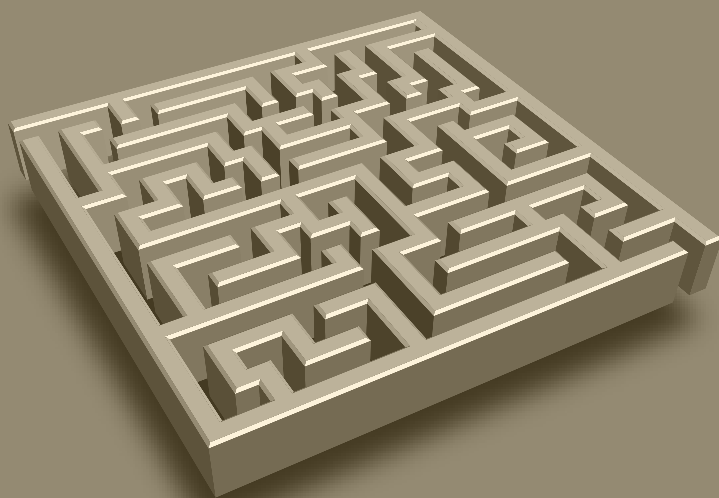
Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

OSFI ANNUAL REPORT 2006–2007

CHARTING A COURSE



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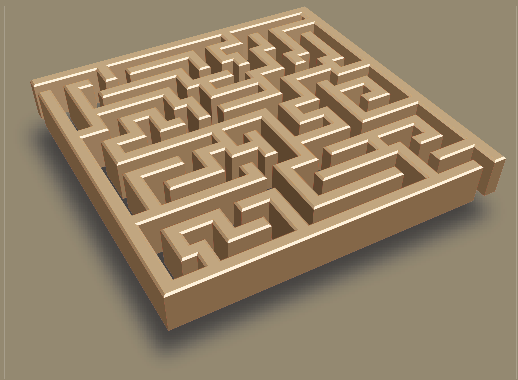

CHARTING A COURSE

OSFI works with industry and our government partners to find the best route through an increasingly complex, dynamic and global financial landscape – a maze of pathway choices. Many solutions are possible; the challenge is finding the one that supports effective risk management while recognizing competition. Through efficient regulation and supervision, OSFI charts a course so that Canadians can continue to have confidence in Canada's well-functioning – and internationally respected – financial system.

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OSFI at a Glance

- OSFI was established in 1987 to contribute to public confidence in the Canadian financial system. It is an independent agency of the Government of Canada and reports to the Minister of Finance.
- The financial services sector represents 6% of Canada's Gross Domestic Product, and employs over 700,000 Canadians. A properly functioning, efficient financial services sector is essential to Canada's economy.
- OSFI supervises and regulates over 450 banks and insurers, and over 1,330 federally registered private pension plans. As at March 31, 2007, these organizations managed a total of $3,375 billion of assets.
- The Office of the Chief Actuary, which is an independent unit within OSFI, provides actuarial services for the Canada Pension Plan, the Old Age Security program, the Canada Student Loans Program and other public sector pension and benefit plans.
- OSFI recovers all of its costs. OSFI is funded mainly through asset-based, premium-based or membership-based assessments on the financial services industry and a user-pay program for selected services. A small portion of OSFI's revenue is derived from the Government of Canada for actuarial services relating to various public sector pension and benefit plans.
- The International Advisory Group within OSFI assists selected emerging market economies in enhancing their supervisory system, through training programs or hands-on technical advice. Funding for OSFI's international assistance program is provided by the Canadian International Development Agency.
- OSFI employs 462 people in offices located in Ottawa, Montréal, Toronto and Vancouver.

Letter of Conveyance

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
Ottawa, Canada K1A 0A6

Dear Minister:

Pursuant to section 40 of the *Office of the Superintendent of Financial Institutions Act,* I am pleased to submit to you the Annual Report of the Office of the Superintendent of Financial Institutions (OSFI) for the period April 1, 2006 to March 31, 2007.

This report also includes the report on the administration of the *Pension Benefits Standards Act, 1985* (PBSA) for the period April 1, 2006 to March 31, 2007, pursuant to section 40 of the PBSA.

Yours truly,

Julie Dickson
Superintendent

Ottawa, September 17, 2007

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SUPERINTENDENT'S MESSAGE

CHARTING A COURSE

The financial services industry is dynamic – rapidly changing both here and around the world. Canadian financial institutions are facing increased risks and competition while managing highly complex transactions. As Canada's federal prudential regulator, OSFI's role is to understand today's challenges and be clear about prudential expectations to help chart a course for the future. Finding the best path enables OSFI to protect the rights and interests of depositors, policyholders and pension plan members, while allowing financial institutions to take reasonable risks and compete effectively both at home and abroad.

This report documents our performance during the 2006-2007 year, and demonstrates how we are responding to evolving risks and working with key partners nationally and internationally to enhance safety and soundness.

RISK MANAGEMENT

Managing risk is key to ensuring safety and soundness. All financial institutions are in the business of taking risks, but these need to be managed in order to minimize losses and maintain public confidence in Canada's financial system.

OSFI's role is to be vigilant, and to take action if institutions appear to be engaging in unsafe or unsound activity, or failing to fully understand the potential consequences of the risks they are taking. That means asking a lot of questions and verifying answers. By focussing on the risk management strategies, risk appetite and profile, capital levels and stress testing of institutions, OSFI can help them to prevent or mitigate catastrophic loss. This is an ongoing challenge as financial products and instruments become more complex and the financial services sector continues to evolve – risk is increasingly dispersed across a number of players, many of which (such as hedge funds) are becoming more important.

One of our priorities is implementation of the Basel II Capital Accord. The *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, or "Basel II", provides a new set of standards for establishing minimum capital requirements for banks. It applies to all internationally active banks operating in the jurisdictions of members of the Basel Committee (G10 countries). In 2006-2007, we continued to work closely with Canadian banks and our international counterparts on a roadmap to help them integrate the Accord into their business processes. More than a compliance exercise, we believe the Accord will help institutions to enhance their risk management practices.

Another priority for OSFI is a five-year project to develop a more risk-based capital framework for Canadian life insurance companies. Similar to the Basel II Accord for banks, this framework will allow life insurance companies to better align risk with their capital requirements.

Charting a course is about anticipating and planning ahead. A key role for OSFI is to monitor and assess the impact of changes in the economic environment on the risk profile of financial institutions. We must have the resources in place to identify and deal with an economic downturn or unexpected events/ potential problems, such as a pandemic, that could disrupt business. In 2006-2007, we developed plans to test OSFI's business continuity plan against various scenarios and to assess institutions' stress-testing capabilities. This planning is essential to meeting our ongoing responsibilities for accurate risk assessment and timely, effective intervention.

Although the financial health of federally regulated private pension plans had improved significantly by the end of 2006, the dramatic turnaround demonstrates the volatility in this area. Pension plan sponsors and administrators should seize the opportunity provided by stronger solvency results to enhance their risk management strategies. They must continue to be vigilant and knowledgeable about techniques to manage the potential risks volatility can pose. OSFI will continue to make strategic investments in our pension systems, controls and monitoring resources.

OFFICE OF THE CHIEF ACTUARY

Canada has a public pension system that is expected to be sustainable and affordable well into the future in the face of changing demographic conditions. Ongoing review of the system, including actuarial studies performed by the Office of the Chief Actuary (OCA) on various public pension programs, will help to ensure that this remains the case. During 2006-2007, the OCA released its 22nd Actuarial Report on the CPP, required after Bill C-36 was introduced in the House of Commons as a result of the CPP triennial financial review completed by the federal and provincial Ministers of Finance in June 2006. The OCA also provided statutory actuarial reports, subsequently tabled in Parliament during the year, on the pension plan for the Public Service, the RCMP and the Canadian Forces, including the Public Service Death Benefit Account and the Regular Force Death Benefit Account.

ACCOUNTABILITY

OSFI practices what it recommends; as a result, governance and accountability are continuing priorities. Our accountability framework contains a variety of elements, including a conflict-of-interest policy and a code of conduct to guide our behaviour. Our internal audit group conducts assurance audits based on a comprehensive five-year, risk-based plan, which is posted on our Web site. OSFI's Audit Committee has been operating for a year and a half. One of the few among government departments and agencies to boast a majority of independent members, the Committee offers advice and guidance for all internal audit and related functions. We appreciate the sage counsel it has provided, which has enhanced our governance.

We also conduct periodic anonymous surveys of knowledgeable observers on our operations, consult broadly with industry and other regulators, and welcome opportunities to appear before Parliament to raise awareness about the important work we do. For example, in 2006-2007, on our behalf an independent firm conducted a confidential consultation with insurance companies and related service providers to explore their perceptions of the current insurance marketplace, OSFI in general, and the work of our actuarial division in particular. The results and our response are posted on our Web site.

Financial institutions are not the only place where rapid change is taking place. The regulatory environment is evolving as well, with emerging practices such as principles-based versus rules-based regulation. Already moving in this direction, OSFI will continue to identify new approaches that can be adopted.

In the fall of 2007, Canada's financial sector will be reviewed by the International Monetary Fund (IMF) under its Financial Sector Assessment Program (FSAP). During 2006-2007, OSFI worked with Canadian banks, as well as the Department of Finance and the Bank of Canada, to prepare for the review. Canada was already reviewed by the Financial Action Task Force (FATF), for which OSFI provided input for an international evaluation of our anti-money laundering and anti-terrorist financing regime. Results of the review are expected to be released in early 2008.

MANAGING OUR AFFAIRS

OSFI continues to strive to manage its costs, the majority of which are recovered from industry. Because OSFI places significant reliance on boards of directors, senior managers and external auditors of financial institutions, OSFI's costs are generally lower than regulatory bodies that do not use such systems. However, the need to hire and keep highly skilled staff to deal with the rapidly changing and complex environment, and to make investments in technology to allow us to monitor and assess risk in the financial institutions and pension plans we regulate, continues to place cost pressures on OSFI.

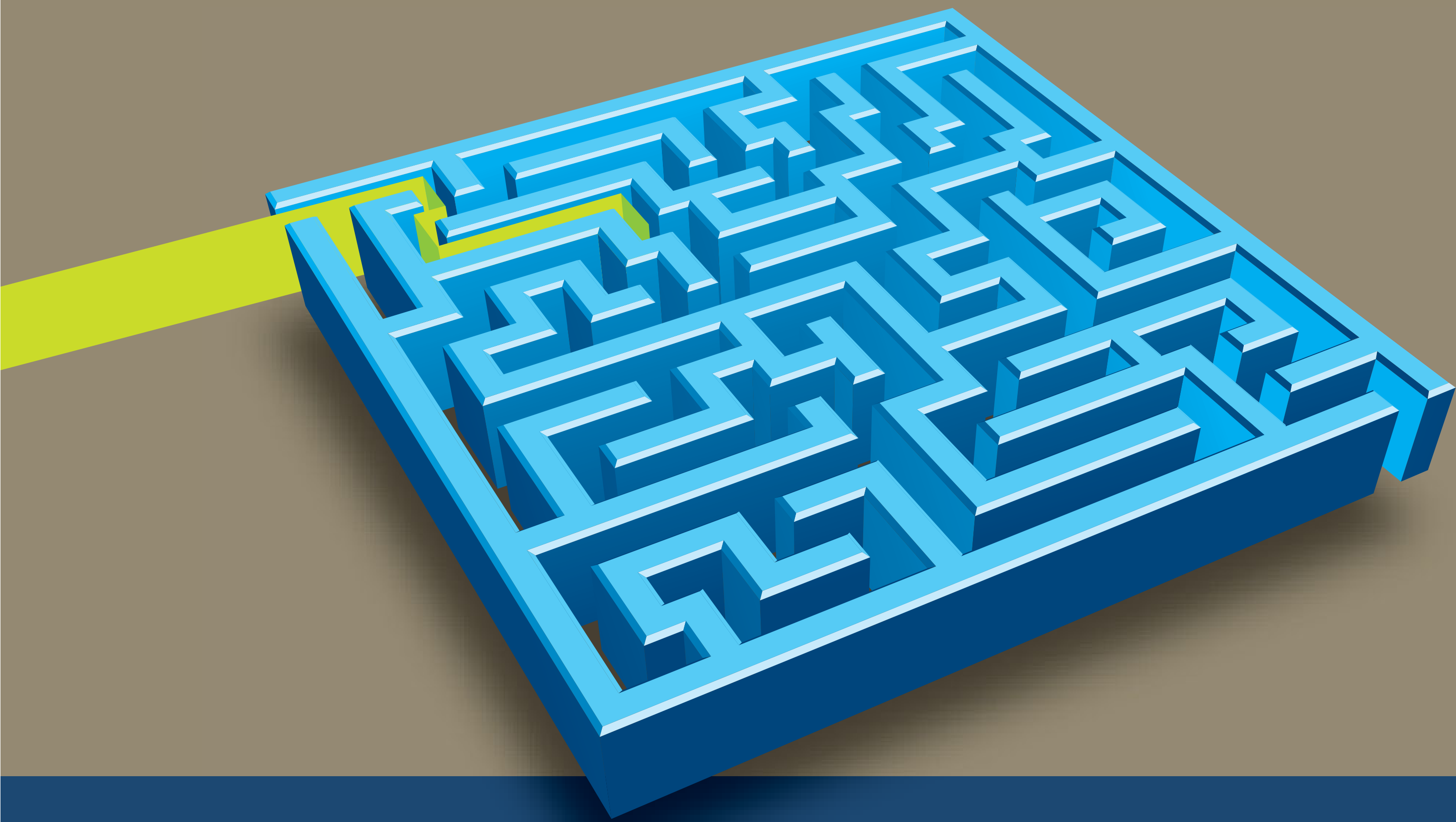
CHANGES AT THE TOP

After 11 years at OSFI, Nick Le Pan resigned as Superintendent in October 2006. I assumed his duties as Acting Superintendent while the process to appoint a new Superintendent was begun and was subsequently appointed Superintendent.

During the year, the executive team welcomed two new members: Ted Price, Assistant Superintendent, Supervision Sector, and Robert Hanna, Acting Assistant Superintendent, Regulation Sector. Change is never easy, and I am very proud of all of my colleagues, who remained dedicated and committed to our priorities and goals during this transition.

OSFI will continue to play a pivotal role in the Canadian financial services industry, charting a course that builds on our strengths and balances our approach. We will also continue to assess and measure our performance in order to retain and enhance our reputation as a world leader in financial regulation and supervision.

Julie Dickson
Superintendent



PERFORMANCE HIGHLIGHTS

OSFI's mandate is to contribute to the safety and soundness of the Canadian financial system, while allowing federally regulated financial institutions and private pension plans to compete effectively and take reasonable risks. We chart a course that balances competitiveness with stability; international rules with Canadian market realities; and efficiency with thoroughness. This approach guided our performance during 2006-2007.

In OSFI's last Annual Report, we outlined our priorities for the coming year. In this section we report back on our major accomplishments in each program area.

In brief, here is what we said we were going to do in 2006-2007, and here are some highlights that illustrate what we accomplished.

PRIORITY

Ensure that OSFI is in a position to review and approve applications that are submitted for approval under the Basel II capital framework.

STEPS TAKEN

- Designed and rolled out a supervisory approval process to review and approve bank applications.
- Finalized the regulatory reporting framework for Basel II.
- Continued to provide support to banks in their preparations for successful filing of their first "parallel run" of the Basel capital adequacy reporting (BCAR) as at October 31, 2006.
- Hosted three 'college of supervisors' events designed to exchange information and discuss cross-border implementation approaches with supervisors of major foreign subsidiaries of Canadian banks.

PRIORITY

Participate in and monitor international work on conceptual changes to accounting standards and the move to international financial reporting standards (IFRS).

STEPS TAKEN

- Participated in the Accounting Task Force (ATF) of the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors' (IAIS) Insurance Contracts Subcommittee, which monitor the International Accounting Standards Board and U.S. Financial Accounting Standards Board joint project to develop a common conceptual framework.
- Provided two comment letters to the International Accounting Standards Board (IASB) on different aspects of the Conceptual Framework project related to measurement and qualitative characteristics of financial reporting, as a result of our participation in the ATF and IAIS.
- Provided input to international colleagues at the ATF and IAIS for their participation in the measurement roundtables hosted by the IASB to gather views from constituents on measurement objectives.
- Provided comments on a paper regarding valuation of insurance liabilities that was submitted for input to the IASB's Insurance Working Group.

David Wilson
Regulatory Officer, Approvals and Precedents,
Legislation and Approvals Division,
Regulation Sector

PRIORITY

Accurate risk assessments of financial institutions and timely, effective intervention and feedback.

STEPS TAKEN

- Intervened with a number of institutions to improve risk management and governance practices and to enhance safety and soundness.
- Reduced the number of "staged" (problem) institutions, as a result of effective intervention by OSFI. The number of staged institutions declined to 25 at the end of 2006-2007 from 36 a year earlier.
- Assigned a low or moderate Composite Risk Rating (CRR) to 95% of all rated institutions as at March 31, 2007. No institution was assessed as high risk. The percentage of institutions with a low or moderate risk rating has been improving steadily since 2002-2003, when OSFI started sharing risk ratings with institutions.
- Focussed risk assessment and intervention activities on emerging areas of risk. For example, OSFI increased the focus on risks arising from Canadian institutions' offshore operations and their ability to manage those risks. Continued to develop and maintain effective working relationships with foreign regulators to optimize supervisory efforts.
- Monitored institutions' ability to manage the adoption of international accounting standards and the implementation of Basel II.
- Reviewed institutions' crisis response and preparedness.
- Continued to assess institutions' ability to detect and deter terrorist financing and money laundering.
- Increased focus on a potential deterioration in asset quality at smaller deposit-taking institutions.
- Monitored P&C institutions closely for pricing behaviour, particulary signs of any weakening in terms of conditions, as well as catastrophic exposures.

Susan Lucas
Senior Officer, Approvals and Precedents,
Legislation and Approvals Division,
Regulation Sector

PRIORITY

A balanced, relevant regulatory framework of guidance and rules that meets or exceeds international minimums.

STEPS TAKEN

- Worked closely with the Department of Finance in the review and update of the financial institutions legislation (Bill C-37), and played a key role in streamlining a number of regulatory approvals for financial institutions in order to increase regulatory efficiency and reduce the burden on financial institutions.
- To meet international minimums, developed Guideline E-17 Assessments of Responsible Persons by FREs, as a draft for comment. The guideline sets out principles to assist federally regulated entities in the establishment of policies and procedures to conduct assessments of the suitability and integrity of their directors and senior officers.
- Released the final version of the Capital Adequacy Requirements (CAR) Guidelines on the implementation of the new Basel Framework for banks and federally regulated trust and loan companies.
- Revised the capital guidelines for banks, life insurance companies, and property and casualty insurance companies to reflect the financial instruments standards that took effect after the 2006 fiscal year.
- Worked with the life insurance industry through the Minimum Continuing Capital and Surplus Requirements (MCCSR) Advisory Committee to develop more advanced risk measurement techniques for the MCCSR.
- Issued the final revised version of Guideline E-15 Appointed Actuary: Legal Requirements, Qualifications, and External Review. The revised guideline avoids duplication with requirements now contained in the CICA's Auditing Guideline 43 on Assurance and Related Services.
- Hosted a second AML/ATF information session designed to highlight some of OSFI's key initiatives and expectations to the federally regulated financial sector.
- Continued to play an active role in the work of the Financial Action Task Force.
- Developed information-sharing agreements with a number of host-country supervisory authorities that regulate significant foreign incorporated subsidiaries of Canadian banks.
- Continued involvement with a number of international groups, including the Joint Forum, the Financial Stability Forum, the Integrated Financial Supervisors, the Association of Supervisors of Banks of the Americas, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Actuarial Association, and Le Groupe des superviseurs bancaires francophones.

PRIORITY

A prudentially effective, balanced and responsive approvals process.

STEPS TAKEN

- Processed 589 applications for approvals, a moderate reduction of 2% in approvals from 2005-2006. However, the complexity of the applications for approvals being reviewed has increased.
- Continued to meet performance standards establishing time frames for processing applications for regulatory approval and for other services that attracted service charges before April 28, 2006.
- Developed home country reports as part of the review of prospective new foreign bank entrants that analyze the regulatory and supervisory regime, and provide a summary of the socio-economic and political environment, in the home jurisdiction.
- Worked closely with law enforcement and other government bodies in determining the suitability of new entrants.
- Hosted a Legislation and Approvals Seminar for industry, focused on issues related to OSFI's approvals process.
- Implemented the new framework governing OSFI's service charges. As a result, the costs associated with the administration of the user fee system fell for both OSFI and financial institutions, and some minor adjustments took place in the allocation of OSFI's base assessments.

Kenneth Ho
Senior Operational Risk Analyst , Operational Risk and Capital Assessment Services, Supervision Sector

Barbara Edwards
Information Specialist, Monitoring & Analytics Support Division, Supervision Sector

Federally Regulated Private Pension Plans

PRIORITY

Accurate risk assessments of pension plans, timely and effective intervention and feedback, a balanced relevant regulatory framework, and a prudentially effective and responsive approvals process.

STEPS TAKEN

- Used the Estimated Solvency Ratio exercise to identify defined benefit plans with an estimated solvency funding deficit (about 51% of supervised defined benefit plans in December 2006, compared to 78% in December 2005). In part due to OSFI's efforts, market conditions and the government's solvency funding relief, almost all of these plans are dealing actively with their deficits through plan funding.
- Worked with the Department of Finance on funding relief regulations for federally regulated defined benefit pension plans.
- Published guidance on funding relief and on plan registrations to clarify OSFI's expectations and improve transparency, and updated the Pension Guide for Members.
- Increased resources and refined internal processes to improve efficiency and timeliness on approvals.
- Dealt actively with late remittance issues in selected defined contribution plans.
- Completed a number of detailed desk reviews of defined benefit plans and undertook a number of on-site examinations during the year, with a continued focus on governance.
- Continued to promote responsible pension plan governance and actuarial practices by working closely with the Canadian Association of Pension Supervisory Authorities (CAPSA) and the Canadian Institute of Actuaries.
- Improved communications with industry, by providing more feedback to individual pension plans and through regular publication of the PBSA Update newsletter.

International Assistance

PRIORITY

Contribute to awareness and improvement of supervisory and regulatory practices for selected foreign regulators through the operation of an international assistance program.

STEPS TAKEN

- Continued to offer unique 'in-house' programs that allow bank and insurance company supervisors from around the world to visit and learn at OSFI, and hosted many delegations to OSFI.
- Worked in 25 different jurisdictions, many of which International Advisory Group (IAG) staff visited several times. Hundreds of foreign supervisors received the benefit of IAG's training.
- The focus continued to move from theory to implementation, as IAG worked alongside foreign supervisors 'in the field'. Provided legislative and regulatory drafting expertise, and assisted with the selection process for senior-level supervisory staff.
- Delivered a comprehensive report to the FIRST Initiative pursuant to a cost-recovery project entitled, "Roadmap for Strengthening Solvency Control in the Chilean Insurance Industry."
- Worked extensively in Ghana, Nigeria and Malaysia to help these jurisdictions implement a system of risk-based supervision for financial institutions.
- Assisted some jurisdictions with self-assessment of their compliance with the Basel Core Principles and the International Association of Insurance Supervisors Core Principles.
- Assisted several jurisdictions that are attempting to correct deficiencies identified during their Financial Sector Assessment Program (FSAP) assessment.

PRIORITY

Contribute to financially sound federal government public pension and other programs through the provision of expert actuarial valuation and advice.

STEPS TAKEN

- Published, in December 2006, the 22nd Actuarial Report on the Canada Pension Plan (CPP) modifying the 21st Actuarial Report on the CPP (the most recent triennial actuarial report) to show the effect of Bill C-36 on the long-term financial status of the CPP. This actuarial report covers two provisions of Bill C-36 that are the result of the CPP triennial financial review completed by the federal and provincial ministers of Finance in June 2006.
- Participated in the federal/provincial committee on the triennial financial review of the CPP.
- Completed the fifth annual actuarial review of the Canada Student Loans Program.
- Tabled in Parliament a number of other reports, including actuarial reports on the Public Service Pension Plan, the Royal Canadian Mounted Police (RCMP) Pension Plan, the Canadian Forces Pension Plan, the Public Service Death Benefit and the Regular Forces Death Benefit.
- Provided actuarial advice on the design, funding and administration of public pension plans to client government departments, including Human Resources and Social Development, Finance, Treasury Board, Public Works and Government Services, National Defence, Veterans Affairs, the RCMP and Justice Canada.
- Prepared actuarial reports for the Public Accounts of Canada.
- Developed the actuarial study on Optimal Funding of the CPP, Actuarial Study No. 6.
- Performed actuarial work with the CPP Investment Board on measuring and managing the contribution rate risk.
- Provided an expert witness report on the mandate and role of the Office of the Chief Actuary in relation to federal pension plans for the Pension Account Litigation.

Corporate Responsibility

PRIORITY

High-quality internal governance and related reporting.

STEPS TAKEN

- Appointed an independent member as vice-chairperson of the Audit Committee.
- Increased capacity in the Internal Audit function and the number of internal audits, and participated in government horizontal audits.
- Met most Treasury Board Internal Audit Maturity Model requirements for the Internal Audit function, leading to OSFI's recognition as a Large Department or Agency under the Internal Audit policy.
- Completed a Treasury Board assessment of OSFI's Management Accountability Framework and achieved "Notable" results in: Effective Planning Function, Portfolio Management, Financial Reporting, Information and Decision Making, Risk Management, Human Resources Planning and Financial Analysis.
- Posted all audits, as well as Superintendent's speeches and appearances before Parliamentary Committees, on OSFI's Web site.
- Published the first edition of *The Pillar* (external newsletter).

Corporate Services

PRIORITY

Enhance resources and infrastructure necessary to support supervisory and regulatory activities.

STEPS TAKEN

- Implemented necessary policies, processes, training and communication plans to ensure compliance with the *Public Service Modernization Act.*
- Continued succession planning in all critical high-risk areas.
- Delivered focused leadership and technical training to staff.
- Updated emergency preparedness tools, facilities and processes to ensure effective recovery and continuity of critical services.
- Planned for alternate resources to sustain critical services in the event of pandemic-related staff shortages and introduced preventative measures to minimize potential impact on staff.
- Completed implementation of the Electronic Document Management System (EDMS).
- Substantially completed Basel II systems development.
- Substantially completed implementation of Business Intelligence (BI) technology for the deposit-taking institutions (DTI) industry for enhanced monitoring and analytics.
- Began implementation of a data management process to maximize the usefulness of financial data collected from the industry while minimizing potential duplication of data collected.
- Implemented a Management of Information Technology Security (MITS) action plan to ensure readiness and effective management of security incidents and adequate protection of information.

Priorities Going Forward

OSFI has six ongoing responsibilities related to program activities.

1. Accurate risk assessments of financial institutions and timely, effective intervention and feedback.
2. A balanced, relevant regulatory framework of guidance and rules that meets or exceeds international minimums.
3. A prudentially effective, balanced and responsive approvals process.
4. Accurate risk assessments of pension plans; timely and effective intervention and feedback; a balanced relevant regulatory framework; and a prudentially effective and responsive approvals process.
5. Assistance in raising awareness and improving supervisory and regulatory practices for selected foreign regulators through the operation of an international assistance program.
6. Contributing to financially sound federal government public pension and other programs through the provision of expert actuarial valuation and advice.

OSFI has identified the following priorities under the above areas of responsibility to achieve our strategic outcomes for 2007-2008. More details can be found on OSFI's Web site in the *Report on Plans and Priorities 2007-2008 to 2009-2010.*

a) Ensure OSFI can respond adequately to shocks as a result of a crisis or pandemic, and cyclicality in the industry.

b) Complete the review and approval, with a reasonably high degree of confidence, of applications that are submitted for approval under the Basel II Capital Accord, and review OSFI practices to align with Basel II requirements.

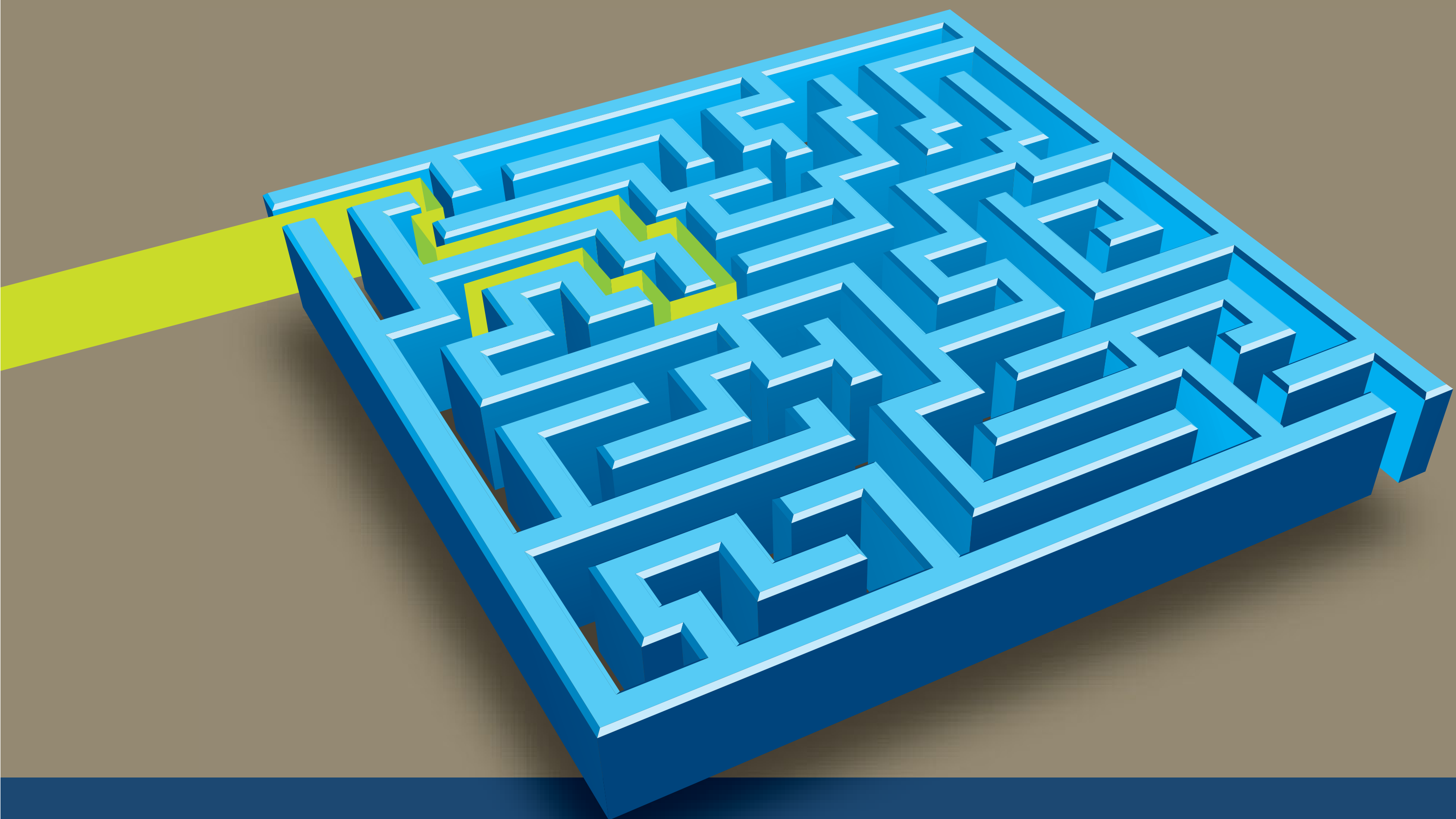
c) Participate in Financial Sector Assessment Program (FSAP) Update and Financial Action Task Force (FATF) reviews and be in a position to deal with any feedback that results from the reviews.

d) Implement the move from Canadian generally accepted accounting principles (GAAP) to International Financial Reporting Standards (IFRS) in 2011 by considering changes to OSFI's prudential regime, including consideration of changes in accounting for insurance.

e) Develop and agree on a capital framework for life insurance companies, over a five-year period.

f) Enhance OSFI's ability to perform as required in an increasingly complex pensions environment.

g) Ensure OSFI has the human resources available to fulfill its mandate, through better long-range, integrated planning.



CORPORATE RESPONSIBILITY

RESPONSIBILITY AND MANDATE

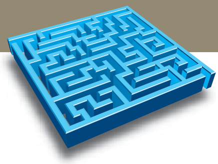
Role

OSFI was established in 1987 by an Act of Parliament: the *Office of the Superintendent of Financial Institutions Act* (OSFI Act). OSFI supervises and regulates all banks in Canada and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and private pension plans.

The OSFI Act provides that the Minister of Finance is responsible for OSFI. It also provides that the Superintendent is solely responsible for exercising the authorities under the financial legislation and is required to report to the Minister of Finance from time to time on the administration of the financial institutions legislation.

OSFI works with a number of key partners. Together, these organizations constitute Canada's network of financial regulation and supervision and provide a system of depositor and policyholder protection.

OSFI also houses the Office of the Chief Actuary, which provides actuarial advice in the form of reports tabled in Parliament to the Government of Canada.



Legislation

OSFI derives its powers from the seven Acts below and is responsible for administering the first six:

1. *Bank Act*
2. *Trust and Loan Companies Act*
3. *Green Shield Canada Act*
4. *Cooperative Credit Associations Act*
5. *Insurance Companies Act*
6. *Pension Benefits Standards Act, 1985*
7. *Office of the Superintendent of Financial Institutions Act*

Acts 1 to 5 set out the rules for the structure and operation of federally regulated financial institutions and the sixth does the same for the standards for private pension plans.

Mandate

OSFI was created to contribute to public confidence in the Canadian financial system. We do so while charting a course that allows financial institutions to be competitive.

Under our legislation OSFI's mandate is to:

- Supervise federally regulated financial institutions and private pension plans to determine whether they are in sound financial condition and meeting minimum plan funding requirements respectively, and are complying with their governing law and supervisory requirements;
- Promptly advise institutions and plans in the event there are material deficiencies and take, or require management, boards or plan administrators to take, necessary corrective measures expeditiously;
- Advance and administer a regulatory framework that promotes the adoption of policies and procedures designed to control and manage risk;
- Monitor and evaluate system-wide or sectoral issues that may impact institutions negatively.

OSFI's legislation also acknowledges the need to allow institutions to compete effectively and take reasonable risks. It recognizes that management, boards of directors and plan administrators are ultimately responsible and that financial institutions and pension plans can fail.

Jason LaMontagne
Communications Specialist, Communications and Public Affairs Division, Corporate Services Sector

Julie Boyer
Human Resources Assistant, Human Resources and Administration Division, Corporate Services Sector

Apolinar Martinez
Business Intelligence Analyst, Information Systems, Corporate Services Sector

The Office of the Chief Actuary (OCA), which is an independent unit within OSFI, provides actuarial services to the Government of Canada. While the Chief Actuary reports to the Superintendent, he is solely responsible for the content and actuarial opinions in reports prepared by the OCA. He is also solely responsible for the actuarial advice provided by the Office of the Chief Actuary to the relevant government departments, including the executive arm of provincial and territorial governments, which are co-stewards of the CPP.

Strategic Outcomes

From our mandate, OSFI has identified two strategic outcomes:

1. **To regulate and supervise to contribute to public confidence in Canada's financial system and safeguard from undue loss.**

   OSFI safeguards depositors, policyholders and private pension plan members by enhancing the safety and soundness of federally regulated financial institutions and private pension plans.

2. **To contribute to public confidence in Canada's public retirement income system.**

   This is achieved through the activities of the Office of the Chief Actuary, which provides statutory actuarial reports, and advises on the state of various public pension plans and on the financial implications of options being considered by policy makers.

Who We Regulate

OSFI supervises and regulates all federally incorporated or registered deposit-taking institutions (e.g., banks), life insurance companies, property and casualty insurance companies, and federally regulated private pension plans. These 1,785 organizations managed a total of $3,375 billion of assets (as at March 31, 2007). (*See figure 1*)

OSFI also undertakes supervision of provincially incorporated financial institutions on a cost-recovery basis under contract arrangements with some provinces.

figure 1

	Deposit-Taking Institutions	Life Insurance Companies	Property & Casualty Companies	Federally Regulated Private Pension Plans	Total
Number of organizations	148	114	191	1,332	1,785
Assets	$2,679 billion	$463 billion	$103 billion	$130 billion	$3,375 billion

Program Activities

OSFI's strategic outcomes are achieved through program activities.

Regulation and Supervision of Federally Regulated Financial Institutions

The three sub-activities of this program are:

- *Risk assessment and intervention* includes activities to monitor and supervise financial institutions, monitor the financial and economic environment to identify emerging issues, and intervene in a timely manner to protect depositors and policyholders, while recognizing that not all failures can be prevented.
- *Rule making* encompasses the issuance of guidance and regulations, input into federal legislation affecting financial institutions, contributions to accounting, auditing and actuarial standards, and involvement in a number of international rule-making activities.
- *Approvals* of certain types of actions or transactions undertaken by regulated financial institutions. This covers two distinct types of approvals: those required under the legislation applying to financial institutions and approvals for supervisory purposes.

Regulation and Supervision of Federally Regulated Private Pension Plans

This program incorporates risk assessment, intervention, rule making and approvals related to federally regulated private pension plans under the *Pension Benefits Standards Act, 1985.*

International Assistance

OSFI supports initiatives of the Government of Canada to assist emerging market economies in strengthening their regulatory and supervisory systems. This program incorporates activities related to providing help to selected countries that are building their supervisory and regulatory capacity.

Office of the Chief Actuary

The Office of the Chief Actuary (OCA) provides a range of actuarial services, under legislation, to the Canada Pension Plan (CPP) and some federal government departments, including the provision of expert and timely advice. The OCA monitors and communicates the financial status of various public pension and benefits plans by submitting regular statutory actuarial reports. These reports are designed to inform Parliamentarians, client departments and decision makers, thereby contributing to greater public confidence in the management of the programs.

Corporate Services

The above functions are supported by corporate initiatives undertaken by the Corporate Services Sector, which contribute to the effectiveness and efficiency of OSFI.

Resources

Financial Resources

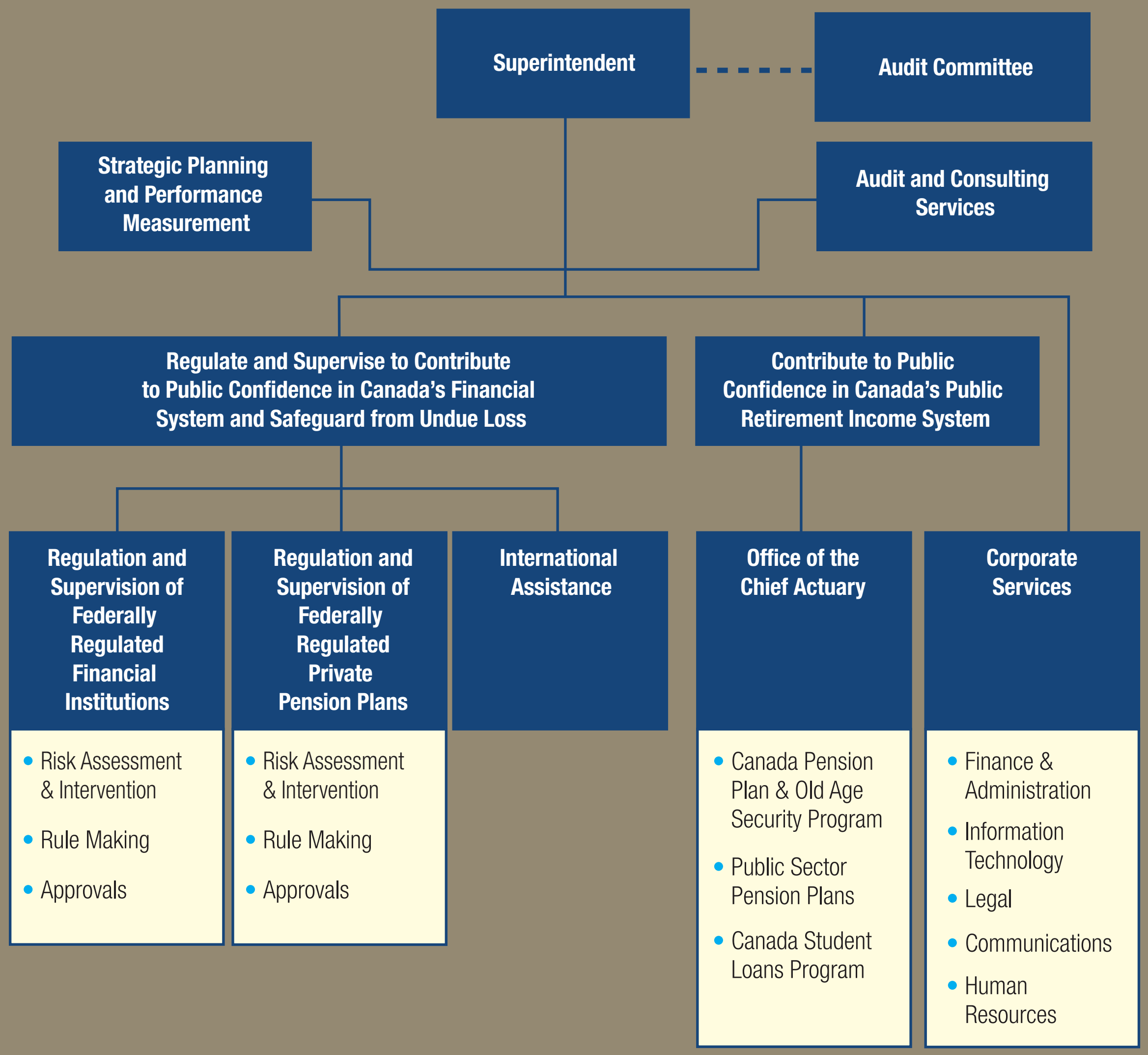
OSFI recovers all of its costs. The organization is funded mainly through asset-based, premium-based or membership-based assessments on the financial services industry and a user-pay program for selected services. A small portion of OSFI's revenue is derived from the Government of Canada, primarily for actuarial services relating to the Canada Pension Plan, the Old Age Security program, the Canada Student Loans Program and various public sector pension and benefit plans.

Human Resources

OSFI employs 462 people in offices located in Ottawa, Montréal, Toronto and Vancouver.

The way OSFI meets its strategic outcomes is set out in the following chart.

figure 2



as at March 31, 2007

EXECUTIVE TEAM

Julie Dickson
Superintendent of Financial Institutions

Julie Dickson was appointed **Superintendent of Financial Institutions** in July 2007, for a seven-year term. Ms. Dickson joined OSFI in April 1999, and was Assistant Superintendent, Regulation Sector, from January 2000 to June 2006, when she was named Deputy Superintendent. In October 2006, she was appointed Acting Superintendent. Prior to joining OSFI, Ms. Dickson served in both the public and private sectors. In the federal government, she served for 15 years with the Department of Finance, primarily in areas related to financial institution policy. In the private sector, Ms. Dickson served as Group Leader of the Financial Institutions Practice for a national consulting firm from 1995 to 1998. She is a member of the Accounting Standards Oversight Council of Canada, and was a member of the Basel Committee on Banking Supervision from 2002 to 2006. She also represents OSFI on the Financial Stability Forum and the Integrated Supervisors group. As Superintendent, Ms. Dickson serves on the Council of Governors of the Canadian Public Accountability Board and on the boards of directors of the Canada Deposit Insurance Corporation and of the Toronto Leadership Centre.

F. Edward (Ted) Price
Assistant Superintendent, Supervision Sector

Ted Price was appointed **Assistant Superintendent, Supervision Sector** in June 2006. Since joining OSFI in 2001, Mr. Price has served in several senior management roles, most recently as Senior Director, Financial Conglomerates Group, where he directed supervision and risk assessment of large banks and insurance companies. He also led the implementation of the Basel II Capital Accord Framework in Canada. Mr. Price began his career at OSFI as Senior Director, Capital Markets Division. Prior to joining OSFI, Mr. Price was a senior executive with Prescient Markets, Inc., an Internet-based investment bank, from 2000 to 2001. Between 1983 and 1999, Mr. Price held various positions in government finance, fixed income and capital markets product development at ScotiaCapital, Inc. In 1995, he was appointed to the Executive Committee and relocated to New York to direct the firm's U.S. business.

Robert (Bob) Hanna
Acting Assistant Superintendent, Regulation Sector

Robert Hanna was appointed **Acting Assistant Superintendent, Regulation Sector**, in October 2006. He also continued to serve as Senior Director, Capital, Accounting and Research Division, a position he had held since January 2000. This division develops and maintains capital rules or guidelines for financial institutions, interprets accounting principles that apply to institutions, and leads the development and policy interpretation of internationally agreed capital standards in Canada. Mr. Hanna joined the predecessor of OSFI, the Inspector General of Banks, in 1984, and has held a number of positions primarily in the policy and research areas. He has also served as the co-chair of the Minimum Continuing Capital and Surplus Requirements (MCCSR) Advisory Committee, an industry-supervisory group that is investigating more risk-sensitive capital measures for life insurance companies. Mr. Hanna currently represents OSFI on the Basel Committee on Banking Supervision and was OSFI's representative on the Basel Capital Task Force that oversaw the development of the Basel Capital Framework (Basel II).

Donna Pasteris
Assistant Superintendent, Corporate Services Sector

Donna Pasteris was appointed **Assistant Superintendent, Corporate Services Sector**, effective April 8, 2002. She is responsible for OSFI's human resources; financial and corporate planning; professional development and training; communications and public affairs; information management and information technology; and administrative services. During her career, Ms. Pasteris has held a number of senior management and executive positions in the private and public sectors, including at C-Mac Industries Inc., Atomic Energy of Canada Ltd., Montreal General Hospital, and McGill University in Montréal.

UPDATE

Before the publication of this Annual Report, **Robert Hanna** was confirmed as Assistant Superintendent, Regulation Sector. As well, **Donna Pasteris** retired as of August 31, 2007. The best wishes of OSFI go with her.

ACCOUNTABILITY

Accountability Framework

OSFI's accountability framework comprises a variety of elements.

In addition to the Annual Report, OSFI reports to Parliament through the publication of a *Report on Plans and Priorities* (RPP) and a *Departmental Performance Report* (DPR). OSFI also produces and distributes to its stakeholders an annual Plan and Priorities. The Superintendent reports to the Minister of Finance on OSFI operations, and periodically appears before various House of Commons and Senate Committees.

OSFI participates in established international reviews jointly led by the World Bank / International Monetary Fund to determine whether OSFI is meeting internationally established principles for prudential regulators.

OSFI consults extensively with financial institutions, other government agencies and subject-matter experts on its regulatory rules before they are finalized. OSFI has its financial statements reviewed and approved by an Audit Committee, composed primarily of external members, and audited annually by the Office of the Auditor General. OSFI also reviews its budgets and business plans with stakeholder groups.

OSFI regularly conducts anonymous surveys of knowledgeable industry observers to assess its performance and effectiveness as a regulator. This includes how OSFI compares to other regulators. Survey results are disclosed on OSFI's Web site. OSFI also regularly conducts surveys to gauge public confidence in financial institutions and private pension plans.

The Office of the Chief Actuary (OCA) provides transparency regarding Canada's public retirement income system through the production and subsequent tabling before Parliament of regular actuarial reports on the Canada Pension Plan (CPP), Old Age Security (OAS) program and public sector employee pension and benefit plans. A number of these reports are peer reviewed. The Chief Actuary periodically appears before various House of Commons and Senate Committees. The Superintendent chairs a committee of users of the services of the OCA to review OCA operations and overall budgets and business plans.

Consultation with Insurance Stakeholders

To monitor the status of OSFI's strategic outcomes, OSFI conducts periodic, anonymous, independent consultations with its stakeholders. This provides OSFI with an indication of its performance in certain areas, such as the appropriateness of its supervisory or rule-making practices and the usefulness of its feedback to institutions. It is one of the ways OSFI can find out if it is perceived to be charting the right course.

In the fall of 2006, OSFI commissioned The Strategic Counsel, an independent research firm, to conduct consultations with insurance companies to explore their perceptions of the current insurance marketplace, of OSFI in general, and of the work of OSFI's actuarial division in particular.[1] The aggregate results of the confidential one-on-one interviews with executives and professionals representing a cross-section of the insurance companies regulated by OSFI enabled OSFI to assess if we are providing the guidance and direction our stakeholders need.

[1] OSFI provided The Strategic Counsel, an independent research firm, with a list of executives and professionals representing a cross-section of the life and property and casualty insurance companies regulated by OSFI. The research firm conducted 64 one-on-one confidential interviews. The research firm independently selected the samples from the list, and OSFI does not know who was interviewed. Unless otherwise noted, the findings reported emerged consistently across stakeholder groups.

Overall the findings revealed that OSFI is viewed as being effective in discharging its mandate, and that staff involved in actuarial matters are knowledgeable in core areas. Respondents identified areas for improvement such as providing greater feedback on required filings; broadening communication about OSFI's international efforts; and increasing the level of expertise and the complement of staff dealing with actuarial matters. More details can be found in the section of this report on Federally Regulated Financial Institutions. The complete survey report, *Report on Actuarial Consultation*, is available on OSFI's Web site.

BENEFITS TO CANADIANS

Contributing to a Sound Economy

OSFI's strategic outcomes, supported by our plans and priorities, are intrinsically aligned with broader government priorities. A properly functioning financial system that inspires a high degree of confidence among consumers and others, inside and outside Canada, who deal with financial institutions makes a material contribution to Canada's economic performance.

The financial services sector represents 6% of Canada's Gross Domestic Product and employs over 700,000 Canadians. A properly functioning, efficient financial services sector is essential to Canada's economy. The achievement of OSFI's strategic outcomes, which are shared by other institutional partners within government and the private sector, provides an essential foundation for a productive and competitive economy.

Keeping Canadians Informed

In 2006-2007, OSFI continued to communicate its plans and activities to a wide range of interested parties. As part of its commitment to openness and transparency, OSFI made public several reports, including its 2005-2006 Annual Report; its *Plan and Priorities 2007-2010; Report on Actuarial Consultation*; several reports from the Office of the Chief Actuary, including the 22nd Actuarial Report on the Canada Pension Plan (CPP) and several statutory actuarial reports for public sector employee pension and benefits plans. The full text of these reports can be found on OSFI's Web site.

Angelica McCrea
Facilities & Material Officer, Human Resources and Administration Division, Corporate Services Sector

Lisa McGill
Manager, Human Resources and Administration Division, Corporate Services Sector

OSFI is recognized as an international model for prudential regulators and receives many requests to address conferences and other events. In response, the Superintendent and other senior OSFI officials delivered a number of presentations to industry and regulatory forums and groups across Canada and around the world. Audiences and venues included the Empire Club of Canada, the Canadian Institute of Actuaries, the World Bank, the London School of Economics, the Institute of International Bankers, and Parliamentary Committees. Many of these presentations and reports are available on OSFI's Web site.

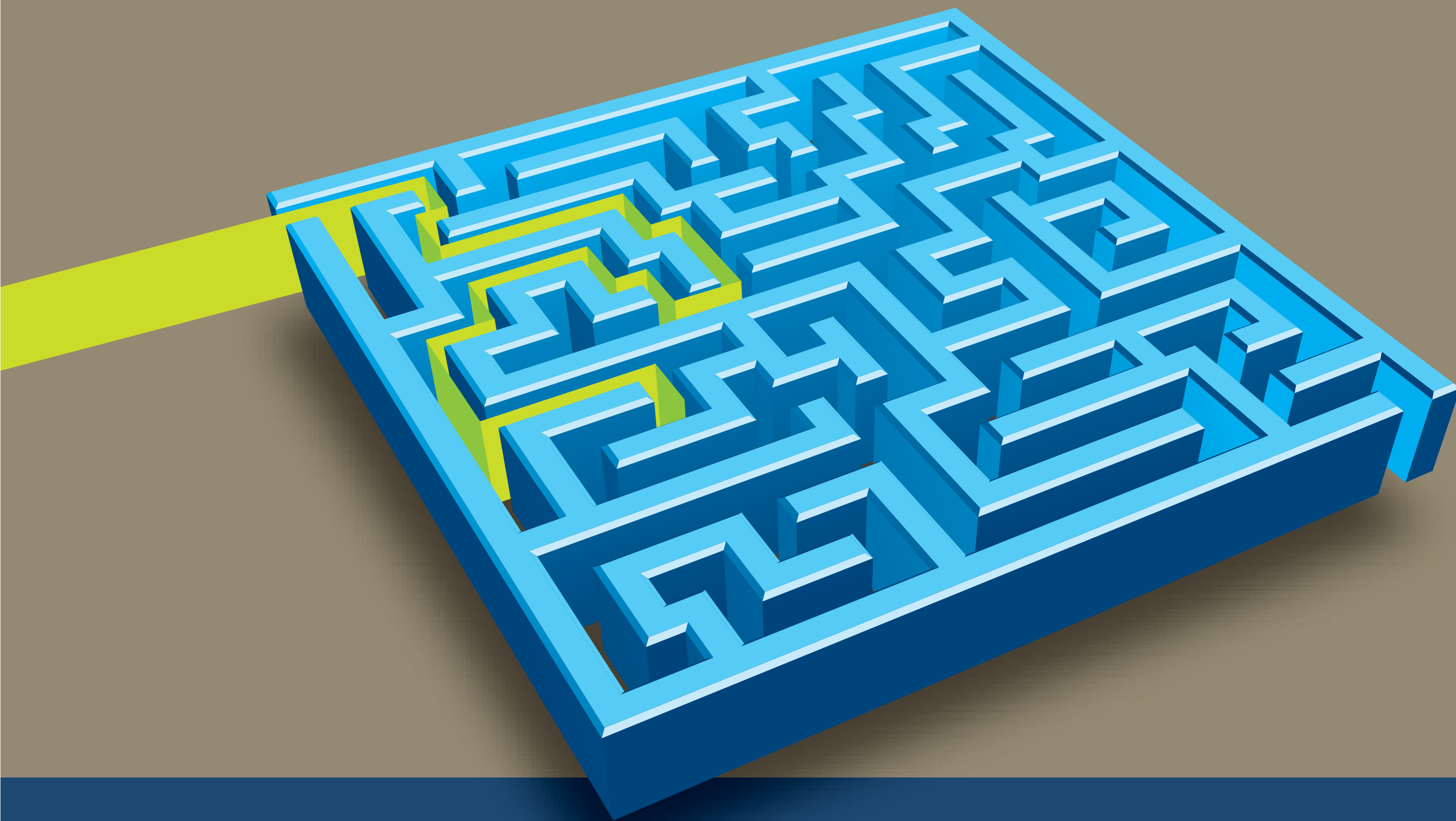
OSFI's first external newsletter, *The Pillar*, was introduced to provide a timely reminder of the latest guidelines, notices, public statements, and other pertinent information released by the Office. The name reflects OSFI's prudential mandate, to regulate and supervise in a manner that contributes to the strength of Canada's financial system.

Significant changes were made to OSFI's external Web site as it was converted to comply with the *Common Look and Feel Standards for the Internet* according to Treasury Board guidelines, and to provide all interested parties with easier access to our information on line.

SHARING OSFI'S EXPERTISE

Throughout 2006-2007, OSFI shared its expertise with interested Canadians, including members of the general public, industry, regulators, legislators and the news media:

- Served over 1,140,830 visitors to OSFI's Web site
- Handled 12,299 public enquiries
- Responded to 121 enquiries from Members of Parliament
- Replied to 114 enquiries from representatives of the news media
- Delivered over 40 speeches and presentations to industry and regulatory forums



FEDERALLY REGULATED FINANCIAL INSTITUTIONS

RISK ASSESSMENT AND INTERVENTION

Office of the Superintendent of Financial Institutions Act

" … to supervise financial institutions in order to determine whether they are in sound financial condition and are complying with their governing statute law and supervisory requirements under that law … and to promptly advise the management and board of directors of a financial institution in the event the institution is not in sound financial condition or is not complying with its governing statute law or supervisory requirements … and to take the necessary corrective measures …deal with the situation in an expeditious manner."

Financial Environment

Guiding Institutions through an Increasingly Complex Landscape

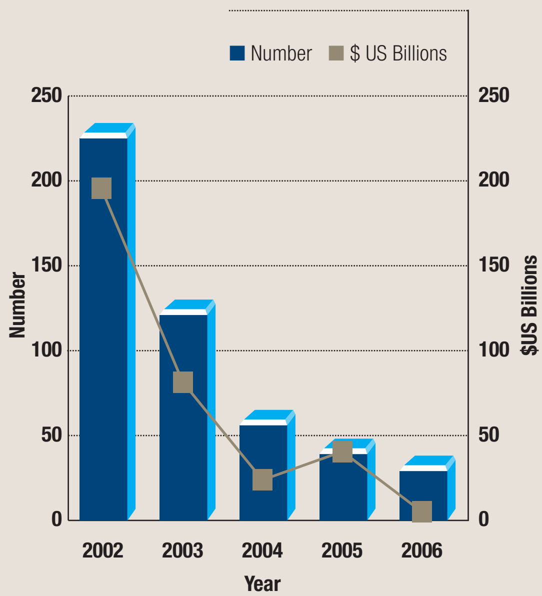
Canadian financial institutions are highly international. Their health is affected by economic and financial conditions in Canada and abroad.

Despite a slowdown in the United States, global economic growth remained resilient in 2006 and was particularly strong in Asia. In Canada, there was robust growth in the first six months of the year but the economy slowed in the second half. That was largely attributable to reduced demand for Canadian exports from weakened automotive and housing sectors in the U.S. Offsetting this drag on real Gross Domestic Product (GDP) was growth in non-residential construction and personal expenditures. Moderate economic growth is projected for 2007.

Equity markets in Canada and abroad were volatile in the first half of 2006, but stabilized over the final six months and showed overall gains for the full year.

The global corporate default rate remained near all-time lows (*see figure 3*), and credit trends were broadly favourable. However, the global default rate is expected to edge up in 2007. In Canada, there are signs the credit cycle has peaked and is in the early stages of a slowing trajectory.

Global Corporate Defaults
figure 3

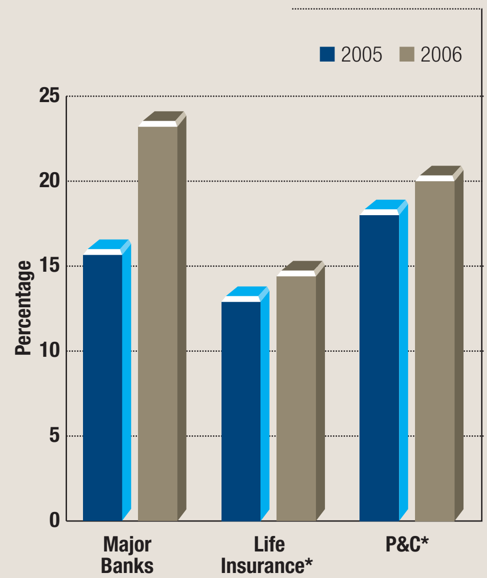


Source: Standard and Poor's

The global corporate default rate remained near all-time lows.

Supported by positive economic and financial market conditions in Canada and abroad, Canadian financial institutions continued to perform very well in 2006, enjoying record profits in many cases. As well, they remained well capitalized, and credit quality was good. *(See figure 4)*

Return on Equity
figure 4



* Excludes reinsurers

Canadian financial institutions continued to perform very well in 2006, enjoying record profits in many cases.

In response to a number of developments in the financial environment, OSFI supervisors enhanced their risk assessment and intervention activities to set their sights on emerging areas of risk.

In response to a number of developments in the financial environment, OSFI supervisors enhanced their risk assessment and intervention activities to set their sights on emerging areas of risk.

Canadian financial institutions are operating in an increasingly complex and competitive international environment. OSFI, as supervisor of the consolidated operations of Canadian financial institutions, faces more pressure to increase its assessment of risks arising from offshore operations and to monitor Canadian institutions' ability to manage those risks. This requires increased cross-border cooperation. Accordingly, OSFI will continue to develop and maintain effective working relationships with foreign regulators to optimize its supervisory efforts.

Increased complexity in both the banking and insurance industries means institutions must adopt enhanced analytical techniques, risk-transfer mechanisms and new control processes to keep pace with the inherent risks. To keep pace with industry developments, OSFI regularly assesses its risk-based planning and supervisory processes and will be conducting a more formal review of its supervisory framework over the next few years.

As institutions are faced with adopting international accounting standards and implementing Basel II, OSFI supervisors will monitor their ability to manage these challenges.

Various events over the past few years have required financial institutions and OSFI to focus more on crisis response and preparedness. As well, in Canada and many other jurisdictions, there has been greater attention paid to the ability of financial institutions to detect and deter money laundering and terrorist financing. Institutions are overall compliant with their anti-money laundering and anti-terrorist financing. OSFI's assessments indicate that although most federally regulated financial institutions assign a high level of importance to their anti-money laundering and anti-terrorist financing risk management programs and compliance obligations, there is scope for further improvement in these areas.

Jean-Pierre Girouard
Manager, Approvals and Precedents, Legislation and Approvals Division, Regulation Sector

Louis Bourgeois
Director, Approvals and Precedents, Legislation and Approvals Division, Regulation Sector

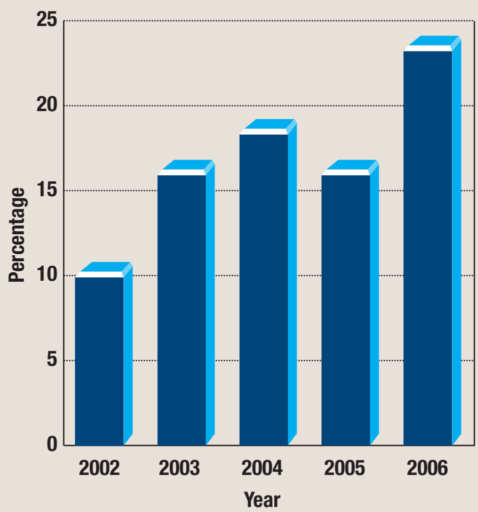
Major Canadian Banks

The six largest Canadian banks posted very strong profits in 2006. Average return on equity was 23.2%, compared with 15.9 % in 2005. (*See figures 5 and 6*)

Domestic retail business lines continued to be the primary driver of earnings growth. In particular, there was rising demand for mortgage and business loans and for credit card products.

Also fuelling the strong performance were higher investment banking revenues. Good expense management and lower tax rates also drove year-over-year core earnings growth.

Major Banks: Return on Equity
figure 5

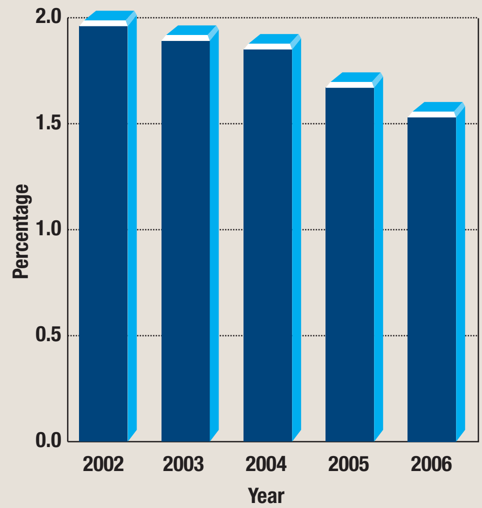


The major banks posted very strong profits in 2006.

Credit quality was strong and stable in 2006, with gross impaired loans remaining at historical lows.

The major Canadian banks were more active as acquirers in the U.S. and in the international arena in 2006, as they found opportunities limited in Canada. However, with the U.S. marketplace remaining highly competitive, there was little organic growth from the banks' U.S. operations.

Major Banks: Net Interest Margin – Interest Income Less Interest Expense/ Average Total Assets*
figure 6



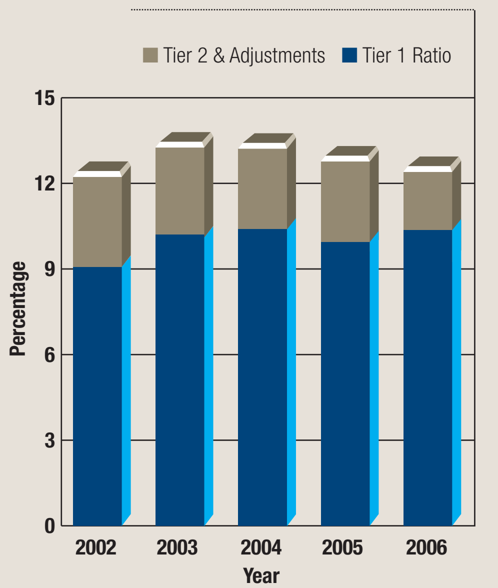
** Historical data have been restated.*

The trend of margin compression was still evident in 2006.

The six largest Canadian banks posted very strong profits in 2006. Average return on equity was 23.2%, compared with 15.9 % in 2005.

The overall capital position of the major banks remained strong as at the end of 2006. The average ratio of total capital to risk-adjusted assets was 12.4%, considerably higher than the Bank for International Settlements' 8% minimum threshold and OSFI's 10% target. These high levels of capital provide a buffer against unforeseeable adverse economic or financial developments. They may also support selective acquisitions in the future, and further dividend increases and common share repurchases. (*See figure 7*)

Major Banks: Risk-Weighted Capital Ratios
figure 7



The overall capital position of the major banks remained strong in 2006.

Overall, OSFI was satisfied with the financial condition and risk management practices of the major Canadian banks in 2006-2007. Looking ahead, the outlook is still moderately positive but profit growth could diminish as economic growth slows and consumer delinquencies rise. It is important to note that banks have significantly reduced their large corporate credit exposures over the last four years. They have also improved their risk management processes and their loan loss reserves.

With a less favourable revenue outlook and a highly competitive market, the banks will be challenged in continuing to grow and earn targeted rates of return. OSFI anticipates that banks will continue their cost management efforts as they take on risks that may be challenging to manage or provide for adequately. As a result, overall risk may increase.

Allyson Lang
Senior Compliance Officer,
Compliance Division,
Regulation Sector

Canadian banks and OSFI are well advanced in efforts to implement the Basel II Capital Accord, but this is requiring continued focus and ongoing work. The new capital framework and events in the market are also requiring banks and OSFI to focus more on the measurement and management of operational risk and its relation to capital. In charting a course for supervision efforts, OSFI must factor in the challenges faced by institutions along with the need for quality implementation.

OSFI supervisors will continue to place a priority on monitoring the major banks' compliance with anti-money laundering laws, particularly in their foreign operations.

Other Deposit-Taking Institutions

As at March 31, 2007, OSFI supervised 61 smaller Canadian deposit-taking institutions, including 14 banks, 39 trust and loan companies (excluding bank-owned trust and loan companies), 7 credit union centrals and 1 cooperative retail association. OSFI employees also supervised 25 subsidiaries, 24 branches and 33 representative offices of foreign banks.

Smaller domestic deposit-taking institutions and foreign banks in Canada have adopted a wide range of business strategies. Accordingly, the factors affecting these institutions are varied and the risks more specific to their individual strategies.

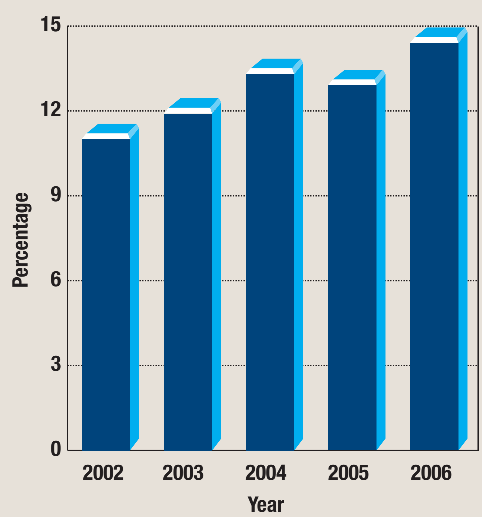
Driven by favourable economic conditions in Canada and continued strong demand for financial products in 2006, the smaller deposit-taking institutions showed broad-based year-over-year growth in assets and net income. Capital ratios remained generally strong, and there was a decrease in the number of staged institutions.

Given indicators that the credit environment may become less benign, OSFI will monitor the smaller deposit-taking institutions for potential deterioration in asset quality. Significant downturns in Canadian real estate markets could create risk exposures for some institutions. These areas will be watched for adverse developments. OSFI supervisors will also continue to monitor this group for compliance with anti-money laundering and anti-terrorism financing controls, and for their degree of pandemic preparedness.

Life Insurance Companies

The Canadian life insurance industry had a very solid year in 2006. Average return on equity was 14.4%, up from 12.9% the year before. (*See figure 8*) For the three largest competitors, industry consolidation over the past five years has presented opportunities to gain economies of scale. Smaller competitors are more focused on market niches where they believe flexibility and responsiveness will allow them to compete without necessarily being the lowest cost providers.

Life Insurance Companies: Return on Equity*
figure 8



** Excludes reinsurers*

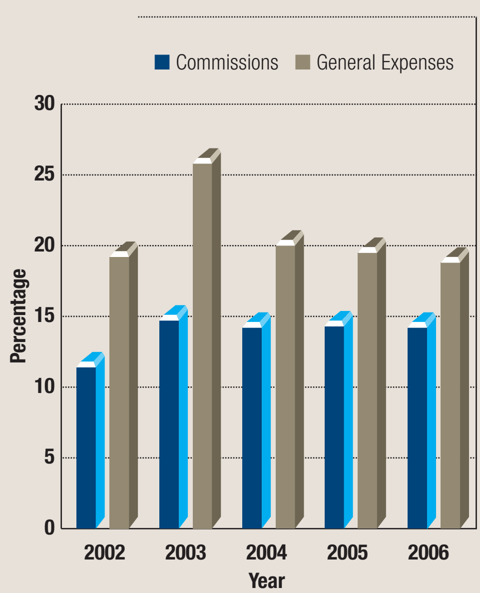
Life insurance industry profitability increased in 2006.

The Canadian life insurance industry had a very solid year in 2006. Average return on equity was 14.4%, up from 12.9% the year before.

The three largest life insurance companies reported strong operating results in both their protection (individual and group) and wealth-management businesses. They have also been benefiting from the strong global economy, given their geographic diversification (although the strong Canadian dollar dampened the Canadian-dollar value of profits earned in the United States). They continue to explore expansion opportunities overseas, while enjoying strong credit quality in their fixed-income portfolios.

For the smaller life insurers, which are less diversified than the conglomerates, premium and new business growth was more modest. Expense ratios are also more of an issue for these companies, as they do not benefit from the scale and technology of their larger competitors to drive down costs. However, these institutions are profitable. (*See figure 9*)

Life Insurance Companies: Expenses as a % of Premiums*
figure 9

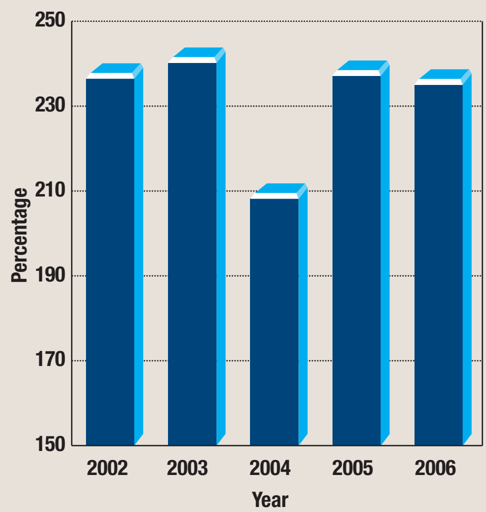


** Excludes reinsurers*

Continued expense control contributed to the life insurance industry's strong performance in 2006.

The life insurance industry is well capitalized. Capital ratios for the life insurance industry remained well above minimum regulatory requirements. OSFI's supervisory target ratio for Minimum Continuing Capital and Surplus Requirements (MCCSR) for Canadian companies is set at 150%. The average MCCSR ratio for Canadian life insurers in 2006 was 235%, significantly above OSFI's target capital level. Overall, asset quality remained strong. (*See figure 10*)

Life Insurance Companies: MCCSR Ratios*
figure 10



** Excludes reinsurers*

In 2006, the average MCCSR ratio for Canadian life insurers remained significantly above OSFI targets.

With overall strong capital and returns, the life insurance industry is in a healthy position at present; however, it faces several challenges.

The credit worthiness of life industry assets such as bonds, mortgages and real estate is currently high overall, but credit risk tends to be subject to cyclical variations, and the industry needs to be prepared for a possible downturn.

Another challenge is the potential adverse impact of a global pandemic on claims and operations. OSFI surveys institutions as part of its ongoing supervisory work to assess individual insurer preparedness. Insurers are also including scenarios related to the impact of a pandemic in their annual dynamic capital adequacy testing (DCAT). The testing looks not only at the impact of higher mortality, but at the broader picture as well, such as the impact of a depressed equity market. DCAT results viewed so far indicate that, while Canadian life insurers would suffer a temporary earnings decline, they would remain solvent.

Given the importance of the three largest insurers' international operations to their overall performance, OSFI will continue to actively review these operations to promote risk management capabilities commensurate with the risks assumed.

Property and Casualty (P&C) Insurance Sector

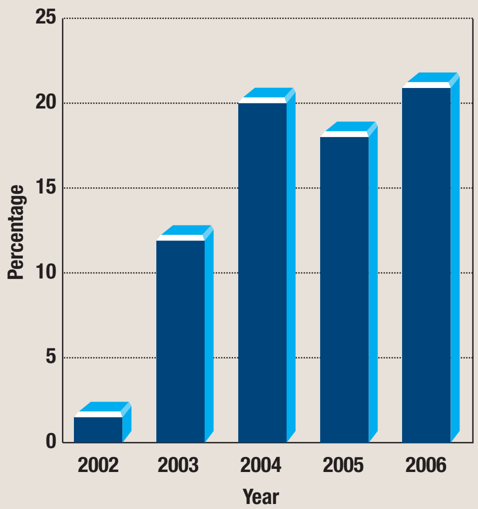
The property and casualty insurance industry continued to perform above industry norms and reported another very profitable year in 2006. Average return on equity was 20.9%, up from 18.0% the previous year.

This profitability was supported by strong underwriting results and good investment returns. All major business lines produced solid results. Canadian automobile insurance continued to be very profitable due to the sustained effectiveness of automobile insurance reforms and continued low frequency levels. However, there were signs of softening, with automobile insurance loss ratios generally climbing over the year, largely due to premium rollbacks in several provinces. Claims frequency and severity also began to creep up.

Personal and commercial property results were also very profitable in the absence of any major natural catastrophes or other adverse events during the year. (*See figures 11 and 12*)

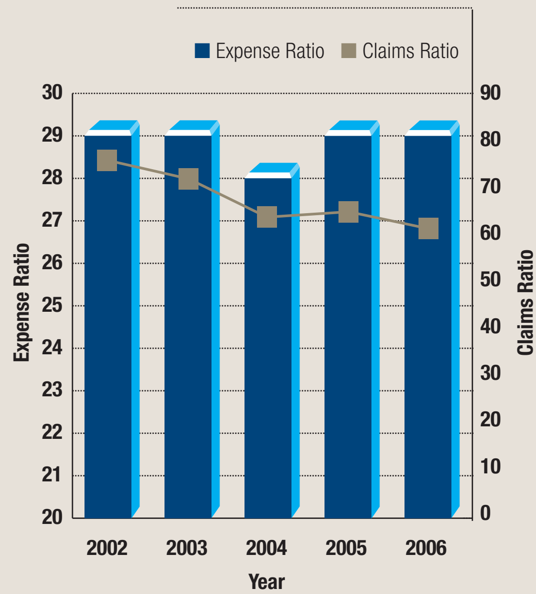
Given the importance of the three largest insurers' international operations to their overall performance, OSFI will continue to actively review these operations to promote risk management capabilities commensurate with the risks assumed.

P&C Insurance: Return on Equity*
figure 11



** Excludes reinsurers*

P&C Insurance: Expense and Claims Ratios*
figure 12



** Ratio of expenses and claims to earned premiums; excludes reinsurers*

The performance of the P&C industry was above industry norms in 2006, due to strong underwriting results and good investment returns.

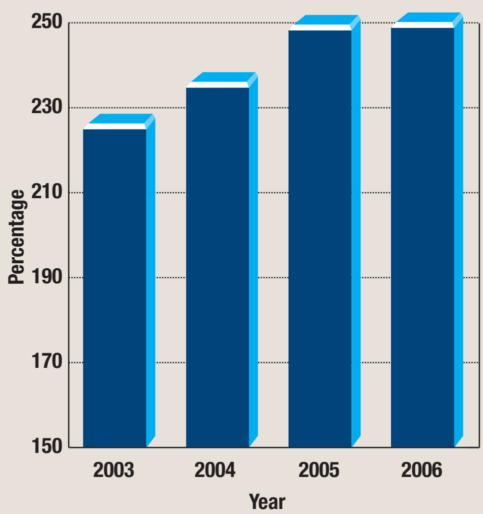
Overall, expense and claims ratios were good again in 2006. However, auto loss ratios climbed during the year.

Anne Langer
Manager, Financial Institutions Group - Deposit-Taking Institutions, Supervision Sector

Simone Redman
Analyst, Basel Implementation Division, Supervision Sector

Investment income remained strong, as institutions continued to benefit from the bull market of the last five years. Overall, P&C companies were well capitalized in 2006. The results of the Minimum Capital Test (MCT) for Canadian companies and of the Branch Adequacy of Assets Test (BAAT) for branches of foreign companies led to a combined MCT/ BAAT ratio for the industry in 2006 of 249%, which is well above OSFI's minimum supervisory target of 150%. *(See figure 13)*

P&C Insurance: MCT/BAAT Ratios*
figure 13



** Excludes reinsurers*

In 2006, the combined MCT/ BAAT ratio for the industry was well above OSFI targets.

With the industry's improved health over the past few years, the number of staged P&C companies has declined. As at March 31, 2007, the number of staged P&C companies further decreased to 11, from 16 a year earlier.

High capital levels supported payment of increased dividends to shareholders and common share repurchases in 2006. Merger and acquisition activity at the company level has been very quiet, although there has been some activity to enhance distribution platforms.

Although the P&C sector has shown improvement in recent years, it remains inherently volatile. Renewed profitability could lead to more intense competition and the underwriting of less profitable business. Lack of acquisition opportunity has strained growth for many larger players who will focus instead on growth in organic market share with pricing and product feature incentives, particularly in automobile insurance. This may result in a decline in underwriting discipline. Lower deductibles and other "accident-waiving" features may adversely impact otherwise favourable claims trends. OSFI will monitor the P&C industry closely for signs of imprudent pricing behaviour. Supervisors will also keep an eye on catastrophic exposures at individual institutions. The industry is increasingly recognizing the threat of climate change. Terrorism also remains a major risk.

Guy Bernèche
Senior supervisor, Market Risk,
Financial Institutions Group - Montréal,
Supervision Sector

Supervisory Policies

Managing Risk Effectively

OSFI uses a modern, risk-based supervisory framework to identify and intervene on a timely basis when a financial institution's practices are imprudent or unsafe. The methodology involves assessing the risks inherent in an institution's significant activities, assessing how effectively those risks are being managed and monitoring the institution's financial condition. OSFI has detailed guidance to assist supervisors in applying the framework.

Where appropriate, OSFI uses the work of an institution's risk management control functions, as well as the work of its external auditor and appointed actuary, to ensure suitable policies and processes are in place and are being followed at all levels to effectively manage and mitigate risks to acceptable levels. This allows OSFI to focus its resources on reviewing the high-risk areas of an institution.

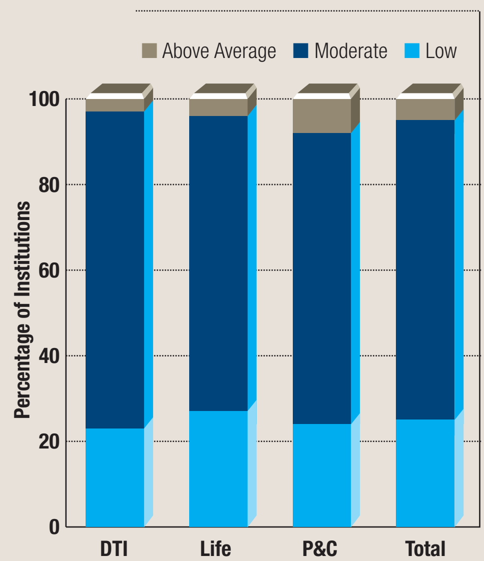
Supervisory work consists of periodic on-site reviews at institutions to test controls and to confirm the adequacy of risk management and governance practices. OSFI also monitors the financial condition and affairs of institutions on an ongoing basis. In line with OSFI's early intervention mandate, problem companies are subjected to a higher level of review and intervention as appropriate. OSFI has been continually fine-tuning its supervisory process based on experience. A more formal review of the overall supervisory framework, which has been in use since 1998, will be conducted over the next few years.

Composite Risk Ratings

The Composite Risk Rating (CRR) represents OSFI's overall assessment of an institution's safety and soundness. The CRR is guided by a set of assessment criteria that were developed in consultation with the industry. There are four ratings for Composite Risk: 'low', 'moderate', 'above average' and 'high' risk. The CRR is reported to most institutions at least once a year (certain inactive or voluntary wind-up institutions may not be rated). The confidentiality of these ratings is protected by regulation.

As at the end of March 2007, 95% of all rated institutions were assigned a low or moderate CRR. No institution was assessed as high risk. The percentage of institutions with a low or moderate risk rating has been steadily improving since 2002-2003, when OSFI started sharing risk ratings with institutions. The improvement is in part due to more favourable economic and financial conditions for Canadian financial institutions, but also reflects the strengthening of risk management control functions in a number of companies. (*See figure 14*)

Composite Risk Rating by Sector
figure 14



As at March 31, 2007, 95% of rated institutions were assessed as low or moderate risk. No institution was assessed as high risk.

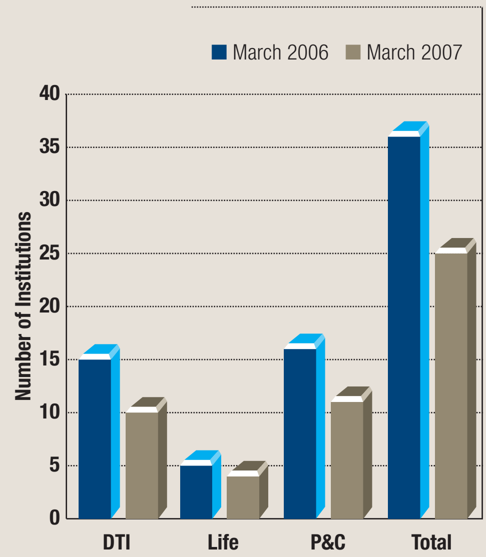
Intervention Ratings

Financial institutions are also assigned an intervention rating, as described in OSFI's Guide to Intervention for Federal Financial Institutions, which determines the degree of supervisory attention they receive. Broadly, these ratings are categorized as: normal (unstaged); early warning (stage 1); risk to financial viability or solvency (stage 2); future financial viability in serious doubt (stage 3); and non-viable/insolvency imminent (stage 4).

As at March 31, 2007, there were only 25 staged institutions, a decrease from 36 the year before. The reduction in the number of problem institutions was mainly among smaller deposit-taking institutions and property and casualty insurers. There are very few staged life insurers. All but one of the staged institutions were in the early warning (stage 1) category. (*See figure 15*)

There were no significant withdrawals from the Canadian market in 2006-2007.

Number of Staged Institutions
figure 15



A reduction in the number of problem smaller deposit-taking institutions and property and casualty insurers contributed to a 36% decrease in the number of staged institutions in 2006-2007.

HIGHLIGHTS OF THE 2006 CONSULTATION WITH INSURANCE STAKEHOLDERS

Charting a Clear Course for the Future

OSFI, as the primary regulator of federally regulated life, and property and casualty, insurance companies, interacts with representatives of these companies and professionals who act on their behalf in order to fulfil its mandate.

In 2006, OSFI commissioned The Strategic Counsel to conduct confidential consultations with insurance companies to explore perceptions of the current insurance marketplace, of OSFI in general, and of the work of OSFI's actuarial division in particular.[2] This information allowed OSFI to know if we are providing the guidance and direction needed to help our stakeholders chart a clear course for the future.

The consultation comprised a series of confidential one-on-one interviews with executives and professionals representing a cross-section of the insurance companies regulated by OSFI. The interviews were conducted from September through December of 2006.

Overall the findings revealed that OSFI is viewed as being effective in discharging its mandate, and that staff involved in actuarial matters are knowledgeable in core areas. Areas for improvement were identified, such as providing greater feedback on required filings; broadening communication about OSFI's international efforts; and increasing the level of expertise and the complement of staff dealing with actuarial matters.

[2] OSFI provided The Strategic Counsel, an independent research firm, with a list of executives and professionals representing a cross-section of the life and property and casualty insurance companies regulated by OSFI. The research firm conducted 64 one-on-one confidential interviews. The research firm independently selected the samples from the list, and OSFI does not know who was interviewed. Unless otherwise noted, the findings reported emerged consistently across stakeholder groups.

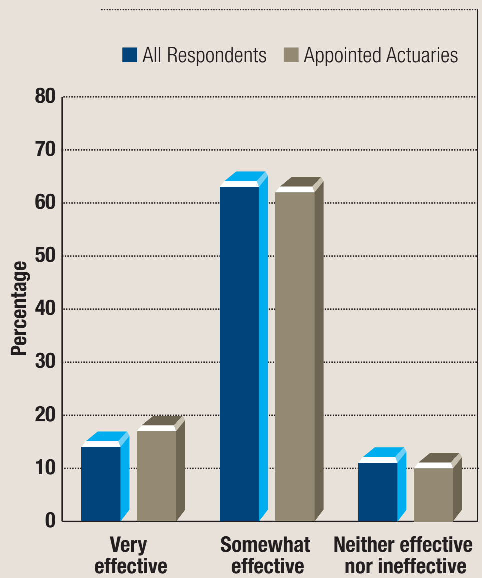
OSFI is developing an action plan to address areas for improvement and will keep the industry informed of its progress. The complete survey report, *Report on Actuarial Consultation*, is available on OSFI's Web site, under About OSFI / Reports / Consultations and Surveys.

Detailed Findings

OSFI has steered a course that has "improved the quality of actuarial practices" but needs to "increase expertise in specialized areas."

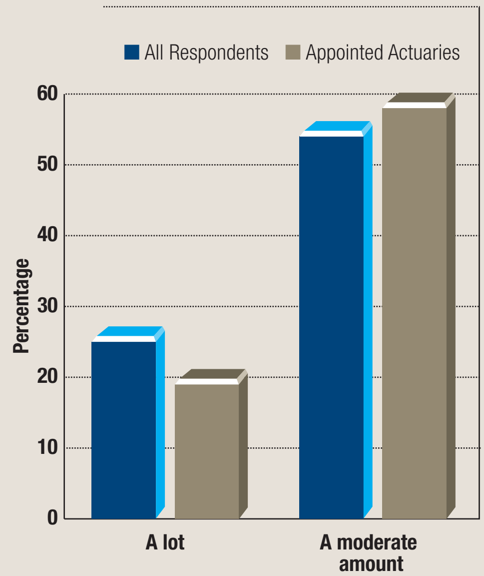
- OSFI is generally perceived to be effective in discharging its mandate, and in identifying problems and being proactive in dealing with issues. (*See figure 16*)
- OSFI is seen to be actively involved in actuarial forums, nationally and internationally, and to have a constructive relationship with the Canadian Institute of Actuaries (CIA). OSFI's influence on the CIA is perceived to have improved the quality of actuarial practices. Participants would like to know more about the progress and outcome of OSFI's international efforts. (*See figure 17*)

Effectiveness of OSFI's Processes for Indentifying Problems
figure 16



OSFI's processes for identifying problems are generally perceived as effective.

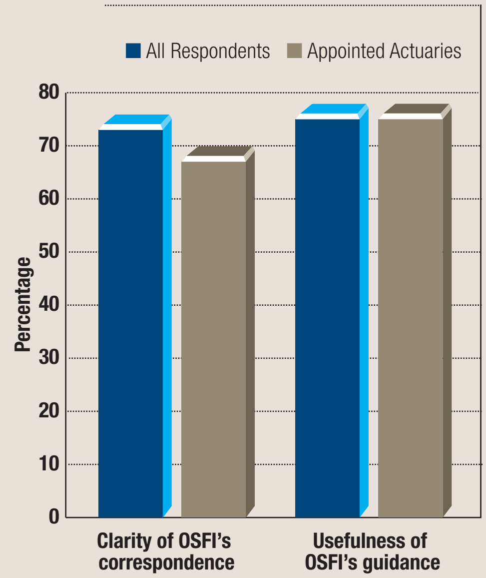
OSFI's Influence in Improving Actuarial Practices
figure 17



OSFI's influence on the CIA is perceived to have improved the quality of actuarial practices.

- Executives and professionals generally hold positive impressions of the knowledge of OSFI staff dealing with actuarial matters in core areas: legislation, OSFI guidelines and regulatory policy, and CIA Canadian Standards of Practice. Participants did, however, express a desire for OSFI to increase staff knowledge and expertise in more specialized areas, such as the reinsurance market.
- OSFI's guidance is viewed as useful, and management letters and written correspondence is thought to be clear. Participants would like to receive the Memorandum to the Appointed Actuary earlier in the year. (*See figure 18*)
- Participants are seeking greater feedback from OSFI on the quality and content of required filings.

Perceptions of OSFI's Guidance and Correspondence*
figure 18



** Combined good and very good rating*

OSFI's guidance is seen to provide a strong indication of OSFI's expectations.

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RULE MAKING

Office of the Superintendent of Financial Institutions Act

"… to promote the adoption by management and boards of directors of financial institutions of policies and procedures designed to control and manage risk."

Rule making includes OSFI's contributions to the amendment of legislation or regulations, the issuance of guidelines, rulings and advisories, and collaboration with several standard-setting agencies (domestic and international). During 2006-2007, OSFI's rule making activities continued to promote sound risk management practices by institutions, which assists OSFI in achieving its mandate. OSFI stayed the course by promoting rules that balance the goals of safety and soundness with the need for institutions to operate within a competitive marketplace.

Due to the complex and global nature of the financial sector, rules are increasingly being developed in the international arena. OSFI continued to work through international bodies to develop sound international rules that can be directly or indirectly applied to Canadian financial institutions.

Domestic Rule Making

Revisions to the Financial Institutions Legislation

Streamlining Regulatory Requirements

Legislation applicable to federally regulated financial institutions is reviewed every five years to ensure it remains current and promotes an efficient, competitive and safe financial services sector. As the administrator of the federal financial institutions legislation, OSFI was actively engaged in the most recent review of financial sector legislation.

Leading up to the November 2006 introduction of Bill C-37, *An Act to amend the law governing financial institutions and to provide for related and consequential matters*, OSFI worked closely with the Department of Finance. OSFI analysed stakeholder submissions in response to the White Paper released in June 2006 and provided input to the drafting of Bill C-37.

As a prudential regulator, OSFI's participation in the legislative review took into account a number of key considerations, including:

- Ensuring legislative changes do not imprudently increase risk to financial institutions;
- Enhancing clarity of the legislation;
- Ensuring OSFI has the necessary authority to act when necessary; and
- Reducing regulatory burden where appropriate.

OSFI played a key role in streamlining a number of regulatory approvals for financial institutions in order to increase regulatory efficiency and reduce the burden on such institutions. Examples of reductions in approval requirements include:

- Certain approval requirements were transferred from the Minister to the Superintendent (e.g., the approval required when an insurance company reinsures less than substantially all of its insurance risk);
- A single approval can cover multiple transactions of a similar nature, such as the sale of a block of loans, over a period of time; and
- A number of approval requirements were eliminated altogether where they were no longer considered necessary.

In the context of Parliament's consideration of Bill C-37, then Acting Superintendent Julie Dickson appeared before the House of Commons Standing Committee on Finance and the Senate Committee on Banking, Trade and Commerce. Bill C-37 received Royal Assent on March 29, 2007.

Collaboration with Standard Setters

OSFI maintains a close working relationship with the Canadian Institute of Actuaries (CIA) as both OSFI and the CIA have an interest in promoting appropriate actuarial standards that lead to acceptable valuations. OSFI supports the CIA's initiative to create the independent bodies known as the Actuarial Standards Board (commenced July 1, 2006) and the Actuarial Standards Oversight Council (commenced January 1, 2007) as this structure will enhance the overall effectiveness of the CIA.

OSFI has continued its involvement with a number of CIA practice committees, and OSFI and CIA executive groups met several times during the year. In 2006-2007, OSFI and the CIA continued their collaboration on a number of projects including:

- The development of qualification standard certificates for the Appointed Actuary(AA) in Canada. This work is designed to ensure AAs have the technical skills and relevant experience to discharge their duties in a competent manner.
- The role of the auditor and the valuation actuary in light of the new Canadian Institute of Charted Accountants' (CICA) Audit Guideline AuG43 on Assurance and Related Services. This work also led to the issuance of OSFI's final revised version of Guideline E-15 (discussed further below).

OSFI maintains a strong working relationship with the CICA. During 2006-2007, OSFI worked closely with the CICA to modify OSFI guidance that would be affected by the changes to the accounting standards for financial instruments. OSFI continued its membership on the Canadian Accounting Standards Board's (AcSB) Financial Instruments Working Group and the User Advisory Committee and, in 2006, gained membership on the International Financial Reporting Standards Advisory Committee. OSFI also collaborated with the Auditing and Assurance Standards Board, and was represented on the Auditing and Assurance Standards Oversight Council and the Accounting Standards Oversight Council.

Capital Guidance

Banks and Trust and Loan Companies – CAR

After a detailed consultative process with industry stakeholders, OSFI released in December 2006 the final version of its Capital Adequacy Requirements (CAR) Guidelines on the implementation of the new Basel II capital framework for banks and federally regulated trust and loan companies (deposit-taking institutions – DTIs). The revised guideline is designed to ensure Canada meets its international commitments while reflecting the Canadian environment in which DTIs operate. The revised regulatory capital requirements come into effect as of the 2007-2008 fiscal year.

The Guidelines, CAR A (intended for smaller institutions that generally have less complex operations) and CAR A-1 (for the more complex operations of internationally active institutions), incorporate the more risk-sensitive capital standards contained in the Basel Committee on Banking Supervision (BCBS) report *International Convergence of Capital Measurements and Capital Standards.*

OSFI played a key role in streamlining a number of regulatory approvals for financial institutions in order to increase regulatory efficiency and reduce the burden on such institutions.

DTIs wanting to use the advanced approaches outlined in CAR A-1 must obtain approval from OSFI. Several DTIs conducted self-assessments during 2006-2007 based on supervisory expectations that had been issued by OSFI in the previous year. OSFI will complete a review of these self-assessments to determine if approval will be granted and, if so, whether any conditions need to be applied.

In May 2006, OSFI issued an advisory regarding regulatory capital treatment of changes arising from the new Accounting Standard for Financial Instruments. This standard became effective for fiscal years beginning on or after October 1, 2006. The advisory relates to regulatory capital treatment of available-for-sale instruments, hedges, own credit risk, the fair value option and capital required.

Under Basel II, banks and trust and loan companies will be required to deduct certain significant minority investments in banks, securities and other financial entities, and investments in insurance entities that are not consolidated for regulatory purposes from both Tier 1 and Tier 2 capital, as opposed to the current deduction from total capital. To reduce the immediate impact of this change, OSFI issued an advisory in March 2007 that provides for a transition period that will allow these companies to delay implementation of the change until either 2009 or 2012, depending upon the type of investment. This change ensures that Canada will be providing treatment similar to that in several other countries that are implementing Basel II.

Life Insurance Companies – MCCSR

OSFI's Minimum Continuing Capital and Surplus Requirements (MCCSR) guideline for life insurance companies was revised to reflect the financial instruments standards that took effect after the 2006 fiscal year. The impact of the new accounting standards on the capital required is being phased in over two years. A number of minor changes were also made, including the requirement for the appointed actuary to provide an opinion on the accuracy of the MCCSR.

OSFI and the life insurance industry are working together through the MCCSR Advisory Committee (MAC) to develop and incorporate more advanced risk measurement techniques into the MCCSR. The MAC consists of senior representatives from the Canadian Life and Health Industry Association, the Canadian Institute of Actuaries, Assuris, the Autorité des marchés financiers and OSFI. In 2006, the MAC developed high-level principles to guide the development of a new more risk-sensitive capital framework for life insurers, and started work on a vision paper outlining the framework. The MAC continues to work on adjusting the MCCSR for new and anticipated accounting changes, such as the impact the changes to the accounting for financial instruments is having on the valuation of policyholder liabilities.

To ensure transparency to stakeholders, OSFI has determined that going forward, major changes will be made to the MCCSR every three years. Annual changes will be limited to the correction of errors, the clarification of existing requirements, or revisions to reflect new accounting or actuarial standards.

Property and Casualty Insurance Companies – MCT and BAAT

OSFI, in consultation with the Insurance Bureau of Canada, completed its fine-tuning of the Minimum Capital Test (MCT) and Branch Adequacy of Assets Test (BAAT) for domestic and foreign property and casualty insurers respectively. The revisions also prescribe capital treatment of items arising from the new Financial Instruments Accounting Standards that were in place for the first quarter of 2007. OSFI conducted a number of preliminary discussions in response to an expression of interest by the property and casualty industry regarding the use of models-based approaches to risk measurement.

Other Guidance

Fair Value Option

In June 2006, OSFI issued the final version of its accounting Guideline D-10: Accounting for Financial Instruments Designated as 'Held for Trading' (Fair Value Option). The Guideline promotes sound risk management when financial institutions use the Fair Value Option available under Section 3855 of the Canadian Institute of Chartered Accountants' Handbook. A slightly revised version was released in February 2007 to permit use of the Fair Value Option when certain criteria are met in respect of loans being held with intent of reselling for profit. The Guideline is effective for fiscal year 2007.

In consultation with industry stakeholders, OSFI made a number of other changes to its guidance material in order to reflect the revised accounting treatment of financial instruments, including:

- Consequential amendments to six accounting guidelines to ensure they reflect the changes to the accounting for financial instruments;
- Revisions to regulatory capital returns as well as to a number of other regulatory reporting returns and associated instructions; and
- Initiation of work on revising Guideline D-9, Source of Earnings.

Appointed Actuary Guidance

In November 2006, OSFI issued the final revised version of Guideline E-15, Appointed Actuary: Legal Requirements, Qualifications, and External Review. The guideline, which describes the role of the Appointed Actuary in federally regulated insurance companies and sets out some of OSFI's expectations with respect to that role, was revised to avoid duplication with requirements now contained in the CICA's Auditing Guideline 43 on Assurance and Related Services. OSFI's Guideline E-15 also provides more emphasis on the educational aspects of external review.

Suitability of Directors and Senior Officers

Several international organizations have issued core principles and recommendations that require directors and senior officers of financial institutions to be regularly evaluated with respect to suitability and integrity. In this regard, during 2006-2007, OSFI worked with the industry to develop guidance for the assessment of responsible persons. This work led to the spring 2007 release of Draft Guideline E-17 Assessments of Responsible Persons by FREs. The guideline sets out principles to assist federally regulated entities in the establishment of policies and procedures to conduct assessments of the suitability and integrity of their directors and senior officers. The guideline will help ensure that OSFI guidance remains consistent with international developments and with regulatory standards in comparable foreign jurisdictions. The guideline is also consistent with OSFI's Corporate Governance Guideline by elaborating on one aspect of board effectiveness and quality governance: the processes used to ensure that directors and senior officers meet certain requirements upon appointment and on an ongoing basis.

Anti-Money Laundering and Anti-Terrorism Financing Initiatives

In 2006, OSFI focussed its AML/ATF assessment program principally on the conglomerate banking sector. Canada's conglomerate banks are, for the most part, reasonably well advanced in the development of effective AML/ATF programs. However, where necessary, OSFI intervened to ensure institutions addressed identified deficiencies, and shared this information with the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) under the Memorandum of Understanding.

In 2007, OSFI's principal AML/ATF focus will turn to the life insurance sector. OSFI will also continue to study and evaluate emerging issues (such as trade-based money laundering and the identification of customers in non-face to face situations), and monitor financial institutions' plans to improve their ability to detect and deter money laundering and terrorist financing.

In December 2006, Bill C-25 received Royal Assent. The Bill was designed to strengthen Canada's anti-money laundering (AML) and anti-terrorism financing (ATF) framework to bring it closer to standards set by the Financial Action Task Force (FATF), the international standards setting body. The Bill amended the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* and imposes new compliance and risk management obligations on Canadian financial institutions. OSFI will be monitoring how the federally regulated sector complies with the new requirements.

OSFI recognizes that financial institutions must address AML/ATF risk in their operational plans. In 2006, OSFI hosted a second AML/ATF information session designed to highlight some of OSFI's key initiatives and expectations to the federally regulated financial sector. This session was held via satellite transmission in Toronto, Montréal and Vancouver, and attracted 350 attendees representing over 150 financial and other institutions.

OSFI continued to play an active role in the work of the Financial Action Task Force (FATF), which is the inter-governmental policy making body that develops and promotes national and international policies to combat money laundering and terrorism financing.

As a member of the FATF, Canada is subject to a periodic mutual evaluation by the FATF. OSFI is one of several federal partner agencies and departments that provided input to the FATF evaluation of Canada's AML/ATF regime in early 2007. The results are expected to be released in early 2008.

OSFI is also represented on the Cross Border Banking Committee of the Bank for International Settlements, which deals with AML/ATF issues.

International Activities

Negotiating a Route through the Global Financial Marketplace

Due to the ever-increasing globalisation of the financial services industry, international bodies continue to play a key role in the development of regulatory frameworks for banks and life insurers. In 2006-2007, OSFI continued to contribute to the development of sound rules that can be applied internationally. At the same time, OSFI worked with regulated entities to apply these frameworks in a way that respects both the realities of the Canadian marketplace and the need for Canadian institutions to be on a level playing field with their foreign competitors.

OSFI continued to build informal, but effective, relationships with foreign supervisors. In 2006-2007, OSFI developed information-sharing agreements with a number of host-country supervisory authorities that regulate significant foreign-incorporated subsidiaries of Canadian banks. The goal is closer coordination of supervisory work and sharing of results where appropriate.

Conceptual Changes to International Accounting Standards

Given the Canadian Accounting Standards Board's (AcSB) strategic direction to converge with International Financial Reporting Standards (IFRS) in 2011, OSFI has focused on responding to International Accounting Standards Board (IASB) projects through active participation in the Accounting Task Force (ATF) of the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors' (IAIS) Insurance Contracts Subcommittee.

Through active participation and membership on the ATF, OSFI worked to provide comment letters in 2006 to the IASB on its Discussion Paper on "Measurement Bases for Financial Accounting – Measurement on Initial Recognition" and on its Preliminary Views document on the "Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information." In addition, early in 2007, the ATF participated in international roundtables hosted by the IASB and the U.S. Financial Accounting Standards Board on the measurement phase of their joint conceptual framework project.

Through active participation and membership on the IAIS, OSFI worked on the second liabilities paper on principles regarding valuation of insurance liabilities, which was submitted for input to the IASB's Insurance Working Group.

International Association of Insurance Supervisors

OSFI continued to work with the International Association of Insurance Supervisors (IAIS), an international working group that represents insurance regulators and supervisors from about 180 jurisdictions. Through the issuance of guidance and the provision of training, the group is dedicated to enhancing the standards for life and property and casualty insurance supervision. In 2006-2007, OSFI contributed to the development of several guidance papers, including a standard on disclosures for life insurers, a standard on asset liability management, and a common structure for the assessment of insurer solvency. OSFI was also an active participant in the development of training and resource materials (Core Curriculum), which include 36 basic-level training modules and five advanced case studies. In addition, OSFI participated in the IAIS as a member of the Executive, Technical and Implementation Committees, and hosted IAIS quarterly meetings in May-June 2006.

Joint Forum

The Joint Forum was established in 1996 by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors. OSFI continued its active membership in the Joint Forum, which works to achieve consistency of supervisory approaches on issues of common interest across financial sectors and national borders. During 2006-2007, the Joint Forum issued papers on the management of liquidity risk in financial groups, high-level principles for business continuity, and issues and observations regarding regulatory and market differences. OSFI participated directly in the development of the liquidity risk and business continuity planning papers.

OSFI continued its involvement with a number of other international groups, including the Financial Stability Forum, the Integrated Financial Supervisors, the Association of Supervisors of Banks of the Americas, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Actuarial Association, and Le Groupe des superviseurs bancaires francophones.

OSFI is one of several federal partner agencies and departments that provided input to the Financial Action Task Force evaluation of Canada's anti-money laundering/anti-terrorism financing regime in early 2007.

Basel Committee on Banking Supervision

Improving the quality of banking supervision worldwide

The Basel Committee on Banking Supervision (BCBS), which provides a forum for cooperation on banking supervisory matters, seeks to enhance understanding of key supervisory issues and to improve the quality of banking supervision worldwide. The BCBS brings together supervisors and regulators of international banks from the G10 countries, of which Canada is a member.

During 2006-2007, the BCBS focused much of its energy on facilitating implementation of the Basel II regulatory capital framework (Basel II). The framework, which introduces a more risk-sensitive capital standard for credit and operational risk, is now more closely aligned with the processes banks were already using. It also supports enhancements in risk measurement and risk management.

The BCBS Accord Implementation Group allows supervisors to share information and approaches to the implementation of Basel II, thereby promoting consistency across jurisdictions. OSFI will continue its active membership in the BCBS, where it is involved in the Accord Implementation Group, the Accounting Task Force and the Policy Development Group.

In 2006-2007, OSFI hosted three ‘college of supervisors’ events, designed to exchange information and discuss cross-border implementation approaches with supervisors of major foreign subsidiaries of Canadian banks. Similarly, in its capacity as ‘host supervisor’, OSFI attended a number of supervisory colleges given by foreign supervisors. This focus on building relationships and sharing approaches with foreign supervisors has proven a successful mechanism supporting implementation for Canadian banks across their global operations.

Preparing the way for implementation of Basel II in Canada

Canadian banks and OSFI continued their efforts to achieve initial implementation of Basel II. A significant amount of work was undertaken by banks during 2006-2007 to provide OSFI with the necessary self-assessments to support OSFI’s decision on whether to approve the use of the more complex Advanced Internal Ratings-Based (AIRB) approach for calculating minimum capital requirements. OSFI intends to grant approvals, either conditional or unconditional, prior to the November 1, 2007 implementation of Basel II. Disclosure is a key component of the capital adequacy framework.

In order to improve the efficiency of handling regulatory data, OSFI built and tested a new data warehouse designed to accept and manage Basel and detailed credit data. OSFI continued to provide support to banks in their preparations for successful filing of their first “parallel run” of the Basel capital adequacy reporting (BCAR) as at October 31, 2006. Ongoing support included the provision of validation rules for BCAR reporting, the tracking and clarification of filing instructions, and providing a test environment in which deposit-taking institutions can pilot planned fixes to errors made in their first BCAR filings. To support OSFI's review of applications for advanced approaches, OSFI also completed the design and roll out of a supervisory approval process to review and approve bank applications and tested Business Intelligence tools to support ongoing supervisory monitoring under Basel II.

As institutions are faced with adopting international accounting standards and implementing Basel II, OSFI supervisors will monitor their ability to manage these challenges.

BCBS consultation papers

OSFI participated with other BCBS members in the development and finalization of several consultative documents in 2006-2007. OSFI fully supports these papers and believes they are an effective vehicle for articulating supervisory expectations.

Sound Credit Risk Assessment and Valuation for Loans

This paper addresses how common data and processes may be used for credit risk assessment, accounting and capital adequacy purposes, and for highlighting provisioning concepts that are intended to be consistent with prudential and accounting frameworks.

Supervisory Guidance on the Use of the Fair Value Option by Banks under International Financial Reporting Standards

This paper focuses on supervisors' expectations for key policy positions and sound practices for banks that the BCBS believes will promote sound risk management and controls, and maintain the integrity of regulatory capital measures.

Observed Range of Practice in Key Elements of Advance Measurement Approaches

This paper describes specific practices that have been observed in relation to some of the key challenges advanced measurement approach (AMA) banks currently are facing in their operational risk-related work in relation to internal governance, data and modelling.

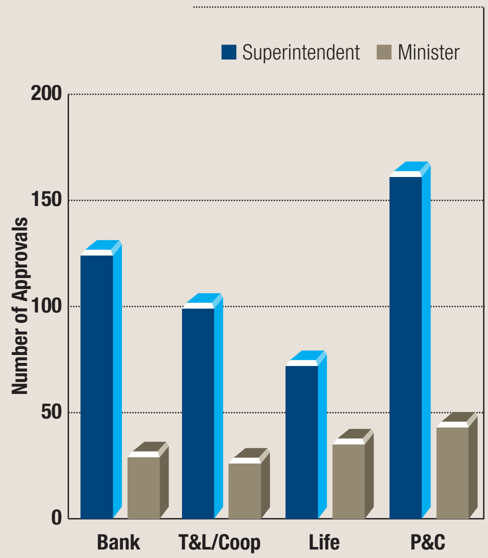
Principles for Home-Host Supervisory Cooperation and Allocation Mechanisms in the Context of Advanced Measurement Approaches – consultative documents

This draft paper clarifies the key elements of supervisory cooperation with respect to the implementation of the advanced measurement approach (AMA) and establishes a framework of principles to facilitate information sharing in the assessment and approval of AMA methodologies.

APPROVALS

Federally regulated financial institutions and other applicants are required to seek regulatory approval for certain types of transactions, including incorporations, orders authorizing the carrying on of business activities in Canada, corporate restructurings and ownership changes. OSFI's approvals process often entails dealing with precedent-setting situations or proposals that sometimes require the development of formal rulings and advisories. The latter provide insight on how OSFI interprets certain provisions of the legislation it administers. OSFI's approvals process is driven by the need to achieve efficiency and thoroughness and the timely processing of applications while ensuring that complex transactions are carefully considered.

Approvals by Industry Sector 2006-2007
figure 19



OSFI processed 589 applications for approvals in 2006-2007, of which 23% were Ministerial approvals. The total processed was 2% less than the previous year.

Applications and Opinions

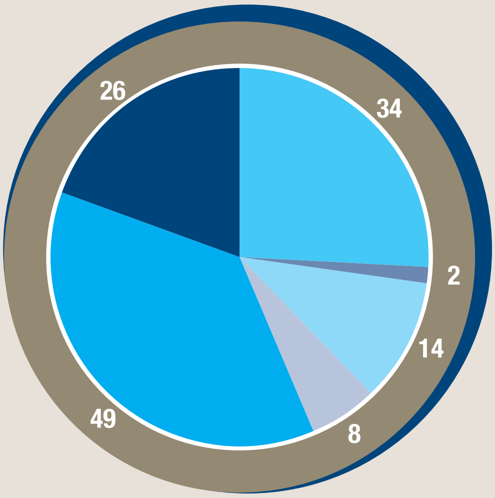
OSFI processed 589 applications for approvals in 2006-2007, a moderate decrease of 2% over the previous year's numbers (603 applications were processed in 2005-2006). (*See figure 19*) While it is impossible to predict fluctuations in the number, or the predominant types, of approval requests from year to year, the reduction in numbers for 2006-2007 can be partly attributed to certain administrative steps implemented by OSFI to reduce the number of recurrences of certain types of approvals by the same institution within the fiscal year. The trend towards innovative or ground-breaking initiatives has increased the complexity of many applications and, in some cases, raised new regulatory or public policy issues.

Ministerial approvals accounted for 23% of the approvals processed by OSFI during the year. (*See figure 19*) Almost half of the Superintendent approvals in 2006-2007 were subject to the statutory "deemed approval" regime which, subject to certain exceptions, requires that they be processed within 30 days of the date of receipt. Most Ministerial approvals related to the acquisition of control or of a significant interest in federally regulated financial institutions, transfer of business or reinsurance transactions, and applications for the incorporation of financial institutions or the authorization of Canadian branches of foreign financial institutions. (*See figures 20 and 21*)

When requested, OSFI provides advance opinions on the eligibility of proposed capital instruments and validates models used by institutions to ensure compliance with the regulatory capital regime. A total of 30 such opinions and validations were provided in 2006-2007 compared to 33 the previous year.

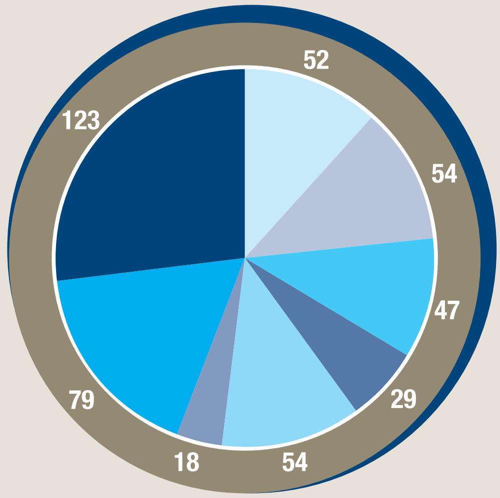
Effective April 28, 2006, all user fee service charges were repealed except for fees related to services provided to non-federal financial institutions (e.g., new applicants) and for fees related to rulings, formal interpretations, capital quality confirmations and to requests for copies of corporate documents.

Major Types of Ministerial Approvals
(Number of Approvals)
figure 20



- Transfer of Business 34
- Amalgamation 2
- Incorporation/Continuation/Branch Establishment 14
- Foreign Bank Designation/Exemption 8
- Significant Interest/Control 49
- Other 26

Major Types of Superintendent Approvals
(Number of Approvals)
figure 21



- Reinsured by Related Party 52
- Redemption of Shares/Debentures 54
- Transfer/Acquire > 10% Assets 47
- Substantial Investment 29
- Data Processing 54
- Large Dividends 18
- New/Changes to Orders 79
- Other 123

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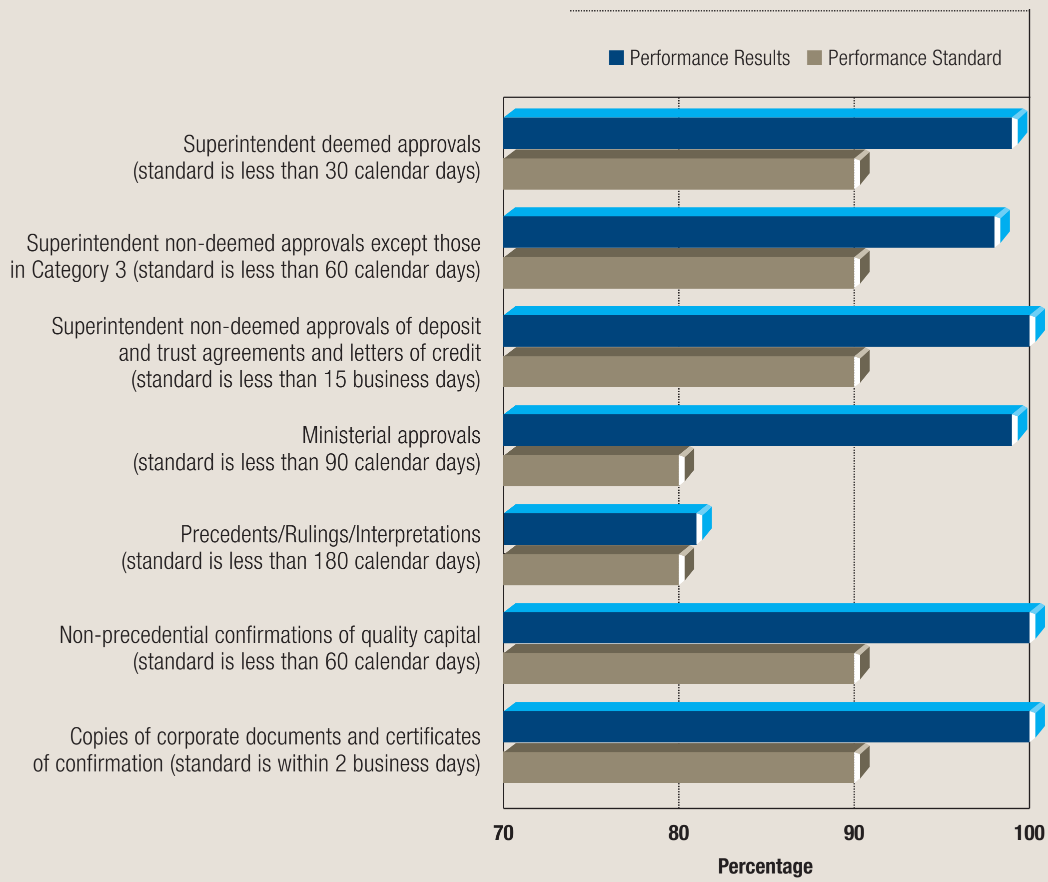
PERFORMANCE STANDARDS

In keeping with OSFI's and the Government of Canada's commitment to enhance accountability and transparency relating to services provided, OSFI has implemented performance standards establishing time frames for the processing of applications for regulatory approval and for other services. In 2006-2007, OSFI met or exceeded all its established performance standards. (*See figure 22*)

OSFI Performance Against User Fee Service Standards 2006-2007*
figure 22

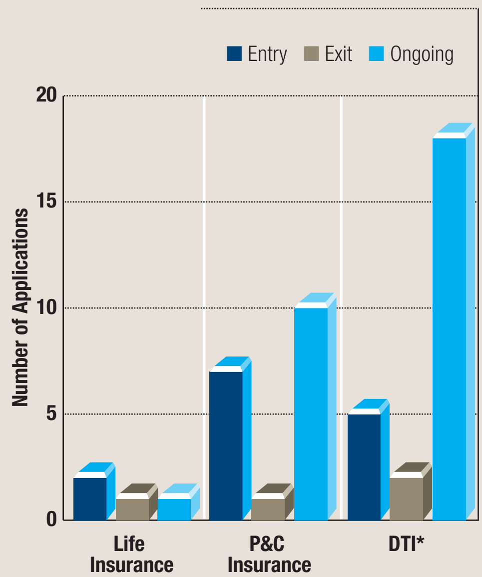


** Approval processing times from date of receipt of completed application.*

New Entrants in the Financial Sector

During 2006-2007, three trust companies were incorporated or continued as well as four new insurance companies (one life and three property and casualty). Furthermore, two foreign bank branches (one lending and one full-service) and five foreign insurance branches (one life and four property and casualty) were established. *(See figures 20 and 23)*

FRFI Entry, Exit and Ongoing New Entry Applications 2006-2007
figure 23



* Includes non-deposit-taking institutions

There were 14 new entrants in 2006-2007.

The proposed activities and services to be performed by the new trust company entrants are varied, including one that is a non deposit-taking transfer agent and trustee, one that is a mortgage lender and back-office processor and one that will provide all forms of consumer financial services. The two new foreign bank branches are major financial institutions originating from the U.S. and Ireland.

New entrants in the insurance sector included two Canadian mortgage insurers and one conversion of a foreign branch of a U.S. life company to a Canadian life insurance company, sparked primarily by a U.S. tax ruling affecting annuity payments to Canadian annuitants of that branch. In 2006-2007, two additional applications to incorporate mortgage insurance companies were processed by OSFI. No further transactions related to the U.S. tax ruling are expected in the coming year. There were a number of ownership changes and transfers of business, resulting in large part from the rationalization of corporate structures in the insurance sector.

A number of banks and trust companies required approvals during 2006-2007 for ownership changes and/or corporate restructurings. There continues to be strong interest in the incorporation or acquisition of banks or trust and loan companies and, on the part of foreign banks, the establishment or expansion of their operations in Canada. As a result of an increase in interest in establishing a bank in Canada on the part of prospective foreign banks from a number of unfamiliar jurisdictions, OSFI has researched and developed a number of country reports that analyse the regulatory and supervisory regime, and provides a summary of the socio-economic and political environment in the applicant's home jurisdiction. Also, OSFI continues with its practice to require security checks on new entrants, Canadian and foreign, and on the proposed senior officers and boards of directors of new financial institutions.

OSFI has seen indications that our domestic applicants are seeking ways to target both corporate and retail niche markets. There has been a lot of interest recently in Islamic or Shari'a-compliant financial services, and OSFI has been studying these to see how they fit into our current regulatory system.

Foreign financial institutions are able to participate in the Canadian marketplace in a variety of ways, which often results in OSFI having to deal with numerous complex applications related to the establishment of their Canadian business. This trend represents a challenge for OSFI due to the diversity of applicants, the sometimes unfamiliar jurisdictions, the often innovative or complex business proposals and corporate structures presented.

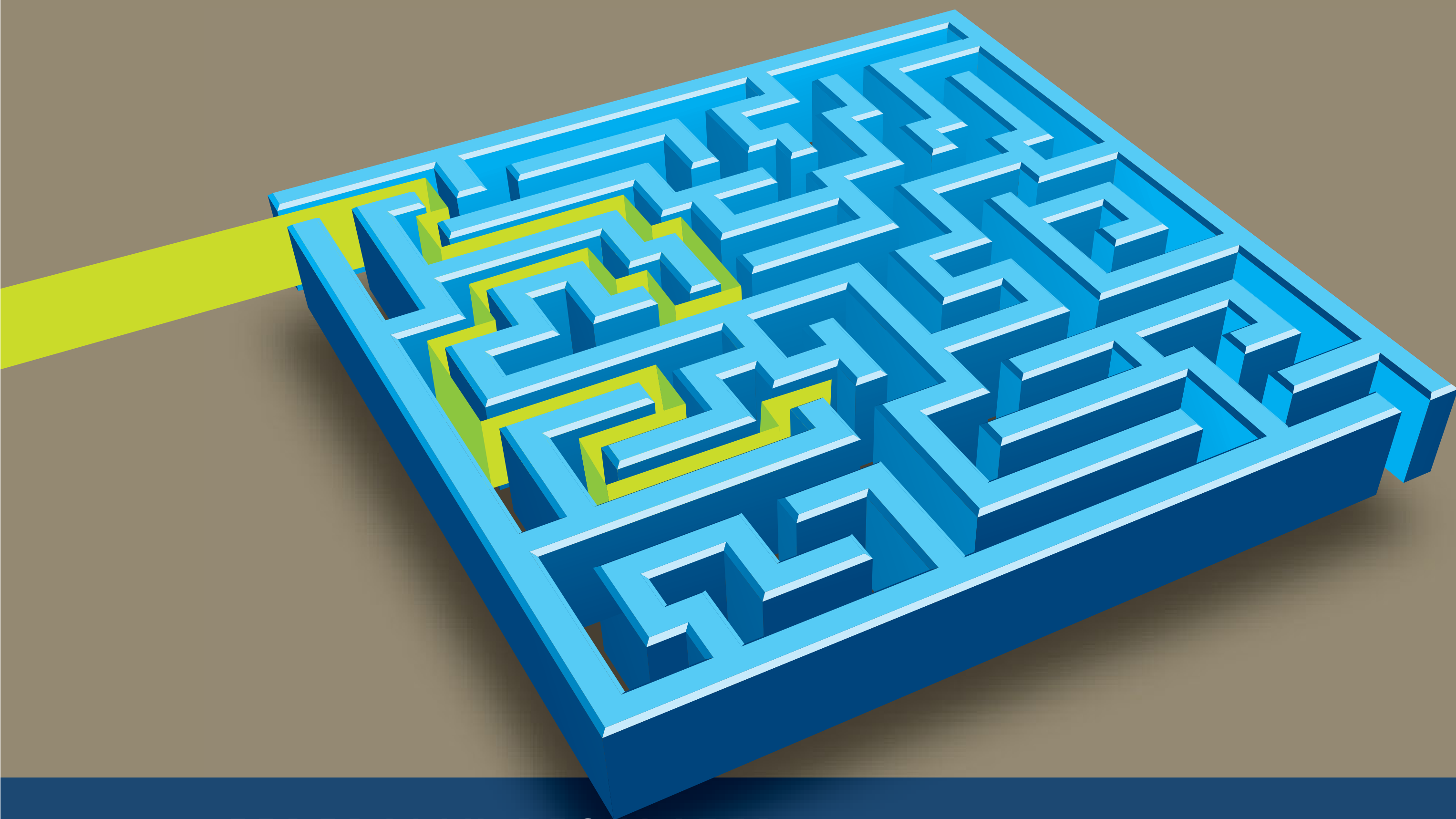
Guidance and Education

During the course of OSFI's work, new issues come to light that require precedential or new interpretations of the financial legislation. In 2006-2007, OSFI spent a considerable amount of time dealing with technical issues related to the application of the legislative provisions that deal with the Canadian operations of foreign financial institutions.

In keeping with OSFI's objectives of enhancing the transparency of its statutory approvals process and of promoting better understanding of OSFI's interpretation of the federal financial institution statutes, OSFI develops and publishes Advisories and Rulings. While OSFI did not publish any advisories or rulings in 2006-2007 due to other priorities, a considerable amount of work was done on a number of issues related to the administration of the legislative provisions dealing with business in Canada, insurance of risks in Canada and de facto control. A draft advisory relating to the insurance of risks in Canada was prepared and discussed with various industry groups. Other rulings and/or advisories resulting from OSFI's work on the previously mentioned issues will be published in 2007-2008.

In October 2006, OSFI hosted its fifth annual Legislation and Approvals Seminar which was attended by approximately 100 representatives of financial institutions and advisors. The seminar focused on issues relating to OSFI's approvals process, including new entry trends and challenges, prospective rulings and advisories, capital rules and developments, and OSFI priorities. Given the positive feedback, OSFI expects to host a similar seminar again in the fall of 2007.

Foreign financial institutions are able to participate in the Canadian marketplace in a variety of ways, which often results in OSFI having to deal with numerous complex applications related to the establishment of their Canadian business.



FEDERALLY REGULATED PRIVATE PENSION PLANS

Office of the Superintendent of Financial Institutions Act

" … to supervise pension plans in order to determine whether they meet the minimum funding requirements and are complying with the other requirements of the PBSA and its regulations and supervisory requirements under that legislation …and to promptly advise the administrator of a pension plan in the event that the plan is not meeting the minimum funding requirements or is not complying with other requirements … and to take, or require the administrator to take the necessary corrective measures …to deal with the situation in an expeditious manner."

Private Pension Environment

Charting a Course in a Challenging Environment

During 2006-2007, financial and economic conditions continued to create a challenging environment for private pension plans. Though funding pressures eased over the period, as a result of strong investment returns, stable long-term interest rates and the Solvency Funding Relief Regulations introduced by the federal government in November 2006, vigilance is still required. The perfect pension storm may have passed, but the low interest rate environment lingers and a significant number of defined benefit pension plans are expected to continue to face large funding demands. For some plan sponsors, the ability to meet these demands remains a concern.

OSFI conducts a series of calculations every six months to estimate the solvency of the defined benefit plans it regulates. Based on this exercise, in December 2006, about half (51%) of all defined benefit plans supervised by OSFI had an estimated solvency ratio less than 1.0 (compared to 78% in December 2005).

The regulations governing federally regulated private pension plans contemplate that plans may from time to time operate in a deficit position, and provision is made within the regulations to permit funding of these deficiencies over a five-year period. OSFI recognizes, however, that there will be circumstances where plans that do not have sufficient assets to cover all the liabilities will have to be restructured. Overall, OSFI continues to see the situation facing defined benefit plans as stable but challenging, provided there are no material adverse changes in asset markets or long-term interest rates.

Public awareness of the importance of retirement income has grown in recent years, as large numbers of Canadians near retirement and attention has been focussed on the financial position of the pension sector. One consequence has been an increase in the number of pension-related court challenges and decisions. OSFI expects courts to look increasingly to regulators to make decisions under relevant legislation, and OSFI will continue to review court decisions that chart the course for pensions and that affect OSFI's pension policy direction.

In addition, developments affecting actuarial and accounting standards, including the increased use of market rates and prices have implications for pensions. Innovative new investment products and strategies to optimize returns and match pension liabilities are on the horizon, and regulators like OSFI must strike a course that takes into account the risk implications for both defined benefit and defined contribution pension plans.

Risk Assessment and Intervention

OSFI supervises private pension plans covering employees in federally regulated areas of employment. These include banking, inter-provincial transportation, telecommunications, and other sectors such as federal undertakings outside the legislative authority of the provinces (e.g., businesses or undertakings in the Yukon, Northwest Territories and Nunavut).

Also falling under federal jurisdiction is any work, undertaking or business declared by the Parliament of Canada to be for the general advantage of Canada or for the advantage of two or more provinces. Uranium mining is an example of an undertaking that falls within this category. Most other private pension plans are governed by the pension legislation of the provinces in which their members are employed (with the exception of Prince Edward Island, which does not have private pension plan legislation).

As at March 31, 2007, 1,332 private pension plans were registered under the *Pension Benefits Standards Act, 1985*, (PBSA), covering over 582,000 employees. In 2006-2007, plan assets increased by 12%, to a value of approximately $130 billion. The great majority of members, and assets that OSFI regulates, are in defined benefit plans. Over the past four years, there has been a small but steady increase in the proportion of defined contribution plans relative to the total number of plans. (*See figures 24, 25 and 26*)

Some plan administrators have expressed concerns about the long-term viability of their defined benefit pension plans and a desire to move away from defined benefit toward defined contribution plans. While statistics at year-end for 2006-2007 do not illustrate a significant shift in the number of defined benefit plans, OSFI anticipates that over time this trend may become more prevalent if current market conditions and challenges persist. While there has been some growth in the number of defined contribution plans, the statistics of the past four years do not show any significant

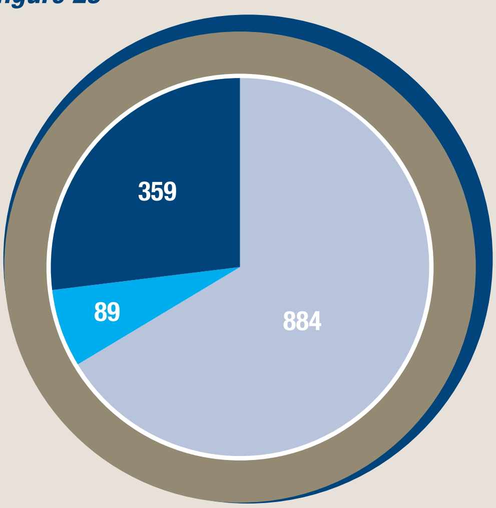
As at March 31, 2007, there were 1,332 private pension plans registered under the Pension Benefits Standards Act, 1985 *(PBSA), covering over 582,000 employees.*

Pension Plans by Type (last 4 years)
figure 24

	Y-E 2006-07	Y-E 2005-06	Y-E 2004-05	Y-E 2003-04
Total Plans	**1,332**	**1,304**	**1,284**	**1,256**
Defined Benefit	359	345	344	336
Combination	89	87	84	84
Defined Contribution	884	872	856	836
Total Membership	**582,000**	**576,000**	**572,000**	**547,000**
Defined Benefit	386,000	383,000	386,000	367,000
Combination	98,000	99,000	99,000	96,000
Defined Contribution	98,000	94,000	87,000	84,000
Total Assets	**$130 billion**	**$116 billion**	**$104 billion**	**$95 billion***
Defined Benefit	$108 billion	$95 billion	$85 billion	$78 billion
Combination	$19 billion	$18 billion	$16 billion	$15 billion*
Defined Contribution	$3 billion	$3 billion	$3 billion	$2 billion

* restated

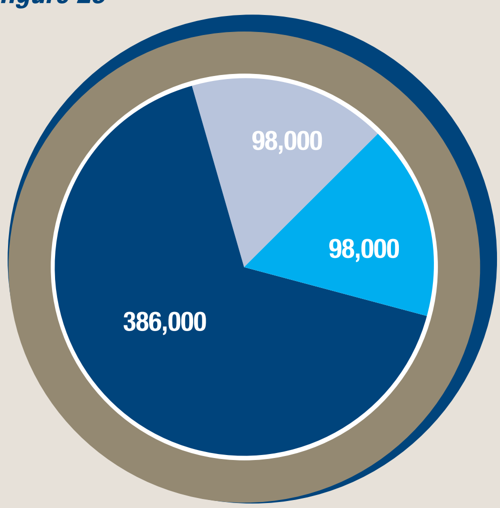
Pension Plans by Type*
(Number of Plans)
figure 25



Defined Benefit 359
Combination 89
Defined Contribution 884

** As of March 31, 2007*

Membership by Plan Type*
(Number of Members)
figure 26



Defined Benefit 386,000
Combination 98,000
Defined Contribution 98,000

** As of March 31, 2007*

Of the 1,332 private pension plans regulated by OSFI, only one third are defined benefit or combination plans, yet these plans account for 83% of membership.

movements in the number of plan members or in the associated assets. This may in part be due to the fact that members' assets in defined contribution plans are paid out upon retirement or termination (i.e., membership ceases and the assets are no longer in the plan).

The most current pension plan financial statements filed during the 12-month period ending March 31, 2007 report that 58% of pension assets are invested in equities, 37% in debt instruments and 5% in diversified and other assets. *Equities* include investments in pooled funds, stocks, and shares in real estate, resource and investment corporations. *Debt instruments* include government and corporate bonds, mortgage loans, and deposits. *Diversified assets* cover balanced mutual and segregated funds and miscellaneous assets or other investments that are not included in the other two categories. In aggregate pension plans maintained essentially the same asset allocation as in the previous period.

Private pension plans under federal jurisdiction recorded an average return of 12% on their investments, slightly under the 13% average recorded in the previous fiscal year.

The average estimated solvency ratio for all defined benefit plans rose to 1.06 over the past year (compared to 0.90 the previous year). Estimated solvency ratios calculated by OSFI using year-end 2006 data showed that approximately 51% of all defined benefit plans supervised by OSFI were under-funded, meaning their estimated liabilities exceeded assets, with 36% of these under-funded plans having liabilities that exceeded their assets by more than 10%.

Given the current pension environment and the impact of potential future adverse changes in economic conditions or financial markets, OSFI will continue to carefully monitor both the condition of private pension plans and, to the extent possible, that of their sponsors, and will intervene when necessary.

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ADJUSTMENTS TO PENSIONS

As required by the *Pension Benefits Standards Act, 1985*, plan sponsors report the extent to which they have provided inflation protection and the source of funds for the adjustments.

Inflation Protection

In 2006-2007, 22% of the plans that offer defined benefits reported increases in pensions being paid out (compared to 34% the previous year). Of these plans, 22% also increased deferred pensions.

Increases were based on full Consumer Price Index (CPI) in 33% of cases, 28% on partial CPI and 39% using other formulae, such as excess interest, a flat dollar amount, or a percentage of pension payment. In 74% of cases (77% in 2005-2006), adjustments were made as a result of collective agreements or were required by the plan text. In the remaining cases, employers made voluntary adjustments.

Source of Funds for Adjustments

During 2006-2007, 32% of the plans that made adjustments to pensions did so using surplus funds or gains (compared to 30% the previous year). The remainder used sources outside the pension fund, created unfunded liabilities, or used some combination of options to improve pensions.

In 25% of cases, where plans had surplus/gains, they improved benefits, while in 54% of cases the employer used surplus/gains to reduce contributions. The remaining 21% used their surplus/gains for both. This is a small change from 2005-2006, when 24% used surplus/gains to improve benefits and 58% reduced contributions while 18% did both.

Supervisory Policies and Practices

Charting OSFI's Pension Supervisory Framework

OSFI's approach to pension plan supervision is both to recognize the need of plan administrators to take reasonable risks in their investment and funding strategies and to intervene when appropriate to protect the rights and interests of plan members. While OSFI is careful not to impose undue regulatory burden that might discourage the maintenance or formation of private pension plans, OSFI is mandated to protect private pension plan members. Despite considerable financial pressure on pension plans, there are very few cases of plans terminating with reduced benefits, and these have affected a very small number of Canadians.

To align and respond to the changing external environment for pensions, OSFI commenced a review of the pension supervisory framework in 2006-2007. In addition, OSFI's Enterprise Risk Management assessment has identified a need to upgrade the systems that support OSFI's supervisory efforts. These two initiatives will span the next few years. In the human resources area, the Private Pension Plans Division will focus on fully integrating additional staff hired during 2006-2007. Meanwhile, the main pillars of OSFI's current supervisory framework for pension plans is expected to continue to involve early warning tests, solvency testing, on-site examinations, the watch list and use of intervention powers.

Early Warning Tests

OSFI has developed a series of early warning tests to detect risks based on information submitted in pension plans' filings. An initial series of automated tests is run to identify higher-risk plans. These plans are then subjected to a more detailed analysis by OSFI's pension plan supervisors in an effort to assess whether further action should be taken. In 2006-2007, 30% of plans that remitted filings were subjected to a more detailed review.

Solvency Testing

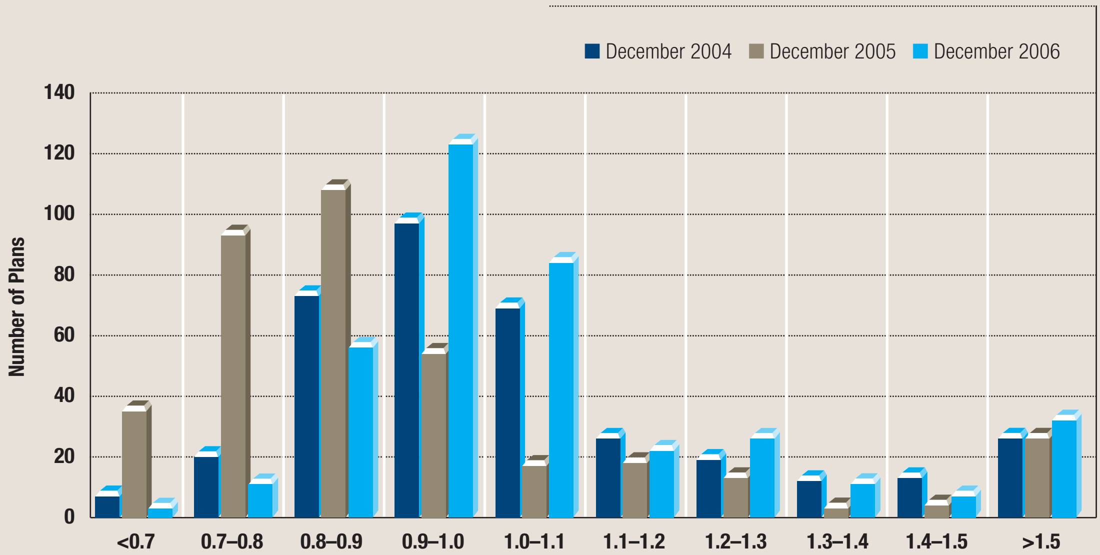
Early detection of solvency and funding problems is a key element in safeguarding members' benefits. OSFI runs a solvency test on a semi-annual basis to estimate solvency ratios for all defined benefit pension plans, between their actuarial valuation reporting periods. Depending on the results, plan administrators are contacted and asked to validate these results and/or to provide additional information on their pension plans. If the estimated solvency ratio is close to or less than one, or if the plan's risk profile warrants, various interventions are considered, including, but not limited to, informing members or requests for early filing of valuation reports, which may identify the need for additional payments to fund identified deficits. This test has provided OSFI with important information, which has allowed it to intervene earlier in at-risk pension plans. (*See figure 27*)

In addition, OSFI continued to identify underfunded pension plans that were taking contribution holidays in 2006-2007. In certain circumstances it was OSFI's view that the taking of contribution holidays was not prudent. OSFI took action, ranging from strongly encouraging plan sponsors to cease contribution holidays, to requiring enhanced notification to members and/or requesting early valuation reports, triggering enhanced funding. These situations were all dealt with to OSFI's satisfaction.

On-Site Examinations

OSFI's risk-based supervisory approach includes on-site examinations of selected pension plans. The selection of plans for on-site examination is based on a number of factors including, but not limited to, the assessed risk to beneficiaries. On-site examinations enable OSFI to enhance its assessment of the financial situation and quality of the administration of plans. They also provide OSFI with the opportunity to meet the individuals involved in plan administration, thereby improving communications between these administrators and the Office. OSFI

Defined Benefit Plans – Estimated Solvency Ratio Distribution (past 3 years*)
figure 27



** as at December 31*

The estimated solvency ratios calculated by OSFI showed a strong positive shift in 2006, as a large number of plans moved up into the 0.9–1.0 and 1.0–1.1 bandwidths.

performed a number of on-site examinations during the year with a continued focus on governance and disclosure to members, and completed detailed desk reviews of defined benefit plans.

Watch List

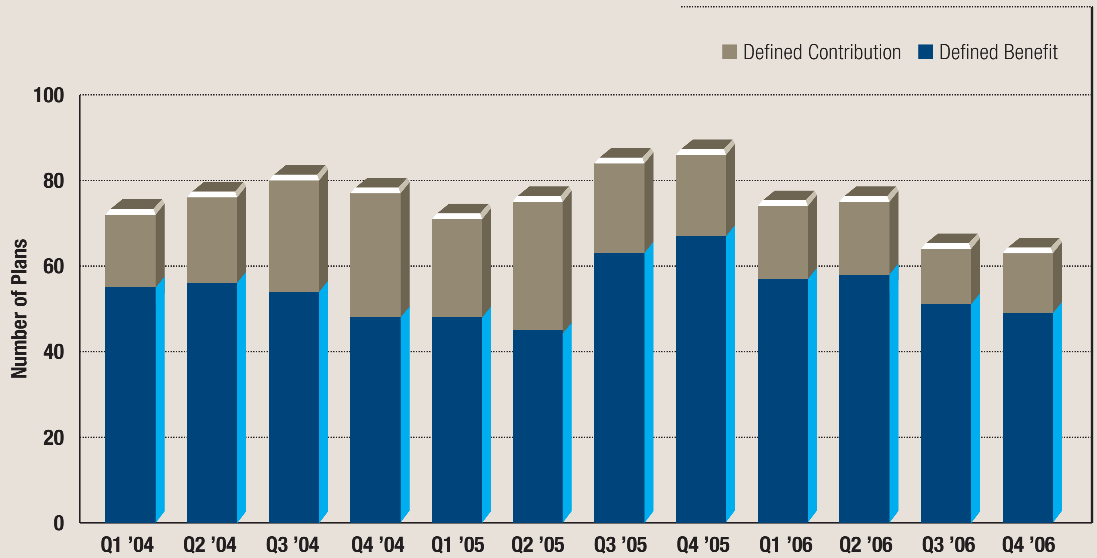
Consistent with a risk-based approach to supervision, OSFI considers the size of the plan's deficit and the sponsor's capacity to fund it. Pension plans that give rise to serious concern, due to their financial condition or for other reasons, are placed on a watch list and are actively monitored. The number of private pension plans on OSFI's watch list declined during 2006-2007 from 86 at the start of the year to 63 at the end of the year. Of these, 49 were defined benefit plans (67 in 2005-2006) and 14 were defined contribution plans (19 in 2005-2006). During the course of 2006-2007, 11 new plans were added to the watch list and 34 were removed, in part due to OSFI's intervention.[3] (*See figure 28*)

Intervention

OSFI works actively with plan sponsors, administrators, custodians and other stakeholders trying to find reasonable solutions to protect members' benefits. In 2006-2007, OSFI intervened with respect to high-risk pension plans, including to enforce minimum funding requirements and timely remittance of contributions. OSFI also used its authority to require a number of plans to provide enhanced and prompt disclosure of financial information to members.

[3] Data prior to 2005-2006 have been restated to reflect a change in the way OSFI counts watch list plans. Plans with no specific concerns but that are related to watch list plans are now excluded from the count.

Watch List Trend by Plan Type (past 3 years)
figure 28



During 2006-2007, the pension plan industry improved but funding challenges continued for some plans.

Rules and Guidance

Navigating between the Need for Rules and the Voluntary Nature of Pension Plans

In the spring of 2006, the federal government announced as part of its budget that it would move forward with proposed regulatory change to give defined benefit pension plans temporary solvency funding relief in response to the challenging circumstances defined benefit plans were facing. The Solvency Funding Relief Regulations came into force in November 2006. In order to assist pension plan administrators who may wish to pursue solvency relief under the Regulations, OSFI posted information explaining the Regulations and issued a Guide for completing the Notification Form and Statement Form that must accompany each actuarial valuation report that is filed using the Regulations.

In keeping with OSFI's objectives of promoting transparency and to improve stakeholders' understanding of OSFI's expectations, in March 2007, OSFI issued an updated version of its Pension Members' Guide. The guide, which is intended for plan members, administrators and sponsors, explains some of the minimum standards that apply to all federally regulated private pension plans.

OSFI navigates between the need for rules and the voluntary nature of pension plans. Setting rules and guidance is done through co-operation and consultation with major stakeholders and other regulators.

OSFI continues to promote responsible pension plan governance and actuarial practices by working closely with the Canadian Institute of Actuaries and the Canadian Association of Pension Supervisory Authorities (CAPSA). OSFI is a member of CAPSA, a forum for discussing common issues faced by federal and provincial pension plan supervisory authorities.

Approvals

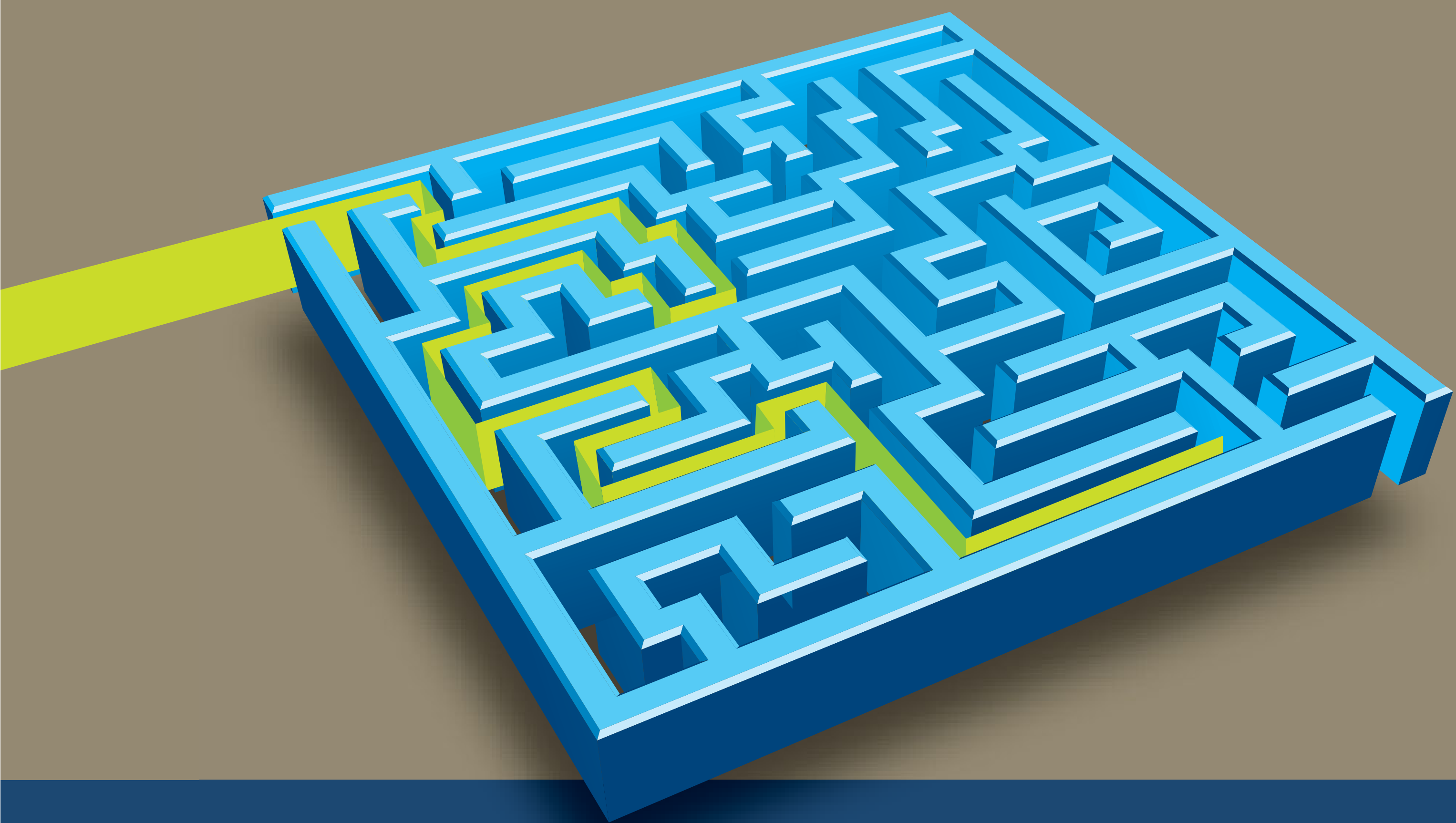
Federally regulated private pension plans are required to seek approval from the Superintendent of Financial Institutions for different types of transactions affecting pension plans, including plan registration, asset transfers (including mergers and spin-offs), full and partial plan terminations, refunds of surplus, or reduction of benefits. During 2006-2007, additional resources and more streamlined processes were introduced to improve timeliness while ensuring complex transactions are carefully considered. In 2007-2008, OSFI will pursue enhancements to its automated systems to support the pension approvals function.

During the year, OSFI processed 96 applications for approval and received 105 new requests. In 2006-2007, 56 new plans were registered with OSFI. Of these, 27 were defined benefit plans. A further 28 registered plans, affecting about 3,900 members, distributed all remaining funds either to members, the sponsor or through consolidation with other plans. One refund of surplus was approved during 2006-2007.

In support of the new pension relief regulation, OSFI developed a standard form and published guidance to clarify its expectations.

John Grace
Specialist, Pension Policy,
Private Pension Plans Division,
Regulation Sector

Judy Cameron
Managing Director,
Private Pension Plans Division,
Regulation Sector



INTERNATIONAL ASSISTANCE

Globalization of the financial system continues unabated and Canadian financial institutions are increasingly playing an active role. Canada and other G-7 governments recognize that upgrading the supervisory capacity of emerging market regulatory bodies can enhance the stability of the global financial system. This is particularly relevant as countries deal with significant implementation issues related to the new Basel II accord.

Canada plays an important role in this regard, in part through OSFI's technical assistance program, which helps selected emerging market economies to improve the supervisory systems for their financial institutions. OSFI's technical assistance program is also of benefit to Canadian financial institutions, as it strengthens supervisory regimes and increases confidence in foreign jurisdictions in which some Canadian institutions operate.

OSFI's International Advisory Group (IAG), founded in 2001, conducts needs assessments and provides hands-on technical advice, training, workshops and seminars, primarily to supervisors in Asia, Latin America, Africa and the Caribbean. The Canadian International Development Agency (CIDA) provides the bulk of the funding for the group.

Again in 2006-2007, IAG hosted many international delegations to OSFI. Of particular note, and success, was a training seminar conducted by IAG for the benefit of delegates to the tri-annual meeting of the International Association of Insurance Supervisors (IAIS) which was held in Ottawa. Early in the year, IAG also arranged an attachment to OSFI for several Caribbean jurisdictions to discuss Basel II implementation issues and challenges.

IAG offers bilateral and multilateral training programs and provides technical assistance in various locations outside of Canada. Training often extends beyond the typical classroom setting and is developed to meet the needs of the specific jurisdiction, including hands-on technical advice, consulting services and follow-up.

During 2006-2007, IAG delivered bilateral or multilateral programs, sometimes in partnership with other technical assistance providers, in 25 different jurisdictions, many of which it visited several times. In the process, hundreds of foreign supervisors from over 75 different countries received the benefit of IAG's training. (*See figure 29*)

As IAG's ongoing relationship with key jurisdictions matures, the focus continues to move from theory to implementation. IAG is particularly proud of the successes it has achieved working alongside foreign supervisors 'in the field'. IAG continues to provide legislative and regulatory drafting expertise, has played a key role in the selection process for senior-level supervisory staff and has reviewed reorganisation plans for a failed financial institution. IAG addressed industry participants and regulators on important subjects such as corporate governance and Basel II, and has supported foreign regulators with their industry consultation processes.

In 2006-2007, IAG continued to assist some jurisdictions with their self-assessment exercise against the Basel Core Principles and the International Association of Insurance Supervisors' Core Principles. IAG also assisted several jurisdictions that are attempting to correct deficiencies identified during their Financial Sector Assessment Program (FSAP) assessment.

During 2006-2007, IAG concluded its work and delivered a comprehensive report to the FIRST Initiative pursuant to a cost-recovery project "Roadmap for Strengthening Solvency Control in the Chilean Insurance Industry." The project was proposed by the World Bank on behalf of the Chilean authorities to follow up on FSAP recommendations. The project's principal objectives were the development and implementation of a risk-based supervisory approach to be applied to life

For several years, OSFI's International Advisory Group has held individual in-house programs in Ottawa for banking and insurance supervisors from all parts of the world. This photo includes participants from Taiwan, Russia, Papua New Guinea, Hungary, India, Switzerland, Czech Republic, Thailand, Albania, Luxembourg, Republic of Mauritius, United States of America, Malaysia, China, Slovakia, Trinidad & Tobago, Poland, Dubai, Botswana, Bahrain, Guatemala, Singapore, Belgium, Jordan, Norway, Bermuda, Austria, South Africa and the Philippines. OSFI staff included in the picture are Kim Norris, Jean Sarazin and Ralph Lewars. Missing from the photo are James Bruce and Janet Dubeau.

Canada and other G-7 governments recognize that upgrading the supervisory capacity of emerging market regulatory bodies can enhance the stability of the global financial system.

and non-life insurance companies, and the development of an Asset-Liability Matching (ALM) approach to be applied to life insurance companies for capital adequacy purposes.

IAG is involved in a number of longer-term projects. In addition to the Dominican Republic, where IAG has been active since a major banking collapse in 2003, IAG is also working extensively in Ghana, Nigeria and Malaysia to help these jurisdictions implement a system of risk-based supervision for financial institutions.

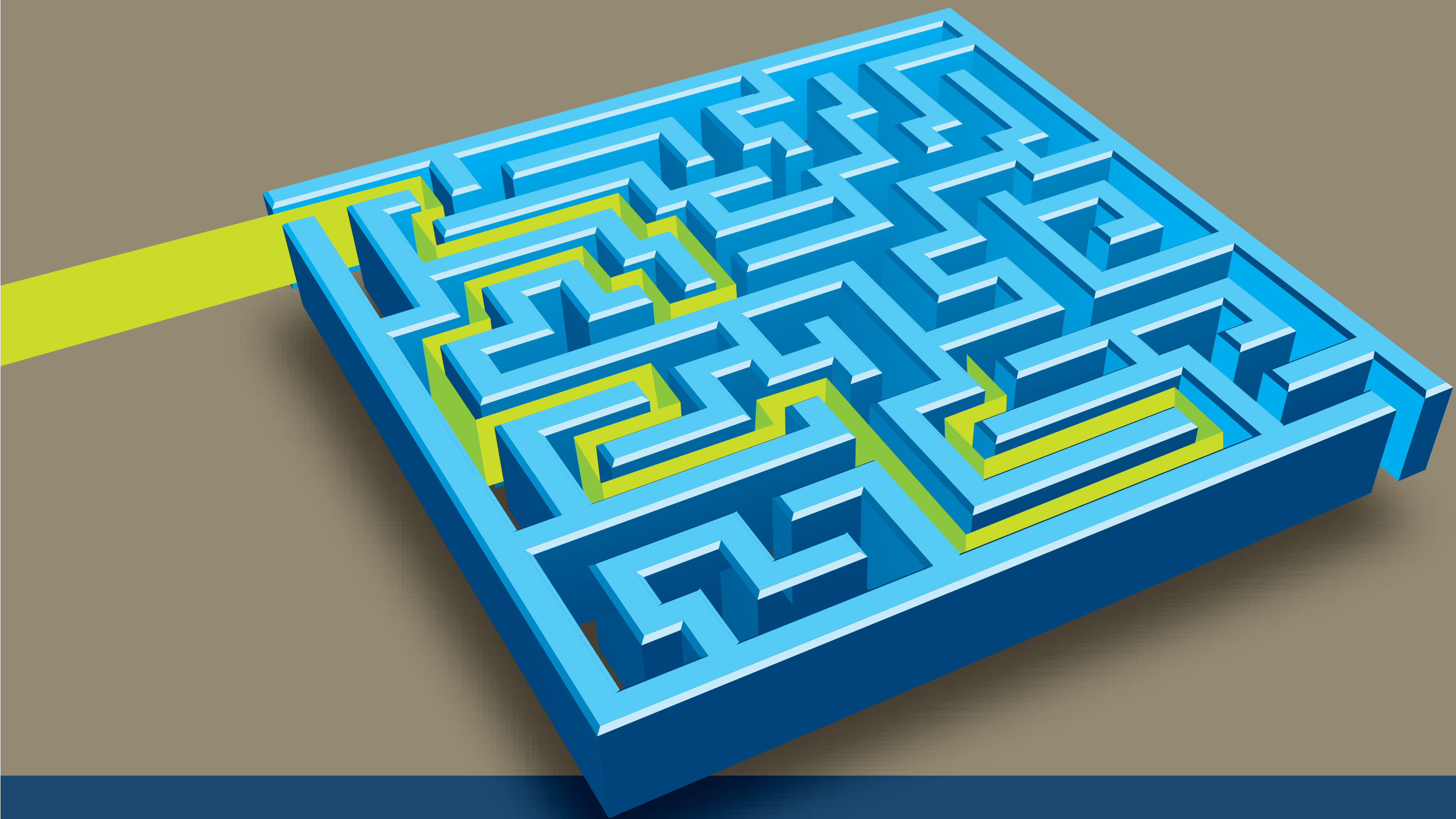
IAG attempts to partner with other technical assistance providers around the world, where feasible, in order to achieve efficiencies and economies. Individuals with significant financial institution regulatory and supervisory experience, knowledgeable in 'today's' supervisory techniques and principles, staff IAG. This positions IAG well to provide effective—and current—technical assistance to the benefit of emerging and developing bank and insurance supervisors.

OSFI continues to support the Toronto International Leadership Centre for Financial Sector Supervision through its role on the Board of Directors. Experienced individuals from Canada and abroad help supervisors acquire the knowledge and leadership skills to build effective supervisory regimes in their countries. IAG provides resources, most notably Program Leaders, to assist with the delivery of the Centre's programs.

During 2006-2007, IAG delivered programs in 25 different jurisdictions.

figure 29

1. Antigua and Barbuda
2. Australia
3. Austria
4. Barbados
5. Botswana
6. Chile
7. Colombia
8. Costa Rica
9. Dominican Republic
10. Ghana
11. Guatemala
12. Hong Kong
13. Kazakhstan
14. Labuan
15. Malaysia
16. Mexico
17. Nepal
18. Nigeria
19. Paraguay
20. Peru
21. St. Lucia
22. Switzerland
23. Trinidad and Tobago
24. Uruguay
25. Venezuela



OFFICE OF THE CHIEF ACTUARY

The Office of the Chief Actuary (OCA) has unique responsibilities within OSFI. The OCA was created to provide actuarial and other services to the Government of Canada and provincial governments that are Canada Pension Plan (CPP) stakeholders. It was established within OSFI as an independent unit and, while the Chief Actuary reports to the Superintendent, he is solely responsible for the content and actuarial opinions in reports prepared by the OCA.

The current environment for the retirement income system puts an additional onus on the OCA to be, and be seen to be, fully accountable and professionally independent. The OCA maintains its credibility and the quality of its work by adhering strictly to professional actuarial standards. The Chief Actuary and all Fellows and Associates are members of the Canadian Institute of Actuaries (CIA) and are subject to the CIA Rules of Professional Conduct. The statutory actuarial reports are prepared by OCA Fellows of the CIA and co-signed with the Chief Actuary to enhance the internal quality control process.

Role and Responsibilities

The federal government, through the CPP in conjunction with the provinces and territories, and through public sector pension arrangements and other social programs, has made commitments to Canadians and is responsible for ensuring the sustainability of these commitments. In the case of the CPP, these commitments have been made in conjunction with the provinces and territories, which are co-stewards of the plan. Some are long-term, and it is important that decision-makers, Parliamentarians and the public understand the inherent risks these commitments present. The OCA has a vital and independent role to play in this process. The OCA provides appropriate checks and balances on the future costs of the different pension plans and social programs that fall under the OCA's responsibilities.

The OCA conducts statutory actuarial valuations of the CPP, Old Age Security (OAS) program, and pension and benefits plans covering the federal Public Service, the Canadian Forces, the Royal Canadian Mounted Police (RCMP), federally appointed judges, and Members of Parliament. Since 2001, the OCA has also been responsible for undertaking the actuarial review of the Canada Student Loans Program.

Whenever a bill is introduced before Parliament that has a significant impact on the financial status of a public pension plan or social program falling under the statutory responsibilities of the Chief Actuary, the OCA must submit an actuarial report valuing this impact to the appropriate minister. The Chief Actuary submits these reports to the ministers of Finance and of Human Resources and Social Development, and to the President of the Treasury Board.

The OCA also provides the relevant government departments, including the executive arm of provincial and territorial governments, which are co-stewards of the CPP, with actuarial advice on the design, funding and administration of these plans. OCA clients include Human Resources and Social Development, Finance, Treasury Board Secretariat, Public Works and Government Services, National Defence, Veterans Affairs, the RCMP and Justice Canada.

Charting a Sustainable Course

The Canadian retirement income system includes diversification both of the sources of income (private and public pensions) and of the funding approaches. A mix of full funding (registered private pension plans/registered retirement savings plans), partial funding (CPP/QPP) and pay-as-you-go funding (OAS/GIS) is well recognized for its capacity to adapt to changing conditions, including the aging of the population. The combination of Old Age Security (OAS), the Guaranteed Income Supplement (GIS), the compulsory contributory pension plans (CPP and QPP), private employer pension plans and individual savings plans has contributed significantly to reducing poverty among seniors over the past three decades.

Canada has set in place a public pension system that is expected to chart a sustainable and affordable course well into the future in the face of changing demographic conditions. Ongoing review of the system, including actuarial studies performed by the OCA on various public pension programs, will help to ensure that this remains the case.

Examining the Impact of Bill C-36 on the CPP

The OCA is required by law to produce an actuarial report on the CPP every three years. The next report will be published in 2007. The OCA participated in the federal/provincial committee's CPP triennial financial review completed in June 2006.

In December 2006, the Chief Actuary published the 22nd Actuarial Report on the CPP, as a supplement to the 21st Actuarial Report on the CPP, to show the effect of Bill C-36 on the long-term financial status of the CPP. This bill was introduced before the House of Commons following the completion of the CPP triennial financial review by the federal and provincial ministers of Finance in June 2006.

First, Bill C-36 amends the CPP to relax the current contributory requirements for disability and disabled contributor's child benefits for individuals who have 25 years or more of contributions. In these situations, contributory requirements will be met if applicants have valid contributions in three of the last six years. Valid contributions in four of the last six years would continue to be required for all other CPP disability benefit applicants. Applicants would still have to meet the existing medical criteria to qualify for the benefits.

Second, it amends the CPP to bring into operation the existing full funding provision for benefit enhancements or new benefits that is set out in section 113.1(4)(d) of the Act. The proposed amendments provide for the calculation and the public reporting of the full funding costs as well as the integration of these costs into the process for setting the contribution rate.

The 22nd Actuarial Report on the CPP confirms that, if the current Plan is amended, a legislated contribution rate of 9.90% for years 2007 and thereafter would be sufficient to financially sustain the Plan for the next 75 years. Assets would accumulate to $147 billion (4.4 years of annual plan expenditures) by 2010. By keeping the legislated contribution rate unchanged at 9.90%, part of the manoeuvring room between the legislated contribution rate of 9.90% and the current Plan steady-state contribution rate of 9.77% is being used to fully fund the amendment. As a result, total CPP assets are projected to be lower than projected under the 21st Actuarial Report on the CPP. Still, assets would cover 6.15 years of annual plan expenditures by 2050.

A copy of the report, entitled "Actuarial Report (22nd), supplementing the Actuarial Report on the Canada Pension Plan", can be found on OSFI's Web site under Office of the Chief Actuary.

Jean-Claude Ménard was appointed **Chief Actuary** in August 1999. He is responsible for preparing the actuarial reports of the Canada Pension Plan, the Old Age Security program, the Canada Student Loans Program, and pension and benefits plans for federal public servants, the Canadian Forces, the RCMP, federal judges and Members of Parliament. Prior to joining OSFI, Mr. Ménard held progressively senior roles with the Quebec Pension Board, culminating in his appointment as Chief Actuary and Director of Valuation in 1995. From 1992 to 1994, he served as vice-chairman of an Examination Committee of the Society of Actuaries. Since 2002, he has been vice-president of the Technical Commission on Statistical, Actuarial and Financial Studies of the International Social Security Association (ISSA).

Reports, Services, Presentations and Special Studies

The OCA completed a number of reports in 2006-2007, including actuarial reports on the pension plans for the Public Service, the RCMP and the Canadian Forces, as well as the Public Service Death Benefit Account and the Regular Force Death Benefit Account. These reports were subsequently tabled before Parliament, and provide actuarial information to decision-makers, Parliamentarians and the public, increasing transparency and confidence in the retirement income system. The OCA also completed its fifth annual actuarial review of the Canada Student Loans Program.

For every actuarial report tabled or prepared, the OCA provides a detailed presentation to the client department.

Other services provided by the OCA during the year included:

- Various expert witness reports before the CPP Review Tribunal and the Pension Appeals Board;
- Ongoing advice and support to the federal-provincial CPP committee of officials;
- Public Accounts actuarial reports on the major public sector pension plans sponsored by the government including information used in the financial statements of the Public Service, Canadian Forces and RCMP pension plans;
- Public Accounts actuarial reports for the Public Service Health Care Plan and Pensioners' Dental Service Plan, and assessment of the workers' compensation actuarial liability for the accounting of retirement and post-employment benefits under the government accrual accounting policies;
- Public Accounts actuarial report on Pension Act-related post-employment benefits for the Canadian Forces including war veterans;
- Ongoing advice to Veterans Affairs Canada on programs covering members of the Canadian Forces and war veterans;
- Ongoing advice to the Judicial Compensation and Benefits Commission;
- Ongoing advice to the Treasury Board Secretariat on group insurance plans covering federal government employees, Canadian Forces and members of the RCMP;
- Ongoing advice and support given to the CPP Investment Board, the Public Sector Pension Investment Board (PSP Investments) and the Pension Advisory Committees of the Public Service, the Canadian Forces and the RCMP;
- Annual presentation by the Chief Actuary to the OCA Consultation Committee, Joint Meeting of the Public Service, RCMP and Canadian Forces Pension Advisory Committees and PSP Investments, and also to the OSFI Audit Committee;
- Work as vice-president of the International Social Security Association (ISSA) Technical Commission on Statistical, Actuarial and Financial Studies;
- Work for Heritage Canada to estimate Chinese Head Tax lump-sum payments;
- Work with the Society of Actuaries' Social Security Committee (migration, stochastic and mortality); and
- Participation in a Policy Dialogue on "Future Challenges Facing Canada's Retirement Income System: A Focus on Workplace Pensions and Private Saving," organized by Human Resources and Social Development Canada.

The Chief Actuary delivered presentations to a range of audiences including:

- the Social and Economic Dimensions of an Aging Population (SEDAP) Conference on "Private Pensions and Income Security in Old Age: An Uncertain Future," McMaster University, Hamilton, Ontario;
- part of the Society of Actuaries' strategic project, Retirement 20/20, "The Canadian Retirement Income System – a Society Perspective", at the Building the Foundation for New Retirement Systems Symposium, Washington, D.C.;
- the Board of Directors of the CPP Investment Board, "Issues Being Addressed in the Next Actuarial Report on the Canada Pension Plan as at 31 December 2006", Toronto, Ontario;
- the 28th International Congress of Actuaries, "Is There an Optimal Level of Pre-Funding? – Optimal Funding of the Canada Pension Plan", Paris, France. This was a preview of the release of the 6th actuarial study published in the spring of 2007 on Optimal Funding of the Canada Pension Plan;

- delegations from various countries to share our expertise on the current environment of the retirement income system.

The OCA is continuously involved in preparing various experience studies and research covering a wide range of social security, demographic and economic issues that may affect the financial status of pension or benefits plans. Some of these studies also serve to support policymakers in developing and analysing various policy options in the context of plan reforms. The information presented in these studies could benefit private sector organizations that evaluate social security or private pension plan schemes.

Ongoing Improvements

In 2007-2008, the OCA will maintain the tradition of continual improvements to the actuarial methods by applying more extensive and sophisticated stochastic analysis as was recommended by the CPP peer review panel. The OCA will continue to study and implement most recommendations made by the peer reviewers. As well, the OCA will complete and send statutory triennial actuarial reports to the President of Treasury Board on the pension plans for Members of Parliament and for federally appointed judges. The statutory triennial actuarial report on the pension plan for the RCMP – Part IV will be provided to the Minister of Finance.

By examining various investment scenarios, the OCA has determined that the current investment strategy of the Public Sector Pension Investment Board (PSP Investments), which is to diversify the portfolio into a mix of fixed and variable income securities, meets the mandate of maximizing investment returns without undue risk.

Alice Chiu
Actuarial Officer,
Public Pensions,
Office of the Chief Actuary

Understanding Funding Risk within the Federal Public Sector Pension Plans

The public sector pension plans have approximately 795,000 members, consisting of 353,000 current employees of the federal government and 442,000 retired employees. For many plan members, their pension plan is their main source of income during retirement.

The Government of Canada created the Public Sector Pension Investment Board (PSP Investments) to invest plan contributions from government and employees. The mandate of PSP Investments is to act in the best interests of plan members by investing to achieve maximum returns without undue risk. Since April 2000, PSP Investments has been investing some of the contributions in capital markets.

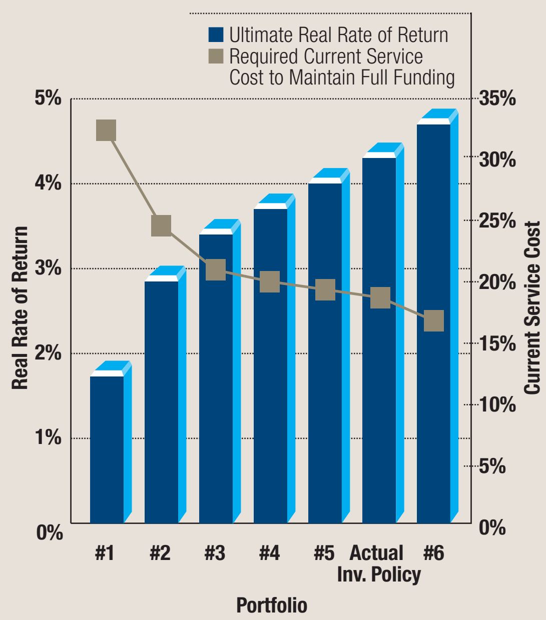
A major risk that any pension plan faces is funding risk, i.e., the risk that the assets backing the liabilities would be insufficient to meet obligations. If funding deficiencies or surpluses were to continue for an extended period of time, risk would be transferred from one generation to another and could ultimately take the form of an increase or a decrease in the contribution rate.

Given the increasing diversity of the PSP investment portfolio, the OCA decided to increase the level of information on funding risk in its actuarial report. The OCA examined various investment scenarios, comparing the possible rate of return, the associated risk and the impact of this on the cost of contributions (referred to as the 'service cost' of the plan). For example, if the PSP Investments were to switch from the current portfolio of fixed and variable income securities to a portfolio that consists solely of long-term Government of Canada bonds, either the current service cost of the plan would have to increase substantially in order to maintain the current funding status or benefits would have to be reduced. Neither of these is a desirable option.

The following graph shows the impact on the current service cost for different investment policy strategies, i.e., going from a risk-free strategy towards riskier ones. In comparison to the assumed Actual Investment Policy of 30% bonds and 70% equities, Portfolio #1 bears no risk and is invested solely in long-term real return federal bonds. Portfolio #2 is invested in long-term federal bonds assuming the ultimate assumption is attained in 2015. The other portfolios, #3 to #6, are actively managed and invested in an increasing proportion of equities, therefore their respective rates of return increases according to the risk taken.

The current investment strategy of PSP Investments, which is to diversify the portfolio into a mix of fixed and variable income securities, meets the mandate of maximizing investment returns without undue risk.

Investment Policy Impact on Plan Funding
figure 30



The Public Service Pension Plan undertakes some risk in order to increase the probability of achieving the long-term investment target of a 4.3% real return plus inflation (CPI).

A copy of the report, entitled "Actuarial Report on the Pension Plan for the Public Service of Canada", can be found on OSFI's Web site under Office of the Chief Actuary.

Reviewing the Course of Future Funding for the Canada Pension Plan

In early 2007, the OCA published a study concluding that the current partial-funding model of the Canada Pension Plan (CPP) is robust and appropriate for the purpose of contributing to the long-term financial sustainability of the CPP.

The CPP provides protection to millions of Canadian workers and their families against the loss of income due to retirement, disability and death. In 2006, four million Canadians received CPP benefits, with a total value of approximately $26 billion. These benefits included pensions, survivors and orphans benefits, and disability benefits. A further 12 million Canadian workers made contributions to the plan.

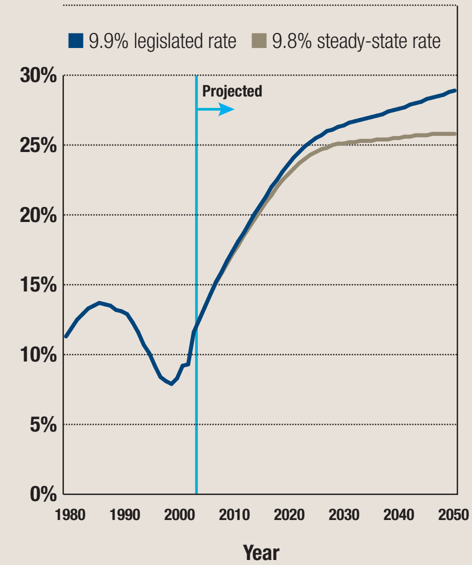
Canadians want to feel confident that the CPP will be able to meet their needs in future years. The OCA study determined the current steady-state method of funding the CPP will chart a stable course, ensuring the CPP is affordable and sustainable for current and future generations of Canadians.

In undertaking the study, the OCA compared the funding schemes used to attain the goal of financial sustainability of retirement funds of several countries. There are three basic methods: pay-as-you-go, partial funding, and full funding. The pay-as-you-go method uses the contributions of today to pay for the benefits of today. Under a fully funded scheme, total contributions paid by workers during their working lives are used to pay for their own benefits, while under a partially funded scheme, contributions by workers cover a portion of their future benefits.

Legislated reforms in Canada in 1997 led to a change in the funding of the CPP from a pay-as-you-go basis to the partially funded, steady-state model used today. Steady-state funding ensures the contribution rate is sufficient to ensure the long-term financial stability of the CPP. The legislated contribution rate is 9.9%. The contribution rate is currently 9.8%, and is determined by the Chief Actuary as part of each triennial actuarial valuation of the CPP.

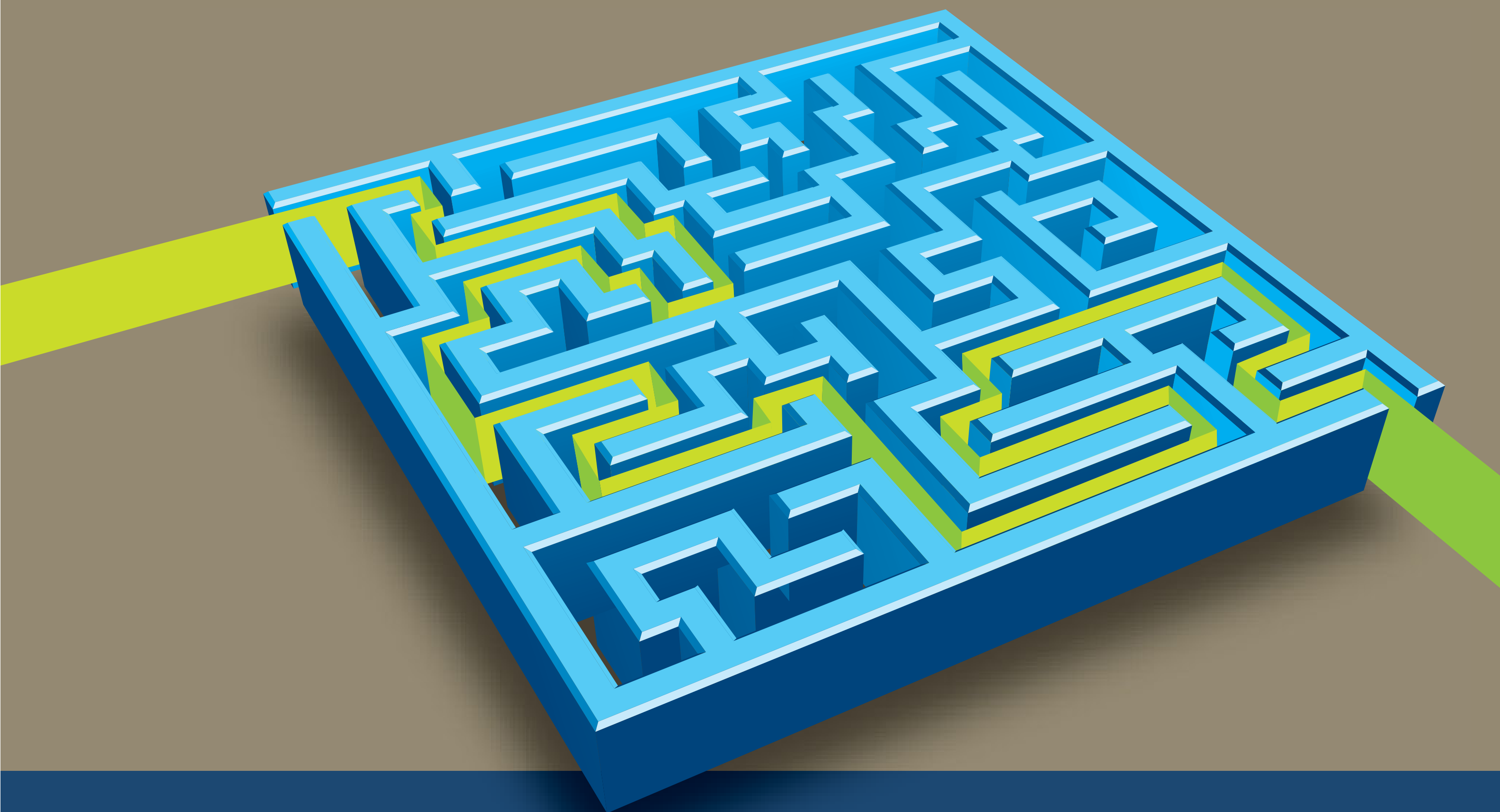
The report concludes that steady-state funding of the CPP is the optimal form of funding for the plan, and that the objective of pre-funding the CPP should remain paramount.

CPP Funding Ratio
figure 31



Under the steady-state contribution rate of 9.8%, the funding ratio for the CPP reaches a level of 25% by 2030 and remains relatively stable thereafter.

A copy of the report, entitled "Optimal Funding of the Canada Pension Plan", can be found on OSFI's Web site under Office of the Chief Actuary.



CORPORATE SERVICES

Linking Human Resources Planning to Business Planning

Following the introduction of the new *Public Service Employment Act* (PSEA) on January 1, 2006, OSFI continued to promote understanding among employees of the new staffing policies, procedures and the link between business planning and HR planning. Sector-specific HR plans were developed identifying potential resourcing risks and corrective actions necessary to deal with business plan priorities. A direct output of this process was a restructuring of Corporate Services in the first quarter of 2007 to improve work processes and the delivery of services within the organization while allowing for the proactive transfer of skills and experience dictated by the succession plan within the sector.

Sector-specific staffing plans were prepared and communicated to employees on a quarterly basis in order to facilitate the transparency of staffing processes and to increase employees' understanding of future staffing needs. Employees were kept abreast of the skills, knowledge and competencies deemed to be in short supply or considered assets when selecting candidates and assured that, whatever changes were provided under the new Act, the core values and principles of merit, non-partisanship, fairness, access and transparency have not changed.

Developing Staff

OSFI places a great deal of importance on training and developing its employees. In order to ensure organizational readiness and to enhance career development, OSFI continued its Human Resources planning program. One facet of this program involves leadership development. During the year under review, the 360° feedback process, implemented in late 2005, became a source of input to assess mandatory leadership goals as part of the performance management process for all executive staff in 2006. In tandem, the mandatory leadership development program, consisting of leadership skills and business process training, continued throughout the year resulting in approximately 70% of the curriculum being completed.

A new deployment program was also developed during the year to recognize and enable internal talent to move laterally within the organization. The program is intended to offer employees an opportunity to develop new skills and knowledge while taking on new challenges. The program is anticipated to begin in September 2007, with all deployments expected to be in place by early November.

While general technical training focused on enhancing workflow and analytic tools capability, key subject-matter training such as on Basel II and financial instruments, was provided to supervisors, and coaching continued to be provided to hiring managers in light of the new staffing regulations that came into effect in January 2006. A curriculum of core courses for Regulation Sector employees was also developed and rolled out.

Improving Internal Communication

In 2006-2007, OSFI continued to strengthen the effectiveness of its internal communications by engaging its employees and encouraging more communications through existing programs such as employee orientation sessions, informal meetings with members of the executive team, town hall meetings and enhancements to the intranet. New initiatives were also launched, including a regular online update from the Superintendent to keep employees apprised of significant information, and a more active internal speaker's bureau to offer employees more opportunities to share information on a variety of topics of interest. The frequency of the electronic newsletter, *@osfi*, was converted from weekly to daily so as to provide employees with more timely information. Finally, in January 2006, employees from OSFI's four offices gathered in Cornwall, Ontario for an employee conference with the theme "Cool Work, Amazing People." The next conference will be held again in Cornwall in January 2008.

Managing Risks to the Working Environment

OSFI continues to recognize the importance and responsibility to improve the security of its employees, its assets and its information. To this end OSFI drafted appropriate security policies and procedures, conducted security training and awareness sessions throughout 2007 to inform and regularly remind employees of their security responsibilities and to address their issues and concerns. Furthermore, in compliance with the Government Security Policy, a series of Threat and Risk Assessments were completed in all our facilities in order to identify the vulnerability, determine the security posture of OSFI and provide us with the capacity to reduce risk to an acceptable level by incorporating efficient preventive and protective measures.

In 2006-2007, OSFI finalized the review of its Business Continuity and Contingency Plan to ensure the continued availability of essential services, programs and operations, in the event of interruptions caused by unforeseen events such as extended power failures, and severe weather conditions.

OSFI also improved our security clearance and tracking processes minimizing staffing delays and expediting security renewals.

Enabling Information Management

OSFI has a multi-year IM/IT strategy that is dependent on implementing technology to support centrally managed information stores. These stores will allow information to be efficiently captured, stored and shared, and managed as a strategic asset. The technology is being standardized across the organization enabling the pursuit of an integrated approach to information management and delivery.

The bulk of changes currently under way are being executed in IM/IT in support of this strategy. Data continues to be consolidated while reporting interfaces and analytical capabilities continue to be standardized as well as enhanced in accordance with changing business requirements. This is enabling OSFI to respond ever more readily to changes in the financial sector by providing easier access to existing data, allowing for more comprehensive cross-sector reporting and improving system flexibility. OSFI also implemented a data management process to maximize the usefulness of financial data collected from the industry while minimizing potential duplication of data collected.

New data architecture and standards have been developed to ensure that data accuracy, quality and security levels remain high in this new data warehousing environment. During 2006-2007, a number of new internal business applications began using this technology including the application required to manage the new Basel Framework.

OSFI completed the current phase of the Electronic Document Management System (EDMS) project to reorganize the balance of its electronic records to improve information sharing. EDMS is enabling OSFI employees to share information more easily and ensuring that electronic corporate records continue to be managed effectively in accordance with government policy.

In addition, OSFI has embarked on a review of those legacy systems currently supporting the execution of pension plan reviews. This review will result in the development of an implementation road map for the replacement of these systems in accordance with OSFI's approved strategic IM/IT plan.

Nicole Carolan
Administrative Coordinator,
Projects and IM/IT Services,
Corporate Services Sector

Jordan Simard
Human Resources Coordinator,
Human Resources and
Administration Division,
Corporate Services Sector

FINANCIAL STATEMENTS

BUDGET AND ASSESSMENT HIGHLIGHTS

OSFI recovers its costs from several revenue sources. The vast majority of OSFI's costs, which are for risk assessments and intervention (supervision), approvals and rule making, including related overhead costs, are charged to the financial institutions and private pension plans that OSFI regulates and supervises.

Highlights for the 2006-2007 budget, as compared to estimates, include:

- OSFI met its target, as communicated to financial industry associations, of keeping the overall increase in base assessment fees under 5.5%. Total base assessments to financial institutions were in fact 5.4% lower than the estimates that had been communicated to industry, and represented a growth of 4.9% over the previous year.
- Assessments are differentiated to reflect the costs incurred by OSFI's activities related to each industry group. Base assessments on the deposit-taking sector rose by 6.0% from the previous year to reflect OSFI's increased efforts in that sector in support of the New Capital Adequacy Framework (Basel II) implementation, International Financial Reporting Standards (IFRS) and Anti-Money Laundering/Anti-Terrorist Financing activities. Base assessments on the property and casualty insurance sector increased by 6.3% due to OSFI's increased efforts on IFRS, the Minimum Capital Test (MCT) and Branch Adequacy of Assets Test (BAAT). Base assessments on the life insurance sector increased by 2.0%.

- Surcharges to problem institutions were 26.9% higher than estimated for the year due to differences in the duration of assigned “stage” ratings, and 16.4% lower than the previous year, mainly due to improved economic conditions and hence a lower than planned number of staged institutions.
- User fees for applications for approval were 67.3% higher than estimated, in part due to a one-month delay in the coming into force of the *Regulations Amending the Charges for Services Provided by the Office of the Superintendent of Financial Institutions Regulations 2002*, and in part due to increased volumes and a different mix of legislative approvals that attracted a service charge. User fees were 54.6% lower than the previous year; this reduction was anticipated and planned for.
- Actual overall expenses were 5.3% below budget estimates and up 2.9% over the previous year, versus a planned increase of 9.0%. A higher vacancy rate, a drop in the employee benefits rate set by Treasury Board, and lower Professional Services costs for credit consultants contributed to lower than planned expenses. These reductions were offset by non-recurring restructuring costs and an increase in Information Management/Technology (IM/IT) spending due to continued investments to support OSFI’s regulatory and supervisory activities.
- During 2006-2007, a greater proportion of Corporate Services efforts were focused on the Regulation and Supervision of Federally Regulated Financial Institutions program due to large projects such as the New Capital Adequacy Framework (Basel II), enhanced reporting and analytics (Business Intelligence) tools, and International Financial Reporting Standards. As a result, a higher than planned share of Corporate Services costs was allocated to the deposit-taking, property and casualty insurance, and life insurance sectors.
- The average number of full-time equivalent employees during the year was 456, or 31 less than budget estimates. OSFI focused aggressively during the latter half of 2006-2007 on filling vacancies, particularly in the Toronto office, and ended the year with an actual head count of 462, an increase of 26 or 6.0% from March 31, 2006.

FINANCIAL HIGHLIGHTS

Background

OSFI recovers its costs from several revenue sources. OSFI is funded mainly through asset-based, premium-based or membership-based assessments on the financial institutions and private pension plans that OSFI regulates and supervises, and a user-pay program for selected services.

The amount charged to individual institutions for OSFI's main activities of risk assessment and intervention (supervision), approvals and rule making is determined in several ways, according to formulas set out in regulations. In general, the system is designed to allocate costs based on the approximate amount of time spent supervising and regulating each industry. Costs are then assessed to individual institutions within an industry based on the applicable formula, with a minimum assessment for smaller institutions.

Specific user fees cover costs for certain approvals. The coming into force on April 28, 2006 of the *Regulations Amending the Charges for Services Provided by the Office of the Superintendent of Financial Institutions Regulations 2002* reduced the number and types of legislative approvals that attract a fee. Ongoing costs to process approvals for which user fees no longer apply are recovered through base assessments.

Problem (staged) institutions are assessed a surcharge on their base assessment, approximating the extra supervision resources required. As a result, well-managed, lower-risk institutions bear a smaller share of OSFI's costs.

OSFI also receives revenues for cost-recovered services. These include revenues from the Canadian International Development Agency (CIDA) for international assistance, revenues from provinces for which OSFI provides supervision of their institutions on contract, and revenues from other federal agencies for which OSFI provides administrative support. Effective 2002-2003, cost-recovered services revenue also included amounts charged separately to major banks for the implementation of the internal ratings-based approach of the New Capital Adequacy Framework (Basel II); these cost-recovery Memoranda of Understanding will expire in October of 2007, after which time any ongoing Basel II costs will be recovered through base assessments.

Overall, OSFI fully recovered all its expenses for the fiscal year 2006-2007.

Effective 2002-2003, OSFI began collecting late and erroneous filing penalties from financial institutions that submit late and/or erroneous financial and corporate returns. On August 31, 2005 the *Administrative Monetary Penalties (OSFI) Regulations* came into force. These Regulations implement an administrative monetary penalties regime pursuant to which the Superintendent can impose penalties in respect of specific violations, as designated in the schedule to the Regulations. These Regulations incorporate the late and erroneous filing penalty regime and replace the *Filing Penalties (OSFI) Regulations.* These penalties are billed quarterly, collected and remitted to the Consolidated Revenue Fund. By regulation, OSFI cannot use these funds to reduce the amount that it assesses the industry in respect of its operating costs.

The Office of the Chief Actuary is funded by fees charged for actuarial services relating to the Canada Pension Plan, the Old Age Security program, the Canada Student Loans Program and various public sector pension and benefit plans, and by a parliamentary appropriation.

Federally Regulated Financial Institutions

Revenues

Base assessments to industry rose by $3.0 million, or 4.9%, for the year ended March 31, 2007. Revenue from user fees and charges decreased by $1.9 million, or 38.9%, from the previous year due to fewer problem institutions and the rationalization of the user-pay regime effective April 28, 2006. User fees for approvals were 54.6% lower than in 2005-2006.

Cost-recovered services revenue from major banks related to implementing the internal ratings-based approach of the New Basel Capital Accord was $3.4 million, an increase of $0.4 million from the previous year.

Expenses

Total expenses were $70.9 million, a $1.6 million, or 2.2%, increase from the previous year.

Human resources costs, the main driver of OSFI's expenses, reflect the result of an aggressive filling of vacancies in the latter half of the year, and additional resources in support of the New Capital Adequacy Framework (Basel II), Anti-Money Laundering/Anti-Terrorist Financing activities, and International Financial Reporting Standards activities. Human resources costs also reflect, in accordance with collective agreements, the planned growth in employee compensation and performance-related pay, which is available to employees at all levels within the organization, as well as non-recurring restructuring costs.

During 2006-2007, OSFI also enhanced its governance and accountability framework through increased capacity in its Internal Audit function and the appointment of four independent members to its Audit Committee. The members' stipends and fees are recorded in Professional Services costs.

OSFI continued to implement its information management/technology plan and make related improvements to its business processes. During 2006-2007, OSFI's significant IM/IT investments were in support of Basel II, and enabling technologies for information management and enhanced reporting and analytics to support its supervisory and regulatory activities. A greater proportion of these investments were classified as capital acquisitions than in the previous year, and therefore IM/IT costs were $0.9 million, or 8.4%, lower than in 2005-2006.

Financial Institution Assessments by Industry

OSFI assessments are differentiated to reflect the costs incurred by each industry group. The chart below shows the growth of base assessments by industry group over the past five years. Base assessments are the costs allocated to an industry, less specific fees for approvals and surcharges for problem institutions. Assessments for the P&C sector over this five-year period rose more than for other industry sectors, reflecting an increase in OSFI's time due to economic conditions and a greater number of staged institutions in this industry.

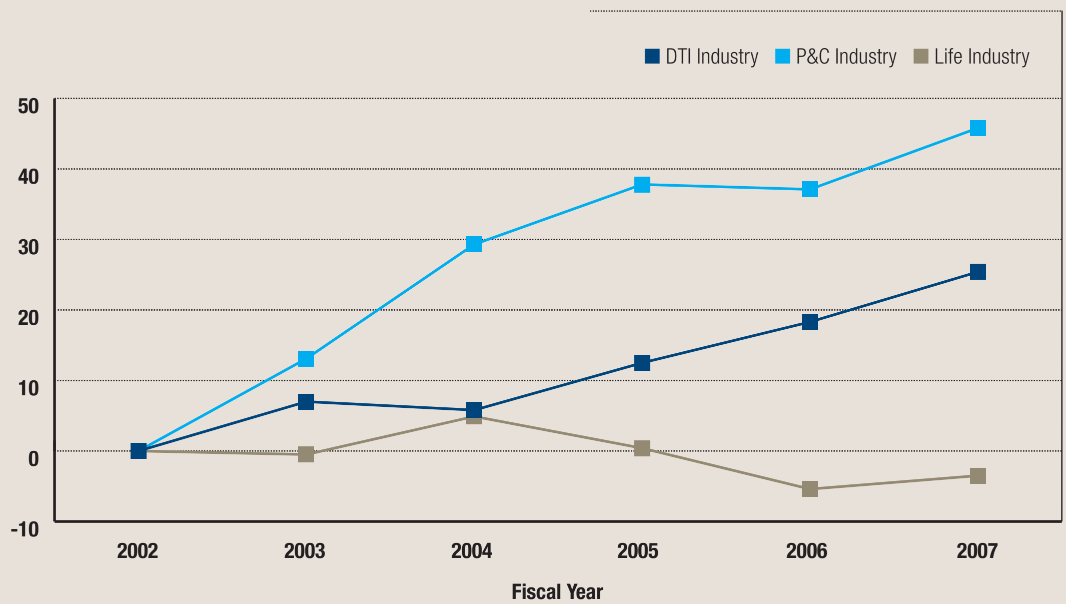
In the last three years, the increase in base assessments to the deposit-taking industry reflects heightened activity on parts of the New Capital Adequacy Framework (Basel II) implementation, increased efforts on Anti-Money Laundering/Anti-Terrorist Financing activities, and international work on conceptual changes to accounting standards. Although the latter impacted all industries during 2006-2007, OSFI's efforts during 2005-2006 were most heavily weighted on the deposit-taking industry.

The increase in base assessments across all industries during 2006-2007 was also driven by investments in large IM/IT projects such as Business Intelligence for monitoring and analytics and International Financial Reporting Standards, enhancements in OSFI's governance and accountability framework, and other corporate-wide initiatives such as IT Security, Business Continuity Planning, and Pandemic Planning.

The reduction in base assessments to the life industry in 2004-2005 and 2005-2006 reflects the impact of consolidation among the major companies in this industry.

In addition to the above expense drivers, significant shifts in revenue types caused an increase in base assessments across all industries. These shifts, resulting from the rationalization of the user-pay regime in 2006-2007 and a reduction in surcharge assessments due to the current favourable economic conditions, were planned and previously communicated to the regulated industries.

Base Assessments by Industry
Cumulative Growth Rates from Fiscal Year 2002



Federally Regulated Private Pension Plans

Fees Assessed

OSFI's costs for regulating and supervising pension plans are recovered from an annual fee charged to plans, based on the number of plan members. Plans are assessed a fee when applying for registration under the PBSA and when filing the Annual Information Return. Total fees assessed during the fiscal year ending March 31, 2007, were $5.4 million, up from $3.8 million a year earlier.

The fee rate is established based on OSFI's estimate of current year costs to supervise pension plans, adjusted for any excess or shortfall of fees in the preceding years. The estimate is then divided by the anticipated assessable membership to arrive at a per member fee. The rate established for fiscal year 2006-2007 was $16.50 per assessable member, an increase of $4.50 from the previous year.

The aforementioned excess or shortfall of fees in any particular year is amortized over five years in accordance with the fee formula set out in regulations. Past years' surpluses have historically kept fee rates down; in 2003-2004 and 2004-2005, however, OSFI incurred unplanned expenses related to problem pension plans that depleted the surplus position. The rate established for fiscal year 2007-2008 is $24.00 per assessable member.

Expenses

The cost of administering the PBSA for fiscal year 2006-2007 was $5.9 million, an increase of $0.4 million, or 8.0%, from the previous year. This increase is largely driven by an increased focus on pension plan issues due to the higher number of "at-risk" pension plans. As a result, OSFI increased its staff complement in the Pensions area by 12.5% during the period to enhance its supervision, rule-making and approvals activities. In addition, during 2006-2007 OSFI commenced its Pensions Processes and Systems Renewal project, which is expected to be completed during 2007-2008.

Fees Assessed and Expenses
For Fiscal Years 2000-2001 to 2006-2007

($000, except Basic Fee Rate)

Year	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007
Fees Assessed	3,765	3,332[1]	3,270	3,549	3,444	3,846	5,402
Expenses	3,239	3,439	3,163	4,322	4,919	5,442	5,875
Basic Fee Rate per Member[2]	12.00	11.00	10.00	11.00	11.00	12.00	16.50

[1] Restated from $3,439 to report fees assessed on a cash basis.
[2] The minimum and maximum annual assessment per plan is derived by multiplying the annual assessment by 20 and 10,000 respectively. With an annual assessment of $16.50 per member, the minimum annual assessment is $330 and the maximum is $165,000.

International Assistance

Expenses for International Assistance rose by $0.2 million or 12.3% from the previous year, mainly due to increased international travel in support of projects funded by the Canadian International Development Agency (CIDA) and planned growth in employee compensation. Revenues from CIDA for this activity cover approximately three-quarters of its costs. The difference between expenses and revenues for this program is funded by base assessments from federally regulated financial institutions.

Office of the Chief Actuary

The Office of the Chief Actuary (OCA) is funded by fees charged for actuarial services and by an annual parliamentary appropriation. The increase of $0.2 million, or 3.7%, from the prior year in the expenses of the OCA is mainly attributed to planned growth in employee compensation and to the greater share of Corporate Services costs attributed to this program to reflect its fully loaded cost. This greater share is being phased-in over a period of three years effective 2005-2006.

MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Responsibility for the integrity and objectivity of the accompanying financial statements and the consistency with all other information contained in this annual report rests with OSFI's management.

These financial statements, which include amounts based on management's best estimates as determined through experience and judgement, have been prepared in accordance with Canadian generally accepted accounting principles for the private sector. Management has developed and maintained books of accounts, records, internal controls, management practices, and information systems designed to provide reasonable assurance that assets are safeguarded and controlled, resources are managed economically and efficiently in the attainment of corporate objectives, and transactions are in accordance with the *Financial Administration Act* and regulations and with OSFI's policies and statutory requirements.

OSFI's Executive Committee oversees management's preparation of the financial statements and ultimately approves the financial statements and related disclosures. The Audit Committee reviews and discusses with management and the external auditor, OSFI's audited annual financial statements and all significant accounting estimates and judgements therein and recommends to the Superintendent the approval of the audited financial statements.

The Auditor General of Canada, the independent auditor for the Government of Canada, has audited the financial statements of OSFI and reports on her audit to the Minister of Finance.

Julie Dickson
Acting Superintendent of Financial Institutions

Donna Pasteris
Assistant Superintendent
Corporate Services

Ottawa, Canada
May 18, 2007

Office of the Auditor General of Canada
Bureau du vérificateur général du Canada

AUDITOR'S REPORT

To the Minister of Finance

I have audited the Balance Sheet of the Office of the Superintendent of Financial Institutions as at March 31, 2007 and the statements of operations and equity of Canada and cash flows for the year then ended. These financial statements are the responsibility of the management of the Office of the Superintendent of Financial Institutions. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Office of the Superintendent of Financial Institutions as at March 31, 2007 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Douglas Timmins

Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
May 18, 2007

240 rue Sparks Street, Ottawa, Ontario K1A 0G6

Office of the Superintendent of Financial Institutions

BALANCE SHEET

As at March 31, 2007 (in thousands of dollars)

	Note	*2007*	*2006*
ASSETS			
Assets			
Cash Entitlement		$33,025	$34,144
Accounts Receivable	5	5,500	5,076
Accrued Pension Plan Fees		3,225	2,751
Accrued Base Assessments		526	319
Capital Assets	4	13,694	11,625
TOTAL ASSETS		**$55,970**	**$53,915**

LIABILITIES AND EQUITY OF CANADA			
Liabilities			
Accrued Salaries and Benefits		$12,950	$11,293
Accounts Payable and Accrued Liabilities	5	5,815	3,662
Unearned Base Assessments		1,331	3,529
Other Unearned Revenue		1,055	853
Employee Future Benefits	6	7,281	7,040
		$28,432	$26,377
Equity of Canada		**27,538**	**27,538**
TOTAL LIABILITIES AND EQUITY OF CANADA		**$55,970**	**$53,915**
Commitments and Contingencies	12		

Julie Dickson

JULIE DICKSON

Acting Superintendent of Financial Institutions

The accompanying notes are an integral part of the financial statements.

Office of the Superintendent of Financial Institutions

STATEMENT OF OPERATIONS AND EQUITY OF CANADA

For the year ended March 31, 2007 (in thousands of dollars)

	Note	*2007*	*2006*
Regulation and Supervision of Federally Regulated Financial Institutions			
Revenue	10	$71,295	$69,657
Expenses	10,11	70,874	69,317
Net Results before Filing Penalties Revenue		421	340
Filing Penalties Revenue	8	227	805
Net Results		**648**	**1,145**
Regulation and Supervision of Federally Regulated Private Pension Plans			
Revenue	10	5,875	5,442
Expenses	10,11	5,875	5,442
Net Results		**–**	**–**
International Assistance			
Revenue	10	1,568	1,431
Expenses	10,11	1,989	1,771
Net Results		**(421)**	**(340)**
Office of the Chief Actuary of Canada			
Revenue	10	3,787	3,636
Expenses	10,11	4,555	4,391
Net Results		**(768)**	**(755)**
NET RESULTS OF OPERATIONS BEFORE GOVERNMENT FUNDING		**(541)**	**50**
Government Funding	7	768	755
NET RESULTS OF OPERATIONS FOR THE YEAR		**227**	**805**
EQUITY OF CANADA, BEGINNING OF YEAR		**27,538**	**27,538**
Filing Penalties Earned on Behalf of the Government	8	(227)	(805)
EQUITY OF CANADA, END OF YEAR		**$27,538**	**$27,538**

The accompanying notes are an integral part of the financial statements.

Office of the Superintendent of Financial Institutions

STATEMENT OF CASH FLOWS

For the year ended March 31, 2007 (in thousands of dollars)

	Note	*2007*	*2006*
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash Receipts from Financial Institutions, Pension Plans and Other Government Departments		$85,361	$93,596
Cash Paid to Suppliers and Employees		(81,682)	(83,782)
Insurance Company Liquidations (Net)	9	1,017	(1,017)
Filing Penalties Revenue Remitted to the Consolidated Revenue Fund	8	(227)	(805)
Net Cash Provided by Operating Activities		**4,469**	**7,992**
CASH FLOWS FROM INVESTING ACTIVITIES			
Acquisition of Capital Assets	4	(5,588)	(4,817)
Net Cash Used in Investing Activities		**(5,588)**	**(4,817)**
NET INCREASE (DECREASE) IN CASH ENTITLEMENT		**(1,119)**	**3,175**
CASH ENTITLEMENT AT BEGINNING OF YEAR		**34,144**	**30,969**
CASH ENTITLEMENT AT END OF YEAR		**$33,025**	**$34,144**

The accompanying notes are an integral part of the financial statements.

Office of the Superintendent of Financial Institutions

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

1. AUTHORITY AND OBJECTIVES

Mandate

The Office of the Superintendent of Financial Institutions (OSFI) was established by the *Office of the Superintendent of Financial Institutions Act* (OSFI Act) in 1987. Pursuant to the *Financial Administration Act* (FAA), OSFI is a department of the Government of Canada for the purposes of that Act and is listed in schedule I.1 of the Act.

In 1996, OSFI subsequently received a legislated mandate that clarified its objectives in the regulation and supervision of federal financial institutions and private pension plans. Under the legislation, OSFI's mandate is to:

- Supervise federally regulated financial institutions[1] (FRFIs) and private pension plans to determine whether they are in sound financial condition and meeting minimum plan funding requirements respectively, and are complying with their governing law and supervisory requirements;
- Promptly advise institutions and plans in the event there are material deficiencies and take, or require management, boards or plan administrators to take, necessary corrective measures expeditiously;
- Advance and administer a regulatory framework that promotes the adoption of policies and procedures designed to control and manage risk;
- Monitor and evaluate system-wide or sectoral issues that may impact institutions negatively.

In meeting this mandate, OSFI contributes to public confidence in the financial system.

The Office of the Chief Actuary provides a range of actuarial services, under the *Canada Pension Plan Act* and the *Public Pensions Reporting Act* to the Canada Pension Plan (CPP) and some federal government departments, including the provision of advice in the form of reports tabled in Parliament.

In addition, OSFI supports initiatives of the Canadian government to assist selected emerging market economies to strengthen their regulatory and supervisory systems. This program incorporates activities related to providing help to other selected countries that are building their supervisory and regulatory capacity. This program is largely funded by the Canadian International Development Agency, and is carried out directly by OSFI and through its participation in the Toronto International Leadership Centre for Financial Sector Supervision.

[1] A federally regulated financial institution is any entity that has been created or is allowed to offer financial services pursuant to one of the financial institution statutes promulgated by the federal government and includes banks, trust and loan companies, federally registered insurance companies, fraternal benefit societies, cooperative credit associations, and pension plans.

2. REVENUE AND SPENDING AUTHORITY

Pursuant to Section 17 of the OSFI Act, the Minister of Finance may spend any revenues collected under Sections 23 and 23.1 of the OSFI Act to defray the expenses associated with the operation of OSFI. The Act also establishes a ceiling for expenses at $40 million above the amount of revenue collected.

OSFI's revenues comprise assessments, service charges and fees. The expenses against which assessments may be charged include those in connection with the administration of the *Bank Act*, the *Cooperative Credit Associations Act*, the *Green Shield Canada Act*, the *Insurance Companies Act*, and the *Trust and Loan Companies Act*. The formula for the calculation of assessments is included in regulations.

The *Pension Benefits Standards Act, 1985* (PBSA, 1985) provides that fees may be charged for the registration and supervision of private pension plans and for the supervision, including inspection, of registered pension plans. The amount of the fees is set annually by regulation pursuant to Section 39 of the PBSA, 1985.

Section 23.1 of the OSFI Act provides that the Superintendent may assess against a person a prescribed charge ("service charge") and applicable disbursements for any service provided by or on behalf of the Superintendent for the person's benefit or the benefit of a group of persons of which the person is a member. "Person" includes individuals, corporations, funds, unincorporated associations, Her Majesty in Right of Canada or of a province, and a foreign government. The service charges are detailed in the regulations.

Pursuant to Section 16 of the OSFI Act, Parliament annually provides appropriations to support the operations of the Office of the Chief Actuary.

3. SIGNIFICANT ACCOUNTING POLICIES

a) *Basis of presentation*

The financial statements of OSFI have been prepared in accordance with Canadian generally accepted accounting principles.

b) *Revenue recognition*

OSFI matches its revenue to its operating costs. Any amounts that have been billed and for which costs have not been incurred are classified as unearned revenue on the balance sheet. Revenue is recorded in the accounting period in which it is earned whether or not it has been billed or collected. At March 31 of each year, amounts may have been collected in advance of the incurrence of costs or, alternatively, amounts may be owed to OSFI.

Base assessments are billed annually based on an estimate of the current fiscal year's operating costs (an interim assessment) together with a final accounting of the previous year's assessment for actual costs incurred. Assessments are calculated prior to December 31 of each year, in accordance with Section 23(1) of the OSFI Act and the *Assessment of Financial Institutions Regulations, 2001*.

Cost-recovered services represent revenue earned from services provided in accordance with the terms and conditions set out in specific Memoranda of Understanding.

Pension plan fees are earned from registered pension plans. Fee rates are set annually by regulation based on budgeted expenses, forecast pension plan membership and actual results from previous years. Pension plan fees are charged in accordance with the *Pension Benefits Standards Regulations, 1985*.

User fees and charges include revenue earned pursuant to the *Regulations Amending the Charges for Services Provided by the Office of the Superintendent of Financial Institutions Regulations 2002* – as amended from time to time – in respect of legislative approvals and approvals for supervisory purposes, and surcharges assessed to federally regulated financial institutions assigned a "stage" rating pursuant to the Guide to Intervention for Federal Financial Institutions. Assessment surcharges are charged in accordance with the *Assessment of Financial Institutions Regulations, 2001*.

Filing penalties are penalties levied against financial institutions when they submit late and/or erroneous financial and corporate returns due to OSFI. Penalties levied are not available to reduce the net costs that OSFI assesses the industry (i.e., they are non-respendable) and are remitted to the Consolidated Revenue Fund. Filing penalties are charged in accordance with the *Administrative Monetary Penalties (OSFI) Regulations*.

c) *Cash entitlement*

OSFI does not have its own bank account. The financial transactions of OSFI are processed through the Consolidated Revenue Fund (CRF) of Canada. OSFI's cash entitlement represents the amount OSFI is entitled to withdraw from the CRF without further authority. This amount does not earn interest.

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

d) *Capital assets*

Capital assets are recorded at historical cost less accumulated amortization. Amortization is recorded using the straight-line method over the estimated useful lives of the assets as follows:

Assets	Useful Life
Leasehold Improvements	Remaining life of the lease
Furniture and Fixtures	7 years
Office Equipment	4 years
Informatics Hardware	3 years
Informatics Infrastructure (Networks)	3 years
Informatics Software	5 years

e) *Employee future benefits*

(i) Pension benefits

OSFI's eligible employees participate in the Public Service Pension Plan administered by the Government of Canada. Supplementary retirement benefits may also be provided in accordance with the *Special Retirement Arrangements Act*. Pension benefits accrue on pensionable service at a rate of 2 per cent per year up to a maximum period of 35 years, times the average of the best five consecutive years of earnings. The benefits are integrated with the Canada/Québec Pension Plan benefits and they are indexed to inflation.

Both the employees and OSFI contribute to the cost of the Plan. OSFI's responsibility with regard to the Plan is limited to its contributions. Actuarial liabilities are recognized in the financial statements of the Government of Canada, as the Plan's sponsor.

(ii) Severance benefits

On termination of employment, employees are entitled to certain benefits provided for under their conditions of employment through a severance benefits plan. The cost of these benefits is accrued as the employees render their services necessary to earn severance benefits. These benefits represent the only obligation of OSFI that entails settlement by future payment.

3. SIGNIFICANT ACCOUNTING POLICIES (continued)

The cost of benefits is actuarially determined as at March 31 of each year using the projected benefit method prorated on services. The valuation of the liability is based upon a current market discount rate and other actuarial assumptions, which represent management's best long-term estimates of factors such as future wage increases and employee resignation rates. The excess of any net actuarial gain (loss) over 10% of the benefit obligation is amortized over the average remaining service period of active employees.

(iii) Other future benefits

The federal government sponsors a variety of other future benefit plans from which employees and former employees may benefit during employment or upon retirement. The Public Service Health Care Plan and the Pensioners' Dental Service Plan are the two major plans available to OSFI employees and retirees. OSFI's responsibility with regard to these two plans is also limited to its contributions.

f) *Specified purpose account for insurance company liquidations*

OSFI has an interest-bearing, specified purpose account (note 9) within the Consolidated Revenue Fund for insurance company liquidations. Prior to amendments to the *Winding-up and Restructuring Act*, OSFI acted as liquidator of failed insurance companies when appointed by Court Order. Under these circumstances, the Superintendent hired agents to carry out the liquidation work in each case. Section 23.3 of the *Winding-Up and Restructuring Act*, which came into force in 1996, established that the Superintendent can no longer be appointed as liquidator of a failed institution.

In its capacity as liquidator, OSFI pays, on behalf of the remaining active institutions, all expenses related to the liquidation, and then recovers these costs from active institutions pursuant to the *Insurance Companies Act*. Where liquidated companies distribute assets to the Superintendent, these assets are distributed back to the remaining active institutions that paid the costs of liquidation. Accordingly, the revenues and expenses, recoveries and distributions related to this account are not included in the Statement of Operations and Equity of Canada.

g) *Use of estimates*

These financial statements are prepared in accordance with Canadian generally accepted accounting principles, which require that OSFI management makes estimates and assumptions that affect the amounts reported in these financial statements. Liabilities related to human resources and the useful lives of capital assets are the most significant items for which estimates are used. Actual results could significantly differ from those estimates.

h) *Contingencies*

Where it is likely that a contingency existing at the financial statement date will result in a loss, OSFI accrues its financial effects to the extent that the amount of the loss is known or can be reasonably estimated.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2007

4. CAPITAL ASSETS

($ thousands)	Gross Book Values			Accumulated Amortization			Net Book Values	
Categories	Opening Balance	Additions (net)	Closing Balance	Opening Balance	Amortization Expense (net)	Closing Balance	2007	2006
Leasehold Improvements	$ 5,184	$ 233	$ 5,417	$ 690	$ 582	$ 1,272	$ 4,145	$ 4,494
Furniture and Fixtures	3,374	623	3,997	1,292	493	1,785	2,212	2,082
Office Equipment	314	34	348	202	50	252	96	112
Informatics Hardware	1,624	367	1,991	948	443	1,391	600	676
Informatics Infrastructure	1,880	305	2,185	1,310	334	1,644	541	570
Informatics Software	7,284	4,026	11,310	3,593	1,617	5,210	6,100	3,691
Total	**$ 19,660**	**$5,588**	**$25,248**	**$ 8,035**	**$ 3,519**	**$11,554**	**$13,694**	**$ 11,625**

Amortization expense for the year ended March 31, 2007 was $3,519 thousand (2006: $3,013 thousand).

5. RELATED PARTY TRANSACTIONS

OSFI is related, in terms of common ownership, to all Government of Canada departments, agencies and crown corporations. OSFI enters into transactions with these entities in the normal course of business and on normal trade terms. These transactions are measured at the exchanged amount, which is the amount of consideration established and agreed to by the related parties.

OSFI recorded expenses of $19,268 thousand (2006: $18,236 thousand) and revenue of $7,795 thousand (2006: $5,675 thousand) from transactions with other government departments during the year.

As at March 31, accounts receivable and payable with other government entities and unrelated external parties were as follows:

($ thousands)		Related Parties	External Parties	Total
2007	Accounts Receivable	$ 1,963	$ 3,537	$ 5,500
	Accounts Payable and Accrued Liabilities	2,299	3,516	5,815
2006	Accounts Receivable	197	4,879	5,076
	Accounts Payable and Accrued Liabilities	1,297	2,365	3,662

6. EMPLOYEE FUTURE BENEFITS

a) *Pension benefits*

OSFI and all eligible employees contribute to the Public Service Pension Plan. This pension plan provides benefits based on years of service and average earnings at retirement. The benefits are fully indexed to the increase in the Consumer Price Index. The estimated employer contributions to the Public Service Pension Plan during the year were $5,442 thousand (2006: $5,650 thousand).

As required under present legislation, the contributions made by OSFI to the Plan are 2.14 times the employees' contribution on amounts of salaries below $126,500 and 7 times the employees' contribution on amounts of salaries in excess of $126,500.

b) *Severance benefits*

Information about OSFI's severance benefit plan is presented in the table below.

($ thousands)	2007	2006
Accrued Benefit Obligation, beginning of year	**$ 7,681**	**$ 7,016**
Current service cost	649	598
Interest cost	325	360
Benefits paid	(733)	(611)
Actuarial (gain)/loss	(261)	318
Accrued Benefit Obligation, end of year[1]	**7,661**	**7,681**
Unamortized Net Actuarial Loss	(380)	(641)
Accrued Benefit Liability	**$ 7,281**	**$ 7,040**
Net Benefit Plan Expense		
Current service cost	649	598
Interest cost	325	360
Benefit Expense	**$ 974**	**$ 958**

[1] The cost corresponding to annual changes in the accrued benefit liability is recovered from OSFI's various sources of revenue outlined in Note 3 to the financial statements. Amounts collected in excess of benefits paid are presented on the Balance Sheet under the heading of Cash Entitlement.

The significant actuarial assumption adopted in measuring OSFI's accrued benefit obligation is a discount rate of 4.25% (2006: 4.25%).

For measurement purposes, management's best estimate for the general salary increases to estimate the current service cost and the accrued benefit obligation as at March 31, 2007 is an annual economic increase of 2.0% for the plan year 2008 (2006: 2.5% for the plan year 2007). Thereafter, an annual economic increase of 2.0% is assumed (2006: 2.5%). The average remaining service period of active employees covered by the benefit plan is 12 years (2006: 11 years).

7. GOVERNMENT FUNDING

OSFI receives an annual parliamentary appropriation pursuant to Section 16 of the OSFI Act to support its mandate relating to the Office of the Chief Actuary. In this fiscal year, OSFI was granted $768 thousand (2006: $755 thousand).

8. FILING PENALTIES

Filing penalties are levied quarterly to financial institutions when they submit late and/or erroneous financial and corporate returns due to OSFI during the preceding calendar quarter. Penalties levied by OSFI are remitted to the Consolidated Revenue Fund. The funds are not available for use by OSFI and are not included in the balance of the Cash Entitlement. As a result, the penalties do not reduce the amount that OSFI assesses the industry in respect of its operating costs.

During 2006-2007, OSFI levied $227 thousand (2006: $805 thousand) in late and erroneous filing penalties.

9. SPECIFIED PURPOSE ACCOUNT FOR INSURANCE COMPANY LIQUIDATIONS

The following activity occurred in this account:

($ thousands)	2007	2006
Opening Balance	$ 1,017	$ –
Recoveries deposited	–	1,017
Interest earned	38	–
Distribution of assets from liquidated estates	(1,055)	–
Other transactions in respect of liquidation expenses	–	–
Closing Balance	**$ –**	**$ 1,017**
Remaining insurance company liquidations under control of the Superintendent	6	6

10. SEGMENTED INFORMATION

Revenue by Business Activity

($ thousands)	2007					2006				
	Base Assessments	Cost-Recovered Services	Pension Plan Fees	User Fees and Charges	TOTAL	Base Assessments	Cost-Recovered Services	Pension Plan Fees	User Fees and Charges	TOTAL
Regulation and Supervision of Federally Regulated Financial Institutions	$ 63,890	$ 4,357	$ –	$ 3,048	**$ 71,295**	$ 60,878	$ 3,794	$ –	$ 4,985	**$ 69,657**
Regulation and Supervision of Federally Regulated Private Pension Plans			5,875		**5,875**			5,442		**5,442**
International Assistance		1,568			**1,568**		1,431			**1,431**
Office of the Chief Actuary		3,643		144	**3,787**		3,399		237	**3,636**
TOTAL REVENUE	**$ 63,890**	**$ 9,568**	**$ 5,875**	**$ 3,192**	**$ 82,525**	**$ 60,878**	**$ 8,624**	**$ 5,442**	**$ 5,222**	**$ 80,166**

Expenses by Business Activity

($ thousands)	2007	2006
Regulation and Supervision of Federally Regulated Financial Institutions		
Risk Assessment and Intervention	$ 49,440	$ 49,093
Rule Making	14,448	13,477
Approvals	6,986	6,747
Total	**70,874**	**69,317**
Regulation and Supervision of Federally Regulated Private Pension Plans	**5,875**	**5,442**
International Assistance	**1,989**	**1,771**
Office of the Chief Actuary		
Canada Pension Plan and Old Age Security	1,488	1,427
Public Pension Plans	2,457	2,346
Canada Student Loans Program	610	618
Total	**4,555**	**4,391**
TOTAL EXPENSES	**$ 83,293**	**$ 80,921**

11. REVENUE AND EXPENSES BY MAJOR CLASSIFICATION

($ thousands)	For the year ended March 31				
	2007	**2006**	**2005**	**2004**	**2003**
Revenue					
Base Assessments	$ 63,890	$ 60,878	$ 60,171	$ 58,166	$ 56,460
Cost-Recovered Services	9,568	8,624	7,629	7,140	6,266
Pension Plan Fees	5,875	5,442	4,867	4,322	3,155
User Fees and Charges	3,192	5,222	5,943	6,762	4,221
Total Revenue Earned from Respendable Sources	**82,525**	**80,166**	**78,610**	**76,390**	**70,102**
Filing Penalties Revenue	227	805	365	211	710
Total Revenue	**82,752**	**80,971**	**78,975**	**76,601**	**70,812**
Expenses					
Human Resources	58,632	55,254	57,448	55,801	52,215
Information Management/Technology	9,546	10,418	7,972	8,129	5,519
Facilities	6,615	6,247	5,789	5,109	5,098
Travel	3,311	3,333	2,998	2,860	2,953
Administration	2,750	2,623	2,512	2,444	2,059
Professional Development	1,461	1,551	1,062	1,254	1,727
Professional Services	978	1,495	1,553	1,683	1,237
Total Expenses	**83,293**	**80,921**	**79,334**	**77,280**	**70,808**
Net Results of Operations before Government Funding	**(541)**	**50**	**(359)**	**(679)**	**3**
Government Funding	768	755	724	890	707
Net Results of Operations	**227**	**805**	**365**	**211**	**710**
Average Number of Employees	**456**	**434**	**453**	**466**	**454**

12. COMMITMENTS AND CONTINGENCIES

a) Commitments

OSFI has entered into lease agreements for office space and office equipment in four locations across Canada. The minimum aggregate annual payments for future fiscal years are as follows:

($ thousands)	
2007–2008	$ 4,710
2008–2009	4,487
2009–2010	2,308
2010–2011	2,207
2011–2012	2,062
	$ 15,774

b) Contingencies

In its normal course of operations, OSFI is involved in claims and litigation for which provisions have been made to the extent determinable, in accordance with accounting policy note 3 h).

Appendix 1

DISCLOSURE OF INFORMATION

Under the *Office of the Superintendent of Financial Institutions Act*, the Superintendent is required to report to Parliament each year on the disclosure of information by financial institutions and the state of progress made in enhancing the disclosure of information in the financial services industry.

OSFI contributes to and promotes effective disclosure by publishing selected financial information on OSFI's Web site and through Beyond 20/20 Inc.; by providing guidance to institutions on their disclosures; and by participating in international supervisory groups with similar objectives.

OSFI has issued disclosure guidelines for deposit-taking institutions, life insurance companies and P&C insurance companies, setting out minimum requirements for information disclosure on financial, risk management and control practices. These requirements supplement disclosures required by the Canadian Institute of Chartered Accountants (CICA) Handbook under generally accepted accounting principles (GAAP) and other OSFI guidelines.

In 2006, some significant new standards dealing with the measurement and disclosure of financial instruments were adopted in Canadian GAAP to take effect in 2007. As a result, OSFI has been revisiting its disclosure guidelines and enhancements needed to regulatory returns in light of the new accounting requirements, and this work will continue. In connection with this initiative, OSFI has finalized an accounting guideline, *Accounting for Financial Instruments Designated as Fair Value Option*, which provides prudential guidance, including disclosure requirements on the use of the Fair Value Option available under Canadian GAAP for financial institutions.

OSFI continued work on the implementation of the New Capital Adequacy Framework (Basel II) of which Pillar 3 – Market Discipline will require enhanced disclosures by banks of capital and risk management practices. In the past year, OSFI issued guidance providing additional clarification on the implementation of the Pillar 3 disclosure requirements, including the scope of application, timing for implementation, frequency and location of disclosures and compliance requirements. OSFI also issued an advisory clarifying the capital treatment of certain innovative structures and included requirements for enhanced public disclosure in this area.

OSFI continues to be active on international groups involved in disclosure-related initiatives:

- Through its membership on the Basel Committee on Banking Supervision (BCBS), OSFI has been active in several work strands of the International Accounting Standards Board (IASB). This is especially important now that the CICA will be adopting international accounting standards for publicly accountable entities. OSFI participated in the BCBS's publications on *Supervisory Guidance on the Use of the Fair Value Option by Banks under International Reporting Standards* and *Sound Credit Risk Assessment and Valuation for Loans.*
- As a member of the International Association of Insurance Supervisors (IAIS), OSFI participates in the development of guidance papers by various subcommittees of the IAIS. In 2006-2007, the IAIS approved a *Standard on Disclosures Concerning Technical Risks and Performance for Life Insurers*, the third of three standards issued to promote meaningful disclosure by insurers that facilitate market discipline.

Appendix 2

FINANCIAL INSTITUTIONS AND PENSION PLANS REGULATED BY OSFI

	Number[1]	Assets[2, 3] ($ millions)
Banks		
Domestic	22	2,217,584
Foreign Bank Subsidiaries	24	127,323
Foreign Bank Branches	25	58,517
Trust and Loan Companies		
Bank-owned	30	236,594
Other	39	19,662
Cooperative Credit Associations	7	16,471
Cooperative Retail Association	1	3,276
Life Insurance Companies		
Canadian-incorporated	46	437,736
Foreign Branches	49	16,775
Fraternal Benefit Societies		
Canadian-incorporated	11	6,560
Foreign Branches	8	1,636
Property and Casualty Insurance Companies		
Canadian-incorporated	93	72,987
Foreign Branches	98	29,902
Pension Plans	1,332	129,580

1 Number of regulated companies as at 31 March 2007. Includes institutions in the process of liquidation or termination and institutions limited to servicing existing business. A list of institutions regulated by OSFI can be found on OSFI's Web site at www.osfi-bsif.gc.ca under "Who We Regulate".

2 As at 31 January or 31 March 2007 (depending on fiscal year-end) where available, otherwise 31 December 2006.

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

Appendix 3

ASSET BREAKDOWN[1] OF PENSION PLANS REGULATED BY OSFI

As at March 31, 2007, with comparative figures for the year ended March 31, 2006

($ millions)	2007		2006	
Cash	**402**	**0.3%**	**291**	**0.2%**
Debt Securities				
Short Term Notes, Other Term Deposits	4,619	3.6%	3,381	2.9%
Government Bonds	27,244	21.0%	25,053	21.5%
Corporate Bonds	7,153	5.5%	6,776	5.8%
Mutual Funds – Bonds, Cash Equivalent & Mortgage	7,915	6.1%	6,573	5.6%
Mortgage Loans	986	0.8%	1,230	1.1%
General Fund of an Insurer	131	0.1%	102	0.1%
Total Debt Securities	**48,048**	**37.1%**	**43,115**	**37.0%**
Equity				
Shares in Investment, Real Estate or Resource Corporation	6,646	5.1%	6,281	5.4%
Common and Preferred Shares	51,415	39.7%	47,066	40.4%
Stock Mutual Funds	14,274	11.0%	11,958	10.3%
Real Estate Mutual Funds	475	0.4%	323	0.3%
Real Estate	1,610	1.3%	1,756	1.5%
Total Equity	**74,420**	**57.5%**	**67,384**	**57.9%**
Diversified and Other Investments				
Balanced Mutual Funds	3,148	2.4%	2,854	2.4%
Segregated Funds	1,853	1.4%	1,586	1.4%
Miscellaneous Investments	1,552	1.2%	1,060	0.9%
Total Diversified and Other Investments	**6,553**	**5.0%**	**5,500**	**4.7%**
Other Accounts Receivables (net of liabilities)	**157**	**0.1%**	**285**	**0.2%**
Total Net Assets	**129,580**	**100%**	**116,575**	**100%**

[1] Represents asset distribution as reported in the financial statements of pension plans whose year-end falls between January 1 and December 31 of respective years.

How to Reach OSFI

OSFI welcomes questions about its role and responsibilities as well as enquiries related to federally regulated pension plans. Several methods are available to communicate with us:

Toll-free Information Service

OSFI operates a toll-free information service from 8:30 a.m. to 6:00 p.m. Eastern Time, Monday through Friday. It can be reached by calling **1 800 385-8647** or 613-943-3950 for local (Ottawa-Gatineau) calls. E-mail: **extcomm@osfi-bsif.gc.ca**.

Internet

OSFI's Web site address is **www.osfi-bsif.gc.ca**. The site provides timely access to a wide variety of OSFI information and documents, including speeches, news releases, guidelines, legislation, policy statements, bulletins, financial information and a listing of all financial institutions and pension plans regulated by OSFI.

Publications

OSFI publications are generally available on our Web site (www.osfi-bsif.gc.ca) or by contacting:

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