



▶ OSFI ANNOUNCES ITS PLAN AND PRIORITIES FOR 2010-2013 1



▶ OSFI RELEASES ESTIMATED SOLVENCY RATIOS FOR FEDERAL PENSION PLANS ...3



▶ REMARKS BY THE CHIEF ACTUARY TO THE ISSA TECHNICAL SEMINAR4

○ ISSUE 1 | ○ VOLUME 4 | ○ SPRING 2010



OSFI
BSIF

The OSFI Pillar

FROM THE OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS CANADA (OSFI)

Embedded Contingent Capital: A Means for Achieving Market Discipline



The following is an essay entitled, "Protecting banks is best done by Market Discipline," written by Superintendent Julie Dickson and published in the April 9, 2010 edition of the Financial Times.

counteracting the effects of this moral hazard on financial systems. Proposals include 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.

A strong financial system needs market discipline. Unfortunately, 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, creating a strong 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 a better way, which goes by the name of embedded contingent capital. This is a security that converts to common equity when a bank is in serious trouble, instantly increasing the core capital of the bank without the use of taxpayer dollars. The principle is similar to "CoCos", the convertible bonds already issued by some banks. But it would apply to all subordinated securities and would be at least equivalent in value to the common equity.

Regulators and politicians are setting out proposals aimed at

(cont'd page 2)

OSFI Announces its Plan and Priorities for 2010-2013

The Office of the Superintendent of Financial Institutions has posted its Plan and Priorities for 2010-2013. As the core document for OSFI's annual planning cycle, the Plan and Priorities for 2010-2013 outlines key challenges and risks and describes OSFI's priorities for the planning period.

While financial markets have stabilized, risk and uncertainty in the global economy persists, and this is expected to have a continuing impact on the financial institutions and pension plans subject to OSFI oversight.

Through our regulatory and supervisory oversight practices, OSFI will continue to focus on ensuring that financial institutions and pension plans maintain a strong capital base and sound risk management practices.

To view the complete document, visit the OSFI web site at www.osfi-bsif.gc.ca

OSFI Priorities at-a-Glance 2010—2013

- Enhanced Identification of Emerging Risks
- Institutional and Market Resilience
- IFRS
- Capital Adequacy
- Addressing Internal Risks

Dickson: Embedded Contingent Capital... (cont'd from page 1)

This would create a notional systemic risk fund within the bank itself – a form of self insurance pre-funded by private investors to protect the solvency of the bank.

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 stabilise 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 re-capitalised 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, when the value of common equity is minimal. 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 minimising 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 so deep 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.

What would be new is that investors in bank bonds would now have a real incentive to monitor and restrain risky bank behaviour, to avoid heavy losses from conversion to equity.

A key aspect of the proposal is that governments would not guarantee any bank or provide emergency capital unless conversion of contingent capital had taken place. This would ensure that penalties would be doled out appropriately and that taxpayers would not have to foot the entire bill. The larger the contingent capital buffer, the less need there would be for government funds.

Another advantage of embedded contingent capital is that it avoids any need to create a systemic risk fund, which could lead to concerns about what to do with such a fund over time. Instead, investors with a financial interest would decide what each bank should pay when contingent capital was issued – with riskier banks penalised by the market. Thus, regulators would not have to develop a specific charge on systemically important institutions, which is extremely difficult to do.

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 – the shareholders and subordinated debt holders. The reward for its implementation would be a much safer global financial system.



OSFI Issues Seven Draft Revised Accounting Guidelines

OSFI's accounting guidelines currently provide guidance to Federally Regulated Entities (FREs) when applying Canadian Generally Accepted Accounting Principles (GAAP). Since all FREs will be adopting IFRSs for fiscal years beginning on or after January 1, 2011, OSFI's accounting guidelines required revision to align with IFRSs requirements, terminology and references.

OSFI performed a detailed analysis of each accounting guideline in light of requirements under IFRSs. The detailed review resulted in proposed changes that are reflected in the draft revised accounting guidelines or in a recommendation that certain guidelines be rescinded. The final accounting guidelines are targeted for issue in July 2010 with the effective date coinciding with the FREs' adoption of IFRSs.

FREs are invited to provide comments regarding the draft guideline revisions by June 15, 2010.

To view complete documents related to the above, visit the OSFI web site at: www.osfi-bsif.gc.ca

Remarks by Judy Cameron to the House of Commons Standing Committee on Finance

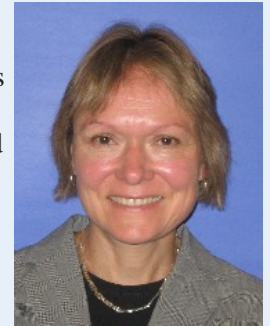
The following is a brief excerpt from remarks by Judy Cameron, Managing Director, Private Pension Plans Division, to the House of Commons Standing Committee on Finance. Ms. Cameron briefly describes the current pension environment and the tools used by OSFI for monitoring the status of federal pension plans.

Everyone is aware of the financial and economic turmoil of the past two years. These developments have produced a double-hit to defined benefit pension plans, as the value of pension assets and liabilities fluctuate with changing financial and economic conditions. The impact of this is reflected in OSFI's solvency testing results. Solvency testing is a key element of OSFI's enhanced monitoring of federal pension plans.

Pension regulations do not require defined benefit pension plans to be fully funded at all times. But, where the ratio of assets to liabilities on a solvency, or liquidation, basis is less than one, the plan must make payments to address the deficiency. OSFI requires under funded pension plans to file an annual valuation report. In addition, we estimate solvency ratios for federal pension plans every six months to provide a snapshot of the financial health of the defined benefit plans we regulate.

Regulation alone cannot improve the environment for pensions. Effective plan governance is also critically important to controlling risks. A key focus of OSFI's supervision is therefore an assessment of the quality of a pension plan's governance. OSFI recognizes that Canadians are concerned about the health of their pension plans. It is important that governments, regulators and pension plan administrators work together to meet the challenges facing private pension plans.

To view the complete remarks, visit the OSFI web site at: www.osfi-bsif.gc.ca



Judy Cameron
Managing Director
Private Pension Plans
Division

OSFI Releases Estimated Solvency Ratio (ESR) for Federally Regulated Private Pension Plans

On Thursday, April 15, 2010, OSFI made public the results of its latest solvency testing of federally regulated private pension plans. OSFI's most recent estimates show that the average ratio has increased modestly to 0.90 at December 2009. An indicator that has shown a more marked improvement is the proportion of materially under-funded plans. Based on OSFI's estimates, at the end of 2009, only 15 per cent of all federally regulated pension plans had a solvency ratio of less than 0.80, whereas at the end of 2008, the comparable proportion was 40 per cent.

To view the complete news release, visit the OSFI web site at: www.osfi-bsif.gc.ca

Chief Actuary of Canada seeks external peer review panel for Actuarial Report on the Canada Pension Plan

The Office of the Chief Actuary (OCA) is commissioning an external peer review of its next Actuarial Report on the Canada Pension Plan (CPP), expected to be released in December 2010. Actuarial reports on the CPP are conducted every three years and are used by the federal and provincial ministers of finance when reviewing and making recommendations on the CPP.

The peer review is intended to ensure that the actuarial reports meet high professional standards and are based on reasonable assumptions in order to provide sound actuarial advice to Canadians. The review will be conducted by members of with the Canadian Institute of Actuaries.

To view the complete news release, visit the OSFI web site at: www.osfi-bsif.gc.ca

Chief Actuary Jean-Claude Ménard's opening remarks to the Technical Seminar of the ISSA

The following is a brief excerpt from the Chief Actuary's opening remarks to the Technical Seminar for Social Security Actuaries and Statisticians in Uruguay. Jean-Claude Ménard is chairman of the **International Social Security Association (ISSA)** Technical Commission on Statistical, Actuarial and Financial Studies.

The overall focus of ISSA for the 2008-10 triennium was on Demographic Changes and Social Security. During the last three years, our Technical Commission has addressed two main projects. The first project was "Longevity improvements and its impacts on the sustainability of social security schemes", and the second project was "Optimal financing of social security schemes in changing demographic environment."

The Commission has also supported two international surveys: the first on the demographic and economic assumptions used in the actuarial analyses of social security schemes, and the second on self-adjustment mechanisms for social security schemes. Another initiative of the Commission is the construction of mortality tables for the countries where such tables do not exist.

The Commission's activities were inevitably affected by the world-wide financial and economic crisis of 2008-2009. However, dealing with the short and mid-term consequences of this crisis, it is important not to forget long-term problems like population aging. Aging is an important cause of economic insecurity due to loss of earned income and deterioration of health. A social security system is the main channel through which a society can build a protection net for its elderly citizens to help them plan for the future and to safeguard them from poverty.

The rapidly changing demographic and economic conditions around the world demand that we apply the best of our professional abilities with integrity and a social conscience.

To view the complete remarks, visit the OSFI web site at: www.osfi-bsif.gc.ca



Jean-Claude Ménard
Chief Actuary

What's New Online (www.osfi-bsif.gc.ca)

Regulation and Supervision of Reinsurance

OSFI has finalized its policy approach to reinsurance regulation and supervision and has issued a response paper outlining policy decisions and impending reforms to reinsurance regulatory and supervisory framework.

Capital Targets - Federally Regulated Insurance Companies

This Guideline sets out OSFI's expectations for federally regulated life insurance companies and federally regulated property and casualty insurance companies. Comments concerning this Draft Guideline should be forwarded to OSFI before August 31, 2010.

Mortgage Insurance

OSFI released an Implementation Note on Mortgage Insurance to provide further information related to the implementation of the *Mortgage Insurance Business (Banks, Authorized Foreign Banks, Trust and Loan Companies, Retail Associations, Canadian Insurance Companies and Canadian Societies) Regulations*.

Infopensions - May 2010 Issue

InfoPensions provides the latest information from OSFI's Private Pension Plans Division. This newsletter and previous issues are available on the Pensions Page of the OSFI Web site.

To view complete documents for the above items, visit the OSFI web site at: www.osfi-bsif.gc.ca

SUBSCRIBER NOTIFICATION



Would you like to be notified when notices or items of interest are posted to the OSFI Web site? Then on your next visit to our site, sign up for notifications at the Subscription Centre located on the home page.

Just select your areas of interest, and when something is posted in that area, you will receive an email with a link to the relevant information.

The OSFI Pillar

The *Pillar* is published by the Communications and Consultations Division of the Office of the Superintendent of Financial Institutions Canada.

For a free subscription, or to provide feedback, please e-mail OSFI Communications and Consultations at: thepillar@osfi-bsif.gc.ca



255 Albert Street
Ottawa, Ontario K1A 0H2