



**Remarks by Superintendent Julie Dickson
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
Financial Services Institute**

**Toronto, Ontario
Thursday, June 26, 2008**

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Introduction

It is good to be here to speak about the past year — in a few days I will have been in the job of Superintendent of Financial Institutions for one year, and quite the year it has been.

Today I want to talk about the two things that have struck me the most over the past year: the strength of Canada's regulatory and banking brand, and the understanding of OSFI's mandate.

Canada's Brand

A strong banking system is a critical element of a strong national economy. And internationally, the reputation of a country's financial system is largely based on the soundness of its banks, because banks — and their interactions with one another — are at the core of the global financial system.

Recently a person based in the UK referred to “Brand Canada”. The person noted that, internationally, the Canadian “brand”, is very strong. This is based on the perceived strength of the underlying fiscal and economic fundamentals, and the lower risks associated with Canadian banks, the corporate sector and the household sector.

Further, I am told that the recent financial market dislocation has enhanced interest in Canada — especially from a counterparty credit risk perspective — because market participants are aware that Canada is weathering the turbulence better than some others. Canadian banks are generally seen as strong counterparties as they tend to be more conservative and better capitalized than many other banks.

The Canadian regulatory brand is also extremely strong internationally. OSFI has played leading roles on the Basel Committee and the International Association of Insurance Supervisors (IAIS). OSFI has been assessed twice by the International Monetary Fund (IMF), and we received top marks on both occasions, most recently in February 2008. We recently volunteered to be assessed again on our

implementation of Basel 2. The international assessors were on site in April and May, and we expect them to issue a report soon.

The institutions we regulate frequently tell us that their ability to enter into other markets is enhanced by the strong reputation OSFI has internationally. This did not happen overnight. It has taken consistent effort to remain in the top tier of prudential regulators internationally, and I am pleased that we have been able to maintain our position.

While turmoil in global financial markets remains an issue, the Canadian banks have withstood a tremendous amount of strain to date. The Canadian banks' ability to cope was evidence not only of their own efforts, but also of prudent oversight and supervision, including features of the Canadian market such as strong capital positions. Further, there was less dis-intermediation in Canada (Canadian banks securitized fewer assets than others) which means that fewer assets have to be put back on balance sheets than elsewhere. That being said, financial market turmoil is still with us and we are definitely not out of the woods. But increased disclosure by banks means that markets are better positioned to predict the further losses that may occur. Going forward, as noted in the Bank of Canada's FSR, a key downside risk would appear to be a deeper than currently expected downturn in the U.S., which could also trigger further significant write-downs and an erosion of profitability.

However, everywhere I go, many people say to me that Canada has fared well in comparison to many other countries. This theme was recently repeated by an official of the IMF and a former chair of the Federal Reserve¹.

In Canada, non-bank ABCP was in the spotlight as one of the more visible fallouts from the global liquidity crunch. Some commentators suggested that OSFI had lax rules, or unique rules that allowed the non-bank market to flourish. In fact, OSFI's rules were irrelevant for non-banks and OSFI had robust capital guidelines that helped the Canadian banking system better withstand the turmoil than other countries.

First, OSFI had a target capital requirement of 7 per cent for Tier 1 capital, and 10 per cent for total capital. Many others countries simply relied on 4 per cent for Tier 1 and 8 per cent for total capital.

Second, OSFI does not allow banks to take on risk without having the commensurate amount of capital to backstop that risk. Thus, we had a capital rule that said that if banks were taking on risk by acting as unconditional liquidity providers to ABCP conduits, they would have to put up the requisite capital to backstop the risk in those liquidity lines.

¹ Heather Scoffield, "Credit Crunch: Canada praised for dodging crisis", *The Globe and Mail*, June 10, 2008.

“Brand Canada” is strong capital, both in terms of level and quality.

“Brand Canada” is also increasingly being linked to robust disclosure by banks. Canadian banks achieved substantial compliance with the enhanced FSF disclosure recommendations even though their mid-year reporting is a full two months ahead of North American and European banks.

In addition to robust capital and oversight and supervision, there are other elements that make up a strong Canadian financial system.

As an example, from a bank supervisory perspective, Canada is seen as a model in terms of inter-agency communication. I, along with the Governor of the Bank of Canada, the Chair of the Canada Deposit Insurance Corporation (CDIC), the head of the Financial Consumer Agency of Canada (FCAC), and the Department of Finance continually meet as a group, and we greatly increased that interaction beginning in early August 2007. We do not need instructions to facilitate this interaction; we do it because inter-agency communication is important, and it strengthens the Canadian financial system.

Canada also has a world-class deposit insurance system. The UK is currently looking to the CDIC for help and guidance on what makes a good deposit insurance system.

A strong banking system is not an accident, and OSFI plans to build on the current strengths in the system, to make it even more resilient to future challenges. OSFI has already begun work on implementing the 60+ changes which are recommended in the recent Financial Stability Forum report. These changes are prudent and necessary, and will serve to further strengthen Canada’s financial brand.

We have also seen that having a prudent regulatory regime pays, and can be a competitive advantage. While regulation has costs, and we sometimes receive complaints that OSFI is too tough, some Canadian banks may now be better placed to take advantage of global opportunities due to their financial positions, along with a strong Canadian dollar and economic fundamentals here at home.

OSFI's Mandate

There has been considerable discussion of OSFI’s mandate in recent months – whether we met it and even whether it is appropriately cast.

What is OSFI's mandate as it pertains to financial institutions?

Under our legislation, OSFI’s mandate is to:

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

Further, our Act says that, in doing all of this, the Office shall strive to protect the rights and interests of depositors, policyholders and creditors of financial institutions, having due regard to the need to allow institutions to compete effectively and take reasonable risks. Also, OSFI's legislation says that, even though regulation and supervision reduces the risk of failure, regulation and supervision must be carried out recognizing that institutions are run by their management and boards, that they carry on business in a competitive environment that requires them to manage risk, but that they can face financial and funding problems that can lead to their failure.

This is actually a complex mandate, though some parts are very clear.

For example, the Act notes that OSFI is not running a failure-free supervisory regime. Normally countries do not run failure-free regimes, because that would force supervisors to severely limit risk taking, which would inhibit innovation at financial institutions and reduce economic benefits. But if OSFI does not intervene when problems are first discovered, and does not use appropriate tools to try to limit losses, we would not be doing our job, which is to protect the deposits of Canadians, many of whom have their life savings in Canadian banks.

While OSFI has many tools with which it can effect change at an institution in order to try to prevent a failure, it is the management and boards of directors who are ultimately responsible. It is management and the board who set business plans and strategies, invest in control systems, create the culture, and take the decisions on a day-to-day basis.

To put this in perspective, OSFI has 500 people to cover 450 financial institutions and 1300 pension plans. In comparison, typically a big bank will have hundreds of people in risk management and internal audit alone. While OSFI does everything possible to reduce the risk of failure (as evidenced by Canada's history of few failures), the Act says that a decision by OSFI to close a financial

institution is a key part of OSFI's responsibility, so as to protect Canadians' life savings held in deposits.

Other parts of our mandate require considerable judgement. The legislation says that we need to have due regard to allow financial institutions to compete effectively and to take reasonable risks. This begs the question, what is a "reasonable" risk? That is one of the key challenges and often we debate with institutions what a reasonable risk is.

The freezing of the non-bank ABCP market led some to suggest that OSFI's mandate was too narrow. Others implied that the mandate was just fine but that OSFI did not meet it because we did not do something about the non-bank ABCP market, whose collapse might have affected Canadian banks — and part of our job is to monitor and evaluate system-wide issues that may impact financial institutions negatively.

OSFI's view is and has been that the collapse of any sector, whether it be non-bank ABCP, real estate, telecom or whatever, always has an impact on banks. The key for us is to know what exposure the banks have to such sectors, and assessing the risk to banks from those exposures should something go wrong. Another key factor for us is stress testing — financial institutions have to consider, in their stress testing, the indirect impacts as well as the direct impacts of something going wrong.

But sometimes there are surprises and even markets with long track records can be affected. In the non-bank ABCP case, there was no consensus that the market posed a significant risk; indeed, the market had worked very well for the previous 17 years and some developments had occurred that were seen as being positive, such as DBRS' decision to change its rating methodology in January 2007.

That is why bank regulators focus on cushions for the unexpected and as well we try to determine whether the banks are too exposed to areas that may be problematic. Even that is a question of judgement.

Looking Forward

Going forward, we need to look at the key factors that lead to financial stability. Is there anything that regulators or accounting standard setters or central banks do that leads to instability? For example, we need to determine whether capital rules are pro-cyclical (amplifying distortions by fuelling aggressive lending on the way up and generating severe pullbacks from credit granting on the way down). We also need to know whether pro-cyclicality is related more to badly managed banks with insufficient capital cushions than to the capital rules themselves — as

there is nothing more pro-cyclical than a badly managed bank². To try to get to the bottom of this, the Basel Committee has developed a comprehensive reporting scheme to track the impact of Basel 2 on both the level and cyclicity of capital in the banking system.

We also need to work with accounting standard setters to determine whether Fair Value accounting rules are pro-cyclical. Do accounting rules and valuations drive asset prices lower in a downturn and higher in an upturn (reflecting the fact that markets overshoot, thus causing fair values to overshoot both on the way down and on the way up)? Or do fair values provide neutral information on market conditions, thereby revealing which institutions have the most complex assets and possibly limiting the build-up of such assets in good times so that there is less to offload in down times? We also need to determine whether accounting rules for loan loss provisions are pro-cyclical by preventing banks from building up reserves in good times, or whether they are neutral in the sense that they prevent management from "managing" financial statements for their own ends in good times and in bad. We need to bring this debate to ground quickly.

As well, what is the public expectation of bank regulators and central bankers when it comes to financial system stability? If we put all the financial stability assessments that were done prior to the turmoil in the financial markets in one room, we could probably fill a stadium. These reports all represent a perspective on something that might affect the system. The volume of paper indicates how difficult it is to predict with certainty. But is there an expectation that a regulator or central banker should be better at predicting the future than other participants? Up to this point, regulators have understood the limitations associated with predicting the future direction of the financial markets, so they have focused on cushions for the unexpected – and the more focused regulators were on cushions, the better off their banking systems were.

I think we can never take our eyes off the cushions, but we can always try to do a better job of anticipating the future direction of the financial markets. However, I do not think we can kid ourselves about the difficulty in doing the latter – each time there is a bubble, there are always fascinating debates and questions about whether the exuberance reflects a new paradigm based on changed fundamentals, or irrational behaviour. This time the innovation was credit risk transfer and slicing and dicing securities to reach more peoples' investment needs. Before that it was technology changing the world. The list goes on.

Another good question pertains to oversight of core institutions like banks versus oversight of the financial system such as the infrastructure that underpins the decentralized over-the-counter markets, which the U.S. Federal Reserve is focusing on now. A related issue is whether private pools of capital such as hedge funds should be regulated and if so, who should regulate and how – as

² Jesus Saurina, Banco de Espana, 'Banking on the Right Path', *Finance & Development*, Quarterly magazine of the IMF, June 2008, Vol 45, No 2.

this is much easier said than done. We will be following these discussions very closely.

None of the above questions have complete answers, but they are being asked by OSFI and by everyone who is closely involved in the regulation of banks in particular. One positive outcome of financial market turmoil has been the move to debate some very large issues and to reflect on what we do and why. Such dialogue moves everyone forward and I continue to encourage it.

Thank you.