Preventing financial institution failures in Canada: Importance of corporate governance

Remarks by Mark Zelmer, Deputy Superintendent, to the Risk Oversight Program
Global Risk Institute
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Thank you for inviting me to speak to you today about the lessons learned from past failures of financial institutions. We all benefit from a stable, efficient and competitive global financial sector. But when a financial institution fails, questions arise about how it happened and whether it could have been prevented. I believe that this program is well timed, as it is important to identify the risks your organizations face during the relatively calm periods, rather than waiting until one is in the midst of a crisis.

OSFI has learned many lessons from past failures, which serves us well as we work to contribute to public confidence in the Canadian financial system. Let me share some thoughts with you.

The Canadian experience

Let's begin with a little bit of history. Unlike some other industrialized countries where financial institutions come and go on a regular basis, there have not been very many outright financial institution failures in Canada recently.

Not many – but there have been a few rather notable failures in Canada, including:

- Home Bank in 1923. Its failure led to the creation in 1925 of the Inspector General of Banks (one of OSFI’s predecessor agencies);
- Canadian Commercial Bank and Northland Bank in 1985. This failure set the stage for OSFI's creation in 1987;
- The disappearance of most of the trust and loan industry by the early 1990s. This culminated in the failure of Central Guaranty Trust Company in 1992. It had $10.4 billion in deposits; and
- The 1994 failure of Confederation Life, an insurance company conglomerate. This was the largest financial institution failure in Canadian history and led to the creation of OSFI's current mandate in 1995.

Many factors contributed to these failures, and I’ll talk about some of those. But let me make one thing clear. The root cause of financial institution failures is usually poor corporate governance and weak internal controls.
OSFI was created to contribute to public confidence in the Canadian financial system. Having a clear mandate in legislation has been and continues to be critical to OSFI’s effectiveness. Our mandate makes it clear that we are to focus on prudential issues and emphasizes early supervisory intervention in problem institutions so as to minimize potential losses to depositors, policyholders and creditors. Of equal importance is what is not included in our mandate – for example, market conduct or promoting Canada as an international financial centre – which keeps us focused on maintaining a safe and sound financial system.

Often when a financial institution encounters stress, it is able to find a suitable merger partner or willing buyers for all or part of its business. This is due to the significant franchise value that may exist within the business. Consequently, the resolution of most stressed financial institutions has been fairly orderly, with minimal disruption to the Canadian financial system.

Today’s Toronto-Dominion Bank (TD), for example, is the result of several purchases and acquisitions of institutions that were experiencing stress, notably Dominion Bank in 1955 and Central Guaranty Trust in 1992 (just to name two). The same is true for the Canadian Imperial Bank of Commerce (CIBC), the Royal Bank of Canada (RBC) and the National Bank of Canada (NBC) – although perhaps not to the same degree as TD.

CIBC is the offspring of a merger between the Canadian Bank of Commerce and the Imperial Bank of Canada in 1961. RBC acquired Northern Crown Bank in 1918 and Union Bank of Canada in 1925. NBC is the result of a significant merger in 1979 between Canadian National Bank and the Provincial Bank – one of the largest bank mergers in Canadian history.

A similar trend has taken place in the life insurance industry. Witness the dismemberment of the remains of Confederation Life in the 1990s, and the disappearance of some notable life insurance groups, which although quite healthy, were merged over time with other institutions (e.g. Crown Life, Mutual Life, Canada Life and London Life).

A ‘bury the dead’ approach for ‘sick’ institutions has generally worked well here in Canada. But, it is questionable whether it would work in the event of a failure of a large, complex financial institution (e.g. one of the six major banks). The global financial crisis suggests likely not.

That is why our partners in Canada and abroad are actively engaged in looking for ways to ensure that all financial institutions can be resolved in an orderly fashion without the public purse being the first port of call. But, I digress.
OSFI’s approach

The Northland and CCB failures in the 1980s are of particular importance. At the time, the Estey Inquiry, which was launched to investigate the causes of these failures, recommended that the “wink-and-nod system of regulation [of the Office of the Inspector-General of Banks] needed to be reshaped and strengthened”.¹

This led to the creation of OSFI (under the OSFI Act) in 1987 as the sole federal and integrated prudential regulator – with a new mandate and stronger supervisory powers. These reforms were an important contributor to the relative stability of Canada’s financial sector during the recent crisis.

It is important to note that according to the OSFI Act, OSFI’s mandate explicitly allows for financial institution failures. This is an occasional, and sometimes necessary, outcome of a competitive and relatively easy-to-enter financial services market.

OSFI’s overall approach is to have in place strong and effective supervision of financial institutions ex ante, and to have a system of early intervention, to promote good governance and risk management practices and controls prior to any serious problems arising.

We have, for example, a well-developed system of ‘staging’ with heightened monitoring and escalating actions that are tailored to the circumstances surrounding a troubled institution.

Strong supervision and early intervention are essential. This is a message that OSFI emphasizes in its dealings with its international counterparts at the Financial Stability Board (FSB), the Basel Committee for Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS).

Our former Superintendent, Julie Dickson, was the chair of the Supervisory Intensity and Effectiveness Committee at the FSB – and this group has completed some important work in this area over the past few years.²

In times of financial institution distress, there is a need for OSFI to work closely with its partners, inside and outside of government.

OSFI’s Superintendent chairs the Financial Institution Supervisory Committee (FISC). This committee includes members from the Department of Finance, the Bank of Canada, the Canada Deposit Insurance Corporation and the Financial Consumer Agency of Canada. All of these agencies have an interest and play important and complementary roles in the recovery or resolution of a troubled institution. In addition, FISC helps to facilitate consultations and the

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exchange of information among its member agencies that relate more generally to the supervision of deposit-taking institutions and insurance companies.

The Superintendent and a Deputy Superintendent are also members of the Board of Directors of Canada Deposit Insurance Corporation. CDIC is responsible for providing deposit insurance and acting as the resolution authority for its member institutions. As well, OSFI works with private sector compensation schemes for situations related to insurance companies.

Banking vs. insurance

Stress scenarios of deposit-taking institutions and insurance companies often differ.

For deposit-taking institutions (DTIs), time is of the essence. Depositors and other creditors can remove their support if they lose confidence in an institution. Consequently, when a DTI encounters stress, there is often a constant and unrelenting threat of a deposit run, not to mention a run more generally of all holders of its liabilities.

So bank supervisors must act quickly to either ‘stop the bleeding’, so to speak, when a going-concern institution faces temporary difficulty or, if the institution is no longer viable, to resolve it effectively with minimal disruption to depositors, creditors and the broader financial system.

By contrast, insurance supervisors often have more time to resolve insurance companies. Insurance companies are less vulnerable to such scenarios and runs, given the more defined contract-driven relationship with policyholders – unless of course an insurance company relied heavily on short-term wholesale funding. The 1994 failure of Confederation Life comes to mind.

For insurance companies, stress scenarios generally develop for essentially two reasons: mispricing and catastrophes.

With respect to mispricing, OSFI officials have in past few years spoken extensively, in a number of public speeches, about the importance of having actuarially sound premiums. The risks of mispricing can be compounded when coupled with rapid (and uncontrolled) growth in insurance business.

A property and casualty insurance company can also be vulnerable to natural disasters and catastrophic losses. Where mispricing often brings about a slow and often drawn out demise in a company, a catastrophic event can lead to insolvency quickly. A natural disaster has been the primary cause of two failures in Canada: National General Insurance (1952) and Mennonite Mutual Hall Insurance (1984). In the past two years, OSFI has focused much of our insurance work in this area. Last year, we published a guideline on sound practices in managing earthquake exposure.

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Of course, reinsurance can act as a defense mechanism for both scenarios. However, over-reliance on reinsurance can be dangerous if it is used as a means to effectively ‘rent’ capital to support rapid growth in insurance premiums. Often, reinsurance cover can evaporate when a company encounters stress (ironically, when the company needs the reinsurance the most), as it struggles to renew its commitments. In such situations, a company can be caught off guard and fail if it cannot quickly raise fresh capital to replace the disappearing reinsurance cover. The failure of Canadian Millers’ Mutual Insurance Company in 2001 is a case in point of how this kind of situation can unfold.\(^4\)

Regulatory capital thus continues to play a critical role in maintaining viability for deposit-taking institutions and insurance companies. The quality of internal risk management is also important.

For example, in the case of Lehman Brothers, it reported a Tier 1 capital ratio of just over 10 per cent in May 2008. It failed later that year. The global disruption that ensued led to a wholesale re-evaluation of bank capital requirements known as Basel III. An important feature of the new requirements is a greater emphasis on common equity capital – the most loss-absorbing form of going-concern capital.

Moreover, many intangible assets are now deducted from common equity in calculating bank regulatory capital in recognition of the fact they may not offer much tangible value for a bank in times of stress. There is also a lot more regulatory focus on bank risk models to ensure that calculations of regulatory capital are not overstated by inappropriately sanguine views on the risks embedded in bank activities.

Aside from the fact there were issues with the reported capital figures of some global financial services firms and the market’s reliance on those figures (a matter that is perhaps beyond the scope of this discussion), this highlights the fact that institutions ultimately fail when they lose the confidence of investors or creditors – or, in the case of insurance companies, their sales distribution networks, policyholders and reinsurance counterparts. Confidence does not evaporate overnight. It usually erodes over time in the wake of larger-than-expected losses or lower-than-expected capital. Sometimes this happens in response to public disclosures by the institution itself; markets are also adept at sniffing out bad news before it is publicly disclosed.

**The root cause of failures**

So, low levels of capital can precipitate, and expedite, a financial institution failure. But what are the underlying causes or problems that allow an institution to reach that point?

The Northland and CCB cases in the 1980s, as I noted earlier, and the Confederation Life failure in the mid-1990s, which was well-publicized,\(^5\) highlight the key issues well. Of course, our

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experiences with other failures and near-failures throughout the years have also been highly instructive.

There is a common trend. The root cause of financial institution failures is usually poor corporate governance and weak internal controls.

The Board of Directors of a financial institution plays a particularly important role in this regard. OSFI views the Board as a critical line of defence and makes every attempt to highlight any problems with the Board early on so that they can be rectified. In some cases, we may have to reiterate our concerns as the Board may initially not be very responsive or even in denial. In such cases, we have seen the Board continue to support Senior Management, whose actions and decisions may have been the source of the problems.

As well, the Board and Senior Management of a failing institution often tend to blame poor macroeconomic and market conditions for their institution’s deteriorating performance.

But, in our view, conditions in the economy and financial markets are a given – something that all competing financial institutions face. Financial institutions should, therefore, have effective risk management strategies to weather any storms.

So, OSFI’s intervention must not only be early, but also persistent.

As I alluded to earlier, entry and exit are part of a well-functioning financial system. Sometimes, business models simply do not succeed in a competitive marketplace. In such cases, the key to a smooth resolution process is for the board and management of a financial institution to recognize this early enough, cut their losses and take action to exit – sell or wind down – while there is still some remaining value to distribute to shareholders.

Poor governance and internal controls are often camouflaged during good economic times (by high profits and rising asset prices), but are exposed during the bad times. Poor governance is the dry tinder, and a weak economy the accelerant.

This was clearly evident during the 2008 financial crisis in the U.S., where lapses in governance had allowed the build-up of excessive risks in financial institutions prior to the crisis. These risks became all too evident during the crisis when it was more challenging to address them.

Credit, investment and insurance losses (and, hence, the depletion of capital) are generally the result of poor governance structures (e.g. lack of oversight or information), lax risk management practices and/or the lack of effective internal controls – not the cause of a financial institution’s difficulties.
The importance of corporate governance

OSFI places a significant emphasis on corporate governance. This is at the heart of our ongoing supervisory activities.

The recently updated Corporate Governance Guideline (2013) sets the tone and includes such features as clearly explaining our expectations for a Risk Appetite Framework and the need to split the Chair and CEO role so as to foster independence. In addition, we recently established a Corporate Governance Division to work with institutions in this area and to support OSFI frontline supervisory staff.

By design, this guideline focuses solely on the role of the Board, risk governance more broadly (including the roles of the CRO and the Board Risk Committee), and the role of the Audit Committee, as these are the critical elements from a prudential perspective. It reflects lessons from our supervisory work and experiences.

OSFI was one of the first prudential regulators in the world to require regulated financial institutions to have a Board-approved risk appetite framework. The foundation of a financial institution’s governance and control framework is its risk culture – OSFI is a strong advocate of the FSB’s recently published guidance on risk appetites and culture.6

We reinforce these governance principles in our operational guidelines. Guideline B-20, perhaps one of the better known guidelines in OSFI’s toolkit, places a focus on the risk governance aspects and internal controls with respect to the underwriting practices and processes of mortgage lending institutions.

OSFI’s requirements mean that Canada’s domestic systemically important banks (our largest banks) are among the world’s leaders in disclosure practices. This is evidenced by OSFI’s requirement that these banks adopt the recommendations of the Financial Stability Board’s Enhanced Disclosure Task Force. The Own Risk and Solvency Assessment (ORSA) guideline for insurance companies, published at the beginning of this year (January 2014), is another case in point. This guideline promotes a better understanding of the interrelationships between the internal risk profile and capital needs of an insurer.

Backing all of this guidance is a dedicated corporate governance supervisory team at OSFI, which was established post-crisis in 2010. OSFI fosters a close relationship with financial institutions’ Boards and Senior Management.

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A key message here – and one that I would like to conclude with – is that focusing exclusively on the capital and liquidity levels of financial institutions – a temptation for all solvency regulators – is simply not enough. Clearly enunciated expectations for sound risk management practices at financial institutions, coupled with effective supervision, are also essential for maintaining a strong and stable financial system.

Thank you for your time. I would be pleased to answer any questions.