Office of the Superintendent of Financial Institutions Canada | Bureau du surintendant des institutions financières Canada

OSFI at 30: Learning from the past; looking to the future

Remarks by Superintendent Jeremy Rudin to the Economic Club of Canada

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Introduction

I would like to thank the Economic Club of Canada for once again providing me an opportunity to speak to the financial services community.

Three years ago, I delivered my maiden speech as Superintendent to this very forum. I had been on the job for a mere three months. Today, I will speak to you as a more seasoned and — I hope — wiser Superintendent.

A time to reflect on our past

The financial services sector plays a critical role in our national life. Financial institutions help power our economy and so contribute to our collective prosperity. When our financial institutions are sound, efficient and competitive, we all benefit.

Proactive and expert regulation and supervision of financial institutions are essential to securing those benefits for all Canadians.

That is why the Government of Canada created OSFI in 1987.

As this year marks OSFI's thirtieth anniversary, it is an appropriate time to reflect on our past, and how we are positioned for the future.

So today, I am going to share with you a very selective history of OSFI's first thirty years. In particular, I will describe what I see as the four most important chapters in OSFI's history, underlining how each of those episodes had a positive impact on how OSFI performed in the past, and how we will perform in the future.

They are:

1. Our proactive approach to regulation and supervision, which arose from the events that led to the creation of OSFI in 1987;
2. Our balanced mandate, which we were given in the mid-1990s;
3. Our disciplined approach to confidential information, which received crucial reinforcement in the early 2000s; and
4. Our constant battle against complacency, best exemplified by our reaction to the 2008 Global Financial Crisis.

How OSFI came to be

Having existed for only thirty years, OSFI is a relative newcomer to the Canadian financial services scene. By contrast, almost all of Canada's largest financial institutions can trace their roots back to before Confederation.

It was not until 1875 that the Government of Canada established the Department of Insurance, and it was nearly fifty years later, in 1924, that the Office of the Inspector General of Banks was created.

Much like the Superintendent of Insurance, the initial role of the Inspector General of Banks was largely limited to reviewing the financial statements of the institutions. As late as 1977, the Office of the Inspector General of Banks had only seven employees.

As you know, that did not last.

Two developments in the mid-1980s sparked the creation of OSFI.

The first was growing competitive pressures within the financial services industry. The long established space between the traditional "four pillars" of the industry: banks, trust and loan companies, insurance companies, and securities dealers, was closing and that put pressure on the regulatory barriers that had been in place up until then.

The second development was the failure of two banks based in western Canada: Canadian Commercial Bank and Northland Bank. Although these two banks represented less than one per cent of the assets of the Canadian banking industry, important questions arose about the circumstances surrounding the failures.

That prompted the government to launch a commission of inquiry into the failures, led by the Honourable Willard Z. Estey.

In late 1986, the government announced its intention to merge the Office of the Inspector General of Banks and the Department of Insurance into one entity: the Office of the Superintendent of Financial Institutions.

OSFI came into being on July 2, 1987.

The will to act

OSFI's creation was more than a symbolic gesture, and more than a simple merger of two distinct organizations. It was about establishing a new and more empowered approach to regulation and supervision.

Above all, it was about creating a regulator and supervisor that would have the characteristic that Justice Estey valued above all: "the will to act."[1]

Let me give you an early example.

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[1] Estey, Willard Z. *Report of the inquiry into the collapse of the CCB and Northland* Bank, Ottawa, Canada: Minister of Supply and Services Canada, 1986

In the wake of the oil price shocks of the 1970s, many of the world's major banks developed a new line of business: taking deposits from cash-rich oil producers and using them to make loans to what were then called "less developed countries" or LDCs.

Tempted by the initial profitability of this business, many banks turned a blind eye to their high exposure to a small group of borrowers, and to the very limited security that they had on loans to sovereign countries. By the time OSFI was set up in 1987, the large loans that many Canadian and foreign banks had made to Latin American countries had already begun to turn sour.

Within two months of taking office, Michael McKenzie, the first Superintendent, instructed the Canadian banks to proactively increase their provisions on these loans to quite conservative levels. He also obliged the banks to charge those increased provisions against income immediately, rather than spreading the charge over five years, as had been the previous practice.

Not long after, he instructed the major Canadian banks to exceed the newly developed international standards for the quality of the capital that they were required to hold.

These were bold and unpopular moves in the banking industry.

In what would become a familiar scenario, OSFI was criticized for being too conservative.

But looking back, even the former head of the Canadian Bankers Association, Robert MacIntosh, conceded the point. "In retrospect, Mackenzie was right," he wrote. "By pursuing a rigorous policy, he helped force the Canadian banks to take drastic action to strengthen their balance sheets."[2]

Thirty years later, this proactive approach — this "will to act" — remains one of the keys to our success.

A balanced mandate

Let us turn now to the mid-1990s and to the second chapter in our story — when OSFI received its balanced mandate.

The second Superintendent of Financial Institutions, John Palmer, took the helm of the organization as the severe recession of the early 1990s left its mark on the Canadian financial system.

In his first speech as Superintendent, John reported that over 100 federally-supervised financial institutions had gone out of business on OSFI's watch. Most of those went quietly, through merger or windup, with little or no losses for depositors, policyholders, or other creditors.

But not all.

For example, what was, and remains, the largest financial institution failure in Canadian history took place in 1994: the demise of Confederation Life.

This experience — as well as the other failures and near-failures — motivated the government of the day to consider what OSFI's mandate *should be*.

[2] MacIntosh, Robert. *Different Drummers: Banking &Politics in Canada*. Toronto, Canada: Macmillan Canada, 1991

The existing legislation already tasked OSFI with regulating and supervising financial institutions, but it was largely silent about the goals and objectives that should guide OSFI in those tasks.

The revisions to the *OSFI Act* in 1995 enshrined a clear mandate for the organization, one with two major elements.

First, OSFI is to regulate and supervise financial institutions so as to protect the interests of depositors, policyholders and other creditors.

Second, and simultaneously, OSFI is to be mindful of the importance of allowing financial institutions to compete effectively and take reasonable risks.

Our *Act* makes it very clear that it is not simply a suggestion that OSFI balance these two aspects of its mandate. It is a requirement.

“Regulation and supervision *must* be carried out…”[3] says the *Act*, with regard for the fact that the provision of financial services requires risk taking, and that risk taking can lead to failures.

At the same time, Parliament gave OSFI two roles to play.

The first is to reduce the likelihood that financial institutions will fail — that is the role to which we devote most of our time.

The second is to be ready to step in promptly to minimize the impact of failures on depositors and other creditors when failure cannot be avoided.

This means that when there are no failures, we are doing our job, as long as we have been effectively promoting the safety and soundness of the institutions. It also means that when there *are* failures, we are also doing our job, as long as we intervene promptly to prevent further deterioration of the position of the depositors, policyholders and other creditors.

The confidentiality clause

Let me now say a few words about confidentiality, as this is a cornerstone of how we do our job and a key part of what makes us effective.

From the beginning, OSFI has had broad powers to compel financial institutions to give us information. And, under the *OSFI Act*, we are bound by legislation to keep that information confidential.

This brings me to the third chapter in our history that I will highlight today — the crucial reinforcement of OSFI’s approach to confidential information through legislation and regulation.

In the year 2000, late in John Palmer’s term as Superintendent, a new issue arose.

The Office had recently completed a new risk-rating scheme for financial institutions. To get the maximum benefit from the new system, John wanted to be able to share each institution’s risk rating with the institution itself. Before doing that, however, he wanted to ensure the ratings would remain confidential.

[3] *Office of the Superintendent of Financial Institutions Act* (R.S.C., 1985, c. 18 (3rd Supp.), Part I) http://laws-lois.justice.gc.ca/eng/acts/O-2.7/FullText.html

OSFI had two main reasons for this.

First, it would allow us to move a troubled institution through our stages of intervention — a process which aims to improve the soundness of an institution — without having the perverse effect of undermining public confidence in the institution and destabilizing it.

Second, this confidentiality would encourage institutions to be open with us about their issues, knowing that if those issues caused us to downgrade our opinion of the institution, that opinion would not be disclosed.

Fortunately, the government of the day agreed with those arguments, and adopted regulations that protected the confidentiality of supervisory information.

In my view, both of the promised advantages of this approach to confidentiality have been realized in Canada.

Building on the legislative requirements, we have long maintained a policy not to comment on individual financial institutions, even when such comments would not violate the confidentiality provisions of the legislation.

Why do we maintain such a strict discipline?

It is because any comment that we might make on a specific institution would immediately be parsed for what it could reveal.

Everything we said would be closely examined for what it might signal about our confidential knowledge: what we chose to say, or chose not to say, how our comments contrasted with what we had said about other institutions, how they contrasted with what we had said about the same institution previously, and so on.

So you will not hear any institution-specific comments from OSFI.

I hope you will keep this in mind if and when you notice our reticence to speak about what we know, or what we are doing.

At the same time, we are strong proponents of disclosure about financial institutions by the financial institutions themselves. All OSFI-supervised institutions, even those that are privately held, are subject to disclosure requirements that are tailored to the nature and size of the institution.

Moreover, the fact that our domestic systemically important banks are among the world leaders in disclosure is partly due to our strong encouragement.

The Global Financial Crisis

No tour of OSFI's history, however brief, would be complete if it did not include the 2008 Global Financial Crisis — the fourth chapter in my selective history.

As is well known, our banks and insurers demonstrated remarkable resilience that attracted increased global attention to Canada's system of financial regulation and supervision.

Many articles have been written about the performance of the Canadian financial sector during the crisis. All of those articles cite, as a crucial factor, the proactive approach taken by the third and fourth Superintendents, Nick LePan and Julie Dickson.

Nick and Julie demonstrated their “will to act” by raising capital standards above the international norms, and by strengthening the hands-on supervisory approach that had been launched by their predecessors.

These, too, were not among OSFI’s more popular initiatives at the time, but they proved their worth during the crisis.

I mention this chapter in OSFI’s history to highlight another feature of our organization: OSFI’s resistance to complacency and its resolve to learn and improve.

We were fortunate to have had Julie Dickson as Superintendent throughout the crisis period, and for the years following. She might have been expected to think that OSFI’s success during the Global Financial Crisis showed that our regime was already up to the task and needed no further improvement. Instead, she and her colleagues saw the crisis for what it was: a wake-up call that more needed to be done to make the Canadian financial system resilient.

Rather than being complacent, OSFI increased the quantity and quality of capital that institutions were required to have, strengthened liquidity requirements, and developed new or revised guidance in key areas, including corporate governance, regulatory compliance and operational risk, to name but a few.

The road ahead

Each of the four chapters in OSFI’s history that I have spoken about today provides a lesson from the past that OSFI must apply to the future.

The events that led to the creation of OSFI highlighted the need for the “will to act”. You can see this in our current approach to mortgage underwriting standards.

We clearly see the potential risks caused by high household indebtedness across Canada, and by high real estate prices in some markets. We are not waiting to see those risks crystalize in rising arrears and defaults before we act.

Rather, we are adapting our standards to new developments, as set out in our 2016 letter to the industry about mortgage underwriting, and our recently proposed changes to the *Residential Mortgage Underwriting guideline*, commonly known as B-20.

To implement our balanced mandate, we need to ensure that the expectations that we set for financial institutions are principles-based and scaled to the size and complexity of the institutions we supervise, wherever possible.

Later this year, we will showcase an example of our commitment to this practice through our revised approach to ensuring the effectiveness of board oversight of financial institutions.

Our policy of protecting confidential information is firmly established and well entrenched in legislation; we will maintain that discipline so as to maximize our effectiveness.

And finally, we will continue to combat complacency by maintaining our commitment to continuous improvement. For example, we recently completed major overhauls of our capital requirements for life insurers and mortgage insurers to take advantage of new data and new risk modelling techniques.

We will soon move forward with improvements to our bank capital regime, whether or not the Basel Committee on Banking Supervision can come to a new agreement.

Conclusion

All of my predecessors have banged the drum against complacency, and with good cause.

The future will be very different than the world of today, and no one knows how the next crisis will emerge.

Parliament has charged us with a well-designed mandate, and OSFI has built an enviable record of fulfilling that responsibility.

By remaining focused on that mandate, by having the will to act, by staying disciplined about confidentiality, and by constantly learning and improving, I believe that OSFI will continue to build a record of success well into the future.

Thank you. I would be happy to answer your questions.