PERFORMANCE REPORT

Office of the Superintendent of Financial Institutions Canada

For the
period ending
March 31, 1997

Improved Reporting to Parliament —
Pilot Document

Canada

Available in Canada through your local bookseller or by

mail from Canadian Government Publishing – PWGSC

Ottawa, Canada K1A 0S9

Catalogue No. BT31-4/62-1997
ISBN 0-660-60348-9

Foreword

On April 24, 1997, the House of Commons passed a motion dividing what was known as the *Part III of the Estimates* document for each department or agency into two documents, a *Report on Plans and Priorities* and a *Departmental Performance Report.* It also required 78 departments and agencies to table these reports on a pilot basis.

This decision grew out of work by Treasury Board Secretariat and 16 pilot departments to fulfil the government's commitments to improve the expenditure management information provided to Parliament and to modernize the preparation of this information. These undertakings, aimed at sharpening the focus on results and increasing the transparency of information provided to Parliament, are part of a broader initiative known as "Getting Government Right".

This ***Departmental Performance Report*** responds to the government's commitments and reflects the goals set by Parliament to improve accountability for results. It covers the period ending March 31, 1997 and reports performance against the plans presented in the department's *Part III of the Main Estimates* for 1996-97.

Accounting and managing for results will involve sustained work across government. Fulfilling the various requirements of results-based management – specifying expected program outcomes, developing meaningful indicators to demonstrate performance, perfecting the capacity to generate information and report on achievements – is a building block process. Government programs operate in continually changing environments. With the increase in partnering, third party delivery of services and other alliances, challenges of attribution in reporting results will have to be addressed. The performance reports and their preparation must be monitored to make sure that they remain credible and useful.

This report represents one more step in this continuing process. The government intends to refine and develop both managing for results and the reporting of the results. The refinement will come from the experience acquired over the next few years and as users make their information needs more precisely known. For example, the capacity to report results against costs is limited at this time; but doing this remains a goal.

This report is accessible electronically from the Treasury Board Secretariat Internet site:
http://www.tbs-sct.gc.ca/tb/key.html

Comments or questions can be directed to the TBS Internet site or to:

Government Review and Quality Services
Treasury Board Secretariat
L'Esplanade Laurier
Ottawa, Ontario, Canada
K1A OR5
Tel: (613) 957-7042
Fax (613) 957-7044

Office of the Superintendent of Financial Institutions Canada

Performance Report

For the
period ending
March 31, 1997

James Peterson
The Secretary of State
(International Financial Institutions) Finance

Foreword

On April 24, 1997, the House of Commons passed a motion dividing what was known as the *Part III of the Estimates* document for each department or agency into two documents, a *Report on Plans and Priorities* and a *Departmental Performance Report.* It also required 78 departments and agencies to table these reports on a pilot basis.

This decision grew out of work by Treasury Board Secretariat and 16 pilot departments to fulfil the government's commitments to improve the expenditure management information provided to Parliament and to modernize the preparation of this information. These undertakings, aimed at sharpening the focus on results and increasing the transparency of information provided to Parliament, are part of a broader initiative known as "Getting Government Right".

This ***Departmental Performance Report*** responds to the government's commitments and reflects the goals set by Parliament to improve accountability for results. It covers the period ending March 31, 1997 and reports performance against the plans presented in the department's *Part III of the Main Estimates* for 1996-97.

Accounting and managing for results will involve sustained work across government. Fulfilling the various requirements of results-based management – specifying expected program outcomes, developing meaningful indicators to demonstrate performance, perfecting the capacity to generate information and report on achievements – is a building block process. Government programs operate in continually changing environments. With the increase in partnering, third party delivery of services and other alliances, challenges of attribution in reporting results will have to be addressed. The performance reports and their preparation must be monitored to make sure that they remain credible and useful.

This report represents one more step in this continuing process. The government intends to refine and develop both managing for results and the reporting of the results. The refinement will come from the experience acquired over the next few years and as users make their information needs more precisely known. For example, the capacity to report results against costs is limited at this time; but doing this remains a goal.

This report is accessible electronically from the Treasury Board Secretariat Internet site: http://www.tbs-sct.gc.ca/tb/key.html

Comments or questions can be directed to the TBS Internet site or to:

Government Review and Quality Services
Treasury Board Secretariat
L'Esplanade Laurier
Ottawa, Ontario, Canada
K1A OR5
Tel: (613) 957-7042
Fax (613) 957-7044

Office of the Superintendent of Financial Institutions
Performance Report to Parliament
for the period ending March 31, 1997

Table of Contents

SECTION I: DEPARTMENTAL OVERVIEW

Mandate

The Office of the Superintendent of Financial Institutions (OSFI), established by an Act of Parliament in 1987, is responsible for regulating and supervising banks, insurance, trust, loan and cooperative credit societies that are licensed or registered by the federal government, and for supervising federally regulated private sector pension plans. OSFI also has specific responsibility under various acts for providing actuarial and other services to the Government of Canada.

Under Bill C-15 (assented to in May 1996) OSFI was given specific responsibilities for contributing to public confidence in Canada's financial system and for minimizing losses to policyholders, depositors and creditors of financial institutions.

Mission

Pursuant to this mandate, OSFI has developed its mission statement which reads:

> "We are the primary regulator of federal financial institutions and pension plans. 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."

Objectives

The OSFI mission statement identifies five objectives. They are:

- <u>Safeguard from undue loss</u> - Identify institution specific risks and trends, and intervene in a timely manner so as to minimize losses to policyholders, depositors and pension plan members.

- <u>Public Confidence</u> - Contribute to public confidence by enhancing the safety and soundness of the Canadian financial system, including the evaluation of system wide risks and the promotion of sound business and financial practices.

- Quality - Improve the knowledge and skills of OSFI employees and the quality of processes and systems to meet the challenges of a rapidly changing environment.

- Cost Effectiveness - Maintain full and open dialogue with stakeholders on the costs and benefits of work undertaken.

- Competition - Fulfil OSFI's regulatory mandate having due regard to the need to allow institutions to compete effectively.

Strategic Priorities

(1) Accountability Framework

With limited resources, focus is essential, and an important OSFI initiative has been to define its mission, its strategic objectives, and the performance standards it will use to determine whether it has achieved those objectives. It is also intended that these standards will ultimately be used to permit OSFI to report to the Government and the public on its performance. Broad specifications for ten performance standards were established, and work is underway to develop measurable standards in each case. This work is challenging and virtually no precedents are available in Canada or around the world, but good progress is being made.

(2) Identifying and Understanding Emerging Risks

With many new developments in the financial sector, OSFI must understand the risks which financial institutions are assuming and the risks to which the financial sector itself is exposed in order to concentrate its resources on the most significant areas of risk. With this in mind, OSFI carried out a number of internal studies of emerging risks, with a view to identifying those requiring enhanced regulatory and supervisory attention.

(3) Dealing with Emerging Risks

Informed by new objectives and an enhanced understanding of emerging risks, OSFI undertook a fundamental review of all its regulatory and supervisory practices and methodologies. Work on this review, which is expected to be completed in 1999, will produce recommendations concerning changes to OSFI's existing practices and methodologies, in order to ensure that OSFI continues to focus on the areas of greatest risk.

In addressing areas of risk, OSFI has two fundamental strategies. The first is to satisfy itself that an appropriate control framework is in place in each financial institution for all major risks. The second is to ensure that financial institutions maintain sufficient regulatory capital to cushion depositors and policyholders against those risks.

(3) Improvements to the Regulation and Supervision of Pension Plans

While many pension funds benefited from buoyant equity markets, others were adversely affected by reduced returns on fixed income investments and a loss of membership due to industrial restructuring. A few plans are experiencing solvency problems and OSFI is shifting its emphasis toward solvency issues in order to be in a better position to assess the capacity of each plan to meets its obligation to its members. To accomplish this, OSFI is enhancing on-site inspections, developing solvency early warning tools, and has recommended a number of important changes to the Pension Benefits Standards Act, 1985 (PBSA). These were contained in a Bill introduced by the Honourable Doug Peters, the former Secretary of State (International Financial Institutions), in the last session of Parliament. With the dissolution of Parliament, this Bill lapsed. It is anticipated that the Bill will be re-introduced in the new session of Parliament.

(4) Human Resources Development

None of the above initiatives can succeed without experienced, knowledgeable and highly motivated professionals, who are capable of keeping abreast of the many changes taking place within the financial sector. OSFI has several initiatives underway to assist it in attracting, retaining and developing the professionals needed to carry out its challenging mandate. One initiative is to define OSFI's core competencies and to develop a professional development program around these competencies. Some important steps in this direction were taken in 1996-97.

Organization by Business Lines

OSFI has two business lines:

(1) Supervision of Financial Institutions and Pension Plans

OSFI supervises about 500 financial institutions and 1,100 pension plans. The pension plans are employer-sponsored plans that are subject to provisions of the Pension Benefits Standards Act, 1985. In addition, on a cost-recovery basis, OSFI carries out reviews of certain provincially chartered institutions through federal-provincial agreements or as an agent of the Canada Deposit Insurance Corporation.

(2) Actuarial and Other Services to the Government of Canada

OSFI prepares actuarial reports pursuant to the Public Pensions Reporting Act and the Canada Pension Plan and various other statutory reports on government pension and insurance programs. Furthermore, OSFI was responsible for collecting tax under Part I of the Excise Tax Act and administer an insurance plan under the Civil Service Insurance Act, but these functions were transferred to Revenue Canada and Human Resources Development on April 1, 1997.

SECTION II: DEPARTMENTAL PERFORMANCE

A. Performance Expectations

Planned versus Actual Spending Tables

Resource Requirements by Organization and Business Line

Comparison of Total Planned Spending to Actual Expenditures, 1996-97 by Organization and Business Line ($ millions)			
	Business Lines		
Organization	**Supervision of Financial Institutions and Pension Plans**	**Actuarial and Other Services to the Government of Canada**	**Totals**
Operations Sector		2.0	2.0
	(1.4)	**2.0**	**0.6**
Policy Sector			0.0
	(0.4)		**(0.4)**
Corporate Services Sector		0.5	0.5
	(0.7)	**0.5**	**(0.2)**
TOTALS	0.0	2.5	2.5
	(2.5)	**2.5**	**0.0**

Note : Shaded numbers denote actual expenditures/revenues in 1996/97
All numbers above are net (expenditures minus revenues)

Comparison of Total Planned Spending to Actual Expenditures, 1996-97 by Business Line ($ millions)					
Business line	**Operating**	**Capital**	**Subtotal: Gross Voted Expenditures**	**Less: Revenue Credited to the Vote**	**Total Net Expenditures**
Supervision of Financial Institutions and Pension Plans	38.3	0.5	38.8	38.8	0.0
	35.9	**1.1**	**37.0**	**39.5**	**(2.5)**
Actuarial and Other Services to the Government of Canada	3.9		3.9	1.4	2.5
	3.9		**3.9**	**1.4**	**2.5**
Totals	42.2	0.5	42.7	40.2	2.5
	39.8	**1.1**	**40.9**	**40.9**	**0.0**
Other Revenues and Expenditures					
Revenue credited to the Consolidated Revenue Fund					(1.4)
					(1.4)
Cost of services provided by other departments					0.1
					0.1
Net Cost of the Program					1.2
					(1.3)

Note : Shaded numbers denote actual expenditures/revenues in 1996/97

Departmental Planned versus Actual Spending by Business Line (millions of dollars)					
Business Lines	**Actual 1993-94**	**Actual 1994-95**	**Actual 1995-96**	**Total Planned 1996-97**	**Actual 1996-97**
Supervision of Financial Institutions and Pension Plans	(0.9)	(2.2)	1.6	0.0	(2.5)
Actuarial and Other Services to the Government of Canada	2.4	2.5	2.6	2.5	2.5
Total	1.5	0.3	4.2	2.5	0.0
Note : All numbers above are net (expenditures minus revenues)					

Summary of Performance Expectations

Office of the Superintendent of Financial Institutions Key Results Commitments	
to provide Canadians with:	**to be demonstrated by:**
Sound and responsive regulation and supervision of federally chartered, licensed or registered financial institutions and pension plans	• policy holders, depositors and pension plan members safeguarded from undue loss • supervisory and regulatory strategies that respond to emerging risks • public confidence in Canadian financial institutions and pension plans • competitiveness of the entities supervised
Actuarial advice and other services	• services are provided to Parliament and other federal programs and pension funds in a professional, cost-effective and timely manner

Performance measures against which OSFI can test its success in meeting its strategic objectives are currently under development. This task is complicated by the fact that virtually no models of performance measurement exist for a financial institutions regulator; therefore, creativity is required. OSFI hopes to have several measures in place, on a provisional basis, for the 1997-98 planning year, with others to follow in subsequent years. In summary, here are proposals for the measurement of OSFI's performance currently under review:

Public Confidence

- a composite financial indicator of risk to reflect the overall financial condition of the Canadian financial sector and its constituent industry groups;

- effectiveness surveys, directed to the measurement of the quality, effectiveness, impact, relevance and utility of OSFI's activities in promoting the adoption of sound business and financial practices; and

- a national opinion survey of public attitude towards, and confidence in, the financial sector and its constituent industry groups.

Safeguarding from Undue Loss

- a quantitative intervention index, to measure the efficiency and effectiveness of OSFI's interventions, and to focus on the number of institutions and value of assets represented on the stages of OSFI's Guides to Intervention;

- a qualitative intervention index, to measure OSFI's effectiveness in carrying out the actions called for in the Guides to Intervention respecting financial institutions of concern to OSFI; and

- a loss recovery index, to measure the cost to the system of dealing with institutions which fail.

Competition

- enhancing the process of developing regulations, guidelines, and policy statements by conducting more formalized and specific consultation with respect to their competitive impact. This may be done through discussion or a questionnaire;

- developing an intrusiveness index, based on the volume and complexity of regulation imposed;

- developing a regular survey-based approach (either survey or focus group) to elicit industry views;

- commissioning research by third parties, such as that done recently by the Conference Board of Canada on the cost of regulation; and

- developing an ongoing program evaluation methodology.

Cost Effectiveness

- the ratio of supervisory costs (direct and indirect) in dollars and in staff time, for each industry sector, to assets or revenues;

- comparison of OSFI's internal compliance costs as defined above with similar cost figures from other jurisdictions (e.g. the provinces, the U.S., the U.K. etc.); and

- derivation of a total compliance cost by industry, including OSFI internal costs and all internal and external costs incurred by institutions to ensure compliance with OSFI requirements, and a comparison between OSFI's internal compliance costs and the total compliance costs for each industry segment.

Quality

- core competency profile

  Core competencies are being developed which will be used to assess training needs through the evaluation of individual and organizational gaps between actual and target competencies.

- level of employee satisfaction

  A comprehensive employee survey has been conducted which will provide base year data for periodic assessment of overall employee satisfaction within OSFI, and which will allow for some benchmarking with other organizations engaged in similar activities.

- comprehensive quality index for OSFI processes

  Test indices are being examined to assess their relevance and validity in reflecting the overall quality of both internal OSFI processes and outputs and activities driven by external requests for OSFI rulings or approvals.

B. Departmental Performance Accomplishments

Identifying and understanding emerging risks on an ongoing basis

In the 1996-97 planning period, OSFI made additional efforts to identify, understand and prioritize important and emerging risks being faced by federally-regulated financial institutions. The results of this work, developed through a standing internal task force drawn from the Policy and Operations sectors, have been used in the planning process for the current period. Reviews of key risks are ongoing.

In addition, a research paper on the effects of technology on the financial sector was prepared by the Policy Sector. This work resulted in two additional projects:

- first, a policy statement on outsourcing business functions to regulated and unregulated service providers has been released. The statement is intended to address a growing trend for financial institutions to outsource core business functions - a trend facilitated by technology; and

- second, OSFI developed a consumer-friendly statement, for its Internet web site, describing the role of regulation. Implementation is planned for the fall of 1997. A frequently updated list of federally-regulated financial institutions will also be made available on the Internet web site. This responds to concerns that technology, notably the Internet, enhances the scope for consumers to be misled regarding the regulated status of financial services providers.

During 1997, Canada's first electronic financial institutions were incorporated. Because they will be dependent for their survival on non-traditional distribution channels, these institutions created new issues for the supervisory system, such as the need to review steps taken by the institutions to ensure the security of the products to be offered via customers' personal computers.

Closing the expectations gap

A key challenge that OSFI faces with respect to its goal of contributing to confidence in the Canadian financial system is the need to foster a realistic understanding of the role of regulation and supervision. Most Canadians deal with federal financial institutions and place some direct or indirect reliance on OSFI. It is important that the basis for such reliance be realistic and understood.

In 1995, the federal government clarified, through the release of a discussion paper entitled "Enhancing the Safety and Soundness of the Canadian Financial System", that regulation cannot and should not attempt to prevent all failures of financial institutions. A regulatory mandate that attempts to prevent all failures could result in a regulatory regime that is overly intrusive and costly. Such a regime could also discourage institutions from taking reasonable risks, and could therefore put Canadian financial institutions at a competitive disadvantage. An alternative regulatory mandate, based on the concept of having mandatory supervisory intervention and legislated levels of key financial variables or "trip wires", is inherently inflexible and could create incentives for inaction or deferred action by an institution's supervisor. Neither option is acceptable. Instead, a more flexible regulatory framework, which allows for early resolution of an institution's problems, has been retained for the Canadian marketplace. OSFI has been mandated to safeguard the interests of depositors and policyholders. However, the mandate recognizes that failures of financial institutions can and will occur. It is important that OSFI continue to work in a variety of ways to make its role and mandate understood.

Enhancing disclosure of financial information

Heightened awareness by consumers of the financial conditions of their financial institutions can have a favourable impact on public confidence. The 1995 discussion paper proposed that more information on the financial condition of federally- regulated financial institutions be disclosed and that it be disclosed more frequently. Federal financial institutions legislation has been amended to accommodate these proposals. Both the Canadian Institute of Actuaries (CIA) and the Canadian Institute of Chartered Accountants (CICA) have formed committees to address actuarial and accounting disclosure issues and both have developed additional guidance for disclosure by financial institutions. OSFI has issued specific disclosure requirements for deposit-taking institutions in its Guidelines on Annual Disclosure Requirements. Similar guidelines in respect of insurance companies are in the process of being finalized.

The guidelines describe the additional information to be included with annual reports and address areas such as: investment and lending portfolios; segmented information regarding assets, liabilities, and revenue; interest rate sensitivity position; and actuarial liabilities. Institutions will also have to address their risk management and control practices in areas such as: credit risk; liquidity risk; interest rate risk; foreign exchange rate risk; and reinsurance risk.

In addition, OSFI now makes year-end financial statements of federally-regulated financial institutions available on its Internet web site. Monthly data is also available with respect to assets of individual banks and domestic assets of the banking industry on a consolidated basis.

Under the OSFI Act, OSFI is required to report, through its Annual Report, on the disclosure of information by financial institutions and describing the progress being made in enhancing disclosure. Due to the relatively recent implementation of these disclosure initiatives, a more detailed progress report will be included in next year's Annual Report.

Co-operating with other domestic and international regulators in order to contribute to a stronger regulatory and supervisory framework

OSFI participates in the work of the Basle Committee on Banking Supervision under the auspices of the Bank for International Settlements (BIS). This work includes efforts to implement and monitor the credit and market risk capital requirements, to encourage sound risk management practices, and to enhance reporting, disclosure and accounting harmonization efforts. In addition, a special task force of the Committee will soon begin to develop co-ordinated supervisory approaches to the possibility of using credit risk modelling techniques for capital purposes. This work is expected to result in further changes to supervisory and examination practices.

OSFI also participates in the Joint Forum of Banking, Securities and Insurance Supervisors, which is developing new approaches to supervision and information sharing for international conglomerates of deposit-taking institutions, investment dealers and insurance companies. An exercise using an existing Canadian conglomerate was completed in 1996-97 to identify the suitability of current supervisory approaches to the particular structure, operations and risk management of the conglomerate. This exercise, and those completed by other countries, will be used to develop additional proposals regarding the harmonization and co-ordination of supervisory activities over the coming year.

OSFI contributes senior representation to the International Association of Insurance Supervisors (IAIS), the work of which is similar to, but at an earlier stage of development than, that of the Basle Committee.

Finally, OSFI has embarked on a process for updating and enhancing its memoranda of understanding with other regulators, beginning with banking regulators in the United Kingdom and the United States.

On the domestic front, OSFI is involved in a number of harmonization and co-ordination initiatives and is committed to continuing these efforts. OSFI and the Ontario Securities Commission have enhanced communication on regulatory issues and activities. OSFI continues to work with the Canada Deposit Insurance Corporation (CDIC) to reduce non-productive duplication and enhance cost-effectiveness. OSFI has also developed agreements with a number of provincial financial institutions regulators under which OSFI performs certain supervisory activities, such as examinations, on a contract or delegated basis. In 1996, OSFI conducted on-site examinations on a cost recovery basis for provincially-regulated financial institutions in Ontario, Manitoba, Prince Edward Island, New Brunswick, Newfoundland and Labrador. OSFI is currently updating its agreements with the Province of Manitoba to provide examination and monitoring functions for financial institutions incorporated in that province.

Contributing to a sound domestic regulatory framework

Over the 1996-97 period, OSFI worked closely with the Department of Finance on two legislative initiatives. First, OSFI contributed to Bill C-82 which, for the most part, came into force in mid-1997. This Bill included provisions relating to foreign bank entry, self-dealing, joint ventures and access to capital for mutual life insurance companies. Second, OSFI took the lead in developing a White Paper concerning changes to the Pension Benefits Standards Act, 1985 (PBSA) which was released in July 1996, followed by the introduction of enabling legislation in March 1997. It is anticipated that this legislation will be reintroduced in the new Parliament.

In consultation with the Department of Finance, OSFI will also play a lead role in developing an appropriate prudential framework to accompany proposed legislation that will enable foreign banks to establish branches in Canada. This framework is slated for public release by the end of 1997.

Working with professional associations to assess the basis for reliance

The ability to rely on professional groups such as external auditors and appointed and independent actuaries is one of the key factors in maintaining a cost effective supervisory system. For larger institutions, this reliance extends to the internal audit function. The sustainability of the reliance levels must be reconfirmed periodically.

In 1996, a review of the internal audit function at the major deposit-taking institutions was carried out. Generally, this review confirmed that OSFI could continue to rely on the internal audit functions of these institutions. The review also resulted in several recommendations to ensure that reliance levels can be sustained. A "best practices" paper has been developed, and will be used to assess internal audit units in other financial institutions supervised by OSFI. In future planning periods, similar reviews will be completed in other areas where OSFI places significant reliance on third parties.

Developing standards of business practice

OSFI continues to work with the industry sectors to develop standards and "best practices". Over 1996-97, OSFI worked with the Canadian Life and Health Insurance Association (CLHIA) on the development of standards of sound business and financial practices and an associated self-assessment process. These standards, which are currently in place on a voluntary basis, will become OSFI guidelines next year. Modifications may be made as a result of experience in the transition period. These guidelines could become formal regulations in the future.

Strengthening the balance sheets of financial institutions

In recognition of the important role of capital as a cushion in the event of financial difficulty, several capital-related projects have been initiated. The results of these projects will be taken into consideration as part of the longer term goal to develop institution-specific capital requirements.

- Canadian financial institutions have become more active internationally and have expanded their lines of business. In a liquidation scenario, assets located outside Canada or under the control of other legal entities may not be free to flow back to the regulated financial institution in Canada. For example, assets located in other jurisdictions may not be available to support Canadian claims because of actions of foreign insolvency officials, legal or taxation issues, foreign exchange controls, or the political intervention of another country. The determination of how much capital is likely to be available can depend on where in a corporate group a problem emerges, what regulatory actions are taken in other jurisdictions, and other variables. OSFI has undertaken a project to better understand the capital available to support obligations to Canadian depositors, policyholders and creditors. The data obtained will be used to determine capital availability in a variety of circumstances.

- The risk-based capital adequacy requirements currently in place for Canadian banks are based on the international standards agreed upon in 1988 by the Basle Committee on Banking Supervision. Under that framework, banks have been required to maintain minimum capital of 8% of risk-weighted assets for credit risk purposes and a specified amount for market risk, as determined by formula or by using a bank's internal models. Ongoing work of the Committee, in which OSFI participates, involves the review of the existing standards and, in particular, the purposes and characteristics of bank capital. Such a review will serve as a yardstick for establishing criteria to evaluate capital instruments. Future considerations include areas of risk which are not currently addressed by capital requirements and new capital measurement techniques.

  Although the capital ratios of the major Canadian banks exceed the minimum required by the Basle Committee standards, ratios have declined slightly over the past two years. OSFI has expressed a preference that capital return to 1995 risk-weighted levels (approximately 7% tier 1 capital and 10% total capital). OSFI is also encouraging the banks to enhance methodologies for matching capital levels to their individual risk profiles.

- OSFI continues to refine the Minimum Continuing Capital and Surplus Requirements (MCCSR) and Test of Adequacy of Assets Margin requirements (TAAM). These standards establish minimum capital standards for Canadian life insurance companies and for foreign companies transacting business in Canada on a branch basis.

- OSFI continues to evaluate inter-company exposures and to reflect appropriate measures in its capital requirements. The 1997 MCCSR guideline will incorporate new requirements for lapse risk and will impose other requirements for changes in interest rate environment risk. The changes to these standards have been continuous since 1992 and several different transition rules are now in existence. To improve stability, OSFI has announced a moratorium on substantive changes until the year 2000, by which time a more fundamental review can take place.

- In recognition that credit risk remains one of the more significant risks faced by deposit-taking institutions, OSFI developed a policy statement on general provisions and allowances for credit losses at deposit taking-institutions. This statement addresses risk management and accounting issues and what OSFI expects from federally-regulated deposit-taking institutions with respect to their general provisioning policies. OSFI has also issued a companion accounting paper on recognizing and measuring inherent credit risk. These papers are applicable to deposit-taking institutions with year ends starting on or after November 1, 1998.

- As a result of the significant increase in the trading activities of Canadian banks, OSFI has issued a guideline on the capital adequacy requirements for market risk. This guideline applies to deposit-taking institutions that meet minimum trading requirements and is consistent with the international standards approved in 1996 by the Basle Committee. Market risk encompasses interest rate risk and equity risk in the portfolio of trading securities and foreign exchange and commodity risk across the entire institution. Institutions will be expected to implement the guideline by January 1998.

- Internationally, work has been spearheaded by the BIS on reducing and controlling foreign exchange clearing and settlement risk. Many of the issues identified are the responsibilities of the banks themselves. Together with the Bank of Canada, OSFI is surveying Canadian banks on practices and proposed future developments (including industry initiatives and initiatives by individual institutions) and is following other market developments. Depending on the extent of the private sector initiatives undertaken, possible future supervisory initiatives may be considered. An important recent development in risk control is the implementation of Multinet, which provides for the netting and clearing of foreign exchange positions and reduces risk to the clearing and settlement system.

Reviewing and rechallenging regulatory and supervisory practices

To use resources effectively, OSFI seeks to apply and enhance a risk-based approach to the examination and monitoring practices which it applies to financial institutions and pension plans. During the course of 1996, increased co-ordination of the examination of conglomerates took place between the deposit-taking and insurance examination groups, in order to deal with risks on a consolidated basis.

Given the accelerating rate of change in the financial services industry, the Regulatory and Supervisory Practices Group was formed in 1997 to review OSFI's existing regulatory and supervisory approaches. Through a pilot examination project involving two large conglomerates, one a major Canadian-based international bank and the other a major Canadian-based international life insurance company, the Practices Group will develop recommendations for improvements to supervisory and examination methodology. The review will also include consideration of internal processes for carrying out the analysis of information on individual financial institutions and the links between OSFI's Policy and Operations functions. Completion of this complex project is expected in two years. Under the auspices of this group, a team of market risk specialists has been assembled to review and validate internal models that have been developed by the major banks to measure market risk.

Refining the early intervention framework

One of OSFI's ongoing challenges is to identify areas of concern early and to intervene appropriately to minimize problems and losses to policyholders, depositors and pension plan members.

To help meet this challenge, over the past year OSFI has further developed the Guide to Intervention for Deposit-Taking Institutions and the Guide to Intervention for Insurance Companies. A Guide to Intervention for Pension Plans has also been prepared. These documents outline the main criteria used to classify a financial institution or pension plan at a particular stage of supervisory concern, and the actions which may be taken by OSFI at each of these stages. During 1996-97, OSFI further refined the criteria for classifying institutions at particular stages, and it is intended that the Guides will be updated annually.

The electronic data base systems available to OSFI's analysts and examiners already provide ready access to key financial information concerning financial institutions. In 1996-97, the first phase of a series of early warning tests was developed. These tests will be integrated with the data base for deposit-taking institutions during 1997-98.

Ensuring that supervisory staff have appropriate skills

An important objective for OSFI is to ensure that supervisory staff have the level of skill and knowledge required to meet the challenges of the rapidly evolving financial services marketplace. One key to this objective is recognizing areas where additional technical or "specialist" skills are required. The creation of the market risk team under the auspices of the Regulatory and Supervisory Practices Group is a step in this direction. Over the 1997-98 fiscal year, OSFI will begin to establish specialist teams in other areas, which will ultimately include financial conglomerates, foreign-owned financial institutions, and financial products.

Continuous monitoring of the regulatory burden imposed on institutions and pension plans

Competitive barriers can be lowered by taking legislative initiatives to remove artificial or antiquated requirements. For example, Bill C-82 served to remove or rationalize technical rules in a number of areas, such as self-dealing and joint venture arrangements. OSFI worked closely with the industry and the Department of Finance to develop the technical amendments contained in Bill C-82, and will continue to do so for future legislative reviews. Legislation being developed to allow foreign banks to carry on business through branches in Canada represents another example of an initiative to reduce regulatory barriers.

Proposed amendments to the PBSA, to be re-introduced in 1997, also include some steps to reduce the regulatory burden. As a result of these changes, OSFI will no longer be required to review all plan documents and plan amendments. Plan administrators will be required to attest that documents and amendments to documents meet regulatory requirements. In addition, the proposed legislation would enable the development of a simplified pension plan for small employers. A simplified pension plan would utilize standardized documents prepared by professional groups or financial institutions, and would be administered by a financial institution. This would reduce costs and simplify administration for small employers.

Larger issues concerning competition are being investigated by the Task Force on the Future of the Canadian Financial Services Sector. The report of the Task Force in 1998 may suggest additional changes to remove barriers to competition.

Further reducing overlap and duplication of regulation in the Canadian financial system

In addition to the initiatives involving provincial governments mentioned earlier, OSFI has been working closely with the Department of Finance and the Ontario Ministry of Financial Institutions to develop an agreement under which the federal government would assume responsibility for the prudential regulation and supervision of trust and loan companies operating in Ontario. Such an agreement would be consistent with the 1996 announcement of the Government of Ontario that it is interested in pursuing alternative arrangements for trust and loan regulation in the province. This would represent an important step forward in improving the efficiency of the regulatory structure for financial institutions in Canada.

Streamlined information-gathering requirements for insurance companies have also been developed with the Province of Ontario. During 1996, OSFI reached an agreement with the Ontario Insurance Commission (OIC) which provided that OSFI would supply the OIC with annual return data for federally regulated insurance companies (life and property and casualty) and fraternal benefit societies operating in Ontario. As a result, commencing with the 1996 year end, these companies and societies are no longer required to file their annual returns with the OIC. Several other provinces have expressed interest in this type of arrangement, and OSFI is prepared to co-operate with them in a similar fashion.

Maintaining a dialogue on costs with industry associations

OSFI meets annually with the Canadian Bankers Association, the Canadian Life and Health Insurance Association and the Insurance Bureau of Canada to discuss costs incurred, projected cost increases, new initiatives, and cost management strategies for the coming year.

Ensuring effective control of OSFI's costs

As part of its commitment to stakeholders to control its operational costs, OSFI embarked in 1995-96 on a program to review the way in which annual budgets are developed and approved, and has focused on actively challenging budget submissions from all organizational units. This process was furthered in 1996-97 through the addition of a detailed action planning and prioritization exercise in line with OSFI's five strategic objectives and the adoption of a two-year budgeting horizon for its operating budgets.

During 1997-98, OSFI will further refine its planning and budgeting process to ensure better linkages among its main planning framework components and to provide better sequencing between the main planning activities within the OSFI planning cycle. It is anticipated that these enhancements will provide more complete analysis in support of final planning and budgeting decisions and will allow for timely input of final budget amounts. The key elements in this process will be a full review of the 1997-98 planning cycle process, with significant work to be completed on the OSFI Planning Framework and related processes, guidelines and tools in time for implementation during 1998-99.

OSFI has achieved its target of reducing overall Corporate Services operating costs by 15%. This has translated into a zero real growth of Corporate Service budgets in 1997-98. This reduction has been realized despite making provision for the resumption of collective bargaining, a sharp increase in Government of Canada Employee Benefits Plan charges and the introduction of several important new corporate initiatives.

Concentrating on OSFI's core activities

In 1995-96, a study was conducted of OSFI's functions and activities in terms of their contribution to OSFI's strategic objectives. As a result, the Pension Advice Section was transferred to Revenue Canada, Taxation, in 1996, and, in April 1997, the Excise Tax function, which OSFI had performed for a number of years, was also transferred to Revenue Canada. At the same time, OSFI's responsibilities under the Civil Service Insurance Act were transferred to Human Resources Development Canada.

Exploring more equitable cost allocations among the sectors regulated

During 1996-97, an internal task force was mandated to examine the feasibility of adopting a modified user pay system for assessing OSFI's costs to the industry. A primary objective of the task force was to develop a better cost measurement and cost recovery system. The task force has completed a review of OSFI's current methodology for levying assessments and has provided the Canadian Bankers Association, the Canadian Life and Health Insurance Association, and the Insurance Bureau of Canada with a report outlining the results of the review. The report also provides a series of alternatives for industry consideration. OSFI expects to have a decision on this issue by April 1998.

At present, OSFI also incurs costs that are not directly related to the regulation and supervision of financial institutions or pension plans. For example, OSFI provides advice and information to members of the legal and accounting professions, but does not charge directly for this service. OSFI is currently reviewing this practice as part of its user pay initiative.

To build on previous inter-agency work, OSFI has also been planning a parallel study on the burden to financial institutions of the information requirements of OSFI, the Bank of Canada and the Canada Deposit Insurance Corporation. Owing to its scope and complexity, this study has been deferred, pending completion of other priorities.

Quality

A cornerstone of OSFI's efforts to maintain a high standard of regulatory and supervisory quality is the recruitment, development and retention of a highly skilled, professional and motivated workforce. This would be a significant challenge under the best of circumstances, but it is a particularly difficult one now in the face of heavy demand for talented individuals on the part of financial institutions, continuing pay constraints in the public sector, and high staff departure levels. To respond to this challenge, OSFI has initiated the development and implementation of a multi-faceted human resources management strategy. This strategy includes such elements as maximizing OSFI's human resource management flexibility and autonomy, the simplification and consolidation of its staff relations and position classification frameworks, the identification of core competencies and critical skill sets, and the acquisition and implementation of effective recruitment, training and professional development approaches and tools.

As part of this process, OSFI seeks the input of its employees on issues of importance in the direction and management of the organization. To this end, OSFI has initiated a review of its staff performance appraisal process, has adopted a cyclical upward feedback program, and has completed a comprehensive employee survey to gauge employee perceptions and opinions. It has also taken steps to improve communication between management and staff to ensure that issues are identified and discussed in an open and progressive manner.

Simplifying staff relations and human resource management frameworks by consolidating the employee classification system under a single universal classification scheme

As a first step towards the simplification of its human resource and staff relations frameworks, OSFI is developing a Universal Classification System (UCS) for all employee groups and levels within the organization. Benchmark job descriptions have been developed by a task force consisting of management, employees and union representatives. Work is currently underway to complete position analysis questionnaires for all positions within OSFI. It is anticipated that the UCS process will be completed before the end of 1997-98.

Identifying core competencies and assessing staff against expected competency levels

OSFI has launched a process to identify core competencies for all areas of operation in line with its mission and strategic objectives. Once finalized, this list will be used to support or provide the necessary parameters for OSFI's initiatives in staff recruitment, development and training, performance appraisal and career and succession planning. It is expected that the first phase of the core competencies project will be completed by the end of 1997-98.

Developing a comprehensive learning guide and training plan to address core competencies

A comprehensive learning guide, listing all OSFI training and development tools and proposed training and development initiatives, has been published to serve as a catalogue of training opportunities sponsored by the organization. In tandem with the identification process for OSFI core competencies, the Professional Development and Training Division will develop a comprehensive training plan, targeting the training and development needed to support the acquisition and retention of core competencies by all management and staff.

Obtaining greater flexibility to manage human resources in a highly responsive and adaptive fashion

As a result of the need to ensure flexible and timely responses to changing labour market conditions, OSFI is exploring options to mitigate current challenges, including the possibility of opting out of the Public Service Employment Act. Such a change would require the support of the government.

Ensuring that OSFI's information technology (IT) is effective in meeting its evolving needs

Within the overall framework of OSFI's IT architecture, several key initiatives have been launched to enhance its capabilities in the area of information management and technology. These include:

- improving and expanding OSFI's external (Internet) and internal (Intranet) web sites and completing extensive electronic document management and electronic forms pilot projects. The implementation of such initiatives is expected to significantly reduce the need for paper-based communication, both internally and externally, while enhancing access to all types of information by OSFI stakeholders, including OSFI staff;

- designing and implementing an upgraded dial-in capability in support of remote working situations and teleworking capability; and,

- implementing a server and desktop replacement program to optimize the acquisition of hardware and the management of IT assets in line with a lifecycle approach.

C. Key Reviews

1. Emerging Risks Task Force

OSFI undertook additional efforts to identify, understand and prioritize important and emerging risks being faced by federally regulated financial institutions. The result of this work, developed through a standing internal task force drawn from the Policy and Operations sectors, has been used by OSFI in its priority setting and activity planning process for the current period.

2. Effects of Technology on the Financial Sector

An internal research paper was completed by the Policy Sector on the effects of technology on the financial sector. This work led to the development of two secondary products. The first was the development and release of a policy statement on outsourcing of core business functions by financial institutions with either regulated or unregulated service providers. The second was the development of enhanced, consumer-friendly information on the OSFI Internet Site describing the role of regulation and providing a frequently updated listing of federally-regulated financial institutions to address concerns that technology, notably the Internet, broadens the scope for consumers to possibly be misled regarding the regulated status of financial services providers.

3. White Paper on Changes to the *Pension Benefits Standards Act (PBSA)*

OSFI led the process of developing a White Paper concerning changes to the *Pension Benefits Standards Act, 1985 (PBSA)* which was released by the Secretary of State (International Financial Institutions) in July, 1996 . This was followed by the introduction of amending legislation in March, 1997. Both the White Paper and the proposed legislation were developed in a working group format in close consultation with the Department of Finance. The legislation was not passed prior to the end of the last session of Parliament but will be reintroduced in the new session.

4. Review of Internal Audit Functions in Major Deposit Taking Institutions

In 1996, OSFI carried out a review of the internal audit functions at the major deposit-taking institutions. The results of this review confirmed the appropriateness of OSFI's continued reliance on the results of internal audit for these institutions. The review also resulted in several recommendations being made to ensure that future reliance levels can be sustained. A "best practices" paper has been developed and for use by OSFI to assess internal audits in other institutions and similar reviews will be completed in future planning periods in other areas where OSFI places significant reliance on third parties.

5. Standards of Sound Business and Financial Practices

During 1996-97, OSFI worked with the Canadian Life and Health Insurance Association (CLHIA) on a review of sound business and financial practices for the life insurance industry resulting in the development of related standards and an associated self-assessment process. These standards, which are currently in place on a voluntary basis, will become official OSFI guidelines within the next year.

SECTION III: SUPPLEMENTARY INFORMATION

Authorities for 1996-97 - Part II of the Estimates

Financial Requirements by Authority (millions of dollars)

Vote		**1996-97 Main Estimates**	**1996-97 Actual**
40	Office of the Superintendent of Financial Institutions - program expenditures	2.5	2.5
(S)	Civil Service Insurance Actuarial Liability Adjustment(1)		0.3
(S)	Payments to defray the expenses arising out of the operations of the Office pursuant to section 16 & 17 of the *Office of the Superintendent of Financial Institutions Act* Total authorized limit shall not, without Treasury Board approval, at any time exceed by more than $40,000,000 the total of the assessments and revenues received and authorized by the Act to be spent		(2.5)
	Total Department	**2.5**	**0.3**

(1) OSFI was responsible for the administration of the *Civil Service Insurance (CSI) Act* up to March 31, 1997. On April 1, this function was transferred to Human Resources Development Canada.

The CSI Regulations made pursuant to the above Act required the Superintendent of Financial Institutions to calculate the liability in the CSI Account at the end of each fiscal year. Should the liability be greater than the balance of the account, an amount equal to the difference should be credited to the account.

Revenues by Class (millions of dollars)	
	1996-97 Actual
Revenue credited to the vote	
Supervision of financial institutions	36.1
Supervision of pension plans	3.2
Services provided to:	
Canada Deposit Insurance Corporation	0.2
Canada Pension Plan	1.4
	40.9
Tax revenue credited to the Consolidated Revenue Fund*	1.4
	42.3

* Under Part I of the *Excise Tax Act*, a 10% premium tax is imposed on certain insurance premiums paid by residents of Canada to unauthorized insurers or to authorized insurers through brokers or agents outside Canada. The administration of this tax was transferred to Revenue Canada on April 1, 1997

Legislation Administered by the Office of the Superintendent of Financial Institutions	
Bank Act	S.C., 1991, c. 46, as amended
Insurance Companies Act	S.C., 1991, c. 47, as amended
Civil Service Insurance Act (1)	R.S.C., 1952, c. 49, as amended
Co-operative Credit Associations Act	S.C., 1991, c. 48, as amended
Part I of the Excise Tax Act (1)	R.S.C., 1985, c. E-15, as amended
Pension Benefits Standards Act, 1985	S.C., 1986, c. 40, as amended
Trust and Loan Companies Act	S.C., 1991, c. 45, as amended

(1) The administration of the *Civil Service Insurance Act* was transferred to Human Resources Development Canada and the *Part I of the Excise Tax Act* to Revenue Canada on April 1, 1997

List of Contingent Liabilities

As at March 31, 1997, contingent liabilities estimated at $22.5 million were outstanding against the Office of the Superintendent of Financial Institutions.

- $2.5 million relate to a claim for loss of property from Scottish and York Insurance Company and Victoria Insurance Company Limited, reinsurer of Security Casualty Company.

- $20.0 million relate to two Third Party claims for contribution and indemnity of any amounts owing by certain former Directors of Northland Bank to the Canada Deposit Insurance Corporation and Her Majesty the Queen in right of Canada, as represented by the Minister of Finance ($10.0 million) and to the Northland Bank and Deloitte & Touche Inc. ($10.0 million) in connection with the failure of Northland Bank.

While these cases are in various stages of litigation, it is not the policy of the Office of the Superintendent of Financial Institutions to comment on them. They must, however, be recognized as potential liabilities against the Crown and are, therefore, presented for information purposes only.

References

Office of the Superintendent of Financial Institutions
General Services
255 Albert Street
13th Floor
Ottawa, Ontario
K1A 0H2

telephone: (613) 990-7655
fax: (613) 952-8219
Web Site: www.osfi-bsif.gc.ca

Publications available*:

Annual Report
Actuarial Reports
- Canada Pension Plan
- Canadian Forces
- Judges
- Members of Parliament
- Old Age Security
- Public Service
- Royal Canadian Mounted Police

Accounting and Supervisory Guidelines
- Capital Adequacy Requirements
- Derivatives Best Practices
- Derivatives Disclosure
- Exposure to Designated Countries
- Guideline for Deterring and Detecting Money Laundering
- Liquidity
- Minimum Continuing Capital and Surplus Requirements
- Securities Lending

Manual of Reporting Forms and Instructions for Chartered Banks
PBSA Update
Report of the Superintendent of Financial Institutions - Investment Companies
Report on the Administration of the *Pension Benefits Standards Act, 1985*
Summary of Financial Data Life and Property and Casualty Insurance Companies
Year-End Data
- Banks
- Trust and Loan Companies and Co-operative Credit Associations

* A charge for publications may apply.