary circumstances, for example, when an FMI’s private liquidity providers are unable or unwilling to fulfill their commitments.

Under the PCSA, the Bank has the authority to extend liquidity to the operator of designated clearing and settlement systems. The Bank’s updated ELA policy clarifies the policy framework that would guide such lending.

Canadian-domiciled designated FMIs are eligible for Canadian-dollar ELA at the Bank’s discretion. Moreover, where it is operationally feasible, the Bank could provide foreign-currency ELA, if needed, to prevent a Canadian-domiciled designated FMI from failing to meet its obligations to a foreign FMI. Foreign-domiciled designated FMIs are generally not eligible for ELA because the primary responsibility for overseeing these systems and ensuring the availability of emergency liquidity rests with the FMIs’ lead central bank.

As part of its oversight, the Bank requires designated FMIs to have a credible recovery plan, which the Bank expects all designated systemic FMIs to have in place by the end of 2016. While a credible recovery and resolution framework is not an ELA eligibility requirement for FMIs, such ELA could be

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26 The Bank’s oversight of FMIs is conducted in close collaboration with FMI operators and relevant authorities, such as Finance Canada, provincial regulators and, in the case of the foreign-domiciled designated FMIs, the Bank of England and the US Federal Reserve Board.

27 Section 2 of the Payment Clearing and Settlement Act defines payments system risk as the risk that “a disruption to or a failure of a clearing and settlement system could cause a significant adverse effect on economic activity in Canada by (a) impairing the ability of individuals, businesses or government entities to make payments, or (b) producing a general loss of confidence in the overall Canadian payments system, which includes payment instruments, infrastructure, organizations, market arrangements and legal frameworks that allow for the transfer of monetary value.”

28 Systemic risk for an FMI is the risk that the inability of a participant to meet its obligations in an FMI as they become due or that a disruption to or a failure of an FMI could, by transmitting financial problems through the FMI, cause (i) other participants in the FMI to be unable to meet their obligations as they become due, (ii) FIs in other parts of the Canadian financial system to be unable to meet their obligations as they become due, (iii) the FMI’s clearing house or the clearing house of another FMI within the Canadian financial system to be unable to meet its obligations as they become due, or (iv) an adverse effect on the stability or integrity of the Canadian financial system.

29 FMIs currently designated as systemically important for Canada are the LVTS, CDSX, the Canadian Derivatives Clearing Service (CDS), CLS Bank and SwapClear. In addition, the Automated Clearing Settlement System (ACSS) is designated as having the potential to pose payments system risk.

30 In particular, designated FMIs are required to have sufficient and highly reliable liquid resources to cover the default of their largest participant under extreme market conditions.

31 A domestic FMI could require intraday access to foreign currency to meet its obligations to a foreign FMI; thus, foreign currency ELA could prevent an unnecessary and costly default of the domestic FMI.
used to support effective recovery and orderly resolution in much the same way as described previously for FIs. In 2016, the Bank of Canada and the Canadian Securities Administrators (CSA) issued guidance on FMI recovery planning that clarifies certain international expectations in a Canadian context. This guidance covers aspects such as the key components of a recovery plan, tools used for recovery and implementation of the recovery plan. The Bank and other relevant federal authorities are also examining a Canadian resolution regime for designated FMIs.

Conclusion

Key updates were made in December 2015 to the Bank of Canada’s ELA policy. As a result, the Bank has strengthened its ability to promote stability in the Canadian financial system.

By requiring a credible recovery and resolution framework as an eligibility criterion for FIs, the Bank ensures that ELA is provided as part of a broader plan by authorities to return failing institutions to long-term viability or facilitate their orderly liquidation, thereby avoiding the costly economic impact of a disorderly failure. The Bank is also now willing to accept Canadian-dollar mortgages as collateral as a last resort, effectively expanding the potential capacity of firms to draw on ELA, if needed.

The updated ELA policy also clarifies the conditions that must be met for provincially regulated FIs to be eligible for ELA. In providing ELA to eligible provincially regulated FIs, the Bank can provide ELA to support the long-term viability of such institutions when their disorderly failure would have significant adverse consequences for the broader financial system or economy, while recognizing that provincial governments are responsible for the FIs they regulate.

Finally, the Bank has clarified the conditions under which it would provide ELA to FMIs, to ensure these firms have access to sufficient liquidity in times of extraordinary stress, allowing them to continue providing the services that underpin the smooth functioning of the financial system.

The 2015 updates to the Bank’s ELA policy reflect an ongoing commitment to ensuring that the Bank of Canada can act effectively as the lender of last resort and that the policy guiding the Bank’s provision of ELA reflects the evolution of the Canadian financial system. This commitment will continue, and the Bank will periodically review its ELA policy.

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Literature Cited


