

A stronger regulatory case for Canadian PSE bonds

By Warren Lovely

Public sector primacy, that might be the unofficial motto of Canadian fixed income markets where government and/or government-related entities have long taken centre stage. Beyond ultra-deep and well-established markets for federal-provincial government securities, a separate set of Canadian public sector entities (PSEs) have become an increasingly vibrant source of primary supply and secondary liquidity.

Canadian PSEs already boast top-notch ratings and abundant bondholder safeguards. And if **OSFI's proposed liquidity guidelines (for 2027)** are ultimately adopted, certain of these names would benefit from **improved regulatory treatment** too, specifically a new High-Quality Liquid Asset (HQLA) Level 1B designation. This combination of primary/secondary market *RELEVANCE*, high quality *RATINGS* and more efficient *REGULATORY* treatment make for a compelling combination. Call it the 3 Rs! Investors should take notice.

OSFI's draft liquidity adequacy guideline

Presented on May 21, 2026, the aim of OSFI's 'Draft Liquidity Adequacy Requirements (LAR) Guideline (2027)' is to "ensure that liquidity requirements continue to align with the underlying risk faced by institutions, to enhance the clarity of our liquidity rules, and to improve the consistency of their application."

Most significantly, **OSFI is proposing a new HQLA Level 1B designation that would be applied to certain PSE securities lacking an explicit government guarantee, as well as select covered bonds.**

The draft guideline is subject to a **60-day consultation period** (ending July 20, 2026). Email comments to: Consultations@osfi-bsif.gc.ca. A finalized LAR guideline would take effect May 1, 2027.

From HQLA Level 2A to Level 1B

Pursuant to OSFI's existing/active LAR guideline, standard market practice has more recently involved classifying many federal-provincial pension-related securities as HQLA Level 2A, requiring a 15% haircut/penalty when calculating key liquidity metrics. Under the proposed guideline, certain PSE securities and qualifying covered bonds would be assigned to a new Level 1B category. **This enhanced liquidity classification would necessitate a smaller 7% haircut/penalty.** This would undoubtedly be a positive development for qualifying securities, enabling more efficient regulatory treatment vs. the status quo.

Note: Under the proposal, sovereign debt would be categorized Level 1A, these highest-of-all quality assets continuing to be subject to a 0% haircut/penalty. Given an explicit GoC guarantee, Canada Mortgage Bonds and NHA MBS would also be classified Level 1A. Direct and guaranteed provincial government securities could likewise be classified Level 1A under the proposal.

Returning to PSEs... As is customary, the draft guideline does not specify by name the entities that could qualify as Level 1B. Rather, OSFI outlined the **following conditions** (all of which would need to be satisfied):

- the entity is a federal or provincial Crown corporation established by statute for the sole purpose of managing and investing public pension assets on behalf of the sponsoring government(s);

- the entity has a long-term issuer credit rating of at least AA- (or equivalent) and a short-term rating of at least A-1+ / R-1(high) (or equivalent);
- its securities are traded in large, deep and active markets, including active two-way repo markets, and have demonstrated a proven record as a reliable source of liquidity in stressed market conditions;
- the securities qualify as eligible collateral at central banks under normal operating conditions; and
- the securities are senior unsecured.

Separate Level 1B conditions were set out for covered bonds, including institution affiliation, credit rating and minimum issuance size requirements.

As it relates to LAR guideline applicability, readers are advised to refer to the draft language directly. We believe **careful consideration should be given to the precise definition of qualifying pension-related issuers**, including an entity's formal legal structure and scope of operations. We'd likewise highlight the potential for additional points of clarification/adjustment in the final LAR guideline, based on prospective feedback received during the 60-day consultation period (currently underway).

OSFI's liquidity guideline sets caps by HQLA level (after haircuts have been applied). While there would remain no limit on Level 1 assets per se, it is intended that **Level 1B securities comprise no more than 70% of an institution's total stock of HQLA.** The existing 40% cap on Level 2 assets would remain in effect. Based on current available information, the Level 2 share at Canada's large banks is less than 20%. All else equal, converting certain PSE securities currently classified as Level 2A assets to 1B could create even more room against the Level 2 asset cap.

Thoughtful, made-in-Canada approach

We view OSFI's proposed Level 1B designation, the associated haircut and asset concentration limit as a thoughtful/nuanced approach. The intended regulatory treatment **recognizes the growing importance, high-quality nature and enhanced liquidity profile of select PSEs** (and covered).

We see a **close parallel to how the ECB treats the strategically important covered bond market across the pond**, where liquid/high quality covereds can be classified as Level 1B assets subject to a similar 7% haircut and 70% HQLA asset cap. The concept of 'regulatory reciprocity' could see other national regulatory bodies refine their treatment of Canadian PSEs, ostensibly following OSFI's lead.

To us, OSFI's announcement sends an **important signal to fixed income investors, bathing qualifying PSE securities in a more favourable regulatory light.** In a similar vein, recall an earlier move by the Bank of Canada (effective 2019) to treat federal and provincial pension plan securities as eligible collateral under its Standing Liquidity Facility. Still, the draft LAR guideline is of far more than symbolical importance, since holding the proposed Level 1B assets would allow for mechanical improvement in key metrics for affected banks.



Implications for Basel III liquidity metrics: LCR & NSFR

As outlined, the new HQLA Level 1B designation (and the lighter haircut on eligible securities) would have direct bearing on key Basel III liquidity ratios that systemically important banks are required to manage.

The most direct/mechanical implications relate to the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The former (LCR) is a shorter-term liquidity test, while the latter (NSFR) gauges longer-term sustainability. These are complementary metrics, with normal course limits clearly set out and closely scrutinized.

Canada's domestic systemically important banks (D-SIBs) are required to report on these and other Basel-related metrics, with timely standardized disclosure available via quarterly/annual reports.

As it stands, all six of Canada's big banks are comfortably above LCR and NSFR thresholds (both set at 100%). As of April 30, 2026, the weighted average LCR for Canada's six D-SIBs amounted to 129% (ranging from a low of 124% to a high of 170%). For the corresponding period, the weighted average NSFR at Canada's big six banks was 114% (ranging between 111-118%).

Liquidity Coverage Ratio (LCR)

As noted, the LCR is a shorter-term metric which aims to ensure an institution has sufficient liquidity to survive a 30-day stress scenario. The LCR is calculated as follows:

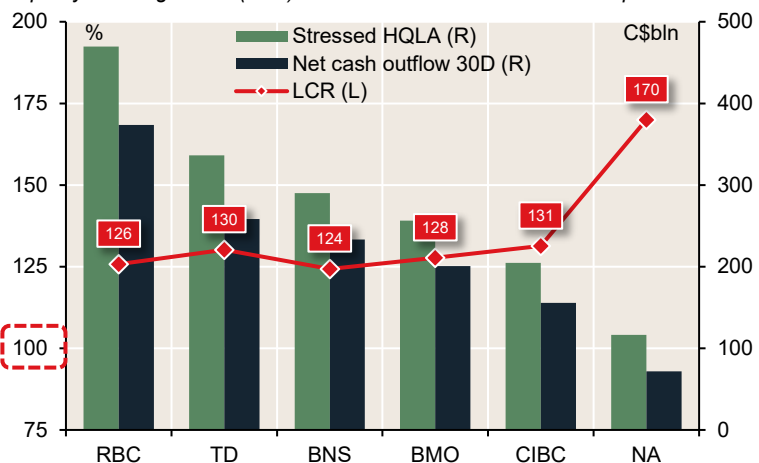
$$LCR = \frac{\text{Stock of HQLA in stressed conditions}}{\text{Net cash outflows over next 30 days}} \geq 100\%$$

Note: The weighted level of HQLA in stressed conditions is arrived at by applying relevant 'haircuts', typically 0% to 50%, with the prescribed penalty steeper for lower liquidity assets. As noted, the proposed Level 1B haircut would be 7% vs. 15% for a Level 2A asset.

In normal times (i.e., non-stress events), the LCR should be no less than 100%, with higher values implying a greater buffer against stress. For a given set of cash flows, the draft LAR guideline could increase the stressed stock of HQLA (i.e., the LCR numerator). That's because holdings of qualifying federal-provincial pension-related securities (and eligible covered bonds) could receive a smaller haircut/penalty. The result? An increased/enhanced LCR score, all else equal.

Chart 1: A closer look at the LCR at Canada's D-SIBs

Liquidity Coverage Ratio (LCR) at Canada's six D-SIBs: As of 30-Apr-26



Source: NBC, individual company reports | Note: Based on current HQLA haircuts

Net Stable Funding Ratio (NSFR)

The draft LAR guideline (and prescribed haircuts) would likewise enhance/improve the NSFR to the extent an institution holds qualifying assets. The NSFR is calculated as follows:

$$NSFR = \frac{\text{Available amount of stable funding (ASF)}}{\text{Required amount of stable funding (RSF)}} \geq 100\%$$

Note: This amounts to a ratio of capital and liabilities relative to assets, with a detailed set of 'factor' adjustments prescribed for various ASF and RSF components.

As noted, NSFR complements the LCR and is focused on institutional resiliency and longer-term sustainability. Canada's D-SIBs are required to maintain a NSFR of 100% on an ongoing basis, with higher scores signifying relatively greater funding stability.

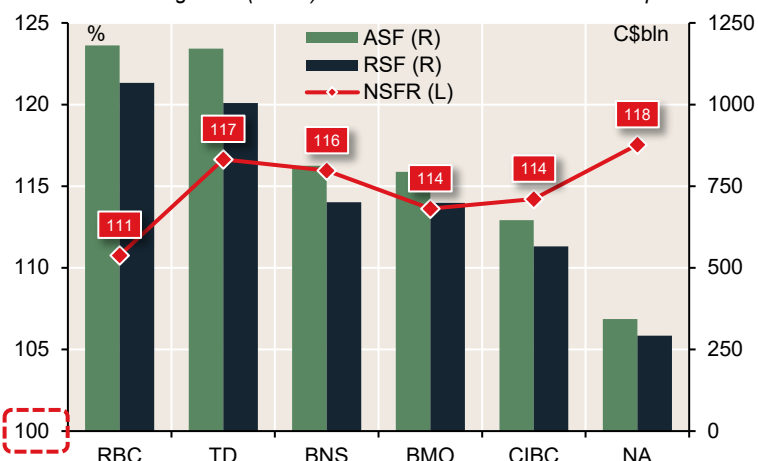
Consistent with the approach taken on the LCR, liquidity directly influences the NSFR calculus. The more liquid an asset, the lower the RSF factor/multiplier, which results in less Required Stable Funding. Since RSF is the denominator in the NSFR calculation, a more favourable interpretation of asset liquidity and lower RSF would increase the ratio for a given capital/liability profile.

NSFR definitions mirror those used for the LCR. It follows that RSF factors largely mimic HQLA haircut factors. Specifically, securities satisfying the proposed Level 1B definition, including eligible PSEs and covered bonds, would be subject to a 7% RSF factor.

Note: The original draft guideline, as first published May 21, 2026, erroneously listed a 93% RSF factor for Level 1B assets. The detailed factor table has since been corrected, specifying a 7% RSF factor for Level 1B assets (including qualifying PSE securities).

Chart 2: NSFR snapshot across Canada's big banks

Net Stable Funding Ratio (NSFR) at Canada's six D-SIBs: As of 30-Apr-26



Source: NBC, individual company reporting | Note: Based on current ASF/RSF factors

To summarize, whether its via the LCR or the NSFR, the draft LAR guideline could improve liquidity metrics for systemically important banks holding qualifying PSE securities. The proposed change would effectively make these securities more efficient from a regulatory perspective. This amounts to 'good news', potentially bolstering closely watched Basel metrics and/or providing greater flexibility on portfolio management for regulated institutions.

Beyond the potential adjustments in Basel liquidity metrics (LCR and NSFR) outlined above, it's possible that an improved HQLA classification for qualifying PSEs could see banks adjust repo funding charges for related securities. This could depend on whether



the proposed OSFI guideline prompts securities lenders to adjust/re-rate PSE collateral. Fair to say that any prospective reduction in funding costs could enhance return characteristics for leveraged investors.

Capital adequacy implications less direct

To clarify, OSFI's May 2026 draft guideline deals with Liquidity Adequacy Requirements (LAR) as opposed to Capital Adequacy Requirements (CAR), the latter including a focus on risk weightings.

As it relates to risk weights, note that **OSFI's existing CAR guideline makes no explicit reference to securities issued/guaranteed by federal and provincial pension asset managers**. Rather, the 'Standardized Approach' to credit risk currently assigns a 20% risk weight to "non-central government public sector entities (PSEs)".

For reference, the Government of Canada's sterling credit ratings qualify the sovereign for a 0% risk weight under the 'Standardized Approach', while direct/guaranteed provincial government exposures are treated the same as the GoC (i.e., 0% risk weight).

We continue to believe that there is an argument for assigning a <20% standardized risk weight to certain PSE securities. In light of the proposed changes to the LAR guideline (including the HQLA Level 1B designation and reduced haircut), **it is possible that OSFI could proceed with a corresponding adjustment to standardized risk weights for qualifying PSEs in the CAR guideline**. Saying that, no formal announcement on CAR has been made at the time of reporting.

Subject to OSFI approval (and other conditions), regulated institutions can apply their own internal estimates of risk for the purposes of determining capital adequacy. This is referred to as the 'Internal Ratings-Based Approach (IRB)' and we believe most large banks have opted for this approach.

Under an internal ratings-based (or non-standardized) approach to credit risk, **an enhanced liquidity assessment (and improved market access) might argue for a lower probability of default and/or loss given default** on relevant exposures. We understand this to be particularly relevant for corporate credit risk models. However, to the extent a regulated institution subjects PSE exposures to a non-corporate or 'parapublic' credit risk model, **OSFI's draft guideline and proposed Level 1B designation may not directly impact assigned risk weights**.

We'd note that individual institutions could have different interpretations of credit risk and capital adequacy requirements, with potentially unique risk weights for PSEs (and other securities) as part of their approved IRB model. Note, however, that **specific IRB model parameters are not publicly disclosed**.

In summary...

If finalized, OSFI's draft LAR guideline (now subject to consultation) and the planned creation of a HQLA Level 1B category would undoubtedly be **a positive development for qualifying federal and provincial pension asset managers**.

Affected PSE securities (and qualifying covered bonds) would receive **more favourable/efficient regulatory treatment**, with a lower haircut/penalty (7%) relative to the status quo (15%). It's possible that **repo funding charges for securities impacted by the proposed rule could likewise improve**.

All else equal, more efficient/favourable treatment of qualifying assets **could generate incremental investor demand** (from bank treasuries if not more broadly). Marginal investor demand could **bolster market capacity for pension-related issuers**, where borrowing programs have generally expanded in line with rapid growth in underlying assets. We'd emphasize that the bulk of **PSE primary bond supply and secondary outstandings tend to be placed/reside in tenors nicely aligned with bank treasury demand**, making the product a natural fit. Consider: In the past decade, the overwhelming majority (>95%) of Canadian PSE bond issuance has been 10-years or under, with 5s the single most commonly utilized tenor.

Beyond increased market capacity, deeper/broader investor demand could also **support PSE valuations relative to securities where regulatory treatment remains static**. In domestic (i.e., CAD) and core international debt capital markets, that could result in relatively firmer pricing for select PSEs vs. sovereign curves and against sub-sovereign governments. We'd note that certain PSE credit spreads enjoyed a modest degree of relative support in the wake of the OSFI announcement and could benefit from additional performance if the guideline is formally adopted in its current form.

Canada's pension-related securities are unquestionably high quality. Moreover, as we've routinely highlighted, demonstrated growth in primary market issuance, secondary trading volume and total bonds outstanding have clearly bolstered liquidity profiles. To us, **the growing relevance/importance of Canada's PSE sector is clear. OSFI's draft LAR guideline indirectly acknowledges as much**.

We encourage interested parties to engage in the consultation process and keenly await OSFI's finalized guideline, which would take effect next May.

Reference / select links:

OSFI > [Homepage & Guidance Library](#)

OSFI (May-26) > [Liquidity Adequacy Requirements \(LAR\) – Guideline \(2027\)](#)

OSFI (Jan-26) > [Liquidity Adequacy Requirements \(LAR\) – Guideline \(2026\)](#)

OSFI (Sep-25) > [Capital Adequacy Requirements \(CAR\) – Guideline \(2026\)](#)

BoC (Mar-26) > [Assets Eligible as Collateral under the Bank of Canada's Standing Liquidity Facility](#)

BoC (Jul-19) > [Changes to Assets Eligible as Collateral under the Bank of Canada's \(the Bank\) Standing Liquidity Facility](#)

BIS > [Basel Committee on Banking Supervision \(BCBS\)](#)

EU (Jan-15) > [Liquidity coverage requirement for Credit Institutions – Regulation](#)



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