United States General Accounting Office

GAO

Report to the Honorable
Charles E. Schumer
House of Representatives

September 1995

BANK REGULATORY STRUCTURE

Canada

564307

GAO/GGD-95-223

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259978

September 28, 1995

The Honorable Charles E. Schumer
House of Representatives

Dear Mr. Schumer:

Proposals to consolidate United States bank regulatory agencies have raised questions about how other countries structure and carry out their various bank regulation and central bank activities. You asked us to provide you with information about the structure and operations of regulatory activities in several countries. This report presents the information you requested for Canada. It describes the Canadian bank regulatory structure and its key participants, how that structure functions, and how banks are examined in Canada.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to Members of the House Committee on Banking and Financial Services, other congressional committees, and other interested parties. We will also make copies available to others on request.

The report was prepared under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. If you have any questions, please call me on (202) 512-8678. Other major contributors are listed in appendix I.

Sincerely yours,

James L. Bothwell

James L. Bothwell, Director
Financial Institutions
and Markets Issues

Executive Summary

Purpose

Proposals to consolidate U.S. bank regulatory agencies have raised questions about how other countries structure and carry out their bank regulation and supervision and central bank activities. Representative Charles E. Schumer asked GAO to provide information about the structure and operations of such activities in several countries.[1] This report presents the information requested for Canada, which provides an example of a structure that features a federal supervisor other than the central bank. GAO's objectives were to describe (1) the Canadian bank federal regulatory and supervisory structure, and its key participants; (2) how that structure functions, particularly with respect to bank authorization or chartering, regulation, and supervision; (3) how banks are examined; and (4) how participants handle other financial system responsibilities. This report provides requested information about the Canadian bank regulatory structure, but does not attempt to evaluate that structure.

Background

The banking structure in Canada is relatively concentrated. Canada has six major domestic banks with nationwide branch networks and diversified operations that held 90.9 percent of Canada's total bank assets and 88.6 percent of domestic assets. As of December 31, 1994, there were 11 domestic banks in Canada and 53 subsidiaries of foreign banks, which were first allowed to enter Canada as banks in 1980. Banks in Canada are required to be federally chartered and carry out a number of nonbanking activities—including trust, securities, and most insurance activities through wholly owned subsidiaries.

Government inspection of banks was introduced in 1924 when the Canadian government amended the Bank Act to create the Office of the Inspector General of Banks (OIGB) after the failure of a large bank that had over 70 branches. A number of failures in the early 1980s led to a review of the supervisory methods of OIGB. The review recommended consolidation of bank and insurance company supervisory offices, which resulted in the creation of the Office of the Superintendent of Financial Institutions (OSFI) in 1987. The founding of OSFI was intended to create a strong supervisory institution to oversee the safety and soundness of financial institutions and to address the growing similarities between banks and nonbank financial institutions. To accomplish these goals, OSFI's authority was strengthened

[1] For information on GAO's already issued reports on the German and British regulatory systems, see Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994) and Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994). GAO is also preparing reports on the regulatory systems of France and Japan.

and its scope was extended to all federally incorporated financial institutions.[2]

Deposit insurance in Canada was introduced in 1967 when the Canada Deposit Insurance Corporation (CDIC) was established following a few financial institution failures and the dissatisfaction of provincial governments with the lack of deposit insurance. CDIC insures the deposits of all federally incorporated financial institutions along with deposits of most provincially incorporated institutions. CDIC is run by a Board of Directors and a Chairman, who report to Parliament through the Minister of Finance.

Canada established its central bank in the Bank of Canada Act of 1934. The main responsibility of the Bank of Canada was, and is today, the formulation and implementation of monetary policy. After its establishment, disagreements over responsibility for monetary policy arose between the Bank of Canada and the federal government. To resolve those differences, a mechanism was incorporated into the Bank of Canada Act in 1967 that requires the Governor and the Minister of Finance to "consult regularly on monetary policy and on its relation to general economic policy." The mechanism also provides an explicit directive through which the Minister of Finance can override the Bank of Canada's monetary policy.

Results in Brief

Since 1987, OSFI has been formally recognized in statute as the primary supervisor of federal financial institutions in Canada. OSFI's responsibilities include administering the application process for incorporating financial institutions; issuing financial institution regulations and guidelines; taking both formal and informal enforcement actions—relying mostly on informal actions, such as recommendations; and taking the lead in resolving problem institutions. OSFI also has the authority to examine and receive considerable information from financial institutions. OSFI has overall supervisory responsibility for all activities of financial institutions, but securities activities conducted in subsidiaries are reviewed for OSFI by the cognizant provincial securities regulator.

OSFI conducts full-scope, on-site examinations of financial institutions with a staff of full-time examiners. OSFI relies on a financial institution's external auditors for an assessment of the fairness of an institution's

[2]Henceforth, financial institutions in this report refer to federally chartered deposit-taking financial institutions, which include all banks and federally chartered trust companies.

annual financial statements. External auditors also have a responsibility to report to OSFI anything that they discover during the course of their work that might affect the well-being of an institution, and OSFI advises external auditors about anything material that has come to its attention concerning a financial institution.

OSFI shares certain regulatory and supervisory responsibilities with other government agencies, such as CDIC and the Department of Finance. CDIC has a secondary supervisory role, but it has increased its influence over supervision and regulation in recent years by taking advantage of its authority to issue standards. For example, the Standards of Sound Business and Financial Practices By-laws set forth that each member institution should establish sound business and financial practices in eight areas, such as liquidity management. In addition, CDIC has some enforcement authority, such as terminating deposit insurance or assessing premium surcharges, and takes the lead in resolving failed institutions. The Minister of Finance has final decisionmaking authority over key supervisory decisions, such as incorporating a financial institution, closing an institution or terminating deposit insurance. The Bank of Canada's current role in bank supervision is largely limited to providing information to other participants in the decisionmaking process.

OSFI, CDIC, the Minister of Finance, and the Bank of Canada also share, to some degree, in other financial system responsibilities, such as liquidity provision, crisis management, payment and settlement systems management, international representation, and lender of last resort responsibilities.

Two primary committees have been established to improve the relationships and the sharing of information among the four regulatory agencies. The Financial Institutions Supervisory Committee (FISC) was established to enhance communication on financial institutions' supervisory issues and is not a decisionmaking or advisory body. The Committee is chaired by the Superintendent of Financial Institutions and includes the Deputy Minister of Finance, the Governor of the Bank of Canada, and the Chairman of CDIC. These four members also make up the Senior Advisory Committee (SAC) that meets under the Chairmanship of the Deputy Minister of Finance to discuss policy changes or legislative proposals. A current White Paper proposal is intended to further clarify roles and coordination among these agencies.[3]

Figure 1: Responsibility for Bank Regulatory and Related Functions in Canada

Key participants	Developing laws	Developing regulations	Issuing regulations	Chartering banks	Bank information reporting and analysis	Bank supervisory oversight	Bank examinations	Developing enforcement actions	Enforcement authority	Failure resolution	Liquidity provider	Crisis management	Payment/clearance system	International forum representative	Deposit insurance	Lender of last resort
Public																
Department of Finance	●	●	●	●						●		●		●		
OSFI		●	●	●	●	●	●	●	●	●		●		●		
CDIC		●	●		●	●	a	●	●	●		●			●	●[b]
Bank of Canada					●		c				●	●	●	●		●
Private																
CPA													●			
External auditors							●[d]									

Note: OSFI, CDIC, the Bank of Canada, and the Minister of Finance are all involved in information sharing and coordination of activities.

[a]CDIC does special examinations for troubled banks.

[b]CDIC has a more limited role than the Bank of Canada in serving as lender of last resort.

[c]The Bank of Canada does not conduct regular examinations, but has the power to request special examinations.

[d]External auditors may perform special audits for OSFI, CDIC, or the Bank of Canada; and OSFI uses their financial audits in deciding upon the scope of the examination.

Source: GAO analysis.

[3]The White Paper is a policy paper called Enhancing the Safety and Soundness of the Canadian Financial System, which was released on February 9, 1995. It contains a set of proposals that allow for early intervention in problem institutions, enhanced disclosure of financial information, a stronger prudential framework for financial institutions, a revised framework for the protection of policyholders, and measures to contain costs for the deposit insurer and to control systemic risk in the clearance and settlement systems.

Principal Findings

OSFI Has Primary Responsibility Over Authorization and Supervision

Although, technically, the Minister of Finance issues "letters patent" that incorporate federal financial institutions, OSFI actually is responsible for the application process and recommends to the Minister of Finance whether a financial institution should be federally chartered. CDIC is responsible for approving applications for deposit insurance, and CDIC and OSFI are to coordinate this process. Provincially incorporated financial institutions apply to provincial regulators for incorporation and apply to CDIC for deposit insurance.

OSFI and CDIC can both take enforcement actions against federal financial institutions, although OSFI has available a wider range of enforcement actions compared to the more narrowly defined actions available to CDIC. According to OSFI officials with whom we spoke, the enforcement actions taken by OSFI have usually been informal. In such cases, OSFI recommends that certain actions are to be taken by a financial institution to remedy identified problems. Formal enforcement actions, such as directions of compliance, have rarely been used. According to OSFI officials, institutions usually comply with informal recommendations, knowing that OSFI will not hesitate to use more formal action if compliance is not forthcoming. CDIC officials with whom we spoke said formal enforcement actions consist primarily of imposing a premium surcharge—which has never been done—and terminating a member's deposit insurance—which was done once for an otherwise solvent member.

OSFI and CDIC Have Responsibility for Regulations and Guidelines

OSFI is responsible for administering and interpreting legislation concerning financial institutions by developing regulations and guidelines. OSFI generally issues guidelines because the process of issuing regulations is long, complex, and less flexible. Although guidelines do not have the force of law, according to OSFI officials, they are usually followed by all financial institutions.

CDIC has the authority to issue bylaws, which have the force of law. CDIC bylaws pertain to the operations and functions of CDIC and its members and include eight Standards of Sound Business and Financial Practices By-Laws for member institutions. The Standards By-laws were enacted in 1993 and cover eight areas, such as credit risk management. The Standards By-laws have related guidance that CDIC issues to assist member institutions in following the Standards By-laws. Compliance with the Standards is measured through a financial institution's self-assessment process, which, starting in 1995, OSFI is to review and verify during its annual examination of federal financial institutions.

OSFI, CDIC, and the Bank of Canada Rely on Many Sources of Information to Carry Out Their Responsibilities

OSFI, CDIC, and the Bank of Canada have developed a shared statistical reporting system, whereby financial institutions are required to report data, such as quarterly income statements and annual financial reports.[4] This data reporting system meets the supervisory and deposit insurance needs of OSFI and CDIC, as well as the monetary policy information needs of the Bank of Canada.

To carry out its supervisory responsibilities, OSFI relies on several sources of information beyond that provided in the data reporting system. Financial institutions are required to file periodic reports, including annual financial statements, with OSFI. Institutions provide more specific information if requested to do so. In addition, OSFI obtains supplemental information from numerous informal meetings and discussions with financial institutions and from several formal meetings with institutions' management, audit committees, and external auditors. These meetings allow OSFI to gather information on an institution's activities, such as how an institution is controlling risk, and provide a formal opportunity for discussing OSFI's examination findings.

Although CDIC relies on OSFI for most of its information on the financial condition of its members, it can also receive financial statements directly from financial institutions and other financial information from the data reporting system. In addition, CDIC can request that a special examination be done by either OSFI examiners or hiring its own consultants if, for instance, its Board of Directors has determined that a financial institution poses a high risk of failure. Such examinations are intended to provide CDIC with additional current information to assess failure resolution options and CDIC's potential liability if a financial institution were to fail.

The Bank of Canada uses the data reporting system to get information about the financial system and individual institutions, primarily to fulfill its monetary policy responsibilities. In addition, the Bank of Canada receives information directly from financial institutions—particularly the six

[4]Under the data reporting system, financial institutions submit their data to OSFI, which then redirects it to the Bank of Canada for processing. Once processed, the information is redistributed to OSFI and CDIC.

largest banks—and market intelligence from such sources as money markets, investment banks, and contacts with other financial institutions.

Several committees, such as FISC and SAC, have been established to address problems of coordination and overlap among the participants in financial institution regulation and supervision at the federal level. The White Paper proposals, which are currently being discussed, are intended to help improve the supervisory and regulatory system by further clarifying participants' roles, providing for greater transparency in the system, establishing an earlier intervention process, and increasing supervision over the clearing and settlement system.

OSFI is required to examine financial institutions once a year. This responsibility is carried out by OSFI's part-time examiners who plan, conduct, and report the results of the examinations. OSFI officials said the scope of the examinations typically include the financial institution's activities and exposures to risk, the solvency of an institution, and an institution's compliance with legislation and guidelines. During the examination planning process, OSFI examiners are to review the work of the external auditors to identify issues that should be addressed in the on-site examination, to minimize duplication, and to determine the scope of the examination.

Participants Have Several Other Financial System Responsibilities

OSFI, CDIC, the Minister of Finance, and the Bank of Canada share several other financial system responsibilities.

- The Superintendent of Financial Institutions, a Deputy Superintendent of Financial Institutions, the Deputy Minister of Finance, and the Governor of the Bank of Canada are all members of CDIC's Board of Directors.
- The Bank of Canada services day-to-day liquidity needs for the banking system.
- The Bank of Canada and CDIC, in a more limited capacity, act as lenders of last resort to solvent institutions. In this capacity, the bank of Canada seeks the assurance of OSFI regarding the viability of the institution. The Bank of Canada's lending is on a secured basis, and CDIC's lending is on either a secured or unsecured basis.
- OSFI, CDIC, the Minister of Finance, and the Bank of Canada all play roles in crisis management involving financial institutions.

- OSFI and the Bank of Canada both represent Canada on the Basle Committee of Bank Supervisors.[5] The Bank of Canada and the Associate Deputy Minister of Finance also represent Canada in other forums, such as meetings of the finance ministers and governors of the Group of Seven Countries.
- The Bank of Canada is the settlement institution for members of the payments system and appoints the Chairman of the Board of Directors of the Canadian Payments Association. Although the Bank of Canada does not own or operate the payments system, the recent White Paper proposal would give the Bank of Canada regulatory oversight of the systemic risk aspect of the clearing and settlements system.

Recommendations

This report contains no recommendations.

Agency Comments

Senior officials from OSFI, CDIC, the Department of Finance, and the Bank of Canada reviewed and commented on a draft of this report. These comments were generally technical in nature and were incorporated where appropriate.

[5] The Basle Committee on Bank Supervision was created in 1974 under the auspices of the governors of the G-10 central banks and is the main forum for central bankers and supervisors to reach agreement on how best to supervise international banks. Its members meet several times a year and consist of senior representatives of bank supervisory authorities and central banks from 12 countries.

Contents

Abbreviations

BIS	Bank for International Settlements
CAMEL	Capital Adequacy, Assets Quality, Management Quality, Earnings, and Liquidity
CBA	Canadian Bankers Association
CCB	Canadian Commercial Bank
CDIC	Canada Deposit Insurance Corporation
CEO	Chief Executive Officer
CICA	Canadian Institute of Chartered Accountants
CPA	Canadian Payments Association
FSP	Financial Sector Policy
FIRP	Financial Institutions Restructuring Process
FISC	Financial Institutions Supervisory Committee
GAAP	generally accepted accounting principles
IMF	International Monetary Fund
OECD	Organization for Economic Cooperation and Development
OSFI	Office of the Superintendent of Financial Institutions
OIGB	Office of the Inspector General of Banks
P&A	Purchase and Assumption
SAC	Senior Advisory Committee

Introduction

The banking system in Canada is relatively concentrated, with six large banks that have nationwide branch networks and diversified operations. Bank regulation and supervision are the exclusive responsibility of the federal government, although certain provincially incorporated financial institutions, such as securities firms, are under the jurisdiction of the provinces. As a result of financial institution failures and reviews of the supervisory process, the federal regulatory system has gradually evolved from a system of minimal regulation of federal financial institutions to one with more oversight by federal supervisors.

Overview of Canadian Banking Industry

Banks in Canada carry out a number of nonbanking activities—including trust, securities, and most insurance activities—through wholly owned bank subsidiaries.[6] Banks were given the authority to enter the securities business under 1987 revisions to the Bank Act.[7] In 1992, banks were permitted to enter into the insurance and trust businesses through subsidiaries. All of the major banks have wholly owned securities and trust subsidiaries and have recently started to enter the insurance business.

The Canadian banking industry has consolidated quite significantly, from 36 banks in the early 1900s—many of which were locally based—to 9 domestic banks and 53 foreign-owned banks, with over 8,200 branches serving more than 2,700 communities in the provinces and territories. As of December 31, 1994, Canada's six largest banks held 90.9 percent of total bank assets and 88.6 percent of domestic bank assets. As a result of nationwide branching and a broad range of permissible activities, the major chartered banks[8] in Canada are able to diversify geographically as well as by lines of business.

Until 1980, foreign banks were prohibited from establishing subsidiaries, branches, or agencies in Canada.[9] Banks in Canada were required to be mostly Canadian-controlled and to be widely held; that is, no individual shareholder could hold more than 10 percent of the bank's voting shares. These banks were classified as Schedule "I" banks. The Banks and

[6]Canadian banks are prohibited by law from establishing bank holding companies, which are entities that may have significant ownership interests in both banks and nonbank financial firms.

[7]The Bank Act was first known as an Act Relating to Banks and Banking, and throughout this report we refer to it as the Bank Act.

[8]Commercial banks in Canada are commonly referred to as chartered banks, because for a long time a bank could be established only by a charter granted in a special act from the Canadian Parliament.

[9]The prohibition on foreign interests establishing banks in Canada existed between 1967 through 1980.

Banking Law Revision Act of 1980 opened the Canadian market to subsidiaries of foreign banks by creating a new category of permissible banks, called Schedule "II" banks. Ownership of these banks was initially limited to foreign banks, but in 1992 Schedule II banks were expanded to include ownership by foreign and domestic banks, which are also required to be widely held. At the time of the initial legislation, there were several legal differences between the Schedule I and II banks. However, primarily due to international agreements, there are not likely to be any significant differences, and Schedule II banks operate in the same manner as Schedule I banks.

As of 1994, there were 11 domestic banks in Canada—9 Schedule I banks and 2 Schedule II banks—most of which had nationwide branches; and 53 Schedule II banks that were subsidiaries of foreign banks. Other financial institutions that provided banking services included 20 trust companies, 10 loan companies, and 7 cooperative credit associations.

Table 1.1: Federal Canadian Financial Institutions (October 31, 1994)

Canadian dollars in billions[a]

Type of institution	Number of institutions	Total assets	Percent of credit industry assets
Schedule I banks	9	$740.5	84.6%
Schedule II banks (domestic)	2	10.8	1.2
Schedule II banks (foreign)	53	65.1	7.4
Trusts[b]	20	15.3	1.7
Loan companies[b]	10	36.3	4.1
Cooperative credit associations[c]	7	7.3	0.8
Total	**101**	**$875.3[d]**	**100.0%[e]**

[a]On April 1, 1995, the Canadian dollar was worth 0.713 in U.S. dollars.

[b]Trust company and loan company statistics are as of November 30, 1994. Trust company numbers include only federally chartered trust companies and exclude all trust companies owned by banks. Loan company numbers exclude those owned by mortgage companies.

[c]Cooperative credit association statistics are as of December 31, 1993. Cooperative credit associations are nonprofit associations that are owned by their respective member credit unions.

[d]Schedule I and II Banks make up $816.4 billion (Canadian), or over 90 percent, of the total assets of federally regulated financial institutions.

[e]Percentages may not add to 100 percent due to rounding.

Source: Policy and Research Division, OSFI.

History of Bank Regulation and Supervision in Canada

During the first century of federal bank supervision, Canada gradually increased the attention given to the safety and soundness of banks' operations. The creation of the Office of the Superintendent of Financial Institutions (OSFI) in 1987 was intended to improve bank supervision by increasing government involvement in the supervisory process.

Federal Bank Supervision Evolved Between 1867-1978

Banks in Canada were originally incorporated by individual provinces, and rules on how banks were governed differed from province to province. In 1867, when Canada became a confederation, the British North America Act gave the new federal government exclusive jurisdiction over all matters related to money and banking to ensure that the rules for the banking industry would be the same throughout the country.

To implement this change in jurisdiction and to govern how banks operate in Canada, the Canadian government passed the Bank Act in 1871. The Bank Act governs banks and prescribes the conditions under which banks may be formed, the range of activities in which they may engage, the general conduct of their operations, and the relationship they will have with the government and bank regulators. The Bank Act is revised approximately every 10 years to ensure that it remains in tune with changes in public policy, economic conditions, or any other developments affecting the financial system.

The first Bank Act (1871 Act) institutionalized branch banking in Canada by authorizing all banks previously incorporated in the provinces to open branches and do business throughout Canada. It also raised capital requirements for banks in order to exclude those entities without sufficient start-up capital from becoming banks. However, there was no provision made for any form of external supervision of banks. The Bank Acts of 1881 and 1891 did not deal with supervisory issues.

The Canadian Bankers Association (CBA), a private industry association, was established in 1891 and was tasked with establishing and operating a clearing system for the banking community. In 1980, the operation of the clearing system was taken over from the CBA by the quasi-public organization, the Canadian Payments Association (CPA) in order to ensure that nonbank depository institutions would have equal access to the payments system.

Proposals for various forms of external supervision of Canadian banks were put forward as early as 1880 following a round of bank failures.

However, it was not until the 1913 revision of the Bank Act that a requirement for independent audits of banks was enacted for the first time. Under this provision, banks were required to have annual audits by an external auditor chosen by the bank's shareholders from a panel selected by the CBA and the Minister of Finance.

Before the Bank Act could be revised again, Canada went through a significant economic downturn. There was a general fall in the prices of farm products along with more bank failures, both of which were frequently blamed on the banking system because of the lack of available credit. The government's response, as represented by the Minister of Finance, was to improve the system of external bank audits already put in place by the 1913 revision of the Bank Act. The 1923 revision of the Bank Act consequently made changes to the previously enacted audit requirement by (1) requiring each bank to be audited by two audit firms, subject to replacement every 2 years; (2) requiring that bank auditors be experienced and belong to an association of accountants; and (3) authorizing the Minister of Finance to select an auditor to examine the affairs and business of a bank and provide an audit report to the Minister of Finance. The 1923 revision was intended to ensure that audit reports would be filed in a routine manner by qualified auditors, thereby providing some form of supervision over banks, but not requiring government inspection.

In 1924 the failure of the Home Bank, a bank with 70 branches, provided the impetus for additional changes to the Bank Act. An inquiry into the conduct of the Minister of Finance in connection with the Home Bank failure and the Department of Finance's supervisory capability determined that if the Minister of Finance had investigated the Home Bank and acted on the findings, the bank could have been liquidated at a cost lower than the cost that resulted from its failure.

The conclusions of the Home Bank inquiry led the Canadian government to establish a system of government bank inspections. An amendment to the Bank Act in 1924 provided for the appointment of an Inspector General of Banks to head the relatively small Office of the Inspector General of Banks (OIGB). OIGB's primary duty, on behalf of the Minister of Finance, was to make sure that banks observed the safety and soundness provisions of the Bank Act. It fulfilled this duty by conducting annual bank inspections as well as by relying on information submitted by banks on an annual basis, audit reports from external auditors, and discussions with bank managers. Although OIGB did not have enforcement authority, it could turn to the courts if it needed to take some specific action, such as closing a bank.

During the late 1920s and early 1930s, Canada, similar to many countries, experienced a major depression. Although no banks failed, the banking industry was thought to have contributed to the depression because it had not extended credit. As a result, in 1933, before the next decennial revision of the Bank Act, the Canadian government set up a board of inquiry to (1) consider the advisability of establishing a central bank as a "preliminary step toward an easy money policy," (2) examine the Bank Act, and (3) look at the functions and operations of the Canadian banking system.

The result of the inquiry was the enactment in 1934 of the Bank of Canada Act establishing Canada's central bank. Although the creation of the Bank of Canada led to the initiation of required bank reserves and the phasing out of privately issued bank notes, the main responsibility of the Bank of Canada was, and remains today, the formulation and implementation of monetary policy. Its role in this area has not been without controversy: In 1956, the Minister of Finance blamed the Bank of Canada for following a tight monetary policy during a period of high unemployment and slow economic growth. By 1961, continuing conflicts between the government and the Bank of Canada forced the resignation of the Governor of the Bank of Canada.

In response to the treatment of his predecessor, the new Governor of the Bank of Canada insisted that in the normal course of events, the Bank of Canada would have responsibility for monetary policy; but in the case of disagreement between the Minister of Finance and the Bank of Canada, the government would be responsible for directing the Bank of Canada's monetary policy. The Minister of Finance agreed, and the Bank of Canada Act was amended in 1967 to formalize the arrangement. According to Bank of Canada officials, this arrangement made it clear that the government was to take ultimate responsibility for monetary policy, but that the Bank of Canada was to accept immediate responsibility for monetary policy so long as a directive was not in effect. As of April 1995, a directive had never been issued.

In 1964, the Canadian government appointed the Porter Commission to report on the banking and financial system and to recommend legislative changes. The Commission concluded that large banks had too much power and independence. Its findings resulted in several legislative changes that increased competition among financial entities but did not extend federal supervision to nonbank financial entities. The 1967 revision of the Bank Act reduced regulation of banks by (1) softening the distinction between banks, trusts, and loan companies; (2) allowing banks to make mortgage loans; and (3) removing the interest rate ceiling on bank loans. In addition, bank reserve requirements were lowered.

The dissatisfaction of provincial governments with the absence of deposit insurance in Canada led the federal government to introduce legislation on deposit insurance. The Canada Deposit Insurance Corporation (CDIC) was thus established in 1967 and provided coverage for other financial institutions, such as trust companies and credit unions. The province of Quebec was the only province that had established its own deposit insurance system, but only for institutions incorporated in Quebec. All banks and other financial institutions in Canada are members of CDIC and are therefore covered by its deposit insurance system, bylaws, and standards.

Dissatisfaction With Supervision Led to Creation of OSFI in 1987

The failure of a number of financial institutions in the early 1980s led to a review of OIGB's supervisory methods. The Canadian government set up a special commission of inquiry, the Estey Commission, to examine the effectiveness of the supervisory and regulatory system. The reviews were made public in 1986 along with the federal government's Blue Paper, "New Directions for the Financial Sector," which recommended the consolidation of the bank and insurance company supervisory offices. In 1987, the Department of Insurance and OIGB were merged to form the Office of the Superintendent of Financial Institutions (OSFI).

Because OSFI governs other federally incorporated financial institutions, such as insurance companies and trust companies, OSFI was established by the Office of the Superintendent of Financial Institutions Act of 1987 instead of the Bank Act. OSFI was created to deal with the growing similarity between banks and nonbank financial institutions and with the need for a modern regulatory framework, including a strong supervisory capability. To accomplish this goal, OSFI's supervisory authority was strengthened—its staffing increased, and its scope of authority was extended to include all federally incorporated financial institutions, including banks, insurance companies, and trusts.[10]

[10]Henceforth, the term financial institutions in this report is used to designate federal deposit-taking financial institutions, such as banks and trust companies.

At the time OSFI was created, the decision was made to keep CDIC separate from OSFI. The federal government decided that the mandates of CDIC, as the deposit insurer, and OSFI, as the supervisor, were substantially different, thus justifying keeping the two separate despite some overlap in their responsibilities. According to Canadian officials, the government felt that some overlap was useful, since it created checks and balances in the supervisory system. As the insurer, CDIC had to be concerned about minimizing the cost to the system of financial institutions' failures. As the supervisor, OSFI had to be concerned about maintaining confidence in the financial system.

Canadian banks are to be regulated and supervised with the specific purpose of ensuring safety and soundness of individual banks along with the stability of the system as a whole. Canadian banking law does not address such issues as fair lending or community reinvestment. Even so, in consultation with bank regulators CBA has developed voluntary guidelines on such issues as consumer and small business lending. The large Schedule I banks have also played a significant role in developing and promoting these guidelines—partly out of a sense of social responsibility, and partly to head off legislated solutions to problems.

Supervision of Banks' Nonbank Activities

As previously noted, OSFI is responsible for supervising financial institutions that are federally incorporated, such as banks, insurance companies, and federally incorporated trusts. However, since all securities firms and some trusts are incorporated at the provincial level, the 10 provinces have the principal responsibility for the supervision of such institutions.

Under an agreement signed in April 1987 by the federal Minister of Finance and the Ontario Minister of Finance, OSFI is to be responsible for regulating "securities-related activities of federal financial institutions carried on directly by the institution."[11] Securities activities that are restricted to subsidiaries of a bank or insurance company—including underwriting of equity and debt and secondary market trading in equities—are to be supervised at the provincial level.

[11]The permitted activities are specifically listed in the agreement and include those relating to (1) sovereign debt, (2) money markets, (3) debt securities of the institution, (4) secondary market trades in corporate debt securities, (5) capital market activities in syndicated or consortium loans, (6) portfolio management and investment counseling to the extent permitted by law, (7) dealings in mutual funds, and (8) trades for fully managed accounts.

OSFI and the Ontario Securities Commission have signed a Memorandum of Understanding that enables OSFI to receive regulatory information on nonbank subsidiaries from provincial regulators and enables the provincial regulators to obtain from OSFI information on the banks owning subsidiaries.[12] OSFI is also to receive financial information from the parent companies on their securities subsidiaries. OSFI remains responsible for the supervision of the banking organization as a whole—for example, for ensuring that the consolidated entity is meeting consolidated capital requirements. The provincial regulator, on the other hand, sets capital levels for the securities subsidiaries and is responsible for ensuring that those capital and other securities requirements are being met.

OSFI also supervises 18 trust companies that are not owned by banks. In its role as an agent of CDIC, OSFI examines 5 of the 18 trust companies that are provincially chartered and are CDIC members. As an agent of the provincial regulators, OSFI examines the 13 other provincially chartered trust companies that are not members of CDIC.

Overview of Participants in Bank Regulation, Supervision, and Examination

Although OSFI is the primary financial institution supervisor, the Department of Finance, CDIC, and the Bank of Canada all play roles in regulating or supervising financial institutions—either directly or through committees.

OSFI

OSFI is headed by the Superintendent of Financial Institutions, who is appointed for a 7-year renewable term by the Cabinet. The Superintendent reports directly to the Minister of Finance.

OSFI is divided into three sectors: the Policy Sector, the Operations Sector, and the Corporate Sector. The Operations Sector includes the Deposit-Taking Institutions Sector, which is to supervise banks, federally incorporated trust and loan companies, and cooperative credit associations. At the end of June 1995, the Deposit-Taking Institutions Sector had 130 employees, including 71 full-time examiners located in OSFI's regional offices—45 in Toronto, 12 in Montreal, 8 in Vancouver, and 6 in Winnipeg.

[12]OSFI has worked with the other provincial regulators to establish the same agreement concerning securities activities that OSFI has with the Ontario Securities Commission.

OSFI activities are to be conducted on a cost-recovery basis, meaning that its operations are paid for through industry assessments. For 1992 and 1993, deposit-taking institutions were assessed a total of $14.8 million (Canadian).

Department of Finance

The Department of Finance is headed by the Minister of Finance, described to us by Canadian officials as the most influential member of the government's Cabinet after the Prime Minister. The Bank Act gives the Minister of Finance responsibility for financial institutions, and the 1992 revision to the Bank Act allows for the delegation of that responsibility. The Minister of Finance has delegated many of the responsibilities over financial institution policy to the Secretary of State (International Financial Institutions).[13] The Minister of Finance has delegated to the Superintendent of OSFI administrative matters relating to financial institutions, such as incorporating new banks.

The branch of the Department of Finance that is responsible for financial services industry issues is the Financial Sector Policy Branch (FSP), which consists of three divisions: Financial Markets, Financial Institutions, and Financial Sector Policy. It includes a permanent staff of 55 people, as of January 1995, of whom half are to be involved in policy formulation concerning financial institutions.

CDIC

CDIC is a crown corporation[14] and was incorporated under the CDIC Act in 1967 to provide deposit insurance. CDIC is run by a Board of Directors and a Chairman, who report to Parliament through the Minister of Finance. The Board of CDIC includes the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Financial Institutions and a Deputy Superintendent of Financial Institutions, and four independent private-sector directors. The Cabinet is to appoint the four private-sector directors for 3-year terms and the Chairman for a 5-year term. The directors are to represent a range of business experience, particularly in the areas of banking, finance, real estate, accounting, auditing, insolvency, corporate law, and management.

As of December 1994, CDIC had a permanent staff of about 90 people headed by the Chief Executive Officer (CEO) and President, who is also a government Cabinet appointee with a 5-year term.

[13]In 1980, the Canadian government created 11 Secretaries of State to replace junior ministers.

[14]A crown corporation is an entity formed by the Canadian government to fulfill a public need.

Bank of Canada

The Bank of Canada is to be overseen by its Board of Directors, which is composed of the Governor; the Senior Deputy Governor; 12 Directors; and the Deputy Minister of Finance, who is a nonvoting member. The Directors are to be appointed for 3-year terms by the Minister of Finance with the approval of the Cabinet. The Directors are to appoint the Governor and Deputy Governor for 7-year terms, again with the Cabinet's approval. Directors can be removed by the Board with the Cabinet's approval.

The Board is to meet at a minimum seven times a year and is responsible for the Bank's management, administrative policies, and expenditures. In 1994, the Board established a Governing Council made up of the Governor, Senior Deputy Governor, and four Deputy Governors to manage the Bank.[15] An Executive Committee of the Board, composed of the Governor, the Senior Deputy Governor, the Deputy Minister of Finance as a nonvoting member, and four directors, is to meet regularly and submits minutes from its meeting at the following Board of Directors meetings. Monetary policy is to be formulated and implemented by senior management of the Bank of Canada, who are to report on monetary policy to the Board and the Executive Committee at their regular meetings.

As of February 1, 1995, the Bank of Canada had 2,055 staff who performed the 4 major functions of the Bank of Canada: monetary policy formulation, banking activities, bank note issuance, and management of the Government of Canada's debt. The Monetary and Financial Analysis Department had a staff of 54 people responsible for financial systems and analysis—focusing mainly on financial analysis for monetary policy purposes. Within the Monetary and Financial Analysis Department, the Regulatory and Payments System Analysis Division is to do the analysis on regulatory and clearing and settlement system issues. The Division is to include four economists and one research advisor.

External Auditors

All federal deposit-taking financial institutions in Canada are required to have an annual financial audit. The big six accounting firms[16] are the primary auditors for banks and trusts, although there are one or two regional firms that also audit banks. Although the Bank Act no longer requires banks to have two auditors, Canadian officials with whom we spoke said the large Schedule I banks still retain two audit firms.

[15]The Council is to decide on broad organizational and strategic issues as well as on basic approaches relating to the Bank of Canada's responsibilities in monetary policy and other areas.

[16]These firms are known in the United States as Ernst and Young, Arthur Andersen LLP, Deloitte & Touche, KPMG Peat Marwick, Coopers & Lybrand, and Price Waterhouse.

FISC

The Financial Institutions Supervisory Committee (FISC) was established by the Office of the Superintendent of Financial Institutions Act of 1987 to enhance communication among the participants in financial institution regulation and supervision. The Committee is chaired by the Superintendent of Financial Institutions and includes the Deputy Minister of Finance, the Governor of the Bank of Canada, and the Chairman of CDIC. FISC is not authorized any staff.

SAC

The four members of FISC also make up the Senior Advisory Committee (SAC). The Committee is chaired by the Deputy Minister of Finance. SAC is to meet when there are policy changes or legislative proposals to be discussed.

A committee below SAC called "Sub SAC" is made up of deputies or assistants and is to meet every few months. In addition, there are working groups below Sub SAC that are to meet throughout the year. The same issues and alternatives talked about at SAC are to be discussed at Sub SAC and in the working groups, with discussions generally involving specific details and their implications.

Objectives, Scope, and Methodology

At the request of Congressman Charles E. Schumer, we examined various aspects of the Canadian bank regulatory system. Specifically, our objectives were to describe (1) the Canadian bank regulatory structure and its key participants, (2) how the banking structure functions, (3) how banks are examined, and (4) how the participants handle other financial system responsibilities. We completed similar studies on the bank regulatory structure and operations in several other countries.[17]

To address these objectives we conducted interviews with officials of the Office of the Superintendent of Financial Institutions, the Department of Finance, the Canada Deposit Insurance Corporation, and the Bank of Canada. They provided us with various documents, including annual reports, guidelines for banks, standards of sound business and financial practices, copies of legislation and proposed legislation, and statistics on the banking industry.

[17]For information on GAO's already issued reports on the German and British regulatory systems, see Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994); and Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994). GAO is also preparing reports on the regulatory systems of France and Japan.

We also met with senior executives of Canadian banks; senior executives from external auditing firms; individuals from CBA, the association representing banks in Canada; the Trust Association of Canada, the association representing trust companies; the Toronto Futures Exchange; CPA, the association that runs the payments and settlements system; and several other experts on Canadian bank regulation and supervision and bank audits in Canada.

Finally, we reviewed the Consolidated Bank Act and Regulations, the law that relates most directly to bank regulation and supervision; the Bank of Canada Act, and the CDIC Act; the guidelines and standards of the regulators; and other documents that related to the Canadian bank regulatory structure. This review does not constitute a formal legal opinion on the requirements of the law, nor does it include an evaluation of the efficiency or effectiveness of the Canadian bank regulatory structure.

We conducted our review, which included two visits to Canada, from August 1994 through February 1995 in accordance with generally accepted government auditing standards. We gave senior officials at OSFI, CDIC, the Department of Finance, and the Bank of Canada a draft of this report for their comments. They generally agreed with the facts as presented and provided primarily technical comments, which have been incorporated where appropriate.

Bank Chartering, Regulation, and Supervision

Since 1987, OSFI has been formally recognized in statute as the primary supervisor of financial institutions in Canada. Nevertheless, it shares certain regulatory and supervisory responsibilities with others. By law, the Minister of Finance is responsible for chartering or incorporating federal financial institutions, although OSFI administers the application process. The Minister of Finance also has the final decisionmaking authority over key supervisory decisions. CDIC has a secondary supervisory role but has increased its influence over supervision and regulation in recent years by taking advantage of its authority to issue standards. A less extensive role is played by the Bank of Canada that basically involves information sharing. FISC and SAC are used to communicate and coordinate regulation and supervision activities.

The Minister of Finance Charters Federal Financial Institutions, but OSFI Administers the Application Process

Financial institutions in Canada were initially permitted to incorporate only by a special act of Parliament. Parliament delegated this responsibility to the Minister of Finance, and in 1980 the Minister of Finance was given the power to issue "letters patent" to charter or incorporate financial institutions in accordance with the Bank Act.

Although, technically, it is the Minister of Finance that is to issue letters patent, OSFI is responsible for the application process. The application for letters patent is to be reviewed by OSFI, which then makes recommendations to the Minister of Finance as to whether the financial institution should be chartered. We were told that the Minister of Finance has always accepted OSFI's recommendations.

The analysis that OSFI is to do on behalf of the Minister of Finance includes assessing (1) the source of financial resources for the financial institution, (2) the soundness and feasibility of plans for the future development of the financial institution, (3) previous experience of the owner of the financial institution, (4) the competence and experience of the financial institution's management, and (5) whether incorporating the financial institution is in the best interest of the Canadian financial system.

CDIC and OSFI have an administrative agreement whereby both agencies are to coordinate on the application for incorporation and deposit insurance. Once incorporation is granted, CDIC then makes a decision on approving the financial institution's application for deposit insurance.[18] Before a financial institution is authorized to accept insured deposits, CDIC normally

[18]CDIC members include provincial financial institutions, which are outside of OSFI's purview, and the chartering and insurance approvals for those institutions are to be made between the provincial chartering authority and CDIC.

requires that the applicant's promoter, affiliates, or controlling entity provide CDIC with a legal undertaking, which could involve a guarantee from the parent company. In the last 5 years, CDIC has denied deposit insurance to three applicants, all of which were provincial applicants.

Responsibility for Financial Institution Regulation Falls Primarily to OSFI and CDIC

OSFI is responsible for administering and interpreting legislation relevant to financial institutions by developing regulations and guidelines, which must be approved by the Minister of Finance and the Cabinet before they are issued. CDIC has the authority to issue bylaws, which have the force of law.

OSFI Is Responsible for Regulations and Guidelines

OSFI is responsible for developing financial institution regulations, but before regulations are issued they are to be (1) reviewed by the Privy Council;[19] (2) published in the Canada Gazette for a 60-day comment period, with comments incorporated as appropriate; (3) approved by the Minister; and (4) approved by the Cabinet. OSFI officials told us they generally issue guidelines because the process of issuing regulations is long, complex, and less flexible. Although guidelines do not have the force of law, the officials said they are usually followed by all financial institutions.

Financial institution industry guidelines have included such subjects as capital adequacy requirements, how assets may be securitized, large exposure limits, and the classification of loans guaranteed by a parent of the financial institution. OSFI's guidelines include such information as definitions, limits, or procedures that should be taken into account and the type of information that should be provided to OSFI. Because OSFI regulates all federal financial institutions, the guidelines generally address financial institutions other than banks. For example, the guideline for securities lending applies to insurance, trust and loan companies, and banks. In recent years, OSFI has issued 17 guidelines relevant to the banking industry. OSFI officials told us they do not issue interpretive letters explaining the guidelines, they just revise the guidelines if further clarification is needed.

In developing both regulations and guidelines, OSFI is to consult extensively with the industry, principally with the institutions or associations that the regulation or guideline affects. Although OSFI has the

[19]The Privy Council is a department that carries out the day-to-day duties for the Prime Minister of Canada.

primary responsibility for developing regulations and issuing guidelines, the Minister of Finance has the primary responsibility for developing and proposing financial institution industry legislation. OSFI may, however, be involved in drafting such legislation.[20]

CDIC Has Authority to Issue By-Laws

CDIC has the authority to issue by-laws, which have the force of law. These by-laws pertain to the operations and functions of CDIC and its members.

CDIC has made use of its authority by issuing new by-laws in the areas of (1) standards of sound business and financial practices, (2) deposit insurance applications, and (3) deposit insurance premium surcharges. In addition, CDIC is in the process of developing by-laws on consumer information and trust and joint accounts.

CDIC issued the Standards of Sound Business and Financial Practices By-laws (Standards By-laws) on August 17, 1993, following 4 years of extensive consultation with regulators, member institutions and their associations, accountants, lawyers, and other interested parties. The Standards By-laws stipulate that each member institution should establish sound business and financial practices in eight areas: liquidity management, interest rate risk management, credit risk management, real estate appraisals, foreign exchange risk management, securities portfolio management, capital management, and internal controls. According to the CDIC Chairman, an important consequence of the Standards By-laws "is to make clear the responsibility on boards of directors and officers of deposit-taking institutions for ensuring implementation and compliance with standards of sound business and financial practice."

Each of the eight Standards By-laws has a standards document that sets out what CDIC considers to be the minimum policies, procedures, and control criteria that financial institutions need to have in place. CDIC officials told us that banks and other insured institutions are expected to effectively apply these standards in order to manage their business activities on a sound basis and prudently control their various exposures to risk. The standards set out the "best practices," many of which CDIC officials said were already being followed by CDIC's best-managed members. If applied and followed, the standards are intended to reduce the likelihood of an insured financial institution failing and reduce the risk of loss assumed by CDIC. CDIC sees nonadherence to the standards as an early indicator of potential problems, and it may terminate the institution's

[20]CDIC and the Bank of Canada are also involved in drafting legislation through SAC.

deposit insurance. The standards, however, are new, and CDIC officials expect to have a better idea of industry adherence after the next cycle of annual examinations.

Compliance with CDIC's standards are to be measured through a member's self-assessment process, which OSFI is to review during its annual examinations of financial institutions. A member's self-assessment requires the institution's management and Board of Directors to confirm that the policies and procedures required in the standards are (1) in place, (2) sound and prudent, and (3) being followed by the institution. Each member is to submit a Standards By-laws self-assessment report on the adherence to the standards to CDIC by July 31 of each year. If CDIC does not consider the self-assessment done by an institution adequate, the institution is required to conduct a more detailed self-assessment.[21] An institution is also required to submit a detailed report if it does not meet all of the following conditions, based on its most recent quarterly financial statements: (1) meet the capital ratio required by the regulator; (2) have a ratio of net nonperforming loans to capital of less than 1/2; and (3) have sufficient capital to withstand a loss over the next 4 quarters equal to a loss sustained during the last 4 quarters. Lastly, institutions that are new members will be required to complete a detailed report. In addition, if CDIC or OSFI, in the case of federal financial institutions, have any concerns about the institution, a detailed report is also required. (See app. I for more detailed information on the Standards By-laws.)

In fiscal years 1993 and 1994, CDIC issued other by-laws dealing with the Application for Deposit Insurance, Policy of Deposit Insurance, and Premium Surcharges. The Application By-law introduced a new form of application for deposit insurance and the Policy By-law requires that members provide regular financial information and business plans to CDIC on request and is designed to ensure that CDIC has access to information about its members. The Premium Surcharge By-law, which went into effect on January 26, 1994, allows CDIC to charge penalty surcharges if an

[21]There are two kinds of standards self-assessment reports: a simplified report and a detailed report. The simplified report includes a representation letter that says that management has followed the standards. The letter is followed by a description of processes the institution followed in conducting the self-assessment and then a resolution by the member's Board of Directors saying that the Board is familiar with the standards, has considered the management representation letter concerning adherence to the standards, and has approved the report on behalf of the member. The detailed report presents the criteria for the member's adherence to each standard, the basis on which the member decided on the criteria, and explains how the member met the criteria for each standard. As with the simplified report, a letter and resolution statement are included in the detailed report. If a member submits a simplified report to CDIC, the member must retain evidence to support the report, as the member will have to provide it to OSFI during its annual examination of federal financial institutions in order for OSFI to report to CDIC on the member's adherence to the standards.

institution fails to (1) follow the CDIC Standards By-laws, (2) comply with record-keeping and information requirements, (3) comply with any provision of the Bank Act or other relevant law, or (4) meet the terms of undertaking given to CDIC.

OSFI and CDIC Are Responsible for Enforcement

OSFI and CDIC both have the authority to take enforcement action against financial institutions for which they have responsibility. However, OSFI has a wider range of enforcement actions, both formal and informal, at its disposal than does CDIC.

OSFI Relies Primarily on Informal Enforcement Actions

Although OSFI has the authority to use a wide range of enforcement actions, its officials told us they tend to rely principally on informal actions. They said institutions usually comply with informal recommendations, knowing that OSFI will not hesitate to use more formal action if compliance is not forthcoming. For example, after each examination of a financial institution, OSFI discusses with the institution's management any problems that were found and sends a management letter to the institution "recommending" actions to be taken. OSFI officials said these recommendations are followed because the institutions understand that more serious, formal enforcement actions could follow if recommendations are disregarded. According to OSFI officials, most of OSFI's enforcement is accomplished through management letter recommendations.

If an institution's problems continue to escalate, OSFI officials said they will take more formal enforcement actions. For instance, OSFI may obtain a letter of undertaking from the institution. OSFI may also do a follow-up examination on the financial institution in the same year that it did the first examination, or commission an external auditor to do an audit of the institution. In addition, OSFI can order a financial institution to increase its capital, which the official said is usually a precursor to forcing an institution to be sold or to be liquidated. OSFI has ordered an increase to an institution's capital twice since it was given the authority to do so in 1992.

Although it has yet to use them, there are other formal actions that OSFI is authorized to take. These include issuing a direction of compliance or recommending that CDIC undertake a Financial Institutions Restructuring Process (FIRP).[22] A direction of compliance enables OSFI to direct a

[22]FIRP basically expropriates the rights of the shareholders. Under FIRP, the ownership of the shares goes to CDIC, and CDIC can then sell the shares to another financial institution without shareholder approval. In order to use FIRP, CDIC has to have a purchaser available.

financial institution to stop what OSFI considers to be an unsafe or unsound practice. FIRP can be used when OSFI makes a determination that an institution "has ceased, or is about to cease, to be viable" and reports the lack of viability to CDIC. In such situations, CDIC may take control of the institution.

According to OSFI officials, a financial institution may appeal an OSFI determination or action either by taking OSFI to court or by appealing to the Minister of Finance. According to OSFI officials, under the normal right of appeal, the institution can take OSFI to court, although this has never happened. In the majority of cases, OSFI officials said, financial institutions have appealed to the Minister of Finance who, while he has listened to the institutions' concerns, has yet to alter in any way OSFI's enforcement actions. All important actions taken by OSFI, such as a recommendation to close a financial institution, are to be reviewed by the Secretary of State (International Financial Institutions).[23]

CDIC Also Has Enforcement Authority

Although CDIC may also take specific, narrowly defined enforcement actions, CDIC officials said it exerts more influence through moral suasion or by having OSFI put pressure on a financial institution. If CDIC determines that these initial actions have not led to satisfactory results, it may take enforcement actions that include (1) levying a premium surcharge against an individual member if it fails to abide by certain by-laws or other relevant statutes or (2) terminating an insured institution's deposit insurance.

CDIC may also terminate an institution's insurance when the institution is not following CDIC's by-laws, even when it is otherwise solvent. CDIC has cancelled deposit insurance four times in the cases of failed members, and it has terminated deposit insurance as an enforcement action against one solvent member.

[23]As noted in chapter 1, the Minister of Finance has delegated most of the responsibility for financial institutions to the Secretary of State (International Financial Institutions).

OSFI and CDIC Coordinate the Resolution of a Financial Institution's Failure

Until an institution reaches the point where it is declared insolvent, or not financially viable, and is placed in liquidation, OSFI has the lead in resolving the troubled institution but is to coordinate its actions with CDIC. If a financial institution is declared insolvent by OSFI, CDIC can terminate the institution's deposit insurance. The Minister of Finance and the Bank of Canada are kept informed about a troubled institution through FISC, but their officials told us their roles take place behind the scenes, providing input to OSFI, if necessary.

Attempts Are Made to Find Early Solution

Once a financial institution is put on the regulatory watchlist,[24] both OSFI and CDIC are to monitor the institution's situation more extensively than is usual.[25] In the early stages of a problem situation, OSFI is to be in frequent contact with the financial institution and take enforcement actions to help get the institution's management to rectify the problems. Depending on the circumstances, OSFI may exert pressure on the institution's management and board of directors to restructure the institution or find an acquirer or merger partner. If the institution's condition further deteriorates, OSFI may develop plans to take control of the financial institution's assets, especially if conditions deteriorate to the point at which its viability comes into question. According to an OSFI official, once OSFI takes control of a financial institution's assets, it usually intends to liquidate the institution.

CDIC is also to work with OSFI to find solutions for problem financial institutions at the federal level. When a CDIC member is on the watchlist, OSFI is to continually update CDIC's Board on the status of the financial institution. Once CDIC becomes aware that a financial institution poses a high risk of loss—generally from information it has received from OSFI—CDIC may order a special examination in order to (1) determine CDIC's financial exposure if the institution were to fail; and (2) have a basis for intervening in the situation, such as suggesting to the institution and OSFI a purchase and assumption transaction (P&A) with a potential acquirer, or suggesting to the institution that it voluntarily liquidate. According to CDIC officials, both resolution alternatives are normally considered at the same time.

[24]The watchlist includes financial institutions considered by OSFI and CDIC to be problem institutions whose risk profiles are not effectively managed and whose viability is of concern.

[25]CDIC and OSFI officials are to meet with the Secretary of State of International Financial Institutions once a month to talk about institutions on the watchlist and other problem institutions. Basically, an institution is placed on the watchlist when its capital is below required levels or it is operating in an unsafe and unsound manner.

When it is clear that the financial institution presents imminent risk to the deposit insurance fund, CDIC officials said they generally consider four options for resolving the institution: (1) the institution is liquidated and CDIC pays depositors up to the limit of their insured deposits; (2) a P&A transaction takes place in which the failed institution is sold to an acquirer; (3) CDIC pays another institution to run the failed institution; or (4) CDIC provides direct financial assistance to the failing institution by making advances, guaranteeing acquired assets, or making a deposit at the institution. CDIC staff provide its Board with information on the costs of each option, and the Board then makes a determination on how to resolve the institution.

Other Participants Have a Role

During the resolution process, the Deputy Minister of Finance and the Governor of the Bank of Canada are to participate through CDIC's Board of Directors in the decisionmaking process either to close a financial institution, which is OSFI's responsibility, or to terminate a financial institution's insurance, which is CDIC's responsibility. The Secretary of State (International Financial Institutions) is to be briefed by OSFI on the state of affairs of a problem institution and is to become more involved if there is a possibility that federal funding might be required.

Once OSFI determines a financial institution is, or is likely to become, insolvent and should be closed, it is to make a recommendation to the Secretary of State (International Financial Institutions) about closing the institution. If the Secretary of State (International Financial Institutions) agrees with OSFI's recommendation, the Secretary is to ask the Attorney General's office to start winding up the affairs of the financial institution. Similarly, if CDIC recommends terminating the deposit insurance of a financial institution, the Secretary of State is to decide whether to agree with the recommendation, and, if he agrees, the termination process begins. Although the Secretary has the authority to reject an OSFI or CDIC recommendation, Department of Finance officials said he has never done so.

The Bank of Canada's Supervisory Role Is Limited

The Bank of Canada's current role in banking supervision is relatively limited. First, the Bank of Canada is a source of information on the systemic implications of closing a financial institution and is frequently asked for its judgment on that issue by the other supervisory participants. Second, it is included in and can initiate discussions with other participants in the regulatory and supervisory structure about potential systemic issues and initiatives to address those issues. This role is based principally on its participation in the financial system as lender of last resort. Third, the Governor of the Bank of Canada is an advisor to the Minister of Finance on a broad range of issues and meets with the Minister of Finance regularly. Finally, the Governor is an ex officio member of the CDIC Board of Directors and a member of FISC and SAC.

Relationships Among Participants in Financial Institution Regulation and Supervision Are Complex

The relationships among the participants in financial institution regulation and supervision in Canada are quite complex. Numerous responsibilities overlap among the major participants involved in regulation and supervision at the federal level, and decisionmaking requires significant coordination. Committees have been created to improve coordination and information sharing among the participants.

OSFI and CDIC Relationship Is Complex

According to Canadian financial institution regulatory officials, the relationship between OSFI and CDIC has been complicated because of differing philosophies stemming from their primary responsibilities as supervisor and deposit insurer, respectively.

CDIC, as the deposit insurer, has been concerned about minimizing the cost of failing institutions to the insurance fund, and consequently it has preferred that an institution be resolved sooner rather than later to reduce the likelihood of losses increasing over time. OSFI, on the other hand, has been primarily interested in system stability and thus has tended to pursue all avenues of addressing a problem institution thought to be viable in order to maintain stability and public confidence in the financial system. Because OSFI's perspective can occasionally lead to increased losses, the different philosophies have led to some disagreements between OSFI and CDIC.

In addition, CDIC has the authority to issue by-laws and has done so in order to exercise its supervisory responsibilities. CDIC's issuance of the Standards By-laws further clouded the regulator's and insurer's jurisdictions.

Purpose of Coordinating Committees Is to Improve Relationships and Information Sharing

Several committees have been established, both in legislation and more informally, to address the problems of coordination and overlap among the participants in financial institution regulation and supervision. FISC, as noted in chapter 1, was established in the Office of the Superintendent of Financial Institutions Act of 1987 to improve information sharing among the Committee's four members: OSFI, the Department of Finance, CDIC, and the Bank of Canada. The Committee was deemed necessary by Parliament because it was felt that a lack of information and coordination contributed to the weaknesses of the pre-1987 regulatory system. The Committee is not a decisionmaking body or even an advisory body. Its purpose is "to facilitate consultations and the exchange of information among its members on all matters relating directly to the supervision of financial institutions." The Committee is to meet on a regular basis to discuss regulatory issues.

In addition to FISC, the same representatives also make up the membership of SAC. As mentioned in chapter 1, SAC provides the forum in which policy changes and other legislative changes are to be discussed.

OSFI and CDIC have also established an OSFI/CDIC Liaison Committee which, according to officials with whom we spoke, is an attempt by the CDIC Chairman and the Superintendent of Financial Institutions to improve the working relationship between the two organizations and provide a forum to discuss issues. The Committee is to meet once a month.

Although the establishment of these committees signals an acknowledgement that better coordination is needed among the participants in the financial institution regulatory structure, there has been some dissatisfaction with how some of the committees work. According to officials with whom we spoke, concerns have been raised about the quality of information sharing, the frequency of meetings, the manner in which the agendas are set, and the accountability of the committee members.

White Paper Proposes to Clarify Participants' Roles

In February 1995, the Secretary of State (International Financial Institutions) proposed a White Paper or policy paper on Enhancing the Safety and Soundness of the Canadian Financial System. The purpose of the White Paper proposals is to help improve the supervisory and regulatory system and alleviate tensions by further clarifying participants' roles, providing for greater transparency in the system, establishing an earlier intervention process, and increasing supervision over the clearing and settlement system. The Secretary of State (International Financial Institutions) expects the White Paper proposals to be placed in legislation as soon as possible.

OSFI and CDIC's Roles to Be Clarified

During the course of developing the White Paper, the Secretary of State (International Financial Institutions), in consultation with the other participants, looked at the financial institution regulatory structure—specifically at merging, separating, or keeping OSFI and CDIC the way they are now. The Secretary decided to keep both organizations as they are now, recognizing that some overlap between the two can provide for healthy checks and balances. For example, the independent assessments CDIC makes appear to provide a constructive second look at the supervisory practices of OSFI, and the access and interactions OSFI has with the financial institutions provides CDIC with better insights to the safety and soundness of various banking practices.

Nevertheless, the White Paper clarifies the roles of OSFI and CDIC in the regulatory and supervisory intervention process in three principal ways. It proposes that (1) the Superintendent of Financial Institutions is to be given a clearly defined legislative mandate that would clarify OSFI's role and the manner in which it is to carry out its role, (2) the actions and respective roles of OSFI and CDIC are to be further clarified to provide each organization with a range of regulatory measures that it may take, and (3) the Superintendent of OSFI is to be given the authority to take control of an institution earlier than can be done under current legislation.

Roles of the Minister of Finance and the Bank of Canada May Also Change

In addition to the clarification of OSFI and CDIC roles, the White Paper also proposes redefining the roles of the Minister of Finance and the Bank of Canada. The proposal formally assigns most of the Minister of Finance's current administrative decisionmaking responsibilities to OSFI. Currently, OSFI supports the Minister of Finance's decisionmaking through its analysis. The proposals also give the Bank of Canada direct regulatory responsibility for clearing and settlements, which the Bank of Canada had already informally assumed.

Currently, under the authority of the Minister of Finance, the Secretary of State (International Financial Institutions) has the final say on whether a financial institution should be closed, its deposit insurance terminated, or whether regulators can undertake a FIRP or otherwise take over an institution. The White Paper proposes that the role of the Minister of

Finance be refocused by requiring the Superintendent of Financial Institutions, as opposed to the Minister of Finance, to make the decision regarding the financial condition of an institution. Under the proposal, the Minister of Finance would still be able to prevent an institution's closure in exceptional circumstances, if the Minister of Finance determines that the closure is not in the public's interest.

In addition, the White Paper proposals specify legislatively a more explicit role for the Bank of Canada in the oversight of the clearing and settlements system in order to help control systemic risk. In part, this means that the private sector operators of the clearing and settlements system would obtain the Bank of Canada's approval regarding how they monitor and control for systemic risk. (See ch. 4 for more information.)

Supervisory Information Is Obtained Through Monitoring, Examinations, and External Audits

In order to fulfill its supervisory role of identifying emerging problems in financial institutions at an early stage, OSFI relies on information obtained through oversight, annual examinations, and annual audits performed by external auditors. CDIC relies primarily on OSFI for information on institutions it insures. While somewhat removed from the supervisory process, the Bank of Canada nevertheless collects detailed reports on financial institutions that are used principally for monetary policy purposes. These reports, along with its Governor's membership on FISC, keep the Bank of Canada informed in case of a financial crisis.

Monitoring Provides Ongoing Supervisory Information

OSFI, CDIC, and the Bank of Canada have developed a shared reporting system through which financial institutions are required to report data concerning their activities and operations. This data reporting system is designed to meet the supervisory and deposit insurance information needs of OSFI and CDIC, as well as the monetary policy information needs of the Bank of Canada.

Financial Institutions File Periodic Reports With OSFI

Financial institutions in Canada are required to submit a variety of data to OSFI, including annual consolidated financial statements, quarterly income statements, allowances for loan losses, holdings in subsidiaries and associated companies, and geographical distribution of assets and liabilities—both inside and outside of Canada. According to OSFI officials, if OSFI needs more specific information than that reported, it requests that the institution provide it.

The information on bank activities helps OSFI assess a financial institution's risk profile and helps OSFI examiners in scoping their examinations.

CDIC Relies on OSFI for Most of Its Information on Financial Institutions

CDIC relies primarily on OSFI for information on the financial condition of its federal members and normally has access to comparable information other CDIC members routinely submit to their provincial regulators. CDIC also receives OSFI's examination results through copies of management letters and examination reports from OSFI. The management letter provides CDIC with a description of the issues OSFI has identified as needing the attention of the institution's management along with the actions management has committed to taking to address those issues. CDIC automatically receives all examination reports on problem institutions from OSFI and can request examination reports on other institutions. The

OSFI Section 29 report reflects the examination results for the period examined. Specifically, OSFI confirms in the report that (1) the CDIC premiums are correct, (2) the institution is in satisfactory financial condition, and (3) that CDIC's standards are being followed.

CDIC may also obtain specific information on a financial institution from OSFI, or directly from the institution. CDIC also receives the equivalent of call report data[26] from the data reporting system and gets annual financial statements directly from its members.

All of the information that CDIC receives is to be used to do risk assessments of the member and to assess the member's risk management policies and procedures. CDIC also compares the information that it receives directly from financial institutions in the annual financial statements with the information received from OSFI examiners.

The Bank of Canada Gets Frequent Information

Although the Bank of Canada has no direct statutory responsibility for supervision, Bank officials told us they receive current information about the financial system and individual institutions through the data reporting system in order to fulfill its monetary policy and lender of last resort responsibilities, as well as to be able to assist in any financial crisis (see ch. 4 for additional information). The Bank of Canada is to receive the fully consolidated monthly balance sheets from financial institutions, as well as weekly liquidity reports from selected financial institutions. It is also to receive quarterly reports from financial institutions on loan concentrations, securities, and deposits. In addition, the Bank of Canada is to get information and intelligence from market sources, such as money market and foreign exchange data, and it has contacts with investment banks and other financial institutions that provide information on financial market developments.

According to Bank of Canada officials, all the information collected in the data reporting system is processed by the Bank of Canada, which downloads the data to databases maintained by both OSFI and CDIC.

Meetings With Financial Institutions Also Produce Information

The financial information reported by financial institutions is essential to an ongoing understanding of an institution's activities and financial condition. However, an OSFI official said that the reported information

[26]These data typically provide a statistical depiction of the bank's financial activities, such as the types of loans or securities holdings.

alone is not enough to give OSFI a complete picture of a financial institution's operations. The reported information, therefore, is supplemented with informal meetings and discussions with institutions.

During informal meetings and discussions, OSFI is to sit down with the senior management of a financial institution and go over the institution's risk management policy—what the institution defines as risk and how the institution controls the risk. These meetings provide key information on what an institution is doing, according to an OSFI official, and also help OSFI examiners scope their annual examinations, i.e., focus OSFI's information collecting on the risks inherent in the institution's activities and on those activities where an in-depth look is required. For instance, according to OSFI officials, during an informal meeting with a bank, the bank management told OSFI that it was planning to undertake more extensive derivative activities. As a result, OSFI examiners made a point of looking hard at the bank's treasury department. An OSFI official said that OSFI has also established good relationships with the chief inspectors of the institutions' internal audit departments, generally a good source of information, because the internal audit departments of large financial institutions generally have extensive audit programs, such as for assessing internal controls.

The informal meetings with OSFI are to be held as needed rather than being held on a set schedule. An OSFI official said that OSFI staff basically have ongoing discussions with institution staff. The number of meetings varies, but at a minimum OSFI is to meet with the larger financial institutions quarterly. If a financial institution is on the watchlist, OSFI is to meet with the institution monthly to discuss its situation.

In addition to informal meetings, OSFI officials told us they have formal meetings with financial institutions. OSFI holds a formal meeting with the financial institution after every examination. It has separate meetings with the institution's Audit Committee, management, and external auditors. In addition to meeting with the Audit Committee, OSFI has a private meeting with the independent Board members. At these meetings, which are held to discuss OSFI's examination findings, any concerns that the Board members wish to raise are to be discussed. In such meetings Audit Committee members often want to ask OSFI questions that they can not comfortably ask during the formal meeting with the financial institution.

OSFI officials also said they meet with financial institutions under the auspices of CBA to discuss emerging issues in the industry. CBA meetings usually entail discussions on general issues concerning financial institutions and are not institution-specific.

Market Information—Particularly That Provided by the Largest Banks—Is Obtained by OSFI and the Bank of Canada

The Canadian banking system is relatively unique in the concentration of banking assets in the six largest banks. We were told by both bank and OSFI officials that these banks play an important role in the Canadian economy and pay a large portion of the insurance premiums. The bankers believe they have a special responsibility for ensuring the stability of the financial system, as well as a self-interest in that stability, and they take such systemic responsibilities very seriously. Consequently, the bankers may relate concerns to OSFI or to the Bank of Canada and may offer comments on the trends in particular industries, geographical areas, or products. However, the banks have no express responsibility for informing regulators about specific problems with individual banks.

Despite the frequent formal and informal meetings financial institutions have with OSFI, a senior OSFI official told us that OSFI feels that it does not hear from them as frequently as it would like, and the Bank of Canada is more likely to obtain earlier market information than OSFI does. Bank officials told us that the Bank of Canada meets formally with the six largest banks twice a year. These discussions generally center around the economy and monetary policy. The officials said that the CEOs of these banks know they can call the Governor of the Bank of Canada if they are concerned about issues, such as past concerns about the overall exposures of banks to Latin America, or concerns with general market developments. These banks also have meetings at lower levels with Bank of Canada officials on such issues as the clearing and settlements system.

Coordinating committees such as FISC are also to provide regulatory participants with information about problem institutions, industry conditions, and emerging problems in the industry and economy.

OSFI Uses Information Gained From External Audits

Although OSFI has legal responsibility for examining financial institutions at the federal level, it relies on the institutions' external auditors for assessments of the fairness of the institutions' financial statements.

Annual Audits Are Required Under the Bank Act

The Bank Act requires that all federal deposit-taking financial institutions receive annual external audits and stipulates that the auditors report on, among other things, institutions' annual financial statements. The primary objective of an external audit is to express an opinion on the financial statements prepared by an institution's management. In fulfilling this objective, the auditor is to issue a report that confirms that (1) the audit has been conducted in accordance with generally accepted auditing standards; (2) the accounting principles used by the financial institution and significant estimates made by management have been assessed; (3) the overall financial statement has been evaluated; and (4) the financial statement fairly presents the financial condition, results of operations, and changes in financial condition of the institution being audited.

External auditors are to look at risks, such as treasury products, capital markets activities, and the bank's ability to collect on its loans. External auditors are also to report on any loans greater than one half of 1 percent of the financial institution's capital when, according to OSFI, a loss of capital is likely to occur. According to external auditors with whom we spoke, they generally rely heavily on the financial institution's internal audit departments for information, because these institutions, especially the large ones, have strong internal auditing departments. In many cases, the work that the internal audit departments have done dictates the degree to which the external auditors review transactions. For instance, one external auditing firm that we talked to said that it does not look at certain loans because it relies on the internal auditors' review of them.

How an external auditor conducts an external audit is governed by guidelines issued by the Canadian Institute of Chartered Accountants (CICA), the accounting industry's national association. Although these guidelines were developed by the industry, the Bank Act specifies that financial institutions should operate in accordance with generally accepted accounting principles (GAAP), and it gives OSFI the power to modify GAAP through directives. OSFI officials told us they have made use of their ability to modify GAAP, and thus narrow CICA guidelines, by issuing their own directives or guidelines on issues otherwise covered by GAAP. For instance, because GAAP requirements are fairly broad, OSFI has tended to narrow what is required under GAAP, forcing CICA standards to have tighter definitions than exist in GAAP in some areas, such as goodwill. Generally, CICA and OSFI have a good working relationship, but OSFI's ability to issue its own directives on GAAP has resulted in some tension between the two, according to officials of both organizations.

Exchange of Correspondence Confirms Responsibilities of Auditors and OSFI

OSFI generally does not have a direct client relationship with external auditors, since auditors are appointed and paid for by the financial institution being audited. Nevertheless, OSFI relies on the work being done by the external auditors in undertaking its supervisory responsibilities. According to OSFI, this means that OSFI

> "is dependent on the auditors applying professional standards to express an opinion that the financial statements present fairly, in all material respects, the financial position, results of operations and changes in financial position of the financial institutions in accordance with generally accepted accounting principles, including the reporting requirements of the Superintendent."

However, OSFI officials acknowledge that an audit of financial statements does not provide absolute assurance as to the integrity of the financial statements because of the use of judgment and testing in audits, the limitations of internal controls, and the nature of audit evidence.

Before every external audit of a financial institution, OSFI and the institution's external auditor exchange letters confirming the "reliance process." First, the financial institution is to send a letter to OSFI notifying OSFI whom its external auditor will be. Second, OSFI is to write a letter to each financial institution's external auditor saying that OSFI is to (1) rely on the audit opinion regarding the financial statements of the financial institution and on the auditor's audit report, (2) require a copy of the institution's audit report, (3) request access to the auditor's workpapers[27] in order to establish the basis for reliance and to minimize duplication of effort, and (4) advise the external auditors of any matters that they should consider prior to the audit's report date. The auditors are to respond in writing to OSFI giving OSFI approval to review their workpapers and providing the date when they will give OSFI a copy of their report on the audited institution.

OSFI's letter is also to remind the audit firm that it is the duty of the auditor to report simultaneously to the institution's CEO and OSFI anything that it discovers that might affect the well-being[28] of the financial institution. In addition, external auditors are required to address in an annual letter to OSFI any issues that affect the well-being of an institution. Because OSFI and the external auditors have conversations at various times during the

[27]Workpapers are the records kept by the auditors of procedures performed and their results and information obtained and conclusions reached in performing the audit and preparing the audit report.

[28]Through CICA, and in close consultation with OSFI, external auditors have defined well-being as the existence or viability of the banks.

year—specifically after OSFI's examination and the annual external audit—to discuss issues that are regulatory in nature, such as the well-being of a financial institution, the annual letter generally does not present new information. An OSFI official said that neither OSFI nor external auditors want surprises about a financial institution so all the participants keep one another other informed. External auditing officials we spoke to also described the Canadian financial system as a system of no surprises in which external auditors, OSFI, and the financial institutions are all open about information concerning financial institutions.

There is also an auditors' advisory group, which is to meet three times a year with OSFI in order to discuss systemic issues rather than institution-specific issues. Through this type of dialogue, the external auditors and OSFI seek to ensure their awareness of industry trends as well as regulatory and operational issues affecting the industry.

OSFI Makes Extensive Use of Auditors' Workpapers

OSFI officials described an arrangement it has with the auditing profession whereby OSFI is given access to auditors' workpapers, even though it has no express statutory right to such access. OSFI uses these workpapers to (1) confirm that OSFI can rely on the auditor's opinion of the fairness of the audited institutions's financial statements; (2) highlight the areas of mutually defined risk so that OSFI can use the auditor's work and not duplicate the work; (3) identify the prudential concerns that auditors identify during their audit; (4) provide an additional source of information in forming a risk profile of a financial institution; and (5) learn from the auditor's observations about the strength or weakness of a financial institution's internal control systems, management, and audit department.

According to OSFI guidance, examiners are to meet with the external auditor before the actual review of the workpapers. The purpose of meeting is to provide an overview of the audit in order to identify the main areas of focus in reviewing auditors' workpapers. Possible discussion items for the meeting include (1) general questions about the audit process, the auditors' opinion of senior management and the board of directors and their effectiveness, and the control culture of the financial institution; (2) specific questions about the audit plan and audit approach; (3) specific questions about the control environment, management effectiveness, audit committees, business conduct review committees, and the internal control systems; (4) the relative conservatism of management and the auditors' views on the risk profile of the institution; (5) significant audit findings; and (6) specific transactions.

After OSFI examiners have completed a review of the auditor's workpapers, using CAMEL[29] components they are to summarize the important aspects they think should be followed up on in OSFI's annual examination or that otherwise affect the scope of their examination. This summary allows the examiners to use the auditors' work to help develop the scope of their examination under each CAMEL component. According to OSFI, there should be three sections under each CAMEL component: (1) a summary of the external audit scope and procedures, (2) a summary of the audit findings, and (3) a summary of the implications for the examination scope.

OSFI Can Expand an External Audit

OSFI has the authority to expand the scope of an external audit at any time at the cost of the institution being audited. For example, OSFI may ask the auditor to take a more detailed look at a financial institution's loan portfolio or internal controls. The financial institution is informed of an OSFI request for an expanded audit since the institution must bear the additional cost. A senior OSFI official said that although OSFI has requested expanded audits in the past, it prefers to obtain information from other sources because of its concerns about the independence of the relationship of the external auditor to the financial institution.

According to OSFI officials with whom we spoke, OSFI may also expand its own examinations by using an expert or independent external auditor to get more in-depth information. According to OSFI officials with whom we spoke, OSFI has used such expanded examinations when it (1) believed the financial institution had a problem, (2) did not have the expertise to examine a specific operation of the institution, or (3) wanted to conduct an across-the-system study of a specific aspect of banking. OSFI believes that the across-the-system studies are particularly useful because they provide an incentive for financial institutions that are evaluated and ranked below their peers in the area examined to improve their standing. OSFI is doing an across-the-system study on corporate governance of consolidated institutions during its 1995 annual examinations. In addition, OSFI intends to do a major study of treasury departments in all banks in 1996, again during its annual examinations. OSFI is currently developing a pool of experts on derivatives to include, for example, individuals from external audit firms, who may then be available to direct special derivatives audits. These individuals are to be hired as consultants to OSFI and paid by OSFI. OSFI is then to be reimbursed for its outlays through

[29]CAMEL refers to the rating system used by supervisory agencies to assess the financial condition of financial institutions. CAMEL stands for Capital Adequacy, Asset Quality, Management Quality, Earnings, and Liquidity.

annual assessments to the industry, since OSFI is completely industry-funded.

OSFI Has Some Concerns About Auditors' Work

External auditors, who are appointed by a financial institution's shareholders every year, must meet certain legislative qualifications. For example, a firm of accountants is qualified to be an auditor of a bank if two or more members are accountants in good standing with CICA, have 5 years of experience at a senior level performing audits, reside in Canada, and are independent of the bank. The requirement for auditing experience has resulted in the auditors for most big financial institutions belonging to one of the big six auditing firms, although one or two regional firms also audit financial institutions.[30]

When a financial institution changes its external auditor, the former auditor is required to submit a written statement to OSFI and to the new auditing firm explaining the circumstances and reasons for the change. OSFI officials told us that OSFI has the right to disapprove of an auditor but has never done so. In addition, the Minister of Finance can revoke the appointment of a financial institution's external auditor, but this also has never happened, according to officials with whom we spoke.

According to a senior OSFI official, the degree of reliance OSFI places on auditors' work is well-founded in 90 percent of the cases. Generally, OSFI does not have trouble with the firms as a whole, but with individuals working at the firms. Nevertheless, OSFI officials believe that at times some auditors may not be as diligent in their work, or perhaps not be as independent of their clients, as OSFI would like them to be.

If OSFI is not satisfied with the work of an external auditor, OSFI is to inform the auditor, and officials from the two will discuss the problem. In addition, there is an industry auditor advisory committee, which is a part of CICA, that meets three times a year. If OSFI has a problem with external auditors, OSFI can raise the relevant issue with the advisory committee at these meetings. If OSFI thinks that an auditing firm is not doing something it should be doing, OSFI can use its influence with the accounting industry to point the firm in the right direction. According to officials with whom we spoke, external auditors like to prevent problems and be as cooperative with OSFI as possible, since OSFI comments on its reliance on an external audit and can reject external auditors' appointments.

[30]Until the 1992 revision, the Bank Act required that institutions be audited by two accounting firms. Although this requirement is no longer in place, all of the largest banks have retained two accounting firms to conduct their annual audits, at least one of which is a "big six" firm.

External Auditors Subject to Unlimited Liability

The work of external auditors in Canada is subject to unlimited liability. Auditors of failed financial institutions are particularly vulnerable to lawsuits initiated by CDIC, given its explicit policy of vigorously pursuing lawsuits against parties culpable in a financial institution's failure when CDIC believes it can recover losses incurred as a result of the failure. CDIC officials told us that CDIC filed several suits against external auditors in 1994, with two of those subsequently settled out of court.

CDIC initially wanted external auditors to attest to management's self-assessment of a financial institution's compliance with CDIC standards. CDIC accepted the members' argument that this would be too costly, since members would have to expand auditors' engagements to audit the self-assessments. Therefore, according to officials, external auditors will not be required to attest to compliance with the standards.

OSFI Does On-Site Examinations of Financial Institutions

The Bank Act requires OSFI to examine federal deposit-taking financial institutions once a year. This responsibility was being carried out by OSFI's 71 full-time examiners as of June 1993, who must plan, conduct, and report the results of the examinations.

Examination Objectives and Planning

The purpose of an examination is to ensure that the financial institutions observe the provisions of the Bank Act as implemented and to determine whether the institutions are in sound financial condition. To achieve this purpose, OSFI has established the following objectives, which are included in its examination guidelines: (1) to develop a thorough understanding of the financial institution and its environment, (2) to detect solvency and compliance problems on a timely basis, (3) to obtain information on a systemwide basis, (4) to gather information on policy matters, and (5) to help resolve detected problems promptly. More generally, OSFI examinations also allow it to analyze trends and to make recommendations on changes in legislation or regulations.

During the examination planning process, OSFI examiners are to review the work of the external auditors to identify issues that should be addressed in the on-site examination, to minimize duplication, and to scope the examination. This review is to include a discussion with the external auditors and a review of their workpapers. By the time OSFI examiners review an auditor's work, the workpapers may be dated, and OSFI guidelines advise examiners to take this into account.

Examination

OSFI is to conduct annual full-scope,[31] on-site examinations that, according to the Superintendent of OSFI, "represent a de facto assessment of management and its ability to manage." The scope of OSFI's examinations is to include the financial institution's activities and exposures to risk, the solvency of an institution, and a financial institution's compliance with legislation, regulations, and guidelines.

During its examination OSFI has the right to look at all records, cash, assets, and securities held by the financial institution and to obtain information from the institution's officers and auditors on its condition and affairs. OSFI has historically focused its examinations mainly on the financial institution's loan portfolio. OSFI employs outside consultants to carry out the review of credit files at all examinations. Loan review consultants are primarily retired senior credit officers from the largest Canadian banks. According to OSFI officials, this expertise has allowed OSFI to have the respect of the institutions it supervises, with the result that the credit consultants' findings and recommendations for provisions are generally accepted without confrontation. Under the direction of examiners, these experts are to look at (1) a sample of loans that is large enough to ensure the integrity of the loan rating system and the quality of the loans and (2) at all nonperforming loans. They may also do an independent classification of loans for OSFI if the financial institution's loan classification system is found inadequate. Examiners are to check a financial institution's prudential ratios, such as its capital-to-assets ratio.

In addition to examining a financial institution's loan portfolio and ratios, OSFI is to look at (1) control processes, (2) the independence and work programs of the institution's internal audit function, and (3) treasury activities. In examining control processes, OSFI is to assess policies the institution has put into place and evaluate general risk management. OSFI's assessment of the internal audit function is to include a review of the audit plan, the quality of staff at the senior level, the independence of the staff, and identify to whom they report. OSFI relies to a great extent on the internal audit function of the financial institution to provide examiners with information in such areas as subsidiaries and the treasury department. According to OSFI and financial institution officials, OSFI's meetings with a financial institution's personnel during an examination are far-reaching and cover most aspects of each area of operation. In addition, OSFI obtains information from answers to written questions it provides a financial institution before the examination.

[31]Full-scope examinations include examining the asset quality of financial institutions, assessing their systems and controls, judging their capital adequacy and reserves, and assessing their compliance with laws and regulations.

During the examination process, OSFI also receives information from the financial institution on large exposures. Because the exposures identify the borrowers, financial institutions do not submit this information in a report, which means that the Bank of Canada and CDIC do not have access to this information through OSFI Section 29 or other reports.

Annual examinations of the largest banks take about 2 to 3 months and amount to one staff year each. The examination timetable for other examinations is risk-based, and therefore the timetable is widely divergent depending upon the perception of risk at the institution. OSFI officials said they have done examinations of subsidiaries when these subsidiaries are federally regulated deposit-taking institutions, such as loan and trust companies. When a subsidiary is provincially regulated, such as a securities subsidiary, OSFI is to rely upon the provincial regulator but is to review the risk management practices that exist at the parent level to monitor the operations of the securities subsidiary.

Reporting and Follow-Up

Once OSFI has finished examining a financial institution, OSFI officials are to meet with the institution's CEO, management, Audit Committee, and external auditors to discuss the examination's findings. OSFI then is to write a management letter—which in effect is its final examination report—to the financial institution's CEO and the Chairman of the Audit Committee. The financial institution's external auditor also receives a copy of this letter.

OSFI's management letter is to outline the scope of OSFI's examination and includes findings and recommendations that comments on the financial institution's CAMEL components; discussions of asset provisions and the financial institution's internal audit function; assessments of the credit quality, corporate governance, operations, and treasury activity; and comments on any findings or issues OSFI wants to bring to management's attention. OSFI must also comment on the financial institution's adherence to CDIC's standards of sound business and financial practices. The length of the management letter varies from 2 to 10 pages depending on what OSFI has to say. According to OSFI officials, there are no surprises to senior management of the financial institution because wrap-up meetings are held before the examination is completed. The examination letter or report is provided to the institution prior to meetings with the institution's Board of Directors and Audit Committee.

According to regulatory and bank officials, bank management takes OSFI's recommendations seriously. After the financial institution receives the letter, the institution's management is to send a letter back to OSFI articulating the agreements reached during the institution's meeting with OSFI, including the actions the financial institution is to take. OSFI is then responsible for following up on its recommendations. For example, the implementation of an agreement on the allowances for loan losses will be readily apparent in the financial institution's year-end financial statements; a follow-up on recommendations of an institution's internal controls can realistically be assessed only during the next examination.

CDIC and FISC Members May Request Examinations

Although CDIC generally relies on OSFI for information, CDIC occasionally feels it necessary to obtain first-hand information from financial institutions. In such cases, CDIC has the authority to have examinations performed. Other members of FISC may also request special examinations, but they have never done so.

CDIC May Have Special Examinations of Its Members

If CDIC's Board of Directors so determines, CDIC may have a special examination done on a member institution. Reasons for a special examination may include, among other things, concern that the institution poses a high risk of failure. According to CDIC officials, some of these examinations are expensive but they provide CDIC with information to assess failure resolution options.

The special examinations are to involve a review of the assets and liabilities of the financial institution—assessing the performing assets, loan loss provisions, spread analyses, financial projections, and cash flow forecasts. The examinations also involve the off-balance-sheet activities as well as the institution's system technology, internal controls, and corporate governance. CDIC undertook special examinations of three institutions in fiscal years 1993 and 1994, by hiring either its own consultants or using OSFI examiners. According to officials with whom we spoke, all three institutions subsequently failed.

Special Examinations Can Also Be Requested by Members of FISC

All members of FISC have the authority to require a special examination of any bank or federally chartered trust. Since OSFI and CDIC already have the authority to conduct examinations, this provision applies principally to the Minister of Finance and the Bank of Canada, although their officials said neither has ever used the authority.

OSFI, CDIC, the Minister of Finance, and the Bank of Canada Participate in Other Financial System Responsibilities

OSFI, CDIC, the Minister of Finance, and the Bank of Canada have other financial system responsibilities, such as providing liquidity, resolving crisis situations, and participating in international forums. The Bank of Canada and CDIC, to a limited extent, share lender of last resort responsibilities.

Liquidity Provider

The Bank of Canada is to provide short-term liquidity or temporary advances to financial institutions that have shortfalls in their reserve balances due to such events as unexpected payment flows associated with the daily clearing and settlements system. The Bank of Canada Act allows the Bank of Canada to lend to all banks or to any other member of CPA that has a deposit with it. Generally, the Bank of Canada lends to direct clearers.[32] If there is a liquidity problem, the Bank of Canada is to lend to a direct clearer or to an indirect clearer through its direct clearer. Thus, financial institutions other than banks, such as trust and loan companies, have access to the Bank of Canada's discount window, whereby they can receive funds to help with liquidity needs. The Bank of Canada is to provide liquidity to financial institutions only on a secured basis.

Crisis Management and Resolution of Failed Financial Institutions

Depending on the nature of the situation, each regulatory participant in financial regulation and supervision plays a role in crisis management. According to regulatory and bank officials, cooperation among the participants in the Canadian bank regulatory structure has historically been heightened in a crisis.

OSFI has primary authority for supervising financial institutions and is usually in charge of a crisis until a financial institution fails. At that point, CDIC usually takes over responsibility for resolving the failed financial institution. The Minister of Finance is also aware of potential crises situations because OSFI informs the Secretary of State (International Financial Institutions) about problem institutions, and because of the Deputy Minister of Finance's role in FISC.

The Bank of Canada is also to be involved in a crisis from a systemic risk standpoint. If a financial institution failure has systemic implications, the Governor of the Bank of Canada may work behind the scenes to quietly arrange a merger with the help of other regulators or, as has been the case in some previous failures, arrange for liquidity support from the six big

[32]Direct clearers are banks and nonbank deposit institutions that settle their mutual obligations arising from the clearing and settlement of payment items on the Bank of Canada's books. Indirect clearers settle through direct clearers.

banks in Canada. According to regulatory and bank officials, the prestige carried by the Governor of the Bank of Canada often lends credence to his views and support for his proposals.

For example, when the Canadian Commercial Bank (CCB) was suffering severe liquidity problems in 1985, the forum for finding a solution was through the Bank of Canada.[33] The Bank of Canada played the major role in getting all of the parties together and hammering out a support package with the official approval of the government whereby the six largest banks were asked to provide CCB with funding to serve its liquidity needs. When CCB's liquidity problem became a solvency problem, the government protected all of the bank's depositors and creditors except for the six largest banks, since their liquidity support was considered to be CCB bank capital rather than a provision of credit.

There is still an ongoing lawsuit regarding the issue of repayment to the six largest banks for their support of CCB. Some regulatory and bank officials we spoke with felt that because the six largest banks were not paid back after the CCB failure, given a similar situation, they would not be as likely to participate in resolving another crisis. Other banking officials with whom we spoke disagreed with this assessment, stating that since the six banks have such a large stake in the stability of the Canadian banking system, they would find it in their best interests to participate.

International Forums

OSFI and the Bank of Canada both represent Canada on the Basle Committee on Bank Supervision.[34] OSFI is to take a lead role in such issues as capital requirements and most other supervisory issues. The Bank of Canada is to take the lead in risk containment and other systemic issues, such as market risk of foreign exchange activities.

The Bank of Canada is also to advise the federal government on international financial matters and frequently represents Canada at international meetings. For example, it participates in meetings of the

[33]Even though CCB represented only 0.6 percent of the assets held by all banks in Canada, it was feared by the Canadian government that the bank's failure would hurt the economy of western Canada.

[34]The Basle Committee on Bank Supervision was created in 1974 under the auspices of the governors of the G-10 central banks and is the main forum for central bankers and supervisors to reach agreement on how best to supervise international banks. Its members meet several times a year and consist of senior representatives of bank supervisory authorities and central banks from 12 countries.

finance ministers and governors of the Group of Seven Countries,[35] the Organization for Economic Cooperation and Development (OECD), the Bank for International Settlements (BIS), and the International Monetary Fund (IMF).

Lender of Last Resort

The Bank of Canada has an important role in maintaining system stability. This includes acting as lender of last resort to ensure that a liquidity problem at a financial institution does not threaten the viability of the financial system.

As lender of last resort, the Bank of Canada is prepared to make what its officials call extraordinary advances to any institution experiencing liquidity problems because it cannot meet deposit withdrawals. The officials said that when acting as lender of last resort, the Bank of Canada insists that institutions be solvent and that lending be well-collateralized in order to protect the public funds that are at risk. It monitors the value of an institution's collateral or portfolio by relying on OSFI's assessments and has never lost money on its secured lending.

CDIC can protect insured deposits by serving as a lender of last resort. It can do this by making secured loans and unsecured advances to member institutions and by purchasing assets from them. Under the Investment Companies Act and the Co-operative Credit Associations Act, CDIC can also act as an agent through which the government of Canada can make short-term loans for liquidity purposes to Canadian-controlled sales finance companies, cooperative credit societies, and provincial organizations responsible for stabilization and liquidity funding for credit unions.

Officials said that before CDIC lends they make an assessment about whether the institution is likely to become insolvent. Some CDIC loans have lost money; however, the advances were made as part of a least-cost alternative, and in CDIC's opinion losses would have been greater under other alternatives.

[35]Group of Seven Countries is a group of major industrial countries where national leaders or their representatives meet occasionally. The seven countries include the United States, United Kingdom, Germany, Japan, Canada, France, and Italy.

Canadian Payments System Is Privately Run but Headed by a Bank of Canada Representative

The Canadian Payments Association (CPA) was created by an act of Parliament in 1980 to "establish and operate a national clearings and settlements system and to plan the evolution of the national payments system." The management and operation of CPA are the responsibility of a Board of Directors, the members of which are elected by CPA's member institutions. The sole exception is the Chairman of the Board of Directors, who is appointed by the Bank of Canada and is an employee of that institution. This gives the Bank of Canada significant influence over the management and operation of CPA.

The creation of CPA made the payments system available to all deposit-taking financial institutions. In the system run by CBA, before CPA was created, only banks had such access. However, CPA members are required to have accounts with the Bank of Canada to qualify as direct clearers, and this entails meeting certain criteria specified by the Bank of Canada. Currently, there are four nonbank deposit institutions that meet the criterion to maintain settlement accounts at the Bank of Canada—one trust company, two cooperative institutions, and one financial institution owned by the Alberta Provincial Government.

The Canadian payments system does not provide for finality of payment in the settlement of transactions. Thus, if a direct clearer were to fail before all payments had been settled, the system would have to be unwound: that is, all transactions completed that day involving the failing direct clearer would have to be reversed and other transactions not yet completed would not be processed. CPA is now working toward a Large Value Transfer System in which payments are to be irreversible and final settlement is to be made at the central bank. The objective is to contain systemic risk and provide same-day final settlement to CPA member institutions. The potential losses to the system are to be shared among participants.

The Bank of Canada interacts with the payments system in two ways: (1) it is responsible for the final settlement of balances for the national clearing and settlement system, and (2) it acts as the agent of the federal government by clearing government receipts and disbursements. Furthermore, both bank and nonbank institutions that participate directly in the clearing and settlement process are to maintain settlement accounts at the Bank of Canada through which daily clearing gains and losses are to be settled. Each direct clearer has access to overdraft facilities at the Bank of Canada.

Apart from a provision of the CPA Act that requires the Superintendent of Financial Institutions to report annually to the Minister of Finance as to whether CPA is operating in conformity with its act and by-laws, there is no statutory regulation or supervision of the Canadian payments system. However, as noted in chapter 2, if proposals in the White Paper are passed into legislation, the Bank of Canada will have regulatory responsibility for systemic risk in the clearing and settlements system, which, according to Bank of Canada officials, the Bank of Canada has already informally assumed.

Deposit Insurance Is Provided by CDIC

Under the CDIC Act, CDIC provides deposit insurance against the loss of part or all of deposits up to $60,000 (Canadian). All financial institutions, other than credit unions and certain provincial institutions, must become members of CDIC to qualify for its deposit insurance. Members of CDIC's Board of Directors include the Superintendent of Financial Institutions, the Deputy Minister of Finance, and the Governor of the Bank of Canada.

CDIC provides for its coverage through a premium levied on the insured deposits of its members. In 1994, the premium was 1/6 of 1 percent and was the same for all institutions regardless of size or riskiness.

The major cost to the deposit insurance fund is the cost of depositors' claims from previous CDIC member failures. As a result of cumulative deposit claims paid from previous insured institutions' failures and related loss provisions, CDIC had a deficit of $1.65 billion (Canadian) as of March 31, 1994. The deficit is the difference between the amount that CDIC has had to pay depositors, along with the cost of the financial assistance provided to the failed institutions, and the amount that CDIC expects to recover when the assets of the failed institution are liquidated.

Standards of Sound Business and Financial Practices

The CDIC Act provides for CDIC to be instrumental in the promotion of standards of sound business and financial practices for member institutions. In that capacity, CDIC has established by-laws called the Standards By-laws of Sound Business and Financial Practices (Standards By-law). The eight Standards By-laws are:

- CDIC Interest Rate Risk Management Standards By-Law
- CDIC Credit Risk Management Standards By-Law
- CDIC Foreign Exchange Risk Management Standards By-Law
- CDIC Securities Portfolio Management Standards By-Law
- CDIC Liquidity Management Standards By-Law
- CDIC Real Estate Appraisals Standards By-Law
- CDIC Capital Management Standards By-Law
- CDIC Internal Control Standards By-Law

For each Standards By-law there is a standards document that assists member institutions in developing the policies, techniques, and procedures required by CDIC to fulfill the standard. The CDIC Board of Directors is to measure compliance with the standards document as the basis for determining whether a member institution is following standards of sound business and financial practices established under the Standards By-laws. Compliance with CDIC's standards is measured through a self-assessment process that OSFI reviews during its annual examinations. The standards documents cover:

Standards of Sound Business and Financial Practices: Interest Rate Risk Management. The standard sets out the minimum policies and procedures for members' interest rate risk management programs. The standard covers interest rate risk limits, how the interest rate risk will be measured, the minimum criteria that the institution should have in place to manage and control its exposure to interest rate risk, and the role of the Board of Directors and management in this area.

Standards of Sound Business and Financial Practices: Credit Risk Management. The standard sets out the minimum policies and procedures for members' credit risk management programs. The standard covers the credit risk identification and risk management policies needed in such areas as portfolio concentration limits, credit granting, and documentation and collection processes; internal credit inspection/audit procedures; and the roles of the Board of Directors and management in this area.

Standards of Sound Business and Financial Practices: Foreign Exchange Risk Management. The standard sets out the minimum policies and procedures for members' foreign exchange risk management programs. The standard covers foreign exchange risk management policies in such areas as risk limits, control procedures, and delegation of authority; foreign exchange risk management and control procedures on the measurement and inspection/audit of foreign exchange risk; and the roles of the Board of Directors and management in this area.

Standards of Sound Business and Financial Practices: Securities Portfolio Management. The standard sets out the minimum policies, procedures, and criteria that member institutions need to have in place and apply in order to manage their securities portfolios and exposures to position risks. The policies under this standard cover such areas as securities portfolio quality and return objectives, selection of securities dealers and counterparties, securities portfolio concentration limits as well as monitoring procedures, and the roles of the Board of Directors and management in this area.

Standards of Sound Business and Financial Practices: Liquidity Management. The standard sets out the minimum policies, procedures, and criteria that member institutions need to have in place and apply in order to manage their liquidity management programs. The standard covers the liquidity and funding polices, management and control procedures, and the roles of the Board of Directors and management in this area.

Standards of Sound Business and Financial Practices: Real Estate Appraisals. The standard sets out the minimum policies, procedures, and criteria that member institutions need to have in place and apply to ensure that real estate appraisals conducted in real estate-related financial transaction are prudent and appropriate. The standard covers the requirements for appraisals, engagement of appraisals, contents of appraisal reports, the appropriate kinds of appraisal valuation approaches, and the roles of the Board of Directors and management in this area.

Standards of Sound Business and Financial Practices: Capital Management. The standard sets out the minimum policies, procedures, and criteria that member institutions need to have in place and apply to ensure that they have adequate capital plans to manage their capital. The areas that members have to cover under this standard include capital management polices and procedures and the roles of the Board of Directors and management.

Standards of Sound Business and Financial Practices: Internal Control. The standard sets out the internal controls that member institutions need to have in place and the control environment within which the controls will be applied. The standard covers such areas as the internal control environment, the responsibility of the Board of Directors and management, organizational and procedural controls, independent inspection/audit, and the role of the Board of Directors and management in this area.