REPORT OF THE INQUIRY INTO THE COLLAPSE OF THE CCB AND NORTHLAND BANK

AUGUST
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By
THE HONOURABLE WILLARD Z. ESTEY
Commissioner

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TO HER EXCELLENCY
THE GOVERNOR GENERAL IN COUNCIL

MAY IT PLEASE YOUR EXCELLENCY

I, the Commissioner, appointed in accordance with the terms of Order in Council P.C. 1985-2932 of 29 September 1985, to inquire into and report on the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank, and to make any consequential recommendations for changes in the control of the banking industry in Canada:

BEG TO SUBMIT TO YOUR EXCELLENCY THE FOLLOWING REPORT.

Commissioner

27 August 1986

Report of the Inquiry into the Collapse of the CCB and Northland Bank

Appendices

Protocol

In order to assist the reader, the following list presents those abbreviations commonly found in the report.

BSDP	Bank Sponsored Drilling Program (CCB)
CBA	Canadian Bankers' Association
CCB	Canadian Commercial Bank
CDIC	Canada Deposit Insurance Corporation
CEO	Chief Executive Officer
CICA	Canadian Institute of Chartered Accountants
COC	Comptroller of the Currency (United States)
FDIC	Federal Deposit Insurance Corporation (United States)
FRB	Federal Reserve Board (United States)
GAAP	Generally Accepted Accounting Principles
LDT	Licensed Deposit-Taking Institution (United Kingdom)
MARGUN Loans	Marginal and Unsatisfactory Loans
MUL	Marginal and Unsatisfactory Loans
NAL	Nonaccrual Loan
NEL	Nonearning Loan
NPL	Nonperforming Loan

OIGB	Office of the Inspector General of Banks
OSC	Ontario Securities Commission
QSC	Quebec Securities Commission
REIT	Real Estate Investment Trust (CCB)
RRRL	Renegotiated Reduced Rate Loan
SBEC	Small Business Equity Corporation
SEC	Securities and Exchange Commission (United States)
SMART	Senior Management Assessment and Recovery Team (Northland Bank)
$M	Million Dollars
$B	Billion Dollars

Foreword

In the conduct of this Inquiry and the preparation of this report, I am indebted to the very small Inquiry staff assembled on short notice for this project. From the day following the issuance of the Order in Council proceedings took over almost completely, without prior notice, the time of the Commission counsel as well as the Commission's staff. It is very difficult to preempt without notice the time and availability of high calibre professional and administrative staff. Each one of them joined the Inquiry with personal inconvenience and sacrifice.

The analysis of a bank's operation relies heavily on accounting. Bank auditing is a specialty within the accounting profession and a bank auditor is a very rare bird. Because all the bank auditors in the country are somehow affiliated with accounting firms who hold appointments with one or more of the Schedule A banks, we were unable to locate an active bank auditor without some conflict of interest. We were very fortunate in enlisting the help of Vernon Turley, a retired bank auditor who was a partner of Coopers & Lybrand in Montreal and was engaged in the audit of major Canadian banks for almost 40 years. His insights into the complex and rarefied atmosphere of bank accounting and bank auditing procedures were of great assistance and were a unique contribution to this Inquiry. Because of his prior commitments, our demands upon him were sometimes met at great personal inconvenience.

The investigation and organization of the hearings fell entirely upon our Commission counsel, John Sopinka, Q.C. of Stikeman, Elliott, Toronto. A leading counsel in Canada and with particular experience in Commission of Inquiry work from both sides of that process, John Sopinka's contribution to the Inquiry was invaluable. He laid out the investigative program, examined almost all the witnesses and presented in a series of submissions over the life of the Inquiry both sides of all the issues seen to be relevant to the Commission's mandate. With an already full schedule of counsel work around the country, all this was accomplished at the expense of weekends and holidays.

In all this Mr. Sopinka was assisted by a brilliant young lawyer from Stikeman Elliott, Mr. Peter Howard. On him fell the burden of taking possession of the extensive documentation of the federal agencies and departments, of the two banks and of related organizations; and of analyzing, organizing and presenting the relevant portions of this material as exhibits for the Inquiry. In all he culled out and processed some thousands of pages of documents. While other counsel participating may sometimes have thought they should have received their bound books of exhibits with more lead time, no one challenged the fairness and efficiency with which Mr. Howard approached this monumental task. He also supervised the expurgation of this vast record of documents in order to protect the private information of persons who dealt with these banks in the ordinary course of business. Mr. Howard examined witnesses during the hearings and prepared submissions from various points of view on the issues raised in the evidence. All these studies were made available to all counsel before presentation at public hearing to the Commission. This great volume of work taxed to the limit even a young counsel of the vigour and training of Mr. Howard.

Serving as full-time Commission legal staff were two outstanding students of law, Jamie Benidickson and James T. Eamon. By the end of our project, each had been admitted to the bar (Ontario and Alberta respectively) and now look forward to what will certainly be distinguished careers in the law. Mr. Benidickson came to us already experienced in the work of a Commission of Inquiry. Mr. Eamon is my law clerk at the Supreme Court of Canada, as is Ms. Katherine Young, a law graduate from the University of Saskatchewan now completing articles for admission to the bar of Ontario. She divided her time between the Commission and the Supreme Court until preparation of the report commenced. In this process she conducted research into the various legal issues which the Commission confronted. These three persons were the core of our staff and the final form of the report was much influenced by their work. The time required to prepare this report was greatly abridged by the profound knowledge developed by Messrs. Eamon and Benidickson of the thousands of pages of transcripts and exhibits we collected. For the work and industry of these three highly skilled young law graduates I am most grateful.

Early in the Commission work assistance was obtained from Nigel Campbell of the Ottawa bar (now Toronto bar) in the regulatory framework of the United States and the United Kingdom and in the studies and developments underway in those countries. Professor David Cohen of the Faculty of Law of the University of British Columbia joined the Commission staff after the hearings were completed and contributed much to the organizing of the responses by the Commission to the many proposals received for the revision of legislation and administration and for the improvements to the principles of accounting that they apply to banking. We are all most appreciative of the work of Mr. Campbell and Professor Cohen.

May I also extend the thanks of the Inquiry to those people in the OIGB, the Bank of Canada and the Department of Finance, as well as to the liquidators of the two banks and the auditors of these banks for their assistance throughout the Inquiry. These were the principal sources of records and documents which the Commission required to do its work. Our invasions of these organizations were always cheerfully accepted in a spirit of cooperation. All this was very disruptive to these people and the Commission counsel and staff and myself are truly grateful for their help.

I particularly want to mention the work of the many counsel from Western Canada and Eastern Canada who represented agencies and individuals, some of the major banks, associations and government throughout these long and vigorous hearings. Many days, in order to accommodate travel schedules, the hearings went through 8 to 10 hours without interruption. In all these arduous times, matters proceeded in professional calm under the skilful management of these counsel, all of whom are listed at the end of this report. As is mentioned in the report, some of their clients may have had concerns with proceedings in other forums but with the forbearance expected of highly experienced and skilled professionals, these counsel at no time attempted to bend to their own interests the forum presented by this Inquiry. We were all saddened when Mr. Pierre Genest, Q.C., of Cassels, Brock, Toronto, who represented some of the CCB directors, was taken away by illness. We all missed his direct, incisive and witty interventions in our opening weeks.

We were fortunate, in organizing the work of the Inquiry, to obtain the help of Mr. Paul Ollivier, Q.C., who was lured out of retirement from the Public Service of Canada to act as Secretary of the Commission. By their very nature, Commissions of Inquiry cut across the rules, the methods and habits of the Public Service. Mr. Ollivier's broad knowledge of the experience in the Public Service were particularly useful in facilitating the work of the Commission and for this we are most grateful. Mr. Ollivier was ably assisted in his work by Donna Stebbing, Assistant Secretary, who came to us with experience in both the Public Service and Commissions of Inquiry. Her assistance, particularly in arranging our three lengthy sessions in Edmonton and Calgary, made the quick changes of locale possible. The task of moving thousands of pages of documents around the country and arranging for hearing facilities, shorthand reporters, word processor operators and translation personnel was not an easy one. For her help in this regard and in providing the paraphernalia of a main office in Ottawa, we are most grateful.

A word must be said about the press. As the report states, the Commission was throughout engaged in the delicate task of examining two banks without doing any unnecessary damage to the surrounding banking institutions. This required a constant balancing of the need for information in public examinations and the need of the banking institutions for protection from runs on deposits and loss of public confidence generally. The journalists, print and broadcast, reported these hearings with accuracy and fairness and did so unobtrusively. Television coverage was operated cooperatively by the TV news media and contributed to accurate and fair reporting without any apparent interference with the hearing process itself. This plan was proposed by the Ottawa Parliamentary Press Gallery and with some trepidation adopted by the Commission. It would appear to have been a very successful experiment.

The preparation in a relatively short period of time after completion of hearings of a report of several hundred pages means someone has put a great volume of words into a word processor, followed by corrections and redrafts. This was largely done by my secretary at the Supreme Court, Marjorie Harvey, who additionally organized the preparation of the report in a condition which facilitated its production in print form without further processing. The rest of us watched all this with great appreciation and amazement. Her stamina is exceeded only by her skill.

Telecom Canada arranged the satellite communication facilities by means of which the testimony of a British banker, a bank auditor and a banking expert from the United Kingdom was introduced into the Commission record by two-way television conducted in public in the course of the Ottawa hearings of the Commission. This was a considerable financial saving both to the Commission and to the United Kingdom participants. It also saved the Commission time in being able to hear this evidence in Ottawa when the United States bank regulatory practices were under examination. All this, Telecom Canada did without any charge to the public. It was a most successful experiment and the Commission appreciates the cooperation extended by Telecom Canada and its staff.

My absence from hearings in the Supreme Court in the winter and spring terms placed an added work load on the Chief Justice and my colleagues on the Court. Some of the work of the Court I was able to participate in during the course of the Inquiry but only with the assistance and patience of my judicial colleagues. For this I thank them as well as for their cooperation, forbearance and kindness in this difficult period.

Chapter 1

Summary

This Inquiry was directed to investigate the failures of the CCB and Northland Bank, to report upon the causes of these failures and the regulatory response to them and to recommend any changes in the regulation of the banking industry that these experiences may have shown to be necessary and advisable. This study involves the collapse of two banks which represented about one per cent of the Canadian banking system measured by assets, earnings or any other reasonable standard. It is therefore difficult in some instances to respond properly to proposals general in nature and affecting banking as a whole where the events in these two banks have not produced evidence relating to the proposals.

There is nothing in the considerable record of information assembled by the Inquiry to lead Canadians to fear any lack of strength and integrity in the Canadian banking system. The major banks, representing about 96 per cent of the assets of the industry, continue as world-scale banks whose strength and leadership is today recognized on the international stage of banking. Similarly, nothing has been revealed in the extensive record which indicates any basic inadequacy in the tripartite regulatory system which has been the mainstay of the regulation of banks in this country. No personal dishonesty in any person in private or public service has been revealed.

The complexity of the many issues which have arisen in these affairs and the huge flow of evidence, testimonial and documentary, defy reduction to a comprehensive, fair and accurate summary. An understanding of these events, their consequences in and to the Canadian community, and the solutions recommended requires reference to the whole report. What follows is a brief look at the highlights of the events, the problems encountered in the banks and by the regulators; and at the reactions of management, auditors, regulators, the government, and others to the principal adjustments and solutions recommended to improve the banking system and to reduce the chances of recurrence of these events with all their attendant losses to the community, private and public.

These were two small banks with headquarters in Western Canada. Northland charted its course as a regional bank. CCB intended to cast its net more broadly. Both founding groups saw their market niche as lenders to the mid-market commercial borrowers where the risks and the returns would be somewhat higher than in general banking operations. Funding for these loan operations was to come (and did for some time) from the wholesale money market. This, it was appreciated, would be more expensive than raising lending funds from retail depositors, but the added cost would be offset by the avoidance thereby of the need to establish a costly branch network, and by the anticipated higher returns from the type of lending. Northland also hoped to attract deposits from the credit union system, but this never developed into a significant funding source. The government of the day and its agencies, together with western provincial governments, saw a need for more competition generally in the banking business, and more particularly a need for western-based banks which would be more attentive to local interests.

The evidence reveals that probably there was no neglected niche in this market by the time these banks commenced business. The evidence is more readily open to the interpretation that the improvident lending practices of these banks created a demand from those lacking in the capacity to repay their borrowings and to whom credit should not have been extended. The rapid growth in both banks, spurred by the lending bonanza in the Western Canadian boom, increased the risk of making unsatisfactory loans. The plan of reliance on the wholesale money market for deposits was found by both banks to be entirely unsatisfactory and hazardous for small banks confined in their lending either sectorally, regionally or both. This realization unhappily came too late in the day. The same can be said of management's proclivity to take the easy path by lending large amounts of money to relatively few borrowers and making a significant number of loans to borrowers in the cyclical real estate and energy markets. Each bank also became excessively concentrated in limited geographic areas. These were some of the ills common to both banks, although each suffered from these ills in varying degrees.

If the two banks suffered from design flaws, so did the system in which they operated. The keeper of the gate of entry into the banking business is the Government of Canada. The plan advanced by the founders of each bank was laid out in detail in Parliamentary Committees. The Inspector General of the day testified that he saw no reason why the banks should not be incorporated. Four or five years later, the new *Bank Act* authorized the establishment of Schedule B banks and some 60 of them came into being in 1980-82. No provision was made in the Act for an enlargement of the inspection system or for any adjustment or realignment of that system to accommodate these new banks. The government of the day somehow overlooked the evident need to make some adjustments to the Act to accommodate the changing circumstances in banking and to study the inspection and regulation of banks in the light of these significant changes. In short, the adoption of a policy of expansion of the population of banks was not accompanied by a study of the complementary changes required in the supervisory system.

The role of the Minister of Finance and the Minister of State (Finance) is the execution of the regulatory policies in banking and the making of the final decision on a policy basis relating to the entry and exit of banks from the system. A Minister's reliance on the advice and information supplied by the regulatory staff is as inevitable as it is sensible. A Minister is not absolved from maintaining a policy surveillance over the operations of the supervisor, and must as well be responsible for the presence in the system of senior personnel of appropriate training and experience. The supervisory system and the principal persons in it were all in place well before the present Ministers assumed their responsibilities.

Northland Bank

Northland had many problems other than design flaws peculiar to itself. The bank suffered during much of its existence from a shortage of senior management experienced in banking. Through one-half of its entire history, the Chief Executive Officer of the bank was a person who had no banking experience. There was a large turnover in senior personnel. In its ten years of existence, the bank had four chief executive officers. The same velocity of roll-over occurred in many other senior management positions. Early lending practices were unconventional. The newly arrived Chief Executive Officer in 1981 described the bank as "run like a Mom and Pop shop". When trouble surfaced for all to see in 1982 a director resigned and a critical financial report authored by a financial advisor was circulated to the Board of Directors. Another director, who was not nominated for re-election, also expressed criticism of the bank to the Board, but no action was taken to change the direction of the bank.

Mr. Neapole, an experienced banker, joined the bank in 1983. He and his management team immediately recognized the serious condition of this bank. Accordingly, "survival tactics" were adopted for the purpose of gaining time in which to repair the troubles in the loan portfolio, the principal and virtually sole asset of a bank. The various strategies adopted by management had one object in common: to keep up an appearance of healthy financial condition in the bank's statements until better times returned to Alberta where the largest part of its business took place or until some of the restructured loan arrangements, called workouts, produced some income or recovery of principal.

The cornerstone of these strategies was a valuation standard for the loan assets which took into account future accretions to value by reason of the projected success of the workouts and anticipated improved economic conditions generally. The operational device applied very extensively by the Neapole team was the placing of nonperforming and otherwise unsatisfactory loans into a workout. That operational decision, according to the theory of the bank, immediately enhanced the value of the loan or the underlying loan security. That future value would be achieved at some indefinite time under undefined but improved economic conditions. This future value concept used in Northland justified, in management's opinion, the various accounting procedures in the bank including capitalizing interest and taking accrued interest (which by definition has not been received in cash) into the bank's statement of income although the borrower's ability to pay the interest was at least questionable. In addition, the inflated value of the loan or collateral security enabled management to defer or avoid setting up specific provisions against losses.

The loss experience on loans for the year consists of the net change in specific provisions plus write-offs less recoveries. This "loan loss experience" is charged to the appropriations for contingencies account carried in the capital and reserve section of the balance sheet. The "provision for loan losses" is based on the five-year historical loan loss experience expressed as a percentage of the loans outstanding and applied to the year end balance of loans, and is credited to the appropriation for contingencies account and charged to the statement of income. Consequently, the failure of a bank to set up a specific provision where prudent banking practice would have dictated that this be done results in an overstatement of the value of the loan assets in the balance sheet of the bank and an overstatement of income in the statement of income. Similarly, the capitalizing and accruing of interest, although uncollected, added value to the assets of the bank on its balance sheet and increased the stated income of the bank.

The triggers to all this are the decision to place the loan in a workout, the decision that principal and interest are ultimately collectable, and the valuation of loans on the basis of future values at some indefinite time under undefined improved economic conditions.

While all this activity was proceeding, the bank also undertook to increase its outstanding loans. This was intended to dilute the ever-rising number of nonperforming loans in the loan portfolio as a percentage of total outstanding loans. The plan was based on the assumption that all or most of the new loans would prove to be productive and would produce earnings for the bank. Unfortunately, this rapid expansion of lending occurred from 1982 onwards in the course of a long and severe recession in Alberta, which witnesses from both banks testified was the real cause of their respective failures. This produced new loans and increased balances on old loans and neither category was free from a substantial proportion of unsatisfactory loans.

Another strategy adopted by the Neapole management team was the development of "merchant banking". The merchant banking business enabled the bank to earn fee income. Fee income increased from 1983 levels by some 400 per cent in 1984. Characterizing a fee as the product of a merchant banking effort, rather than as the product of lending, enabled the bank to recognize the entire fee as income immediately and thereby avoid the amortization of the fee over the life of the loan had the fee been classed as being in lieu of interest. Three defects were ultimately revealed in relation to the bank's quest for fee income. First, the lending policy in many instances appeared to be fee driven, resulting in the booking of loans of doubtful quality in order to earn a fee. Second, the policy by its nature would force the bank to maintain its rapid rate of growth in order to maintain the same level of fees. Third, many of the so-called merchant-banking fees were revealed to be simply fees in connection with lending. These should have been amortized.

All these "survival tactics" were undertaken by a senior management evidently aware of the true condition of the bank generally, and of its loan portfolio in particular. It is the evidence as received by this Commission that this awareness was not fully shared by either the OIGB or the external auditors, and this is difficult to understand.

It is clear that management did succeed in maintaining an appearance of financial health by its tactics. The financial statements became gold fillings covering cavities in the assets and in the earnings of the bank. By conventional standards of banking and bank accounting the bank would have been shown as short on assets and earnings. The confidence of the money market would have been lost and deposits withdrawn. The bank, without outside assistance, would have had to close its doors as early as 1983.

Many adversities beset the bank. The CCB collapse in March 1985 shook the money markets. Northland was seen by the professional money managers as being in the same category as CCB. Deposits declined rapidly. The bank had begun to shift its funding base from wholesale to retail deposits but it was a slow and expensive process. Its interest spread narrowed. Without liquidity advances from the Bank of Canada to replace withdrawn deposits, the bank could not have carried on. Eventually these advances totalled about $500M.

The downhill slide makes much that followed anticlimactic. The ceaseless efforts of an enterprising management were directed to raising capital. This they did with great success until the collapse of CCB. Indeed, an underwriting had been scheduled for closing by Northland on the day after the fateful announcement of CCB's rescue program. Two months later a private debenture issue was made in the amount of $16M. The bank by this time had been classified in OIGB internal reports as "unsatisfactory". When the underwriters interviewed the OIGB about the condition of the bank, they were told that the OIGB was aware of nothing which would make it imprudent to proceed with the issue.

Management viewed the liquidity effect of the CCB collapse on their bank as a problem of market perception. They felt that the market expected them to take a large write-off of loans, and a proposal to do so was presented to the Government in July 1985. It was rejected. Governor Bouey saw no need for an asset restructuring to deal with an asserted liquidity, as opposed to a solvency, problem. Nevertheless the Inspector General, as a result of the CCB bailout, was becoming increasingly uncomfortable about the quality of Northland's assets, and accordingly desired to mount an inspection effort. The first results of that effort were available in August 1985, and revealed bizarre banking practices, overstated income, and overstated loan values. The Inspector General took the view that the only viable alternative for Northland was a merger. No government assistance would be advanced.

The National Bank was asked by the Inspector General to consider a merger with Northland. The staff of National examined Northland's loan portfolio, decided that its value was much overstated in the financial statements of the bank, and declined to consider the idea of merger any further.

By 1 September, the bank was insolvent by any reasonable standard. The Inspector General is required by the *Bank Act* to make a determination of this question. The Inspector General advised the Bank of Canada, which was still making liquidity advances to Northland, that the bank was no longer "viable". The Bank of Canada thereupon discontinued its liquidity advances. The Inspector General concluded that without these advances, Northland Bank was unable to pay its liabilities as they came due. The Inspector General thereupon recommended to the Minister of Finance that a curator be appointed. All this was done on 1 September.

A thorough review by the curator, assisted by Royal Bank personnel, confirmed that the bank was indeed insolvent. Many loans were classified as weak, doubtful, and bad. Employing a reasonable method of assessment, the curator concluded that additional specific loan loss provisions in the amount of approximately $190M would be required. Management and the Board of Directors had objected to the appointment of the curator, taking the view that management's approach of working with problem loans and assessing value over a longer period of time, in association with the bank's auditors, would best preserve the bank's assets. Accordingly, the bank was given time to attempt some rearrangement of its affairs. None came to fruition and a liquidator was appointed by the Court of Queen's Bench of Manitoba in early 1986.

That the recession in Alberta played a role in the failure of Northland Bank is undoubted. Its role, however, was secondary. It exposed Northland to a strain that management should have anticipated and should have included in their planning and operations. The poor quality of the loans in its portfolio was the primary condition which caused the collapse. The quality of these loans was exposed with the onslaught of the recession and the collapse was no doubt greatly accelerated thereby. The condition of the loan portfolio in turn was the product of inadequate lending practices and policies adopted by an inexperienced management. The continuous turnover in such experienced banking management personnel as the bank had been able to attract contributed to these troubles.

The activities of management from 1983 onwards did not so much cause the failure of the bank as the delay of that failure. The survival tactics put into practice in the last three years of the bank masked its true financial condition and forestalled for a time the inevitable realization in the market of the true state of affairs. All this is remarkable considering that the directors of the bank received in late 1982 an analysis of the bank which accurately described the bank's condition and foretold its fate. What makes this analysis the more remarkable is that the analyst produced his study from published bank statements and from some discussions with persons in the financial market in Calgary where the bank had its executive offices.

While acknowledging the energy, and indeed the courage, of senior management of the bank in the fiscal years 1984 and 1985 particularly, it must be realized that management crossed over the line of prudential banking and propriety in its efforts to keep the bank afloat. Loan warehouses were established to keep bad loans from reflecting their proper classification. One hundred per cent nonrecourse financing was commonplace. Lending practices became fee driven so as to sustain the income statement of the bank at a time when interest income was foundering. Other unconventional processes were introduced all to the same end: to present a financial picture which would not frighten off the depositors.

To do all this, management had to persuade two potential objectors to accept their tactics. One was the external auditor; the other was the Inspector General.

The auditors, through several consecutive fiscal years, accepted management's operational decisions and the method of reflecting these decisions in the bank's financial statements. Management's operational decision to place poor loans in workout was, in effect, understood by the auditors to require as a concomitant the accounting treatment proposed by management. This began some time in 1982. As the line of sound and prudential banking bent, so did the accounting treatment, until the bank's statements and reality no longer coincided. By the end of fiscal year 1984 the auditors had become, perhaps unwittingly, a part of the survival tactics of the bank. Their certification of the bank's financial statements was accepted by management and by the Inspector General as a validation by the accounting profession of management's processes in this period of dire straits.

The scale of these practices and the valuation consequences of the workout concept were known to the auditors. They accepted the accounting consequences as advanced by management without consequential objection. They did not follow the principles of bank auditing so amply described by the expert witnesses without any dissent from the other accounting witnesses. The auditors did not "stand back" and assess the overall condition of a loan portfolio extensively farmed out into workouts. They continued to accept management's explanations, which pushed recovery on the workout loans further and further into the future at each successive year end review. Some loans were entirely unproductive for several years. Interest continued to be accrued and no loss provisions were taken on these loans or on some loans where the borrower was in receivership. Sometimes the auditors raised a question; sometimes they did not; but they never prevailed in a meaningful way. In the end the auditors failed to bring to bear on their primary task, that of determining whether the financial statements of the bank as prepared by management fairly reflected the financial position of the bank, the principles of bank auditing prevailing in this country as described in evidence before the Inquiry given by qualified experts in this field.

The OIGB took the position that under the tripartite system of bank regulation, so long the practice in this country, they were entitled to and did rely upon the external auditors. If the auditors certified the bank's statements, the Inspector General assumed that the value of the bank's assets and the extent of its income were as set out in those statements. By this longstanding system, the Inspector General did not make his own assessment of the loan portfolio. Indeed, the size, organization and expertise of the OIGB staff indicates clearly that the system did not contemplate such action by the Inspector General. However, the Inspector General in fact went further. The Inspector General, from his own annual inspection and frequent visits to the bank, was clearly aware of all the practices of management already described. Survival tactics and future values were considered reasonable in the circumstances. The Inspector General recognized that the management of the bank was not "conservative" and was indeed dedicated, until very late in the life of the bank, to the practice of rapid loan growth. On one major confrontation of management by the external auditors the Inspector General did not provide any support to the auditors, though approached by them. Rather, he simply left it to management and the auditors to resolve their differences, and expressed satisfaction when they did so. There is no evidence that the OIGB ever determined the significance of the difference or the details of the compromise. The experience did not shake the faith of the OIGB in the financial statements which resulted.

Realization of the consequences of all this, both to the bank and to those persons dealing with the bank, did not appear to come to the OIGB until shortly after the collapse of CCB. The OIGB then began to refine its acceptance of the workout strategy and related value practices so as to impose a time limit on the endless recycling of loan recovery programs. The Inspector General only in 1985 began to call on the bank to recognize the gap that had grown up between asset values as stated on the balance sheet and as they appeared in market reality even on the bank's own files. The Inspector General, in the final analysis, places his reliance on the external auditors for all the information required for the regulation of the bank, but which here did not seem to reach the Inspector General. The Inspector General and his staff met frequently with management, but on 20 July 1985, when Neapole revealed the true state of affairs in the bank, the OIGB was little more prepared and little less surprised than on 14 March when they heard similar revelations from CCB management.

It is necessary in the face of the record compiled by this Commission to conclude that although the OIGB was in possession of all the information essential to a true comprehension of the state of affairs in Northland, awareness did not come. Even if it had, the will to respond was missing. It is a choice of losing alternatives.

The directors of the bank likewise relied heavily on others, this time the management. Little evidence was seen of challenge to management's actions. The directors, relative to the size of the bank, were active borrowers from the bank, but while their approval process of loans to directors bordered on the cavalier, this was not a discrete cause of the failure of the bank. The most serious characteristic of this Board, taken as a whole over the life of the bank, was its lack of anything approaching a detailed knowledge of the business of the bank. The bizarre (but in the eyes of bank management) crucial workout plans, some on a very large scale, were not fully comprehended either by the Chairman or by the Board members. The directors are responsible for policy and for management selection and direction. This Board was not, over the years, successful in performing these functions.

CCB

This was avowedly a bank which intended to become a national enterprise and not a regional bank. Unfortunately, taking the path of least difficulty, the bank opened up and largely stayed in Alberta and British Columbia where the commencement of business of CCB coincided with a large real estate and energy boom. It was easy to make large loans to a few borrowers on a rising real estate and energy market. Everyone in the community was realizing profits in these industries and CCB was anxious to participate in them. In the result, the bank became highly sectoralized and geographically confined in its lending. This realization came upon the bank with the advent of the recession and unhappily its expansion and diversification program into California and Eastern Canada coincided with the onslaught of the serious, long and deep recession in Western Canada.

Ironically, CCB may well have expired eventually by reason of its initial stunning success. In the Eaton years (1976 to early 1983), the bank, in the words of one of its long-term directors, was more successful by many standards and yardsticks of bank analysis than its peers, and indeed, than some of the major banks. Thus it was difficult for the directors to criticize the rapid growth policies of Eaton and some of his expansionist plans. The later serious trouble in the bank began with the aggressive lending practices and policies adopted by management in its early years which produced virtually overnight a large loan portfolio which later turned out to contain many accounts of extremely doubtful value. On his accession to the office of Chief Operating Officer, McLaughlan discussed in disparaging terms the state of the loan portfolio of the bank and the poor lending practices leading to that state in a memorandum to Eaton. He made reference to the "devastating proportions" of nonearning loans. McLaughlan concluded in retrospect that the seeds of the destruction of the bank had been planted in the loan portfolio prior to his succession to the office of Chief Executive Officer in early 1983. Indeed, he acknowledged that, in hindsight, the bank was doomed in 1983. The loans that were by then on the books of the bank were exposed to the wintry blasts of the Alberta recession which came in 1981. Bad loans made in the early years must be classified as a prime, long-term reason for the failure of this bank.

However, there are many other factors competing for this doubtful honour. One was the decision of management taken in 1981, approved by the Board, to purchase a minority interest in Westlands Bank, a California bank heavily involved in real estate lending. This was said to have been undertaken in the guise of a passive investment with a view to diversifying the bank away from its sectoral and geographic concentration but without involvement in active management. That the project was poorly investigated and ill-advised was the universal opinion expressed throughout the evidence. Ultimately, CCB as the parent company was required by the United States regulator, the FDIC, to clean up Westlands' poor loan portfolio, arrange for the infusion of further capital and better management, and generally to take steps to bring the bank back from its perilous state and restore it to financial health. In the end, this was indeed accomplished by compliance with the FDIC cease and desist order, but the price may well have been the death of CCB itself.

Two years earlier, the bank had opened a lending office in Los Angeles, CCB not being licensed to operate in California as a full bank. This branch of the bank engaged heavily in energy loans and by February 1985 had produced such an unstable portfolio of these loans (then mostly in a workout state) that an $85M write-off was suddenly revealed to be necessary. CCB management professed that this was the blow which brought down the bank. These weaknesses had been exposed by the U.S. regulator, this time the FRB, who told the bank, according to management's evidence, to clean up the loan portfolio in the Los Angeles branch or take it home to Canada. The California experiment amounted to a very high price for a failure in diversification.

At about the same time, Eaton appears to have become disenchanted with life in Edmonton in general and work at the CCB in particular. He became more and more remote from the Board of Directors. Eventually he caused the bank to acquire a home for him in Los Angeles where he intended to live while running the bank in Canada. To this the Inspector General properly objected and called upon the Board to take action. When Eaton visited the Inspector General to explain his strange conduct he apparently met with some success, because the record indicates that the Inspector General thought it reasonable to allow Eaton to remain on for a period of two years in order to find a successor.

In the meantime, Eaton had taken up a number of outside activities which eventually came to the attention of the Board, to its extreme annoyance, and led to a discussion of his relationship with the bank. Before the directors resolved the issue, the Ontario trust companies associated with Leonard Rosenberg were "seized". Eaton had entered into several business arrangements with Rosenberg, who in turn came to own or control almost 30 per cent of the outstanding shares of CCB. This was in violation of the *Bank Act* restrictions on ownership and CCB refused to register the offending transfers. The directors forced Eaton to resign. They thought it necessary to disassociate the bank from both Rosenberg and Eaton. Finding an investor to take over the CCB shares owned or controlled by Rosenberg required time, and continued to be an embarrassment to the bank in the financial markets. The Trust Companies Affair hung over the bank as a black cloud, probably for the balance of its life. The immediate impact on the bank was a loss of confidence and a run on deposits, driving the bank to the Bank of Canada for liquidity support. McLaughlan, Eaton's successor as Chief Executive Officer, did not, however, attribute to the Eaton experience the cause of the collapse of the bank.

The story of CCB is much the same as Northland's from this point in its life onwards. Bank management recognized the grave state of the bank and the serious risk it was running in carrying on in its present state. It was essential to shore up quickly the bank's income statement and to protect its balance sheet. To do so, resort was had to a technique of valuation of the loan portfolio which acquired the label in CCB of "baseline value". This valuation technique took into account future economic conditions in establishing the value of an asset in the present. All this was done, at least by September 1983, on a bank-wide basis under a directive which forbade the discounting or the bringing back to present value of those future values which were anticipated by management on the basis of an economic upturn of some kind at some indeterminate time in the future. With the support of this broadened valuation base, CCB proceeded to adopt the same operational and bank accounting decisions as did Northland in respect of income accrual, capitalization of interest and loan loss provisioning. These need not be repeated in this summary. All these strategies, from workout to accounting treatment adopted by management, were well known to the auditors of CCB, and the accounting treatment was carried into the financial statements which were ultimately approved unconditionally by the CCB auditors.

As the nonproductive loans, sometimes referred to as nonperforming, sometimes as nonearning and sometimes as marginal and unsatisfactory, rose in proportion to the total loan portfolio, the survival tactics adopted by management became more energetic and imaginative. Twin objectives became more and more apparent. The first was to obtain, if possible, fee income by one arrangement or another and thereby to buttress the income statement of the bank. The second was to establish by workout and security valuation an asset value which would forestall the necessity of taking a provision against the loan and enable the bank to continue interest income recognition. All this was for the same purpose, and had the same result as in Northland.

Again, management, either from conviction or necessity and very frequently the latter, were quick to find that principal and interest were ultimately collectable and that the value of the underlying security exceeded the principal and accrued interest of the loan. All this was done in the interests of postponing or avoiding indefinitely the classification of loans which would necessitate the taking of a loss provision. To do so would adversely and severely affect the income statement and balance sheet of the bank.

At least one dramatic development was uncovered in the evidence concerning CCB. Management had instructed all the branches of the bank to prepare a report on capitalization of interest in the bank for the years 1982 to 1984 inclusive. This report, duly signed by the various area managers, came in as requested and revealed in all about $59M of capitalized interest. Management, when faced with this documentation, attacked it as being inherently unreliable because, among other reasons, some of this recognized income was acceptable under prudent banking and proper accounting practices. Two difficulties for management at once arise. The first is that, even if the statement was 50 per cent in error, the amount of interest uncollected from sources outside the bank and taken by the bank into income over its last three fiscal periods, if reversed, would have eliminated all earnings during the period as well as all retained earnings in the bank. The second difficulty is that shortly after the bank staff had compiled this statement of capitalized interest, management, to comply with a request for information on the subject issued the same instructions as had earlier been issued to compile the study so vigorously attacked by them in the Inquiry hearings. The explanation given was that prospective compilation of a return of capitalized and accrued interest can accurately be done, but retrospective compilation requires too many judgments to make the resultant study accurate. There is, unquestionably, some truth in this response, but not enough totally to invalidate the information as a window into the conduct of the affairs of the bank from 1982 onward.

Another enlightening development is exposed by the evidence in connection with CCB's efforts to raise capital. This entailed the presentation to the investing public of financial statements which reflected a healthy, successful and profitable bank. Apparently to accomplish the presentation of such financial statements, the bank, commencing in the fall of 1983, set about to improve the nonperforming loan ratio in its financial statements by broadening the valuation base with all its consequential effects on the level of loan loss provisions and interest income recognition. The broadened valuation base would enable the exercise of the "management override" so as to continue the recording of income through the taking of accrued interest into the bank's income statement. All this was done because it had become evident to the bank and to its underwriters that disclosure of nonproductive loans would be required on a securities issue by the provincial regulatory agency. The Royal Bank had recently published a prospectus on that basis. The underwriter was assured by management that all this would be practicable because the nonperforming loan ratios would be improved. None of the measures taken by the bank to accomplish this result were disclosed to the underwriter or to the bank's auditors, although the auditors professed that it would have made no difference to them. This may indeed be true, because they were familiar in some detail with and accepted as appropriate the baseline value concept and other survival tactics adopted by CCB management. Nonetheless the underwriting proceeded and the securities were sold on the market with a prospectus which included financial statements certified by the auditors and in which there was nothing to indicate that in the preparation of these statements, the bank had adopted any collateral security valuation measures different from those used in the preceding year or which would have the effect of reducing the ratio of nonperforming loans in the loan portfolio of the bank. The prospectus was approved by the OIGB under the *Bank Act*.

As in the case of Northland, the practices adopted by CCB and accepted by its auditors relating to valuation of assets, capitalization and accrual of interest and the taking of loan loss provisions, were, according to the evidence taken by the Inquiry, contrary to banking practices in the six largest Canadian banks. Furthermore, the evidence reveals that these practices were not in compliance with the bank accounting principles described in the evidence given by bank auditing experts.

The position of the auditors vis-à-vis these operational decisions and management's decisions of the appropriate accounting treatment is much the same as in Northland. The auditors, in approving the financial statements of the bank for the year 1984, and most likely the year 1983 as well, failed to apply the bank auditing practices and procedures as described in the evidence before the Inquiry by the professional bank auditors.

The dependence of the Inspector General on the external auditors and on management as part of the tripartite supervisory system is again the same in the case of CCB as in Northland. The magnitude of the degree of this reliance is dramatically revealed in the evidence relating to a complaint made to a law enforcement agency concerning certain practices in CCB. The essence of the complaint was that management had directed the bank staff to introduce for improper purposes the asset valuation process already discussed. The law enforcement agency attended at the OIGB, revealed the complaint, and inquired as to the position of the Inspector General. In due course, the OIGB advised the law enforcement agency that, inasmuch as the financial statements for the year in question had been approved by the external auditors, there would be no reason for anyone to investigate the adequacy of the asset valuation process. The OIGB did nothing to investigate the matter and did not advise the auditors of the complaint, nor was legal advice taken.

The Inspector General was aware of the baseline value concept, the workouts, and the active operational and accounting practices adopted by the bank. He shared management's general survival tactics because, like management, he hoped throughout this period that the Western Canadian economy would revive and thereby cure the ills of the bank. It turned out that the economy did not revive, and the Inspector General was faced by a bank with a bleak future. All this was realized by early March 1985, but by then, the Inspector General had foregone any opportunity to intervene. Even then, it may not have been recognized how formidable the problem had become. By then, the Inspector General could offer no solutions.

The Board of Directors must share some responsibility as well for the failure of the bank. They were susceptible to being mesmerized by management, and realization of the true state of affairs and its ramifications came too late. The key is their failure to insist upon simple and straightforward information from management. However, the complex interaction of other forces and the actors, management, auditors and the OIGB, makes it difficult to classify any act or omission on the part of the Board as being an independent cause of the ultimate failure of the bank. The responsibility of the Board, which acts through a dynamic, shifting majority, as in the case of Northland, defies summarization and the reader is encouraged to refer to appropriate sections of the report.

By the end of fiscal year 1984, the management tactics described above had brought about a number of unfavourable results. The financial picture presented by the financial statements did not reveal all the weaknesses in the bank. This forestalled the arrival of discernible insolvency, thereby increasing the cost of ultimate failure to all concerned. Any investors and depositors who relied on the financial statements regarding important matters, principally the state of the loan portfolio, would have been misled. Finally, the obfuscation of the financial statements produced by the survival tactics interfered with a complete understanding of the state and needs of the bank by the participants in the support program, and may well have defeated the attempts of all concerned to save the bank or make a sound decision as to whether or not to stage a rescue attempt.

The bailout or support program of the CCB commenced with McLaughlan's revelations to the OIGB and to the Bank of Canada on 14 March 1985, of the inability of the bank to continue in operation without outside assistance. By 25 March, a government and banking industry supported bailout program had been put in place and announced to the public. The program suffered from many defects brought on by a number of conditions existing at the time. There was no well-defined regulatory framework in the statutes providing for this type of event in the banking community. The Bank of Canada, without the necessary statutory position or staffing, was thrust into the position of leadership in the design, implementation and execution of the program. The information laid before the meeting of government agencies and leaders of the six major Canadian banks by the Inspector General was inadequate for the guidance of the meeting in the decision to rescue the bank or to allow it to fail. The time limitation of one weekend placed an impossible limitation on the meeting, if it were hoped that a workable rescue program could be evolved before the bank was required to resume operations on the following Monday. As it turned out, the program contained a number of flaws which contributed in varying degrees to the slide of the bank into, or further into, insolvency. The failure of the CCB bailout should not, however, preclude the use of rescue techniques when proper circumstances arise in the future.

The OIGB, by reason of its position in the statutory pattern for the regulation of banks, must bear much, but not all of the blame for this condition and for what transpired. As mentioned earlier, the Inspector General was aware of the state of the bank and failed to act. Further comment must be made regarding the OIGB performance in the bailout. The information concerning the health of the bank, and the state of the loan portfolio in particular, was inadequate. Inspections instituted just prior to and during the meeting were not coordinated or well-organized, and the outcome of these loan examinations was incompletely or imperfectly relayed to the meeting. Efforts by the OIGB thereafter to examine the loan portfolio were spasmodic and ineffective until very late in the day when the Hitchman team was dispatched. The monitoring of the rescue program was ineffective, and in the result no adaptation of the program to the unfolding situation was ever brought about. The caution on the part of the Government occasioned a delay in formulating Government policy regarding the contribution of public funds. The limits of responsibility in the Ministers must be to ensure prompt discharge by the public officials of their statutory duties. Here, this principally relates to the Inspector General. Apart from a delay in formulating government policy as to the intervention with public funds in a rescue program of the bank, and a tardiness in responding to the request of the major banks for a detailed and comprehensive loan portfolio assessment, there is no reasonable criticism to be levelled at the responsible Ministers, and none was directed at them in the testimony. Proper caution in the use of public funds rather than "bargaining brinksmanship" with the big banks appears to account for the time taken by the Government for decision. The Ministers reasonably relied on their principal advisor, the Inspector General.

The evidence clearly indicates that the Hitchman Report revealed to all concerned that the true state of the assets of the bank was seriously different from the representation of those assets in the financial statements of the bank. Considerable evidence was directed at this report and some indicated serious inaccuracies in some parts of it. The conclusion as to asset quality was attacked but only on the issue of degree. Even if the assessment of the value of the bank's loans was only 25 per cent correct, the bank's capital had disappeared. McLaughlan accepted the fact that the bank was indeed insolvent on 1 September. The final Hitchman Report was delivered on 13 August. The Governor of the Bank of Canada recognized all this in a discussion with the Minister of Finance when he stated that the Support Program was devised without the knowledge of the CCB loans which was later acquired. The Inspector General agreed that the Hitchman Report was the turning point in his understanding of the state of the bank's loan portfolio. Perhaps the greatest significance of this report is the light it sheds upon the ineffectiveness of the external auditors and the OIGB in discharging their respective functions in the years leading up to the failure.

In the end, the bank failed with the rescue program still in place. The rescue failed because the plan was neither scaled nor attuned to the true state of the losses suffered in the bank's loan portfolio. Had the magnitude of the losses been known, the rescue program may never have been attempted.

All depositors were compensated fully (beyond their insured limits) no doubt because of the announcements made by public officials at the beginning of and during the rescue program, for the purpose of supporting that program by attempting to restore confidence in the bank in the financial markets and in the community generally.

Recommendations

From all the evidence describing the various events in both banks, certain clear lessons can be derived. These lessons in turn have led the Commission to make the extensive recommendations found in Chapter 6. The banking industry recognizes and the evidence taken in the Inquiry supports the importance of the continuance of the tripartite supervisory system, modified to recognize the need for some direct examination by the supervisor of the quality of a bank's loan portfolio, particularly where a bank is emitting trouble signals. This recognizes some of the benefits of the hands-on supervisory system, but only as a supplement to the basic tripartite supervisory process. It is also recommended that a power to issue cease and refrain orders be added to the regulator's arsenal. The only current statutory sanction possessed by the regulator is the power to direct that a bank maintain certain levels of liquidity and capital. OIGB officers have testified that this power is neither expeditious nor feasible in all cases. The current "wink and nod" system of regulation should be reshaped and strengthened. The essential recommendation is that the supervisory function should be placed within a framework which will contribute the primary element revealed by these events to be missing: the will to respond when the signals of trouble in a bank come to the regulator. The proposal is that the OIGB be integrated into a reorganized CDIC. The insurance function and the inspection function would be combined. It is noted that the slow trend in the United Kingdom is away from a consolidation of the inspection service with the central bank, an alternative which the Commission does not recommend here. The insurance and inspection functions are combined in some U.S. agencies, notably the FDIC.

The present functions and staff of the OIGB would be transferred to the CDIC, including the duties of supervising banks and approving prospectuses associated with the public offering of bank securities. The new regulator would be organized as a Commission of three full-time appointees, one from the bank auditing profession, one with senior management experience in the banking business and the third from the insurance business or from the business community at large. The predominant characteristic of the bank regulatory function is administrative. The policy elements relating to establishment and termination of banks should be left with the executive branch, here represented by the Minister of Finance. The Crown corporation instrument is less appropriate to the administrative regulatory role. For these reasons a full-time professional Commission is recommended.

It is the view of this Commission that such an organization, which might be called the Canadian Deposit Insurance Commission, will bring to bank regulation the necessary skills and experience to establish a procedure whereby troubles in a bank will come to the attention of the regulator in a timely fashion. Perhaps of even more importance, this recommendation is founded in the belief that a regulator so organized will have the interest, the will and the skill to respond quickly to troubles in a member of the banking industry, in time to head off ultimate collapse by rescue programs, mergers or other means. It should be added, however, that in all communities where comparable banking institutions have been established, it has been recognized that a regulatory system should not be constructed so as to assure that all banks will be saved whatever the cost may be to the community.

When so reorganized, the regulator should, in the recommendation of this Commission, be the agency primarily responsible for the design and implementation of a bank assistance program designed to ensure the survival of a bank which, in the view of the Minister of Finance, should in the public interest be saved. The provision of liquidity advances would remain in the Bank of Canada but the procedure would be revised, when it has been determined to assist a bank facing long-term liquidity or insolvency problems, so as to center the responsibility for the operation of the program in the regulator. Solvency funding would be organized by the regulator and provided from its own sources, from the banking industry where circumstances warrant, or through loans from the Bank of Canada or the Government of Canada. Upon the success of the bank assistance program, the regulator, with the authority of the Minister, would restore the bank to private ownership. In order to ensure that public funds are not deployed for the purpose of restoring value to the capital investors in a bank whose capital has been lost by the bank, a procedure is recommended whereby the outstanding capital, debt and equity, as defined by statutory amendment, of a bank may, under a bank assistance program, be reduced or cancelled, with compensation ordered by a superior court where it can be demonstrated to the court that the bank was not actually insolvent, or facing imminent and inevitable insolvency, at the date of the bank assistance program. The bank assistance program may include the offer of the opportunity to existing capital investors of the bank to contribute, together with, and on the same basis as the regulator and perhaps others, new capital in the reorganized bank.

The recommended organization for the bank regulator would be sufficiently broad in scope to embrace eventually the delivery of its services to other federally established deposit-taking institutions as well as like provincially established institutions where the provinces so desire.

A number of accounting principles have been examined before the Commission, and a series of recommendations with respect to those proposals is likewise contained in Chapter 6. For the purpose of establishing an ongoing and productive relationship between the banking regulator, the banking industry, the bank auditing profession, and the accounting profession in general, it is recommended that an Advisory Committee be established to assist the regulator on these matters. Its members should be appointed by Order in Council and should be drawn from the bank auditing and general accounting professions, the legal profession and the banking and insurance businesses.

It has been 60 years since this country has experienced a bank collapse, although less serious episodes have culminated in bank mergers. There have also been in those years a number of failures of other financial institutions which involved the regulator of banks, through the CDIC. Whether or not it should have been, this lengthy period of time no doubt was a factor which may have lulled the regulators, the external auditors, and indeed members of the banking community itself, into a false sense of security.

It should be remembered that these events concerned only a tiny fraction of the Canadian banking business. Public confidence in the banking system should not be shaken by these events, but the country should respond to them by improving the banking supervision system. Such a system should be designed so as to reveal to a responsive regulator on a timely basis weakness in a bank, and so as to ensure that banking as an institution will continue to render banking services throughout the country on an economic, efficient and safe basis. The regulatory system should be such as to ensure the maintenance of competitive practices in the banking business and that when opportunities properly present themselves, new entries into the banking system may be permitted. These ill-starred experiments in no way suggest that there is no place in the community for new banks or for the use of bank support programs in proper circumstances.

All the conclusions of this Commission have been reached upon the record established from testimony and documents examined by the Commission. It may be that other forums and tribunals faced with different rules of evidence and having different objectives will reach different conclusions with respect to duties and obligations of the participants in these events.

Chapter 2

Scope of Inquiry

The Inquiry was convened by Order in Council P.C. 1985-2932 on 29 September 1985. The Commission assembled a small staff of lawyers, an accounting advisor, a Secretary and secretarial staff and undertook hearings which commenced in Ottawa on 2 October 1985 and concluded in Calgary on 22 May 1986. Written submissions by participants and from the public continued to be received until early August 1986.

Terms of Order in Council

The Inquiry was directed to inquire into and report on:

> ... the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank including
>
> (a) an examination of all the circumstances and factors contributing to the condition of the banks and resulting in the cessation of their operations; and
>
> (b) regulatory action in dealing with these conditions and circumstances taken by the Government of Canada and its agencies, including the Bank of Canada; ...

The Order goes on to direct the Commission, if it:

> ... concludes that the circumstances so require, to recommend any changes in the regulatory and administrative control of the banking industry in Canada that the experience of the matters reviewed in the course of the inquiry may show to be necessary or advisable.

These terms of reference have not been found by the Commission to be restrictive. The Commission proceeded to conduct public hearings after notice was published in the newspapers in Ottawa, Calgary, Edmonton and Vancouver. It was immediately realized by the Commission and all parties appearing before it that some unusual characteristics attached themselves to these proceedings. The very nature of banking itself necessitated the adoption of some special procedures. Public confidence is one of the prime prerequisites to the survival of a bank, and indeed a banking system. Even the fact of a public investigation of a bank is unsettling to the financial community. Because public interest in banking is high, the daily reporting of evidence at the hearings represented a constant concern, if not a threat to the well being of other banks, particularly those other than the major Canadian banks, sometimes referred to as the "Big 6".

A second matter of prime importance at once became evident. This investigation reflected directly on the welfare and careers of a number of individuals in the staff of these two banks, their directors and auditors, persons engaged in the public service in regulating these banks or conducting related activities, underwriters, and others. Perhaps of even greater concern was the need to protect the private affairs of those customers of these banks who were caught up accidentally and incidentally in their liquidation. Accordingly it was necessary to establish a process whereby the Commission could fully discharge its mandate and at the same time minimize any adverse affects on other banks and individuals affected.

From the outset the thousands of pages of documents entered as exhibits were reviewed and all references identifying borrowers, and others who happened to be dealing with these institutions at the time, were expurgated. Full cross-examination was permitted, but without the right to know or to reveal (if somehow ascertained) the deleted identities. Sometimes this process required additional deletions to prevent improper disclosure. Witnesses were interviewed and documents were examined by Commission counsel in advance so that all information affecting other banks and other people and institutions could be deleted where it was in the public interest to do so and where it did not impinge upon the discharge by the Commission of its responsibilities. It is a tribute to the great number of counsel appearing before this Inquiry that none of these confidences were ever breached. On one occasion, by accident, the identity of persons in high office in another bank was revealed in an exhibit. It is a great credit to counsel and more particularly to the financial press, who reported on the Commission's hearings daily and in great detail, that this slip was never repeated or made the subject of comment by counsel on the record. The detailed, laborious work by Commission counsel and its legal staff is acknowledged with gratitude by more than the Commissioner.

During the course of the investigation, the Commission heard evidence or received submissions from eighty-five individuals. The witnesses appearing before the Commission included management, directors, auditors and liquidators of the CCB and Northland Bank, senior representatives of all the major Canadian Schedule A banks, and officials or representatives of the Office of the Inspector General of Banks, the Bank of Canada, the Canada Deposit Insurance Corporation, and the Department of Finance. The Minister of Finance and the Minister of State (Finance) also testified before the Inquiry. Provincial regulators and underwriters associated with the approval, issuance and exchange of bank securities appeared before the Commission to present information. In addition, the Commission heard from industry representatives, and other experts on particular aspects of the banking industry and the economy of Western Canada in the 1980s. In recognition of the fact that arrangements for the supervision of banks have recently been under review in other jurisdictions, the Commission also heard from experts familiar with the regulation and supervision of banks in the United Kingdom and the United States. Several individuals submitted briefs or memoranda to the Inquiry; a number of these persons appeared before the Commission during the course of its hearings. Individuals who testified during the Inquiry or who made submissions are listed at the end of the Report. For convenience, individuals are referred to in the report by surname only after first being introduced in the report.

When hearings began, the Northland Bank had not been placed in liquidation by the courts of Manitoba (this did not occur until 20 January 1986). Consequently, the evidence surrounding the collapse of CCB was examined first. This examination included the rescue program initiated by government and banks which ended with the appointment of a curator for the CCB on 1 September 1985. Thereafter general regulatory issues, and the process of bank supervision in this country and in the United Kingdom and the United States, were examined. Finally, the evidence leading to the failure and liquidation of Northland came to be considered.

The hearings were conducted in Ottawa during October, November and December 1985, and again in January, February and May 1986; in Edmonton in November 1985; and in Calgary in March and May 1986. The banking and accounting witnesses in the United Kingdom were examined during the Ottawa hearings by two-way satellite television. Experts in United States bank regulation appeared in the Ottawa hearings. In the end some 14,000 pages of evidence was transcribed at these hearings.

At the request of the journalists, both print and broadcast, the Commission permitted the installation of television audio and video facilities in the hearings in all three cities. This was said to provide economies and efficiencies to the journalists and to place all of them on an equal footing. The system worked well and the public interest appears to have been served, and certainly was not injured, by this process.

The issues, which at once arose and remained before the Commission throughout, related to the management of these banks and to systemic matters as well. The role of senior executives, directors, auditors, public regulators, the Bank of Canada, the CDIC, the Ministers of the Crown, the Department of Finance, and the underwriters of bank security issues, all came in for detailed examination in both evidence and argument. All this was done in public hearings except for some procedural sessions with counsel of all parties which were conducted *in camera* in order to avoid unnecessary revelation of confidential information affecting persons not involved with the issues raised in the Inquiry.

It was necessary throughout the hearings to make it known to the participants and to the community at large that the Inquiry was not a convenient forum for the trial or settlement of all issues, public and private, arising out of these failures. A distinction was drawn and maintained throughout between the inquiry process and the trial of rights, duties and differences in and among persons who considered themselves affected by these events. The Commission functioned only in the discharge of its prescribed mandate; all conclusions reached are based only on the evidence gathered by it. Other forums at other times with different roles in our society might have occasion to consider some of these same events. These forums would do so under different rules of evidence and procedure. Such forums may indeed reach different results on their own records of evidence. Such is the basis of our judicial system and of the rights of free citizens to take their differences and grievances to court. It was one of the overriding concerns of this Inquiry to do nothing which might jeopardize such rights and any such proceedings. The Commission is indebted to all who appeared before it for their recognition of this distinction and this principle, and matters were not delayed or prolonged by any attempt to use the Commission for other or improper purposes.

Work of Other Bodies

The Commission derived great assistance from the opportunity to read the transcripts of the proceedings and reports of other bodies, Parliamentary, commission and otherwise. These are listed in Chapter 6. Again the objects and purposes of these bodies were quite different from those of the Inquiry. Matters of a general regulatory nature came up frequently and the work of others on such matters saved this Inquiry much effort and time and afforded helpful guidance.

Appendices

In the course of its deliberations, the Inquiry assembled a great body of fact and information about these two banks, their inspection, operations and ultimate collapse. It also accumulated a very large record concerning the supervision and reports of these banks from the public authorities. It was seen to save counsel time and effort to assemble, collate and distribute to counsel the details and outlines of this evidence at the conclusion of hearings and before argument. This was also hoped to clarify and expose the issues arising from all of these facts and thereby reduce the time required for the hearing of final argument. The Commission received suggestions for modifications of these collations from counsel appearing before it. These were considered, and accepted where it was felt appropriate. The summaries were then expanded in scope to provide background detail to those so interested. These summaries are found in Appendices C, D and E.

Similarly, the history of bank regulation in Canada was reduced to a summary which appears as Appendix A. Appendix B is a summary of the information compiled by the Commission on the supervisory and regulatory systems in the United Kingdom and the United States, and contains some reference to the treatment of similar bank failures in those countries. By a coincidence which was helpful to the Commission, but which could not everywhere be called a happy one, bank failures occurred in both the United Kingdom and the United States just before the failures here, and they followed a pattern and timetable remarkably similar. The Commission has drawn heavily on these vicarious experiences in communities not dissimilar to ours and, as will be seen in Chapter 6, has drawn upon some of the information and lessons found in Appendix B. Appendix F describes the expert evidence heard by the Inquiry about banking practices and the auditing of credit decisions. This appendix contains information upon which some of the recommendations are based.

Recommendations

All associated with this Inquiry have acknowledged throughout that its mandate carried it into a study of only about one per cent of the total Canadian banking industry. These were two small banks which had reached a state of development that had not carried them to national stature by the time of their liquidation. Conclusions built on this narrow base cannot be extended without caution and qualification to the whole banking scene. The major banks have come forward and discussed fully all the issues raised in this Inquiry, but of necessity, largely in the context of these two liquidations which formed the basis of the Inquiry's mandate. It is only the concluding part of that mandate that carries the Inquiry into broader issues of bank supervision and regulation.

In this aspect of the investigation the Commission was fortunate to have the evidence of Mr. William H. Broadhurst, a senior member of the Price Waterhouse executive in Canada, and an acknowledged leader of eminence amongst auditors, with bank audit experience over many years in this country; Mr. Alan J. Dilworth, nominated as its spokesman by the Canadian Institute of Chartered Accountants, a senior partner in Touche Ross, and a leader in the Canadian accounting profession; and Mr. Michael A. MacKenzie, a senior partner in Clarkson, Gordon, a firm long important in accounting and auditing in this country and himself an auditor with long and distinguished experience in the auditing of banks. It is with this outstanding assistance that the Commission is able to respond to a very important part of its mandate and to report upon some of the fundamental aspects of bank auditing and accounting that have been raised in these hearings. This support from the leaders of accounting and bank auditing was also essential to formulate a considered response to the great number of proposals made by the banking and accounting profession to this Commission. These matters form part of the recommendations in Chapter 6. These presentations by auditors, the major banks and the several government agencies were detailed, comprehensive and thought-provoking. The questions posed and answers proffered them provided much of the basis of the Commission's response to the second part of its mandate.

In the course of the Inquiry, the Commission was asked to exercise its powers under the *Inquiry Act* and defray the legal expenses of some parties who considered it essential to their self-interest to meet any statements and references made in the course of the Inquiry hearings which were perceived to be against their interests. Some requests were rejected outright and others were set aside until the Commission could be satisfied that it was important to its work to have the party in question present and represented by counsel, and that fairness justified compensation for reasonable legal expense. Eventually arrangements were made, with express limits, for the former senior management of the two banks to be represented by counsel on this basis during the concluding part of the Inquiry.

Some matters were raised in respect of which the Commission declined to take evidence or to hear submissions. Other matters, such as the competing interests between provincial securities exchange regulators and federal bank regulators, were dealt with incidentally to one of the main issues: the adequacy of response in the supervision of these banks by the office of the Inspector General. Still other matters, such as deposit insurance limits, were clearly not within the mandate but were the subject of several serious proposals. The Commission expresses its views on these matters to the extent that they were the subject of evidence so that those directly concerned with such matters would be aware of the record accumulated by the Inquiry. Finally, the influence of a policy of full insurance coverage on the element of self-discipline by creditors of the bank and on the practice of aggressive deposit-raising tactics by banks is discussed as being within the perimeter of the Order in Council.

The Scene in Western Canada during the Career of these Banks

The Inquiry opened with a great avalanche of evidence concerning the extent and depth of the recession in Alberta and British Columbia. This was to be a subtheme throughout the hearings. The expert evidence was all relevant to the issues and demonstrated a phenomenon not limited to Western Canada.

> Through the 1970s and into the early 1980s, few ... expected the good times to end. Employment growth during the 1970s was double the national average. Perpetual prosperity was at hand.

This sounds like Alberta but was written in July 1986 about banking in Colorado, a region not unlike Alberta. A great many other factors remained to be investigated but the intervention of a partly induced, partly cyclical economic slow-down in the tradition of the principal commercial and industrial activities of the region, formed a foundation upon which this drama was played out. What follows is a study of the relationship between this background condition and the many other elements in the story of these two banks.

Chapter 3

Banks and Bank Supervision in Canada

Chapter 3

Banks and Bank Supervision in Canada

A. INTRODUCTION

To appreciate fully the evolution of circumstances leading to the cessation of operations of the Canadian Commercial Bank (CCB) and the Northland Bank, it is essential to examine the basic components of the Canadian banking system and to understand the overall framework of Canadian bank supervision and the responsibilities of those involved at all levels of the Canadian supervisory system. Those involved include various officers and directors of the two banks whose collapse has been the principal focus of this Inquiry, several audit firms engaged by one or other of these banks in recent years, federal agencies and officials with statutory authority relating to all aspects of banking from inspection to investor or depositor protection and provincial agencies concerned with the issuance of and trading in bank securities. Certain U.S. regulatory authorities were also involved in supervisory activity relating to the CCB.

The evolution of Canadian banking and bank regulation is a complex and continuing process. Readers desiring further information on the historical background are referred to Appendix A of this Report. More detailed information concerning the United States and United Kingdom banking regulatory systems, including recent proposals for change, is set out in Appendix B to this report. References to these systems are hereafter made for comparative purposes and to assess some of the proposals which have been made for the improvement of Canadian banking regulation. Recommendations by the Commission for changes to current Canadian regulatory arrangements are presented in Chapter 6.

B. BANKS

1. Overview of Canadian Banking Industry

The *Bank Act* governs the operation of the Canadian commercial banking system. Since 1980 the legislation has provided for two kinds of banks known, according to their designation in appendices to the statute, as Schedule A or Schedule B banks. Only these institutions are "banks", and allowed to describe their business as "banking".

The distinction between Schedule A and Schedule B banks is established by s.5 of the Act. A Schedule B bank is a closely held bank without restriction on the number of shares held by any one person, Canadian or non-Canadian, resident or non-resident. Schedule A banks are widely held: no one may hold more than 10 per cent of the voting shares, and not more than 25 per cent of any class of shares may be held by non-residents. The letters patent or special act establishing any bank provides whether it is an A bank or a B bank. Certain restrictions have been placed upon B banks. For instance, B banks may not, without specific authorization, have more than one branch office and all branches must be in Canada; they may not have domestic assets exceeding 20 times their capital if the voting shares held by one person, or by all non-residents, exceed 10 per cent of all issued voting shares; and foreign-owned B banks may not own collectively more than 16 per cent of the total domestic assets of all banks in Canada.

At 31 October 1984, the last financial year for Canadian banks prior to the cessation of operations of the CCB and Northland Bank, thirteen Schedule A banks were in existence. These banks are listed in Table 3.1 together with information concerning their authorized capital and head office location.

Table 3.1

SCHEDULE A BANKS

Form of Name of Bank	*Class of Shares*	*Authorized Capital (Dollars)*	*Head Office of the Bank*
Bank of Alberta	Common	50,000,000	Edmonton
Bank of British Columbia	Preferred	75,000,000	Vancouver
	Common	250,000,000	
Bank of Montreal	Class A Preferred	1,000,000,000	Montreal
	Class B Preferred	250,000,000	
	Common	200,000,000	
The Bank of Nova Scotia	Preferred	1,000,000,000	Halifax
	Common	1,500,000,000	
Canadian Commercial Bank	Class A Preferred	100,000,000	Edmonton

Table 3.1—*Concluded*

Form of Name of Bank	*Class of Shares*	*Authorized Capital (Dollars)*	*Head Office of the Bank*
	Class B Preferred	1,000,000,000	
	Common	100,000,000	
Canadian Imperial Bank of Commerce	Class A Preferred	750,000,000	Toronto
	Class B Preferred	750,000,000	
	Common	3,000,000,000	
Continental Bank of Canada	4 1/2% Pref.	3,500,000	Toronto
	5 3/4% Pref.	11,500,000	
	Class A Preferred	150,000,000	
	Common	100,000,000	
The Mercantile Bank of Canada	Class A Preferred	100,000,000	Montreal
	Class B Preferred	100,000,000	
	Common	100,000,000	
National Bank of Canada	First Pref.	300,000,000	Montreal
	Class A Convertible Preferred	49,600,000	
	Class B Preferred	300,000,000	
	Common	100,000,000	
Northland Bank	Preferred	35,000,000	Winnipeg
	Common	100,000,000	
The Royal Bank of Canada	First Pref.	1,250,000,000	Montreal
	Second Pref.	1,250,000,000	
	Common	3,000,000,000	
The Toronto-Dominion Bank	Class A First Pref.	625,000,000	Toronto
	Class B First Pref.	625,000,000	
	Common	2,000,000,000	
Western & Pacific Bank of Canada	Common	21,000,000	Vancouver

Fifty-nine Schedule B banks came into existence between the time of the authorizing legislation in 1980 and financial year end at 31 October 1984. Only one of these Schedule B banks was a domestic bank. In 1985 it merged with another Schedule B bank.

2. Internal Operations and Statutory Responsibilities

a. Directors and Officers

The *Bank Act*, in addition to establishing the legislative basis for the formation of banks in Canada, contains provisions respecting their operation. These provisions confer certain powers and impose duties on persons associated with bank management. Subject to the *Bank Act*, the directors are to manage the business and affairs of a bank. The *Bank Act* does not specify minimum or maximum numbers of directors; nor does it require the board to include representatives of particular groups or constituencies.

The directors are required to designate one of their number as chief executive officer and, where authorized by the by-laws, may appoint committees of the board and may delegate to those committees any of their powers other than certain specified powers. It is the responsibility of directors to appoint officers to carry out the functions of a chief manager, a chief accountant and other officers to conduct the business of the bank. It may be said, in general terms, that the purpose of the board is to arrange for adequate management and to provide for its continuity, to represent the bank publicly, and to serve as the final policy-setting body of the bank. The day-to-day operations of the bank are carried out by management. In some banks, it is felt that the main burden of the directors' role is more effectively discharged by an executive committee which is able to meet more frequently than the full board.

In addition to an executive committee, the board may appoint other committees and is required by statute to appoint an audit committee. (The functions of this body are described below.) Regional committees have also been used to monitor and guide bank performance on a regional basis. Loan committees have been established at most banks. The mandate of a loan committee is typically to review all loans outside management lending limits, the bank lending policy, the loan mix, out-of-order loans, loans in arrears and all other related credit matters. The minutes of all meetings are circulated to the other directors. In some banks, the loan committee has delegated to it the full authority of the board to approve loans. In other banks, including the CCB, the loan committee possesses a certain lending limit, and the board itself possesses an even higher lending limit. It may also be the function of the loan committee to review loans above a specified amount, even such loans as were made within management lending limits. There are, however, banks which have very little delegation to committees of the board. It is clear that in Canada there is no standard pattern for the location in the corporation of the authority for loan approvals by management, or by the board or its committees. Nor is there any uniform process in Canadian banks for the monitoring of trends in relation to the control and management of the loan portfolio of the bank, except that in the major banks all board members are informed on a regular basis about the significant elements making up the loan portfolio.

In exercising their powers or discharging their duties, directors and officers are subject to a statutory duty of care owed to the corporation. Section 54 provides that they must "(a) act honestly and in good faith with a view to the best interests of the bank; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." The *Bank Act* also provides, however, that a director who relies in good faith on "(a) financial statements of the bank represented to him by an officer of the bank or in a written report of the auditors of the bank fairly to reflect the financial condition of the bank; or (b) a report of an accountant, lawyer or other person whose profession lends credibility to a statement made by him" is not liable for failure to discharge the duty of care.

Considerable importance is attached to the timely and reliable flow of information to directors. For example, an exhibit filed by the Bank of Nova Scotia indicated that directors of that bank receive the following information on a regular basis: the nature of the loan portfolio, reports on nonperforming loans and on all significant loans which are causing concern, statistics as to loan losses in regions, industries and classes of business, the nature of the funding of the bank, comparisons as to performance with other banks over relevant periods of time, and reports as to the performance of the national economy and its components.

b. Internal Inspection Systems

By their nature, banks are exposed to several major threats to the accurate reporting of financial results. These include recording and aggregation errors, inability to recover full value of all loans, taking interest and fees into income before receipt, and incorrect valuation of trading assets and liabilities such as foreign exchange. Canadian banks have developed control structures to monitor and respond to these risks. It is the internal inspection department which tests the reliability and operation of these control systems. The purpose of the inspection division is to provide the board and senior management of the bank with an independent perspective on the operations of the credit department and its loan authorization and loan management functions. Thus, the internal inspection division has two functions; to audit the quality of loans and to audit the bank's control structures. In some of the major banks these two functions are contained in the one department and in others they are separated.

Although operationally part of management, the chief inspector of a bank and the internal audit staff enjoy a measure of effective independence which leaves them somewhere between the board of directors and its audit committee and line management of the bank. This system, with variations in the individual banks, and while not required by the *Bank Act*, has become a part of the traditional structure of Canadian banks.

Particular practices as to the duties and organization in internal inspection departments vary from bank to bank. Thus the Bank of Nova Scotia has an internal audit system whose chief officer reports to the President but has a directive that if anything comes to his attention that is not satisfactorily resolved, it must be referred to the CEO, and beyond him, to the Chairman of the Audit Committee. All credits of $1,000,000 and over are examined by the senior credit audit department. At the Canadian Imperial Bank of Commerce, the Chief Inspector brings situations with which he is concerned to the attention of the Credit Division but he also has direct access to the Chief Executive Officer and direct access to the Audit Committee. He is instructed as part of his mandate to report to the Audit Committee and is regularly invited to attend at the Audit Committee. Evidence given by senior officers of other major banks demonstrates a comparable emphasis on the position of the Chief Inspector and the importance of his contribution in ensuring that a bank is not confronted with sudden surprises which threaten its financial stability. As Mr. Frazee, then Chairman of the Board of the Royal Bank, testified, the internal inspection department is the reason he could sleep at night.

c. *The Audit Committee of the Board*

In the absence of a Ministerial order providing an exemption, the *Bank Act* requires the directors of a bank to appoint an audit committee of the board. The audit committee is composed of not less than three directors. No member of the committee may be an officer or employee of the bank or any of its affiliates. The statutory duty of the audit committee is set out in s.243(3):

> The audit committee of a bank shall review the annual statement and any other financial statement of the bank that may be required by the by-laws to be submitted to the shareholders before such statements are approved by the directors.

While the establishment of an audit committee of the board is mandatory, the procedures followed by that committee vary between banks. Traditionally, it is the role of the committee to ensure that the bank has processes in place that ensure the production of accurate and reliable data, and to ensure that those procedures are functioning. The Chief Executive Officer of the Bank of Nova Scotia testified that the Audit Committee of that bank reviewed the internal control system of the bank, its loss provisioning and the management letter which the auditors customarily provide to the bank in connection with their annual audit. The auditors of the Bank of Nova Scotia present to the Audit Committee in reasonably broad detail the audit work done, the assumptions made, their views as to the adequacy of internal controls, their opinion as to loss provisioning and any other observations which they wish to make.

The Audit Committee of the Canadian Imperial Bank of Commerce also plays a key role in its affairs. Its meetings are frequent and deal with many details so that it actively examines the financial condition of the bank. In recent years, the Audit Committee met at least once a month and examined the loss provisions made for every significant account. Accounts are also reviewed by industry sector. There is a minimum requirement of four meetings per year.

In general the role of the Audit Committee at the Royal Bank is to ensure to the extent that it can that the auditing processes within the bank, both by the internal audit and the external audit, meet the criteria that a prudent director would normally expect. The Committee's written terms of reference direct it to meet from time to time with the internal and external auditors to discuss the scope of the annual and interim examinations made by the auditors and to review the controls, procedures and accounting practices of the bank. The Committee also reviews the audited financial statements, prospectuses, management plans for information systems, and recommendations with respect to the nomination and remuneration of auditors.

Generally speaking, audit committees do not get involved in individual loans. It is not within the terms of reference of the audit committee of any of the banks which appeared before this Inquiry (including CCB and Northland Bank) to consider loss provisions on individual loans (other than large and significant loans) or to consider whether a loan should be classified as unsatisfactory or given any particular status for the purpose of income recognition. However, the adequacy of the total level of loss reserves is assessed by the audit committee.

The work of the audit committee in all the major Canadian banks is closely related to the work of the external auditors who play an integral role in identifying any problems which the bank may have.

C. EXTERNAL AUDITORS

Since 1923 the *Bank Act* has required the engagement of two firms of accountants to serve as shareholders' auditors in a bank. By s.242 the primary duty of the auditors is to examine the annual financial statements prepared by management and to report to the shareholders as to whether such statements (which shall include the statement of assets and liabilities, the statement of income, the statement of appropriations for contingencies and the statement of changes in shareholders' equity) reflect fairly the financial position of the bank at the end of the financial year in question and the results of operations for the year under review. Where the examination has not been made in accordance with generally accepted accounting principles (GAAP) or was not prepared on a basis consistent with the prior year, the auditors are required to include such remarks as they consider necessary. The *Bank Act* further provides that:

> It is the duty of the auditors of a bank to report in writing, individually or jointly as they see fit, to the chief executive officer and chief general manager any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification, and without restricting the generality of the foregoing, they shall as occasion requires make a report to those officers with respect to
>
> (a) transactions of the bank that have come under their notice that, in their opinion, have not been within the powers of the bank, and
>
> (b) loans owing to the bank by any person the aggregate amount of which exceeds one-half of one per cent of the total of the paid-in capital, contributed surplus and retained earnings accounts of the bank, in respect of which, in their opinion, loss to the bank is likely to occur....

Such a report shall also be presented to the board of directors and to the Inspector General.

The reporting format for the annual financial statements to shareholders is prescribed by the *Bank Act*. The components of the financial statements are to be prepared in forms specified by particular schedules to the *Bank Act*. The accounting principles for banks prescribed by the *Bank Act* and by regulations from the Office of the Inspector General of Banks (OIGB) are different from generally accepted accounting principles, with which users of financial statements can be expected to have some basic familiarity. In Canada, GAAP have been prepared and are regularly modified by the Canadian Institute of Chartered Accountants. Some provisions of the *Bank Act* modify the application of GAAP to bank auditing. Other provisions of the *Bank Act* create additional accounting rules.

The statement of appropriations for contingencies is the most significant departure of bank accounting practices from generally accepted accounting principles. The appropriations for contingencies account is included in the "Capital and Reserves" section of a bank's balance sheet. Once a bank's actual loan loss experience for the year is known, the provision for loan losses is determined by calculating the ratio of the total loan loss experience to the total eligible loans outstanding for the current and four preceeding years, and applying this ratio to loans at the end of the current year. This figure is credited to appropriations for contingencies and charged to the income statement. The actual loan loss experience for the year is charged to the appropriations for contingencies account. This procedure has the effect of smoothing the annual charge to income for loan loss expense. Other entries to the appropriations account are transfers to and from the retained earnings account.

A typical certificate issued by bank auditors reads:

Auditors' Report
To the Shareholders, The Royal Bank of Canada

We have examined the consolidated statement of assets and liabilities of the Royal Bank of Canada as at October 31, 1985 and the consolidated statements of income, appropriations for contingencies and changes in shareholders' equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion these consolidated financial statements present fairly the financial position of the Bank as at October 31, 1985 and the results of its operations for the year then ended in accordance with accounting principles prescribed by the Bank Act applied on a basis consistent with that of the preceding year.

Touche Ross & Co.
Price Waterhouse
Chartered Accountants

Montreal, December 2, 1985

The Canadian Institute of Chartered Accountants is the professional body primarily responsible for establishing standards for the accounting and auditing profession in Canada. In the handbook published by the CICA for the guidance of its national membership, the certificate to be issued by auditors in approving financial statements generally reads as follows:

AUDITORS REPORT

. . . . .

In my opinion, these financial statements present fairly the financial position of the company as at _______, 19__ and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

City (signed)________________________
Date CHARTERED ACCOUNTANT

The Minister may under s.242 of the *Bank Act* require that the auditors report on the adequacy of bank control procedures, and the Minister may enlarge or extend the scope of an audit or direct any other or particular examination to be made, at the bank's expense. Such a review has never been directed, yet the existence of the power to so order distinguishes audit provisions in the *Bank Act* from other statutes dealing with corporate auditors and emphasizes the public interest in the well-being of the banking industry.

The work of bank auditors is of particular importance to the OIGB, the principal government agency in the field of bank supervision. Access by the OIGB to the work of the auditors comes about in three ways: (i) the OIGB may under s.246(5) contact a bank's auditors to obtain clarification on matters coming to its attention and concern; (ii) the OIGB meets with the auditors during the annual inspection of each bank to discuss accounting policies of the bank and bank procedures; and (iii) the OIGB relies on the financial statements as certified by the auditors.

There is some imprecision in the present *Bank Act* in establishing either the right of the Inspector General to consult with and to obtain information from the auditors, or the right of the auditors to communicate their concerns and advice to the Inspector General without breach of their statutory or professional duty. On the other hand, the OIGB relies on the auditors in the great bulk of its work in the credit evaluation area, that is, in assessing the value of the loan portfolio of a bank. Whether specific loan provisions are adequate, capitalizing of interest is justified, and accrual and recognition of fee and interest income is appropriate, are matters left to the auditors. Additionally, although the OIGB will review the stated policies of the banks and on occasion issue guidelines, it is left to the auditors to ensure that stated policies are adhered to and that the control systems within the bank are effective and applied.

On the other hand, the auditors do not give an opinion specifically directed to these matters. Section 5000.01 of the CICA Handbook explains in relation to the standard opinion language that: "... such an opinion is not an assurance as to the future viability of an enterprise nor an opinion as to the efficiency or effectiveness with which its operations, including internal control, have been conducted." The auditors state that their function is to seek reasonable assurance that the financial statements taken as a whole are not materially misstated. Further, audit procedures are designed on the assumption of management's good faith, subject to the exercise of the auditor's professional judgment as supported by examination and outside assistance as required.

In practice, the determination of whether there has been compliance with bank procedures is generally left to the internal inspection function of the bank. The auditors participate in the planning of the internal inspection department inspections and assess the adequacy and quality of the inspection department in order to assess the results of the internal inspection. This sequence in turn leads the auditors to their decision whether to rely on the inspection department. In the Northland Bank the auditors did not initially rely on the internal inspection department at all, and never developed the state of reliance and cooperation seen in the major banks.

In the credit area, auditors have recognized that they are not bankers. Therefore, the taking of provisions for anticipated losses and the propriety of the capitalization of interest and of the accrual of interest are the preserve of management. The auditors' role here is to assess the reasonableness of management's judgment. The auditors do not review all loans in the bank; nor do they necessarily review all the actual loan files. The review of loans selected by the auditors may not go beyond an examination of board sheets or loan summaries prepared by bank management. Of course, auditors do exercise independent judgment. For example, one experienced bank auditor testified:

> When an auditor reviews any doubtful loans to which management has already made a judgment, it is my view that the auditor must be prepared, based on his own judgment, and within the context of his overall view of the loan provisioning in that organization, to disagree with the judgment of management and to consider the need for a qualification of accounts if an increase in the specific provision that he feels is necessary is not made and it is material.

It is clear that the Inspector General, in discharging his duty under the *Bank Act* to examine and inquire into the business and affairs of each bank, relies heavily upon the external auditors of the bank for financial information relating to the bank's operations and particularly relating to the state of the loan portfolio. The external auditors in turn rely upon the management of the bank who prepare and present in the first instance the financial statements for the period from time to time being reported upon. The external auditors also rely, in varying degrees according to their discretion, on the internal audit or inspection system of the bank. The internal inspection system, with some very few exceptions, in turn looks to management for assessment of loan loss provisions, valuation of loans and related matters. Thus it can be said that the inspection system is founded upon information presented by the management of the bank which drifts upwards through inspection and audits until it reaches the Inspector General in the course of his supervisory function.

Where auditors do have concerns about bank practices, it is expected that they will express them to the Inspector General. This occurs in the course of the annual inspection of each bank. Further, the auditors' Memorandum for Discussion with the audit committee (if any) is available for review by the Inspector General. It is a part of the Inspector General's inspection to review the minutes of the board meetings and of the audit committee meetings. It has not been the practice of the Inspector General to meet with the audit committee of the board of directors.

In the course of the Inquiry, various parties were asked for an opinion why the *Bank Act* provides for dual auditors. Although each firm takes overall responsibility for the audit, the workload is allocated between the two firms. Auditors believe that the dual audit system ensures that conflicts of interest can be accommodated; that is, where a borrower is a client of one auditor, the other auditor is available to review the loan file. They also believe it promotes the independence of the auditors because the auditors, when challenging the financial statements prepared by management, speak with two independent voices. The developing practice in the banks is to retain a lead auditor on a continuous basis and alternate the second auditor on a two-year roll-over basis. This is consistent with the *Bank Act* and, according to the evidence, has been adopted to produce considerable efficiencies and savings in expense and management time. However, the practice does weaken, somewhat, the argument that independence of the auditors is reinforced by the dual system.

D. INSPECTOR GENERAL OF BANKS

1. Responsibilities of the OIGB

The primary responsibility of the Office of the Inspector General of Banks is set out in s.246 of the *Bank Act*: the Inspector General is responsible to the Minister of Finance generally for the administration of the Act and has the status of a deputy minister. He is obliged by the statute to inquire into the affairs of each bank at least annually so as to satisfy himself that the provisions of the Act regarding the safety of the interests of depositors, creditors, and shareholders are observed, that other provisions of the Act are observed, and that the bank is in a sound financial condition. The Inspector General reports in writing to the Minister at the conclusion of each annual examination.

2. Organization and Staffing of the OIGB

The Inspector General is an officer of the Department of Finance appointed by the Governor in Council on the recommendation of the Minister in whose opinion the nominee "has had proper training and experience to be the Inspector General of Banks". At the time here in question the Inspector General was a career public servant with experience in the Department of Trade and Commerce and the Department of Finance, as well as a period on secondment to the Royal Commission on Banking and Finance.

The personnel of the OIGB are members of the Public Service of Canada and, as such, their employment and remuneration are governed by the regulations applicable to the civil service generally. However, the cost of operations of the Inspector General's office is borne by the banks chartered under the *Bank Act* by an annual assessment based on their individual average total assets. At 31 March 1984, the last fiscal year end of the OIGB prior to the implementation of the CCB Support Program, the actual strength of the office was 29 persons, including 14 classified as inspectors, analysts or equivalent. These officials were responsible, at that time, for the supervision of some 70 banks. Table 3.2 presents information on the size of the OIGB for the period 31 March 1977 to 31 March 1986.

Table 3.2

OIGB STRENGTH 1977 – 1986

As at March 31	*Actual Strength*	*Analyst/Inspector/ Equivalent*
1977	7	N/A
1978	13	6
1979	16	8
1980	18	8
1981	20	11
1982	19	9
1983	28	12
1984	29	14
1985	35	17
1986	48	21

For about half a century, from 1925 to the mid-1970s, there were never more than eleven banks licensed to operate in Canada. Some new Schedule A banks, including the CCB and Northland, came into operation in the mid-1970s. Shortly after the 1980 *Bank Act* revision, 60 Schedule B banks were introduced into the banking system. As Table 3.2 indicates, no significant increase in the inspection staff of the OIGB occurred. Only six inspectors were added between 1981 and 1985.

Staff size is of some importance in relation to the matters before this Inquiry for the Inspector General has in the past requested and has been denied by the government increases in staff as the responsibilities of the OIGB expanded. For example, on 11 May 1982, in an appearance before the House of Commons Standing Committee on Finance, Trade and Economic Affairs, the Inspector General said:

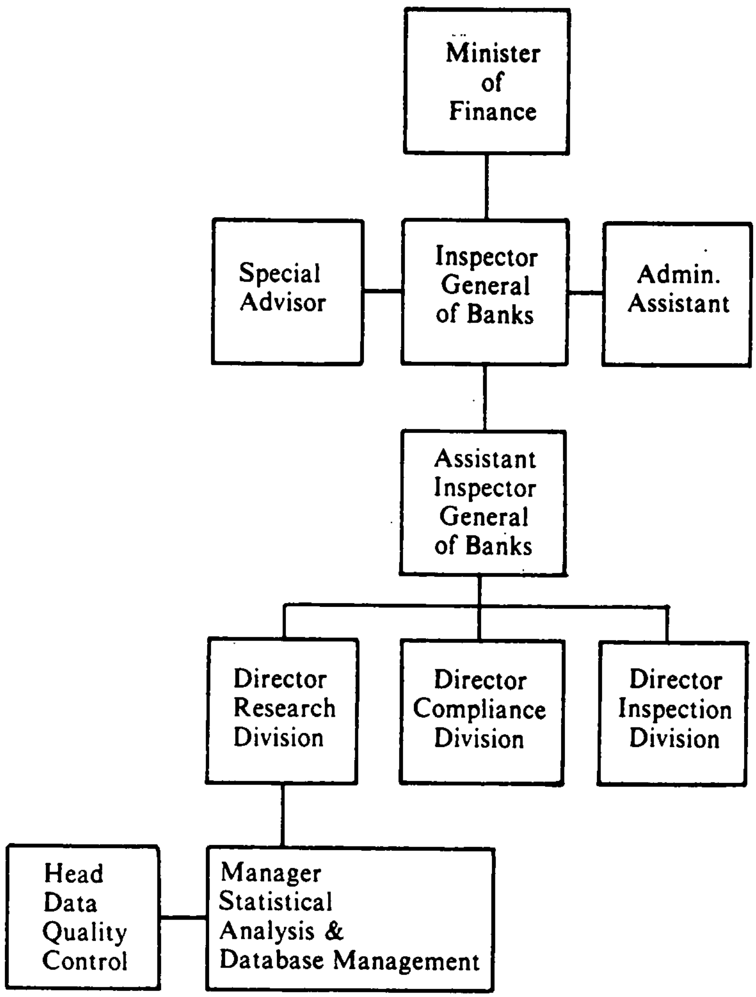
> The staff is too small. It is too small in the structure of the responsibilities we have been given under the new *Banks and Banking Law Revision Act* of 1980; in terms of an enormous increase in the compliance responsibility under the legislation; in response to the chartering of the number of new banks; and in terms of the monitoring of this rapidly expanding and complex system.

On the same occasion the Inspector General did express the view that the existing staff was sufficient to "monitor adequately the general health of the banks and of the system", although it would be "extremely difficult" to do so.

The OIGB is organized in three divisions corresponding to the principal functions of the office: research, compliance and inspection.

Table 3.3

ORGANIZATION CHART
OFFICE OF THE INSPECTOR GENERAL OF BANKS
1 April 1985



a. Research Division

The Research Division has five principal functions: general research and analysis, prudential policy development, tax and accounting policy development, statistical analysis and data base management, and the early detection of problem banks. The Research Division analyses the returns required of the banks, and is also responsible for the maintenance of an "early warning system", which is intended to identify those banks requiring special attention because of emerging problems and to detect unsatisfactory trends in the industry.

b. Compliance Division

This Division, as the name suggests, performs an enforcement role. Specifically, the Compliance Division must ensure that banks and others are complying with banking legislation and related regulations by developing and enforcing appropriate standards, policies and procedures. The Division will recommend and carry out the imposition of approved directives to the banks and direct the taking of legal proceedings, if necessary, in cases of noncompliance. The Division maintains contact with senior officers of banks, legal counsel, accounting firms, officials of federal and provincial government departments and private sector sources in order to ensure awareness of developments related to banks, individually or collectively.

c. Inspection Division

This Division plans, organizes and directs a program of continuous examination of the financial position and operating results of all the Schedule A and Schedule B banks pursuant to the *Bank Act*. The inspection provides the basis for the Inspector General's annual report to the Minister of Finance on the financial condition of each bank.

To carry out its work, the Inspection Division is required to develop standards, policies and practices for the conduct of examinations of all the banks. The Division may recommend, as required, the imposition of constraints on the activities of a bank or banks where inspections indicate that such action is necessary in the interest of depositors or shareholders.

3. Regulatory Procedures

The banking industry is regulated in four ways: statutory restrictions, regulations promulgated by Order in Council, ministerial regulations and directives, and guidelines issued by the Office of the Inspector General.

The *Bank Act* itself places statutory restrictions on the nature of the business that a bank may undertake. Apart from the duty of care placed on the directors of a bank, the Act does not regulate the manner in which business is conducted (that is, whether business decisions are prudent or imprudent). Banks are required by s.175 of the *Bank Act* to maintain adequate capital and liquidity, and the Minister of Finance may issue directives in relation to these matters. The effectiveness of such a directive, of course, depends upon the availability to the bank of such capital as may be directed and this will depend upon market availability or, in the case of a Schedule B bank which is a subsidiary, the strength of the parent organization.

The regulations deal with a variety of matters, including Banking Related Data Processing Services, Cost of Borrowing Disclosure, Financial Corporations, Guarantees, Insider Reports, Prospectus Requirements, and Venture Capital Corporations. The only regulations dealing with solvency and liquidity are the Reserves Regulations, promulgated by Order in Council pursuant to s.208 of the *Bank Act*. These regulations prescribe the primary and secondary reserves which a bank is required to maintain and the method of their calculation. These reserves are classified by the regulations either as primary reserves, which are interest free cash deposits with the Bank of Canada, or secondary reserves to be held by the bank itself in the form of, *inter alia*, treasury bills and day loans to investment dealers.

Guidelines of the OIGB fall into two classes: rules regarding the completion of statistical returns to the OIGB, and rules regarding the standardization of certain banking procedures. Most guidelines apply equally to all banks. Although the guidelines have no legal force, the banks have historically cooperated with the OIGB by complying with them on a voluntary basis. Some of the more important guidelines are discussed below.

a. Capital and Leverage

Capital adequacy and leverage, both of which terms describe the relation between the capital of a bank and its assets, are the subject of OIGB guidelines for Schedule A banks. These guidelines provide a definition of capital for regulatory purposes. They are relatively new, having been issued on 3 March 1983, amended on 19 December 1984, revised on 15 February 1985, and further clarified in a letter of 21 June 1985. The maximum leverage ratio considered appropriate by the OIGB is between 20 and 25; that is, a bank may have 20 to 25 times as many assets (principally outstanding loans) as capital. Capital adequacy standards are implemented on a bank-by-bank basis in the course of the discussions which take place at the time of each bank's annual inspection.

b. Prudential Lending Limits

There are also guidelines on prudential lending limits. The maximum exposure to individual or related borrowers is limited in relation to the capital of the bank. In 1983, Schedule A banks were limited to 50 per cent of capital for single or connected loans. Schedule B banks were allowed to go to 100 per cent in order to permit earlier attainment of profitability. More recent guidelines have developed a plan for varying the rule according to the circumstances of the bank. For example, the Northland Bank limit was 25 per cent subject to increase to 50 per cent in special circumstances.

The Inspector General also issues directions or suggestions to individual banks, usually after the annual inspection. For example, the Inspector General instructed Northland to limit the expansion of its loan portfolio in 1984-85. This direction or suggestion was disregarded, or more accurately defied, by the bank. The Inspector General's response was limited to proposing that a meeting be held with bank officers.

c. Nonperforming Loans

There is a guideline respecting disclosure of nonperforming loans. The *Bank Act* requires a statutory return of noncurrent loans, as defined in s.58(2) of the *Bank Act*, to the Minister. A noncurrent loan is one where no payment is received by the bank from the borrower, using the borrower's own funds, for periods specified in the statutory definition. The Inspector General has in the past recommended legislation strengthening this definition, without success.

The OIGB has recognized that other statistics regarding loans are useful in measuring the health of the bank. Hence, since 1982, banks have been required to report (in addition to the statutory report on noncurrent loans) unsatisfactory loans on a quarterly basis. In the past, it has been left open to banks to define an unsatisfactory loan, and such loans have been described and reported under various names and definitions by the several banks. As a result, there was some confusion as to whether the figures coming from the banks were comparable. In a statement on nonperforming loans in June 1984, the OIGB introduced a standardized definition of nonperforming loans, and prescribed the treatment of the recognition of income on such loans. All banks were required to follow the guideline set out in the paper for the 1985 fiscal year. This guideline offers a definition of a nonperforming loan, but leaves a discretion in the bank to determine whether a specific loan does or does not fall within the class. More details about this guideline are found in Appendix F.

d. Sovereign Loans

Many banks have engaged in lending to foreign governments. These loans are referred to as sovereign or country loans. Sovereign loans have been treated both by the Inspector General and by the banks as being quite different from domestic loans, and are subject to different accounting applications for the determination of reserves and other matters in connection with reporting these loans in financial statements of the banks. The OIGB has recently been involved in offering guidance to the banks regarding loss provisions on sovereign loans as a class (and not on an individual loan basis) and the accounting treatment of such provisions in the bank's financial statements. There is no similar guideline in relation to domestic loans since it is felt by the Inspector General that such a guideline may tend to become a substitute for the judgment of senior management.

Sovereign lending was never a significant activity in CCB. A large percentage of Northland's early loans were made to foreign countries, but the proportion of such loans diminished after 1979, and by 1985, represented only $37.5M of the $1.2B loan portfolio.

4. The Bank Inspection Process

Bank inspection is a two-stage process. First, banks submit responses to a pre-inspection questionnaire. This questionnaire, in the case of domestic banks, is tailored to each bank, and will cover individual loans, bank organization, off balance sheet liabilities, dealing in foreign exchange markets, and any other matter of concern to the inspectors. On the basis of the questionnaire and information already available to it, the OIGB produces a pre-inspection report. This document provides a guide or agenda to the inspectors for the consideration of the various concerns the OIGB may have in relation to a particular bank. The inspectors are now concerned principally with capital adequacy, asset quality, management quality, earnings, and liquidity. This review system is sometimes referred to as CAMEL.

Through 1982 and 1983, the reported data were analyzed within the OIGB on a semi-mechanical or manual basis. The analysis was focused on the annual inspection and formed the basis of the pre-inspection reports prepared in advance of the on-site examinations of banks. The analyses employed many of the same ratios which are part of the Early Warning System, and underlay the conclusions and judgments reached concerning the condition of the bank under review. Due to the fact that much of the data analysis was done manually, it was not feasible at that time to make comparisons at as many points in time as is possible in a electronic system. A revised mechanized Early Warning System supplanted the manual methods during 1984. The ratios produced by this system are based on the same data submitted during 1982 and 1983 which were used in the manual analysis. The complete conversion of the analysis of data in the OIGB and the Early Warning Systems, to an electronic basis, has now been completed.

Following completion of the pre-inspection analysis, two or three inspectors (depending on the size and nature of the bank) undertake an on-site inspection at the head office of the bank. The inspection lasts between one and four days, and consists of discussions with senior officers of the bank, with the heads of various divisions of the bank, and with the external auditors. The inspectors also review minutes of the board of directors' meetings to ensure that management is providing the directors with the information necessary for them to fulfill their responsibilities. In the case of domestic banks it is customary for the Inspector General or the Assistant Inspector General to join the inspectors prior to the completion of the on-site investigation.

A Post-Inspection Report is then prepared, and the appropriate opinion is sent to the Minister. The Post-Inspection Report has been considered by the OIGB to be an internal document, and unavailable to the auditors, to bank management, or to the directors. At the time of the Inquiry, this policy was under review by the OIGB. Beginning with inspection reports prepared in 1984, the Inspector General rates each bank on a numerical scale on the basis of its inspection.

In the course of the year, any concerns which the inspectors may have, will be dealt with by communication with the various banks, as required. Such communication may also relate to information obtained through an informal network, including foreign regulators and other government departments, or through scrutiny of the returns provided to the OIGB by the banks periodically throughout the year.

The main character of the inspection system, according to the OIGB, is reliance on the two external auditors of each bank. The efficiency of, and compliance with, internal control systems of each bank is left to the internal and external auditors for evaluation. The OIGB does not test internal control systems of banks, compliance with stated policies, or the value and regularity of the loan portfolio (at least until 1985). The OIGB acquires piecemeal evidence of various practices going on in the banks, but the office does not have the resources to examine the component loans in the entire portfolio. The acceptance of financial statements as reported on by the auditors is a fundamental part of the inspection process, and the notes to the financial statements are relied upon to determine what policies govern the business of the bank.

As a result of the CCB experience of March 1985, the OIGB has decided to engage retired bankers to conduct inspections of the component loans in the loan portfolio. As of January 1986, the OIGB employed seven retired bankers under contract, and had engaged by secondment one active banker from the staff of a Schedule A bank whose function is to train inspectors rather than to inspect on-site himself. This team has been to a few of the banks, and is expected to visit every bank. Whether this is to be done annually in all banks has not yet been determined. The OIGB also plans to commence review of the auditors' working papers.

5. Reliance and Accountability in Canadian Bank Supervision

The Canadian system of bank supervision rests upon the separate performance by management and the directors, the external auditors, and the OIGB of their respective duties, and upon the relationship and interaction between them. These interrelationships, and in particular the extent to which any party may reasonably have relied on the conduct of the others to support or sanction its own judgment on various matters of concern to the safety and soundness of a bank, have been particularly controversial throughout the Inquiry. The importance of suitable means to ensure accountability and the need to adapt those means to an efficient supervisory system will be central to the recommendations set out in Chapter 6. Here it is sufficient to illustrate the divergence of views put forward at the Inquiry by reference to the submissions of counsel for several of the participants on this basic issue.[7]

Counsel for the OIGB stated in final argument:

> In assessing both the system and the conduct of those responsible for its implementation, it is important that we put this whole problem in the context in which the system was understood. For a number of years in this country, up until recently, it was assumed by the public and Government of Canada, that the Inspector General of Banks could and should rely on audited financial

statements and financial data reviewed by auditors, and it was assumed and understood that the Inspector General did not have adequate resources and personnel to perform independent analysis to show that that reliance was justified. And so, in my submission, it was no part of the responsibility of Mr. Kennett or other members of the office to second-guess the basic structure that was in place for them.

Counsel for the CCB auditors stated:

However, it is submitted that to characterize the auditors as the pivotal point or cornerstone of the system, or to say that the main character of the bank regulatory system in Canada is its reliance on the two external auditors, overstates the role of the auditors as part of the regulatory system, (as opposed to their function as auditors for the bank and its shareholders) and understates the role of the Inspector General of Banks. It is the Inspector General who has the ongoing duty to review the financial condition of banks, the full power to review all of the records and activities of a bank at any time and to take steps to enforce the provisions of the Bank Act as required.

Counsel for the Northland Bank auditors stated:

We submit that the auditors' responsibility is limited by law and practice to an opinion on whether the financial statements of Northland Bank present fairly the financial position and operating results of the bank in accordance with prescribed accounting principles. Absent specific additional responsibilities under the provisions of the Bank Act, or as agreed with management, the auditors had no other responsibilities or obligations.

Counsel for the Bank of Nova Scotia and the Canadian Imperial Bank of Commerce stated:

A basic thrust of this submission is that these failures occurred largely because the two banks in question departed from the practices which have made the Canadian banking system stable and successful over such a long period by assuming excessive risks and that the system of governance employed by them was defective. It will also be submitted that the experience of these banks and the regulatory systems of other countries shows that there is no magic formula which will minimize the risk of failure. Rather it will be submitted that the stability of the system must depend largely on establishing a form of corporate governance which will lead to prudent management supplemented by a regulatory scheme designed to ensure that early remedial action is taken when this is not present. It will be submitted that the evidence demonstrates that the beneficial effect of regulation is limited as ultimately the safety of the system must depend on the management and the directors of banks.

Counsel for the Directors of the CCB stated:

Of all those with responsibilities concerning the financial information of the bank (the board, the auditors, management and the OIGB) only the board of directors has no hands-on role in performing or inspecting the valuation, accounting and other processes which culminate in the preparation of the financial statements. The board must rely on its officers, employees, auditors, lawyers, regulators and other professionals who prepare and explain the

> reports tabled before them. In deciding to approve the financial statements, directors must discharge their duties to act reasonably, in good faith and with a view to the best interest of the bank, but in doing so are expected and entitled to rely on information and opinions provided to them by others.

Before turning to the analysis of events surrounding the cessation of operation of the CCB and Northland, several other agencies or institutions require brief descriptions.

E. THE DEPARTMENT OF FINANCE

The *Bank Act* vests in the Minister of Finance certain powers including the power to revoke the appointment of auditors (s.239(1)), to require auditors to report on the adequacy of procedures adopted by banks for the safety of creditors (s.242(1)), to enlarge the scope of the audit (s.242(2)), to dispense with the audit committee of the board of directors (s.243(2)), to require a bank to furnish "such other information at such times and in such form as the Minister may require" (s.229), and to authorize an examination or inquiry when it is believed that an offence under the *Bank Act* has been committed (s.246(4)). The Minister also has authority to issue written directives to a bank in relation to capital adequacy and liquidity (s.175(1)). The Minister is required to appoint a curator to supervise the business and affairs of a bank which suspends payments in Bank of Canada notes of any of its liabilities as they accrue (s.278(1)) and may make such an appointment if the Inspector General reports the opinion that a bank will not be able to pay its liabilities as they accrue (s.278(2)). All such powers are exercised on the basis of factual evidence, or reasonable cause for concern.

The Minister of Finance, in the present Government, delegated his responsibilities for the administration of the *Bank Act* to the Minister of State (Finance). By letter dated 5 October 1984, the Minister of Finance authorized the Minister of State (Finance):

> Subject to such directions and guidelines as I may give you from time to time to exercise the powers, duties and functions of the Minister of Finance under the statutes administered under my direction by the Department of Insurance and the Inspector General of Banks.

All parties before the Commission assumed that there are no legal impediments to such delegation. In practice, delegation has often entailed joint action under the *Bank Act* by the two Ministers while, as the Minister of State (Finance) explained, "the ultimate responsibility remains with the Minister of Finance."

The Deputy Minister of Finance serves as the administrative head of the department. The OIGB is a branch of the Department of Finance and the Inspector General has the status of a Deputy Minister with a statutory reporting accountability to the Minister of Finance. In practice the Inspector General reports to the Minister of State (Finance).

The Minister of State (Finance) relies heavily, as to bank matters, on the Inspector General who has extensive contact with other officials in the Department of Finance, particularly in the Financial Sector Policy Branch. In effect, the Inspector General runs the day-to-day business of administering the *Bank Act* and the Minister's attention is ordinarily restricted to policy decisions. In making such policy decisions, the Minister derives assistance from the Inspector General, from the Capital Markets Division of the Department of Finance, and from personal staff, although members of these two latter groups do not, at least at present, have banking backgrounds.

Both Ministers testified that the Inspector General is intended to have a measure of independence from the Ministry to insulate him from purely political considerations. This flows from the fact that the Inspector General holds office during "good behaviour". The independence is intended to enhance the quality and objectivity of the advice on which the Ministers rely.

F. THE BANK OF CANADA

The Bank of Canada undertakes a number of distinct tasks as the nation's central bank. One of these tasks is to act as the fiscal agent for the Government of Canada. In this role, it advises on and manages the national debt. The Bank of Canada also advises on exchange market matters, manages the country's international reserves and buys and sells foreign exchange in accordance with the Government's policy regarding intervention in the exchange market.

In its other roles, the Bank of Canada acts as principal. The Bank of Canada's primary function is formulating and implementing monetary policy. The Bank of Canada also acts as banker to the nation's banking system, and serves as a source of liquidity support under certain conditions.

There are essentially two types of situations which call for liquidity support from the Bank of Canada. The first pertains to temporary advances, generally for a term of one day, which the Bank of Canada is prepared to provide, within certain limits, to chartered banks encountering shortfalls in their reserve balances as a result of unexpected payment flows associated with the daily cheque-clearing and settlement process. In addition, banks are required to maintain reserves at the Bank of Canada in accordance with s.208 of the *Bank Act*, and advances are at times required by the banks to meet these reserve requirements. Loans in this first category are sometimes referred to as ordinary advances.

The second situation concerns requests for extraordinary advances. In making extraordinary advances, the Bank of Canada provides special assistance to chartered banks which are experiencing difficult liquidity problems because of a loss of depositor confidence and are unable to meet deposit withdrawals from their own resources (for example, by selling liquid assets) or from additional deposits raised in the market at or near their usual rates of interest. The *Bank of Canada Act* (s.18(1)(h)) allows the Bank of Canada to make loans or advances for periods not exceeding six months. Such loans or advances may be renewed. Extraordinary advances are intended to prevent the failure of the particular institution which is illiquid but still solvent, and to preserve confidence in other deposit-taking institutions and the financial system.

The Bank of Canada is required by s.25 of the *Bank of Canada Act* to transmit weekly and monthly to the Minister of Finance a statement of assets and liabilities in a form which stipulates the reporting of advances to provincial governments and to "Members of Canadian Payments Association" which includes all banks. This information is published by the Government of Canada in the *Canada Gazette*. In this way, liquidity advances to members of the Canadian Payments Association are disclosed on an aggregated basis. Pursuant to s.232 of the *Bank Act*, information on individual banks contained in certain returns required from the banks, including Schedule J of the *Bank Act*, within which advances to a bank from the Bank of Canada are specifically set out, is published monthly in the *Canada Gazette*.

Accumulating the knowledge to assess the financial soundness and solvency of chartered banks is an integral part of the process of bank supervision. The Bank of Canada does not have the powers to undertake prudential supervision of banks; it does not have the power to demand information on a regular basis on the individual loan or deposit transactions of banks. As a result, the Bank of Canada has no bank auditors, no bank examiners and no personnel experienced in the inspection or supervision of chartered banks. The Canadian system of bank regulation and supervision, based on an information network of external bank auditors, internal bank inspection systems and bank managements, operates in conjunction with the Inspector General of Banks. The Bank of Canada's contact with the supervisory system is through the Inspector General of Banks. The system is designed to operate separately from the Bank of Canada, and the central bank must rely on the judgments that emerge from it. If according to these judgments a bank is solvent, then the Bank of Canada stands prepared to provide any liquidity support required although it naturally expects the borrowing bank to take action, as soon as possible, to reduce its reliance on Bank of Canada advances. Neither the *Bank of Canada Act* nor the *Bank Act* specifies this policy in precise terms, but the Bank of Canada and the OIGB together adopted a practice in connection with these two banks whereby the Inspector General determined that the bank was not viable and would be insolvent in the absence of Bank of Canada liquidity advances, and in reliance thereon, the Bank of Canada then ceased to make liquidity advances.

It should be noted that the Bank of Canada and the OIGB maintain close and constant contact on an informal basis. The two offices share certain statistical data. The Bank of Canada makes available to the OIGB all qualitative and statistical information that it receives concerning individual banks. In addition, the Bank of Canada processes a number of statistical returns required by the OIGB pursuant to the *Bank Act*. However, the Bank of Canada does not process or receive returns showing information on individual loan and deposit accounts or any other prudential information pertaining to the operations of chartered banks. The Inspector General will naturally make available to the Bank of Canada his solvency judgments based upon the results of inspections conducted by or on behalf of the OIGB.

In recent years, the Bank of Canada has, on occasion, facilitated the arrangement of special lines of credit amongst Canadian chartered banks. Such lines of credit provide an indication of confidence in the bank that is provided with the special line of credit. In addition, it produces less publicity if a chartered bank arranges a special line of credit with other chartered banks rather than receiving advances from the Bank of Canada.

The role of the Bank of Canada in events surrounding insolvency, real or apprehended, in a bank is examined further in Chapter 6.

G. THE CANADA DEPOSIT INSURANCE CORPORATION

The Canada Deposit Insurance Corporation (CDIC) is a corporation created under the provisions of the *Canada Deposit Insurance*

Corporation Act, (*CDIC Act*) for the purpose, among others, of providing deposit insurance with respect to insured deposits with member institutions. Generally speaking, the CDIC insures deposits up to $60,000. However, because various types of accounts or deposits may constitute separate "deposits" for the purpose of deposit insurance, an individual may have insured deposits in excess of $60,000. The CDIC was also intended to provide emergency liquidity funding to deposit-taking institutions and to assist in improving the regulation of such institutions. This authority was not invoked in connection with either of these two banks.

The Chairman of the CDIC is appointed by the Governor in Council on the recommendation of the Minister of Finance of "a person of proven financial ability". The CDIC Board of Directors includes the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Insurance and the Inspector General of Banks or designated alternates, and the Chairman of the CDIC. Recent amendments to the *CDIC Act* provide for up to four additional members appointed from outside the public service.

While the CDIC is, for all purposes, an agent of the Crown in right of Canada and has the ability to borrow from the Government of Canada to meet current obligations, its ultimate source of funds is premiums from member institutions (virtually all of the federally-incorporated deposit-taking institutions and many provincially-incorporated deposit-taking institutions) together with their respective depositors. Thus, deposits made with them, to the appropriate limits, are insured by the CDIC. Premiums, formerly charged at the rate of one-thirtieth of one per cent of insured deposits, have recently been increased to one-tenth of one per cent.

The CDIC's rarely used power to make loans to member institutions for the purpose of reducing or averting a threatened loss to the Corporation is found in s.11(a) of the *CDIC Act*. The advances can be made where an institution requires liquidity support to avoid forced liquidation of assets. In some cases, advances were made where an institution had been closed and the Corporation was faced with paying the insured claims. In such a case, funds can be advanced after the institution has been closed to enable liabilities to be met as they come due. This approach (known as the "run-off" method) is taken where it is thought the cost to the CDIC would be less than putting the institution under formal liquidation and paying all the insured depositors at one stroke and also paying liquidation costs. This method can sometimes benefit uninsured depositors as well as insured depositors.

While the CDIC has the responsibility to insure deposits and to compensate depositors for the loss of their insured deposits in failed member institutions, it has only limited powers to prevent failures (particularly in the case of chartered banks) or to attempt to avoid future problems through inspection procedures or by regulation. Under s.21(1) of its Act, the CDIC is entitled to have the affairs of each Canadian chartered bank examined on its behalf by the Inspector General of Banks at such time as the Corporation may require, but at least once each year. The CDIC is not otherwise empowered to conduct any examination of a bank.

The CDIC is also entitled to "prescribe standards of sound business and financial practices" for member institutions and when it holds the view that a member institution is following unsound business or financial practices, the Corporation is required by s.24 of its Act to report the facts in writing to the president or chairman of the member institution. There is no clear guidance in the *CDIC Act* as to how such bank practices are to be discovered by CDIC. Nor is there any procedure for the issuance and enforcement of any corrective orders. For banks, at least, there is no other CDIC "regulatory" capability until a bank becomes insolvent or ceases to take deposits, in which case its insurance may be cancelled under s.27 of the Act.

For provincial institutions which are members of the CDIC the situation is different. The CDIC may select a person to inspect such an institution's affairs and may terminate (or, presumably, threaten to terminate) the deposit insurance for engaging in unsound business or financial practices, breaching a condition of the policy of insurance, or failing to remove unsound business or financial practices, or to remedy a breach of condition of the policy of insurance.

The CDIC's direct involvement in the matters before this Inquiry results from the fact that the Corporation was the insurer of many of the deposits made with the CCB and the Northland Bank. CDIC funds represented a significant component of the CCB support package in March 1985, and in the capacity of insurer the CDIC has paid several hundreds of millions of dollars to depositors in both institutions. The CDIC also commenced and successfully prosecuted the actions necessary to obtain the orders for the winding up of CCB and Northland under the *Winding-up Act* in the Courts of Queen's Bench of Alberta and Manitoba, respectively. The Corporation was appointed as Inspector under the winding-up proceedings for the CCB. The CDIC has been appointed as the agent of the Government of Canada for the purposes of the *Financial Institutions Depositors Compensation Act*, an Act proclaimed in December 1985 to provide compensation to all depositors in the two banks without the limitation applicable under the CDIC legislation. Estimates made as the compensation legislation proceeded through Parliament suggested costs to the Government of $875M, depending on the amounts to be recovered through liquidation.

H. DEPARTMENT OF INSURANCE

The Department of Insurance was established under the *Department of Insurance Act*. The Minister of Finance is the Minister responsible for the department whose Deputy Head is the Superintendent of Insurance. The latter, as noted earlier, is a member of the Board of Directors of the CDIC. The statute is not concerned with the regulation of banks and is briefly mentioned here only to facilitate understanding of matters later discussed concerning the inspection of financial institutions generally.

Where liquidity advances are made by the CDIC, the Corporation relies on the Superintendent of Insurance to examine and report on the federal trust companies and loan companies, and upon the Inspector General of Banks to examine and report on the banks. Section 251 of the *Bank Act* permits the Inspector General to disclose information to the CDIC. To examine provincial member institutions the CDIC has designated the Superintendent of Insurance. For this purpose, the Superintendent works in cooperation with provincial authorities in those provinces that have a field staff for examining provincial institutions.

From the time of its origin in the late nineteenth century, the Department of Insurance has had a field staff to examine the conditions and affairs of the institutions under supervision. The trust and loan companies came under the supervision of the Department of Insurance in 1920. The inspectors, in contrast to the Office of the Inspector General of Banks, evaluate the loan portfolio (consisting mainly of mortgage loans) of almost thirty trust and loan companies, employing for this purpose a staff of 40 or 50 inspectors in 1982. In addition, the inspectors are responsible for the examination of the affairs of between 450 and 500 insurance companies. All these examinations are undertaken by means of head office inspections carried out without prior announcement.

I. PROVINCIAL SECURITIES COMMISSIONS

Institutional arrangements regarding the regulation of bank securities and securities trading are relevant to the cessation of operations of the CCB and Northland Bank for several reasons. Each bank, in the months preceding its demise, prepared a prospectus in order to raise additional capital from public investors. The steps taken to attract new funding raise issues relating to an apparent tension in the regulation of financial institutions between depositor protection and the protection of the interests of shareholders or potential investors. Constitutional questions and practical considerations regarding interaction and communication between federal and provincial officials arise from the relationship between federal bank regulation and provincial securities regulation.

Part IV of the *Bank Act* regulates the distribution of bank securities. A bank may not distribute any of its securities unless a preliminary prospectus and a prospectus in a form substantially as prescribed by the Minister have been filed with the Inspector General. The Inspector General is under a duty to issue a receipt for a preliminary prospectus forthwith upon the filing of the document; however, where it appears to the Inspector that a preliminary prospectus in respect of which a receipt has been issued is defective in that it does not substantially comply with the requirements of the *Bank Act* and the regulations, the receipt may, under s.147, be withdrawn. The Act requires the Inspector General to issue a receipt for a prospectus filed with him unless it appears to him that the prospectus fails to comply in any substantial respect with any of the requirements of the Act or the regulations, or contains a misrepresentation or any statement, promise, estimate or forecast that is misleading, false or deceptive, or if it appears to the Inspector General that it would not be in the public interest to issue a receipt for the prospectus.

Section 148 of the *Bank Act* requires that a prospectus shall provide full, fair and plain disclosure of all material facts relating to the securities to be distributed, and shall contain such financial statements, reports or other documents as are required by regulations prescribed by the Minister under s. 146. After a receipt is issued, and before the completion of the distribution of the securities, any change relating to the distribution of these securities that could reasonably be expected to have a significant effect on the price of such securities, must be filed by way of an amendment to the proposed prospectus. Comprehensive regulations have been issued by the Minister of Finance for the approval of prospectuses under the *Bank Act*. The Act specifically covers both primary and secondary distributions of bank securities.

Provincial securities commissions are also concerned with the distribution of bank securities. For instance, both the *Ontario Securities Act* and the *Quebec Securities Act* cover any distribution of securities in those provinces, including those of chartered banks. The provincial statutes in many provinces require that there be full, true and plain disclosure in the prospectus. A preliminary prospectus must be filed. A preliminary receipt is issued for the document. Deficiency notices are given to the issuer where the provincial authority considers compliance with provincial law so requires.

In the case of a national filing, the various provincial securities commissions have agreed upon a policy of shared responsibility. The issuer selects one jurisdiction as the principal jurisdiction to act as the conduit for all communications going to and from the issuer. That jurisdiction has responsibility for the initial review of the document and for the comment deficiency letter. The other jurisdictions then have an opportunity to provide additional comments. These are collated by the principal jurisdiction, which prepares a second comment letter to be delivered to the issuer. The consolidation of all these comments in the second letter is produced by cooperation between the principal jurisdiction and the commenting jurisdictions.

Banks are not treated differently by the Ontario Securities Commission (OSC) or the Quebec Securities Commission (QSC) than any other issuer of securities except that in the course of clearing a prospectus, a copy of the comment letters is sent to the Inspector General. However, no formal procedures govern relations between the Inspector General and the provincial securities authorities. The OSC keeps the Inspector General informed of what it is doing. On the other hand, the pattern of the Inspector General's contacts with the OSC has varied over the years. For example, in 1984, the Inspector General provided copies of its correspondence with the issuer to the OSC. At other times they have not sent copies of their communications to the OSC. There appears to be no communication by the OIGB concerning the substance of specific deficiencies or other defects in prospectuses under process.

Hence, in the consideration of prospectuses, the provincial Securities Commissions and the OIGB are on separate and parallel tracks. The provincial Commission does not receive substantive information from the Inspector General to assist it in its assessment of the prospectus. The Securities Commission does not have any confidential information regarding banks. It takes the certified financial statements and the statements of the solicitors filing the document at their face value. The provincial Commission has no way of judging whether there has been a misrepresentation. Further, according to the current practice or course of dealing between the two bodies, the provincial authority is not aware of the OIGB's comments regarding prospectus deficiencies. Currently, the OIGB simply directs its requests directly to the filing solicitor. The Quebec Securities Commission asserts the right to be informed by the federal agency, the OIGB, of the inspection reports and other material, confidential and otherwise, received by the federal regulator.

The OSC is aware that the Inspector General receives confidential information through its inspection process. The Commission, therefore, takes comfort from the fact that the prospectus is approved by the Inspector General. Article 19(f) of O.S.C. Policy 5.1 provides that the OSC will not issue a final receipt in relation to a prospectus filed by a chartered bank unless the Inspector General has issued a receipt. On the other hand, the OIGB takes the position that federal bank supervisors are not responsible to attest to the accuracy of all information contained in a prospectus, but to ensure that the information called for by law or regulation is provided. The accuracy of the information is the responsibility of the issuer and, to some extent, the auditors and underwriters. Neither the OSC nor the OIGB, in most circumstances, make any qualitative or merit analysis of a prospectus. As noted above, the Inspector General may refuse a receipt for a prospectus if it is in the public interest to do so. The Ontario statute also includes some merit regulation which, according to testimony before this Commission, is only brought into play in very extreme circumstances.

The Ontario statute requires continuous disclosure of material changes. These are defined as any event that significantly affects the price of the securities in question. There is a requirement, under s.74 of the statute, to file a material change report and to issue a press release. Confidential disclosure is possible under s.74.

The conflict, real or potential, between the two levels of regulators of dealings in bank securities, is illustrated by the post-filing changes in the condition of the issuer. The Ontario Act permits the issuance of a waiver of disclosure of confidential material but such a waiver must be reconfirmed every ten days. The OSC assesses the request for confidential filing and decides whether the information may be made public. It has not been the practice of the OSC to allow a matter which ordinarily would call for disclosure to be kept in confidence on an indefinite basis; the objective is to get the information out as quickly as possible. This might raise serious concerns in the case of a bank bearing in mind its sensitivity to shifts in the level of public confidence. However, as long as the continued confidentiality can be supported, the information might never be released to shareholders or potential investors. The Quebec Act contains no provision for such confidential waivers. This issue will arise in full practical form if "cease and refrain" orders are authorized under the *Bank Act* as recommended in Chapter 6.

In his testimony before the Commission, Robert Steen, the Deputy Director of Corporate Finance for the OSC, took the position that disclosure to the investing public is the overriding concern, not the need for confidentiality respecting certain matters affecting banks.

The procedures of the QSC are similar in many respects to those of the OSC. The President of the QSC, Paul Guy, testified that the QSC has concluded that there is no reason to exempt banks from prospectus approval by securities commissions simply because such approvals may also be provided by the OIGB. Indeed, the QSC takes the position that it would be possible for it to decline to permit a bank issue in the Province of Quebec if it found the condition of the institution unsatisfactory on the basis of the financial statements or other public information, notwithstanding approval by the OIGB.

Legal proceedings under the Civil Code and an action for damages for false or misleading prospectus information were recently instituted by Quebec investors in connection with the CCB preference share issue in February 1985. The QSC has investigated the matter but its involvement in litigation has so far been confined to the issues of jurisdiction and the suitability of proceeding with the private actions in Quebec rather than in Alberta.

One final aspect of the law relating to securities transactions should also be noted. Section 358 of the *Criminal Code* sets out certain offences in connection with false prospectuses. The manner in which official investigations under this provision are carried out is relevant to the history of the CCB and the response of the OIGB to complaints dealing with alleged violations of the *Criminal Code*.

J. FOREIGN AGENCIES

The Inspector General maintains informal contact with foreign regulatory agencies, notably those of the United States. The contact serves two functions. First, when a foreign bank seeks to enter the Canadian banking industry by way of a subsidiary, the OIGB will seek confirmation from the home regulatory authority that the parent bank is in good standing. In some cases, the Inspector General will request more specific information. Secondly, when Canadian banks operate in a foreign jurisdiction, the local regulatory authority will acquire information from its inspections of the operations of the branch or subsidiary of a Canadian bank. That information may be communicated to the Inspector General.

In the case of CCB, both its L.A. Agency and its wholly-owned subsidiary, Westlands, were subject to supervision by various U.S. authorities at the state and federal levels. The FDIC and the FRB, whose general responsibilities are described in Appendix 2, were the principal agencies involved in supervision of the CCB. The OIGB was contacted on several occasions by U.S. regulators who forwarded information acquired in their inspections. Details of these contacts may be found in Chapter 4 and Appendix F.

During these contacts, the OIGB was informed of problems found in regard to management of the United States operations of CCB, and in regard to quality of the loan portfolios. Apparently both the U.S. federal regulatory agencies furnished copies of their 1984 reports to the Inspector General and to CCB. Neither the Inspector General nor the liquidator of CCB could locate and deliver copies of these reports to the Commission. It is the policy of the U.S. regulators not to release their reports to the public, directly or indirectly, and all copies of these reports apparently were returned to the U.S. agencies or destroyed by both the OIGB and the CCB, probably in accordance with a condition imposed by those agencies at the time of the delivery of these reports. The Commission is aware of the contents of some of these reports from other documents but has not seen these potentially important reviews of CCB produced in California in 1984 relating to the L.A. Agency and Westlands, the CCB subsidiary bank operation in California. This illustrates the complexity and delicacy of international regulation of banking institutions.

Northland Bank had no significant banking operations outside Canada which attracted foreign regulation.