Scotiabank™

GLOBAL ECONOMICS

INSIGHTS & VIEWS

May 24, 2024

Contributors

Jean-François Perrault
SVP & Chief Economist
Scotiabank Economics
416.866.4214
jean-francois.perrault@scotiabank.com

Does the Federal Government Really Want Banks to Lend Less?

- **Canada is implementing Basel IV on an accelerated timeline relative to key competitors. The Office of the Superintendent of Financial Institutions is requiring Canadian banks to implement these reforms by mid-2026. The United States appears to be reconsidering implementation of some of the Basel reforms while the UK and Europe are fully implementing in 2030 and 2032 respectively.**
- **Implementation may require banks to shed up to $270 billion in risk-weighted assets to meet the output floor by mid-2026. This would reduce lending to firms and households, including mortgage credit by about 9% of current nominal GDP at a time of elevated financing needs.**
- **Government-mandated requirements to shed assets (or raise capital) run counter to efforts to raise investment and improve access to the housing market for Canadians. This seems to be another instance of policy inconsistency in the Canadian policymaking landscape.**

Canada's financial system is consistently ranked as one of the most resilient in the world. This is no small part due to the approach the Office of the Superintendent of Financial Institutions (OSFI) has taken in overseeing our financial system. Much like the Bank of Canada, OSFI has a high degree of influence on our country's financial system through its supervision and regulation of federally regulated financial institutions and pension plans. Though it doesn't have the visibility of the Bank of Canada and its rate-setting process, OSFI has a large impact on bank lending and the monetary policy transmission mechanism.

Take the implementation of Basel IV for instance. The Basel Accords are a set of international agreements to strengthen the global banking system. They have been negotiated and implemented in waves and have imposed requirements on banks through national regulatory and supervisory agencies such as OSFI in Canada. Previous waves (Basel I, II, and III) laid out liquidity, capital and risk management requirements for banks. Basel IV is in the process of being implemented. It builds on the previous iterations of the Basel Accords in a number of ways, but one aspect in particular is of concern in this note: the output floor.

The output floor determines how banks will calculate risk-weighted assets (RWA), forcing them to shift from an internal model-based approach that is grounded in the lending institution's loss experience for calculating RWA to a standardized approach, which is generally risk indifferent to bank experience, for calculating these assets. These RWA are used to determine a bank's capital ratio (the ratio of regulatory capital to RWA). For conservative lenders like Canadian Banks, this change will substantially raise RWA and therefore lead to higher capital requirements. The minimum capital ratio itself is mandated by OSFI and is occasionally adjusted depending on economic conditions.

While these may appear to be technical changes, they will have significant impacts on bank behaviour. Table 1 shows the current RWA for Canadian banks and compares them to the RWA from the standardized approach. At present, Canadian banks largely use internal models to calculate RWA. This approach generates substantially lower RWA than the standardized approach, reflecting the historically strong risk management practices of these banks. Owing in part to the large difference between internally determined RWA and those that flow from a standardized approach, Basel IV laid out a timeline for implementation of the standardized approach. OSFI has decided that full Canadian implementation will occur in mid-2026. At that time, RWA in Canadian banks will need to be at least 72.5% of those calculated from a standardized approach. This is the so-called output floor. Currently, the floor is at 65%.

Table 1: Current RWA vs Standardized RWA For Big 6 Canadian Banks (Millions of Canadian Dollars, 2024-Q1)	Total Actual RWA	RWA Calculated Using Full Standardized Approach (i.e. Used in The Base of The Output Floor)
1 Sovereign	50,503	55,506
of which:		
Categorized as MDB/PSE in SA	35,125	42,458
2 Banks and Other Financial Institutions	40,318	57,687
3 Covered Bonds	6,259	6,537
4 Equity	45,788	45,788
5 Purchased Receivables	162	162
6 Corporates	916,704	1,480,577
of which:		
FIRB is Applied	320,500	656,851
AIRB is Applied	434,717	662,302
7 Retail	547,196	881,159
of which:		
Qualifying Revolving Retail	131,566	141,398
Other Retail	183,040	227,665
Retail Residential Mortgages	232,591	512,095
8 Specialised Lending	82,910	192,843
of which:		
Income-Producing Real Estate and High Volatility Commercial Real Estate	51,971	119,692
9 Others	61,498	67,400
10 Total	**1,751,338**	**2,787,659**

Sources: CMS2 supplements for 2024-Q1 from the quarterly financial reports of Scotiabank, Royal Bank of Canada, Bank of Montreal, Canadian Imperial Bank of Commerce, Toronto Dominion Bank and National Bank.

Transitioning from the current 65% to the final 72.5% will impact capital ratios unless actions are taken. This is of course by design, as these regulations are meant to further strengthen capital management in banks. To keep capital ratios at minimum required levels, banks can either raise capital by issuing shares or retaining earnings (through lower dividends for example) or reduce RWA. Recent tax policy changes have reduced earnings by banks making it harder for banks to build capital by retaining earnings. Banks can always raise capital by issuing equity, but this option is unappealing given valuations. As a result, it is likely that banks will choose to shed RWA in order to meet capital requirements.

Table 2 demonstrates the impact on bank assets once the 72.5% floor comes into force in 2026. It is based on the most recent financial disclosures for the Big 6 banks in Canada. The last column of the table calculates the change in RWA required to achieve the 72.5% output floor assuming current capital ratios are maintained, and no actions are taken by banks to raise capital. This may be an extreme example, but it helps illustrate the challenge using the current balance sheets of the Big 6 banks.

Table 2: Change in RWA Required to Maintain Stable Capital Ratio (Millions of Canadian Dollars, 2024-Q1)	Total Actual RWA	RWA Calculated Using Full Standardized Approach (i.e. Used in The Base of The Output Floor)	Current Ratio of Actual RWA to Standardized RWA	RWA at The 72.5% Floor	Change in RWA Required to Maintain Current Capital Ratio by 2026
Total	1,751,338	2,787,659	62.8%	2,021,052.775	-269,714.78

Sources: Scotiabank and CMS2 supplements for 2024-Q1 from the quarterly financial reports of Scotiabank, Royal Bank of Canada, Bank of Montreal, Canadian Imperial Bank of Commerce, Toronto Dominion Bank and National Bank.

As a whole, banks would have to shed about $270 billion in assets by 2026 if capital ratios remain unchanged and banks do not raise capital. This represents about 9% of current nominal GDP and would represent a major pull back in lending relative to the current situation. Risk-weighted assets are overwhelmingly in corporate and retail lending. As a result, any asset shedding would likely be concentrated in these areas and would see banks lend less than would otherwise be the case to companies and individuals to meet these objectives. Moreover, as retail lending includes a large component of residential mortgages, banks would likely reduce mortgage financing to meet the regulatory changes. It is of course possible that banks choose to raise capital instead of shedding assets, but even if we assume that a 50/50 split between asset shedding and capital raising, the system would still see banks shed assets worth around 4.5% of GDP.

The potential impacts of these changes raise a number of policy concerns. While it is clear that a more capitalized banking system is a safer system, there is an economic cost to making an already-safe system safer. It is for policymakers to determine if those costs are worth it, but there can be no doubt that moving forward will reduce bank-intermediated credit available to Canadians relative to the current situation.

These impacts must be considered within the context of two key policy challenges in Canada: our weak productivity performance and the deterioration in housing affordability triggered by our chronic inability to create enough housing to meet demographic requirements. The federal and provincial governments have launched a number of initiatives in recent months that seek to improve our productivity performance and close housing gaps. In many ways, these efforts seek to reduce the cost of financing of investments in the hopes that this will boost the residential and non-residential capital stock given the central and well documented role lower-than-necessary investment plays in each challenge.

Governments will argue that there is a determined and concerted effort to tackle these challenges. This may well be true across levels of government, but it is less apparent within the federal apparatus. We have noted in the past the conflict between monetary and fiscal policies and the interest rate impact of mis-calibrated fiscal policies. Another coordination failure appears to be underway, this time between the implementation of Basel IV regulations and federal objectives on the housing and productivity front. Implementation of the output floor could force banks to cut back lending to the very sectors of the economy governments are trying to mobilize financing for. Moreover, a potential reduction in mortgage financing at a time of dramatically rising demographic requirements risks making housing even less accessible to some Canadians despite government efforts to the contrary.

An additional consideration is the timeline associated with implementation of the floor. As noted above, Canada will fully implement the floor in mid-2026. It now appears uncertain if the United States will proceed with implementation of some of the Basel reforms. In the UK, the floor will be fully implemented in 2030. In Europe, transitional arrangements will be in place until 2032. It is clear that Canada is moving to implement these reforms at an accelerated pace relative to our main competitors. While this will mean a more resilient banking system in Canada relative to these countries, it will place Canada at a competitive disadvantage at a time when access to finance is critically important in meeting the needs of Canadians and for transforming our economy.