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INTENSITY AND EFFECTIVENESS OF FEDERAL BANK SUPERVISION IN CANADA—TECHNICAL NOTE

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TECHNICAL NOTE

INTENSITY AND EFFECTIVENESS OF FEDERAL BANK SUPERVISION IN CANADA

Prepared By

Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Canada. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations.

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THE QUALITY OF FINANCIAL SUPERVISION IN CANADA AND ITS CONTRIBUTION TO FINANCIAL STABILITY[1]

"REGULATION DIDN'T SAVE CANADA'S BANKS"[2]

A. Introduction

1. **Canada has often been seen as a bastion of banking safety.** Canadian banks entered the recent crisis, which unfolded in 2007, with a solid funding base and high risk-based capital levels. They generally avoided the deterioration in residential mortgage underwriting standards that occurred in the United States and did not take large positions in U.S.-originated subprime mortgage securities, mortgage-back securities, or derivatives, despite the Canadian banks' proximity to and in several cases, significant presence in the U.S. financial market. The credit quality of Canadian banks' domestic portfolio of loans and securities, both private and public sector, remained high throughout the crisis years and while the Canadian government provided a public guarantee program for bank debt during the crisis, no Canadian bank used these guarantees.

2. **This raises the question of why Canadian banks, and the Canadian financial sector as a whole, have been able to avoid or minimize exposure to the problems that have recently plagued financial systems in so many other developed countries?** The answer may help guide the international response to the crisis, which has emphasized weaknesses in the international prudential standards (such as Basel II) under which banks in the crisis countries were operating. How did Canada, operating under the same international standards as the crisis countries, manage to avoid the crisis?

B. Summary of Findings

3. The success of the Canadian financial system over the past few years in avoiding crises appears due to a combination of factors:

- A strong economy and conservative federal fiscal stance. Canada's fiscal and trade accounts and public debt levels before the global financial crisis enabled the government to credibly stand behind the Canadian financial sector while economic growth, which dipped in 2009 but then quickly recovered, minimized pressure on asset quality. This paper, however,

[1] This note was prepared by Jonathan Fiechter, IMF Expert, as part of the Canadian FSAP Update over the course of the summer of 2013. It benefited from the work of the FSAP mission, including in particular the products of the assessment teams that looked at banking, insurance, and securities market supervision and from numerous conversations with past and present government officials and senior officials from the private sector and academia.

[2] The headline from a Wall Street Journal article by Marie-Josée Kravis, "Regulation Didn't Save Canada's Banks," online.wsj.com, May 7, 2009.

focuses not on the enabling macro conditions but instead examines the contributions of the institutional arrangements and market characteristics that helped Canada avoid many of the risky practices in the financial sector that arose in the U.S. and some European countries.

- A very effective and intrusive federal system of supervision and regulation that practices "close touch" supervision and emphasizes the accountability of board directors and management for the overall safety and soundness of institutions and their adherence to supervisory guidance.

- A well functioning and collaborative financial regulatory infrastructure comprised of the Office of the Superintendent of Financial Institutions (OSFI), the Bank of Canada (BOC), the Department of Finance (DOF), the Canada Deposit Insurance Corporation (CDIC), and the Financial Consumer Agency of Canada (FCAC). Unlike many other countries, supervisory information, including institution-specific information, is shared among all members on a confidential basis, which facilitates more informed federal policies. This group works together collaboratively and does not appear to have threatened the independence of OSFI.

- A relatively concentrated financial system that is profitable, conservatively run, and has a strong reputation.

- A government-backed mortgage finance system that has fostered standard residential mortgage underwriting guidelines nationwide and provided a core base of profitable government-backed residential mortgage loans.

- Government efforts to ensure that while a healthy level of competition exists in the financial markets, banks are discouraged from competing on the basis of low underwriting standards and under pricing of risk.

C. Background

4. **The global financial crisis (GFC) served as a wake-up call in a number of developed country capitals around the world.** The crisis had its origins in the largest financial institutions in the United States and quickly spread to financial markets in a number of other developed countries. Many of these countries had previously been considered as models for high quality and sophisticated supervision and had been the driving force behind the development of global financial standards in the banking, insurance, and capital markets sectors.

5. **Soon after the onset of the GFC, financial policy makers at both the national and international level began devising a series of remedies to address what were considered flaws or omissions in the then existing regulatory standards.** Some countries have also considered measures to reduce the risk of their large banks through requiring divestment of some investment banking activities and/or restructuring the institutional arrangements for the supervision and regulation of their financial markets.

6. A key priority has been to encourage the various international standard-setting bodies to upgrade their supervisory principles based on lessons learned from the GFC. While there was widespread support in the international community for many of the regulatory revisions proposed by the standard setters, it was also clear that simply changing the rules would likely not be sufficient. A striking feature of the GFC was that not all developed countries were equally affected. Canada is often cited as such an example.[3]

7. Concerned that too little emphasis was being placed on the important role of supervision, the International Monetary Fund published a Staff Discussion Note in May of 2010 titled "The Making of Good Supervision: Learning to Say No."[4] In that paper, Fund staff stated that a critical element of effective supervision was the "ability" to supervise, which requires appropriate resources, authority, organization and a coordinated and collaborative approach across all involved agencies. The Financial Stability Board (FSB) formed a Supervisory Intensity and Effectiveness group (SIE) comprised of senior staff from the national supervisory agencies and IMF to identify best supervisory practices, to make recommendations to the standard setters on areas that would benefit from greater attention, and identify areas where supervisory practice still needs to be improved.

8. This note reviews the contribution of supervision to the strong performance record of Canadian banks. The note focuses primarily on the federal supervision of financial institutions that fall under the jurisdiction of OSFI. While Canada has a diverse financial system that includes both federal and provincial financial supervisors, and a range of different types of financial institutions, most of the assets and the major financial institutions are part of banking or insurance groups that are regulated and supervised by OSFI.

9. The note will also review other factors that may have contributed to this outcome. These factors include an apparent cultural conservatism in the country that has caused Canadian financial institutions to avoid some of the excessive risks taken by institutions in other countries and the benefits of the concentrated structure of the Canadian financial system with a few large institutions dominating the Canadian banking system.

10. While Canada's financial system has performed very well over a number of years, no system is immune from difficulties. Conditions, both domestically and internationally, are constantly changing and so practices and systems that may have worked in the past need to be constantly reevaluated. In fact, in 2006-2007, some Canadian banks did suffer from losses in commodity trading and write-downs of holdings of collateralized debt obligations and mortgage-backed securities and the non-bank backed asset-backed commercial paper market required restructuring. Box 1 seeks to identify several areas that might strengthen the current system or benefit from further analysis.

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[3] See for example, "Know Thy Neighbor: What Canada Can Tell us about Financial Regulation", John Courtney and Pietro Nivola, Brookings, April 29, 2009.

[4] See http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf.

11. Finally, two necessary caveats. First, this note reflects current practice at OSFI, some of which may have been enhanced since the onset of the crisis based on lessons learned in other countries. Second, despite some very good work by different groups such as the FSB's SIE to identify metrics related to supervisory effectiveness, this important effort remains a work in progress. While some key principles have been identified that are very important for effective supervision, there does not appear to be a single framework or model that guarantees success. Supervision needs to be constantly adapting.

Box 1. Sustaining Canada's Success

While Canada's financial system has demonstrated great resilience in recent years, Canada's continued success in avoiding crises cannot be taken for granted.

- OSFI is growing in size, taking on more responsibilities, and undergoing a change in leadership;
- New financial reforms are coming out of the FSB/G-20 that will affect banks' profitability;
- Large Canadian banks continue to expand outside of Canada; and
- While government support of the residential mortgage market through the CMHC helped stabilize this market during the GFC, the government recently has been imposing limits on the use of government-backed mortgage insurance.

Five areas that would benefit from increased attention:

1. Canada's close-knit financial system (everyone knows everyone) has enabled informal and flexible reporting systems and processes that in the past have worked well. As the scope and size of the federal regulatory system expands and the major financial institutions, both federal and provincial, become larger and more complicated, **greater formalization of processes and mandates, and an increased level of transparency and reporting by these institutions is recommended.**
2. OSFI is formally under the Minister of Finance (and reports to Parliament through the Minister), but , exercises operational independence. **Formalizing this independence in statute by authorizing OSFI to issue its own enforceable regulations and making its prudential decisions virtually final would reduce the risk that future federal governments might scale back OSFI's independence.**
3. Governmental and natural barriers to entry provide an element of protection for the large Canadian banks, which dominate the Canadian retail financial market. The banking system is often described as an oligopoly. Rules are applied equally to all significant competitors. This protected environment has helped foster a profitable and well-capitalized banking system. The benefits that accrue to banks from the current regime, including OSFI's international reputation for being more conservative than many other regulators, may have made Canadian banks more accepting of OSFI's approach of implementing strict and conservative prudential standards. **How sustainable is the continued dominance of the six large banks in retail finance? Will the stricter regulatory policies for systemically important banks, along with innovations by nonbank competitors, the greater use of the Internet, and changing demographics, change the competitive balance?**
4. Provincially supervised credit unions provide an important service to their members, who expect the same level of safety as bank depositors. **As credit unions grow in systemic importance, it is important to ensure they are subject to the same level of rigorous supervision and regulation as banks, and their depositors should receive the same assurance of protection as CDIC-insured depositors.**

QUALITY OF SUPERVISION

12. Any assessment of supervisory quality has to start with three essential pillars: supervisory mandate, independence and resources.

A. Statutory Mandate

13. OSFI has a statutory mandate that is simple and straightforward and is intended to protect the interests of depositors, policyholders, and creditors. The four elements of the mandate are to:

- Supervise federally regulated financial institutions to determine whether they are in sound financial condition and in compliance with their governing law and supervisory requirements;
- Promptly advise institutions in the event there are material deficiencies and take, or require management or boards to take corrective measures expeditiously;
- Establish a regulatory framework that promotes the adoption of policies and procedures to control and manage risk; and
- Monitor and evaluate system-wide or sectoral issues that may impact institutions negatively.

14. OSFI, and its focused mandate, grew out of bank failures in the late 1980s and problems with trust and loan companies, which exposed weaknesses in the regulatory system in existence at the time. The result was a conscious decision to include in OSFI's mandate a focus on prudential issues and an emphasis on early supervisory intervention in problem banks to minimize potential losses to depositors.

15. What is omitted from OSFI's mandate is as important as what is included. OSFI's mandate does not include market conduct, ensuring public access to financial services, nor the development of the financial sector, all of which in some other countries have led either to conflicts with prudential considerations or a diversion of resources away from an emphasis on a safe and sound financial system.

16. Having a narrow and clearly focused mandate assigned to OSFI as well as to its sister agencies and DOF has meant there is less potential for confusion among the different functions regarding respective roles and responsibilities. At the same time, a narrow safety and soundness mandate puts a premium on ensuring very good communications and collaboration with market conduct supervisors and establishing mechanisms for resolving differences. The major risk facing OSFI with respect to its mandate is that because OSFI's performance has been so strong in recent years, there is a risk that its mandate in the future may be expanded by government, causing its resources to become even more stretched and its focus blurred.

B. Operational Independence

17. OSFI enjoys de facto supervisory independence even though on paper, OSFI is formally part of government. The Canadian financial institutions statutes (e.g. Bank Act and Insurance Companies Act) contain approval provisions that are under the authority of both the Minister of Finance and the Superintendent of Financial Institutions. The manner in which Ministerial discretion can be exercised depends on the specific wording of the provision in question. In many cases, the statute specifies that the Minister may consider all relevant factors, including the recommendation of the Superintendent before making a decision. The Minister is permitted, however, under the statutes, to take decisions that may be contrary to the Superintendent's recommendation in cases where the other factors such as national security and the best interests of the financial sector are viewed by the Minister as of greater importance.

18. OSFI appears to have maintained the operational independence to exercise its prudential judgment. For instance, while OSFI presently lacks the ability to issue its own regulations, OSFI has adopted a practice of relying on regulatory "guidelines" that it can issue promptly, without waiting for governmental approval. While the consequence is that the guidelines are not directly enforceable in law, failure to meet a guideline is viewed by OSFI as indicative of a failure to meet the underlying legal standard. If OSFI determines that a bank has not met the standard, OSFI has sufficient tools to compel compliance. The guidelines are, therefore, indirectly enforceable under the law. In practice based on conversations with the industry, the guidelines are viewed as equivalent to regulations by the industry.

19. This approach of using guidelines works well in the current environment and has provided OSFI with an effective tool for expeditiously addressing emerging risks in supervised institutions without having to rely on the more cumbersome process of obtaining government approval for its formal regulations. One vulnerability that arises under this approach, however, is that under different senior staff at OSFI and the DOF, OSFI's future reliance on guidelines could, at least in theory, be curtailed. Another vulnerability is that private institutions might one day choose to legally challenge the enforceability of guidelines, which would hamper their effectiveness. While OSFI would still likely retain the ability through its other powers to achieve the same outcome, the regulatory process would become more cumbersome. Giving OSFI full authority to make its rules binding (e.g. ability to issue its own enforceable rules) and with full accountability, would remove this vulnerability and make the federal financial regulatory system even stronger.

C. Resources

20. OSFI's leadership has an important degree of independence over the use of its resources. OSFI is financed primarily through fees levied on federally regulated financial institutions, rather than through the government's general revenue. This provides an important degree of fiscal independence from the government and its budget while at the same time, providing a degree of accountability of OSFI to the banking and insurance industry to spend its funds wisely.

21. OSFI is subject to the imposition of government-wide fiscal restraints such as wage freezes (when in force), as well as the administrative guidance of the Treasury Board of Canada.[5] Current guidance includes, for example, a formal requirement to obtain approval of the Minister of Finance before spending money on large events such as supervisory colleges or when such events are not directly related to the delivery of OSFI's core mandate. These restrictions, for the most part, have not imposed practical constraints on OSFI's operational independence or hindered OSFI's ability to obtain the necessary resources.

22. Having observed the causes and the consequences of the recent crisis, OSFI has been able to build up its supervisory capacity in recent years through a significant increase in its supervisory and support staff. Between 2007 and 2012, OSFI's supervisory head count increased by approximately 50 percent. It had sufficient flexibility under the law[6] to offer competitive compensation packages to mid-career and senior hires from the financial services industry.

23. The ability to be able to attract and retain financial sector specialists has been a crucial element in OSFI's ability to deliver effective supervision. As the business of banking has become more complex, supervisory staff in developed countries has struggled to keep up with the latest innovations and market practices. Supplementing the examination teams with mid- and senior-level staff from the industry and financial markets with hands-on experience has facilitated OSFI staying current with emerging risks and added to the expertise and credibility of the exam teams in questioning senior management at the financial institutions.

D. Principles-based Supervision

24. OSFI has adopted a principles-based rather than rules-based approach to supervision. A principles-based approach is more adaptive to changing conditions. Successful implementation of principles-based supervision requires knowledgeable and experienced staff, who are able to exercise judgment and focus on outcomes rather than on an institution's strict compliance with the text of the rule or policy. OSFI's success in building a strong supervisory cadre, including industry experts, has enabled it effectively to implement principles-based supervision. Importantly, OSFI senior management has delegated significant responsibility to the senior supervisors and backed them up when they have made tough calls.

25. For a system of principle-based supervision to work, the industry must be comfortable with and accept the supervisory discretion that accompanies such a system. A principles-based system requires an acceptance by the regulated entities of the judgment and actions by the supervisor even in the absence of specific rules or laws that have been violated. This acceptance

[5] The Treasury Board is broadly responsible for accountability and ethics, financial, personnel and administrative management and comptrollership in the federal government.

[6] OSFI has the power to act independently by virtue of its categorization as a separate agency (Schedule V of the *Financial Administration Act* (FAA)), and the delegation of powers to Superintendent. The Superintendent may determine the terms and conditions of employment, with periodic reporting to the Public Services Commission (PSC) to demonstrate it has complied with the PSC's framework and policies.

appears to be present in Canada. OSFI successfully anticipated some of the problems that banks in other countries encountered. This foresight has made OSFI more credible both with the industry and with the government.

E. Intensity of Supervision

26. OSFI has also adopted a supervisory philosophy of holding the board of directors and senior management accountable for ensuring that an institution is operated in a safe and sound manner, complies with relevant laws and regulations, and keeps OSFI informed of any problems.[7] Each bank's board of directors is expected to understand and approve the business objectives of the firm, its significant strategic initiatives, and the internal control framework and should be fully engaged in the appointment and performance of the heads of the various oversight functions such as audit and risk. OSFI assesses the quality and effectiveness of boards and in some cases has encouraged improvements to the composition of boards it finds weak. OSFI also expects boards to alert OSFI as important issues arise—a "no surprises" approach.

27. As part of its program of emphasizing the accountability of boards and senior management for the management of the banks, OSFI engages in what is referred to as "close-touch" supervision. This means a high level of engagement occurs between OSFI and each of the banks, particularly the large institutions. Contact is frequent and at all levels of the institution, including the board. OSFI has sought to elevate the role and independence of the CRO and CFO by having regular meetings with these individuals as well as with the board members in charge of the audit and risk committees. Such "close touch" supervision, which was mentioned on several occasions during meetings with bankers, is an explicit objective of OSFI and appears to have produced very positive results.

28. A key element of effective supervision is a willingness to increase supervisory pressure promptly when a supervisor identifies weaknesses in an institution. While OSFI in the normal course of supervision will keep the management and board apprised of any concerns it has related to the institution's compliance with rules and guidelines, OSFI will increase the frequency and intensity of its intervention when it identifies material risks including the failure of an institution to follow up on previously identified issues. OSFI has an explicit and legal mandate for early intervention and its supervisory approach flows from this. The objective is to engage with a regulated institution at an early stage to protect depositors

29. OSFI has established a formal system of placing institutions into one of four stages of supervisory intensity and intrusiveness based on OSFI's assessment of the risks posed by the institution. The process of "staging" an institution is described in a public document issued jointly by OSFI and CDIC on OSFI's approach to intervention and the role of the CDIC.[8] The stages range from intensive supervision under Stage 1 all the way to Stage 4, which might lead to OSFI taking

[7] OSFI (January 2013), *Guideline: Corporate Governance.*

[8] OSFI & CDIC (2008), *Guide to Intervention for Federally Regulated Deposit-Taking Institutions.*

control of an institution and possibly applying to the Attorney General of Canada for a "winding-up" order. When an institution is "staged", OSFI will send a supervisory letter formally notifying management, the board of directors and external auditor of the institution and will require that the institution take steps to address the identified problems. OSFI will then meet with the bank to outline its concerns and discuss remedial actions.

30. During the period during which the institution is "staged" OSFI increases the frequency and intensity of monitoring and reporting requirements and conducts enhanced and more frequent supervisory reviews. OSFI will apply an assessment surcharge to the firm to cover the costs of its additional supervision. OSFI might, if conditions warrant, establish an on-going presence at the bank and require that external specialists be brought in to assess certain areas of risk (again at the bank's expense).

31. OSFI keeps the CDIC fully informed of its concerns with the institution and proposed actions and provides updates to the Bank of Canada, the Department of Finance, and FCAC (see the Financial Institutions Supervisory Committee described later in this note). The CDIC also has a "watch list" of troubled institutions, which is closely correlated with OSFI stages (particularly to OSFI Stage 2). CDIC can independently place members on this watch list. CDIC sends these members a letter indicating they are on the watch list and that additional monitoring through OSFI, direct contact or information requests may be required. Depending on the severity of the problem, CDIC may also conduct its own special examination, for which it may charge a fee as well as levying a deposit insurance premium surcharge, after consultation with OSFI. CDIC's involvement and the knowledge that the FISC is being kept informed is intended to convey to the institution's management and board directors the seriousness of the underlying issues that have been identified by OSFI.

F. OSFI's Conservative Approach

32. OSFI has adopted a policy of conservative supervision that includes intrusive supervision, a requirement for meaningful and high quality capital in the banks, and safeguards against the introduction of risky behavior such as using lowered underwriting standards to gain market share. Despite the competitive nature of the Canadian financial system, there has been little evidence of the destructive competition for revenue and market share that has been prevalent in some other G-7 countries in recent years. Government has leaned against risky competitive practices and market dominance —for instance, by tightening guidelines for residential mortgage loan underwriting as problems in mortgage markets outside of Canada emerged and not allowing mergers among the large banks.

33. While OSFI's close touch approach with management may raise concerns that OSFI may become too close to the industry, there is no evidence of regulatory capture in the Canadian federal financial system. OSFI has sought to be ahead of the international community in the adoption of new prudential standards and to be even more conservative in setting minimum standards than the minimums that have been agreed to internationally.

34. OSFI has established higher capital requirements than required under Basel rules, emphasizing the quality of capital as well the level, and retaining a formal leverage limit. While "regulation did not save Canadian banks,"[9] OSFI's decision to be an early adopter of international rules, and to implement such rules conservatively contributed to the strong standing of Canadian banks. Banks' internal processes and risk controls are expected to exceed international standards and to be "superior" rather than "adequate" or "average." More recently, Canada is among the first of the advanced economies to adopt the Basel III capital standard and was the first country to adopt a Domestic Systemically Important Bank (D-SIB) framework, subjecting the designated banks to a capital surcharge starting on January 1, 2016.

35. A key benefit of this long-standing conservative approach is that Canadian banks entered the GFC in 2007 from a position of capital strength. These higher prudential standards contributed to the strong international reputation of the Canadian banks for being well managed and well supervised[10] and have resulted in their often being included on international lists of the safest bank banks in the world.[11]

36. The Canadian financial institutions recognize the benefits of supervision by OSFI. There may be a halo effect that has come with OSFI's international reputation as a conservative supervisor that provides a certain degree of comfort to Canadian banks' offshore counterparties and allowed Canadian banks to retain access to private institutional liquidity during the GFC.[12] In recognition of this benefit, along with the expectation of continued market dominance of the domestic banking market, Canadian banks appear to be less inclined than institutions in some other countries to push back against strong regulatory standards.

37. This responsiveness by institutions to directions from OSFI has permitted OSFI to emphasize moral suasion over a more formal enforcement approach. OSFI does not appear to have a pattern of large fines or litigation. While OSFI does not appear reluctant to "stage" an institution that is encountering problems, its initial approach is to seek to work with management. This has fostered a good working relationship and dialogue with the industry. Such an approach, of course, requires close monitoring of remedies pursued by the bank and strict follow-up when problems are not promptly addressed.

G. Scope of OSFI Supervision

38. Under Canadian federal law, a bank is an entity that is incorporated and regulated at the federal level by OSFI. Banks, by definition, cannot be incorporated at the provincial level. In

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[9] Kravis, M.J. (May, 2009).

[10] "Australian and Canadian Major Banks", Fitch Ratings, January 30, 2012 notes that OSFI is "widely regarded as being conservative...applying higher capital requirements...than suggested under the Basel rules" and in "advance of the GFC" which is indicative of "a more active and conservative approach to supervision."

[11] See for instance, Global Finance, "22nd Annual Ranking of the World's 50 Safest Banks," August 23, 2013.

[12] "Canadian banks top choice for U.S. money market funds", Financial Post, John Shmuel, October 20, 2011.

practice the considerable majority of public deposits—over 90 percent—and most of the provision of credit is associated with the federal banking system.

39. A benefit of OSFI's formal responsibilities is that it supervises banks, trust companies, the major insurance companies, and some pension funds. This provides OSFI supervisors with a broader perspective than if they were solely focused on commercial banks. Given the universal banking model in Canada with banks engaged directly in retail and commercial banking, and in investment banking, wealth management, and insurance through affiliates, OSFI's wider scope of supervisory responsibilities facilitates its ability to conduct group-wide supervision. OSFI also maintains good working relationships with the provincial securities and insurance supervisors, which facilitates sharing of examination information covering those bank affiliates that are outside the federal system.

40. Canadian federal law, however, and CDIC deposit insurance coverage do not apply to all depository institutions. At the provincial level, there are some depository institutions that are systemically significant from a provincial perspective (see Box 2), which are not routinely monitored at the Federal level. Because credit unions offer deposit services to their members, any serious difficulty in the credit union sector (either in a group of small and mid-sized credit unions or in one of the larger credit unions) has the potential for raising doubts about the safety of deposits in other depository institutions, including depositors of banks, trust companies, and other credit unions. This is because it is unlikely that Canadian depositors fully comprehend the differences in the strength and reserve levels of the CDIC compared to the various provincial deposit insurance schemes. As crises in other countries demonstrate, depositor confidence in the safety of insured deposits can be very difficult to maintain when depository institutions are failing.

Box 2. Large Credit Unions—Are They Domestic Systemically Important Financial Institutions?

The Canadian financial system includes large cooperative financial groups, supervised outside of the federal system by various provincial regulatory and supervisory bodies There are large deposit takers regulated at the provincial level in Alberta, British Columbia, and Québec. Such large credit unions require the provincial supervisors to have the capacity, on a standalone basis, to effectively supervise them.

The FSAP mission was not charged with undertaking an assessment of compliance with the Basel Core Principles for Effective Banking Supervision by any of the provincial supervisors of credit unions. But it did conclude that similar to large banks, the large provincial credit unions might pose a vulnerability to financial stability. Effective supervision of a large depository institution is difficult under the best of circumstances. Certain large credit unions, with their multiple business lines, are complex and require specialized supervision similar to that of the larger banks. Because of the wide dispersion of supervisory talent across the provinces, however, it can be challenging for a single provincial supervisor, on a standalone basis, to acquire the breadth, depth of experience, and supervisory capacity needed for the task. In part this is because there is no peer institution to serve as a comparator when the provincial regulator monitors only one large deposit taker.

Box 2. Large Credit Unions—Are They Domestic Systemically Important Financial Institutions? (Concluded)

Financial stability considerations suggest that large credit unions, particularly those that pose a systemic risk, should be subject to the same level of rigorous supervision and regulation as other major depository institutions in Canada—something the Autorité des marchés financiers (AMF), amongst others, seeks to achieve. More informal collaboration among the provincial supervisors and between the provincial supervisors and OSFI—for instance comparing performance with peer institutions and conducting stress tests—would be helpful.

Viability is linked to maintaining access to liquidity. But as with supervision, deposit insurance provided at the provincial level lacks the national diversity of the CDIC, and does not have the federal backstop of CDIC. It is important that the respective provinces have the fiscal resources to backstop the credit unions' depositors and resolve any nonviable credit unions in an orderly fashion. In the event of a problem at one of the large credit unions or a number of smaller ones, depositors may otherwise question the capacity of the provincial insurance fund and its sponsoring province to cover all provincially-insured deposits.

COOPERATION AND COLLABORATION AMONG FINANCIAL REGULATORY AGENCIES

A. Importance of Insulating Supervision from Political Interference

41. The revised Basel Core Principles place increased emphasis on arrangements that foster cooperation, information sharing (including institution-specific information), and collaboration across the relevant domestic and foreign authorities. Generally, the relevant group of authorities include prudential and market conduct supervisors, central banks and agencies responsible for countering money laundering and the financing of terrorism. It does not usually include a representative from government.

42. In fact, one of the hallmarks of strong supervision, and one that has received significant attention in the FSAP program, is ensuring a level of independence to protect the supervisor from political pressure. The focus on independence has its origin in past international examples of harmful government interference that have resulted in poorly resourced supervisory agencies (sometimes at the behest of the supervised institutions, which often are assessed to cover the costs of the supervisory agencies), constraints on supervisory agencies adopting conservative and unpopular regulations and policies, and delays in prompt supervisory action against individual problem banks. As a consequence of this experience, FSAP missions have frequently been critical of any formal role that the government might have in the leadership of the organization (e.g. sitting on the board of the supervisory agency) or when there is the potential for interference in the ability of the supervisor to issue regulations and policies, or instances in which government officials have the ability to interfere in or override licensing decisions.

43. In some countries, this focus on supervisory independence has resulted in relatively constrained information sharing and limited communications and collaboration between the

supervisory agency and government. This may be reinforced by built-in statutory restrictions on the ability of the supervisory agency to share confidential information with finance ministries and may result in minimal consultation on major supervisory decisions related to policy or individual institutions.

44. The presumption is that by not sharing such information, *ex ante*, the possibility of someone from government attempting to alter a prudential policy or supervisory action will be reduced. Absence of sharing information also provides some relief and protection to government officials. Not having access to such information puts them in a position to more easily rebuff calls from industry trade associations and major financial institutions asking for their assistance to block a supervisory policy or action.

B. Canada Regulators Collaborate Closely with Government

45. Canada, however, has chosen to go down a different path. The Department of Finance describes itself as one of the 5 federal financial sector regulatory agencies, along with OSFI, the Bank of Canada, the Canada Deposit Insurance Corporation, and the Financial Consumer Agency of Canada. The DOF's role is to develop policy and legislative initiatives to ensure the safety and soundness of the financial sector.

46. But the level of collaboration and coordination has gone beyond policy and legislative initiatives. A close informal working environment has been fostered in Canada, along with a set of more formal committees and an interlocking board governing the deposit insurance agency.

47. On the more formal side, to ensure cooperation and coordination among the various agencies, Canada has formed several fora in which senior officials of OSFI, BOC, DOF, the CIDC, and FCAC meet on a regular basis. The most important of these, from the perspective of supervisory effectiveness, are the Financial Institutions Supervisory Committee (FISC), the Senior Advisory Committee (SAC), and the Board of the CDIC.

48. The FISC is chaired by the OSFI Superintendent and includes the BOC, DOF, FCAC, and CDIC. Under the OSFI Act, every member of the committee is entitled to any information on matters relating directly to the supervision of financial institutions, bank holding companies or insurance holding companies even when such information is confidential supervisory data. In return, FISC members commit to maintaining the confidentiality of such information.[13] FISC meets at least quarterly, and more often as needed. FISC is designed to foster good coordination and communication among federal agencies with respect to strategies and action plans for addressing problem financial institutions. What this means in practice is that during the recent financial crisis, there were weekly meetings of the FISC and a free flow of information among all of these parties so that everyone was kept informed.

[13] The sharing of confidential institution-specific data means the securities regulators cannot easily be involved in this group.

49. It is important to note that FISC serves as a consultative body, and it existence does not appear to have impinged on the authority assigned to OSFI. Votes are not taken at FISC. While OSFI receives input on supervisory matters through the FISC, accountability and decision-making with respect to supervisory decisions remain with OSFI.

50. SAC, which has the same membership as FISC, is chaired by the Deputy Minister of Finance, and acts as a discussion forum for financial sector policy issues, including financial stability and systemic vulnerabilities. When appropriate, other government agencies are invited to this discussion. Each SAC member remains responsible for formulating policies consistent with their mandates. As with FISC, the SAC is not a decision-making body. Policy issues are discussed at SAC to ensure coordination and to discuss how such policies may affect the different sectors of the financial system and real economy.

51. Finally the CDIC Board of Directors is responsible for making decisions and recommendations on the use of resolution tools for federally-regulated member institutions. The Board includes the SAC members along with six others drawn from the Canadian private sector, including the Chair. The presence of the six outside board members on the CDIC brings a non-governmental perspective to CDIC decision-making. The CDIC is well staffed and has the capacity to conduct its own special examinations and to act as a second pair of eyes regarding the health of the depository institutions.

52. The result of these different informal and formal processes is that senior members of OSFI, the Bank of Canada, the DOF, FCAC, and the CDIC meet and work together on a regular basis. The benefit of these relationships is widely recognized. As one senior official stated, "people are willing to invest in these relationships."

C. Benefits of Canadian Approach to Regulatory Collaboration

53. This arrangement has had at least three positive outcomes. First, while there may be disagreements among the federal members of the various groups, everyone is kept fully informed of the issues and the likely actions that will be taken to address them. Entities, such as the Department of Finance that do not have first-hand experience with supervision and regulation, are kept up-to-date with the issues. A unique aspect of the Canadian financial system is that the major financial statutes governing the banking and insurance sectors sunset each five years and need to be renewed. This process is managed by the DOF and the collaborative relationship among the regulatory entities ensures that all relevant parties have an opportunity to identify provisions of the statutes in need of updating.

54. Second, senior industry representatives have said that because of these close working relationships among the regulatory agencies, they presume that when OSFI speaks or takes an action, the government has been fully informed and stands behind OSFI's decision. As a consequence, it is not common in Canada for the industry or individual major banks to attempt to go around unpopular OSFI decisions by trying to get the Minister of Finance or DOF to intervene with OSFI on their behalf.

55. Third, in a crisis, these various fora mean that the key federal finance and regulatory officials are accustomed to working together. The routine meetings of the different committees and the presence of all of the key officials on the board of the CDIC reduce the possibility that in a crisis, government officials will unintentionally give conflicting or contradictory messages, which the experience of the last few years has demonstrated can harm the credibility of government efforts to reassure markets.

56. The challenge in making government, through the DOF, such a close partner is to guard against the DOF taking an expansionary view of its role and gradually invading the responsibilities of the other agencies. The sensible division of responsibilities among the agencies and clear mandates for each agency, which are enforced by the agency heads, appear to have prevented mission creep, and a blurring of responsibilities or encroachment by government in the operations of the independent agencies.

57. The small size of the Canadian financial sector and the integrated federal regulatory infrastructure may have also contributed to the well functioning regulatory system. Most senior staff in the financial regulatory agencies have worked together for years and there appears to be a natural rotation of senior staff among the agencies and the DOF that has helped foster good interagency working relationships. The proximity of the headquarters of the federal agencies (all within a short walk of each other) in Ottawa has also facilitated good communications. And because of the small number of key private financial institutions, which again are located within easy walking distance of each other, albeit in Toronto, there is a reliance on informal communications. The comments were often heard that "everyone knows everyone", "everyone knows who is working on what", and that it is easy to get the heads of the federal agencies and the CEOs of the major institutions around a small conference table.

NON-SUPERVISORY FACTORS

58. The Canadian banks managed the global financial crisis very well. While institutions suffered a drop in earnings, only one of the six banks reported an annual loss (in 2008), and none appeared to be in danger of failure. The Canadian government introduced a financial guarantee scheme to ensure the banks had access to liquidity, but none of the Canadian banks made use of the program.[14] All of the banks are now well-capitalized, are reporting strong profits, have highly rated long-term debt, and four of the six appear on the Bloomberg list of the strongest and safest banks in the world.[15]

59. While these banks have benefited from strong supervision, two other factors may have also contributed to the absence of financial crises in Canada: the structure of the financial industry and government actions to minimize the risk to residential mortgage lenders.

[14] "Australian and Canadian Major Banks," Page 4, Fitch Ratings, January 30, 2012.

[15] "World's Strongest Banks," Bloomberg, September 13, 2013.

A. Structure and Conservatism of Canadian Bankers

60. The financial sector is made of a small group of domestic institutions that operate nationwide and have adopted relatively conservative business models. The six largest Canadian banks, all of which have been designated by OSFI as D-SIBs, dominate both the Canadian banking system and the Canadian financial sector. These six banks held 93 percent of total Canadian bank assets as of mid-2013 and 40 percent of total financial sector assets. The dominance of these large banks in the Canadian banking system has existed for many decades. Given the extensive branch networks and name recognition of these large banks, it is difficult for new entrants to break into the market except through acquisitions. Foreign bank subsidiaries and branches held less than 5 percent of Canadian bank assets and acquisition of a major bank is discouraged by the "widely held" rule, which limits the scope for mergers and acquisitions of large institutions.

61. A similar pattern exists in the life insurance sector, which is dominated by three Canadian companies.[16] While this note focuses primarily on the banking sector, many of the same factors may apply to the federally supervised insurance companies.

62. All of the large Canadian banks have adopted conservative business models. Their funding is primarily through deposits and lending focuses on traditional bank products in Canada in the personal and commercial sectors. While the six large banks have adopted a universal bank model—they have diversified into wealth management, mutual funds, insurance and own the large broker dealers—their primary focus and most important source of revenue remains in the traditional commercial banking business in Canada. In 2012 for the top six banks, over 70 percent of profits were derived from Canadian operations. While pricing in some markets such as residential mortgages and credit cards appears to be robust as measured by interest margins, generally banks appear to compete not on price but on customer service and product features.[17]

63. Because of limited opportunities to expand domestically, all of the Canadian banks have cross-border operations. This is generally carried out through foreign banking subsidiaries, which engage in traditional commercial banking with local currency funding. While the large banks appear to pursue common business strategies in Canada, they have taken different approaches in their foreign ventures in the United States, Caribbean, Latin America and to a lesser extent, Europe. While this cross-border expansion provides a degree of geographical diversification, foreign operations also present risks due to different lending cultures, business practices, regulations, and simply the fact that foreign operations may be very distant from headquarters. OSFI has established

[16] The life and segregated funds sector represents some 16 percent of the Canadian financial sector. The top three Canadian institutions, all of which are supervised by OSFI, held 76 percent of total Canadian life insurance assets in 2012. The property and casualty market, which has a number of foreign players and a large group of provincially supervised institutions, represents only 2 percent of the financial sector market.

[17] Eggert (2012) p. 15.

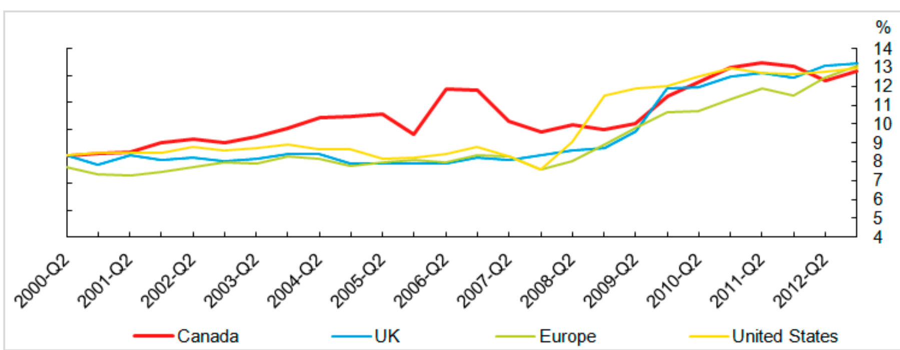
strong working relationships and information sharing arrangements with the relevant foreign supervisors of these banks and is sensitive to the extra risks posed by such operations.[18]

64. Canadian banks have benefited from the provision of mortgage insurance by the Canadian Mortgage and Housing Corporation (CMHC), a Crown Corporation. While the next section of the paper provides more detail on Canadian housing policy, any discussion of Canadian banks should include the possible benefits to banks arising from the government backing of CMHC's mortgage insurance programs

65. One of the major benefits of the CMHC program for banks has been its effect on risk-weighted capital. Because CMHC has assumed virtually all of the credit risk on insured mortgages loans, subject to strict underwriting requirements, and the interest rate on the loans resets every five years, these loans are a low risk for the banks. Under Basel capital rules, residential mortgage loans are assigned a low risk weight and debt that is guaranteed by the full faith and credit of the federal government is assigned a zero risk weight. For the six largest banks, residential mortgage loans represent the majority of their loans and their single largest asset class, and most of these loans carry mortgage insurance. The result of this is that a Canadian bank can have a relatively high risk-based capital ratio for a given level of leverage compared to other banks that hold riskier assets on their balance sheet. This is illustrated in the following figures, which compare Canadian banks to major banks in the United States, United Kingdom, and Continental Europe. (Note that accounting differences across countries make these numbers from Bloomberg "indicative").

66. The first figure shows that Canadian banks entered the GFC in 2007 with high **risk-weighted capital levels**, relative to the other banks in the sample.

Figure 1. Basel Tier 1 Capital Ratio



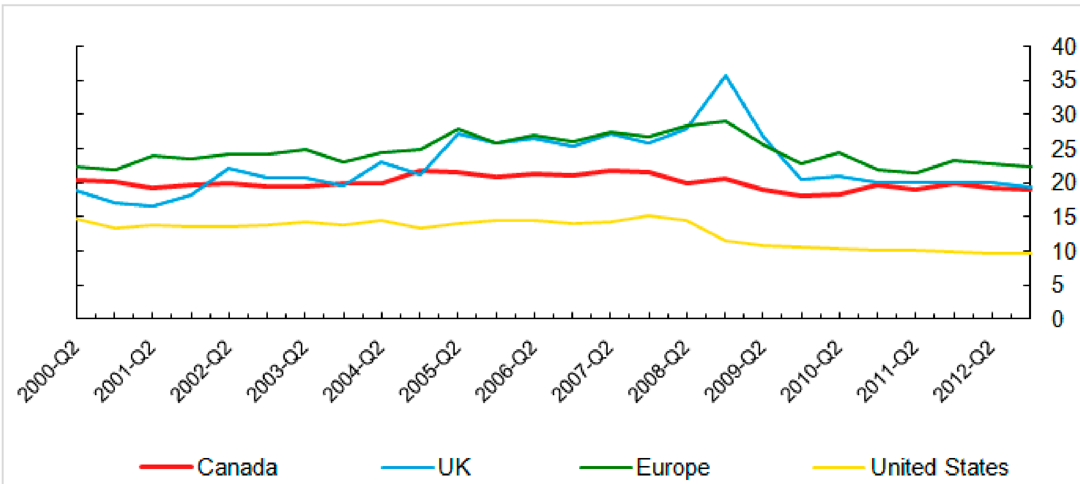
Note: Europe and U.K. – Basel I for 2000–2007, Basel II for 2008–2011, Basel II.5 for 2012
United States: Basel I
Canada: Basel I for 2000–2007, Basel II for 2008–2011, Basel II.5 for 2012
Source: Bloomberg
Last Observation: 2012Q4

[18] OSFI has entered into Memorandums of Understanding (MoUs) with more than 30 foreign counterparts. CDIC recently obtained the legislative authority to share member-specific institution obtained from OSFI with relevant foreign authorities subject to a condition that the Superintendent and the CDIC Board agree with the release of the information.

67. The second figure illustrates that on an **unweighted basis**, however, Canadian banks' asset to equity ratio (the amount of leverage) was much closer to that of U.K. and European banks. (The ratio is higher than for banks in the United States, although the U.S. figures exclude some off-balance sheet assets that are included for banks in the other countries.)

Figure 2. Leverage Ratio

(asset to equity)



Source: Bloomberg

Last Observation: 2012Q4

68. OSFI imposes an assets to capital multiple (ACM) test that limits leverage to 23 times capital although it expects banks to keep below 20 times capital as a rule (and sets much lower leverage ratios for smaller banks (which lack diversification) and new entrants to the market.[19] The relatively stable level of the Canadian banks' leverage ratio indicates that the banks adjust their business actively in order to avoid hitting the limit. OSFI modeling suggests that the proposed new Basel leverage ratio of 3 percent (i.e. an assets to capital multiple of 33.3 times, but using a different definition for the denominator) is broadly equivalent to OSFI's current leverage ratio limit.

69. Because what matters to investors is how much a bank earns against its absolute capital level (rather than its risk-weighted capital ratio), the higher the leverage, the higher the return on equity (ROE) for an equivalent ROA. What this means is that to meet a given ROE target, a more leveraged bank can earn less on its lending and investments (e.g. take on less risk and operate with a lower ROA) than a bank with lower leverage.

70. Canadian banks over this time period, therefore, may have been under less pressure to generate high income to meet their ROE targets than U.S. banks. The higher leverage of the

[19] CDIC increases contributions from banks which exceed 85 percent of their maximum leverage ratio.

Canadian banks did not mean these banks were riskier than the other banks in the sample—rather it reflects the advantage to Canadian banks of the government's support of the Canadian residential mortgage market.

71. The Canadian banking system is frequently referred to as an oligopoly.[20] The structure of the system, which has been dominated by six large domestic banks for a number of years, is to a significant extent a consequence of government policy. A requirement that ownership of the big banks be widely held has been in place for a number of years. This requirement along with a government policy that has discouraged the merger of large banks, has also served to prevent the acquisition of any of these large banks. [21] By effectively eliminating the threat of a take-over, this policy provides a degree of protection to the individual banks' management.[22]

72. While the Canadian banks compete with each other domestically for market share—suggesting that the 'oligopoly,' such as it is, does not prevent competition[23]—their relative competitive position has remained fairly constant over the years. Among the six large banks, the Royal Bank of Canada has remained the largest bank in Canada since at least World War II while National Bank of Canada has been the smallest of the large banks.

73. The Canadian banks readily acknowledge the benefits of the current system, which has produced stable profitability for the industry for a number of years. The banks have a strong and valuable franchise, which they wish to preserve. This may be an example of what has been referred to "as a partnership between the government and a group of bankers" with regulatory policies that "reflect the deals that gave rise to those partnerships."[24] It has been suggested that in return for the government's acceptance and support of the current structure, the banks are more accepting of OSFI's more conservative and intrusive supervision. OSFI's approach of requiring higher (and high quality) capital levels, of emphasizing the accountability of the board and senior management to manage and control the bank's risk appetites, of probing bank management who wish to adopt some of the riskier products popular in other jurisdictions, and an even-handed application of its rules to all federally supervised institutions, has created an environment in which Canadian banks have been able to prosper and avoid many of the problems encountered in other financial markets.

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[20] Eggert, (2012), p2.

[21] Four of the banks proposed merging into two banks in 1998 but government did not grant approval. This prevented the banks from increasing to where they were able to match the size of the big global banks. Some analysts believe that this inability to grow may have protected them from some of the excessive levels of risk exposure that was assumed by much larger global banks ahead of the crisis. *"Canadian Banks 2008, Perspectives on the Canadian banking industry"*, Pricewaterhouse Coopers.

[22] The widely held rule is seen has having "dampened competition in the banking market and allowed the big banks to operate without fear of foreign takeovers, "The Political Economy of Canada's "Widely Held" Rule for Large Banks", Eric J Gouvin, New England University School of Law, 2001.

[23] The policy of preventing mergers between large banks ensures there are sufficient participants to support competition.

[24] Calomiris (2013), p 9.

GOVERNMENT SUPPORT OF RESIDENTIAL MORTGAGE LOAN MARKET

74. Another factor in the strong performance of Canadian banks' may be their large holding of Canadian residential mortgage loans. For all of the six large banks, residential mortgage loans represent the majority of their loans and their single largest asset class. While poorly underwritten U.S. residential mortgages loans, and their subsequent securitization into mortgage-backed securities, were at the center of the crisis in the U.S. financial sector, residential mortgage loans on Canadian housing have not posed a similar problem for Canadian banks for five reasons.

75. First, Canadian banks often conduct their own underwriting of mortgage loans rather than relying on independent brokers. This gives the banks more control over the quality of the loans and minimizes the issue that arose in the U.S. of mortgage brokers being compensated on the volume of loans generated with inadequate attention paid to the quality of underwriting.

76. Second, in most provinces, Canadian banks have full recourse to take legal action to recoup money from the homeowner if a foreclosed home is sold for less than the amount owed on the mortgage.[25] This avoids the phenomenon, again seen in the United States, of higher risk loans being made where there is no recourse to the other assets of borrowers in the event of default. This helps to limit the incentives in Canada for borrowers to buy houses as investment properties with the intention of retaining the house if its price rises, while turning the mortgage loan back to the bank and walking away, if housing prices fall below the loan amount.

77. Third, the Canadian government has taken an active role in promoting affordable housing and housing credit through the Canada Mortgage and Housing Corporation (CMHC). CMHC has a Mortgage Loan Insurance program that provides 100 percent government-backed insurance to lenders.[26]

78. Fourth, the Canadian government has demonstrated its willingness, when warranted, to tighten the rules for government-backed insured mortgages and underwriting standards. Mortgage lending requirements relating to the provision of government-backed mortgage insurance were relaxed in the mid-2000s, which contributed to easy access to mortgage finance and helped boost the housing sector. Since 2008, the federal government has reversed the loosening that occurred in the mid-2000's and undertaken four rounds of measures to tighten the eligibility

[25] The exceptions are the Provinces of Alberta and Saskatchewan. The Province of Alberta does not always offer recourse to lenders, based on the vintage and nature of the loan. In Saskatchewan, recourse only applies to re-financed mortgages. (See "Canadian Mortgage Market Primer", in Market Musings, TD Securities, July 5, 2010.)

[26] The Government also backs private mortgage insurers' obligations to lenders subject to a deductible equal to 10 percent of the original principal amount of the mortgage loan. In the event of a private mortgage insurer's winding-up, the Government would honor lender claims for insured mortgages in default, subject to the 10 percent deductible and any applicable liquidation proceeds. There are two active private mortgage insurers in Canada.

requirements for mortgage insurance (e.g. tightening required mortgage loan amortization from 40 years down to 25 years). OSFI also issued underwriting guidelines for federally regulated financial institutions. These two efforts, which have also been applied to many of the non-federally regulated mortgage lenders, reduced the ability of more aggressive lenders from seeking to expand their mortgage business by adoption of soft underwriting terms, and, thereby, forcing other banks in the market to either match their competitors weak underwriting standards or lose business.

79. Finally, the Canadian legal system has a very efficient foreclosure system. When a borrower defaults on a loan, the bank is able to gain access to the collateral, often in less than a year. The ability of the lender to resolve default situations in a timely and cost effective manner has the effect of lowering the cost of defaults and hence, making the cost of mortgage finance less expensive.

CONCLUSION

The Canadian banking system and indeed, the Canadian financial system managed the financial crisis very well. While Canada was not immune to the liquidity pressures that arose in a number of countries with open capital markets, prompt action by the authorities and the willingness of financial institutions to raise capital early in the crisis despite steep discounts in their share prices, facilitated a quick recovery.

80. Key characteristics of Canada include a high quality and conservative approach to federal bank supervision, supported by a close and effective working relationship among the government agencies, a relatively conservative and non-complex banking system, and a government housing policy that has contributed to a very safe and liquid residential mortgage finance system. In combination, these different factors have resulted in a banking system whose large banks are viewed both domestically and internationally as among the strongest banks in the world.

81. Contributory factors to this favorable outcomes were the effectiveness of OSFI, the fact that government regulatory authorities worked so well together, the concentrated and conservative nature of the Canadian banking sector, and the support of the residential mortgage market that government provided through the CMHC.[27] For instance, the high risk-based capital levels held by Canadian banks, which were so important as the banks entered the GFC, were both a consequence of OSFI's decision to implement a conservative interpretation of the Basel capital rules and a reflection of the conservative nature of Canadian banks. From the perspective of financial stability, the Canadian banking system weathered the crisis very well. The supervisors, central bank, and government were viewed as being proactive and effective and Canadian banks throughout the crisis were perceived as having strong and robust balance sheets.

[27] The strong economy and conservative federal fiscal policies are also factors.

82. This success raises two questions—are there additional steps that Canada might take to strengthen even further their current system; and are there lessons from the Canadian experience for other countries?

- Additional Steps: Box 1 at the beginning of this note and the FSAP's Financial System Stability Assessment list a number of recommendations for Canada that address current gaps and vulnerabilities. Some of these gaps such as the vulnerability to financial stability posed by large provincial depository institutions are referred to in this note.

- What "lessons" from Canada's experience might be of value to other countries? Four that standout from this note are the benefits of (1) "close-touch" supervision that holds management and boards fully accountable for the performance of their bank and which becomes significantly more intense as weaknesses and vulnerabilities are identified, (2) the strong capital positions of Canadian banks as the crisis unfolded, which reflected the long standing conservative approach taken by OSFI in implementing international supervisory guidelines, (3) the close collaboration and full information sharing among the five Canadian regulatory authorities, including the Department of Finance, which enabled a prompt and effective response to the crisis; and (4) efforts by the government to ensure balanced competition—enough to ensure good quality services provided to the economy, but fettered to limit risky behavior intended to gain market share.

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