



## **Developments in Bank Supervision – a Canadian Perspective**

**Remarks by Ted Price, Assistant Superintendent, Supervision Sector  
Office of the Superintendent of Financial Institutions Canada  
to the  
Centre for Monetary and Financial Economics Conference  
at Carleton University**

**Ottawa, Ontario  
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## **Developments in Bank Supervision – a Canadian Perspective**

### **Introduction**

Thank you for the opportunity to speak today.

Canada's financial system has performed remarkably well during the financial crises that troubled most of the developed world in the past few years.

This country's sound economic and fiscal situation during this period is due, in part, to the fact that we traveled a different path than other countries. Canada created a platform for success that was more than simply a function of good economic fundamentals. Canada's success reflects a strong, well-regulated financial sector and well managed banks.

Today I will share a few of the reasons why the Canadian system fared so well. I will also share some thoughts on how banking regulation is developing in talks among global players and international regulatory bodies.

### **State of the Industry**

Before I get into the core of my remarks, let me provide an overview of what we are currently seeing on the ground in the banking sector in Canada.

While we have seen the economy improving and risk reduced, events of the past few weeks clearly indicate that we are not out of the woods yet. Improvement at financial institutions usually lags the economic cycle by about a year, and there are some early positive signs. Let's hope this continues.

Generally, the Canadian financial sector fared well, but some institutions were impacted more through the crisis than others.

In 2009, capital and credit markets showed signs of stabilization and improvement. Although global macroeconomic conditions and challenging credit conditions continued to impact the historically high rates of return of Canadian banks, they remained profitable and adequately capitalized. The majority of banks reported increased profits with many institutions benefiting from increased capital markets revenues.

Canada's larger banks reported improvements in financial performance in 2009 and continued to outperform many of their international peers. These banks have broad, geographically diversified portfolios, with extensive domestic and international operations. Their businesses extend beyond traditional lending and deposit-taking activities, and include operations in insurance, trading, investment banking and wealth management.

Smaller bank institutions also reported improved financial results. These institutions are typically regional, niche players who focus on one or two credit products such as mortgage lending, commercial real estate or credit cards.

Overall, the Canadian deposit taking industry continued to be well capitalized, and capital levels were increased last year. The average Tier 1 capital ratio rose from 9.81 per cent in 2008 to 12.15 per cent in 2009. The average capital level was well above the Bank of International Settlements' (BIS) 4 per cent minimum Tier 1 threshold as well as OSFI's 7 per cent Tier 1 target. The average Return on Equity for the deposit-taking sector declined modestly from 11.6 per cent in 2008 to 11.2 per cent in 2009, reflecting growth in capital levels across the group.

I said a moment ago that we are not out of the woods yet. The Canadian system remains exposed to external shocks, such as the sovereign debt crisis now in Europe, or the threat of a double dip in the U.S. We will also be watching how the credit markets react to shifts in fiscal and monetary policy as the stimulative policies of the past few years are gradually withdrawn

Closer to home, for the remainder of 2010, we anticipate a gradual improvement in the domestic economy, and rising employment levels. If that is the case, credit markets should continue to improve. It looks like the worst is behind us in loan delinquencies and loss provisions. And while we do not have particular concerns today, sectors we are monitoring closely include commercial real estate and consumer lending. Have we turned the corner? Still too early to say, and much will depend on the strength and sustainability of the recovery.

## **Reasons for Canada's Performance**

A strong system of appropriate risk management and robust regulation does not spring up overnight; it has been a long journey to get to where OSFI and the Canadian financial system are today.

OSFI is often asked what we think contributed to the performance of Canada's financial system during the global meltdown. There were many reasons, but three that I think played an important role are:

- Going into the crisis, government, corporate and personal balance sheets were relatively healthy in Canada. This provided important shock absorbers against the stresses of 2008 and 2009;
- Risk in the banking system was generally well managed; and,
- The regulatory regime had some unique features that contributed to its effectiveness. Among those features were:
  1. a clear mandate and regulatory tool-kit for OSFI to ensure the safety and soundness of Canadian banks;
  2. a regulatory system where all banks, and all of their subsidiaries, are under the scrutiny of a single regulator; and,
  3. robust regulatory rules in the areas of capital and leverage.

I would like to further explore these three features of our regulatory regime, to demonstrate the impact they have had on the success of the Canadian system.

### 1. A Clear Mandate and Proper Tools

Prudential regulation is strengthened when regulators have clear mandates, are free of conflicting objectives, and have the necessary tools and authority to deal with problems as they arise. The financial crisis demonstrated that financial stress can be exacerbated by conflicting regulatory objectives that make supervisors unwilling, or unable, to require timely corrective action.

Currently, how many financial supervisors have clear responsibilities and objectives, as well as funding that is stable and sufficient? And if the current crisis is not a wake-up call that demonstrates that these issues are of fundamental importance, what would be?

In the 1980s and 90s, Canada had a rash of small institution failures. In 1995, we had a failure of a large life insurer. A key lesson learned from these episodes was that Canadian supervisors had no clear mandate defining their job. Were they to intervene when problems were evident, such as when there are significant losses due to poor risk management or excessive risk taking? Or, were they to intervene much earlier when there were no losses, but perhaps some red flags?

After much discussion, an attempt to answer these questions was provided in a legislated mandate for OSFI about 15 years ago. This was part of a larger agenda designed to improve the incentives and powers of safety net agencies in Canada. OSFI now has a clear prudential mandate to strive to protect the interests of depositors, while having due regard to the need to allow financial institutions to compete effectively and take reasonable risks.

For OSFI, this put depositor protection ahead of the need for institutions to compete. The legislation was clear in setting the fundamental priority for the supervisor, this was important, because supervisors ultimately can find themselves torn between multiple competing goals.

In some other jurisdictions, supervisory statements contain wording like “safeguard the attractiveness of the financial center as a location”, or “maintain the country’s competitive position”. In these situations, supervisors may have been instructed to give more weight to factors other than safety and soundness.<sup>1</sup>

Supervisors need to be sure about their job, they need to know how far they should push issues, they cannot be timid in their risk assessments, and they cannot avoid dealing with senior management and boards at the institutions. They have to be empowered in setting rules and in overseeing institutions.

How do we enforce our mandate? When required, OSFI has powerful and flexible tools to take action quickly. But because we share mutual respect with our banks, OSFI is often able to achieve its regulatory objectives without reverting to these formal tools.

Looking forward, effective prudential regimes will be characterized by regulators with focus, effective tools and accountability. Successful regulators will not relax rules to win business from other jurisdictions – or to promote the business objectives of their domestic institutions if they are not consistent with prudential regulatory objectives.

Successful regimes cannot expect prudential regulators to forego prudential objectives to achieve non-prudential goals. Instead, banks and investors will seek regulation that is focused, transparent, consistent and fair – these are the hallmarks of a strong and reliable financial system.

## 2. The Scrutiny of a Single Regulator

Regulators are increasingly talking about which institutions, activities and markets should be subject to which forms of regulation. The crisis raised concerns that certain financial intermediaries may have been subject to

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<sup>1</sup> [http://siteresources.worldbank.org/EXTLACOFFICEOFCE/Resources/870892-1243630619860/John\\_Palmer\\_paper.pdf](http://siteresources.worldbank.org/EXTLACOFFICEOFCE/Resources/870892-1243630619860/John_Palmer_paper.pdf)

ineffective regulatory schemes, or no regulation at all. Certainly this was a contributing factor to the crisis.

In Canada, OSFI conducts consolidated prudential regulation of banks and federally incorporated insurers, which includes all of their subsidiaries, domestic and international. This results in a prudential regulatory umbrella over all of our major Canadian securities firms and investment banks, as they are subsidiaries of the major banks.

Further, the predominate structure for our financial services groups is that they are headed by a regulated financial institution, which is typically regulated by OSFI – unlike the holding company structure seen in some other jurisdictions. Having a regulated Canadian financial institution at the top enhances our ability to understand the risks facing the group. If OSFI has regulatory authority over the top entity, our mandate gives OSFI the ability and responsibility to identify and act on potential problems throughout the group. To be effective, our experience indicates that supervisors need to be aware of the financial status and risk profile in all corners of the conglomerate.

For successful regulatory frameworks, it is not about using the illusion of control to give false comfort. Nor is it a question of ‘turf’. Successful regulators seek to avoid both over-regulation and under-regulation, and work to ensure that those who are best equipped to regulate receive the proper mandate to do so.

### 3a. Robust Rules - Leverage

Excess leverage was another key contributor to the financial crisis. In addition to “on-balance sheet” leverage, several types of off-balance sheet obligations – such as loan commitments, securitization conduits and derivatives – effectively increased economic leverage.

Excess leverage contributed to the pre-crisis bubble, but as the turmoil developed, the crystallization of losses created capital adequacy issues, runs on liquidity and the need to de-lever. This de-leveraging exacerbated the market volatility and downturn in capital markets and the economy.

Canada, like the U.S., has a regulatory limit on leverage for banks. In Canada, we call this our “assets-to-capital multiple”, or ACM. Unlike the U.S., Canada’s ACM includes off-balance sheet items in an attempt to better reflect a bank’s economic leverage.

The Basel framework talks about three pillars: 1) minimum capital requirements; 2) internal risk management and capital planning; and 3) disclosure to facilitate market discipline<sup>2</sup>. While not perfect, our leverage ratio has been a fourth pillar supporting the Canadian banking system.

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<sup>2</sup> <http://www.bis.org/publ/bcbsca01.pdf>

In Canada, ACM targets are set individually and range from high single digits to a multiple of 23. As such, they are customized to a bank's risk profile, with large diversified and well-managed banks having the higher leverage. Consequently, going into the crisis the six largest Canadian banks had an average leverage multiple of just over 16:1. Compare this to U.S. and European banks, which were often twice as levered, or more.

The ACM is a blunt tool. It is intended to supplement the more precise risk-based capital by controlling leverage. It acts to limit excessive growth and arbitrage of the risk-based capital rules. A leverage ratio is important since it helps a bank avoid traps posed by low or zero risk-rated exposures appearing to have no material risk – for example, Collateralized Debt Obligations (CDOs) hedged by AAA monoline insurers. A leverage ratio limits balance sheets, thereby forcing banks to allocate resources wisely, considering balance sheet size, risk/reward and diversification.

As regulators seek a way to control excessive leverage in national and international banking and economies, a leverage ratio will become an internationally mandated feature of the Basel framework. Further, although this work is still ongoing, this leverage ratio will probably ascribe a value to broad classes of instruments and structures that create economic leverage without creating on-balance sheet assets.

However, as this international leverage ratio will likely be introduced over time, be calibrated for a broad class of international banks with different business models, and be a minimum standard rather than a customized bank-specific framework – we expect our ACM to continue to apply, perhaps with some conforming changes. In the near term, for Canadian banks, we will continue to ensure that their leverage is prudent given their risk profiles.

### 3b. Robust Rules - Capital Buffers

It is commonly agreed that, despite record profits in the years before the crisis, many banks went into the turmoil with inadequate levels of high quality capital. When losses arose and markets were closed, new capital could not be raised on reasonable terms. Banks with inadequate capital buffers suffered from declining share prices, rising funding costs, and reduced sources of funding. In many cases this culminated in government capital infusions and government borrowing guarantees.

During the crisis, hundreds of banks failed in other countries. Meanwhile, Canadian banks maintained strong balance sheets, capital levels and dividend payments. This is in large part due to their higher capital levels at the onset of the crisis. This did not happen by accident. Canadian banks have, for many years, been required by OSFI to meet a regulatory minimum well in excess of Basel

minimum requirements. Further, to reflect management's view of risks and their capital adequacy plan, banks are expected to set internal capital targets in excess of OSFI rules.

But not only is the quantity of capital is important, the quality of capital is equally important. While Basel effectively requires only 2 per cent common share capital, OSFI's requirement is for Canadian banks to hold at least 5 per cent common share capital.

The key is that our banks started the crisis with more high quality capital, and less leverage than most international banks. This enabled Canada's banks to continue to raise capital from private sources on reasonable terms while other banks were not able to do so. In the past two years the large banks have increased Tier 1 capital by over \$30 billion through earnings and from the capital markets.

Going forward, regulators will require more, higher quality, capital. Just as analysts have become increasingly focused on tangible common equity, regulators will work to ensure that common or core equity make up a high proportion of capital.

### **Rules vs. Supervision**

To this point, I have focused on the rules, and who we regulate. Rules (such as minimum capital requirements, leverage ratios) are important, but in the Canadian experience, how we perform the actual day-to-day supervisory oversight of financial institutions is just as important. To be effective, you need tough rules and effective supervision.

I want to discuss the importance of effective supervisory oversight because there is a tendency to either ignore its importance, or worse, to downplay it. There is a view that supervisory judgment has failed time and again, and that we should therefore rely far more on rules than on supervisors going forward. Those critics forget that the rules failed as well – our record in getting the rules right is not stellar. Over-reliance on rules could create a system with even more risk, as rules often have unintended consequences which can take quite some time to be apparent.

If I can use an analogy, let's look at highway traffic control. I think everyone here would agree, legal limits aside, there is a prudent speed limit to driving. In a *laissez faire* world, we would each pick the limit that best suits us. But that does not work because some drivers would pick speeds so high that they endanger others. So we need legal limits. However, in the absence of proper monitoring everyone would drift back to bad behaviour, which is why we need enforcement.

Rules and supervision combine to keep the roads safer. That is why supervision of financial institutions matters.

### So what is financial supervision?

Supervision is the essential task of figuring out whether there could be a breakdown in risk management controls at an institution, and whether the culture of the institution and its appetite for risk will create dangers that could lead to insolvency.

Supervisory oversight is about the kind of attention financial institutions receive from supervisors on a regular basis. It is about the questions we ask, what we say to institutions, how we say it, the type of information we request, the people we ask to meet, how we deal with push back, what we do when we go on-site or otherwise deal with an institution, the extent to which we tick boxes or think about the core risks and how they are being managed.

In short, supervisors are the people on the front lines who identify risk management problems at individual institutions and decide what to do about them. They decide whether to tell an institution to stop growing its business in certain areas until problems are fixed, or require an institution to do more stress testing, or require an institution to raise capital, or require that an institution hire expertise in a particular area to manage risk, or push an institution to spend money on their data systems so they can more clearly see what risks they have taken on. These are critical functions and they help make institutions safer and limit losses.

So, why is so much attention being paid to rules, with virtually no focus on the role of supervision? It may be because changing a rule is seen as a concrete step, as taking decisive action. It is very visible to the public and can swiftly generate a reaction. And it may be, in part, because flaws in key rules are more easily identified after a crisis. It may also be because fundamentally improving supervision means improving the mandate, autonomy and powers of the supervisor – and this is difficult to do.

For example, at the start of the global financial crisis, it was apparent that the minimum level of capital that banks were required to have under international capital agreements was too low, and it is easier to change capital requirements than it is to change a supervisory system, particularly on a global basis.

In crafting new international rules for the financial sector, we need to start focusing on the role that day-to-day supervisory oversight plays, because rules are just one part of the equation. A financial sector with strong regulatory rules, but with weak supervisory oversight, is not safe and sound.

To strengthen the global financial system, we need better rules and better supervision.

### Effective Supervision

Despite its importance, there is surprisingly little information on what constitutes an effective supervisory regime. Perhaps this explains why there are some very different approaches to supervision around the world.

Some of the differences include:

- the extent of on-site versus off-site supervision (some supervisors have permanent offices at banks, others visit for weeks at a time, and others visit for a few hours);
- the extent to which supervisors focus on compliance (relatively easy) versus risk identification and mitigation (relatively difficult);
- the role of the supervisor in corporate governance (some supervisors send observers to sit in on board meetings, and some put potential directors through intense interviews with experts prior to their appointment);
- the extent to which work is outsourced to consultants or external auditors, versus being performed by qualified in-house staff; and,
- different styles of oversight (autocratic, paternalistic, democratic, or *laissez faire*).

Its name notwithstanding, the Basel Committee on Banking Supervision focuses far more on rules, and on sound risk management practices for banks, than on approaches to supervision. Indeed, in the Basel Core Principles for Effective Banking Supervision it says, “The Core Principles are neutral with regard to different approaches to supervision, so long as the overriding goals are achieved.”<sup>3</sup> This is a gap that needs to be filled.

### **Future Direction of Regulation**

I have talked about why Canada’s financial system was well placed going into the crisis, but what does the future hold? There are discussions underway at a number of international bodies, but getting international agreement can be difficult due to issues as basic as mandates, legal systems, and varied experiences during the crisis.

It is premature to draw conclusions right now about what the final capital and liquidity rules will be. We need to give the process a chance and a critical part of the process is really just beginning. April 16, 2010 was the due date for comments to the Basel Committee on Banking Supervision (BCBS) on the

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<sup>3</sup> <http://www.bis.org/publ/bcbs129.htm>

proposals for enhanced capital and liquidity rules that were released in December 2009. At the end of April 2010 global banks provided detailed quantitative impact study results to their supervisors. The latter will ultimately give us a global snapshot of the potential impacts of proposed changes to these rules. Concurrently, an international review of the macroeconomic impacts of the proposals has begun.

This information will enable us to have in-depth discussions of what the capital rules should be. We anticipate decisions in early fall. By year-end 2010, it is anticipated that the new rules will be announced, for implementation by the end of 2012. The Basel Committee will also consider appropriate transition and grandfathering arrangements.

Having the facts and figures, and reports on macroeconomic impacts, will enable us to tackle basic questions, such as how much capital is enough? As a bank, do you need enough to cover any possible crisis, or do you need enough to maintain market confidence in such a crisis, allowing you to go to market to raise more?

In Canada we would say that in developing the new rules, too little capital or liquidity is lethal but if too much capital or leverage is required under the new rules, then that could be a big problem too. We continue to think that in Canada we had it about right: banks had enough capital to maintain market confidence when the crisis hit, and consequently were able to raise more. Many banks in other countries were not able to retain market confidence, and had to go to their governments for support.

The work to develop a new capital regime is a challenge because we want to get this done quickly to reduce uncertainty about what capital requirements are going to be, but we want to get it right, and the issues involved in setting capital rules are complex.

We will continue to use our influence to affect the outcomes. While we are a small country, our success has not gone unnoticed and our voice has more weight as a result. Further, I think that globally, having Canada on board with the final rules will be seen as important, given our track record. But as noted, changes are coming and the status quo is not going to be the outcome.

It is also in the interest of Canada's banks to continue to demonstrate the sound business decisions and prudence that they are known for, and which was seen as a strength in the crisis, and this also means preparing for change.

#### Embedded Contingent Capital

Let me close by talking about a subject we at OSFI believe may be important to the future of financial regulation.

As a result of the global financial crisis, there is now a deeply embedded presumption that governments will use taxpayer dollars to bail out banks. A side effect of this is that it has reduced market discipline on banks and created an incentive for banks to take undue risks. Should this be allowed to continue, it will leave bank supervisors as the main restraint on excessive risk taking – not the banks themselves or their investors.

There is also a concern that the current subordinated capital in banks was not effective in absorbing the losses incurred, prior to government intervention; they provided little or no shock absorption.

Regulators and politicians are setting out proposals aimed at counteracting the effects of this moral hazard on financial systems, and to improve the loss absorption of subordinated capital. Proposals have included bank taxes, the creation of systemic risk funds, and capital surcharges for systemically important banks.

To date, none of these proposals has been universally accepted.

OSFI has suggested that there is another way: embedded contingent capital. Embedded contingent capital is a feature on certain securities that forces conversion to common equity when a bank is in serious trouble, thereby replenishing the core capital of the bank without the use of taxpayer dollars. It would apply to all subordinated securities and would be at least equivalent in value to the common equity.

As an example, consider a bank that issues \$40bn of subordinated debt with these embedded conversion features. If the bank took excessive risks to the point where its viability was in doubt and its regulator was ready to take control, the \$40bn of subordinated debt would convert to common equity in a manner that heavily diluted the existing shareholders. While other, temporary, measures might also have to be taken to help stabilize the bank in the short run, such capital conversion would significantly replenish the bank's equity base.

On conversion, the market would be given the message that the bank had been solidly recapitalized with common equity, and not that it was still in trouble and its common equity had been bolstered only modestly.

The conversion trigger would be activated relatively late in the deterioration of a bank's health, this (together with an appropriate conversion method) should result in the contingent instrument being priced as debt. Being priced as debt is critical as it makes it far more affordable for banks, and therefore has the benefit of minimizing the effect on the cost of consumer and business loans.

An identifiable conversion trigger event could be when the regulator is ready to seize control of the institution because problems are such that no private buyer

would be willing to acquire shares in the bank. This is advantageous as regulators generally already have the power to seize control of an institution, so this is not new for either bank supervisors or bank investors.

The existence of embedded contingent capital would mean that investors in subordinated bank bonds would have a real incentive to monitor and restrain risky bank behaviour, to avoid heavy losses from conversion to equity. This may encourage more disclosure to address these investor's concerns. The prospect of dilution of common equity holders and associated implications for bank management can create real incentives for these parties to act prudently. Deposit holders and rating agencies would see both common and subordinated debt available to absorb loss.

Embedded contingent capital provides a means to address many of the problems related to moral hazard and market discipline, with less complexity. It forces the costs of excessive risk taking on to the right people – shareholders and subordinated debt holders. The reward for the implementation of embedded contingent capital would be safer financial systems around the world. We are happy to see that this initiative is now being discussed globally, as we believe it has a lot of merit.

## **Conclusion**

If I can suggest a common theme that explains OSFI's relative success, it is that OSFI has maintained a clear focus on long-term risk management and capital adequacy. OSFI has worked with its banks to ensure that these principles were operationalized, and were not just part of a compliance exercise.

Going forward, there is a risk that regulators will try to regulate more through rules, instead of trying to supervise more effectively. In my view, that would be about as successful as lowering speed limits, without enhanced surveillance on highways.

Effective regulation in Canada has meant a targeted, principles-based supervisory regime, coupled with tough capital and leverage rules. As the importance of good regulation is heightened in an increasingly complex financial world, we believe Canada has a lot it can share, and we are happy to do so.

It has been my pleasure speaking to you. I hope my remarks have been of value, and I look forward to any questions you may have.

Thank you.