

OSFI

Office of the Superintendent of Financial Institutions

ANNUAL REPORT 1998-99



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OSFI’S MISSION

To better focus on its legislated mandate, and to provide a framework for accountability, OSFI has developed a mission statement.

Our mission is to safeguard policyholders, depositors and pension plan members from undue loss. We advance and administer a regulatory framework that contributes to public confidence in a competitive financial system. We also provide actuarial services and advice to the Government of Canada.

We are committed to providing a professional, high quality and cost-effective service.



Left to right: Jim Dolan, Geraldine Low and Philip Yung of Foreign Bank Branch Supervision, Ottawa



The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, Canada
K1A 0A6

Dear Minister:

Pursuant to section 25 of the *Office of the Superintendent of Financial Institutions Act*, I am pleased to submit to you and the Secretary of State (International Financial Institutions) the Annual Report of the Office of the Superintendent of Financial Institutions for the period April 1, 1998 to March 31, 1999.

Yours very truly,

John R.V. Palmer
Superintendent

Ottawa, September 1999

Highlights 1998-99

EXTERNAL HIGHLIGHTS:

MacKay Report: OSFI executives appeared before committees of the House of Commons and Senate to comment on the Report of the Task Force on the Future of the Canadian Financial Services Sector, known as the “MacKay Report.” OSFI staff also presented papers to the Task Force on holding companies, regulatory streamlining, and international regulatory issues.

Demutualization: The federal government introduced legislation to permit demutualization of large Canadian insurance companies. Pursuant to its mandate, OSFI was heavily involved in developing the demutualization regime and undertook a number of actions to protect the interests of policyholders.

Bank Merger Proposals: As requested by the Minister of Finance, OSFI reported on whether the proposed mergers of four large Canadian banks would compromise the financial strength of the resulting entities or make the resolution of financial problems involving either of them more difficult.

Report on the CPP: The Seventeenth Actuarial Report on the Canada Pension Plan was tabled in Parliament. The report found the CPP to be on a sound financial footing, and calculated the steady state contribution rate for the Plan to be 9.8 per cent of eligible earnings.

Foreign Bank Branching: In conjunction with the introduction of legislation permitting foreign banks to operate in Canada on a branch basis, OSFI developed a regime for evaluating applications and supervising entrants. It also released a draft Guide to Foreign Bank Branching, containing information on the requirements and procedures for entry.

Confederation Life Pay-out: KPMG Inc., the liquidator for Confederation Life Insurance Company, announced that Canadian policyholders would be paid in full, with accrued interest. The U.S. rehabilitator also said he expected U.S. policyholders to be paid in full in the future.

INTERNAL HIGHLIGHTS:

Supervisory Framework: A new Supervisory Framework, with greater focus on risk-based supervision, was developed in 1998-99. The Framework, and the methodologies derived from it, will better position the Office to deal with the complexities of today’s financial environment, and to respond to future challenges.

OSFI Reorganization: Formulated and announced in the previous year, the reorganization of OSFI’s supervisory and regulatory resources became reality in 1998-99.

User Fees: OSFI introduced user fees for selected regulatory services, in order to more fairly allocate costs to the users of those services.

Superintendent's Message

1998-99: A YEAR OF TRANSITION

What are we to make of Canada's financial sector at mid-1999? Never before have there been more confusing signals and trends.

Many of these are positive. Taken as a whole, the financial sector is showing the sixth straight year of economic recovery following the recession of the early 1990s, and for some companies, the recovery period stretches back even further. For most participants, earnings continue to be strong, and most companies seemed only slightly affected by the financial instability that shook global markets in the summer of 1997 and continued throughout 1998. Indeed, Canada's financial institutions for the most part managed to avoid many of the problems besetting financial institutions in other countries. In the meantime, it appears that the international financial system has weathered the storms of the last two years and near-term economic prospects seem bright.

On the other hand, these recent events remind us how volatile the international financial system can be. And the fate of companies like Long-Term Capital Management L.P. show us that even the most qualified people and the most carefully developed systems can miscalculate. Financial institutions are, after all, in the business of taking risks.

While most Canadian institutions came through the turbulence rather well, earnings growth for many appears to have levelled off, and the buoyant, ever increasing earnings of the past few years may be difficult to maintain. While there may be few major clouds on the immediate economic horizon, as a prudential regulator and supervisor, OSFI must prepare for any distant storms that might be

brewing, even when the economic weather seems sunny and promising.

In good times like these, the value of prudential regulation may appear less obvious. There may even be a tendency to undervalue the mission of prudential regulators and supervisors like OSFI, which is to safeguard people's savings placed in bank deposits, insurance policies and pension plans. It is usually when an economic downturn occurs that the value of prudential regulation and supervision proves itself or not.

While it is difficult to predict when the next economic downturn might occur, OSFI must be ready for such an event. Preparations began in earnest three years ago in response to detailed revisions to the *OSFI Act*. Before that, OSFI's legislated mandate had been less than clear. All that changed in the aftermath of a series of failures in the early 1990s, culminating in the liquidation of Confederation Life Insurance Company.

Among those revisions was the addition of a clear mandate describing OSFI's accountabilities. One of these was to anticipate problems and intervene early in the affairs of troubled financial institutions, so as to minimize losses to depositors and policyholders. This "early intervention mandate" looked challenging enough when OSFI was given it in 1996. As the financial sector becomes more complex and volatile, it looks more challenging still.

Moving forward, OSFI's prudential mandate will become ever more demanding, with recent or pending changes to the scope of its role, which are likely to include the regulation and supervision of:

- foreign bank branches;
- a number of new institutions, some of which may be riskier than those we have worked with in recent years; and
- financial holding company structures which will be more difficult to regulate and supervise.

With all this in mind, we have been making some profound changes at OSFI.

First, we have reorganized the supervisory function. We have worked to reduce overlap and duplication and to better focus our resources. The organizational distinction between analysis and examination has been eliminated. The full range of supervisory functions has been integrated, with a Relationship Manager assigned to every institution.

Another aspect of the reorganization was the establishment of a Conglomerates Group, where we can concentrate the expertise needed to deal with the largest and most complex institutions.

“...the nature of supervision itself is changing, as set out in a new Supervisory Framework ... Under the new Framework, OSFI assesses an institution’s safety and soundness by focussing on the risks undertaken, and on the risk mitigants...”

Not only have we restructured our supervisory resources, but the nature of supervision itself is changing, as set out in a new Supervisory Framework. It results from a review of our supervisory needs and practices that started almost three years ago when OSFI’s new mandate came into force. Under the new Framework, OSFI assesses an institution’s safety and soundness by focussing on the risks undertaken, and on the risk mitigants, the term we use for the controls an institution imposes to manage and limit risks.

In addition to enhancing our supervisory function, we have put more emphasis on the capital and reserves of regulated institutions, to ensure that there are adequate cushions against loss in today’s more volatile financial environment. This is not one of OSFI’s more popular initiatives with those institutions that must boost capital and reserves, since this

action tends to have a short-term impact on profitability. Some rating agencies, however, think we are not going far enough.

OSFI’s style of supervision is also changing. As contemplated by the new mandate, we are becoming more interventionist when we identify problems at financial institutions and pension plans. We have published Guides to Intervention for each industry group to clarify the steps we would take if problems develop and escalate at the institutions or pension plans we supervise.

OSFI has also reorganized the policy or regulatory function to eliminate overlap and duplication between industries and make a more effective contribution to the policy development process. These changes occurred as OSFI’s Regulation Sector faced an unprecedented wave of transactions, many driven by the consolidation trend that is sweeping the financial sector.

The Regulation Sector also spearheaded OSFI’s contribution to the work of the Task Force on the Future of the Canadian Financial Services Sector (the MacKay Task Force). OSFI’s work included the submission of three papers to the Task Force, appearances at parliamentary committees to discuss the Task Force recommendations, and support to the Department of Finance in developing the government’s Policy Paper which responded to the Task Force recommendations.

As part of the reorganization of the Regulation Sector, a new International Liaison Division was created to oversee a growing number of activities on the international front, including:

- involvement in the Toronto International Leadership Centre for Financial Sector Supervision,
- support for Finance Minister Paul Martin’s efforts to encourage the creation of a new global financial architecture,
- a growing network of bilateral and multilateral relationships with other financial

sector regulators and supervisors in order to respond to the challenges posed by global financial institutions and international transactions.

OSFI also began building a new arm of the organization: the Specialist Support Sector. This sector provides specialist expertise to the other sectors at OSFI. The new teams of specialists focus on selected activities or issues and seek to develop a better understanding of their prudential implications. They then share this understanding with our front-line supervisory and regulatory staff, in support of their activities.

As OSFI changes the way in which it regulates and supervises financial institutions and pension plans, it has made some important administrative changes in support of these initiatives. In 1998, 17 separate pay groups were combined into one new Universal Classification System, one of the first such systems to be introduced in a federal government department. This will make it easier to redeploy talent within OSFI and has also removed some classification and compensation anomalies across the organization. In addition, OSFI was one of the first federal agencies to introduce a performance compensation program including re-earnable bonuses for all qualifying employees.

The extent of the changes at OSFI has been very far reaching. We have re-engineered the entire organization. In comparing 1998-99 with 1994-95, almost everyone in OSFI is doing a job that is new or that has been significantly transformed.

While OSFI has been working hard to strengthen its core supervisory and regulatory functions in order to respond to a more demanding mandate, we have also been trying to improve service to the institutions we deal with. For example, we have implemented user fees for many of the regulatory approvals we consider. Over time, we believe this will lead to a more equitable allocation of costs, and make it possible for OSFI to allocate its own resources more effectively.

We are also working on a number of measures to streamline the regulatory approvals process. As recommended in a report submitted by OSFI to the MacKay Task Force, these include replacing approvals by notices in some cases, or even eliminating them for certain transactions, based on their size or the institution involved. We also want to be able to consider new “one-off” proposals more quickly and to approve them where we see no immediate prudential concerns.

Along with work to improve our level of service to the institutions we regulate, we are also attempting to advocate measures that will increase the competitiveness of Canada’s financial industry.

We have been working in international forums, to encourage the adoption of consistent regulatory and supervisory standards and to foster a level playing field for Canadian financial institutions in world markets.

“We have been working in international forums, to encourage the adoption of consistent regulatory and supervisory standards and to foster a level playing field for Canadian financial institutions in world markets.”

We have pressed for a reduction or elimination of capital taxes on financial institutions. While there are policy goals associated with capital taxes which go beyond OSFI’s mandate, and responsibility for capital taxes is shared by the federal government and the provinces, capital taxes create perverse incentives in prudential terms and also affect Canadian institutions’ ability to compete against their international rivals.

OSFI committed significant resources to research the prudential aspects of a holding company regime that would give financial institutions more flexibility in structuring themselves to meet the needs of a rapidly

changing marketplace. OSFI's conclusions were shared with the MacKay Task Force and with the Department of Finance for use in the preparation of the government's Policy Paper, *Reforming Canada's Financial Services Sector*.

OSFI has played an active role in working with financial institutions and the accounting profession to find a way to level the playing field for Canadian financial institutions vis-à-vis their international competitors in accounting for business combinations.

While much has been accomplished to prepare OSFI for the end of the current economic cycle, whenever that might occur, more remains to be done. Despite a remarkably hard-working and dedicated team of professionals in all its sectors, OSFI's biggest challenge is still to retain, recruit, train and develop more people who can understand and work with an increasingly complicated financial services industry and the more complex risks to which that industry is exposed.

“I'm very proud of the accomplishments of the women and men at OSFI who have risen to the challenges facing them in a professional manner...”

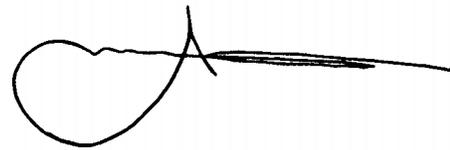
The competition for talent in the financial sector is fierce, and OSFI must continue its efforts to become more competitive in the financial sector labour market if it is to fulfil its mandate in ever more challenging circumstances.

The pace of change at OSFI since the introduction of its legislated mandate in 1996 has been unrelenting. And with more changes affecting OSFI proposed by the government's policy paper, the transformation will continue.

In this context, I'm very proud of the accomplishments of the women and men at

OSFI who have risen to the challenges facing them in a professional manner, and exhibit a remarkable commitment to their calling as regulators and supervisors. It is a pleasure to work with them, and I thank them for their many achievements over the past year.

Sincerely,

A handwritten signature in black ink, appearing to read 'John R.V. Palmer'. The signature is fluid and cursive, with a large loop at the beginning and a long horizontal stroke extending to the right.

John R.V. Palmer

Superintendent

FINANCIAL INSTITUTIONS REGULATED BY OSFI

	Number ¹	Assets ^{2,4} (in millions)
Banks		
Domestic	11	\$ 1,302,127
Foreign	44	\$ 94,882
Trust and Loan Companies		
Bank-owned	32	\$ 143,739
Other	27	\$ 54,939
Cooperative Credit Associations	7	\$ 7,606
Life Insurance Companies		
Canadian incorporated	54	\$ 254,708
Foreign branches	71	\$ 20,536
Fraternal Benefit Societies		
Canadian-owned	13	\$ 6,895
Foreign branches	14	\$ 786
Property and Casualty Insurance Companies		
Canadian incorporated	98	\$ 34,124
Foreign branches	116	\$ 16,354
Pension Plans ³	1,157	\$ 71,224

Notes:

¹ Number of regulated companies as at 31 March 1999. Includes institutions in the process of liquidation or termination and institutions limited to servicing existing businesses. A list of institutions regulated by OSFI can be found on OSFI's web site.

² As at 31 March 1999 where available, otherwise 31 December 1998.

³ Assets for pension plans as at 31 December 1998 where available, otherwise 31 December 1997.

⁴ Total assets of the industries regulated by OSFI are not the simple sum of the above-noted figures. The figures for entities that report on a consolidated basis include subsidiaries whose assets may also be included in a different category.

FEDERALLY REGULATED FINANCIAL INSTITUTIONS

For OSFI, a federally regulated financial institution is any entity (public or private corporation, subsidiary, or branch) that has been created or allowed to offer financial services pursuant to one of the financial institution statutes promulgated by the federal government. Banks, for example, are incorporated or registered under the *Bank Act*, while insurance companies — both life companies as well as property and casualty insurers — are incorporated or registered under the *Insurance Companies Act*. Both Acts specify a number of “dos and don'ts” that govern the activities of these institutions in the public interest.

OSFI: REGULATOR AND SUPERVISOR

OSFI was established by legislation in 1987 to ensure a coordinated approach to prudential supervision and to modernize the regulatory framework for Canada's financial system. The Office (a synonym for OSFI used in this report) regulates and supervises all banks in Canada, as well as all federally registered insurance companies, trust and loan companies, cooperative credit associations and fraternal benefit societies. (See box on page 9: Federally Regulated Financial Institutions.) OSFI also regulates and supervises pension plans under federal jurisdiction and provides actuarial advice to the Government of Canada.

Regulation is the setting of rules of good prudential behaviour for financial institutions and pension plans. This involves a number of tasks related to the legislative regime that governs them: providing input into the development of legislation, interpreting existing legislation, developing guidelines, and considering requests from institutions and plans as required under law.

Supervision, for its part, involves assessing the safety and soundness of financial institutions and pension plans – analyzing their

financial data and confirming the existence of appropriate risk controls, for instance – and monitoring the financial industry for systemic risks.

In addition to the duties set out in the *Office of the Superintendent of Financial Institutions Act*, OSFI has obligations under the *Public Pensions Reporting Act* and *Canada Pension Plan Act*. As well, OSFI administers the following five Acts:

- *Bank Act*,
- *Insurance Companies Act*,
- *Trust and Loan Companies Act*,
- *Cooperative Credit Associations Act*, and
- *Pension Benefits Standards Act, 1985*.

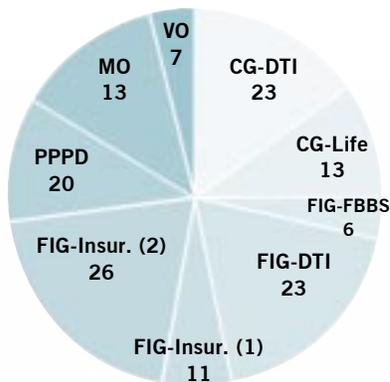
OSFI is organized into four sectors: Supervision, Regulation, Specialist Support and Corporate Services. OSFI's responsibilities are carried out by a staff of about 370 employees in four offices: Ottawa, Toronto, Montreal, and Vancouver.



Left to right: Nicholas Le Pan, Edna M. MacKenzie, John R.V. Palmer and John R. Thompson

THE OSFI ORGANIZATION

NUMBER OF EMPLOYEES IN EACH DIVISION, PER SECTOR



SUPERVISION SECTOR

Deputy Superintendent: Nicholas Le Pan

CG-DTI: Conglomerates Group, Deposit-Taking Institutions

CG-Life: Conglomerates Group, Life Insurance

FIG-FBBS: Financial Institutions Group, Foreign Bank Branch Supervision (Ottawa)

FIG-DTI: Financial Institutions Group, Deposit-Taking Institutions (Toronto)

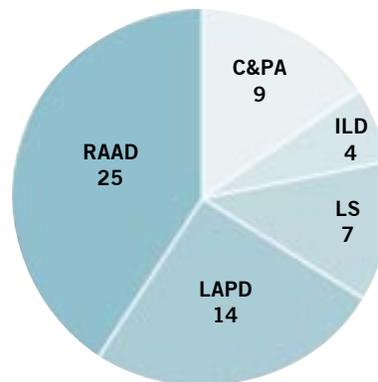
FIG-Insur. (1): Financial Institutions Group, Insurance (Ottawa)

FIG-Insur. (2): Financial Institutions Group, Insurance (Toronto)

PPPD: Private Pension Plans Division

VO: Vancouver Office

MO: Montreal Office



REGULATION SECTOR

Deputy Superintendent: John Thompson

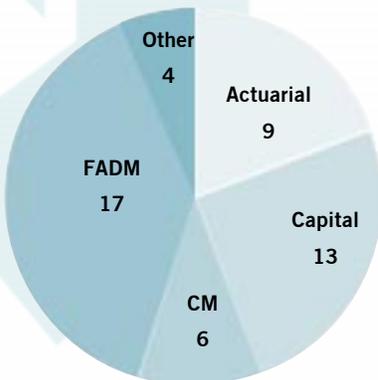
C&PA: Communications and Public Affairs

ILD: International Liaison Division

LS: Legal Services (including Access to Information)

LAPD: Legislation and Precedents Division

RAAD: Registration and Approvals Division



SPECIALIST SUPPORT SECTOR

Assistant Superintendent: Vacant

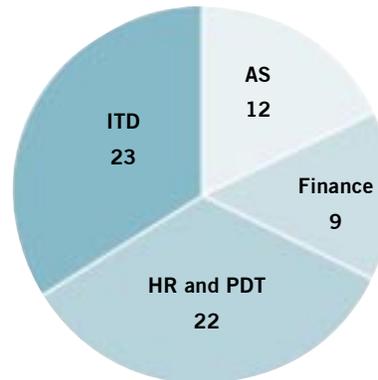
Actuarial Division

Capital Division

CM: Capital Markets Division

FADM: Financial Analysis and Data Management Division

Other (includes Accounting, Compliance, Credit Risk and Financial Services Technology Divisions)



CORPORATE SERVICES SECTOR

Assistant Superintendent: Edna MacKenzie

AS: Administrative Services

Finance and Corporate Planning Division

HR and PDT: Human Resources Management and Professional Development and Training Divisions

ITD: Information Technology Division

Report directly to the Superintendent:

Regulatory and Supervisory Practices Division

Director: Naren Sheth

3 employees

Office of the Chief Actuary

Chief Actuary: Jean-Claude Ménard

19 employees