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Report of the
**Auditor General
of Canada**
to the House of Commons

Chapter 5
Regulating and Supervising Large Banks



Office of the Auditor General of Canada

The Fall 2010 Report of the Auditor General of Canada comprises Matters of Special Importance, Main Points—Chapters 1 to 9, Appendices, and nine chapters. The main table of contents for the Report is found at the end of this publication.

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Chapter

5

Regulating and Supervising Large Banks

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Regulating and Supervising Large Banks

Main Points

What we examined

In Canada, banks are regulated and supervised by a number of federal organizations responsible for contributing to the stability and efficiency of the financial system. The Department of Finance Canada provides policy advice on the legislation that governs banks and their regulation. The Office of the Superintendent of Financial Institutions Canada supervises banks by assessing their financial condition and verifying their compliance with the laws and regulations that govern them. The Canada Deposit Insurance Corporation provides deposit insurance and has some responsibility over managing risks posed by banks as well as in the monitoring and resolution of failing banks. The Bank of Canada has a role in providing lender of last resort facilities as well as in overseeing clearing and settlement systems.

We examined how the Department of Finance Canada and the Office of the Superintendent of Financial Institutions Canada have regulated and supervised the six largest banks in Canada, which are considered the most important to the Canadian financial system. We also examined how the Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada, and the Canada Deposit Insurance Corporation shared information for decision making. In addition, we examined how the federal organizations request information from banks.

Audit work for this chapter was substantially completed on 31 March 2010.

Why it's important

Instability in Canada's financial system can cause the public to lose confidence in banks and fear for their savings. It can also have significant fiscal consequences if the government has to step in and provide financial assistance to a bank that is in danger of failing. Banks play key functions in just about every economic exchange that takes place in the economy and are key sources of financing. Therefore, a sound and stable banking system is essential for Canada's economic well-being.

Compared with many other countries, Canadian banks fared well during the recent global financial crisis. Experts have attributed this in part to Canada's approach to regulating and supervising its banks. However, the recent crisis also caused the global financial environment to change at an ever-increasing pace, with international agreements and commitments producing a more complex regulatory framework. In addition, the financial industry continues to develop more diverse and complex financial models and products, which have higher risks. The stability of the banking system could be impacted if Canada's regulatory framework and supervisory approach do not keep pace with these developments.

What we found

- The Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada, and the Canada Deposit Insurance Corporation regularly share relevant information on regulating and supervising banks. This ongoing exchange of information contributed to Canada's relative success in responding to the recent global financial turmoil as the federal organizations had relevant and up-to-date information for decision making. The Office of the Superintendent of Financial Institutions Canada also interacted appropriately with foreign supervisors and regulators by exchanging information on cross-border issues. These exchanges help Canada stay abreast of emerging issues.
- The federal regulatory framework for banks is kept up to date to reflect emerging domestic and international developments. The legislation governing Canada's banks, the *Bank Act*, is revised every five years following broad consultation. However, there is no process to perform periodic reviews of the effectiveness of the significant parts of the regulatory and legislative framework to determine whether the existing rules and policies support a stable and efficient financial system. Without this type of effectiveness review, it is difficult for the government to determine whether successive regulatory changes are working or have had negative unintended consequences.
- The Office of the Superintendent of Financial Institutions Canada adequately supervises Canada's six largest banks and monitors emerging risks. However, the growing volume and complexity of its work is increasing the demands on its human resources. This challenge, combined with pressures on training and compensation, could affect the Office's ability to attract and retain qualified staff to maintain its capacity and competency to carry out its supervisory mandate.

- Together the Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada, and the Canada Deposit Insurance Corporation are increasingly asking banks for more information, but they are not periodically assessing whether they need all of this information to fulfill their regulatory and supervisory responsibilities. It is challenging for these entities to precisely determine the amount and type of information required. Although efforts are under way to improve the collection of information, progress on assessing the adequacy of information requested from banks has been limited.

The entities have responded. The entities agree with all of our recommendations. Their detailed responses follow the recommendations throughout the chapter.

Introduction

The importance of regulating and supervising banks

5.1 The fundamental roles of Canada's six largest banks are to make and settle payments for almost all transactions in our economy (clearing and settlement activities), to finance their lending activities through active participation in securities and other capital markets (market activities), and to act as an agent between lenders and borrowers (intermediation activities). This intermediation role is probably the most important since it brings together parties with funds to lend with parties that need to borrow funds. The way banks borrow funds, combined with the risks involved in their lending activities, could, in some circumstances, threaten their solvency. Since large banks have key economic functions and are valuable to society, they need to be regulated and supervised. The six largest banks in Canada are federally regulated. These banks hold over 90 percent of total bank assets (Exhibit 5.1).

Exhibit 5.1 Canada's six largest banks hold over 90 percent of total bank assets

Federally regulated banks	Assets (28 February 2010) (\$ billions)
Domestic	
Royal Bank of Canada	651
Toronto-Dominion Bank	568
Bank of Nova Scotia	507
Bank of Montreal	393
Canadian Imperial Bank of Commerce	335
National Bank of Canada	142
Other domestic banks	58
Total domestic	2,654
Total foreign bank subsidiaries and branches	212
Total	2,866

Source: Office of the Superintendent of Financial Institutions Canada

5.2 Regulatory activities, including policy advice, establish the legal framework and rules within which banks operate. Supervision involves monitoring the solvency of individual banks by focusing on elements

such as governance, capital adequacy, risk controls, proper accounting of assets and liabilities, and liquidity. Supervision also includes verifying and enforcing the banks' compliance with the rules established by regulation. Regulation and supervision are concerned with the overall stability of the financial system and its efficiency. An effective regulatory framework, which includes regulation and legislation, and a supervisory approach applied by the responsible federal organizations are key components in promoting the solvency of banks and the stability of the financial system. In turn, these elements promote investment and economic growth, which benefit Canadians.

The Government of Canada's role in regulating and supervising banks

5.3 Under the Constitution of Canada, the Government of Canada has sole jurisdiction for regulating and supervising banks. Key federal legislation governs banks and the federal organizations that regulate and supervise them (Exhibit 5.2). Provincial governments regulate and impose rules on credit unions, caisses populaires, securities dealers, and mutual funds.

Exhibit 5.2 Key federal banking legislation governs banks and federal regulatory organizations

Office of the Superintendent of Financial Institutions Act, 1985: Established the Office of the Superintendent of Financial Institutions Canada as the office responsible for regulating and supervising banks. The Act also established the Financial Institutions Supervisory Committee.

Canada Deposit Insurance Corporation Act, 1967: Established the Canada Deposit Insurance Corporation to protect depositors and promote stability of the Canadian financial system.

Bank of Canada Act, 1934: Established the Bank of Canada to regulate credit and currency in the best interests of the economy.

Bank Act, 1871: The main federal statute for regulating and incorporating banks.

5.4 Several federal organizations are responsible for overseeing the banks' activities and for contributing to the stability and efficiency of the financial system. In its regulatory role, the Department of Finance Canada provides policy advice on legislation that governs banks, is responsible for part of the regulatory framework, and oversees the legislative revision process performed every five years. It also establishes, on behalf of the Minister of Finance, the responsibilities and powers of the federal organizations that regulate and supervise banks, such as the Office of the Superintendent of Financial Institutions Canada (OSFI). OSFI regulates and supervises banks to reduce the risk that they will fail. The Superintendent has extensive powers to monitor and advise on banking activities, and to administer

legislation and regulations under the *Office of the Superintendent of Financial Institutions Act* and other federal laws, such as the *Bank Act*. The Superintendent reports to the Minister of Finance and retains sole responsibility for the decisions and actions related to supervision. The Canada Deposit Insurance Corporation (CDIC) insures the deposits in its member banks and has some responsibilities for resolving bank failures in a manner that protects depositors and contributes to the stability of the financial system. The Bank of Canada is primarily responsible for implementing monetary policy, which is an important element in the stability of the financial system. In its role as lender of last resort, the Bank of Canada has the authority to provide liquidity to banks and markets to stabilize the financial sector. The Bank of Canada is also responsible for overseeing clearing and settlement systems.

5.5 The Minister of Finance has delegated spending authority to the Superintendent of Financial Institutions. OSFI establishes its budget for regulating and supervising banking activities and recovers the costs through assessments and fees levied on the banks it supervises.

5.6 In its 2005 Budget, the government announced that it would clarify the roles and responsibilities of OSFI and CDIC and eliminate unnecessary overlap and duplication. These changes reduced the administrative burden on the banks.

Focus of the audit

5.7 This audit examined the Government of Canada's regulatory framework and supervisory approach and related activities between 1 November 2007 and 31 March 2010. The report focuses on **prudential regulation**, which the Department of Finance Canada and OSFI develop to address institutional risk-taking, including ensuring that there are adequate risk controls and capital in place.

5.8 We looked at how information was shared among the Department of Finance Canada, OSFI, and CDIC, and how these federal organizations share knowledge and information with foreign regulators and supervisors. We also looked at how these federal organizations request information and data from banks.

5.9 We conducted our audit to determine whether the Department of Finance Canada and OSFI have appropriate processes to regulate and supervise Canada's six largest banks. While CDIC has no legislated regulatory or supervisory responsibilities, it manages risks

Prudential regulation—A set of rules and principles enforced by a government agency that focuses on the safety and soundness of banks, including the safety of depositor's funds.

posed by member banks and plays a role in finding and implementing solutions for failing banks.

5.10 Our audit examined if and how the regulatory framework is updated and reviewed in light of emerging developments, as well as whether the supervisory approach is reviewed and applied as intended. The audit focused on Canada's six largest banks because these large and complex financial institutions could pose a significant risk to the stability of the Canadian financial system, and the economy, if they fail. These banks are the Royal Bank of Canada, the Toronto-Dominion Bank, the Bank of Nova Scotia, the Bank of Montreal, the Canadian Imperial Bank of Commerce, and the National Bank of Canada.

5.11 More details about the audit objectives, scope, approach, and criteria are in **About the Audit** at the end of this chapter.

Observations and Recommendations

Information sharing

5.12 The Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada (OSFI), the Canada Deposit Insurance Corporation (CDIC), and the Bank of Canada need to share relevant and timely information to anticipate, assess, monitor, and respond to financial issues and developments that may have consequences for Canada's financial stability. Timely information sharing is necessary to maintain financial stability during financial sector crises. Without information sharing, the organizations that regulate and supervise the banking sector may not be able to properly exercise their roles during crises. For example, the lack of information sharing between regulatory and supervisory authorities was a factor that contributed to the delay in addressing the financial crisis in the United Kingdom, according to the Financial Services Authority of the United Kingdom.

5.13 Although each federal organization in the Canadian regulatory and supervisory system has a distinct mandate, regulators acknowledge that the overall design and function of the system is best served by close coordination and cooperation. The Department of Finance Canada, OSFI, CDIC, and the Bank of Canada share information on regulating and supervising Canada's six largest banks through two primary committees: the Financial Institutions Supervisory Committee (FISC) and the Senior Advisory Committee (SAC). The same federal entities are members of CDIC's Board of Directors and could share information on issues related to large banks as they emerge.

5.14 We examined whether the Department of Finance Canada, OSFI, and CDIC share knowledge and information on regulating and supervising Canada's six largest banks. We looked at documentation from FISC and SAC meetings that took place between 1 November 2007 and 1 November 2009, including agendas, meeting minutes, and documents distributed at the meetings. We also interviewed officials from the Department of Finance Canada, OSFI, CDIC, and the Bank of Canada.

Federal organizations share relevant and timely information for decision making

5.15 We found that during the recent financial turmoil, the federal organizations responsible for regulating and supervising banks met frequently to discuss and address financial stability issues, specific issues affecting banks, international and domestic regulatory developments, and the economy and its impact on the financial system.

5.16 FISC is the main forum through which the Department of Finance Canada, OSFI, CDIC, and the Bank of Canada share and discuss information on banks and coordinate intervention with respect to troubled banks. FISC is chaired by the Superintendent of Financial Institutions and meets quarterly. However, during the recent financial turmoil, it met more frequently to address issues as they arose. We found that, through FISC, the Department of Finance Canada, OSFI, and CDIC shared relevant information to guide decision making.

5.17 SAC is a forum for exchanging information and discussing financial system policy issues, such as proposals for legislative changes, the financial stability framework, and the regulatory framework and supervisory approach. The committee's membership is the same as FISC; however, it is chaired by the Deputy Minister of Finance. SAC usually meets three or four times a year. We found that the discussions of issues that take place at these meetings influence policy changes.

5.18 We found that FISC and SAC facilitate the exchange of information among federal organizations. In addition, the participation of the Department of Finance Canada, OSFI, CDIC, and the Bank of Canada in FISC and SAC has strengthened informal relationships among these federal organizations. We also found that these relationships played an important role throughout the recent financial turmoil, when officials from these federal organizations maintained regular contact with each other outside of FISC and SAC meetings.

The Office of the Superintendent of Financial Institutions Canada receives relevant information from foreign regulators and supervisors

5.19 Supervising banks with international operations requires that regulators, supervisors, deposit insurers, and central banks cooperate and exchange information to strengthen supervision and promote financial stability. We examined whether OSFI interacts appropriately with regulators and supervisors from other countries on cross-border issues. We looked at correspondence, meeting minutes, and memoranda of understanding between the federal organizations and their foreign counterparts regarding the international operations of Canada's six largest banks. We also interviewed OSFI officials.

5.20 We found that OSFI exchanges information with its foreign counterparts on cross-border issues through its participation in international committees and working groups of supervisors that aim to enhance the supervision of banks with international operations. This participation also helps OSFI build relationships, gain influence at the international level, and keep informed of upcoming changes to international policies and guidelines. OSFI officials told us that they are satisfied with the information they receive from their foreign counterparts. We also found that OSFI receives relevant information on Canadian banks operating abroad to fulfill its regulatory and supervisory role.

Regulation

Stable financial system—A system that is robust in the face of a wide range of adverse circumstances.

Efficient financial system—A system that produces a wide range of financial products at the least possible cost and is capable of significant innovation.

5.21 The objective of regulating banks is to achieve a **stable and efficient financial system**, which is in the public's interest. Market forces alone are not sufficient to achieve this objective because banks do not bear all of the economic costs of their activities. Three important reasons for regulating banks are to contain systemic risk, to contain moral hazard, and to protect consumers (Exhibit 5.3). Exhibit 5.4 outlines the policy guidance included in the banking regulatory framework.

5.22 We examined whether the Department of Finance Canada and the Office of the Superintendent of Financial Institutions Canada (OSFI) maintain and update the regulatory framework in light of emerging developments, such as the recent financial turmoil, and periodically review its effectiveness. We looked at documents such as emerging international principles, minutes of federal committee meetings, and related documents. We also interviewed officials of the federal organizations and representatives from Canada's six largest banks.

Exhibit 5.3 Governments have three important reasons for regulating banks

Three important reasons for regulating banks are to contain systemic risk, to contain moral hazard, and to protect consumers.

Banks may take excessive risks in their activities. If these risks result in a bank failing, other banks may fail or be threatened with insolvency because of their connections with this bank. This could threaten the broader financial system and the performance of the economy.

The moral hazard motivation arises from attempting to protect depositors from losses. If governments introduce protection systems to compensate depositors for losses resulting from a bank's insolvency, then depositors will have little or no incentive to assess the riskiness of their deposits and investments. Riskier banks will attract deposits on the same conditions as less risky banks. In addition, the belief that governments will intervene if a large bank fails also undermines investor and depositor discipline. To mitigate moral hazard, governments introduce mechanisms such as capital adequacy requirements to limit financial exposure and excessive risk-taking activities.

Governments introduce banking regulations to reduce the level of risk that consumers are exposed to. For example, governments introduce protection systems for depositors to reimburse them for losses arising from the insolvency of a bank.

Exhibit 5.4 The Office of the Superintendent of Financial Institutions Canada issues policy guidance as part of the banking regulatory framework

The banking regulatory framework contains policy guidance issued by the Office of the Superintendent of Financial Institutions Canada (OSFI). This guidance includes the following:

- Guidelines that describe OSFI's expectations with respect to risk management principles, addressing solvency issues (for example, capital adequacy); prudential standards (for example, exposure limits); and accounting standards (for example, transfer of assets). There are 28 guidelines.
- Advisories that clarify OSFI's position regarding certain policy issues or how provisions of legislation, regulations, or guidelines should be interpreted. There are 57 advisories.
- Rulings that describe how OSFI has applied or interpreted provisions of legislation, regulations, or guidance. There are 23 rulings.

While guidance does not have the force of law, it sets out expectations regarding specific risk management principles. Banks are expected to consider the guidance and to take appropriate action. Therefore, banks should voluntarily comply with expectations set out in guidance documents. If a bank's failure to comply with guidance creates concerns about its safety and soundness, the Superintendent of Financial Institutions can use other intervention powers, such as issuing an order to force compliance or an order to increase the level of capital.

Source: Department of Finance Canada and Office of the Superintendent of Financial Institutions

Federal organizations actively monitor emerging issues

5.23 Following the recent financial turmoil, a large number of international committees and initiatives were established to review and improve the global financial system's regulatory framework. International groups, including the Financial Stability Board, the Basel Committee on Banking Supervision, the Senior Supervisors Group, and the G-20 Finance Ministers, are examining the causes of the financial crisis and what could be done to address identified problems. There have been hundreds of proposals for changes to the financial system, all with the objective of enhancing the resilience of the global financial system and building a more consistent regulatory framework and supervisory approach worldwide.

5.24 Regulations and best practices are now rapidly evolving, and, because of the fast pace of innovation in the financial services sector, regulatory frameworks are being revised. In addition to international developments, emerging domestic issues need to be monitored. We examined how the Department of Finance Canada and OSFI monitor emerging domestic and international developments to ensure that Canada's regulatory framework is kept up-to-date.

5.25 We found that the Department of Finance Canada tracks emerging domestic and international issues and that OSFI monitors and analyzes economic and market data pertaining to domestic and international developments. OSFI recently established a research group to analyze emerging economic issues and market behaviour. OSFI also relies on its Emerging Risk Committee (ERC), which identifies emerging issues and external risks affecting the financial services industry. At its monthly meetings, the ERC discusses topics such as domestic and global market updates, economic conditions, real estate risks, and credit risks, along with possible supervisory responses.

5.26 We found that federal organizations track emerging issues through their participation in committees and working groups at the federal and international levels. These committees and working groups provide important information on emerging trends and policy development.

5.27 The two principal domestic forums for monitoring emerging domestic and international risks are the Financial Institutions Supervisory Committee (FISC) and the Senior Advisory Committee (SAC). We found that emerging issues, such as liquidity risk management, accounting rules, and cross-border issues, were discussed at FISC meetings. Issues related to the legislative and regulatory

framework, such as boundaries of regulation, consumer protection issues, and stability issues, among others, were presented at SAC meetings.

5.28 International issues are monitored through Canada's participation in global forums, including the G-7, G-20, and the Financial Stability Board. In addition to these forums, the Department of Finance Canada and OSFI participate in over 50 international committees and working groups.

Federal organizations maintain and update Canada's regulatory framework

5.29 Keeping the regulatory framework up-to-date is particularly important in the context of market innovation and global financial turmoil. An outdated regulatory framework poses a number of risks and may lead to negative unintended consequences. For example, banks may face a costly compliance regime in pursuit of a regulatory objective that is no longer valid. As well, banks may not be able to adapt to changes and innovations in financial markets if the regulatory framework is not sufficiently flexible. Ultimately, without an effective regulatory framework, the safety and soundness of banks could be jeopardized. We reviewed the processes in place at the Department of Finance Canada and OSFI to maintain and update the legislative and regulatory framework.

5.30 Canada has been regularly updating its financial sector legislation and regulations for more than 135 years. The legislation governing Canada's banks, the *Bank Act*, is revised every five years. Revisions can include regulatory issues raised by stakeholders or FISC partners, or identified in analysis. Some legislative reviews have been used in the past to fine-tune the framework, while others introduced significant policy shifts reflecting fundamental changes in the financial sector (such as in 2001, following the MacKay Task Force). The next revision is scheduled for April 2012. The legislated five-year review provision helps keep the regulatory framework current and provides banks with the flexibility they need to react to changing times. Bills to implement budget measures and other legislation have been used recently to amend the *Bank Act* in the period between the five-year reviews.

5.31 We found that OSFI is maintaining the relevance of its guidelines. More detailed and prescriptive guidelines are subject to regular updates, and OSFI uses a flexible rule-making approach to address emerging risks and opportunities. It has substantial discretion to put forward principles in the form of guidance. During the financial turmoil, OSFI used its power to issue and interpret guidance to restrict

undesirable activities and to permit flexibility. For example, in 2008, OSFI revised the limit on voting equity shares to provide banks with additional financial flexibility, and it released a revised intervention process for dealing with weakening or failing banks.

Canada contributes and adheres to international standards when appropriate

5.32 One challenge for national regulators worldwide is to influence the international agenda for the financial sector, as well as to adapt proposed changes and implement them. Since the financial turmoil, new regulatory principles and standards have been and continue to be developed internationally. We examined the role that Canada's federal organizations have had in developing new international standards and principles, and the review they performed before adopting them.

5.33 Canada's participation in international meetings allows Canada to monitor and shape international developments. We found that federal officials from the Department of Finance Canada and OSFI are involved in developing international standards and that they exercise some influence. Canada co-chaired the G-20 Working Group on Enhancing Sound Regulations and Strengthening Transparency. Senior officials from the Department of Finance Canada, OSFI, and the Bank of Canada are contributing members of the Financial Stability Board (FSB) and related working committees. The Department of Finance Canada and OSFI participated in developing FSB principles on sound compensation practices. A senior Government of Canada representative chairs the FSB Standing Committee on Standards Implementation, and Canada has two members on the steering committee that provides direction to the FSB.

5.34 We found that the Department of Finance Canada and OSFI are committed to the proposed reforms to the extent they are relevant to Canada's financial system. For example, Canada was among the first countries to adopt the Basel II Capital Accord in 2007, which recommends new bank capital requirements in light of the bank's management of risk. The Department of Finance Canada also implemented principles for cross-border cooperation on crisis management. At OSFI, guidance on adequate levels of capital will be revised to align with the new Basel II Capital Accord guidance. As well, OSFI will update guidance on liquidity and leverage once the international standards are established.

5.35 A well-developed regulatory framework should show that international standards are monitored and being adhered to when appropriate. Canada undergoes international compliance assessments,

and, in 2008, the International Monetary Fund found that OSFI complied with the Basel Core Principles for Effective Banking Supervision. As well, Canada has volunteered to be reviewed by its FSB peers in 2011 to assess progress regarding the implementation of international standards.

5.36 We found that the Department of Finance Canada and OSFI are reviewing the benefits of particular international standards to assess if and how Canada could adopt them. While the federal organizations are aware that international organizations influence the domestic regulatory agenda, they also recognize that their primary objective is to adopt regulations that are appropriate for Canada and that adjustments are required to take into account Canadian circumstances. New international standards and proposals are being assessed within the Canadian context. For example, Canada took a strong position against the imposition of a tax on banks that some members of the G-20 were considering. Also, the approach Canada took to implement the FSB principles on compensation was principles-based, in contrast to some countries that rely on a more prescriptive rules-based approach.

Significant parts of the regulatory framework are not subject to periodic reviews of their effectiveness

5.37 A well-designed regulatory framework needs to be regularly reviewed to determine whether policy objectives are being achieved and whether unintended consequences might require the reconsideration of part of the framework. According to the Organisation for Economic Co-operation and Development, the efficiency and effectiveness of financial regulation should be reviewed and evaluated regularly to reassess previously identified problems and needs in the policy framework, identify new problems, adjust policy objectives, assess the effectiveness and efficiency of policy instruments and their readiness for implementation, and assess the processes for making and implementing regulations.

5.38 Considering the large number of legislative and regulatory changes that have been introduced and those that will be introduced in the future, it is particularly important to ensure that the regulatory framework is effective and working as intended, while minimizing negative consequences, and to measure the impact of these cumulative changes on the regulatory framework. We examined how the Department of Finance Canada and OSFI review the effectiveness of the regulatory framework.

5.39 The Cabinet Directive on Streamlining Regulation, introduced in 2007, requires federal departments and agencies to ensure that regulation meets their initial policy objectives and to renew regulatory frameworks on an ongoing basis. We found that the Department of Finance Canada performed some reviews of the effectiveness of bank regulations. The Department's analysis included research on issues such as market failures, the appropriateness of restrictions, and risk to banks. We found, for example, that the Department of Finance Canada, in collaboration with CDIC, reviewed the options available for dealing with a large bank in case of failure. They assessed the shortcomings, costs, and benefits of the resolution tools; made international comparisons; and considered policy issues related to implementing resolution tools. Following this review, the government introduced amendments to the *Canada Deposit Insurance Corporation Act* to allow for an additional failure resolution tool. Also, the Department reviewed the rules governing credit rating agencies and leasing for their effectiveness.

5.40 However, we found that there is no systematic process at the Department of Finance Canada to plan and periodically perform reviews of the regulatory framework, or consistency in the analysis and reporting of the reviews. The Department performs reviews of regulatory issues on an ad hoc basis. Emerging domestic issues or new international standards usually trigger specific reviews. In addition, the Department has not yet implemented the Cabinet Directive on Streamlining Regulation.

5.41 We found that OSFI performed a review of the effectiveness of outsourcing rules. We also found that, in 2005, OSFI reviewed corporate governance rules. OSFI officials indicated that they will review two other guidelines in the 2010–11 fiscal year. OSFI is presently implementing the Cabinet Directive on Streamlining Regulation and will integrate the requirement to perform reviews into its rule-making process.

5.42 While the Senior Advisory Committee, chaired by the Department of Finance Canada, discusses broad policy directions related to financial sector issues, it does not have terms of reference. As well, there is no defined process for identifying financial sector policy issues that need to be reviewed for their effectiveness and the timing of these reviews, or for discussing the findings. The result of these reviews could support proposals for legislative changes or provide assurance to policy makers that the objectives of the regulatory

framework are being met as intended and that they support the achievement of a stable and efficient financial system while minimizing unintended consequences.

5.43 Recommendation. As chair of the Senior Advisory Committee, the Department of Finance Canada should establish the committee's terms of reference, in collaboration with its members. These terms of reference should require the development of plans to perform effectiveness reviews of the regulatory and legislative framework to ensure that significant parts of the regulatory framework are periodically assessed.

The Department's response. Agreed. The Department will consider the recommendation to establish terms of reference for the Senior Advisory Committee (SAC), in consultation with the Bank of Canada, the Office of the Superintendent of Financial Institutions Canada, the Canada Deposit Insurance Corporation, and the Financial Consumer Agency of Canada, including giving SAC a mandate to regularly review the effectiveness of the regulatory and legislative framework.

Supervision

5.44 The objectives of supervising banks are to assess their safety and soundness and to intervene when necessary to protect depositors. The Office of the Superintendent of Financial Institutions Canada (OSFI) uses a supervisory approach that focuses on risks and can be easily adapted to changes in the financial system (Exhibit 5.5). Because this approach is based on principles and not on a specific detailed set of rules, the banks' activities must comply with the regulatory objectives.

5.45 We examined whether OSFI periodically reviews the relevance and application of its supervisory approach. We also examined whether it updates the supervisory approach in light of emerging domestic and international developments, as well as international principles and commitments. We examined whether OSFI appropriately applied the supervisory approach when assessing the safety and soundness of banks and the financial system. We looked at documents such as OSFI's Supervisory Framework and the associated methodology for carrying out the supervisory work in banks. We also examined the documentation that supported OSFI's supervisory review of Canada's six largest banks for the banking year starting 1 November 2008. In addition, we obtained input from OSFI officials and senior executives of Canada's six largest banks.

Exhibit 5.5 The Office of the Superintendent of Financial Institutions Canada relies on risk assessment to supervise banks

The Office of the Superintendent of Financial Institutions Canada (OSFI) supervises Canadian banks on a consolidated basis, including their domestic and international operations, to assess their safety and soundness. The level and frequency of supervisory scrutiny depends on the results of the risk assessment of the bank's significant activities. OSFI's supervision has four phases: planning, examination, reporting, and follow up.

Planning the supervisory work involves understanding the financial environment; identifying the bank's significant activities; and outlining the supervisory approach and supporting rationale for the nature, focus, and timing of supervisory work required to evaluate a bank's risk profile. OSFI's supervisory staff must use sound judgment to determine the significance and materiality of activities in which a bank engages.

Examination focuses on evaluating risks through on-site reviews and ongoing monitoring, including assessing compliance with laws and regulations. On-site reviews are a critical part of the supervisory process since they enhance OSFI's understanding of the bank and its risk profile. OSFI also reviews the bank's risk management practices. OSFI senior supervisors discuss the examination results to determine whether appropriate judgment was exercised and consistently applied across banks.

Reporting includes verbal and written communication of findings, ratings, and recommendations to OSFI's management, as well as the bank's board management.

Follow up on the recommendations addressed to banks is important for assessing progress.

Source: Office of the Superintendent of Financial Institutions Canada

The Office of the Superintendent of Financial Institutions Canada is updating its Supervisory Framework

5.46 Officials from the federal organizations we audited and senior executives of Canada's six largest banks told us that the Supervisory Framework is understood by the banks and has proven to be effective. It is also flexible, which means that it can be adapted quickly to respond to new policies, regulatory issues, and emerging financial market developments. OSFI is currently reviewing and updating its 1999 Supervisory Framework. The review is expected to be finalized by the end of 2010. Such a review allows OSFI to incorporate new approaches and standards to address significant changes in the external environment. Some of these changes, such as implementing the Basel II Capital Accord, are internationally driven. We found that OSFI has implemented the changes required by international agreements in its supervisory approach.

The Office of the Superintendent of Financial Institutions Canada supervises large banks adequately

5.47 Since OSFI's principles-based supervisory approach relies heavily on the judgment of its supervisory staff, it is important for OSFI to have knowledgeable staff who follow the supervisory methodology and document their results. This encourages a consistent application of the supervisory approach across banks. We examined the phases of supervision—planning, examination, reporting, and follow up. We found that OSFI followed its supervisory approach in assessing the activities of the large banks for the year we looked at, even though we found some areas for improvement in our detailed examination.

5.48 We found that planning work was carried out in all cases. However, in four percent of cases, OSFI did not evaluate all activities that were scheduled for assessment. In addition, we could not find documented evidence that planning decisions were appropriately reviewed in all cases. For example, lower-risk activities such as the use of credit cards and personal banking were not assessed as planned. Not carrying out these assessments could result in not identifying risks that may increase over time. As well, because priority setting is partially judgment-based, it is important for senior supervisory staff to review the activities that are planned for assessment.

5.49 We found that the examination work was performed according to OSFI's methodology. However, our detailed examination found documentation lacking. Specifically, 4 percent of the risk assessments for a significant activity were out of date, and 17 percent could not be provided by OSFI. Recent internal audits by OSFI had identified issues with the documentation of analysis. We also found that there was no documented evidence that all assessment summaries were reviewed by senior supervisors, which could increase the likelihood that risks are understated or overstated and not consistently analyzed across banks.

5.50 We found that the results of examinations are reported appropriately and in a timely manner to the banks' senior management. This means that banks are aware of OSFI's views of their risk assessment and mitigation activities and can take corrective actions, if necessary. We also found that OSFI followed up on its recommendations in a timely manner.

The Office of the Superintendent of Financial Institutions Canada is well-regarded by the banks it supervises

5.51 Through questionnaires and interviews with senior bank executives from Canada's six largest banks, we found that they considered OSFI's supervisory staff to be knowledgeable and professional. All of these executives regarded OSFI as a strong supervisor and said that the relationship between the banks and OSFI was working well. Frequent and open dialogue between OSFI and the banks and OSFI's willingness to consider the banks' views were also credited as promoting a positive working relationship.

5.52 OSFI's supervisory approach is also well-regarded by the international community. Officials from federal organizations and bank executives indicated that this regard allows OSFI to effectively represent the interests of Canadian banks and influence the development of international commitments.

Increased regulatory requirements have created human resource challenges

5.53 OSFI's success as a supervisor depends on having employees with highly specialized knowledge, skills, and experience to supervise banks, identify significant issues, and perform accurate assessments of how banks manage risks. We found that OSFI has a human resource strategy and understands its importance for fulfilling its mandate. However, OSFI faces challenges in the current environment.

5.54 Demands on OSFI's supervisory staff have increased. In recent years, the demands have risen in large part due to an increase in the number and complexity of financial activities and financial products, the implementation of international standards, and an increased requirement to formalize and document OSFI's processes and analysis. In December 2007, OSFI noted that supervisory resources were under considerable pressure and that it would be seeking additional resources to carry out its key activities. The issues raised then are still relevant today. While staffing levels have increased since that time, staffing gaps remain. As of 31 March 2010, 10 percent of the positions on the large bank supervisory teams and 12 percent of the positions on the specialist groups supporting them were vacant. Half of these positions have been vacant for one year. According to OSFI, this illustrates that resources are stretched and that there is little flexibility to address unexpected events or attend to managerial responsibilities such as staffing and training.

5.55 Currently, OSFI considers its supervisory staffing levels adequate to carry out its supervisory responsibilities. However, we found that a number of supervisory staff had to be redeployed to assist with the

recent industry-wide executive compensation review. In addition, increased documentation requirements have resulted in less time available for detecting and analyzing risks.

5.56 Senior executives of the six largest banks indicated that OSFI's supervisory staff are currently stretched and that, if competition for hiring in the banking industry increases, OSFI may not be in a position to attract or even retain some of its qualified staff. We also found that OSFI staff are challenged by the increased volume and complexity of the work. This could lead to risk areas not being assessed appropriately and quickly, resulting in increased risk. Bank executives told us that OSFI's current staff are having difficulty reviewing the banks' capital models because of the models' complexity; they have increasingly relied on consultants to perform reviews of the information technology system and financial model.

5.57 We found that while OSFI is aware that training is important for attracting, developing, and retaining staff, work pressures, unexpected market developments, and budget constraints have resulted in less external training than is required to keep up-to-date in specialized areas. As a result, OSFI supervisory staff may not be exposed to the latest financial market innovations, which could result in risks being underestimated or overlooked. In addition, less specialized training could make it more difficult to attract and retain staff who consider training an integral part of their career development.

5.58 The federal government, through its 2010 Budget, signalled the need to exercise financial restraint. As a result, OSFI is looking to bring its budgets for fiscal years 2010–11 to 2012–13 in line with the government's expectations, even though spending for the regulation and supervision of banks is not funded by the federal government, but recovered through assessments and fees levied on the banks themselves. OSFI has been aware for awhile that its supervisory staff compensation is not competitive with the banks and had planned to make adjustments to the way it remunerates its supervisory staff; however, it did not initiate this given the federal government's current financial restraint. Bank officials indicated that the compensation gap is likely to increase further due to anticipated increases in bank staff compensation. This will likely increase OSFI's difficulties in attracting and retaining high-quality staff.

5.59 Recommendation. The Office of the Superintendent of Financial Institutions Canada should update its human resource planning strategy, including specialized training and compensation practices, to ensure that it is in a better position to attract and retain qualified staff.

The Office's response. Agreed. The Office is aware that its compensation structure for all positions at the executive level (including, but not exclusively, supervisory staff) is behind the targeted level and was preparing to revise the structure when the *Expenditure Restraint Act* was introduced. The Office has also changed its approach to market data collection to ensure a more quantifiable means of tracking market movement.

The Office is also aware of the need to ensure that employees are prepared for emerging risks via opportunistic and timely training.

The Office has a comprehensive human resource (HR) planning process that outlines specific strategies to address major opportunities and challenges. Its HR Strategy is revised annually to ensure timely recruitment and retention of the right people with the necessary skills. The HR Plan and Strategy outline the need for the compensation structure to remain competitive and to provide proactive and timely learning opportunities.

We are reviewing options to bring our salary structure more in line with our historical compensation philosophy. This revised structure will be brought forward for approval in the fall of 2010, with implementation after the expiry of the *Expenditure Restraint Act* in April 2011. For training practices, we will ensure that we focus on specialized areas of risk, while continuing to provide opportunistic training for employees.

Data and information requests

Regularly reported request—Financial data that comes from the financial regulatory returns that the banks have to complete periodically. Other information, such as management reports regularly submitted on financial, credit, and market risk, is also considered to be regularly reported information.

Ad hoc request—Information that is collected when up-to-date information is needed or when the financial data is not found in the financial regulatory returns.

5.60 Regulators and supervisors need to collect, review, and analyze reports and statistics from banks to perform their duties. Without appropriate information, supervisors are not able to adequately assess the different risks and this could have important consequences for the financial system. There are two types of data and information requests: **regularly reported** and **ad hoc**. We examined whether the Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada (OSFI), and the Canada Deposit Insurance Corporation (CDIC) request necessary and sufficient information from banks and use this information for regulating and supervising. We reviewed the documentation related to the collection of information and gathered input from OSFI officials and senior bank representatives through a questionnaire and interviews.

Efforts to improve the collection of information are still ongoing

5.61 In 1998, the Bank of Canada, in partnership with OSFI and CDIC, developed a system to collect, validate, manage, and maintain financial regulatory returns from banks. This system, known as the

Tri-Agency Database System, is jointly owned and operated by the three federal organizations.

5.62 The Department of Finance Canada, OSFI, CDIC, and the Bank of Canada are members of the Financial Information Committee (FIC), whose mandate includes assessing and coordinating the ongoing regularly reported financial information requirements of all member federal organizations in a cost-effective manner. The Department of Finance Canada, OSFI, and CDIC request information from banks and use it for regulating and supervising.

5.63 In 2003, the banks requested a review of regularly reported data to assess whether the data submitted by banks to FIC members continued to be relevant, and to create efficiencies in how the data is collected and reported. This led to the Data Rationalization Project, which so far has resulted in the deletion of a small number of data points compared with the total collected. Changes to data requirements are currently under way and additional changes will be made pending the finalization of new Basel rules.

5.64 In addition, an annual housekeeping exercise provides each FIC member with an opportunity to identify data that should be deleted or added to the financial regulatory returns, while taking into account regulatory and accounting changes. Based on this input, FIC discusses possible deletions and additions and informs the banks. Over the last two years, and due to new rules that require data changes, the annual housekeeping exercise has resulted in more data points being added than were deleted. The annual housekeeping exercise does not review ad hoc information requests.

5.65 We found that there is increased collaboration between the FIC members and the banks, and that the banks better understand what information is requested, why it is requested, and how federal organizations use it. We also found that the Data Rationalization Project, the annual housekeeping exercise, and FIC discussions have further reduced duplicate data requests, even though the number of data points has increased due to international pressure for FIC members to collect new data.

5.66 For each large bank, the total number of fields on OSFI regulatory returns increased from 24,000 to up to potentially 10 million following the Basel II Accord and to allow for future data gathering requirements as financial models evolve. Banks fill out the fields applicable to their operations. Each large bank now can submit up to half a million data points annually to OSFI as a result of the

increase in the size of the returns. The Tri-Agency Database System (TDS) was not designed to handle the new types of data, such as that required by the Basel II Accord, or the increased volume of data. Federal officials told us that there are plans to replace the TDS. The design of the new TDS should begin in 2011, with development expected to take several years.

Financial Information Committee members could improve coordination of information requests

5.67 The growing number of federal requests for information from banks pose challenges. We found that coordination among FIC members could be improved as there is no registry of the ad hoc information requested from the banks, which could lead to duplication of requests. We also found that the information the banks provided to the federal organizations in response to ad hoc requests is sometimes inconsistent. For example, when ad hoc requests are not well defined, the banks could interpret them in different ways. Also, federal organizations sometimes use readily available information from the banks for analysis even though this information may not be comparable across banks.

5.68 We found that it is difficult for FIC members to precisely determine the appropriate amount and type of information needed to fulfill the supervisory and regulatory needs. For example, some regularly reported data may not be currently used but may be retained for potential future use. Also, FIC members may want more information to assess new risks.

5.69 Future economic circumstances may require data that is different from the information already available. Therefore, ad hoc requests will always be necessary and could sometimes be numerous depending on the circumstances, such as during the recent financial turmoil. Banks recognize the benefits of being regulated and the need to provide data to FIC members. Federal organizations need to minimize the reporting burden on banks while still collecting the information they require to fulfill their mandates. Collecting, compiling, and disseminating data are costly activities for federal organizations and banks, and analyses need to be done before reducing or introducing additional reporting burdens. Banks and FIC members have a common interest in collecting relevant data in a cost-effective manner.

5.70 Recommendation. As chair of the Financial Information Committee, the Office of the Superintendent of Financial Institutions Canada, in collaboration with committee members, should periodically

review regular and ad hoc information requests that it makes to banks to determine whether information collected is relevant, accurate, and sufficient, while carefully assessing the cost-effectiveness of changes to reporting requirements.

The Office's response. Agreed. The Financial Information Committee (FIC) has pursued its mandate through a common framework that challenges changes to regular financial data collection and the associated reporting burden.

Ad hoc data requests are normally time-sensitive, and, unlike regular data, not conducive to FIC oversight. However, we recognize the need for more formal processes within each agency, and these are under development.

By March 2011, the Office will formally implement a Financial Management Information Policy that outlines principles, processes, accountabilities, governance, and oversight for data collection. The treatment of ad hoc data is included in this policy.

During the Annual Housekeeping exercise, starting in May 2011, FIC will formally reconfirm and minute the relevance and usefulness of the regular data being collected. FIC will discuss any data that could be eliminated.

Also, as part of the Annual Housekeeping process, FIC will engage the banking industry, via the Canadian Bankers Association, on the cost/benefits of a periodic data review exercise and improvements to our ad hoc data collection processes.

Conclusion

5.71 According to some international organizations, Canadian banks suffered less than most countries during the recent period of financial turmoil, in part, because its regulatory framework and supervisory approach, including communication among federal organizations, are effective. A recent, international peer review and the financial crisis have shown that the Canadian regulatory framework is robust. The challenge for Canada is to maintain that advantage in a context where new international standards are introduced, where banks are innovating and getting more complex, and where financial markets are rapidly evolving.

5.72 We found that the Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada (OSFI), the

Canada Deposit Insurance Corporation (CDIC), and the Bank of Canada regularly share relevant information on regulating and supervising banks through formal committees, such as the Financial Institutions Supervisory Committee (FISC) and the Senior Advisory Committee (SAC), and through informal relationships. The ongoing exchange of information helped Canada maintain its financial stability during the recent global economic crisis. We also found that OSFI interacts appropriately with foreign supervisors and regulators by exchanging information on cross-border issues.

5.73 We found that the Department of Finance Canada, OSFI, and CDIC have appropriate processes that are consistent with their mandates, to regulate and supervise large banks.

5.74 We found that legislation, regulations, and guidelines are regularly updated in light of emerging domestic and international developments. At the Department of Finance Canada, we found that some parts of the existing rules or past policy decisions have been assessed for their effectiveness using an ad hoc approach. There is no process for planning periodic reviews of the effectiveness of the regulatory and legislative framework in order to determine whether the existing rules and policies support the achievement of a stable and efficient financial system. We found that OSFI has reviewed the effectiveness of one guideline during the period we examined, and had also conducted another review in 2005. New OSFI guidelines and OSFI-sponsored regulations will now be reviewed for their effectiveness under the Cabinet Directive on Streamlining Regulation.

5.75 We found that OSFI assesses and updates its supervisory approach and monitors and implements emerging domestic and international principles and commitments. We also found that OSFI applies the supervisory approach as intended with respect to the large banks. However, human resource challenges are increasing due to increased workloads, financial restraint, and less time for training.

5.76 Together, the Financial Information Committee members are requesting growing amounts of regular and ad hoc information for regulating and supervising banks. However, managing information remains a challenge and continuous efforts are required to ensure that relevant, accurate, and sufficient information is requested from the banks.

About the Audit

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by The Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

Objectives

The audit examined whether the Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada (OSFI), and the Canada Deposit Insurance Corporation (CDIC) have appropriate processes that are consistent with their mandates to regulate and supervise large banks. The audit had the following sub-objectives:

- to determine whether the Department of Finance Canada, OSFI, and CDIC, to fulfill their responsibilities, exchanged and considered knowledge, information, and data on the regulation and supervision of large banks among themselves and whether OSFI shared information with international regulators and supervisors;
- to determine whether the Department of Finance Canada and OSFI had appropriate practices in place that are consistent with their mandates and designed to keep the regulatory framework relevant to the fulfillment of their responsibilities; and
- to determine whether OSFI assesses the relevance and appropriateness of the supervisory approach and whether it applies it as intended.

Scope and approach

The audit included the Department of Finance Canada, OSFI, and CDIC. At the Department of Finance Canada, we looked at the Financial Sector Policy Branch. At OSFI, we looked at the Regulation and Supervision sectors. At CDIC, we looked at the Insurance and Risk Assessment area. We also interviewed officials from the Bank of Canada. We did not include the Financial Consumer Agency of Canada because it does not have prudential regulatory responsibilities.

The audit focused on the six largest Canadian banks because these large and complex financial institutions could pose a significant risk to the stability of the Canadian financial system. These banks are the Royal Bank of Canada, the Toronto-Dominion Bank, the Bank of Nova Scotia, the Bank of Montreal, the Canadian Imperial Bank of Commerce, and the National Bank of Canada.

We reviewed various documents, including reports, minutes of meetings, and standards issued by international committees. We also reviewed the literature on the subject and interviewed senior representatives from each of the six large banks. We examined the regulatory activities carried out by OSFI and the Department of Finance Canada from 1 November 2007 to 31 March 2010. We also examined the supervisory work carried out by OSFI from 1 November 2007 to 31 October 2009, with a focus on the most recent full banking year from 1 November 2008 to 31 October 2009. The audit did not challenge the judgment of the supervisory work performed by OSFI. In addition, we examined the practices in place to exchange information between federal organizations and the banks.

Criteria

To determine whether the Department of Finance Canada, the Office of the Superintendent of Financial Institutions Canada (OSFI), and the Canada Deposit Insurance Corporation, to fulfill their responsibilities, exchange and consider knowledge, information, and data on the regulation and supervision of large banks among themselves and whether OSFI shared information with international regulators and supervisors, we used the following criteria:	
Criteria	Sources
The Department of Finance Canada, Office of the Superintendent of Financial Institutions (OSFI), and the Canada Deposit Insurance Corporation (CDIC) share knowledge and information on the regulation and supervision of banks.	<ul style="list-style-type: none"> • <i>Office of the Superintendent of Financial Institutions Act</i> (1985), section 18 • Basel Committee on Banking Supervision, Core Principles for Effective Deposit Insurance Systems, June 2009, principle 6 • Government of Canada, Cabinet Directive on Streamlining Regulation, 2007, Coordinating across the Government of Canada, page 7
OSFI interacts appropriately with regulators and supervisors from other countries on cross-border issues.	<ul style="list-style-type: none"> • Government of Canada, Cabinet Directive on Streamlining Regulation, 2007, International cooperation, page 8 • Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, October 2006, principle 25 • Basel II, 2006, paragraphs 780 to 783 • Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, September 2009, recommendations 4, 5, and 7
The Department of Finance Canada, OSFI, and CDIC request appropriate information from banks and use this information for regulating and supervising.	<ul style="list-style-type: none"> • <i>Office of the Superintendent of Financial Institutions Act</i> (1985), section 22 (2) • <i>Bank Act</i> (1991), section 628 (1) • Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, October 2006, principle 21
To determine whether the Department of Finance Canada and OSFI have appropriate practices in place that are consistent with their mandates and designed to keep the regulatory framework relevant to the fulfillment of their responsibilities, we used the following criteria:	
Criteria	Sources
The Department of Finance Canada and OSFI periodically review the relevance of the existing regulatory and legislative framework.	<ul style="list-style-type: none"> • Organization for Economic Cooperation and Development, Policy Framework for Effective and Efficient Financial Regulation, 2008 • Government of Canada, Cabinet Directive on Streamlining Regulation, 2007, section 4.6 • Committee of Sponsoring Organizations of the Treadway Commission (COSO), Enterprise Risk Management—Integrated Framework, 2004, section 4: Event identification; section 5: Risk assessment; and section 6: Risk response
The Department of Finance Canada and OSFI keep the regulatory and legislative framework relevant and appropriate in light of emerging domestic and international developments.	<ul style="list-style-type: none"> • <i>Office of the Superintendent of Financial Institutions Act</i> (1985), sections 3.1 and 4 (2) (d) • <i>Bank Act</i> (1991), section 21 (1) • Government of Canada, Cabinet Directive on Streamlining Regulation, 2007, section 4.6 • G-20 Leaders' Statement, 2 April 2009, paragraphs 13 to 16 • COSO, Enterprise Risk Management—Integrated Framework, 2004, section 4: Event identification; section 5: Risk Assessment; and section 6: Risk response

To determine whether OSFI assesses the relevance and appropriateness of the supervisory approach and whether it applies it as intended, we used the following criteria:	
Criteria	Sources
OSFI periodically reviews the relevance and the application of the existing supervisory approach.	<ul style="list-style-type: none"> • OSFI, Supervisory Framework, 1999 and beyond • <i>Office of the Superintendent of Financial Institutions Act</i> (1985), section 4(2)(a) • Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, October 2006, principle 19 • COSO, Enterprise Risk Management—Integrated Framework, 2004, section 4: Event identification; section 5: Risk Assessment; and section 6: Risk response
OSFI keeps the supervisory approach relevant in light of emerging domestic and international developments, including international principles and commitments.	<ul style="list-style-type: none"> • <i>Office of the Superintendent of Financial Institutions Act</i> (1985), section 4(2)(d) • OSFI, Supervisory Framework, 1999 and beyond • G-20 Leaders' Statement, 2 April 2009
OSFI appropriately applies the supervisory approach when assessing the safety and soundness of banks and of the financial system.	<ul style="list-style-type: none"> • <i>Office of the Superintendent of Financial Institutions Act</i> (1985), section 4(2)(a), (b), and (c) • OSFI, Supervisory Framework, 1999 and beyond • G-20 Leaders' Statement, 2 April 2009, paragraphs 13 to 16 • Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, October 2006, principles 19, 20, 21, and 23

Management reviewed and accepted the suitability of the criteria used in the audit.

Period covered by the audit

The audit covered the period from 1 November 2007 to 1 November 2009. Audit work for this chapter was substantially completed on 31 March 2010.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 5. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Response
Regulation	
5.43 As chair of the Senior Advisory Committee, the Department of Finance Canada should establish the committee's terms of reference, in collaboration with its members. These terms of reference should require the development of plans to perform effectiveness reviews of the regulatory and legislative framework to ensure that significant parts of the regulatory framework are periodically assessed. (5.37–5.42)	Agreed. The Department will consider the recommendation to establish terms of reference for the Senior Advisory Committee (SAC), in consultation with the Bank of Canada, the Office of the Superintendent of Financial Institutions Canada, the Canada Deposit Insurance Corporation, and the Financial Consumer Agency of Canada, including giving SAC a mandate to regularly review the effectiveness of the regulatory and legislative framework.
Supervision	
5.59 The Office of the Superintendent of Financial Institutions Canada should update its human resource planning strategy, including specialized training and compensation practices, to ensure that it is in a better position to attract and retain qualified staff. (5.53–5.58)	<p>Agreed. The Office is aware that its compensation structure for all positions at the executive level (including, but not exclusively, supervisory staff) is behind the targeted level and was preparing to revise the structure when the <i>Expenditure Restraint Act</i> was introduced. The Office has also changed its approach to market data collection to ensure a more quantifiable means of tracking market movement.</p> <p>The Office is also aware of the need to ensure that employees are prepared for emerging risks via opportunistic and timely training.</p> <p>The Office has a comprehensive human resource (HR) planning process that outlines specific strategies to address major opportunities and challenges. Its HR Strategy is revised annually to ensure timely recruitment and retention of the right people with the necessary skills. The HR Plan and Strategy outline the need for the compensation structure to remain competitive and to provide proactive and timely learning opportunities.</p>

Recommendation	Response
	<p>We are reviewing options to bring our salary structure more in line with our historical compensation philosophy. This revised structure will be brought forward for approval in the fall of 2010, with implementation after the expiry of the <i>Expenditure Restraint Act</i> in April 2011. For training practices, we will ensure that we focus on specialized areas of risk, while continuing to provide opportunistic training for employees.</p>
<p>Data and information requests</p> <p>5.70 As chair of the Financial Information Committee, the Office of the Superintendent of Financial Institutions Canada, in collaboration with committee members, should periodically review regular and ad hoc information requests that it makes to banks to determine whether information collected is relevant, accurate, and sufficient, while carefully assessing the cost-effectiveness of changes to reporting requirements. (5.67–5.69)</p>	<p>Agreed. The Financial Information Committee (FIC) has pursued its mandate through a common framework that challenges changes to regular financial data collection and the associated reporting burden.</p> <p>Ad hoc data requests are normally time-sensitive, and, unlike regular data, not conducive to FIC oversight. However, we recognize the need for more formal processes within each agency, and these are under development.</p> <p>By March 2011, the Office will formally implement a Financial Management Information Policy that outlines principles, processes, accountabilities, governance, and oversight for data collection. The treatment of ad hoc data is included in this policy.</p> <p>During the Annual Housekeeping exercise, starting in May 2011, FIC will formally reconfirm and minute the relevance and usefulness of the regular data being collected. FIC will discuss any data that could be eliminated.</p> <p>Also, as part of the Annual Housekeeping process, FIC will engage the banking industry, via the Canadian Bankers Association, on the cost/benefits of a periodic data review exercise and improvements to our ad hoc data collection processes.</p>

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