ESTIMATES

Office of the Superintendent of Financial Institutions Canada

Performance Report

For the period ending
March 31, 1998

Canada

Improved Reporting to Parliament
Pilot Document

The Estimates of the Government of Canada are structured in several parts. Beginning with an overview of total government spending in Part I, the documents become increasingly more specific. Part II outlines spending according to departments, agencies and programs and contains the proposed wording of the conditions governing spending which Parliament will be asked to approve.

The *Report on Plans and Priorities* provides additional detail on each department and its programs primarily in terms of more strategically oriented planning and results information with a focus on outcomes.

The *Departmental Performance Report* provides a focus on results-based accountability by reporting on accomplishments achieved against the performance expectations and results commitments as set out in the spring *Report on Plans and Priorities.*

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Foreword

On April 24, 1997, the House of Commons passed a motion dividing on a pilot basis what was known as the annual *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.*

This initiative is intended to fulfil the government's commitments to improve the expenditure management information provided to Parliament. This involves sharpening the focus on results, increasing the transparency of information and modernizing its preparation.

This year, the Fall Performance Package is comprised of 80 Departmental Performance Reports and the government's "*Managing For Results*" report.

This ***Departmental Performance Report,*** covering the period ending March 31, 1998, provides a focus on results-based accountability by reporting on accomplishments achieved against the performance expectations and results commitments as set out in the department's *Part III of the Main Estimates* or pilot *Report on Plans and Priorities* for 1997-98. The key result commitments for all departments and agencies are also included in *Managing for Results.*

Results-based management emphasizes specifying expected program results, developing meaningful indicators to demonstrate performance, perfecting the capacity to generate information and reporting on achievements in a balanced manner. Accounting and managing for results involve sustained work across government

The government continues to refine and develop both managing for and reporting of results. The refinement comes from acquired experience as users make their information needs more precisely known. The performance reports and their use will continue to be monitored to make sure that they respond to Parliament's ongoing and evolving needs.

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

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Office of the Superintendent of Financial Institutions Canada

Departmental Performance Report

For the period ending March 31, 1998

James Peterson
The Secretary of State
(International Financial Institutions)

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CHART OF KEY RESULTS COMMITMENTS

To provide Canadians with:	**To be demonstrated by:**	**Achievement reported in:**
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	DPR Section III.B.(1)
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	DPR Section III.B.(2)

SECTION 1 : MINISTER'S MESSAGE

The Office of the Superintendent of Financial Institutions (OSFI) exists primarily to safeguard policyholders, depositors and private pension plan members from undue loss. It advances and administers a regulatory framework that contributes to public confidence without unduly restricting the competitiveness of the regulated entities. A secondary function is to provide actuarial and other services to the Government of Canada.

In addition to its regulatory work, OSFI must identify and assess the emerging risks created by changing technological and market conditions and is required to formulate regulatory strategies to respond to the most important risk factors. Meeting these challenges requires OSFI to enhance its training program to develop the necessary expertise.

In the past, OSFI lacked performance standards and measures to gauge its success in achieving its objectives. Assisted by a new mandate that formed part of Bill C-15, development of these standards and measures began in 1996-97 and continued into 1997-98. Some preliminary feedback has been obtained and it will assist OSFI in further refining these tools.

OSFI also provides actuarial and other services to the Government of Canada; this activity is unrelated, however, to its supervisory mandate. In order to carry out this responsibility effectively, a separate organization unit, the Office of the Chief Actuary (OCA), has been created to administer this function. An Oversight Committee, made up of clients of the OCA and chaired by the Superintendent, will oversee the administration of this function.

Since OSFI's regulatory activities are entirely funded by assessments and fees collected from financial institutions and pension plans, any cost increase in these activities will not be borne by the taxpayers. However, OSFI is mindful of the financial burden on the regulated entities and is committed to full and open dialogue with its stakeholders on the costs and benefits of its work.

SECTION II : DEPARTMENTAL OVERVIEW

A. MANDATE, ROLES AND RESPONSIBILITIES

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 S.C. 1996, c6 (An Act to Amend, Enact and Repeal Certain Laws Relating to Financial Institutions) 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.

Pursuant to the above 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."

B. OBJECTIVES

The OSFI Mission Statement identifies five primary objectives. These objectives and the means by which they are to be achieved, are:

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

- Public Confidence - 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.

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

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

C. ENVIRONMENT

In a world of continuous change, OSFI must adapt. Changes to OSFI's operations and structure will permit better concentration of its human resources on key risks and will allow it to better fulfil its mandate of contributing to public confidence in the financial system and protecting policy holders and depositors from undue loss.

No one could have predicted some of the changes that have happened in the financial marketplace over the past 10 years. There has been an explosion of new products to keep up with the demands of demographics. Pension plans have become powerful market participants. The products offered by deposit taking institutions are often indistinguishable from the products offered by insurance companies. Delivery channels have changed.

The trend to globalization could proceed in many diverse directions. The topic of financial stability has been on the agenda of every G-7 summit since 1994 and OSFI continues to work toward that goal through its participation in international organizations of supervisors. This year OSFI puts its support behind the Toronto Centre that was established to provide leadership training to supervisors from developing countries. OSFI also supports another initiative of the Canadian government to strengthen the supervision of financial institutions internationally through a system of multilateral peer review.

OSFI continues to work with the Department of Finance on other issues that could change the way the financial sector operates in Canada, for example, how the process of demutualization of Canada's largest life insurance companies should take place and how foreign bank branching into Canada could affect OSFI's supervisory approach.

The timing of economic cycles is unpredictable but an eventual downturn in the economy is inevitable. OSFI has been encouraging institutions to build up their reserves during these good times. It has also worked to strengthen the capital levels of financial institutions.

In 1996, the government announced the establishment of the *Task Force on the Future of the Canadian Financial Services Sector*. Over the past year, OSFI responded to requests from the Task Force for information and views on a number of issues. The Task Force submitted its report in September, 1998 and OSFI will consider the impact its recommendations will have on its areas of responsibility.

D. ORGANIZATION BY BUSINESS LINE

OSFI has two business lines:

(1) Supervision of Financial Institutions and Private Pension Plans

OSFI supervises about 500 financial institutions and 1,100 pension plans. The pension plans are employer-sponsored plans and 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 III : DEPARTMENTAL PERFORMANCE

A. PERFORMANCE EXPECTATIONS

OSFI's expectations are mainly governed by the five objectives as set out on Page 3. These include the identification of institution-specific risks and trends as well as intervention in a timely manner so as to minimize losses to policyholders, depositors and pension plan members. A second expectation is to contribute towards public confidence by enhancing the safety and soundness of the Canadian financial system, evaluating system-wide risks and promoting the adoption of sound business and financial practices. OSFI also aims at fulfilling its regulatory mandate having due regard for the need to allow institutions to compete effectively as well as maintaining a full and open dialogue with our stakeholders on the costs and benefits of our work. Finally, OSFI endeavours to provide actuarial services to the Government of Canada in a professional, efficient, cost-effective and timely manner.

B. PERFORMANCE ACCOMPLISHMENTS

(1) Supervision of Financial Institutions and Pension Plans

Financial Requirements by Business Line ($ thousands)			
	1997-98 Planned Spending	**1997-98 Total Authorities**	**1997-98 Actual**
Supervision of Financial Institutions and Pension Plans	-	-	(805)
Total Department	-	-	(805)

(a) Safeguarding from undue loss

The safeguarding of policyholders, depositors and pension plan members from undue loss includes refining the supervisory framework, operating an early intervention framework, and encouraging institutions to build reserves against future expected and unexpected losses.

Enhancing the supervisory process

In 1997-98 OSFI reorganized its supervisory activities in response to ever-faster developments in an increasingly complex financial industry. This reorganization is described fully in the June 1998 issue of the OSFI Bulletin. It allows OSFI to continue to change and focus on areas at risk in individual institutions and groups of institutions. To accomplish this, the institution-specific analysis and examination functions were combined and a supervisory group dealing specifically with financial conglomerates was established. At the same time OSFI introduced the "relationship manager" concept to streamline communications with supervised institutions. The relationship manager is responsible for the supervision of assigned institutions and acts as the principal contact for any dealings these institutions have with OSFI.

The newly-established Specialist Support Sector brings additional expertise to the supervisory process. Specialists analyze and monitor certain complex aspects of the financial system that arise from new products or new processes. The resources of the Specialist Support Sector are also available to the Regulation Sector, which has also been reorganized to make more effective use of resources and take advantage of synergies between previously separate groups.

In 1998 a new supervisory framework for deposit-taking institutions and insurance companies was developed. It reaffirms that the assessment of an institution's risk management process is central to OSFI's reliance-based supervision regime. This is consistent with the view of other supervisors around the world. The new framework is designed to focus more clearly on identifying the areas of greatest risk in each institution and to evaluate the quality of their risk mitigants, such as control systems, capital and earnings. It emphasizes on-going monitoring and frequent contact with institutions. The framework is being phased in throughout 1998, with full implementation expected in 1999.

The 1998 amendments to the *Pension Benefits Standards Act, 1985 (PBSA)* allowed OSFI to modify its approach to supervising pension plans. OSFI is no longer required to review every plan document for compliance with legislation. This responsibility has been shifted to plan sponsors and professional advisors. For its part, OSFI will focus on matters affecting the financial condition of pension plans, such as funding and investments. In addition, the amended *PBSA* gives the Superintendent increased powers to take action or cause action to be taken if pension plans become at risk financially.

In May 1998, a draft *Paper on the Risk-Based Supervision of Pension Plans* was issued to explain how OSFI identifies risks on a timely basis. When read in conjunction with the *Supervisory Guide to Federally Regulated Pension Plans*, the paper provides our stakeholders with a good understanding of how OSFI's supervision of pension plans has changed in order to better safeguard pension benefits from undue loss. We believe that this new approach will enable us, given our limited resources, to respond more effectively to the evolving environment in which pension plans operate.

Identifying potential problems

OSFI's early warning systems are designed to identify potential problems well before they raise solvency concerns. These systems use financial data to identify institutions whose performance is not within an acceptable range. OSFI then conducts further investigation and analysis as needed.

For some time, OSFI has used early warning indicators in its on-going monitoring of insurance companies. Considerable time and energy have been invested over the past year in developing similar indicators for deposit-taking institutions. This new early warning system must be tested and refined before it can be incorporated into OSFI's supervisory methodology. This work will be one of the priorities for the new Financial Analysis and Data Management Division.

Providing for expected losses

OSFI's policy on providing for credit losses at deposit-taking institutions has evolved over time. Currently, general allowances are established where certain events or changes in economic conditions indicate that there has been a deterioration in the credit quality of a group of loans. In OSFI's opinion, the application of current accounting and reserving policies results in income and losses being recognized at different times, even though the events are related.

To address these concerns, OSFI developed a policy statement in 1997 on general allowances for credit risk that considered the issue from both a regulatory and an accounting perspective. The policy statement advocates life-cycle costing whereby the costs associated with credit risk (i.e., expected losses) would be recognized over the life cycle of the portfolio.

Currently, OSFI is working with the industry to develop methodologies for the implementation of life-cycle costing. In the meantime, OSFI is providing specific guidance to individual institutions on its expectations for general allowances in the current fiscal year.

Providing for unexpected losses

Deposit-taking institutions - For financial institutions, capital provides a cushion against unexpected losses. Reacting to declining capital levels during 1997-98, OSFI encouraged the major Canadian banks to improve their capital positions and restore them to 1995 levels: approximately 7 per cent for Tier 1 capital and 10 per cent for total capital. By the end of the 1997 fiscal year, the decline had been arrested and, indeed, Tier l ratios for these institutions had increased 8 basis points to 6.9 per cent, while total capital ratios increased by 89 basis points to 10 per cent. In addition, we asked deposit-taking institutions to confirm at the end of each quarter that they have complied with the requirements throughout the period.

Beginning January 1, 1998, deposit-taking institutions with significant trading portfolios were required to maintain capital to cover market risks. Market risk refers to the risk of loss due to changes in interest rates, foreign exchange rates, or the price of equities or commodities. In November 1997, OSFI issued a guideline setting out the capital adequacy requirements for market risk. To calculate the capital requirement, institutions may use the standardized approach set out in the guideline, an internal model, or a combination of the two approaches. Any institution proposing to use an internal model must meet all of the qualitative and quantitative requirements prescribed in the guideline. To date, seven institutions have qualified to use internal models for at least some portion of their market risk capital reporting.

Insurance companies - In August, 1997, OSFI notified life insurers that, beginning with the 1998 year-end results, OSFI would make available to the public certain information on the capital position of each federally-regulated life insurance company. To ensure the accuracy of this information, OSFI advised life insurers that, commencing with the 1997 fiscal year-end, it would require that the returns for the minimum continuing capital and surplus requirements (MCCSR) and the test of adequacy of assets in Canada (TAAM) be subject to external audit.

In July 1997, OSFI issued an MCCSR Newsletter outlining changes to the 1997 MCCSR and TAAM. Among the more significant changes were the introduction of a lapse-risk component and amendments to the components for asset default and changes in the interest rate environment for collateralized mortgage obligations, mortgage-backed securities, and other asset-backed securities. The revised guideline was issued in October 1997.

OSFI also issued a new MCCSR interpretation bulletin in December 1997 providing additional background and examples for the calculation of adjusted deferred and unrealized gains and losses included in capital.

Ensuring assets are adequate and available to support liabilities

Another way to safeguard depositors and policyholders from undue loss is to ensure that there are sufficient assets available to support liabilities, not only in total, but also in each jurisdiction where a financial institution operates. This is important in a global marketplace, since there are no worldwide agreements on regulating conglomerates or liquidating them if bankrupt. Some jurisdictions operate on the assumption that assets belong to the legal entity; others hold the view that assets located in a jurisdiction should be used to meet the liabilities in that jurisdiction. OSFI wants to ensure that if a Canadian financial institution is liquidated, Canadians are as well compensated as depositors and policyholders elsewhere.

In July 1997, OSFI surveyed the major banks and life insurance companies to assess the location of assets for each major line of business. The analysis was complicated by two factors. First, the location of an asset can be defined in several ways. Second, the actions of other supervisors cannot always be anticipated.

OSFI has provided the institutions with an overview of its analysis and findings and it will embark on a second phase of the project to test assumptions and review certain areas in more depth. These include location of collateral, intercompany guarantees, issues related to depositories, intercompany assets and liabilities, and pledging.

Establishing earthquake reserves

Two of the more populated regions of Canada - British Columbia's lower mainland and Quebec's St. Lawrence valley - are vulnerable to major earthquakes. In August 1997, OSFI issued a guideline, *Earthquake Exposure and Sound Practices,* that sets out sound practices for the management and measurement of exposure to earthquake-related claims. OSFI sees the guideline as a major step towards improving the preparedness of the property and casualty industry to deal with such an event.

The guideline was developed in consultation with provincial regulators, the Insurance Bureau of Canada, individual property and casualty insurance companies, professional associations and other interested parties. The guideline requires a company with policies insuring against earthquake damages in British Columbia or Quebec to estimate its probable maximum loss from an earthquake and to establish the appropriate reserves by no later than December 31, 1998. During the 1998-99 fiscal year, OSFI will follow up with individual companies to ensure that they are meeting this timetable.

(b) Public Confidence

Contributing to public confidence includes effective rule-setting and the encouragement of sound business and financial practices, both domestically and internationally. In performing these tasks, we develop legislation, regulations, guidelines or policy statements, and we work with the financial industry on professional practices.

Establishing a framework for the effective supervision of private pension plans

During 1997-98, OSFI continued to work closely with the Department of Finance on a legislative initiative to enhance the supervision of federally-regulated pension plans. The legislation amending the *Pension Benefits Standards Act, 1985 (PBSA)* - known as Bill S-3 - was passed in June 1998, and most sections of the Bill will become effective later this year.

Although the framework for federally-regulated private pension plans is fundamentally sound, the supervisory and prudential systems enabled by the PBSA needed updating. As an added concern, some pension plans were adversely affected by reduced returns on fixed income investments and a loss of membership due to industrial restructuring. Bill S-3 will provide OSFI with an enhanced range of powers and regulatory tools to deal more effectively with plans raising solvency or compliance concerns. As well, Bill S-3 enhances the governance, funding, and investment requirements of plans, and includes provisions to facilitate future harmony with the provincial pension regulators. The legislation will be supplemented by a number of regulations in the coming year.

While most of the 1,100 pension plans regulated by OSFI are well managed and well funded, it has become evident through the supervisory process that some plan sponsors do not fully understand their responsibilities. This is evidenced by findings of inappropriate actions by third-party professionals, excessive plan expenses, conflicts of interest, and improper plan amendments in some cases. This knowledge and the change in supervisory direction to a risk-based approach, requires that OSFI assist plan sponsors and administrators in understanding their responsibilities for the safety and soundness of their pension plans. Accordingly, OSFI has issued the following guidelines:

- *The Supervisory Guide to Federally Regulated Pension Plans* (September 1997) promotes awareness and enhances transparency of OSFI's system of intervention ,

- *Instructions for the Preparation of Actuarial Reports* (October 1997) promotes compliance with the requirements of the PBSA ,

- *Guideline on Disclosure of Information* (March 1998) outlines enhanced disclosure practices to members and other plan beneficiaries so that they can make informed decisions concerning their retirement,

- *Investment Guideline (Draft)* (April 1998) helps administrators to develop investment policies and use them as tools in attaining the objectives of their pension plan, and *Guideline for Governance of Federally Regulated Pension Plan* (May 1998) highlights issues administrators should consider when developing and reviewing a governance framework.

Developing standards of sound business practices

The *Standards of Sound Business and Financial Practices for Life and Health Insurers* operating in Canada were released in July 1997, the culmination of a process begun in 1994. The development of the standards was a joint initiative of OSFI, Quebec's Inspecteur général des institutions financières, the Canadian Life and Health Insurance Association and the Canadian Life and Health Insurance Compensation Corporation (CompCorp). In February 1998, the standards were reissued as OSFI guidelines. Ultimately, Quebec withdrew from the joint initiative but subsequently issued its own guideline for the companies it regulates.

The guidelines identify five broad categories of prudent business and financial practices: capital, asset quality, liability quality, relationship of assets and liabilities, and controls. The guidelines represent the minimum operating standards with which all federally-regulated life and health insurers are expected to comply. Eight of the guidelines were adapted from standards issued by the Canada Deposit Insurance Corporation for deposit-taking institutions. Two new guidelines deal with liability issues.

Companies are expected to assess their compliance with the guidelines for 1998. Compliance assessment will be based upon OSFI's Program for Assessment of Regulatory Compliance (PARC). PARC was released in September 1997, following a consultative process with industry representatives. Under PARC, each year the board of directors must pass a resolution acknowledging its responsibilities under the standards and stating that it is satisfied that management has taken reasonable steps to ensure compliance.

The PARC guide sets out OSFI's self-assessment process and filing requirements. OSFI may ask to see supporting documentation as part of its examination process. The first PARC filings are scheduled for 1999.

Cooperating with other international regulators

OSFI continued its involvement in the work of key international supervisory bodies, such as the Basle Committee on Banking Supervision (Basle Committee), the International Association of Insurance Supervisors (IAIS) and the Joint Forum on Financial Conglomerates (Joint Forum).

Basle Committee - OSFI's contribution to the work of the Basle Committee focuses on three subgroups (Capital, Risk Management, and Information), two task forces (Accounting and Models) and two working groups (Innovative Capital Instruments and Securitization & Credit Derivatives). Their mandates are to encourage sound risk management practices; to enhance reporting, disclosure and accounting harmonization efforts; and to refine the credit and market risk capital requirements, (a task which includes research on the qualities of capital instruments and the measurement of credit risk). During the year, a number of consultative papers and final documents were issued by the Basle Committee on the following topics: core principles for effective banking supervision, internal controls, computer malfunctions related to the Year 2000 date change, derivatives disclosure, electronic money, reporting assets and liabilities on a net basis, specific risk modelling, interest rate risk and various amendments to the Capital Accord.

The Basle Task Force on Accounting Issues is chaired by OSFI. The task force completed surveys on bank accounting principles and the valuation of loans. As well, it began developing guidance on loan loss provisioning and acted as a focal point for input on an international standard setting process for banking supervisors.

IAIS - Over the past year, OSFI chaired the Executive Committee of the IAIS and made a significant contribution to its work. OSFI produced a number of papers dealing with insurance supervisory principles and a corresponding self-assessment programme, a supervisory standard on derivatives, Year 2000 issues, and a report for the G-7 on the work of the IAIS. OSFI also provided input to papers being developed on licensing, on-site inspection, solvency assessment and reinsurance.

Joint Forum - OSFI continued as an active member of the Joint Forum, its capital adequacy working group and mapping task force. The Joint Forum and its sub-groups produced several consultative documents focusing on key aspects of the supervision of financial conglomerates, including capital adequacy, fit and proper principles, a framework for supervisory information sharing and supervisory coordination. These papers were circulated to the industry for comment in February 1998, and are available on the internet site of the International Organization of Securities Supervisors.

Memoranda of understanding - In addition, OSFI initiated a number of memoranda of understanding (MOU) with other key regulators. One MOU was signed with the Bank of England (subsequently assigned to the United Kingdom's new Financial Services Authority). Others were signed with two U.S. agencies: the Federal Reserve Board and the Office of the Comptroller of the Currency.

Strengthening the standards of actuarial practices

The work of actuaries affects a significant portion of the income statement and the balance sheet of an insurance company. Consequently, when OSFI carries out its responsibilities for the supervision of insurance companies, it relies on the work of actuaries in assessing the financial position (focusing on today) and the financial condition (focusing on tomorrow) of these companies. Given the nature of actuarial work, the professional judgement of actuaries plays a key role in both the company's reports and OSFI supervision.

OSFI has continued to work with the Canadian Institute of Actuaries to expand and strengthen actuarial standards of practice, to narrow the range of interpretation that actuaries can take in applying the standards, to improve disclosure of the work of the actuary, and to establish a process for assessing the compliance of actuaries with the standards. The current focus of this work has been in compliance and, more specifically, on peer review (or practice review).

The Canadian Institute of Actuaries is planning to introduce a practice review program that would eventually apply to all actuaries who are doing public actuarial work. At first, the practice review program will focus on appointed actuaries who work for life insurance companies. The program will then be expanded to cover appointed actuaries for property and casualty insurance companies and pension actuaries.

Preparing institutions for the Year 2000

Experts are warning that there could be serious disruptions throughout the world when the date changes to January 1, 2000, due to the failure of computer systems and microprocessors to correctly recognize the date change. Often these systems or chips use only two digits to identify each year (e.g., 98 for 1998). As a result, when the date changes to year 2000 they may mistake 00 for 1900 or perhaps not recognize it as a valid date at all.

Responsibility for ensuring Year 2000 compliance by federally-regulated financial institutions rests with the institutions' board of directors and senior management. Since 1996, OSFI has encouraged and supported their efforts to become compliant. OSFI staff review the state of Year 2000 readiness of financial institutions as part of the risk-based supervisory process and take additional monitoring and supervisory actions where necessary, including reporting to CDIC and CompCorp on any issues affecting their member institutions.

OSFI's actions were reviewed in 1998 by the federal government's Task Force Year 2000. It reported that "OSFI should be congratulated for the very proactive and forceful approach it has adopted to focus the senior management of financial institutions on the Year 2000 issues. The Office has created and maintained a strong momentum and its approach could serve as a model, where applicable, for other federal regulators."

In 1997 OSFI issued a Year 2000 best practices document describing issues that most institutions should consider as part of their Year 2000 projects. The document indicates that all critical systems should be Year 2000 compliant by December 31, 1998. This allows time in 1999 to complete testing and confirm the readiness of entities upon whom the institutions depend, such as reinsurers, counterparties, clearers, etc. The best practices document is used as the benchmark for reviewing an institution's progress.

Last year, OSFI found that many, but not all, financial institutions had allocated significant resources to deal with the Year 2000 problem and planned to meet the December 31,1998 target. A review of the industry's state of readiness will be part of the 1998 examinations. In addition, OSFI has established a centralized information unit on Year 2000 issues to review procedures and coordinate contacts with other supervisors.

(c) Competition

It is not OSFI's role to facilitate competition. However, OSFI tries to respond in a flexible manner to new initiatives put forward by the industry or policy makers. In addition, OSFI recognizes that solvency regulation and supervision can impose constraints on the ability of a financial institution to compete, particularly with unregulated institutions, accordingly OSFI has an obligation to limit regulatory constraints to those that are essential for accomplishing the other elements of its mandate.

This objective is consistent with the development of a more targeted and effective regulatory and supervisory framework.

Preparing for foreign bank branching

Since 1980, foreign banks have been restricted to banking in Canada through subsidiary operations. In February 1997, the federal government announced that it would review its current policy on the entry and operation of foreign banks in Canada. It said it would develop a new framework for entry, including the development of a regime to permit foreign banks to operate in Canada through branches. In revising the foreign bank entry policy, a number of factors were taken into consideration. One was a desire to increase competition in the Canadian financial marketplace while at the same time ensuring that issues such as safety, soundness and integrity of the financial system continue to be respected.

In May 1998, the government announced that the legislation amending the foreign bank entry regime would be deferred until the delivery of the report of the Task Force on the Future of the Canadian Financial Sector this fall. Notwithstanding this deferral, OSFI continues to dedicate resources to develop a supervisory framework that will accommodate direct branching by foreign banks in Canada. To this end, a Foreign Bank Branch Supervision Division has been established as part of OSFI's reorganization. This division has been involved in developing the entry criteria, defining the assessment process and establishing the supervisory framework for bank branches. Once the enabling legislation is passed, the division will participate in the assessment of applications and will be responsible for the supervision of the branches of foreign banks.

Facilitating the demutualization process

During the past year, four large Canadian life insurance companies announced plans to convert from mutual companies into publicly traded stock companies, a process referred to as "demutualization."

Policyholders of mutual life insurance companies own the company. In converting to a stock company, eligible policyholders would become shareholders and the company would have greater access to capital markets. Policyholders would retain the contractual benefits of their existing policies and would have the choice of either holding their new shares or selling them on the open market.

Access to capital is a key factor for Canadian insurance companies competing in both domestic and foreign markets. OSFI appreciates the increasing need for access to capital markets in a highly competitive financial services industry and is working with the Department of Finance to develop regulations to guide demutualization.

OSFI wants to ensure that the well-being of policyholders remains paramount in any demutualization process. In this regard, a number of key principles will guide the development of regulations. These include the placing of a fair value on the company, the allocation of that value to policyholders, the provision of an opinion by an independent expert on the fairness and equity of the value of the company and on the method and assumptions used to calculate that value, and an opinion by an independent actuary on the fairness and equity of the nature and amount of the benefits to be provided to policyholder.

Creating a level playing field

During 1997, OSFI, the Canadian Bankers Association, and representatives of the deposit-taking industry established a task force to identify differences in the requirements of supervisors in Canada, the United States and the United Kingdom and to determine whether changes to the regulatory regime in Canada are needed. The issues identified include general allowances, asset securitization, cumulative and non-cumulative perpetual preferred shares and other hybrid capital instruments, the assets-to-capital multiple and capital taxes. Priority was given to general allowances and asset securitization, since the Basle Committee is reconsidering the definition of capital for deposit-taking institutions.

General allowances - Under the 1988 Basle Capital Accord, general allowances of up to 1.25 per cent of risk-weighted assets can be included in Tier 2 capital, provided that certain criteria are met. In 1997, to foster a level playing field, OSFI decided to permit partial recognition of general allowances - up to 0.625 per cent of risk-weighted assets - in capital, with OSFI approval. Deposit-taking institutions wishing to include general provisions in capital are required to submit a written application to OSFI with an action plan outlining how they intend to recognize inherent credit risk.

Asset securitization - In 1998 a consultative group was formed by OSFI and the Canadian Institute of Chartered Accounts (CICA) to develop a CICA guideline for asset securitization that would be consistent with accounting treatment in the U.S. The current Canada-U.S. differences centre mainly on how to recognize a sale. Under Canadian generally accepted accounting principles (GAAP), a sale is recognized when the significant risks and rewards of the group of assets are transferred. Under U.S. GAAP, a sale is recognized when control is transferred based on individual components. Guidance from the consultative group is expected in 1999.

Reducing overlap and duplication of regulation in the Canadian financial system

One important way to ensure that financial regulation and supervision is cost effective and does not unduly impede competition is to look for ways to reduce overlap and duplication among jurisdictions. OSFI already performs examinations on a contract basis for certain provinces and is willing to expand that role. In the past year, OSFI started to explore the possibility of expanding that activity to include pension plan examinations for some provinces.

Last year we reported that OSFI had reached an agreement with the Financial Services Commission of Ontario (FSCO) whereby OSFI would supply FSCO with annual return data for regulated insurance companies and fraternal benefit societies operating in Ontario. As a result, these companies and societies were no longer required to file annual returns with FSCO. Since then, similar agreements have been signed with Prince Edward Island and Alberta. Some other provinces have expressed interest in this type of arrangement. Some would prefer direct access to OSFI's databases. We will consider this alternative if there is sufficient interest.

During the past year, OSFI was actively engaged in discussions with Ontario officials on the possibility of OSFI assuming the supervision of trust and loan companies incorporated in Ontario. There are some limits on what OSFI can do in terms of expertise and jurisdiction. Considerable thought has been put into how this process would work and how to handle the areas that OSFI could not undertake. The issue has been left with the Ontario government for decision.

(d) Cost-Effectiveness

OSFI recovers its expenses for the supervision of financial institutions through an annual assessment process. Expenses associated with the supervision of pension plans are recovered by means of an annual fee charged to pension plans.

Developing an equitable cost allocation system

OSFI's current practice is to recover costs from financial institutions and private pension plans solely on formula-based annual assessments. In response to concerns raised by industry associations and in furtherance of the Superintendent's goal of a more equitable allocation of costs, OSFI established an internal task force in 1996 to examine the feasibility of a modified user-pay system. Based on its recommendations, OSFI has proposed a number of changes in the manner it recovers costs from financial institutions. These changes will ensure that institutions and non-regulated third parties that place greater demands on OSFI pay a higher proportion of OSFI's costs. This would be done through the use of direct user fees. The proposed user fees would be based on the time spent on selected activities, with due regard (where possible) to the fees charged by other regulatory agencies for similar services.

OSFI believes that the implementation of user pay fees is an important step in moving towards its objective of a more cost effective regulatory system. During an extensive consultative process, industry associations and individual institutions supported the concept of a user pay system, provided it were done in a cost-effective manner.

The views of the industry associations, along with those of other stakeholders, were integral in shaping OSFI's proposed phased-in implementation of user-pay fees and changes to the current assessment methodology. The first phase is scheduled for implementation on January 1,1999.

Refining the budgeting process

In 1997-98, OSFI reviewed the way in which it develops, reviews, challenges and approves annual budgets. Implementation of a new business model and methodology was delayed because of the reorganization. It is expected that the new processes will be implemented in the 1999-2000 planning cycle.

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

Financial Requirements by Business Line ($ thousands)			
	1997-98 Planned Spending	**1997-98 Total Authorities**	**1997-98 Actual**
Actuarial and other services to the Government of Canada	1,687	1,814	1,759
Total Department	1,687	1,814	1,759

During 1997/98, the Actuarial Services Division prepared financial projections on more than 1,000 proposed changes to the CPP. In September, 1997, the CPP Actuarial Report Number 16 was tabled in the House of Commons. This report showed the costs of the amended CPP plan and described the changes to the plan provisions that became effective on January 1, 1998. The preparation of the next CPP and Old Age Security (OAS) statutory actuarial reports as of December 31, 1997 also began in the same year. As well, DYNACAN, the microsimulation model of the Canada Pension Plan for policy analysis, became fully operational in 1997/98.

The actuarial valuation reports for the Public Services and the Canadian Forces pension plans were completed and tabled in the House of Commons. The year end liabilities in respect of all pension and insurance plans sponsored by the government were provided to the Comptroller General for Public Accounts purposes. As well, various proposed plan amendments were costed at the request of the government.

SECTION IV : FINANCIAL PERFORMANCE

Table 1. Summary of Voted Appropriations

A. Authorities for 1997-98 Part II of the Estimates Financial Requirements by Authority ($ thousands)				
Vote	**Program Name**	**1997-98 Planned Spending**	**1997-98 Total Authorities**	**1997-98 Actual**
40	Office of the Superintendent of Financial Institutions - Program expenditures	1,687	1,814	954
	Total Department	1,687	1,814	954

Table 2. Comparison of Total Planned Spending to Actual Spending

Departmental Planned Spending versus Actual Spending by Business Line for 1997/98 ($ thousands)

Business Line	FTEs	Operating	Capital	Voted Grants & Contri-butions	Subtotal: Gross Voted Expendi-tures	Statutory Grants and Contri-butions	Total Gross Expendi-tures	Less : Revenue Credited to the Vote	Total Net Expen-ditures
Supervision of financial institutions and private pension plans	374	42,201	1,115	-	43,316	-	43,316	43,316	-
	374	*42,201*	*1,115*	-	*43,316*	-	*43,316*	*43,316*	-
	361	**37,891**	**493**	**-**	**38,384**	**-**	**38,384**	**39,189**	**(805)**
Actuarial and other services to the Government of Canada	25	2,906	82	-	2,988	-	2,988	1,301	1,687
	25	*3,033*	*82*	-	*3,115*	-	*3,115*	*1,301*	*1,814*
	24	**2,751**	**77**	**-**	**2,828**	**-**	**2,828**	**1,069**	**1,759**
Total	399	45,107	1,197	-	46,304	-	46,304	44,617	1,687
	399	*45,234*	*1,197*	-	*46,431*	-	*46,431*	*44,617*	*1,814*
	385	**40,642**	***570***	**-**	**41,212**	**-**	**41,212**	**40,258**	**954**
Other Revenues and Expenditures									
Revenue credited to the Consolidated Revenue Fund									1,000
									1,000
									-
Cost of services provided by other departments									93
									93
									93
Total									2,780
									2,907
									1,047

Note :

Figures for planned spending are in normal font.

Figures for total authorities are italicized.

Figures for actual spending are bolded.

Table 3. Historical Comparison of Total Planned Spending to Actual Spending

Departmental Planned versus Actual Spending by Business Line ($ thousands)					
Business Lines	**Actual 1995-96**	**Actual 1996-97**	**Planned Spending 1997-98**	**Total Authorities 1997-98**	**Actual 1997-98**
Supervision of financial institutions and private pension plans	1,602	(2,451)	0	0	(805)
Actuarial and other services to the Government of Canada	2,605	2,466	1,687	1,814	1,759
Total Revenues Credited to the Vote	4,207	15	1,687	1,814	954

Table 4. Crosswalk between Old Resource Allocation and New Allocation

Not Required

Table 5. Resource Requirements by Organization and Business Line

Comparison of 1997-98 Planned Spending, and Total Authorities to Actual Expenditures by Organization and Business Line ($ thousands)			
	Business Line		
Organization	**Supervision of Financial Institutions and Pension Plans**	**Actuarial and Other Services to the Government of Canada**	**Totals**
Operations Sector	-	-	-
	-	*-*	*-*
	-	**-**	**-**
Policy Sector	-	-	-
	-	*-*	*-*
	-	**-**	**-**
Corporate Services Sector	-	-	-
	-	*-*	*-*
	(805)	-	**(805)**
Office of the Chief Actuary	-	1,687	1,687
	-	*1,814*	*1,814*
	-	**1,759**	**1,759**
TOTALS	-	1,687	1,687
	-	*1,814*	*1,814*
	(805)	**1,759**	**954**
% of TOTAL	**-84.4%**	**184.4%**	**100.0%**

Note :

Figures for planned spending are in normal font.
Figures for total authorities are italicized.
Figures for actual spending are bolded.

Table 6. Revenues to the Vote

Revenue Credited to the Vote by Business Line ($ thousands)					
Business Line	**Actual 1995-96**	**Actual 1996-97**	**Planned Spending 1997-98**	**Total Authorities 1997-98**	**Actual 1997/98**
Supervision of financial institutions and private pension plans	35,170	39,478	43,316	43,316	39,189
Actuarial and other services to the Government of Canada	1,311	1,375	1,301	1,301	1,069
Total	36,481	40,853	44,617	44,617	40,258

Table 7. Revenues to the CRF

Revenue Credited to the Consolidated Revenue Fund by Business Line ($ thousands)					
Business Line	**Actual 1995-96**	**Actual 1996-97**	**Planned Spending 1997-98**	**Total Authorities 1997-98**	**Actual 1997/98**
Supervision of financial institutions and private pension plans	-	-	-	-	-
Actuarial and other services to the Government of Canada*	982	1,374	1,000	1,000	-
Sub-total	982	1,374	1,000	1,000	-
Unplanned					-
Total	**982**	**1,374**	**1,000**	**1,000**	**-**

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

Table 8. Statutory Payments

Statutory Payments by Business Line ($ thousands)					
Business Line	**Actual 1995-96**	**Actual 1996-97**	**Planned Spending 1997-98 ***	**Total Authorities 1997-98 ***	**Actual 1997/98 ***
Supervision of financial institutions and private pension plans					
Actuarial and other services to the Government of Canada	313	259	-	-	-
Total	313	259	-	-	-

* Civil Service Insurance Actuarial Liability Adjustment. The administration of the *Civil Service Insurance Act* was transferred to Human Resources Development on April 1, 1997.

Table 9. Transfer Payment

Not Required

Table 10. Capital Spending by Business Line

Capital Spending by Business Line ($ thousands)					
Business Line	Actual 1995-96	Actual 1996-97	Planned Spending 1997-98	Total Authorities 1997-98	Actual 1997/98
Supervision of financial institutions and private pension plans	941	1,083	1,115	1,115	493
Actuarial and other services to the Government of Canada	117	82	82	82	77
Total	1,058	1,165	1,197	1,197	570

Table 11. Capital Projects by Business Line

Not Required

Table 12. Status of Major Crown Projects

Not Required

Table 13. Loans, Investments and Advances

Not Required

Table 14. Revolving Fund Financial Summaries

Not Required

Table 15. Contingent Liabilities

Contingent Liabilities ($ thousands) List of Contingent Liabilities	Amount of Contingent Liability March 31, 1997	 March 31, 1998
Loans	-	-
Claims and Pending and Threatened Litigation		
Litigation	22,500	2,500
Non-litigation		
Total	22,500	2,500

SECTION V : OTHER INFORMATION

Contacts for Further Information and Departmental Web Sites

Name	Title	Address	Phone	Fax
Supervision of Financial Institutions and Pension Plans				
John Palmer	Superintendent of Financial Institutions	255 Albert Street, Ottawa, Ontario K1A 0H2	(613) 990-7500	(613) 993-6782
John Thompson	Deputy Superintendent Regulations	255 Albert Street, Ottawa, Ontario K1A 0H2	(613) 990-8010	(613) 993-6782
Nick Le Pan	Deputy Superintendent Supervision	255 Albert Street, Ottawa, Ontario K1A 0H2	(613) 990-7628	(613) 993-6782
Edna MacKenzie	Assistant Superintendent Corporate Services	255 Albert Street, Ottawa, Ontario K1A 0H2	(613) 990-7491	(613) 993-6782
Actuarial and Other Services to the Government of Canada				
John Palmer	Superintendent of Financial Institutions	255 Albert Street, Ottawa, Ontario K1A 0H2	(613) 990-7500	(613) 993-6782
Website : http://www.osfi-bsif.gc.ca				

Legislation and Associated Regulations Administered by the Minister of Finance

Bank Act S.C. 1991, c. 46
Cooperative Credit Associations Act S.C. 1991, c. 48
Insurance Companies Act S.C. 1991, c. 47
Office of the Superintendent of
Financial Institutions Act R.S. c. 18 (2nd Supp.), Part I
Pension Benefits Standards Act, 1985 R.S. c. 32 (2nd Supp.)
Trust and Loan Companies Act S.C. 1991, c. 45

Publications Available

OSFI Annual Report
OSFI Bulletin
Accounting and Supervisory Guidelines
PBSA Update
Actuarial Reports for CPP and other public pension plans