Chapter 4

CCB and the Support Program: Commentary and Analysis

A. Causes of Collapse of CCB
   1. Weaknesses Inherent in the Original CCB Plan
   2. The Stewardship of Howard Eaton
   3. The Western Economy
   4. The California Operations
   5. Management's Response
      a. Accounting Strategies
      b. Need for New Capital
   6. State of CCB by Fiscal Year End 1984
   7. Events Leading to the Call for Government Support

B. The CCB Support Program
   1. Events Leading to the Adoption of the Support Program
   2. Inspections of CCB's Loan Portfolio
   3. Flaws in the Support Program
      a. Adequacy of the Support Package
      b. Treatment of Income from Support Package Loans
      c. Warrants
      d. Priorities on Insolvency
      e. Relations with the Major Banks
      f. Noninvolvement of the CDIC
      g. Failure to Replace Management
      h. Inspections
   4. The Hitchman Report
   5. Conclusion

C. Evaluation of the Supervisory Process

1. Management
2. Directors
3. Auditors of the CCB
4. The Inspector General
5. The Bank of Canada
6. The Minister of Finance and the Minister of State (Finance)

Chapter 4

CCB and the Support Program: Commentary and Analysis

This chapter contains commentary on the causes of collapse of the CCB, on the design and operation of the unsuccessful support program and on the conduct throughout the events in question of particular parties including the management and directors of the CCB, the external auditors, the Office of the Inspector General of Banks (hereafter, the OIGB), the Bank of Canada, the Minister of Finance, and the Minister of State (Finance). Appendices C and D set out in considerable detail a factual description of the evolution and eventual collapse of the CCB following an unsuccessful rescue attempt in the spring of 1985. Although the analysis is based upon the factual description certain descriptive material is repeated here for clarity and convenience.

A. CAUSES OF COLLAPSE OF CCB

During the course of the Inquiry, various possible explanations were put forward to account for the failure of the CCB. CCB's Chief Executive Officer (CEO) and President, Mr. G.W.C. McLaughlan, for example, listed seven principal elements as causes of the collapse of the bank:

1. The excessive concentration of the loan portfolio in two of the most cyclical industries, real estate and energy;

2. Excessive concentration of loan assets in Western Canada whose economy is based on natural resources;

3. The expansion program undertaken by the bank in 1980-81, which unfortunately coincided with the advent of a severe recession. The object of diversification was correct but it came at the wrong time;

4. Excessively large loans to individual borrowers in relation to the bank's capital base;

5. The decision taken in September 1981 to acquire 39 per cent of Westlands Bank in California;

6. The relationship between Mr. Leonard Rosenberg, and trust companies associated with him, and Mr. Howard Eaton, who was then the CEO of the bank; and

7. The inherent danger faced by a small regional bank in raising its deposits from the wholesale marketplace.

Although McLaughlan did not mention poor lending practices, other evidence suggests that CCB's credit granting procedures and policies led to the troubled loans which eventually became a deadly drag on the bank.

McLaughlan testified that the slide into liquidation became irreversible:

> It really started in 1983 ... Rosenberg was certainly the catalyst but it somehow masked the economic undermining of the bank that was occurring at that stage in terms of Western Canada and energy.

While McLaughlan subsequently came to the view that merger was the only solution to CCB's problems, he testified that this was not apparent to him until 27 February 1985. The following exchange concluded McLaughlan's testimony on this matter:

> Q: Why was the condition so deeply entrenched that it went two years before a banker of your experience realized it?
>
> McLaughlan: Because I had certainly concluded in terms of the U.S. energy loans, that the programs that had been in place were going to deliver the planned results. In terms of the balance of the problems in the bank's portfolio being primarily Western Canada, the recovery was underway and would have seen the bank slowly recover to respectable and stable profits. Until the U.S. energy loans collapsed I certainly thought we had reasonable chance of making it, a very good chance of making it. I felt very confident going into 1985 ...
>
> Q: And you might have recovered if either the western economy revived or the U.S. energy economy did not collapse?
>
> McLaughlan: Yes, I will answer that one without qualification.
>
> Q: So that is the history of the whole thing in two simple sentences?
>
> McLaughlan: It is a regional bank lending into two volatile industries with its deposit footings represented by again volatile depositors.
>
> Q: Could you say instead of regional bank a young bank?
>
> McLaughlan: Yes. I mean "region" just in the sense of concentration.

This section analyses the various hypotheses in light of the evidence presented to the Inquiry.

1. Weaknesses Inherent in the Original CCB Plan

As described in Appendix C, the sponsors of the bank perceived an opening or gap in the banking services provided in this country. CCB planned to operate as a commercial and wholesale bank on a national basis, and it would provide services related to merchant banking. The new bank would concentrate on commercial lending in a loan range described as mid-market. The founders believed, and Parliament was so informed, that the major banks did not cover this part of the banking spectrum where the loans were said to be riskier and indeed could not generally be obtained from existing lenders. The higher risks would be offset by a higher loan yield which in turn would permit the bank to finance itself through deposits from the wholesale money market at interest rates higher than those paid for retail deposits by Canadian banks in general. The bank learned well before its collapse that this plan was faulty. It attempted in early 1983 to shift its deposit base away from the uncertain and volatile wholesale market and deposit brokers to retail deposits taken through its own branches.

The evidence predominantly favours the conclusion that there was no market niche which had been overlooked by the existing banking industry. However, the four western premiers attending the Western Economic Conference in 1973 had urged the introduction of this very type of banking enterprise and received federal government encouragement. CCB's sponsors were congratulated by members of the Senate Committee on their initiative. The bank was seen in the West as well as by the federal government as being one which would "lend money where the established banks refused to lend". This was one part of the expectations of the founders which turned out to be true.

One possible answer to the question whether the need for the services CCB proposed to deliver to the community existed at the time of its inauguration has been suggested in the growth of the loan portfolio. However, it may not be satisfactory to conclude that the creation of a loan portfolio in excess of $2B within eight years of the bank's formation proves the existence of an unsatisfied demand for its banking services. The high proportion of unsatisfactory loans might indicate that in the conduct of its lending business, the bank artificially created this market for its services. In the circumstances it may be more accurate to say that CCB extended funding and banking accommodation to borrowers who did not have the will or the financial capacity to repay their loans.

The hazards of wholesale funding may not have been appreciated by CCB's founders in 1976. By 1983, at the latest, McLaughlan had

concluded, "It is a very dangerous practice for a small bank, and particularly a bank based in regional areas, as this one was, with cyclical industries underpinning its economy to be engaged in raising its deposits from the wholesale marketplace". There were no dissenters from this view at this Inquiry.

Presumably, the new Schedule A bank was able to make a fast start in the lending business by large scale wholesale funding which eliminated the expensive and slow establishment of a national retail branch network. The price paid for this quick expansion and the avoidance of a high capital layout for a branch system was vulnerability to large-scale withdrawal of deposits in the downswings of the economic cycles, with critical consequences. Perhaps in earlier times when banks could not lend on real estate mortgages, and contented themselves with short-term and demand loans with a high rollover velocity, the consequences were less serious. The matching of liabilities and assets by term maturity was easy and the incoming and outgoing deposits tides caused less disruption.

The experience of the CCB in the final years shows the reliability of retail deposits. Their availability to regional banks was perhaps due to regional loyalties of the population. Until advances by the Bank of Canada reached inordinate levels and until the publicity surrounding the CCB support program intensified, retail funding remained with CCB at reasonably constant levels.

The designed lending policies of the bank somehow were not translated into a loan portfolio national in scope and diversified industrially. Indeed, the loan inventory took on the opposite characteristics, initially, no doubt, because its head office and its branches were all in the West. Because real estate lending was an easy way to advance large amounts of money relatively quickly, particularly in Alberta and British Columbia, real estate loans predominated from the earliest times in this bank. The same applied to oil and gas lending. This pattern of concentration was greatly accentuated by the extent of the Alberta economic boom of the 1970s and the early 1980s. Bankers new and old naturally joined the "gold rush" bonanza of demand for credit in these booming industries.

The day of reckoning came with the severe recession in the West, felt first through the National Energy Program which was accompanied by inordinately high interest rates, and followed closely by a decline in Alberta's terms of trade (the price of provincial exports relative to the price of provincial imports) largely due to the decline in world petroleum prices and North American natural gas prices. Borrowers in

the West, and hence the banks themselves, suffered from the sharply declining values in their assets. The severe recession turned into a long one, and from the Alberta viewpoint at least, climaxed in late 1985 with an unprecedented collapse in world oil prices which saw the price of oil drop by $10 a barrel in a week. The five largest Canadian banks suffered in Alberta and British Columbia as did the two newcomers. While the significance of the western economic deterioration is discussed more fully below, these common experiences support the view expressed by Mr. J. DesBrisay, a founding director, that CCB was not "... based on taking over loans that other banks would not take... ", although he did believe that CCB loans held an element of greater risk. What is decidedly clear is that the new regional banks could not afford to court the same trade as the well-established national banks with diversified customers and diversified regions of operations. McLaughlan was no doubt correct in his July 1982 statement that, "our mid-market high growth clients are inherently weak in a difficult economic climate", and his testimony that the fate of the borrower is the fate of the lender because "... the position of the bank is really one of reflecting the condition or health of its customers."

The implementation of the bank's aim to enter the merchant banking field is more difficult to assess. By 1981, CCB had founded three subsidiary financial operations. The bank retained a small interest in each, and managed two of these enterprises under contract. None prospered. One was merged with the bank and consideration was given to the merging of the others with CCB as well, not because their future was considered to be attractive, but because the bank might thereby increase its defined capital. Bank management did not consider that any of these subsidiaries were well managed. The merchant banking aspect of the business plan of CCB simply did not work out.

The management of CCB raises other questions. As several witnesses have testified, it is difficult for a new and operationally restricted bank to attract senior management with experience in all important phases of banking from daily counter and cage operations to financing, accounting, corporate governance and regulatory matters. The importance of good management, especially in a new bank, cannot be overstated. The evidence clearly shows that corporate governance is the first and main defence of the bank against the hazards of funding, lending and loan management. It requires strict discipline to resist the temptation to grow too quickly and to match the nature, quality and term of the loan assets to funding liabilities. All this begins with skilled and experienced leaders in banking and they are difficult to attract to a small new bank.

The relationship between management and directors in the CCB was affected by the circumstance that the larger shareholders were directly represented on the Board. It was the opinion of more than one experienced banker that such an arrangement creates a potential condition of conflict in the directors in dealing with the interest of the shareholders at large and with the interest of the depositors. Others considered that the combination of professional managerial experience in banking and an independent board of directors selected from a broad cross-section of business experience and leaders in the community would produce a balanced, directing force for a bank superior to the board comprised of representatives of blocs of shareholders.

Thus, in summary, the following weaknesses in the original plan became apparent as the bank developed:

(a) There was no clear market niche overlooked by the existing banks for mid-market, above average risk commercial lending;

(b) Wholesale funding was a hazardous base for a small bank to build a loan portfolio of mixed term loans on. Too late the bank saw the attractive stability of retail deposits;

(c) The rapid growth of the loan portfolio necessary to establish interest income to support banking operations increased the risk of making unsatisfactory loans;

(d) High concentration of loans in cyclical industries and in limited geographic regions was fundamentally unsound and made the bank unduly vulnerable to downward economic fluctuations;

(e) Merchant banking did not prove a fertile source of revenue;

One thing did pan out. CCB was designed not as a regional bank but as a geographically-diversified bank, and with a little luck in its timing, CCB might have survived long enough to achieve that stature. Certainly under McLaughlan's leadership, efforts were being made to reduce CCB's regional concentration. At the end, 31 per cent of its outstanding loans were in Alberta, although, according to the 1984 Annual Report, 21 per cent of the loans were in Alberta, measured on the basis of loan authorizations which, on the evidence, were never fully advanced.

2. The Stewardship of Howard Eaton

Whatever defects may have been built into the bank from the outset, CCB sailed ahead with every indication of success from its

opening in 1976 under the guidance of Howard Eaton, the first President and CEO. The phenomenal early growth of the CCB was produced from a banking plant which expanded rapidly and brought CCB to the top earning levels, measured by various ratios and percentages, amongst Canadian banks. In the words of DesBrisay, a long time director of the bank, the bank was "spectacularly successful ... we clearly, in our view, had highly competent mid- and senior-level managements. Our practices, we understood, were conservative." Bad loans were an experience which only lay in the future. All the evidence would indicate that at the end of fiscal year 1981 at least, the original plan, the founders' vision, appeared to be working well under Eaton's guidance.

This explosive early start coincided with the parallel climb of the Alberta economy. It was a dramatic boom, fuelled by oil and gas. As the oil industry accelerated, so did the real estate and construction industries. The associated prosperity manifested itself in many ways. Economic experts testified that the business community did not foresee an end at all, at least through 1981. Indeed, Dr. Harries, an economic consultant, testified that a prudent businessman in 1981 would not have foreseen the great downturn which began in 1982. In all this, the bank's customers borrowed money, reaped profits and borrowed more. Naturally, the banks rode the wave of prosperity like the rest of the business community. It was a rewarding experience and apparently regarded as an infinite one.

Then came the opening phase of the recession in the last days of 1980 when Alberta experienced extraordinarily high interest rates, the advent of the National Energy Program, and shortly thereafter a world-wide recession in the oil industry. The recession at the outset was seen, according to the testimony, as being one of moderate depth, and likely of short duration. It turned out to be the most serious recession in Western Canada since the 1930s. That the recession had a very large impact on these banks is, on the record in this Inquiry, undoubted. The cause or causes of the recession itself are not important and therefore are not further examined here. What is important is the magnitude of its impact on the banks and its relevance in determining the causes of collapse. The significance of the recession for the CCB is discussed below.

Even before the recession was recognized, the directors of the bank experienced some concern. Limits to real estate lending were mentioned by Eaton, but no precise controls were put in place. Eaton began to take initiatives on his own. Then it was rumored that Eaton was moving to

California. Indeed, Eaton caused CCB to buy a residence in Los Angeles for the purpose of dividing his time between California and Edmonton. DesBrisay also noted "an apparent growing isolation from the Board or an ignoring of the Board, doing things his way without meaningful board involvement".

Because the sudden growth in the bank in its opening years was largely keyed to loans in Western Canada relating to real estate and oil and gas, the bank became exposed, wittingly or unwittingly, to a risk of serious loss should the Western Canadian economy falter. It is not without irony that, induced by this overconcentration of loans in Western Canada, and in real estate and energy, the bank decided to diversify geographically and sectorally by moving into Eastern Canada and California. This was an expensive move and was unhappily undertaken just as the recession commenced. Thus the prescribed cure to overconcentration may have been correct, but by the time it was administered, it only aggravated the disease. The second part of this experience was the acquisition of a 39 per cent interest in a California bank, Westlands, which had a loan portfolio virtually all of which was in real estate. The move into California in reality increased the bank's exposure to cyclical businesses, for Westlands and CCB's Los Angeles branch loaned heavily in the real estate and oil and gas sectors. Westlands turned out to be badly run, underfinanced and excessively dependent on wholesale deposits for its lending funds. In McLaughlan's words, "by any measurement, this was an ill-conceived and improper investment". By 1984, a director of CCB concluded that the impact of the Westlands venture on CCB was "appalling". Westlands was an Eaton recommendation, opposed by some of the most experienced members of the board.

The Inspector General responded to the growing concerns surrounding Eaton's management by writing to all members of the Board to advise them that the chief executive officer of a Canadian bank must reside in Canada and that the Board should consider the appropriate action in the circumstances existing in CCB. It should be noted in passing that the intervention by the Inspector General, at first decisive, appeared to fade in the face of some opposition from Eaton to his suggested resignation. Indeed the Inspector General indicated his acceptance of a compromise and it was only subsequent developments which brought about Eaton's departure.

In the meantime, the background of the "Trust Companies Affair" was unfolding and Leonard Rosenberg became associated with CCB. By August 1982, the relationship between Eaton and Rosenberg had developed to the point where they proposed to buy from CCB its U.S.

interests under an arrangement which led the Board to appreciate, perhaps for the first time, that Eaton's sights had by then been transferred away from CCB and trained on other ventures. The Board "indignantly" rejected the proposal. Eaton left the bank in January 1983.

The residue of troubles left behind in CCB is well described by Eaton himself in a memo of May 1982. The recession, he stated, had produced $80M in nonearning assets and about $9.5M in uncollected interest of which about $3.8M had been taken into the bank's income statement. Eaton then had placed the bank management on an emergency footing and several drastic measures were announced. DesBrisay said of Eaton at this time, "The Rosenberg connection badly stained the flag of CCB." Loans were made by the bank to the Rosenberg group of companies and indeed some of the corporate manoeuvres of the group may have been indirectly assisted by CCB loans. Rosenberg, through several tentacles of the Greymac group, increased his shareholdings in CCB to about 30 per cent, well above the 10 per cent limit imposed by the *Bank Act*. It was at this point that the Inspector General stepped in, as mentioned above, by calling for some action by the Board. The whole affair indeed hung over CCB like a large black cloud in a heretofore clear sky. CCB's days in the sun were over, but only a few financial experts appeared to perceive it at the time.

The publicity of what has been called in evidence here the Trust Companies Affair led directly to large-scale withdrawal of deposits by the large depositors and professional money managers. Some deposits never returned to the CCB despite the considerable efforts of the McLaughlan management team. CCB immediately arranged for liquidity support from the major banks and had a stand-by understanding with the Bank of Canada for further support.

The testimony given before this Inquiry is divided as to the long-term effect of the Eaton era on CCB. McLaughlan did not agree when pressed on the point that the overexpansion of the bank under Eaton, and the subsequent Trust Companies Affair, were causes of the bank's failure. DesBrisay placed more emphasis on the irreparable harm caused by these two features of the Eaton era and concluded that they started the bank on a downhill slide from which it was unable to recover. However, he too, when pressed on the point, did not attempt to forge a direct link between the events leading up to the departure of Eaton and the ultimate collapse of the CCB:

> Q.: I was wondering whether this episode did not so damage the health of the bank that when it was infected with the deep and long-lasting recession it died

in the process. Had it not been infected, would it have survived? That is the big question.

Mr. DesBrisay: I do not know, sir.

3. The Western Economy

McLaughlan's assessment of the condition of the CCB when he took over as CEO in January 1983 was that the bank would survive. Looking back on the bank's history, he testified that he now realized that "short of a merger" he was not sure if it could have survived. He expressed his final conclusion on this point in his testimony this way: "The assets were there at that stage that were ultimately going to pull down the bank." In short, bad loans had been made which irreparably reduced the bank's earning power, and which would ultimately involve the bank's capital in repayment of maturing deposits.

DesBrisay offered a positive description of McLaughlan's early management:

> Gerry McLaughlan took over really with great confidence and great authority. He immediately exercised his influence, and he was good. He was a very, very dedicated bank officer. His staff was intensely loyal to him. He worked around the clock, and he had, I would say, great confidence. He generated great confidence in the board and great confidence in the people who worked very closely with him.

DesBrisay was also able to point to some concrete signs of a long-term turn-around in the bank in the months following Eaton's departure:

a) The Inspector General, at the conclusion of the 1983 annual inspection, rated the bank's internal control system A+, approved its interest accrual policy, and complimented the McLaughlan management team.

b) The liquidity advances were retired by the end of June.

c) $19.5M capital was raised by a rights offering to CCB shareholders in 1983.

d) By September, many of the Greymac shares in the bank had been acquired by new shareholders.

e) Paul B. Paine, a distinguished member of the financial community, became Chairman of the Board in November, 1983.

The realities of the condition of CCB's loan portfolio, whatever that condition might be attributed to, were the prime responsibility of the McLaughlan team. The roots of those loans which later caused serious problems in the bank reached back to 1981 and beyond. By 1982, everyone in management or on the Board was aware of the presence of a considerable number of unsatisfactory loans. McLaughlan volunteered the observation that there was "an excessive emphasis on growth". In a July 1982 memorandum, he had reported to Eaton that the nonperforming loans had reached "devastating proportions". Either the bank's lending team had followed a faulty plan or had simply made poor credit judgments. McLaughlan's memorandum, described in Appendix C, attributed the problems to both.

DesBrisay, in an undelivered statement prepared for a Board meeting in November 1982, recorded the observation that "our bank has always been adventurous" and stated that he realized that the time had come to consolidate or retrench. This was necessary because:

> During the past year, we have been told of substandard lending practices in our Vancouver platform and of our similar problems in Quebec and in at least one of our U.S. offices. We have heard of waste and inefficiencies in Bancorp. We know that Cancom Funds has been mismanaged. CCB Leasing, I understand, may have been misconceived.

McLaughlan joined CCB in October 1976 as Vice-President, Alberta. He became Senior Vice-President, Alberta and Saskatchewan, in 1979. In 1981, he became Chief Operating Officer, and ascended to President in 1982. His entire career in CCB was spent in Edmonton and mostly as part of senior management in the Head Office. It is fair to conclude that the McLaughlan team, when it moved to the top of the bank in 1983, took command of a loan portfolio which was worth by any standard of measurement less, and probably considerably less, than its principal value. This team was part of senior management when many of the doubtful loans were put in place. McLaughlan had always carried some responsibility for the Alberta lending.

Assuming that the portfolio was indeed worth considerably less than the values carried in the balance sheet in January 1983, several questions arise. Was the downturn in the Alberta economy an economic event of such proportion that a small new bank, however well and prudently managed, would not have survived, or was the recession the inevitable test of the lending practices of the bank which prudent management would have kept in mind in establishing those lending policies and practices? Was the failure of these lending policies and practices, and not the depression in the West itself, the effective cause

of failure? Was the McLaughlan management team from January 1983 onwards contending in a long and deadly battle for survival of the bank against the combination of a large inventory of poor quality loan assets, all the evil infection which flows from that condition in a bank, and a profound economic decline in the bank's principal regional operation? If so, should CCB tactics, practices and performance, from 1983 to 1985 inclusive, be measured, not against the standards and principles followed by the major banks in their conventional operations, but against the conduct of management in an enterprise whose energies must be largely devoted to simply keeping the doors open? Corporate and professional misconduct is certainly not to be tolerated in any circumstances, but happily the record here assembled does not disclose dishonesty or other misconduct legally defined on the part of the senior managers of the CCB. The Inquiry of course has not pursued any events, circumstances and transactions not germane to its mandate, and an observation about legal morality can only be made with reference to the record before it.

Before examining these questions in the light of the record of the McLaughlan years, one should respond to the oft-repeated viewpoint that CCB did no better nor worse in these years than did the major banks in Alberta and British Columbia. From 1982 to 1985, 75 to 80 per cent of the Royal Bank of Canada's total domestic nonperforming loans (NPLs) were in Alberta and British Columbia. Two-thirds of the Royal Bank's domestic loan write-offs from 1980 to 1985, or $1.245B out of $1.853B, were in the same two provinces. Most of the Toronto-Dominion Bank's 1984 loan losses of $924M were in Alberta and British Columbia in the resource and real estate sectors.

There is little room for debate that the major banks encountered large losses in their western operations in these years. These losses were sustainable because of favourable offsetting experiences elsewhere. One must also appreciate that relative to their long and successful track record, their capital and surplus cushion, and their scale of operations, these losses were slight and without serious fiscal consequences. It is this structural strength that renders irrelevant the argument that CCB cannot be faulted for a loan loss experience in Western Canada which was paralleled by the experience of the major banks. A banker backed up by, relatively speaking, limitless resources, can undertake lending programs that would be fatal to a banker without such backup. Banking prudence must be measured with reference to the resources of the bank relative to the taking of the risks in question. The Royal Bank of Canada, the Canadian Imperial Bank of Commerce and other major banks undertook loans in the West in this period with an awareness of their respective financial depth. Many of these loans turned bad as the

economy turned down. CCB had no monopoly on this experience. It was as improvident for the capital-rich banks to do so as it was for CCB, but the consequences were foreseeably different. Apart from their capital strength and depth, the geographically and sectorally diversified majors could rely as they did on the built-in stabilizer of a far-flung branch system which deployed their capital into more stable regions, noncyclical industries and developed economies in and outside this country. Widely distributed branches also afforded the major banks a stable source of retail funding from which to service their western and other loans. All this was in place when the major banks entered the credit fray in the western oil and real estate fields. CCB management had behind them none of these advantages when they pursued the tactic of quick growth in staff and facilities, created funding liabilities in a volatile wholesale money market, and deployed funds in making the loans which came to comprise its troubled loan portfolio. For these reasons a parallel between CCB and the major banks is interesting, but throws little light on the true and basic causes of the failure of CCB.

4. The California Operations

McLaughlan's early moves as CEO were to reduce expenses and the geographic concentration of CCB's loans. While partially succeeding in this, the bank fell behind in sectoral lending concentration. Real estate loan authorizations had increased, and by the end of fiscal year 1984, amounted to approximately 31 per cent of the loan portfolio. This was, at least in part, due to the acquisition by the bank of the remaining 61 per cent of Westlands in June 1984. The defensive measures of shifting funding sources from wholesale to retail proved to be expensive and slow, but necessary. By fiscal year end 1984, retail deposits constituted 20 per cent of total deposit funds, up from virtually zero in prior years.

The decision to develop a significant operation in California proved to be a serious drain on CCB. It is unclear whether CCB only intended to take a passive position in Westlands at the time it acquired the minority position, although there is evidence to suggest the bank was to be more than a passive investor. Certainly, some of its officers, including Eaton, were actively engaged in the bank and indeed borrowed significant personal funds from it. CCB had four out of eleven directors on the Westlands' Board. It is doubtful that Eaton ever intended, or if pressed, could have justified the venture as a dormant investment.

By the fall of 1983, the FDIC had issued a highly critical report on Westlands and CCB's involvement in it. The actual report was not filed

with the Inquiry, but its damning contents became known and are described in Appendix C. The FDIC issued a lengthy Cease and Desist Order, listing a number of conditions which had to be rectified. McLaughlan acknowledged that the order was justified and without compliance with it Westlands would have failed. Accordingly, management was changed, the remaining 61 per cent of Westlands' shares were acquired by CCB, capital was advanced by CCB, and a large number of bad loans were transferred from Westlands to the Los Angeles Agency of CCB.

All this was undertaken to protect CCB standing with the United States regulators because Westlands' deposit-taking branches were vital to CCB if it was to remain fully involved in California. The CCB branch in Los Angeles was only a lending facility without deposit-taking rights. There were potential tax benefits as well, but these were available only if Westlands could be made profitable within the next few years by CCB's financial and managerial support.

The costs of all this to CCB were significant, including the investment in the bad loans transferred out of and the good loans transferred into Westlands by the Los Angeles Agency of CCB, and the diversion to Westlands of the income from a debenture which CCB loaned to Westlands. In the end, Westlands became profitable about the time CCB failed. Superficially at least, it can be said that the FDIC saved the subsidiary bank and killed its parent. Ironically, the surviving subsidiary was seen as necessary in the first place in order to save the parent by diversification of its banking activities. In the end the subsidiary dragged its parent down towards insolvency.

The immediate casualty of the Westlands rescue was CCB's Los Angeles Agency. It was regulated by another United States federal agency, the Federal Reserve Board. The FRB report on this Agency, described in Appendix D and issued around February 1985, could not be found in Canada. The evidence contains some conflicts about the fate of the copies of the report which reached both the OIGB and CCB. What is clear is that CCB transferred some loans out of the Los Angeles Agency to its head office in Edmonton in order to remove them from inspection by United States regulators. All these mechanics were undertaken by CCB to avoid or postpone write-offs or write-downs of the California energy loans. However, room for manoeuvre had, by the end of fiscal 1984, been seriously reduced. The Agency had become a mortuary for the dead and dying loans of Westlands. The FRB rated $108M in loans out of a loan portfolio in the Agency of $350M (U.S.) as "doubtful and substandard". By the time the FRB report reached McLaughlan in February 1985, he had become aware of the sharp

reduction in value of the energy loans in the Los Angeles branch. It is also clear that when the Inspector General was given the FRB report, first orally and then by delivery by McLaughlan, he was not advised of the crisis in the bank by reason of the deteriorating condition of the U.S. energy loans. This takes on added significance when the action taken by the bank in early 1985 is reviewed in detail.

5. Management's Response

a. Accounting Strategies

The crises faced by CCB from at least 1983 onwards were continuous. Loans not being repaid on schedule were rising as a percentage of total loans. These loans were variously described in CCB (and indeed in other banks), as nonperforming, partially performing, unsatisfactory, marginal, nonearning, noncurrent and sometimes "bad". The CCB classified all loans on a scale of 1 to 6; the lower the number, the higher the quality. Class 6 loans required a reservation or write-down in value on the balance sheet, with a consequent charge against income in the income statement.

Faced with this rise in bad loans in 1983 through 1985, CCB had a difficult choice to make. If it called the loan and disposed of the security posted by the borrower in the Alberta and British Columbia economies then existing, the bank would take large losses. The evidence is that these losses would have exceeded the bank's capital. The bank would be insolvent by any definition. On the other hand, the bank could revise the terms of the loans in a number of ways in cooperation with the borrower. The primary object of the workouts (as such arrangements were known) in the circumstances of CCB was not to insure the survival of the borrower but, of necessity, the survival of the lender, the bank itself. Survival of the lender meant in short the avoidance of capital loss which would follow realization of the security. The survival of CCB therefore required that the problem loans in the bank be maintained at a classification above the level where a loss provision must be taken according to CCB's own rules, and income recognition cease. This consequence followed because the taking of a provision had two effects. First, it would diminish the value of the loan asset and the capital on the balance sheet. Second, the earnings of the bank would be reduced because a portion of a loss provision as defined by regulation is charged against the income of the bank.

Of this double impact, the decline of earnings is generally conceded to be the primary signal to the money managers and security rating agencies of troubles in a bank. These forces effectively determine a

bank's access to the wholesale money market on which CCB depended for much of the deposits which it in turn used for the making of loans. Without deposits, the bank could not lend, at least not to its optimum capacity, within the permitted deposit to capital ratio. Concurrently, the loan provisioning process would reduce the asset value of the bank's outstanding loans. These reductions in assets had the effect of reducing reserves to the point of diminishing the bank's capital when the loan loss provisions became extensive. Again, a cyclical effect reduced the attractiveness of the bank to the wholesale money market and to potential investors. Thus the decay in the loan portfolio is fed back into the core of the bank, its capital, by two routes. All this is but to illustrate why a small bank with a narrow base and short history must be wary when the economy in its neighbourhood is in decline. Such a bank needs to avoid reduction of loans to the lower rating categories so as to thereby postpone or even avoid taking loan provisions or write-downs, to the extent that accounting propriety and banking practice will permit.

The evidence discloses that there are several accounting and credit processes open to a bank in these circumstances. The bank can reconstruct the arrangements for repayment of the loan by reducing repayment schedules, by reducing interest rates or by increasing, by valuation adjustment, the collateral security held by the bank. The bank might achieve the same result by finding a replacement borrower and financing its acquisition of the business or assets or the collateral security posted by the first borrower. There are almost endless combinations and variations of such schemes, as the explanation by Mr. R. Lord, one of the auditors of CCB, indicates in Appendix C. A workout was the technique immediately brought into play if a loan threatened to drift from a 4 or 5 into category 6. By reason of its business plan or design, the bulk of CCB loans were in classes 3, 4 and 5. A workout loan in CCB was usually classified as a 4 or 5 on the scale of 1 to 6. They were higher risk loans than the industry as a whole granted on the average. CCB employed various workout strategies in a very energetic drive by its management to save the bank. The intensity of these activities increased through 1984 and 1985. All of these measures had one thing in common: they were dependent upon the accuracy or propriety of management's constant expectation (or hope) that better times would return in Western Canada and in the Western United States where these problem loans were domiciled.

The serious and delicate situation of CCB is revealed by the state of its loan statistics over the early 1980s. In 1981, 3.2 per cent of all loans were classified 5 and 6 (that is marginal and unsatisfactory loans,

frequently called in CCB "MARGUN Loans"). By January 1985, the proportion of MARGUN Loans was 32 per cent. The class 6 loans on 31 October 1981 amounted to about one per cent of all loans. By 1985, it represented about 10 per cent.

The specific provisions taken in the fiscal periods 1981 and 1984, expressed as a percentage of the principal value of MARGUN loans and nonearning loans (NELs), were as described in Table 4.1.

Table 4.1

	Margun Loans	NEL	Total Specific Provisions
1981	10.2%	34.1%	$4.3M
1984	1.5%	4.4%	$8.5M

The total loan portfolio grew from $1.3B in 1981 to $2.3B by the end of 1984. It is apparent that if the 1981 percentages of loss provisions were taken against the amount of the MARGUN loans and NELs in 1984, the effect on CCB earnings would have been calamitous. This is particularly true if class 6 loans were recognized in 1984 in the same proportion as in 1981. The impact is clear when one realizes that the earnings reported were $9.9M for fiscal year 1981, but only $804,000 for fiscal year 1984. The bank's vulnerability to decline in loan values had risen dramatically. The question is whether the classifications taken by management on loan assessments were motivated by traditional banking processes and considerations, or by a natural instinct for survival.

The workout strategies inaugurated by the bank entail, as has been seen, another flexible and subjective standard. Often, a new borrower (a newly incorporated share company, for example) was granted a loan by the bank to acquire the security held by the bank against the defaulting customer. The new loan commonly included as well monies to carry the interest payments for an initial period. Sometimes the interest was simply accrued. Bank accounting principles permitted recognition of this accrued interest in the bank's income if the borrower had an apparent cash flow. The recognized interest was fed into the income

statement of the bank and reported as an asset on the balance sheet, its precise position on the asset side of the balance sheet being determined by whether it was capitalized in the loan asset or simply accrued and carried as an "other asset". For a struggling bank, these generally accepted (in appropriate circumstances) accounting principles had great advantages. Their propriety, however, depended upon a determination by management that this accrued interest, together with the loan principal, was "ultimately collectable" or that the value of security held exceeded the outstanding debt, both principal and interest. Similar considerations apply to the decision whether a loan loss provision against an account is necessary.

This opened up new vistas for management. The value of an asset is a market function which in turn depends upon the time available to realize the asset value in the market. CCB management took the view that the value should not be determined according to the depressed conditions in the western economy between 1983 and 1985, but should include an element which would reflect the value in the market after an expected recovery from the recession two or three years hence. Sometimes the time standard was more elastic, stretching to five years, and in one instance, seven to ten years. This projected value reflected management's view of the level of the economy in these regions in the future years under consideration. Furthermore, the rules adopted by CCB did not allow, let alone require, the evaluation officer to discount or bring back such future economic prospects and returns to the date of determination of value.

CCB management referred to this process as the determination of "baseline value". The attraction of this technique was that it permitted management under the pressures it was facing to produce good results in the bank's financial statements and to postpone the date of realization of value until those days in the undetermined future when the value of the security held would return to a more suitable level. This justified, in the meantime, the recognition of accrued but unreceived income, and at the same time, supported the bank's decision not to place the loan in a classification which would necessitate, even by the bank's own rules, the taking of a loan loss provision. The negative side of this process was that the divergence between the financial statements and market realities became greater and greater but nevertheless difficult to detect by most readers of the statements.

All this might indicate that the bank's financial statements, as prepared by management in the first instance, were fanciful, and that CCB's management was operating without any checks or reviews in those processes directly related to the solvency of the bank. This raises

the important question of how the elaborate accounting and supervision practices prescribed by the auditors and the regulator could have failed to produce informative financial statements which would have loudly proclaimed the oncoming failure of the bank. This matter is more directly addressed in the concluding section of this analysis dealing with the performance of the auditors and the OIGB in supervision. It is necessary, however, to consider banking and accounting practices at CCB in further detail in relation to the initial issue, the causes of collapse. The use of baseline values and their effect on decisions taken in regard to interest accrual, loan loss provisioning and interest capitalization at CCB are significant elements in the timing at least of the bank's demise.

The auditors reported to the Audit Committee in 1984 that: "In certain cases the Bank establishes its internal estimates of own security values (baseline values) which are in excess of appraised values obtained from external sources. The rationale for using baseline values is that the appraisals were obtained in depressed markets and the Bank will control the property and dispose of it when the real estate market recovers. ..." Both management, including directors, and external auditors thus understood that the purpose of the process was to add significantly to the present worth of the security reported by the bank, as compared to its disposal value in the prevailing markets in the western economy.

This "future valuation" device was much debated in the evidence. CCB management considered it to be a procedure whereby "going concern" value could be determined. Any other valuation such as that employed by the bank inspection teams (who, as will be seen, inspected the loans in CCB in 1985) was viewed as "liquidation" or "fire sale" value. All other witnesses who testified on the subject, including the succession of bank credit officers from the major banks who examined the loan portfolio of CCB, the senior officers of the six large banks, and expert witnesses in bank auditing, rejected the concept of determining present value by gauging the level of the economy at some specified or unspecified time in the future, particularly when such supposed future value is not by the formula brought back to the present. None of these witnesses considered that a disposal of security within a reasonable time was equivalent to a forced sale or a liquidation sale. All these witnesses stated that their institutions did not include future values or an assumption of a return to prosperity in the present value of an asset.

The practice in the United Kingdom according to Charles F. Green of National Westminster Bank is to value security, where the borrower's covenant has failed, on a forced sale basis. Our practice in Canadian banking is generally otherwise. However, the determination of present

value on the basis of future expectations is a denial of the purpose of the exercise. Financial statements are stated to be a reflection of the financial position of the institution at the effective date of those financial statements. If the principal asset of the institution, here a bank, is valued on some basis which does not reflect the present worth of that principal asset at the effective date of the financial statements, then the accuracy and the worth of the financial statements are destroyed. Worse still, anyone relying on a financial statement without an awareness that a technique such as baseline value had been employed with reference to the principal assets would be seriously misled.

Interest capitalization became an important issue in the evidence surrounding the operations of CCB. The extent of the practice of interest capitalization in CCB was indicated in a report prepared in June 1985 by the accounting staff at the head office of the bank from returns filed by all branches pursuant to detailed instructions from headquarters. The June 1985 statement revealed a total of $53M of capitalized interest on Canadian loans. The United States loans included an additional $6M of capitalized interest. The reports covered the fiscal years 1982 through 1984 inclusive. Management sought to discredit its own report when it was brought to their attention by the liquidator and by Commission counsel. McLaughlan had previously said in evidence that the bank had been unable to produce reliable evidence on the extent of recognized but unreceived interest. No mention had been made of the June report.

The likelihood of the general accuracy of this report is increased by the fact that the comptroller one month later directed the bank staff to record capitalization of interest prospectively. For this purpose, he reissued the instructions for compiling the report in June. The instructions included an exemption from reporting where capitalization is accepted in bank accounting principles as proper, such as in construction and other loans where it it is provided for in the original loan arrangement. Both management and external auditors considered these instructions adequate for this purpose but not for the retrospective compilation of capitalized interest. This goes only to the question of how much legitimate capitalization of interest was included in the $59M.

The earnings of CCB before taxes in these three fiscal years was, in all, $17.8M. Had this uncollected interest not been taken into income, the bank would have shown a loss of about $41M. If only 50 per cent of this uncollected interest was not properly recognized as income, the loss suffered by the bank in these three years would have been about $12M. The value of the loans would also have been overstated by the same amount, thus distorting the balance sheet as well as the statement of

earnings. Of course, some (and probably most) of the loans in question should have become nonearning loans and classified downwards but for the recognition of this unreceived income, and loss provisions would, of necessity, have been taken in many cases. This would have reduced the appropriation for contingencies account in the balance sheet of the bank. The materiality of this failure to take adequate loss provisions is seen when it is appreciated that the capital of the bank at the end of the fiscal year 1984 was only $120M, and earnings in these periods would have been erased.

What remains unexplained is the failure of the auditors to come across this apparently widespread activity, and to report upon it in one of many ways. The evidence is that in the course of the annual audit, the auditors examined more than 60 per cent of the bank's loans. Such a wide sampling must surely have uncovered the practice when it had been followed on this scale or even anything approaching such a scale. The auditors had discussed this matter with the Audit Committee of the Board. In 1983, their report to the Committee stated that: "The bank's policy of capitalizing interest on problem loans increases the difficulty in demonstrating full collectability of these loans." In 1984, they returned to this question: "We have the feeling that the bank is somewhat more aggressive in its accrual and capitalization of uncollected interest than we would prefer. ..."

On all the evidence, one must conclude that, in all probability, the practice of recognition of uncollected interest income, either by capitalization or by accrual, was widespread in the bank. The conclusion is irresistible that in the effort to show earnings and to protect capital to the last possible moment, management was overborne by the overwhelming flood of unserviced loans of all classifications in the loan portfolio and took refuge in this operational and accounting procedure beyond anything permitted under the principles of prudent bank management or bank accounting. One must also conclude that there was a clear awareness of all this in the auditors and that they failed to adequately respond.

Underlining the whole issue are the rules of the road in banking as to the classification of a loan as nonperforming, and the consequential decisions on when uncollected interest should be taken into income, when accrued interest should be reversed, and finally, when a loan loss provision with respect to a specific loan becomes mandatory. Some of the major banks have different approaches. The Toronto-Dominion Bank had the strictest rule in that "interest contractually due past 90 days" automatically classifies a loan as nonaccrual. The loan may also be classified nonaccrual if management considers there is doubt about

the collectability of interest or principal. Once a loan is classified as nonaccrual all uncollected interest previously recognized as income is reversed and carried against current income. There is no management "override" in the Toronto-Dominion unlike the other major banks where management may forestall a nonaccrual classification of a loan when there is no reasonable doubt as to collectability of principal and interest. However, the chief executive officers of these banks stated that the exercise of management's override is "infrequent", "seldom used", or its "use is unknown". Fuller details are set out in Appendix F.

CCB on the other hand changed its practice in 1982. A memorandum from the comptroller to McLaughlan stated the auditors would question the fact that "we have changed our policy on accruing revenue on NELs. This has resulted in substantial income being recognized in fiscal 1982". This turned out to be a correct forecast. The auditors advised the Audit Committee at year end 1982: "We pointed out that the bank .... had changed its procedure for recognizing interest that is in arrears."

From all this, and from the internal reports in CCB at the end of fiscal 1984, it is apparent that the bank followed less conservative practices in the area of income recognition by the use of the management override than did the large banks. The record indicates that this practice, coupled with its interest capitalization policy and the avoidance of specific provisions on a large scale, produced results that distorted the financial statements of the bank. The precarious condition of the bank would naturally influence management's decision in all these practices and such was the case in CCB. Survival accounting was adopted by the McLaughlan team and largely accepted by the auditors and, as shall be seen, the regulator alike.

Furthermore, in CCB it can be said that management's practice in specific loss provisioning was accepted by the auditors as a fair presentation of the financial position of the bank. Whereas in the Canadian Imperial Bank of Commerce the rule for provisioning states, "A specific provision should normally be established where there is reasonable doubt as to recovery and the outcome is dependent on factors that cannot be forecast with reasonable assurance," CCB took such action only when loss was known to have occurred or was likely to occur. This process was accepted by its auditors. The Clarkson Gordon auditor of CCB stated, "... in many cases it is the bank's decision with respect to how they are going to manage that account that determines the appropriate accounting treatment."

The CCB pattern started, as mentioned earlier, with the bank's decision to revise its arrangement with the borrower by one form of workout or another. The underlying security was valued on the basis of future prospects and the borrower was seen as able to carry the loan by either performance or by the value placed upon the security held by the bank. The loan thus stayed outside the "nonearning" category so that no provision was mandated and none was taken. Survival accounting was as active in protecting the bank's assets as in protecting its income statement. There is no other conclusion open upon the evidence seen by the Inquiry. CCB, by the application of the provisioning policy of the major banks, would have slipped into insolvency at least by the end of fiscal year 1983.

Thus it is clear that management saw that the only hope of survival was to take to one or more of the following lifeboats: (a) recognizing questionable accrued interest (which by definition has not been received in cash) as bank income; (b) postponement of the decision to make a specific loan loss reserve; (c) the establishment of security value on the basis of future values; and (d) other related measures. All this was done in the hope that the recession in Alberta and British Columbia would pass or at least moderate, that the value of its assets would revive, and that the bank's middle market borrowers would return to some measure, at least, of the prosperity they had known before 1982. In fact, none of this happened. In August, 1983, McLaughlan, by a memo, instructed Mr. D.E. Smith, a senior officer of the bank, to classify a group of 16 loans as No. 4 and not to classify them as NEL, so as to "avoid a year end reservation." Two years later, about one-half of these same loans were included in the CCB Support Package and were sold or "participated" out of the CCB portfolio into the hands of the participants in the support group, as bad loans in whole or in part. An even more serious condemnation of CCB stewardship of its business rests in the fact that no provision for loss had been made against most of these loans right up to the day of reckoning in March 1985.

This raises a question which has recurred again and again in this Inquiry: At what point is the good and even courageous intent of management to save the bank and avoid all the losses entailed in its failure, overtaken by a duty to disclose to the shareholders, the regulators and, indeed, to the public at large, the serious condition of the assets of the bank, its declining earnings, the unsatisfactory ratio of capital to liabilities, or any other circumstance that posed a reasonable threat to the solvency and continued existence of the bank?

The drilling program in California illustrates the point. CCB financed the purchase and operation of a repossessed rig to drill a well

using for that purpose the services of a CCB borrower who was unable to service its indebtedness to the bank. The bank stood not only to gain by repayment of the old or new loan, but also stood to receive a participation in an oil discovery should one occur. The bank undertook the drilling rig support program to avoid or at the very least to postpone suffering a write-off of loan assets or a reduction of interest income. This started in 1983, and by 1985, despite rosy predictions along the way, losses had to be recognized by the bank in the amount of $57M (U.S.) out of an energy portfolio of $85M (U.S.). A vice-president of the bank located in Los Angeles, speaking of the oil rig workout loans, revealed much when he wrote as far back as April 1983:

> You will appreciate that the program described above is not without considerable risk to the bank and goes beyond ordinary lending criteria. The willingness of the bank to undertake such risk is a reflection of the concern over the nonearning rig loans and the conclusion that the risks are worth taking, subject to scrupulous engineering, to avoid substantial and unpalatable write-offs.

All of this was considered unacceptable by the Federal Reserve Board on its examination of the Los Angeles Agency where these loans were held. In reporting to the Inspector General by telephone, the FRB expressed a concern not only for the L.A. branch, but for the continuance of CCB itself. In contrast, the Inspector General accepted the explanations of management of these losses and of the FRB criticisms. The Inspector General saw nothing in all this which "would bring the bank down". Management later said this was indeed the cause of the bank's failure although the record would indicate that at the most, the oil venture in California was only one of the last straws that broke its back.

Throughout the same years the bank also undertook workouts in Canada. New companies were created to carry old loans. Security held by the bank was turned over at book value to new borrowers financed by the bank by means of loans to a shell company created for the sole purpose of acquiring the security. The new borrower, by design, had no other assets, and the bank held no guarantees from its owners. Effectively, the new loan was made without recourse. The new borrower's investment was to be expertise and sweat, but not funds. By 1984, the bank had loans in this category with outstanding balances in excess of $350M out of a loan portfolio of $2.2B.

There are many examples of the extent to which the bank would go to keep up the appearance of a prosperous and solvent bank with a productive portfolio of loans. Though the motives of management and

their courage in the face of impending doom may be commendable, the fact is, they knew better and they put new investors and depositors in the bank at great risk.

An even more serious question than the adequacy of management's performance in all this, is the position of the auditors and the state agencies comprising the supervisory framework. Their involvement was central to CCB capital issues where the interests of shareholders, other investors and depositors are in potential, if not real, conflict. The bank, from time to time throughout its career, raised capital for several purposes and by several means, including public offerings, private placements, the sale of equity, and the sale of debt securities. In addition to the need for capital to support loan asset growth according to established ratios, there is a further need in a bank to bring in capital. The market may perceive other advantages less susceptible to mathematical precision such as a larger buffer of capital upon which depositors may rely. Furthermore, the very fact that there are public investors with confidence sufficient to participate in the equity of the bank is a stabilizing factor in the market, and an aid to the attraction of deposits.

b. Need for New Capital

By 1982, and increasingly in 1983 and 1984, CCB felt the necessity to raise equity capital to support its diversification program in Eastern Canada and in California. By that time, it was also contemplating the purchase of the remainder of the outstanding shares in Westlands. These set-backs caused by the deep and prolonged Western Canadian recession, together with the stain which the Trust Companies Affair left on the bank, contributed to the need for the infusion of new capital. To this end, CCB prepared and executed a preliminary prospectus in 1982 for the issuance of preference shares to the general public, the actual sale being scheduled for early 1983. This program was abruptly ended by the Trust Companies Affair. In the course of 1983, CCB did raise $19.5M by a rights offering to existing shareholders, and while this may have been the best available capital program during 1983, it still left an unsatisfied corporate appetite for paid-in capital.

In the spring of 1983, after the Trust Companies Affair ended progress on the planned preference issue, the bank reopened discussions with Dominion Securities Pitfield, apparently because of improved conditions for such an issue by CCB. By the end of the summer the underwriters began in earnest to prepare a prospectus for a public issue. Three serious problems faced the bank and its underwriters in

connection with the proposed underwriting. There was a tax problem relating to refundable dividend tax and an accounting problem concerning a switch by the bank from a cash to an accrual basis for commitment fees during the first three quarters of the 1983 fiscal year. Management, the underwriters and the external auditors recognized the existence of a third and more significant problem which had arisen in connection with the nature and extent of disclosure of nonearning loans. Management discussed this matter off and on and by 10 August 1983, an inter-executive memorandum referred to the problem:

> In preparing the unsatisfactory Loan Report the Credit function has chosen to compare outstandings with "loan value" as opposed to "appraised value" with the result that the shortfall appears to be increased materially. In view of the circumstances that see the Bank endeavouring to effect recovery by holding the various assets until the market returns it seems rather unrealistic to be discounting the appraised value to a loan value to effect comparison with outstandings.

It should be explained that "loan value" refers to a percentage of the value of underlying collateral, which varies with the nature of the collateral, against which the bank will lend. The "shortfall" refers to the difference between the outstanding amount of the loan and the loan value.

By the last week of August 1983, the bank and its advisers were still operating on a timetable which would see the preliminary prospectus signed and filed on 13-14 September. Preparatory to such filing, the President was delegated the task of reviewing and up-dating the nonearning loan section of the prospectus "using the Royal Bank of Canada Prospectus as a guideline".

In the Royal Bank prospectus, which was issued in early 1983 in connection with an issue of preferred shares and warrants, extensive disclosure was made of "nonproductive loans" which were defined as loans where "interest remains uncollected for 90 days beyond the scheduled due date" without any management override provision. The prospectus went on to state that the term "nonproductive loan" would also include any loan where "there is doubt as to ultimate collectability". In all these loans the Royal Bank stated that its policy was to "reverse previously accrued interest which has not actually been collected". In its prospectus the Royal Bank then set out the specific provisions for probable loan losses in connection with the loans in this category and proceeded to disclose the resultant nonproductive loans net of specific provisions for losses for the 5-year period prior to 1983. By

26 August, CCB management listed amongst the critical issues surrounding the preferred share issuance "the treatment of nonearning loans in [the] prospectus".

A second meeting of the working group on the proposed prospectus occurred on or about 1 September and the external auditors who were in attendance recorded the proceedings at that meeting. The three problems adverted to above were again mentioned with the observation that these problems could "effectively stop the prospectus from proceeding". The second problem, being the accounting difficulties resulting from a switch by the bank from cash to accrual for commitment fees in fiscal year 1983, was reiterated without any reference to any discussion about any other change in accounting bases occurring during the fiscal period. Specifically there was no mention of the adoption by the bank of any different accounting or other standard for the valuation of security held in the loan portfolio. The minute of the meeting as prepared by the external auditors states: "We were later told that a recent Royal Bank Prospectus had a rather extensive disclosure on the nonearning loan position of that bank and the disclosure was more extensive than our client felt they could have and still have a successful issue." This minute discloses no explanation for the discontinuance of the plan to file the draft prospectus on 13-14 September.

It is significant that on 14 September management distributed to regions and branches a directive concerning "Marginal/Unsatisfactory Loan Report". The memorandum opened with a discussion of the "Annual Report — September 30th ... Marginal/Unsatisfactory Loan return" and stated that such return would be expanded to include "security evaluation and reservation rationale". For this purpose the memorandum introduced two new sections, numbers 6 and 7, which were to be added to the annual return to head office. Section 6, "Detailed Security Evaluation", stated in part as follows:

> This section will provide the platforms['] best estimate of the eventual recovery value of the security pledged to the Bank and the borrowers['] willingness and ability to repay Bank advances.

The section goes on to describe "Methods of Evaluation" and refers to the establishment of "the recovery value of pledged asset", and then continues:

> This "baseline value" is the price at which the asset will change hands between a willing buyer and a willing seller. The recent recession has for example caused real estate prices to fall very quickly from a record peak to well below "baseline value".

The memo discusses the determination of this value by taking into account the time which will be required for prices, particularly for real estate, to return to acceptable levels.

> The length of time to sell assets has however increased from 1 to 2 months in 1981 to 12 to 24 months.
>
> This time period required to attract purchasers at "baseline values" is "sell-out time". For most areas of the country where recovery is well underway this required timing can be projected with some certainty. "Sell-out time" of the assets should be included in your evaluation comments.

Notwithstanding the fact that the valuation was being worked out at the end of the reporting period, in this case 30 September, the memorandum of instruction went on to state:

> However, in establishing the recoverable value of the assets, the time required to sell the asset should not be discounted from the value. Security evaluations are based on principal recovery only.

The memorandum significantly concluded:

> We appreciate the additional workload placed on you at this busy time. The early dispatch of these instructions will allow much of the work to be completed prior to September 30, 1983. We would like all of the reports in our hands by October 11, 1983.

The external auditors, by a memorandum dated 27 September, advised management that in their valuation of loans, the auditors' approach "would be much the same as last year ..." and would be based on a random selection from the loan portfolio. In this connection the memorandum stated: "We agreed that we would work from the September 30 unsatisfactory loan report *which will be available the morning of October 12*" (emphasis added). There is no indication in this memorandum that the auditors had been advised of the instructions to the field staff of the bank contained in the memo of 14 September. Indeed, the evidence of the auditors given to the Commission is that they were not aware of the memorandum. They added that it would have made no difference to their work if they had known. This may be some indication of the failure of the auditors to appreciate the full consequences to the bank and to the investing public of management's business strategy in the event the economy did not recover and bring asset values back with it.

One would expect to find reflected in CCB's Marginal and Unsatisfactory Loan Reports for the months of August and September the contrast between the loan portfolio valuation made prior to the memo of 14 September 1983 and that made subsequent to that memo.

The record reflects the statement for the month endings 31 August 1983, 30 September 1983, and 31 October 1983. The nonearning loans increased from $187M in August to $199M in September and then decreased to $127M in October. Superficially, one might expect a decrease in the September totals; however, management testified that the write-offs are based on the September reports, that the bank worked hard to wrap up outstanding matters in relation to nonearning loans at every quarter end, and that the auditors based their work primarily on the September reports. It may well be that this trend can be detected at the end of prior fiscal periods, but a decline of $70M in two months must require the receipt of considerable interest income from theretofore barren loans in the months of September or October. There may be the alternative explanation that there had been 100 per cent write-offs of NELs in the two-month period in question so as to reduce the number of loans in that category when expressed as a proportion of the total portfolio. This does not appear to have been the case. An internal bank document for the year end 1983 shows a total write-off on loans for the entire twelve-month period of $13M. By the end of August 1983, $12M of these write-offs had been budgeted. However, it is somewhat difficult to make this comparison because the form of reporting changed between the end of August and the end of October.

In any event, there is a primary problem of determining what would have been the result in October if the pre-14 September 1983 marginal and unsatisfactory instructions had been applied instead of the new section 6. It follows that the complaint by management of the practice of reducing appraised value to loan value as in the memo of 10 August 1983, by the issuance of instructions in September 1983 had the desired effect of reducing write-offs and provisions, and of reducing the percentage of nonearning loans in the total loan portfolio. The two monthly statements showing a large decline in NELs between 30 September and 31 October appear to bear this out because the full management analysis of nonearning loans and write-offs are based on the September report. All this activity confirms the expressed intention of management to overcome the difficulties created by the recent Royal Bank prospectus and the high level of NELs in CCB at 31 July 1983, for the purpose of proceeding with a share issue on the basis of the improved picture of NELs in the financial statements at the end of the fiscal year 1983, instead of using figures based on the former loan valuation standards.

A more detailed examination is required to demonstrate whether the evidence truly supports this conclusion. The report compiled on marginal and unsatisfactory loans on 30 September 1983 makes no mention of the instructions of 14 September 1983, nor does it indicate

any write-offs or loan loss provisions related to any of the 90 loans included in the compilation. It should be observed in passing that 40 of these loans showed that accrued interest was taken into revenue.

The records of the underwriters, Dominion Securities Pitfield, confirm the management memorandum quoted above. On 12 October the underwriters, while proceeding on the new timetable, reviewed the history of the planned issue and the then current problems.

> This [the earlier work on a draft prospectus] all seemed to be very positive and work was proceeding toward a filing in early September.
>
> 3. We had asked Gerry McLaughlan to draft the section on Nonproducing Loans and he finally called a meeting of Lanny Mann, himself and myself during the course of my second visit to Edmonton. At that time, he surfaced the fact that they were not prepared to disclose the level of nonproducing loans since it was approximately 9.7 per cent of total loans and he viewed this figure as unacceptable for publication. He wondered if there were ways around this nonpublication. I indicated to him that there were precedents in various directions on the topic, however, I could give him absolutely no assurance that disclosure of this would not be required by the Securities Commissions. Further, I indicated to him that if the Securities Commissions were doing their job, it was my view that indeed this should be disclosed. In further discussion, I did go as far as to state that I would want to consult with my partners before a final decision were taken but indeed we might well require disclosure of this in the preliminary prospectus since it is an extremely central statistic to the bank's current position. McLaughlan seemed to entirely understand this and moved quickly to mothball the issue since *he is convinced that the statistic will look a great deal better at year end since they are carrying out a detailed loan-by-loan analysis which will lead, he assured me, to a substantial improvement in the balances.* (emphasis added)

McLaughlan, when confronted by these documents, testified that in addition to the problems noted by the underwriters, he was concerned with the reticence of the shareholders of the bank "going public", the offering of stock in a prospectus not founded on recent audited statements and the disclosure of outstanding litigation. Any question of reticence by existing stockholders to have the bank go to the public for funds must surely have been overcome when the draft prospectus was approved for the aborted issue of shares in 1982. As to the second concern, when the timetable for issue of a prospectus on 14 September 1983 was adopted, year-end audited statements more recent than 31 October 1982 were obviously not going to be available. A reference to the difficulties in revealing outstanding litigation is likewise of little true value. When the CCB Real Estate Investment Trust (REIT) offering was made in 1985 more serious litigation was outstanding, and the bank's financial condition was worse than at the time the 1983-84 issue was being prepared. Reference to litigation outstanding is a common element in stock issues.

As to the problem of disclosing a high percentage of nonearning loans in the bank's loan portfolio as they stood at the end of the third quarter, 31 July 1983, McLaughlan said his concern was not for the success of the share issue but rather with the impact such disclosure would have upon the depositor market. It is difficult to see how one could not be concerned about the saleability of equity to public investors but at the same time have a concern about the effect of historically high nonearning loans upon purchasers of debt instruments of the bank. The depositor outranks the shareholder in any circumstance in seeking recovery of his investment and is not dependent upon the earnings of the bank in order to realize upon the deposit. The depositor is able to choose the time for liquidation of his deposit either contractually or on demand, and its face value does not fluctuate with the stock market but is the principal secured by a debt instrument. The wholesale money market is certainly volatile but it is difficult to believe that the feared disclosure would not unsettle the purchaser of a locked-in investment in equity but would upset the short-term depositor who is always poised for escape in any event.

The auditors proceeded to complete the year end statements acting upon the statement of marginal and unsatisfactory loans made up by management effective 30 September 1983, pursuant to the memorandum of instruction circulated throughout the bank on 14 September 1983. The preference share issue eventually resulted in $35M being received from the investing public in early 1984.

What is startling is that none of the major actors in this capital issue, that is management, auditors and underwriters, seemed much concerned about the Inspector General's role or what that office might do when faced with a prospectus in support of such an issue. Disclosure was viewed as a matter vital to the underwriters who also saw that the provincial securities commissions would have to be faced. Management undertook to clear away the burden of disclosure by reducing the NELs to tolerable limits. The route and the measures taken were not disclosed to or discovered by the auditors or the Inspector General although clearly both were aware the CCB was, at least to some extent, by that time employing the baseline value concept in assessing the value of security held by the bank. The Inspector General, acting pursuant to the *Bank Act*, approved the prospectus in January 1984.

The timing and the effect of the bank-wide instruction of 14 September 1983 is of great significance. The memo at least accomplished two things: it implemented baseline value across the board, and it thereby effected a change in the bank's accounting and disclosure policies as regards both the regulator and the public who might take

recourse to the financial statements of the bank. Certainly no effort was made by the bank to advise the auditors, the Inspector General, the Securities Commissions or the underwriters of the memo, its purpose and effect. The bank was driven to present financial statements which would support a prospectus for a public offering for much needed capital. The episode is even more consequential in assessing the performance of the other two elements in the tripartite supervision system, the external auditors and the Office of the Inspector General. Although the disclosure of NPLs in the prospectus was not contained in the financial statements set out in the prospectus, the conclusions reported on the level of NPLs would of necessity be drawn from the same financial records and information as were the statements approved by the auditors as at 31 October 1984.

6. State of CCB by Fiscal Year End 1984

To the end of its fiscal year 1984 the course taken by management in the bank's daily operations, which has just been reviewed, brought about certain results, mostly unfavourable.

1. The financial picture presented by the financial statements of the bank did not reveal the true state of affairs in the bank.

2. By forestalling the arrival of discernible insolvency the cost of ultimate failure to all concerned was increased.

3. Both investors in shares of the bank and depositors were misled if, as must be presumed, reliance was placed upon the bank's financial statements regarding some important matters, principally the state of the principal assets of the bank (its loans) and the bank's true income.

4. When the condition of the bank was revealed to officials of the Government, both executive and regulatory, in March 1985, the obfuscation of the financial statements by the survival tactics adopted by the bank interfered with a complete understanding of the state and needs of the bank and may well have defeated the attempts by the Government and by the major banks to save the bank from liquidation. Alternatively, this conduct by management and the reflection of the bank's affairs in its financial statements may have led the parties to the rescue program into a venture that in cold reality had no hope of succeeding except perhaps at an intolerable cost.

This calls for the examination of a more serious issue: whether there can properly be a publicly funded rescue of a bank which has, as was the case here, passed beyond the point of a mutually voluntary merger with another bank. To lay the ground work for this discussion the events from the end of fiscal 1984 to 14 March 1985 must be briefly examined.

By late 1984 it should have become clear that this was not an enterprise on the verge of a breakthrough to prosperity. It was descending rapidly into liquidation and the causes had been with it for some time, some would say since 1982. It is important to determine when awareness of this perilous state came to management, the directors, the auditors, and the Inspector General; and what each of them did about such knowledge if and when it came to them. If it never came, the issue is when they should have become aware of the bank's terminal condition from information at hand or available on reasonable inquiry having regard to their position, responsibilities and powers. Finally there is the issue whether there is any evidence of active deception or wilful blindness.

McLaughlan's testimony is revealing. He stated he was "guardedly optimistic as fiscal year '85 opened" because first quarter earnings were ahead of budget and the OPEC price drop much rumoured had turned out to be only $1.00 a barrel. The facts are otherwise. The bank had an operating loss the first quarter of 1985 of $2.35M (only a loss of about $1M had been budgeted) and only by claiming tax loss credits was a book profit of $200,000.00 produced. The Federal Reserve Board conducted an annual examination in October 1984. Their report was known to McLaughlan by 12 February 1985. The FRB's view was that 30 per cent of the Los Angeles Agency's loans were "unsatisfactory" and the condition of the Agency was "poor". It considered that the status of the Agency must raise a concern for CCB as a whole.

On 10 December 1984, Divisional Vice-President, Special Credits, U.S., Mr. E.J.D. Pinder, wrote a memo to Mr. R.G. Heisz, Executive Vice-President, U.S. Banking, anticipating losses in the United States Division from $7.15M to $45.15M depending upon the view taken of impending events, and that some accounts would "require reservations this year and we should begin to factor this reality into our planning. ..." This view was reiterated by Heisz at a meeting on 30 January 1985 when he stated that there would be "substantial additional write-offs". There was no indication that the measure was precipitated by an OPEC oil reduction of $1.00 a barrel on 30 January 1985.

There was evidence that the FRB had required United States banks to write off oil and gas loans two years earlier. Allan Taylor of the Royal Bank of Canada had been aware that the United States energy sector had been as described by the FRB two years earlier. Other witnesses from the major banks expressed similar skepticism about the CCB explanation of the suddenness of the CCB collapse as due to the sudden failure of United States energy loans.

The situation in the bank's Canadian operations had also continued to deteriorate. By 31 January 1985, nonearning loans had risen to $256M, and MARGUN loans to approximately $800M. Of the 250 loans reported as marginal and unsatisfactory, many had been in that category for at least two years. The instruction issued on 14 September 1983 by the head office of the bank for evaluation on the basis of baseline value placed a two-year limit on the time for realization of value. The liquidator of the bank, Mr. G. MacGirr, noted in his testimony that those loans which were unsupported by cash payments had become such a drag on the bank that the interest spread had disappeared by early 1985. Without net interest income, deferred taxes were of no help to the bank. Its cash income had dried up. No bank in this condition had a future and the CCB was no exception. By 6 March the Director of the Inspection Division of the OIGB, Mr. N. Grant, had reached this conclusion.

The role of the OIGB in the merger of the CCB REIT into the bank should be mentioned here. As described in Appendix C, the OIGB received preliminary and final prospectuses on 22 January 1985 and 4 February 1985 respectively. The Director of the OIGB Inspection Division, Mr. Grant, had determined after the May 1984 annual inspection that notwithstanding the "satisfactory" rating accorded the bank recorded in a report prepared in the OIGB, CCB should be classified as "unsatisfactory". The Assistant Inspector General and the Inspector General agreed. Nonetheless, the OIGB subsequently approved the preliminary and final prospectuses. No disclosure was made in them of the OIGB rating.

7. Events Leading to the Call for Government Support

The combination of the bank's failure to make specific provisions for bad loans in its financial statements although clearly indicated in many loan files, the inclusion in the statement of income of uncollected interest, the use of future evaluation techniques in assessing the worth of security, and the repeated assertion by management that the California energy loans had suddenly collapsed, may have masked the real problems in the bank so that they were not appreciated by the

regulators and the major banks when McLaughlan approached the Inspector General and the Bank of Canada for assistance. These problems were compounded by a communication breakdown at the top of CCB management. The Chairman of the Audit Committee, Mr. Hillman, himself an auditor, went to Los Angeles on about 11 February and met with officers of Westlands and the Los Angeles Agency of the CCB. He was acquainted with certain problems in the United States operations. He expressly denied seeing the FRB report on the Los Angeles Agency dated on or about 6 February, but he did examine and discuss in Los Angeles the letter from the FRB bearing that date which forwarded the report to the Agency. According to notes, this letter commented upon the quality of the Agency's assets. According to his testimony, Hillman brought the covering letter from the FRB back to Edmonton but he did not bring back the report. He offered no explanation as to why he did not examine the FRB report or why he did not obtain the reaction of the Los Angeles executives to it. He was of course aware of the concurrent merger of REIT with CCB scheduled to close on 18 February, and that much information on CCB was required to be filed with the provincial securities commissions in that connection. He did not report all this to McLaughlan from Los Angeles nor did he do so immediately upon his return to Canada, preferring, as he put it, to let matters proceed through "proper channels". The Heisz report on the California energy loans, telephoned to McLaughlan on 23 February, may not have been ready for delivery on 13 February in Los Angeles to Hillman, but it is a reasonable inference that the discussions between Hillman and Heisz about the quality of loans in the Agency must have included some reference to these energy loans which within 10 days were said to be so critical as to put the survival of the bank in doubt.

As described in Appendix D, the FRB called the Inspector General about their report early in February 1985 and again on 20 February. The FRB reported that the Los Angeles Agency was faced with "staggering losses" which raised concerns not only for the welfare of the Agency but for the whole bank. Between these calls the Inspector General had spoken to McLaughlan and had received reassurances about the state of affairs in California. McLaughlan, according to the Inspector General's recollection, reminded him of the over-reaction typical of United States regulators and stated the workout programs in California "were going well". It says little for management communication that within three days of receipt from the senior staff in Los Angeles of a calamitous report on that branch's loan portfolio, the CEO of the bank was still able to report that things in California were "going well". The Inspector General thereupon advised the FRB that he was satisfied with the bank's management and the solutions which were in hand and that, in any event, all this would be reviewed with the bank at

a meeting already scheduled for 14 March 1985. The CCB reassurances based on detailed loan review in contrast to the FRB's "broadbrush approach" and the age of the FRB assessment, it was said, supported the Inspector General's view of the 20 February information: "It was not a matter of the greatest urgency and it was never regarded by us as being a matter that would bring down the bank."

It may be of some significance that CCB did not forward to the OIGB the FRB report which it had received from Los Angeles between the 6th and 11th of February until 7 March, although the Inspector General specifically requested it on 21 February after the FRB's second phone call. As has already been seen, the Inspector General saw nothing in all this which threatened the bank's future. He thought it could not be so serious as the United States authority had spent much time drafting its report: from October 1984 when the inspection was made, to February 1985 when the report was released. The Inspector General thereupon went on vacation leaving the meeting of 14 March to his staff. In fairness to the Inspector General, it should be pointed out that neither McLaughlan nor anyone on the CCB staff had communicated to the OIGB anything about additions to the agenda of the scheduled meeting for 14 March. In the last communication on this subject, Grant recorded that McLaughlan had advised him that the bank proposed to discuss a "few points including: (a) strategic plan for 1985 and beyond; (b) the next phase of the capital plan; (c) review status of various other matters including U.S. operations."

By 8 March, as detailed in Appendix D, the Bank of Canada had received full information about the OIGB's concerns regarding the condition of CCB. A Bank of Canada memorandum outlining the OIGB's position states that the Assistant Inspector General "intends to probe into the bank's medium term plans and to question his visitors about the measures they contemplate to redress the situation". With reference to a possible share issue, the memorandum further states:

> The CCB could, in turn, use the proceeds from the share issue to cushion the impact of the sale (at a substantial discount) of the doubtful loan portfolio to an arm's length third party.

From this documentation and Grant's memo of 6 March, it is clear that the seriousness of CCB's condition was recognized by the OIGB and by Bank of Canada staff prior to the McLaughlan presentation of 14 March. The Bank of Canada involvement in this inspectional matter was not explained.

The Inspector General and the bank management share at least one position in all this: each claimed, until after 25 March when the

support program was announced, that the sudden fall of the bank was not foreseeable at least until late February or early March and that it was due to the sudden drop in the value of California energy loans which the bank management attributed to a drop in the OPEC oil price of $1.00 per barrel.

There was apparently no close liaison between the United States and Canadian regulators or a sharing of their written reports. McLaughlan by design or accident got in between the two regulators and at least delayed the realization in Ottawa that serious troubles were upon CCB. The Canadian regulators even in February did not appreciate the deadly significance to CCB of the transfer of all the Los Angeles Agency's bad loans to the Canadian head office and the transfer of the good loans to Westlands from the Los Angeles Agency. All this was done for the stated purpose of placing Westlands in a position to benefit from its eligibility to make tax loss carry forward. This process turns out to have saved what was originally to have been CCB's lifeboat but sank the mother ship in the process. Since the Los Angeles Agency represented, according to the Inspector General, 10 to 12 per cent of CCB, the calmness of the Canadian regulator in the face of the United States regulator's report is remarkable.

B. THE CCB SUPPORT PROGRAM

The origins and fate of the plan to rescue CCB are important not so much on the issue of the cause of the bank's failure but because the whole process throws light upon the bank regulatory structure and its participants at that time. They also reveal some basic considerations which must be applied to the determination whether the public interest is served by a bank rescue mission involving public funds, should such a rescue ever again become necessary in this nation.

1. Events Leading to the Adoption of the Support Program

The process leading to the CCB Support Program started with a sudden unannounced presentation by McLaughlan in Ottawa to officials of the OIGB on 14 March 1985 of the need for help. In the absence of the Inspector General, Mr. D.M. Macpherson, the Assistant Inspector General, acted in his place. McLaughlan repeated his exposé later before the Governor of the Bank of Canada and some of his staff. McLaughlan stated that the bank could not survive unless "massive assistance" was provided. Following a report on the background to the situation in which he indicated that the problems were precipitated by the recent severe drop in the value of the bank's California energy loans,

McLaughlan proposed four alternative solutions for consideration. McLaughlan and his staff then made arrangements with the Bank of Canada for interim liquidity support. No one apparently faced up fully to the fact at that time that the issue was not liquidity but solvency.

McLaughlan, having delivered his startling message, left Ottawa for Edmonton, and although the reasons for so doing are not clear perhaps it was to prepare for an adjourned board meeting which was to resume on 19 March. At this point no program had been laid out for a systematic reaction to the CCB situation as revealed by its officers. The Governor of the Bank of Canada, however, showed an awareness of an urgent need for action, because the next quarterly results would soon be available and meetings had already been scheduled by CCB with significant United States depositors.

On Friday, 15 March, the OIGB informed the Minister of State (Finance) about the situation as then understood. The Minister revealed no preference to save or liquidate the bank. On the same day the CDIC Board met. Governor Bouey "strongly argued for saving the bank". The Deputy Minister of Finance agreed so long as Government funds were not committed. In the meantime Macpherson determined from the Royal Bank of Canada that a merger was of no interest to them except as a vehicle for liquidation of CCB. By Saturday, 16 March, both Bouey and Macpherson wanted to involve the major banks. However, the Minister of State (Finance) decided to confine disclosure of the CCB crisis to the Royal Bank for the moment. On Sunday, 17 March, Macpherson advised McLaughlan by telephone that liquidation was a likely course to be taken. McLaughlan was surprised at this revelation and immediately set about with the help of his Comptroller to develop the first version of the rescue program. This provided a general format which became the Support Program that was finally adopted, except in the opening version neither federal funds (other than the CDIC contribution) nor monies from the six major banks would be involved. This idea interested Macpherson who the next day (Monday) advised the Minister of State (Finance), sent Grant to Edmonton to examine the nonperforming loans of CCB and to review estimated loan losses, and summoned McLaughlan back to Ottawa.

At this time there was no assertion of leadership by the Government or any of its agencies in reaction to the bank's crisis. The Government of Canada was weighing the costs of abandoning its general policy of nonintervention by the state in matters of the marketplace against the consequences to CCB's depositors and investors should the bank fail. The Deputy Minister of Finance recognized that "a bailout was inimical to that philosophy ..." but at the same time he

saw the strong possibility of the tidal wave effect that a CCB failure would have upon the bank's creditors and small financial institutions across Western Canada. The proposed rescue plan then under review was a desperately contrived creation prepared without time for reference to the bank's Board, other members of senior management and auditors or lawyers. Nor was the proposed plan subjected to an immediate critical analysis by the combined forces of the OIGB, the Bank of Canada, the CDIC, the Department of Finance and their respective legal and accounting advisors. The Federal Government neither accepted nor authoritatively rejected committing public funds. Nor did the Government decide to bring in immediately experienced representatives from the major banks to survey the problem and to share the burden.

On Thursday, 21 March Governor Bouey invited the Chief Executive Officers of the major banks to a meeting in Ottawa to be held the next day. This was one week after McLaughlan's confession of the problem. The representatives of the Government of Canada came to this meeting without any decision having been made as to whether to contribute public funds to the rescue of the CCB. In the meantime, commencing at least on 19 March and certainly by the morning of 22 March, McLaughlan, Macpherson and Mackness (of the Department of Finance) had received inquiries from people in the financial markets regarding rumours of trouble in CCB. Given the sensitivity of banks to the loss of public confidence and the proclivity of depositors, particularly those from the wholesale money market, to "fly to safety", an immediate decision by the Government on the course to be taken was forced.

On 21 March (Thursday), the two Ministers met with the Deputy Minister, Governor Bouey, and the Inspector General (who had returned to Ottawa the day before). The participants "tentatively" decided to attempt to save the bank by implementing the plan originated by McLaughlan which was relayed to the meeting by a memorandum from Macpherson. Under this plan CDIC would purchase all the loan loss provisions ($244M) which CCB now acknowledged must be set up. The $244M would be repaid by granting CDIC a participation in 50 per cent of the bank's profits. The bank estimated the pay-back period would be 15 years. The plan was to be made attractive to CDIC by a grant of warrants to purchase five million shares of the bank at $5 per share which, at year end 1984, had a book value of $18.50 per share. All dividends on common and preferred shares were in the meantime to be suspended until the $244M had been repaid.

This version of the rescue plan, like those advanced thereafter, referred to "a purchase" of loan loss provisions or an interest therein. This is a significant misdescription because the plan also provided for "repayment of the purchase price", hardly a characteristic of a purchase and sale. If the plan was a "sale" of the interest in specified loans which had been written off or written down, then the $255M (the final figure used in the Program) on the CCB books would have been an asset and could perhaps be treated for both taxation and banking purposes as capital. Further difficulties, however, flow from the eventual failure to classify the moneys to be advanced by the support group to CCB.

Nothing was said in this early version of the plan about the position of collections on these loans of either interest or principal. Nothing was said as to the nature of the $244M in law or accounting, once it reached the accounts of the CCB. Nothing was said in this embryonic form of the support plan about the term or life of the warrants to be issued to CDIC in compensation for the use of its monies. It is understandable that McLaughlan's first draft did not go into details. He was unable to presume that the Government of Canada would invest public funds in a rescue program and he could not appear to assume that his competitors, the major banks, would do so either.

The CDIC tentatively approved this generalized plan on the morning of 21 March, and agreed to participate in the plan to a limit of $75M conditional upon the participation of the chartered banks and the Province of Alberta. The resolution of the Board of Directors contained the proviso that CCB's estimated loan losses be "confirmed by examinations currently in progress" by the Inspector General's representatives. There were other provisos not here relevant.

In the meantime, McLaughlan had prepared another version of this plan dated 20 March for a representative of the Bank of Canada and for Macpherson, in which it was stated that $244M was a payment in purchase of "the aggregate loan losses" and a profit participation in CCB to the extent of $244M less collections on the loans included in the Support Package.

After CDIC approval of its participation in the tentative plan, the Governor of the Bank of Canada on the afternoon of 21 March invited the Chief Executive Officers of the six major banks to a meeting at the Bank of Canada for the next day, Friday, 22 March 1985.

Serious problems had accumulated in the week since McLaughlan's visit to Ottawa on 14 March.

1. No decision had been made by the public authorities to save the bank or to let it go into liquidation.

2. Information then in the hands of the regulators was not adequate either to verify or deny the described state of the bank's loan portfolio as described by McLaughlan on his visit.

3. The financial community's awareness of a crisis was forcing a decision.

4. The bank's proposal for its rescue had been hastily prepared and had not been advanced by this time to an acceptable or workable plan by the public agencies thus far involved.

5. No decision had been made as to availability of public funds to any rescue program which might be undertaken.

The meeting on 22 March was attended by the Governor and the Deputy Governor of the Bank of Canada, the Inspector General, the Deputy Minister of Finance and the Chief Executive Officers or Presidents of the six largest Canadian banks. The Chairman of CDIC was not called to the meeting, although earlier in the week the CDIC had prepared studies of the cost of liquidation of the bank as compared to the cost of running off its affairs in an orderly way over a period of time. Some 20 persons were in attendance at the meeting. All present apparently assumed the Governor of the Bank of Canada should lead the way and preside in these affairs, although the Bank of Canada had almost no role or statutory function to play in the liquidation of an insolvent bank. Bouey stated in this Inquiry, and in the Committees of Parliament, that before these events took place many people perceived the Governor of the Bank of Canada to be something like "the czar" of Canadian banking. But he soon came to appreciate fully that the Bank of Canada was not a main actor in these matters.

The chairman of the meeting, Governor Bouey, made it clear in opening that the question faced by the meeting was one of solvency and not liquidity. The Inspector General related what McLaughlan had told the OIGB and the Bank of Canada concerning the cause of the crisis, that is, the imminent $85M write-off necessary on the United States energy loans, which, coupled with losses suffered in Canada, would eliminate the bank's capital. He reported on these and other problems in the loan portfolio and indicated that the bank had recently been examined by his own representatives. This examination related to loans in both the Canadian and United States divisions of CCB identified in a preliminary way by the bank as being part of the proposed support

package. The Inspector General relayed the essence of the report on this first loan examination to the 22 March meeting and said that the results revealed possible additional loan losses in the range of $60M but that on the whole the assessment of the loan loss situation by the President of CCB was confirmed. The bankers were concerned about the state of the CCB loan portfolio. Allan Taylor, President of the Royal Bank, questioned the Inspector General about CCB's estimate of the losses and asked whether CCB's figures were "exceptionally conservative". The Inspector General's reply was "yes". This may reveal a failure in the regulator to appreciate fully the key importance of the precise state of the loan portfolio to the fate of the bank; which in turn might reveal the almost subconscious acceptance by the OIGB of the auditors' unqualified certificate on the financial statements as a general guarantee that "all's well". Apart altogether from the result of the auditors' certificate, the facts before the Commission are that at each year end the auditors pointed out to the bank and to the OIGB that management should be "more conservative". This was, of course, unknown to the bankers present.

An analysis of the work done by this first inspection team sent out by the OIGB (the first of four inspections performed by bankers and operated by the OIGB) reveals quite a different situation. In fact the assessment of the loan losses on 21 March 1984 was that as much as $68M in additional provisions should be taken on the Canadian division loans along with a further $20M on the United States division loans. Grant had unilaterally reduced this Canadian assessment by about $7M, and it is unclear on the evidence whether this fact or the United States results ever reached the OIGB in Ottawa during the deliberations. Further, in the time available for the first inspection only a very small sample of the loans that were eventually included in the Support Program could be examined in detail. It is difficult to understand how the regulators and indeed the representatives of the major banks and the Bank of Canada would wish to proceed into a detailed rescue program on the basis of an assessment of such a tiny fragment of the bank's loan assets. All present at the meeting on 22 March did agree to one thing. Because of the growing public awareness of the bank's problems, a solution had to be found that very weekend. Otherwise, the only alternative was to close the bank down and not allow it to reopen the next Monday. This forced a preliminary decision as to whether the information at hand was adequate.

McLaughlan joined the meeting and described the present condition of the bank. The essence of the remedy he sought was a support program to provide the bank with about $244M to replace the total of the write-offs occasioned by the energy loan losses which were

seen as imminent and the write-offs which the bank claimed would necessarily be suffered on the treatment of other problem loans in a plan to accelerate the bank's return to profitability. The total principal value of the loans in question was about $520M. The capital of the bank at that time approximated $130M so that it was evident on the most superficial examination of the problem that failing the infusion of these monies the bank would be hopelessly insolvent. The discussions in this opening session started a long series of misunderstandings that continued through to the last days of the bank and indeed into these hearings. The OIGB staff, the Presidents and Chief Executive Officers, and the Bank of Canada's staff appear to have understood the support plan as meaning that the bank would, after receiving the $244M, liquidate the portion of the loans in the group of loans comprising the support plan retained by the bank, and thereby replace the lost principal and restore the loss of earnings these loans represented. McLaughlan's memoranda of 20 March to the OIGB and to the Bank of Canada appear to describe such a program and would not reasonably be understood as allowing the bank to accept the $244M from the parties to the rescue, and then gradually liquidate some of the loans, quickly liquidate others, and write off portions of others so as to restore their interest return to market rates. In short, the parties to the program expected the bank to liquidate its retained interest in the Support Package loans whereas the bank expected to retain some of these interests during a period of slow collection and to retain others as loans performing at market rates of interest. This was but one misunderstanding. Notwithstanding McLaughlan's attempts during and after the weekend of 22-24 March to clarify the terms of the proposed support program, the terms remained ambiguous. The points for which McLaughlan contended would have produced a rescue plan a little more likely to succeed. The structure of the meetings had this unhappy result.

McLaughlan left before any decision was reached. He returned immediately to Edmonton, presumably to arrange for the approval by the Board of any settlement which might be reached and perhaps also, although it is not clear, to endeavour to obtain agreement of the debenture holders to the subordination of the outstanding debentures to the support plan. The major banks retired and came back with a counter-proposal. They were prepared to participate in a total program of $255M of which $75M would be provided by the CDIC from funds of which the banks were substantial contributors. The remaining $180M would be divided equally between the Government of Canada, the Province of Alberta and the six major banks. All of this was subject to the debenture holders accepting subordination to the advances by the parties to the rescue program.

Through all these and subsequent discussions was a request and eventually the assumption that the Inspector General would examine the entire CCB loan portfolio. To this end the bankers agreed to provide a cadre of qualified bank credit officers who would conduct at the Edmonton Head Office an examination of the bank's loans under the general coordination of Grant. It was never made clear whether this examination was to be limited to loans comprising the Support Package or was to cover the whole of the loan portfolio outside the Support Package. More importantly it was not clear whether it was to be completed that very weekend, later during negotiations, or during the performance of any support program which might be adopted by the meeting. The discussions and arrangements surrounding the examination of the bank's loans left a great deal to be desired and it is difficult to comprehend how experienced bankers and the staff of the OIGB could have allowed this issue to remain unresolved through all these meetings and two written agreements. It remained unresolved until at least the first week in July. Some would say on the evidence before the Inquiry that the question was never squarely addressed, and the examination was never completed.

Notwithstanding this glaring omission in the gathering of information vital to the design and launching of any rescue of the CCB, such a plan was undertaken. All this is even more remarkable when one remembers that, faced with similar bank collapses, the banking regulatory authorities in the United Kingdom and the United States, shortly before the CCB episode, responded with precise plans which included a detailed assessment of the true value of the assets of the failed banks and some objective assessment of the reason for failure. In both cases the latter assessment resulted in the immediate replacement of management and the later cancellation of all outstanding shares of the banks which were facing liquidation.

Clearly, the design and scope of the Support Program turned on the condition of the bank's loan assets. If the $244M estimated by McLaughlan was badly in error, the plan could not succeed. It is not unexpected, therefore, that someone, in this case the Inspector General, would believe that the participants, the banks and Government agencies alike, would require examination of the loans identified by McLaughlan as requiring write-downs to determine whether his assessment of the write-down would be sufficient to restore those loans (and indeed the loan portfolio) to appropriate values. It is equally evident that the rescue program would be a futile exercise if the Support Package loans were only part of the burdensome loans in a total portfolio of some $2.3B. It is not therefore unexpected that Allan Taylor, among others, would, throughout the meeting and periodically thereafter, seek an

assurance from qualified bank credit officers that the balance of the bank's loans were producing earnings and were not impairing the bank's capital. What is surprising, however, is that no term requiring an examination of CCB's loan portfolio is to be found in either the initial Memorandum of Intent of 25 March 1985 or the final Participation Agreement of 29 April 1985. Eventually, after the banks had raised the issue with the Inspector General and with the Ministers, a more comprehensive review was undertaken at the instigation of the Minister of Finance by bankers of long experience in some of the major banks but who, at the time of their examination of the CCB loans, were in retirement. A complete examination of all the loans in the bank, however, was never carried out. The Inspector General had an explanation for the failure to pursue a loan examination immediately after the rescue program was constructed. He said that after the Bank of Canada and the Minister of State (Finance) had announced on 25 March that the bank was in a sound condition and solvent, it would appear strange to see these same authorities ordering an independent examination of the bank's principal assets.

2. Inspections of CCB's Loan Portfolio

The inspections which were made require some comment. There was a lack of communication through the OIGB of the results of loan examinations at CCB by the Inspector General's staff and representatives appointed by the Inspector General from the staffs of the major banks. As already seen, the assessment completed on 21 March, as reported to the meeting on 22 March, did not reveal a unilateral reduction by the OIGB of $7M from the additional losses proposed by the bank credit officer who performed the examinations of the Canadian division loans. Grant, under whose direction the examination was made, apparently struck a compromise between the bank's assessment of the loss and that of Tallman, the banker made available to the Inspector General by the Royal Bank. Grant himself did not examine the loans and had no experience in such work. Nor apparently were the results of the United States inspection reported to the OIGB in Ottawa, or by the Inspector General to the bankers at the 22 March meeting. This overlooked another $20M in loss provisions.

The second inspection on 24 March was incomplete and its results were inaccurately relayed to the meeting. The divergence between McLaughlan's description of the loan losses as identified by management and those assessed by the bank examiners was of a magnitude

which would suggest that the meeting, if fully apprised of these facts, would not have proceeded with the Support Program as proposed, or perhaps with any plan.

Beginning in July, George Hitchman, a retired Deputy Chairman of the Bank of Nova Scotia, led a team of retired bankers who examined, in July and August 1985, loans having a principal or face value of some $423M. From this partial examination Hitchman and his colleagues calculated by projection, losses reasonably to be encountered by CCB of some $900M to $1B. It would be readily seen that if only one-tenth of these additional write-offs were actually required to be taken by the bank it was insolvent and beyond redemption by the designed bailout program.

The failure to conduct a timely and effective examination of the loan portfolio was a serious flaw in both the planning and the execution of the program. On the other hand it must be appreciated that according to Hitchman and others a complete assessment of the CCB loans would require several weeks with a large staff of experienced credit officers. This strongly suggests that the procedure adopted by all the parties to the program was seriously inadequate. This in turn would indicate that at least two more phases in the rescue scheme should have been planned so as to allow a retuning of the scheme or its abandonment depending upon the results of the examination of the loan assets. Instead, the incomplete, if not clumsy, Support Program was simply left to function on its own.

3. Flaws in the Support Program

As it turned out, realizations estimated by CCB on the Support Package loans, instead of being at the planned 50 per cent rate, were 30 to 35 per cent only, and CCB, whatever its plans under the original proposal, was immediately unable to assemble capital and to report the earnings which would enable it to survive. More seriously, the lack of precision in defining the nature of the monies infused into the bank by the program caused a further failure in earnings, which in the end produced a complete lack of confidence in the bank by the professional deposit market. The CCB was left completely dependent upon the Bank of Canada for deposits. The Bank of Canada in turn was left solely dependent for its security on a loan portfolio having an unknown true worth, but which was considerably smaller than the value at which the loans were carried in the financial statements of the bank.

The plan had a number of apparent flaws. These are related and analyzed in order to determine the nature of a rescue program appropriate for a bank whose solvency is threatened.

a. Adequacy of the Support Package

The evidence raises considerable doubt as to whether the Support Package was anywhere near adequate. By one test, too simple perhaps, anything less than $500M paid in as quasi-capital would not have sufficed. The bank, according to the evidence of the liquidator, was losing during the 1985 fiscal period about $5M a month. To replace this, the bank would have had to create sound loans which would produce in the order of $50M to $60M of net income a year. If the $500M was paid in without obligation to reduce liquidity advances or other liabilities, the bank would have had the funds necessary for the making of loans sufficient to produce, in theory, the missing income. The first and second assessments of the bank's portfolio by bankers representing the OIGB indicated at least $116M additional loan losses were to be encountered. The third assessment revealed additional losses of at least $57M on the support package assets alone. Some loans included in this group may overlap with loans reviewed in the earlier inspections. The fourth assessment would indicate that a rescue program was not a viable alternative. The bank perhaps had submerged so far below the level of solvency that it could not practically be revived. It is surprising that the "rescue" moneys of $255M were simply paid through the CCB to the Bank of Canada in reduction of liquidity advances. At least the bank might have been able to lend the money out and presumably achieve an interest spread which would contribute earnings to the bank in its hour of need. The favourable Bank of Canada lending rates would have made it easier for the bank to produce such net earnings from the support group moneys. Simply reducing the debt by the bank to the Bank of Canada does not constitute a successful rescue program. Neither can this payment be applied in justification of any opinion that the bank was solvent after the rescue program was implemented on 25 March. The $255M reduced the bank's debt to the Bank of Canada, but itself became an obligation to be retired by collections on the Support Package loans or on liquidation, out of the assets of the bankrupt bank. The receipt of the $255M therefore is irrelevant to the presence or absence of solvency. Whatever state the bank was in at that time remained unaffected by the receipt of the Support Package moneys. The Inspector General, therefore, was in error in finding the bank to be solvent upon receipt of the $255M. It should be borne in mind that the $255M, by the terms of the interim and final agreements, remains an obligation in debt of the CCB. While the reduction of the Bank of Canada debt would improve earnings, the receipt of the moneys from the support group under the circumstances created by the agreements would, contrary to the Inspector General's letter, have no impact on the issue of solvency. The monthly losses being incurred by the bank made it very unlikely that any accumulated earnings might result which would influence the solvency test.

b. Treatment of Income from Support Package Loans

McLaughlan interpreted his designed rescue plan as enabling CCB to collect and record as interest the moneys received on the loans written down in the Support Package. The major banks took the opposite view; that all receipts on the loans would be applied first to principal in accordance with applicable OIGB guidelines and were to be applied in repayment to the participants. This was a part of the largely undocumented understanding accepted informally in connection with the major banks' counter-proposal on 22 March 1985. McLaughlan was not present, and therefore no negotiation in any sense of that term took place from that time forward to the execution of the final agreement on 29 April 1985.

The impact of this provision on the bank was serious. It could not show earnings if it received no interest income from the Support Package loans and/or loans brought into being by means of the new funds advanced to the bank. Without earnings the bank could not attract deposits; without deposits the bank could not remain in business. There is also evidence that the inability to earn income on some of the loans forced a quicker liquidation of those loans with consequent losses greater than projected by CCB.

It is understandable that the one rescued would have little or no bargaining position with the rescuer in working out relative obligations under the plan. On the other hand the rescuers must have been aware of the complete impracticality of a rescue program which would leave the bank without income during the process. In all probability, however, this was not a serious contributing factor in the bank's failure, largely because the collapse came so soon after the introduction of the Support Program and can be ascribed to a combination of many other causes.

c. Warrants

The warrants to be issued to the big banks (in the initial plan, to the CDIC) in the view of CCB management had the effect of closing the equity markets to CCB for "20 to 25 years". The price of the warrants descended from $3 per share in McLaughlan's first draft to 25¢ per share in the final agreement. The period for exercise of the warrants extended from 5 to 10 years before the agreement was signed. The effect of the warrants was, as Chairman Paine testified, to destroy the existing shareholders, and he went on to characterize the terms demanded on the warrants as outrageous.

The warrants raise a serious problem. Without some potential reward for advancing a considerable sum of money under rather risky circumstances, the plan might well have been regarded by the major banks' own shareholders as improvident. Why should a bank come to the aid of shareholders of its competitor? Almost axiomatically, by the time this, or perhaps any, rescue program was adopted the bank was insolvent or on the brink of insolvency. Hence, the bank's shareholders had lost their investment. On the other hand, one must wonder about the fundamental aims, if not the morality, of transferring the warrant concept from McLaughlan's first plan, wherein the warrants were to be issued to a public institution, the CDIC, for their eventual disposal (presumably in the private sector) upon the refurbishing and reorganizing of the bank, to a situation where the warrants were to be issued to competitors. The competitor bank would perforce sell these shares on the market since the *Bank Act* forbids the retention of more than a 10 per cent interest by any single shareholder and completely forbids a bank from holding shares in a competitor.

In the different approaches taken to recent problem banks, upon recognition of insolvency by the Bank of England and the FDIC in the United States, the shareholders were immediately closed out by one device or another. Here there may have been some difficulty, in view of the approach taken by the Inspector General and the Bank of Canada, to demonstrate conclusively the insolvency of the bank and therefore the loss of all value of outstanding shares. That being so, the path of least resistance was the device of warrants even if they were issued to CCB's competitors. If the end purpose of the rescue program was to bring about the continued existence of the CCB as an independent Schedule A bank, it is difficult to see how these warrants were to achieve that purpose except in the circumstance that all the banks agreed on a time and method of sale of the warrants to purchasers qualified under the *Bank Act*.

A rescue program by definition is undertaken when insolvency is present or is considered imminent and inevitable. By definition, insolvency means the shareholders have lost all their investment. Thus before public or indeed private funds are placed in such a bank in order to keep it in business, the outstanding shares should be cancelled or transferred to the rescuers or a trustee for retention for reissue when propitious; subject no doubt to a right in those shareholders under the plan to join the rescuers with new capital on the same basis.

The plan here, probably of necessity and having regard to the paucity of precise information on asset worth and the very short time

available for action, omitted any direct action concerning the shareholders' position and included only a tool for use at a later time to virtually erase these interests. This method had the added advantage of avoiding the prohibition in the *Bank Act* on banks' acquisition of shares in a competitor. Furthermore, the CDIC may not have had the capacity in law to acquire the shares of CCB, perhaps even as a trustee.

d. Priorities on Insolvency

The character in law of the $255M payment, left as it was in an uncertain state in the description in the rescue plan, raised still another problem. The banks considered that their respective share of the $60M contribution should rank in the same way as a depositor's moneys in the bank in the event of insolvency. As McLaughlan was quick to point out, such an arrangement would have to be reflected on the balance sheet of CCB and the marketplace would reflect long and hard before risking any further deposits with a bank facing such a large claim ranking at least equally with the depositors on liquidation. The Support Package should have classified these moneys as an unrecoverable purchase price, as a capital grant of some nature or as a subordinated loan, repayable out of earnings only. What CCB needed at this time of crisis was a loan without recourse in the nature of a capital grant repayable only from future profits and not a loan which would retain that characteristic and revive when the bank ran into further difficulties. Taylor, speaking only for himself, agreed to the merits of this complaint and agreed to reconsider the issue if it turned out to affect adversely CCB's deposit-taking activity.

e. Relations with the Major Banks

It is strange that the Memorandum of Intent and the Participation Agreement made no reference to the continuation of existing interbank credit arrangements between CCB and the major banks. The banks, from their viewpoint, quite reasonably interpreted the Support Package as being a complete articulation of the obligations of the major banks. This is supported by the fact that their contributions, unlike those of the Bank of Canada, did not result in prior security rights under the *Bank Act*. The fact is that the major banks withdrew their support or failed to renew it as the arrangements expired, despite the pleas of the Governor of the Bank of Canada. The effect of this withdrawal of support was said by some who appeared before the Commission to reflect seriously on CCB's future in the money market. Potential depositors, particularly those outside Canada, were quick to appreciate that the major Canadian banks were no longer staying with the arrangements made

with CCB prior to the inauguration of the Support Program. Because this issue, along with many other issues surrounding these events, might come before other forums in the future, further comment upon this matter is not appropriate. There is no clear evidence that this omission from the plan made any significant contribution to the failure of the Support Program.

f. Noninvolvement of the CDIC

The CDIC more than any other federal agency had experience in recent times with the liquidation of financial institutions which came under federal regulatory supervision. However, this agency was only indirectly involved in the negotiations or, more accurately, the deliberations which led to the construction of the rescue plan. The serious defects noted above might well have been pointed out "by those experienced in liquidation" and hence it might have been considered as a flaw in the arrangement not to have formally or thoroughly involved that agency in the formation and execution of the plan.

g. Failure to Replace Management

A rescue plan, by definition, must aim first to restore confidence in and the earnings of the bank. New capital will achieve the second goal, while the first, on the evidence here, required a change of management. The market could not expect improvement from the team which presumptively caused the trouble in the first place. Such was the testimony before the Commission and the experience in the United Kingdom and the United States. That does not conclusively pass judgment on management. It is simply said to be a fact of life in the market.

h. Inspections

As discussed earlier, during the Support Program negotiations and the performance of the plan, the OIGB arranged for four inspections or examinations of the bank's loan portfolio. The first two involved active bankers with loan credit experience in the major Canadian banks. A third inspection took place as a by-product of the work of the special representatives appointed under the Participation Agreement. The last team retained or appointed by the Inspector General for this purpose was made up of retired bankers who again had worked as bank credit officers in the loan granting processes of the major banks.

These inspections produced examination reports which had one thing in common. All found that the loan portfolio was seriously overvalued on the balance sheet and therefore extensive specific provisions would be necessary on many of the loans examined. These reports related to both loans included in the Support Program and loans outside that package. There were elements of confusion surrounding all these inspections:

1. The first two inspections were hastily put together and the first two teams were not certain as to what loans they were examining.

2. All teams were uncertain as to precisely the object of the examination. It was unclear as to what aspects of the loans were of interest to the Inspector General. For example, it was not made clear whether the reports were to reclassify the loans according to the valuation method of the examiner, whether the specific provisions were to be weighed and adjusted, and whether the decisions taken by CCB management regarding capitalization of interest and fee income were to be assessed.

3. In some instances the reports made to the Inspector General, to the bailout meeting, and to the Minister of State (Finance) were not made in writing and, at least in the case of the first two examinations, were apparently not fully and accurately communicated.

4. Extensive capitalization of interest was reported in June by one examiner, apparently doing so on his own initiative, but was not brought to the attention of the bailout participants, and there was no immediate reaction from the regulators.

5. As discussed earlier, OIGB staff, during the first examination, reduced the provisions recommended by one independent expert examiner. This occurred during the meetings of the support group participants undertaken to determine whether the bank should be rescued. On the evidence, this was never reported to the meeting. In another instance, during the third inspection, an examiner's recommended provisions of $50M were reduced by $17M. The OIGB and the bank then agreed that the remaining $33M need not be taken at once even though the examiner felt they were required immediately. OIGB staff instigated these negotiations. None of this was apparently reported to the support group participants.

Other inspections or examinations of the bank were made following formation of the Support Package. A Schedule B bank interested in a

possible merger examined CCB and reported to the Minister of Finance that he "had a dead bank on his hands". Garth MacGirr, the liquidator appointed by the Court of Queen's Bench of Alberta, in his testimony to the Commission stated that many loans were grossly underprovisioned, that is, overvalued in the balance sheet, and that realizations on the Support Package loans would be well below anything anticipated by CCB management when they proposed their rescue plan.

In the result, the information available to the participants in the rescue program clearly showed that even after the unilateral reductions in proposed specific provisions by the OIGB, even if the Hitchman Report of losses was grossly overstated, and even if the results of the examinations were too broadly extrapolated across the total loan portfolio, the capital of the bank had disappeared. Not one of these experienced bankers reached any different conclusion than that the loan portfolio was greatly overvalued in the financial statements of the bank. At the very latest, by 1 August 1985, the only question which remained unanswered was how long had this bank been disguising itself as a solvent bank.

The trouble surrounding the rescue is illuminated by the comments of one of the special examiners, J.R. Johnston, and the Inspector General's reaction thereto. His reports to the Inspector General on the 7th and 24th of June contain comments relevant to an assessment of the bailout program itself:

1. There was little evidence that the policies which had gotten the bank into trouble in the first place had been changed; and

2. It was important to look at the rest of the loan portfolio, that is, the loans outside the Support Program.

It is not known if any participants in the Support Program other than the Inspector General ever saw these reports. It is known, however, that the major banks had been pressing throughout the negotiations and down to at least the middle of June, for an examination of the balance of CCB's loan portfolio. It was not until mid-August that the Inspector General received anything like a comprehensive report on the state of the bank's loan assets.

4. The Hitchman Report

This was the major portfolio examination. Management of the CCB accepted many of the specific provisions proposed by this examination and those made earlier. Management criticized other

proposed write-downs as being based on practices by the big six banks which were not practiced in the small banks. Management also criticized the inspection process itself: the examinations were hurried; many errors were made by the examiners in their calculations; they did not look at the branch files in many cases but relied only on the summary head office files; the valuations of the loans and the security held by the bank were made on a liquidation, not a going-concern, basis; and the extrapolation of the results obtained from the Hitchman team examinations of 84 loans in order to quantify the specific provisions required on the entire loan portfolio, was unreasonable.

The Inspector General's instructions to the Hitchman team were to value loans on a going concern and not on a liquidation basis. Hitchman himself testified "... we are not thinking of reports on a liquidation. We are making up a common sense appraisal to determine what is a potential loss on that account on an ongoing basis." The issue whether Hitchman's extrapolation was reasonable does not require resolution because his overall conclusion that the bank was insolvent is correct. The extension of a sample to describe the whole must frequently be a risky proposition. Hitchman said an examination of all the loans would require 20 or 30 examiners working over a period of two or three months. It appears to be a reasonable approach to do as he did. It is also reasonable to factor downwards all the variables so as to be conservative. Indeed Hitchman invites the reader to conclude that CCB required loan loss provisions of $900M to $1B "or some reasonable percentage of such figures". There is beyond any reasonable debate a considerable data base in support of the Hitchman conclusions. One of his team reported, for example, about Halifax:

> If the quality of the loans at all branches follows the Halifax pattern, the possibility of the bank survival seems remote, simply because their nonrevenue percentage and ultimate write-off will be enormous in terms of their present asset base. It may be that the Halifax loans are not indicative of the standard of other branches, but the few Edmonton-based loans examined by us also include unsatisfactory risks which we assess below the ratings presently applicable to CCB.

It is significant to note that the Hitchman report also reviewed bank-generated internal reports showing that about $722M in loans (about one-third of the total portfolio) were marginal and unsatisfactory loans, about half a billion of which were nonearning. He predicted, accurately, that there will be "very substantial losses in 1985".

The regulators could not simply overlook this report. The scale of the recovery program clearly did not match the size of the wreckage. Too late came the recommendation by Hitchman (which Korthals had

mentioned during the crucial meetings of 22-24 March) that the Board and the management of CCB must be reviewed. Because there was no ongoing machinery to implement and oversee the Support Program, Hitchman's report did not reach the participants. The Minister of State (Finance), who received the Final Report on 12 August, decided not to circulate it and accordingly CCB management likewise did not have a copy. The Minister of State (Finance) did not call upon Hitchman to review it with her, though she discussed his Interim Report with him in July. The Minister felt, and not without reason, that any leakage of the contents of this report would be very damaging to the bank. For that reason she did not pass it around.

In any event, at the end of the day none of the avalanche of criticism unleashed by CCB management, even if given full play and credibility, can reduce the report to meaningless proportions. The Hitchman team was qualified. Given the circumstances in which the project was mounted and the pressure under which they worked, the report is cohesive, organized, and on the major issues, sound. Cross-examination on the report and its author was full and unfettered. The objectivity of the Hitchman team was unshaken. Their motives have not been assailed, and they had no interest to protect, at least none was disclosed.

McLaughlan himself acknowledged in early August 1985 that $200M in additional losses on loans, comprised of $100M in respect of Support Package loans and $100M in respect of loans outside the package, had to be recognized by write-off. The capital of the bank at the time was about $120M. Anything beyond the level of the capital raises nothing new on the issue of insolvency, but only on the question of the appropriateness of undertaking a rescue of the bank. It is helpful to scrutinize the Hitchman report and its conclusions through the eyes of someone standing outside the transaction itself and again with no apparent interest in the outcome on the issue of validity of this report. Such a person is the liquidator, MacGirr, who testified, after being in the office of liquidator about three months, that the specific provisions of $65M set up by CCB itself as of 31 August 1985 were "grossly inadequate". He expressed puzzlement about the nonearning loan figure in the financial statements of the bank at the close of fiscal year 1984 in respect of which he said: "What puzzles me is why the bank was accruing these loans [the loans included in the Support Program] before 31 March, 1985 since by the bank's own acknowledgment the support group loans were the worst loans in the bank." As a result of his examination of the accounts of the bank, he came to certain precise conclusions:

1. "By any standard, [the bank was] hopelessly insolvent on August 31, 1985 ... the bank was probably insolvent on March 31, 1985 and there is at least some doubt in my mind concerning its solvency on October 31, 1984."

2. While he was mystified about some of the actions taken and not taken by the bank, he surmised that "reality catching up with everybody" was probably the reason for the sudden discovery of the need for specific loan provisions on a grand scale.

3. Even an additional $100M in the Support Package would not have saved the bank.

4. While he did not agree with all of the calculations and conclusions in the Hitchman Report, the liquidator was very careful to state that he did not want to quibble about the conclusions of that report so as to obscure the critical fact that the Hitchman Report provided the correct, answer and that CCB at that time was insolvent or at the very least "in very serious financial difficulty".

It was quite obvious that the liquidator could not, in his capacity as such, state publicly his opinion on the true value of the securities held by him as liquidator of the bank. He is in the business of realizing the maximum value in the marketplace. His observations, however, support the conclusion that necessary write-offs amounted to several multiples of CCB's capital.

5. Conclusion

It becomes evident, therefore, that the meetings of 22 and 24 March misjudged the state of CCB's troubles. Mr. R. Utting, a retired Vice-Chairman and Executive Vice-President of the Royal Bank, wrote in a report (described in Appendix D) to CCB in August that such misjudgment occurred outside CCB. This may be so, but the misjudgment may well have been based on facts which in part originated in the management of CCB. Governor Bouey acknowledged in a letter of 28 August 1985 addressed to the Minister of Finance, that "evidence [is] now becoming available that demonstrates clearly that the causes of the present situation already existed at the time the official assurances were given. ..." The reference there is to the press release of 25 March 1985. The letter goes on to state: "But the fact of the matter is that the condition of the CCB was seriously misjudged in the process that led to the establishment of the support package". What follows inexorably is that the management of the bank, the first link in the information chain, and the Inspector General did not equip the

participants in the Support Package meetings with all the information needed to permit a proper and full assessment of the chances of a successful rescue. Many examples are at hand in the record.

As mentioned earlier, the FRB report on the Los Angeles Agency was received by the Inspector General on 7 March 1985. Oral discussions with the FRB had taken place in February 1985. The Inspector General advised the meeting of 22 March that the sudden collapse of CCB was brought on by the unanticipated and sharp turndown in California energy loan workouts consequent upon an OPEC oil price drop initially of $1.00 a barrel, and that the bank became aware of the crisis in Los Angeles in early February, and in Edmonton on 23 February. The Inspector General did not disclose to the meeting, according to all the minutes and testimony received by the Commission, the existence of the FRB report which was based on facts existing in the previous October. The FRB concluded that not only was the future of CCB's United States Agency brought into question by the state of affairs discovered on the 1984 examination, but also the condition of that Agency threatened the existence of the bank. Yet none of this information reached the meetings on 22 and 24 March when the decision to rescue the bank was being made. Neither were the results of the loan examinations, already discussed, adequately divulged to the meeting.

Based upon the limited information made available before and during the meeting, it is difficult to see how the participants could have constructed a detailed and sensible plan which would have held out some prospect for a rescue of the bank. The concept adopted was, in the light of the facts known shortly thereafter, at best half-baked. The bank was dying because the loan portfolio could not produce the income necessary to sustain the bank's operations. This sharply declining income in turn was destroying the ability of the bank to attract deposits. Without deposits the bank could not make loans, and without rolling loans over and putting in place healthy loans the bank had no future. The object of this Support Program therefore was to replace lost income and thereby protect and renew capital. The banks could not in law contribute equity capital, and the government agencies likewise were not in a position, either legally or practically, to do so. Resort was had to what amounted to a long-term loan repayable out of the prospects of collections from bad debts and future earnings. The money infused, therefore, could not be treated as capital, but only served to reduce liquidity advances. Thus, the $255M was simply a liquidity advance and, as Governor Bouey told the meeting when it opened on 22 March, the problem was not liquidity but solvency. This was the philosophical

cleavage in the program as it evolved from the weekend meetings. Other problems arose. Expressed in general terms, these problems suggest certain lessons for the future (to which the Commission returns in the Recommendations).

1. There was no authorized leader (either legally or practically) with the power or authority to direct the design of the program from inception of planning to completion of the execution of the established plan. Subsequently, no single authority was placed in charge as manager of the program with instructions to report back to the participants periodically or at all.

2. No committee of representatives of the participants was established to receive progress reports from the manager of the program. Nor did the meeting assign to the Inspector General any precise program for the gathering of information and the monitoring of the support program and no clear method or apparatus was established to adjust the plan if monitoring revealed a need to do so.

3. The bailout design assumed that the existing management of CCB could successfully manage the bank thereafter. Even if this assumption was correct, some would suggest that the plan should have involved, if confidence were to be re-established in the deposit market, a replacement of the senior management of the bank and, at the very minimum, a reinforcement of its Board of Directors.

4. Although serious difficulty was encountered by the rescue program in the planning stage, the preparation for the meeting by the OIGB was clearly inadequate. The participants were not clothed with the known statistics about the CCB nor was a detailed written report received from the OIGB representatives in Edmonton before the meeting, even though those reports must have been available by 21 March and certainly before the meeting on 24 March. No mention was made of such essential documents as the FRB Report on the California operations of the bank. In short, the meeting launched itself into the establishment of a rescue program before the participants in the meeting understood the state of affairs of the bank which was the subject of the rescue.

5. That the $255M infused into the program was inadequate is transparently obvious. It might have achieved solvency for the

bank but that is very much in doubt from the evidence before the Commission. What is not in doubt is that a successful program would have involved a massive infusion of funds far in excess of $255M. It also would have involved a plan structured to insure an immediate flow of income to the bank and a reasonable prospect that such positive flow of income would continue for the foreseeable future. Finally, such a program would have had to insure either the elimination of the present stockholders and their replacement on some future disposal of the bank, or some intermediate solution involving the use of warrants held in trust, not by competitor banks, but by a public institution such as the CDIC. Some form of agreement would be required whereby any benefits obtained by CDIC in the disposition of the warrants would be shared with the support group members in proportion to their cash contribution to the Program.

All of these comments on the rescue program are consciously expressed in generality. The precise nature of a successful bailout must, as the structure of bailouts in the United States and the United Kingdom detailed in Appendix B shows, reflect in detail the exact condition of the assets and liabilities of the bank, earnings expectations, management and many other factors. The Commission is here concerned only with comments on the general principles involved in such arrangements. Precise recommendations for the future are made later in this Report.

The Commission concludes from all of this that this bailout was ill-starred from the outset and had no chance of success. The crunch came on a Friday with a decision required before Monday morning. The atmosphere was frantic and not conducive to the production of a cohesive and detailed commercial contract. As later observed, the delay in determining to put public funds into a bank rescue ate up time needed to design and implement a workable rescue program. That is not to say that a bailout should not have been undertaken or that those who undertook it acted irresponsibly or negligently. What must be said is that the institution of bailout in the recovery of banks should not be written off on the basis of the experience in the CCB. A rescue program properly designed, efficiently executed and overseen by qualified public and private authorities may be appropriate on future occasions if and when banks fall into difficulties. Sometimes a rescue may well be hopeless. Other times it will be the proper course of action. The complexities of the banking industry are such that however thoroughly the information may be assembled, however carefully the plan be designed, and however intelligently and energetically it be executed, a

successful rescue cannot be guaranteed, with but one exception: when unlimited funds are committed. The decision therefore is complex and the final considerations must be the essentiality of the bank to the system and the community, and whether the cost does not outrun the benefit. The supervisory system, including rescue programs, must be founded on the understanding that commercial banking will produce failures and that it is not in the interests of the community that all such bank failures should be rescued.

C. EVALUATION OF THE SUPERVISORY PROCESS

1. Management

CCB passed through two distinct and separate eras. These two eras in the corporate history called for different talents and styles of management. In the first era, the formative years, the bank saw the boom into which it was born in the mid-1970s accelerate into the early 1980s. In this period, most if not all businesses in Alberta of any size and importance flourished. Profits were universally good, assets expanded, credit was easy, inflation seemed to be beneficial, very few business failures occurred, and unemployment was low. The bank grew in the sense of expanding its loans to the borrowing public by leaps and bounds. Profits grew to match this loan asset growth, and of course, so did its deposit indebtedness. The bank increased its capital sufficiently rapidly to maintain debt/capital ratios within the tolerances prescribed for the industry by the regulator. CCB also extended operations into Eastern Canada and down to California with a view to seeking diversification in both market and sectors of industry. Unhappily, this coincided with the onset of the slowdown in the western economy upon which the bank was largely dependent in its boom years. The early management of CCB made a strategic error in its lending practices by taking on loans on the scale of the big banks. Large loans, sectoral concentration, and a small number of borrowers were the results.

This takes us to the second era in the bank's history. In the rapid growth of the loan portfolio some loans were made which remained in the portfolio to haunt the bank in the lean years ahead. The troubles in the portfolio were seriously aggravated by the energy slowdown in 1981 followed by real estate and a general economic turndown in 1982, accelerating as the 1980s unfolded. This slowdown exposed weaknesses in the bank and in the bank's customers.

In these circumstances, bank management had two new and demanding masters. First, the bank had to protect its income so as to retain its attractiveness to the money-depositing market. Second, it had to protect its capital by protecting its primary assets, the loans. This it did in large part by deferring classification of bad loans wherever possible. This was accomplished by accounting practices which included the recognition of accrued, but uncollected interest, capitalization of interest, and the deferral of making specific provisions against loans for anticipated loss which in better times would have been indicated and taken by the bank. By 1982, management faced the need to realize that its gamble on continuing western prosperity had failed, and that a serious economic reversal faced the bank in all its principal areas before it had attained a stable source of deposit funds and a sectorally and geographically diversified and sound loan portfolio.

If this second era had a theme it would be wrapped up in the word "workout". By this method management, depending on one's viewpoint, either turned its back on bad loans and hoped they would go away with the return of good times in the economy, or accepted the challenge and attempted to restructure loans so as to enable the borrower to meet its obligations partially for the moment and fully at some unknown time in the future.

As has been described earlier, the bank's various workout techniques did not succeed, and in the end management was forced to lay its case before the Government of Canada and seek sufficient financial support to prevent a public declaration of insolvency. Unfortunately for the future of the bank and perhaps for the public generally, management did not describe the extent of its troubles in the proposed rescue program fully and accurately. It perhaps did not appreciate, or in any event did not reveal, the true state of the loan portfolio, the magnitude of its current and prospective losses, and the amount of money required in order simply to survive. It is difficult to appreciate why management of the bank underestimated these problems. Perhaps it was a simple failure to accurately assess the magnitude of the depreciation in the portfolio and the resultant impact on the earning powers of the bank. Perhaps management did appreciate the extent of the decay in the loan portfolio but realized or feared that a full disclosure of the magnitude of the problem and the moneys required in support would scare off the Government and the financial industry whose support was now so desperately needed.

The difference in capital structure and asset spread across the spectrum of industrial-commercial activity and geographic regions, distinguishes the major banks and their experience in the Western

Canada economy in the 1980s from that of CCB and Northland. Hence the conditions in these two groups of banks are incomparable. The difficulty arose in CCB because its management scaled the lending operations according to the strengths and assets of the major banks instead of scaling these operations to their own strengths and assets. Consequently, when the inevitable downturn in the economy came, particularly in the cyclical industries of real estate and energy, new banks which were the product of doubtful design, rapid expansion and imprudent lending policies, such as CCB, were exposed to adverse economic winds and their destruction was inevitable, at least without extensive outside aid. All this must be the conclusion drawn from the evidence introduced in this Inquiry.

The evidence equally reveals a dedication by management to preserving income and the values of the loan portfolio in the balance sheet, all to the end of presenting financial statements which would enable the bank to survive. Without this effort and ingenuity, of course, the bank would not have survived from 1982 through 1985. Whether these practices found their way into the reports of the regulator and the audited financial statements of the bank, and if not, then why not, are issues to be considered below.

The management of CCB cannot be faulted for their courage, energy, industry and ingenuity. To the last day of this bank, the effort to survive was maintained. Unfortunately, it must be said that in its efforts, management, by adopting the survival tactics already examined in detail, went beyond the lines of proper and prudent banking practice. The actions taken, although in some specific situations they might be within the bounds of propriety, led to a general condition where the financial reports were a facade. The reality was, and had been for some time, a bank with inadequate and declining earnings, sagging asset values and waning credibility in the financial community. A sudden return to the western economy of the boom of the late '70s and early '80s might have saved it. The current world slump in the price of oil would most certainly have finished it off. Management knew the rules of banking and exhibited its abilities to run a bank successfully. On this occasion, caught with a low-quality loan portfolio, and a severe recession, they should have faced reality. A timely effort to merge or reorganize might well have succeeded. Even had such efforts failed and liquidation then ensued, it would have reduced or avoided the losses suffered by those who, believing the bank to be sound, dealt with it or invested in it.

All this must be read in the awareness that the extensive record reveals no evidence of self-enrichment or improper personal financial

gain or advancement. This is simply a case where the ends did not justify the means.

2. Directors

The first element of management is of course the directors. In CCB it is difficult to discuss the directors as an entity given the fact that over the course of the bank's life 43 persons served on the Board of Directors, and that of these, only 4 served from the incorporation of the bank to its liquidation. The bank experienced two distinctly different eras of leadership at the board level. The first was under the leadership of W.H. MacDonald, but it is more accurately described as the Eaton era, which came to an end in January 1983 with Eaton's resignation as Chief Executive Officer and as a director of the bank. Paul Britton Paine became a director in September 1983 and Chairman in November 1983. He served to the liquidation of the bank.

On the surface at least, the corporate organization of CCB was conventional. Paine, with whom DesBrisay substantially agreed, offered the following description of the role of the Board during his tenure:

> Firstly, it is to establish basic objectives and broad policies of the corporation ... Secondly to appoint corporate officers, advise them and approve their actions and assess their performance; thirdly, to approve important financial decisions and actions ... budget, strategic plans, compensation, financial audits and ensuring that proper annual and interim reports are given to shareholders.
>
> On the more technical and less important side ... are the approvals of changes in corporate assets ... the issuance of securities ... the declaration of dividends, the delegation of special powers to others ... appropriate filing with the various regulatory authorities. ...

The Board of Directors relied upon four principal sources for their information about the bank's operations: (1) management; (2) the external auditors and their meetings with the Audit Committee of the Board; (3) the internal Inspection Department of the bank; and (4) the Office of the Inspector General. In CCB, the bank did not obtain the same type of information from the internal Inspection Department as is the case in the major banks because the CCB Inspection Department did not assess and classify the quality of the loan assets of the bank, that is, the accuracy of management's classification of these loans or the adequacy of the loan loss provisions taken by management.

The Board operated through various committees including the Loan Committee and the Audit Committee, which are of principal interest to this Inquiry. These two committees were conventional in their constitution and authority within the corporate procedures. Of

concern is the question whether the Board derived the appropriate information and reactions from these committees.

DesBrisay, one of the original directors of the bank, discussed the general involvement of the Board in one important matter, the approval of workout schemes adopted by management:

> Q: Were there any limits as to what they [management] could do that was imaginative [in the context of workouts] without getting board approval?
>
> A: What would be proper and acceptable by accounting standards and by banking standards. They [management] were the determinants of that.

Another interesting illustration of the lack of awareness on the part of the Board of important management decisions is the "Bank Sponsored Drilling Program" (BSDP). This program effectively put the bank into the oil drilling and development business, albeit through the back door of workouts. DesBrisay testified that he did not "think that [the BSDP] is something which would require the involvement of the Board." The general issue of management workout programs is important in the analysis of the causes of failure of the bank. It is a conventional, commonplace activity in banking to undertake a workout program for the legitimate purpose of assisting a borrower in the return to normalcy in its relationship with the bank. Liquidation of a loan is a last resort and a generally unprofitable alternative. It has long been seen as good banking practice to stay with the borrower so long as possible and refrain from repossession of security held. On the other hand, it is obviously not good banking practice to undertake a workout for the artificial reason of avoiding management's recognition of a bad loan. The questions are when management should refrain from undertaking workout programs for the improper motives that offer certain attractions to management under pressure, and the responsibility of the Board of Directors of the bank to see that management refrains from doing so. Since these programs were a substantial immediate cause for the failure of the bank, these are vital questions to this Inquiry.

The position of the Board in the last years of the bank cannot be viewed in proper perspective unless one recalls the experience of the Board in the successful opening years of the bank's life under the Eaton leadership as described in Appendix C. The Eaton management was initially well received by the OIGB. Following the 1982 inspection of the bank by the OIGB, Eaton was able to report the results of that inspection to the Board as follows:

> Asset quality, in which he was more than satisfied; liquidity which would seem to have very good support arrangements; and cost overheads which were not faulted in any way. Mr. Kennett's general comments were positive and the bank was noted for being in control of itself. No regulatory reporting

deficiencies have occurred. He was especially pleased with our loan policies and pronounced them responsible. His staff were particularly complimentary about the bank's management information systems. ... Comparatively we were told that we were doing well against other banks.

Even as the halcyon years of the early Eaton leadership came to a close, many on the Board were beginning to realize that there was something wrong in the bank management. The evidence of DesBrisay and others shows that the operations of the bank drifted away from the immediate knowledge and control of the Board as Eaton's personal objectives gradually diverged from those of the bank. The Board eventually recognized this and, assisted by the Inspector General's letter of 5 November, 1982, brought about the end of the Eaton administration of the bank. Another incident spurring realization of trouble by some directors was the acquisition of the 39 per cent interest in Westlands Bank in September, 1981. This venture was led by Eaton. A number of members of the Board strongly objected to the investment because Westlands was obviously an undercapitalized bank with what was "in reality a negative capital of some $7 1/2M [supporting] ... gross assets of approximately $175M". The majority of the Board overrode the protests of the minority and in doing so committed what stands out as the first strategic error leading to the end of the CCB. This may not have been the case had management properly monitored Westlands as the acquisition plan proposed. In fact, "Westlands became a taboo subject at CCB Board meetings and questions addressed to Eaton were turned aside".

Not on the same scale of capital squander was the expensive experience of the bank in retiring Eaton. In the final settlement regarding Eaton's departure, CCB agreed to purchase the Eaton residence to avoid a costly foreclosure action, and to write off residual stock loans. Total costs were estimated at $750,000, but eventually exceeded this amount.

In the McLaughlan years the relationship between the Board and management underwent further changes. There is no doubt that McLaughlan, having been the President of the bank since May 1982, came into the chair as Chief Executive Officer with a full awareness of the difficulties the bank had in its growing volume of bad loans. One of the measures initiated in 1982 on a small scale, but in full scale by the fall of 1983, was the adoption of a change of policy in the valuation of the loan assets of the bank. Again the Commission is dependent upon the evidence of DesBrisay, who testified that the Board of Directors "were informed that management was reporting to us and the Loan Committee nonearning loans on the same basis that nonearning loans are determined by other banks ...", and that he knew of no change in

1982 or onwards. In the meantime, the evidence is clear that the management of CCB with, from their viewpoint, the best of intentions, had adopted a new mode of valuing security held by the bank. As mentioned earlier, it was a future value concept under the label "baseline value".

The Board not only did not become aware of any change made by management in asset valuation policy but, if the evidence of DesBrisay is representative, did not really believe that management had adopted the use of future values or baseline value in the computation of the worth of the loan portfolio.

> Q. Well, did the board appreciate, when they were told about this change in practice, that this going concern concept involved this kind of thinking, that the economic conditions are bad, appraisals now indicate that this property is only worth X dollars, we think conditions are going to improve in the next couple of years at which time it will be worth X plus Y, therefore, for the purpose of determining whether we capitalize interest we will assume the property is worth X plus Y which is the baseline value. Were you aware that is the way in which they were doing it?
>
> A. Well, I do not think that that is the way they were doing it.
>
> Q. Just answer the question. Were you aware that that is the way in which they were doing it?
>
> A. Well, I can answer the question, but I do not think that that is the way they were doing it.
>
> Q. You were not told that that is the way they were doing it?
>
> A. I do not think that is the way they were doing it.
>
> Q. Were you told that that was the way they were doing it?
>
> A. I am sorry. My understanding was that they were valuing the properties, or the worth of the customer, on the basis that the customer was a going concern and that if it was necessary to liquidate that which the customer had the valuations would be based upon an orderly realization of those assets, not what would bring if sold today.

Paine in his testimony, while not in agreement that management were applying future values, did agree that where there demonstrably was no market in which an asset's value could be realized, it should be the subject of a loan loss provision. This conservative attitude in the Chairman was also reflected in his approach to marginal and unsatisfactory loan classifications. He testified that this category of loan had slowly increased from 21 per cent of the total loan portfolio of the bank at 30 September 1983 to 24.6 per cent a year later, and finally to 29.8 per cent at 31 December 1984.

> This meant that between $750M and $800M of the total loan portfolio fell into this category. Some of the increase came about because I encouraged the Loan Committee to take a more conservative approach to such loans, some of which had not before been placed in this category and in my opinion should have been.

The truth probably is that had Paine's conservative approach to loan classification and provisioning, and particularly the latter, been followed by management, the bank could not have survived very much beyond the end of fiscal year 1983. It follows that had the directors known about the use of future value concepts in the valuation of loan assets with the derivative effect upon the bank's income and asset statements, the bank could not have survived. Its earnings would have disappeared, and the sharp losses to be encountered, together with the diminution of the value of assets on the balance sheet, would have made the raising of deposits either impossible or too expensive to be practical. The evidence of Paine is buttressed by that of the Chairman of the Audit Committee of the Board, who testified that, while the auditors were concerned about some of the bank's accounting practices, the Committee did not feel that the auditors were unduly alarmed and they were prepared to sign, and did sign, the financial statements. Had the Chairman's policy or outlook been applied by management, insolvency may not have ensued. The state of the bank's finances would have been revealed earlier. The chances of successful merger or reorganization were very much better in 1983 than in 1985.

In order to fill out the shape of the strange and ironic dilemma of the bank in the 1980s, it must be pointed out that throughout this period the directors were, of course, faced with the reality that the independent external auditors of the bank continued at each fiscal year end to certify that the financial statements as prepared by the management of the bank fairly represented the financial state of affairs in the bank. The irony is graphically illustrated by the comments of Paine who, faced with the evidence that the Bank had capitalized $59M of interest on loans over fiscal years 1982 through 1984, stated that the OIGB and the auditors must have been "blithering idiots" if they had failed to discover it. It makes it very difficult in these circumstances to assign to any individual director a substantial degree of fault for the ultimate failure of the bank by reason of his inability to respond to the true condition of the financial affairs of the bank. It may be that the directors' responsibility narrows down to the question whether the bank was allowed to continue in its insolvent state beyond the time when it should have been so found, and its structure reorganized or its existence terminated.

The suddenness of the end of the bank was no doubt felt as much by the members of the Board of Directors as by the regulators. The

Board was not involved by McLaughlan in any significant way prior to 14 March 1985. So far as the record reveals, only Hillman, the Chairman of the Audit Committee, had knowledge as early as 11 February 1985 of the impending calamity in the energy loans of the bank in California. Neither he nor McLaughlan relayed this information to the Chairman of the Board in an executive meeting on 4 March prior to the director's meeting on 5 March. Even on 5 March the Board was not apprised of the details of the losses incurred in the U.S. Agency in both energy and nonenergy loans, although the record is clear that these details were in the possession of McLaughlan at the time of the Board meeting on 5 March. In fact, McLaughlan allowed the Board to defer decision on the crisis until a subsequent meeting on 19 March by which time he would be able to carry out the edict of the Board to gather the precise details of the extent of the loss facing the bank from these energy loans. All this was in his possession prior to the meeting of 5 March.

As to the process leading to establishment of the Support Program itself, the Board was not involved in the meetings of 14 March, nor the ensuing meetings on 22 and 24 March except to convene an Executive Committee meeting in Edmonton on the latter date so as to approve the Support Package as finally put together at these meetings by the regulators and the major banks. In the final analysis, however, the directors of the CCB were on a take-it-or-leave-it basis, or as the evidence has it, "sign or die".

The fault of the Board, throughout its history, has been its susceptibility to mesmerization by management, first by Eaton and his lengthy period of success, and secondly by the industry and apparent achievements of McLaughlan. Some members of the Board came to realize in both instances that management was not effectively managing the affairs of the bank, but realization came to the majority too late. In the Eaton era such episodes as the Westlands acquisition placed the future of the bank in serious jeopardy. In the McLaughlan era the struggle against oncoming insolvency was not fully analyzed and appreciated by the Board. Hillman's failure to report immediately to the Board or to the Chairman on his February 1985 visit to the Los Angeles Agency and the impending calamity there, is illustrative of the lack of adequate response on the part of some directors. If there is one key to the troubles encountered by the Board in directing the affairs of the bank, it was their composite failure to insist upon simple and straightforward regular and timely information from management. The institutions and processes were in place in the government of the bank but they did not function because management did not deliver and the

Board did not demand a flow of the basic information necessary to the control of the affairs of the bank and to keep management within the policies as laid out by the Board. The Board's difficulties were increased or perhaps even caused by the failure of the auditors to fully alert the Board as to the practices of management in interest accrual and capitalization, loan loss provisioning, asset evaluation and workouts. It is difficult to disentangle these forces which brought about a semi-paralysis in the Board of Directors of the bank as the final governing agency in the corporation.

This subject cannot be closed without observing that a board acts through a dynamic shifting majority. It is each director, not the Board, who is under certain duties, and the conduct of directors can only be assessed individually. Thus it is most unfair to lump all directors together in any assessment of board action. Some longtime members on the CCB Board swam against the management current through many years. Some recent additions to the Board recognized many of the problems of the past. Others seemed to make little contribution. The Board here, of necessity and for the purposes of the Commission's mandate, must be assessed and adjudged as a unit over the life of the bank. Individual members may well suffer from a description that does not fit their individual records as directors.

Like the auditor who has one powerful last resort power, the directors can resign. Where the corporation is proceeding in a direction perceived to be wrong, the director must withdraw. It is often more difficult to do so where the director represents a large shareholder. Nevertheless, his higher duty is to resign in such circumstances. In the course of the CCB history, some directors with better knowledge or training, in all the circumstances, might well have dissociated themselves from the bank by resignation. That no one did so in CCB is not evidence necessarily of a lack of perception of duty. Founding directors would not find it easy to turn the ship over to someone who is seen by those founders to be destroying the original plan. The Board here, as a unit, must share some of the responsibility with other elements in the corporation for this ship which sank under their feet with a crew on board for which the Board of Directors were responsible.

3. Auditors of the CCB

The Commission now turns to the actions taken by the external auditors of CCB in relation to banking and accounting practices generally found in Canadian banking. These practices, as explained to the Inquiry, are described in Appendix F, and are briefly reviewed here for convenience.

The auditors have the duty of deciding to approve or not to approve the financial statements prepared by the management of the bank. Their approval is granted, as we have seen, by certifying to the shareholders that the financial statements present fairly the financial position of the bank and the results of its operations for a specified fiscal period. Of course, pursuant to provisions of the *Bank Act*, the auditors have additional duties to the Office of the Inspector General and, through that office, to the Minister of Finance.

The auditors know as a fact that in the operation of the bank the directors, management and Inspector General share considerable information. One of the positions taken by the auditors in this bank is that the other two elements in the triangle, that is management including the directors and the regulator, were fully apprised of the situation in the bank through discussions with the auditors. This question frequently arose in the hearings: if the auditors accept the valuation placed upon assets in the process of workout by management, are they exonerated from any error in judgment in that regard by reason of the fact that they have fully advised the directors through their Audit Committee and the Office of the Inspector General, of any doubts or differences with management they may have had? Whether that consequence follows or not, the immediate and only real question is whether the financial statements, on which the auditors expressed their opinion, presented fairly the financial position of the bank.

We start with the presumption in the field of accounting that the subject of the audit, here the bank, is a going concern, but in the words of one of the expert witnesses, "One of the responsibilities of the auditor is to satisfy himself that the going concern presumption is valid" in this instance. Dilworth testified that where there was a perceived threat to the going concern assumption, then the auditor was obliged "to use more conservative" valuation methods in determining the accuracy and fairness of the financial statements. One of the great arguments before the Commission was whether in this process the auditor must value the assets on a "liquidation" or "going concern" basis. Dilworth brought some precision to this debate by pointing out that as a practical matter, where a circumstance developed into a serious recognizable threat to the going concern status of the bank, the auditors must, in valuing the assets of the institution, take into account periods of realization closer to the liquidation process in valuing the assets. Of course, the entire process requires that it be carried out with regard to whether a given issue or piece of evidence is "material" to the fundamental question whether the financial statements fairly present the position of the bank.

The test of materiality was very neatly put by Broadhurst:

> In addition to the various mechanical tests, such as percentage of normalized profit, percentage of total loan portfolio, or some other measure I would like to ask myself one further question, and that is: If the adjustment that I am after was booked, is there a good chance that the readers of the financial statement would take away a message, after the adjustment, which would be different from the message that they would have from the financial statement without the adjustment and, as a result, take a different course of action? This is also subjective.

Materiality is by definition a flexible concept. The scale of materiality of an item in question will vary according to the ratio it represents as compared to the quantity the event may be said to have influenced. Here the CCB auditors had determined that a million dollars was the level of materiality. This was set in 1982 based upon an estimate of "normalized" income of $12M. By fiscal 1984, the earnings in a current cash sense had disappeared entirely, there was a loss of $6.9M from operations, and only by the recovery of income taxes was an income of $800,000 produced. In simple logic, the level of materiality of $1M has no application to a bank with a profit of less than $1M. The scale of materiality reflecting the initial yardstick adopted by the bank's auditors would produce a materiality reference of much less than $1M. This is in accord with the testimony of Broadhurst and Dilworth.

The valuation of loans, the principal assets of a bank, is based on the valuation of the borrower's covenant, or where that has disintegrated, the underlying security held by the bank. Thus the security posted by the borrower is regarded as a "fall-back position". The valuation is of critical importance because in turn it determines the ultimate collectability of principal and interest on the loan in question. The auditor witnesses were unanimous in their view that, however the asset of a bank is valued, the decision should not be based upon an economic forecast by the valuer or anyone else. Broadhurst testified that he "would be alarmed if these assumptions [future economic conditions] included a significant improvement in the economic circumstances." Indeed he agreed that such a practice would be "dangerous".

Broadhurst went on to discuss the process of setting up loan loss provisions against the loan assets in the bank's portfolio:

> Insofar as provisioning of loans, I believe there are two essential approaches. One is the examination of certain individual loans, and the second is a stepping back and viewing the overall loan provision in the light of trends noted and judgments made in the examination of individual loans.

Of the two steps or approaches, he considered the second step as of transcending importance. When valuing a series of assets, particularly

where the valuation is an interlocking process, common sense requires an overall view of the result. Broadhurst refers to this as a "stepping back" and that view is shared by the other expert witnesses.

With regard to the subject of capitalization of interest (in an "unplanned situation", that is outside the initial loan contract), Broadhurst testified that the practice was a "warning signal" to an auditor. The rule in bank auditing, in his view, is simple. This practice should not be undertaken if there is *any* doubt of the collectability of principal and interest on the loan, nor should it be undertaken where the total principal and interest would exceed the value of the security held, valued without reference to expected values at some time in the future. The basic problem facing the auditor, it would appear, is to decide whether a decision by management in the course of banking, which for convenience is referred to as an operational decision, necessarily ordains that the proper accounting treatment to be accorded to the transaction when reflecting it in the financial statements of the bank is that proposed or applied by management. The expert evidence mentioned above was clearly to the effect that it does not. The auditors of CCB, on the other hand, felt bound by the accounting treatment accorded by management to their operational decision. The auditor, of course, has access to all records of the bank and can review the file or a series of files on a spot-check basis and determine why a provision was or was not taken against the stated value of the loan. In addition to Broadhurst, the liquidator of CCB was of the view that the decision by management to work out a loan, in contrast to simply liquidating the loan, was not a bar against taking a provision immediately and thereafter adjusting the provision and the net value of the asset upwards and downwards as the fate of the workout is unveiled. MacGirr testified:

> However, an election to wait on the disposal of the underlying security, in my opinion, should not affect the setting up of appropriate provisions. If it were otherwise—I guess it is obvious—a bank could escape setting up any provisions by simply electing to hang on to all of its bad loans.

In the debate on this issue before the Commission, counsel for the auditors and others sometimes submitted that it was no part of the role of auditors in the valuation process to substitute their judgment for that of management on the determination of the proper balance sheet value of an asset. It is helpful to set out one of many references to this issue by Broadhurst:

> 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.

From all of these experts comes one rather clear and simple key warning. Where the interest is not being paid from the borrower's own cash, Mackenzie said:

> [T]hat's where the focus ought to be because if the bank cannot generate *that kind of earnings* that will be a reflection of a host of other problems, nonperforming loans; it could be a reflection of the fact that they have a concentration of assets in real estate, oil and gas or shipping or whatever, but it is to me the key indicator, and *a key thing to look for*. (emphasis added)

An examination of the detailed evidence, both testimonial and documentary, indicates that the audit firms of CCB, in the year 1984 and probably in the year 1983, did not adhere to the principles enunciated by the three experts which have been summarized above, when determining whether to approve the financial statements as prepared by management. The evidence is clear that, at least with respect to the 1984 audit, the auditors put in a very considerable number of person days (about 300) and in the course of so doing examined about 65 per cent of the entire loan portfolio. In the course of such an examination the auditors should have come across the practices which have been discussed here, namely, the valuation of assets on the basis of future realizations in different economic circumstances than those prevailing at present, the recognition of accrued interest, the capitalization of interest, and management's decisions regarding loan loss provisions.

It is clear from the evidence of the auditors themselves that they were aware that bank management was valuing the loan portfolio and the assets held in security therefor on the basis of "a timeframe of three to five years to see some positive results by way of a turnaround" and that such a basis "... seems reasonable to us". Later on, Lord, on behalf of the CCB auditors, stated in answer to a question from Commission counsel:

> They [management] were really saying two things ... they were saying that our business judgment is that it would be inappropriate to sell the property in today's market and then they were saying we expect a recovery, we will sell the property after the recovery has taken effect in a more orderly market where there are buyers and their business decisions was to hold the particular assets and sell them in a more orderly market ...
>
> Q. And the expectation of recovery is based on a judgment on economic factors, is it not?
>
> A. (Lord) Yes.

This valuation basis necessarily inflates the value of the asset over and above the present market; otherwise, recourse to the future value basis for valuation would be unnecessary. The result of the inflated values of

assets is the advantageous effects on the income statement and the balance sheet as already discussed.

All this leads back to the initial question, has the bank made the operational decision to work out the loan and thereby revise the value of the asset on the basis aforesaid simply for the purpose of mandating an accounting treatment which produces beneficial paper results? If the auditors are bound by operational decisions, the decision of management would not be subject to audit review and the auditor would be free to certify management financial statements as fair almost on an automatic basis. As MacGirr put it so succinctly, if the auditor is so bound by the operational decision, then a bank may avoid ever having to take a provision or ceasing to recognize accrued interest by simply determining values on a basis which would maintain the classification of the loan and justify the continuance of these practices. In short, if the bank in the view of management cannot afford to "take the hit" which would by proper accounting treatment have followed, management would simply make an operational decision to work out the loan and maintain values at a level justifying the deferral of loss provisions and the continuance of income recognition.

Lord and Carr, while maintaining that the operational decision dictated the accounting treatment, and thus foreclosed the auditors from anything approaching a substitution of their judgment for that of management, acknowledged that at least they were able to properly maintain a list of specific reserves which they proposed should be taken in each financial year and a record of those proposals which were rejected by management. The provisions proposed by auditors and rejected by management amounted to $18M in 1983 and $11M in 1984. The auditors say they accumulated this "so that we may have some idea of the range of differences in our opinion from the bank's". Materiality appears to have had little to do with the problem facing these auditors. The $18M in 1983 would have been charged against income through the five-year formula for loan loss provisions and credited against the Appropriations for Contingencies Account on the balance sheet. In 1983 the before tax income was $8.2M and the net income was $6.5M, and in 1984 the bank was in a loss position of $7M before recovery of income tax, producing a net income of but $800,000. Had the auditors insisted on adjusting the provision for loan loss as calculated in accordance with the five-year averaging formula and charged to the statement of income, there would be a reduction in income before tax of $5.5M in 1983 and of at least $2.8M in 1984. Notwithstanding the obvious materiality of the rejected provisions, the auditors in their testimony stated: "... we are not in a position to say our position is correct and the bank's position is incorrect. ..." In this they seem to be in fundamental

disagreement with the testimony of Broadhurst and Dilworth. It is for no purpose to argue that these "differences" are not material when measured against a $2.2B loan portfolio. The gauge of materiality here applicable is the level of earnings and the balance of appropriations for contingencies which would be reduced or even wiped out.

It can be stated in summary that the same line of reasoning was applied by the auditors to their position vis-à-vis management in a decision by management to override the rule requiring the cessation of taking into income accrued interest. When management have determined that there is no reasonable doubt as to collectability of principal and interest and thereby invoke the management override, bank auditors, in the view of the CCB auditors, are powerless. They may have tested the "reasonableness" of management's judgment, but they accepted that judgment in many instances where it was patently unreasonable. Again, the position taken by the CCB auditors is squarely against the testimony of the accepted professional accounting witnesses.

Lastly, the auditors take the same position with reference to the decision by management to work out a loan which otherwise would fall into the nonperforming, or nonearning category. In this situation, the auditors for CCB took the view that once management has taken such a position, the onus is on the auditor to demonstrate the error of management. The auditors' testimony on this third issue is even clearer:

> The bank has made a business decision and unless there is *no* evidence of any possibility of continuing, it is a bank decision to treat the loan as a going concern loan and, accordingly it is not possible to categorically, as auditors say in those circumstances, [state that management's] valuation as a going concern is inappropriate, because the decision has been made to continue with the customer on a going concern basis and there is a program in place to do that.

Reduced to its simplest terms, the auditors say that they may only reverse a management decision on this point where there is no evidence of the possibility of a borrower continuing in business. In effect, they have subscribed to a rule that the management decision to put the loan into a workout carries with it as a concomitant the decisions that there shall be no loss provision taken, that accrued interest shall be taken into income, that interest so treated in the past shall not be reversed, and that they are, therefore, powerless to take the opposite view and to insist upon its implementation and reflection in the financial statements of the bank. This proposition clearly flies in the face of the principles enunciated and accepted without qualification by Broadhurst, Mackenzie and Dilworth. It also virtually denies any real purpose in having external auditors.

Apart altogether from the technicalities of accounting rules, it offends common sense that a bank with the level of unsatisfactory loans which CCB had in the years 1983 and 1984 could by the simple workout device obviate all need for cessation of income recognition or the taking of provisions against losses. Thus on principle and in detail the practices followed by the auditors of CCB in reviewing the financial statements proposed by management were clearly in error, and as a result the financial statements, contrary to their certification, at least in the year 1984, clearly did not fairly reflect the financial position of the bank.

This conclusion logically follows from the report by the auditors themselves to the Audit Committee of the bank in the years 1982 through 1984. It is instructive to review the highlights of the audit observations they made. The auditors noted a change in interest recognition practices for 1982. There was a significant increase in 1982 in the number of noncurrent and nonearning loans. In past years, the bank had discontinued accruing interest on loans and reversed prior accruals where interest arrears exceeded 90 days, but in 1982, the bank established a practice of recognizing interest based on assessment of each account and, in particular, on underlying security values rather than adhering to the 90-day guideline. They expressed concern about specific loans where uncertainty existed and interest was nevertheless recognized. As in the case of specific provisions, the auditors stated that they were not in a position to conclude that the bank would not likely receive the interest in question. The auditors considered the accounting policy change regarding income recognition to be appropriate as long as security values were "critically reviewed". The baseline value concept, originated in 1982, was not considered by the auditors to be a noncritical review of the security values. They clearly were not put on their guard by these contemporaneous occurrences which together would enable the bank to recognize much more income than it could otherwise do.

The 1983 report to the Audit Committee shows continued and increasing acceptance of management's philosophy notwithstanding the continuing economic downturn. The report stated that the auditors accepted management's judgments as to what the ultimate losses on particular accounts would likely be. They told the Audit Committee that it was not possible for them to take the position that management's estimate in any particular case was clearly incorrect, because bank management is more experienced in the matter of collecting difficult loans than are external auditors, and external auditors do not have the "gift of perfect foresight". That year, the "going concern" concept evolved further into something else, and the auditors noted that, to the

greatest extent possible, the bank attempted to maintain the going concern value of the security by taking control of the assets and finding competent new management, thereby buying time for the market value of depressed assets to return to more normal levels. They cited as specific examples some of the real estate loans in Alberta and the drilling rig loans (described elsewhere) in Alberta and the United States. In both cases, the auditors indicated that the success of the bank's strategy in avoiding major losses on these accounts was dependent upon future economic recovery in the Alberta economy and the energy sector in Canada and the United States. Clearly, the accuracy of the auditors' opinion also depended on these factors.

Equally startling was the auditors' acceptance of management's treatment of accrued interest when the security was transferred to a "loan warehouse". Upon transfer of security to some newly created companies, senior management explained that interest continued to be recognized, though uncollected, because of their improved confidence in the full recovery of principal and interest due to the transfer of control of the related security to new and more competent operators. The auditors stated that it was "not yet possible to know how much, if any, of such capitalized interest may not be collected in the future". In the result, management's view prevailed and the uncollected interest continued to be taken into income. The auditors warned that "a significant amount of the problem loan portfolio has been classified as earning" as a result of management's approach. All this was done in the face of the principle acknowledged by the CCB auditors that it is not permissible to capitalize interest unless there is no reasonable doubt of collectability.

The CCB auditors concluded their memorandum for discussion with the Audit Committee in 1983 with the following comments:

1. The bank's policy of capitalizing interest on problem loans increases the difficulty in demonstrating full collectability of these loans.

2. The bank could have justified larger specific provisions on certain loans.

3. The auditors took some comfort from the size of Appropriations for Contingencies Account, which amounted to approximately $24M, and represented additional protection for unforeseen loan losses.

The third comment is clearly contrary to the bank auditing testimony of Mackenzie and Broadhurst who stated that the existence

of such an account is no substitute for taking specific loss provisions. Yet the auditors stated in a memorandum:

> The $18.032M [the total provisions proposed by the auditors and rejected by management] can be seen to be easily covered by the appropriation for contingencies account which is meant to cover these "grey areas". At October 31, 1983, the appropriations account has a balance of $23.947 [M]. Because this total is considerably less than the appropriations balance, no further action has been taken at this point.

The position of the CCB auditors taken in their testimony before the Commission was the same as that of the expert witnesses concerning the Appropriation for Contingencies Account, but they explained their concurrence with management on the basis that the loss provisions rejected by management and waived by the auditors were for "unforeseen" losses and accordingly were properly covered by the balance in the Appropriation for Contingencies Account without need for specific loan provisions. Carr said the losses "would be unforeseen as far as the bank was concerned". Such a position represents delegation of responsibility to management in the extreme, and is representative of the position taken by the CCB auditors in justification for their certification of the bank's financial statements.

The memorandum for discussion with the Audit Committee for 1984 again stated that the bank continued to be less conservative than the auditors would like with respect to loan loss provisions, accrual and capitalization of uncollected interest, and recognition and capitalization of fee income on restructured loans and limited recourse workouts. However, on balance, the auditors were satisfied that the total loss provisions were adequate in the circumstances and that the decision to accrue interest and fees "was made only after careful consideration by senior management". It only need be said in summary that the evidence calling for much more conservative accounting practices lay all around the auditors in 1984, but their response was a continuation of the policies and practices of 1983. The auditors acknowledged that the level of marginal and unsatisfactory loans continued to be at historically high levels and losses would continue to be high. In the 1984 memorandum the auditors recorded their concerns that (1) allowing accrued interest to be taken into income increased the difficulty in demonstrating full collectability of those loans where the current value of collateral security was very "soft"; (2) in the case of U.S. drilling rig loans, the bank was still accruing interest in situations where there was a shortfall of the current value of collateral security when compared with the loan balances, and that the auditors would prefer that interest be accounted for on a cash basis until the collateral security was at least equal to the loan balance; and (3) the bank could have justified larger loss provisions as at 31 October 1984.

The 1984 discussion memorandum removes any doubt that the auditors and the Board of Directors at CCB were aware of all the practices management described in these auditor reports to the Audit Committee. There was no doubt that there was an awareness of the extent of these practices. For example, the external auditors estimated that by the end of 1984, approximately $350M or 17 per cent of the bank's loan portfolio was committed to limited recourse workout loans.

By the end of fiscal year 1984, the auditors had manoeuvered themselves into a difficult position. They acknowledged that the large number of workouts in place precipitated by the difficulties in the economy raised a "business expectation" that losses would continue to be high for CCB. They recommended that the Appropriation for Contingencies Account should therefore be maintained at least at the 1983 level. Nevertheless they did not insist that the bank take the specific loss provisions that they had recommended. Their submission on the subject of the Appropriations for Contingencies Account to the Inspector General read in part:

> ... It was felt ... after reviewing all these specific problem loan files that although additional provisions were not required on specific loans, an additional general provision should be available to provide a safety net for the workout loans.

Thus the auditors waived specific provisions which they would have preferred while, at the same time, they were concerned that losses would continue to run at historically high levels. All this cut squarely against the grain of bank auditing as described to the Commission by the bank auditing experts mentioned above. The auditors put themselves in this position by agreeing to the financial statements prepared by management in prior years and then found themselves unable to explain to management why they must now suddenly adopt the accepted standards of the bank auditing profession. Thus they continued to approve financial statements based on standards which were not accepted by that profession.

By 1983, the auditors were able to state that the practices adopted by management reached the very end of acceptable accounting practices, and certainly were not as conservative as they would wish. The earnings trend in the bank was sharply down and future tax credits aside, the retained earnings would have been effectively drained by the end of fiscal 1984. It follows that by that time there had arisen a perceivable threat to the going concern status of the bank, and hence, there was an obligation founded in accounting principles on the auditors, in the words of Dilworth, to use a more conservative approach to valuation. But for the financial statements for fiscal year 1984 such did not appear to be the case.

The conduct of the auditors in the face of but two examples is sufficient to illustrate all the foregoing practices. A loan was made by the bank to the operator of a sawmill wherein security was posted in the form of the undertaking itself together with timber rights. Difficulties arose in 1981, and by 1982, the borrower was in substantial default. A monitor was therefore appointed. The bank continued to fund the operation and to capitalize interest in 1982. The borrowers failed to meet the budget prepared by the monitor for 1982 since markets remained depressed. A receiver/manager was appointed in early 1983. The bank continued to fund the operation. In 1982, the loan had been increased to $6.3M. Interest was capitalized through 1983 and a loan of over $5M was made to the receiver. The total loan increased during the receivership to $13M. This included capitalized interest of over $1M. The loan was transferred to nonearning status in 1984. The bank declined to take a reserve against this loan exposure in 1982 because it was felt that an attempt to realize on the security would result in a significant loss which, it was anticipated, could be avoided when the expected turnaround in the British Columbia economy occurred in 1983. This loan was still in receivership in 1984 but was not included in the list of "waived provisions" compiled by the auditors. The bank, after many failures, located a new operator in 1984 for the sawmill who was said to have expertise but whose principal attraction seemed to lie in the fact that he lived in the area and could concentrate his attention on the mill. The new purchaser offered to buy the security only on a non-recourse basis through a new company with the debt (which was to be increased by $3M to provide working capital to the new borrower) to be paid by an income debenture out of future profits, if any. All this was done in the face of a report that "lumber prices are declining again" and an explicit statement by the purchaser that there was no assurance that the operations would produce sufficient income to service the debt. Overhanging the whole transaction was a doubt about the ability of the bank to transfer the timber rights to the new operator, and a doubt as to the value of those rights, there being some suggestion that a contingent liability to the Ministry of Forests was attached to the rights.

Despite all this, the auditors did not insist upon a loan loss provision in any of the three fiscal years and did not resist management's income recognition practice throughout this period. They expressed their concern in each annual audit review of this loan. They accepted management's excuses year after year about turnarounds in the industry. At the time of the Support Program, management had recommended a reserve of $4M. The Inspector General's first bank inspection team in March 1985 (Tallman) recommended a provision of $9M. The conclusion is irresistible that for most, if not all, of these fiscal periods, the bank in its financial statements held this loan out as

an asset with a value considerably in excess of that which management ultimately recognized to be the case, and even further in excess of the valuation according to ordinary bank credit practices.

The second example concerned a real estate loan secured by a third mortgage on an apartment building. There was other security which the bank felt to be worthless or of little value. In fiscal year 1982, the balance of principal outstanding was $5M and the loan was rated 3 by the bank. In 1983, the auditors reviewed this loan and reported that it "was in fairly rough condition but yet the bank continues to capitalize the interest". An appraisal in the bank file revealed that the security was valued at $14M. Taking into account prior encumbrances of $10.6M, the audit reviewer concluded that there was a $2.9M deficiency, but that management had concluded that the correct approach was "from a workout viewpoint". The file also revealed that a prior security holder (another bank which held a second mortgage) with a debt of only $1.8M had taken a reserve. The workout involved funding the development of executive suites in the building. The reviewer noted his doubts that revenue from the development program would be sufficient to carry the debt load, but did not challenge the new baseline value of $18M. The auditors did not include this loan on the list of waived provisions. CCB took no reserve and did not reverse interest accrued and recognized in 1983. In 1984, CCB made further advances so that the total exposure was $8.8M with prior encumbrances now accumulated to $11M. The highest appraisal on file (1983) was $18M. The workout proposal had failed. The situation was only saved by management's assigning a new baseline value to the project of $20M (an increase of $2M over the previous year despite the failure of the workout program). Management's latest baseline value of the property was $200,000 in excess of the total of the prior encumbrances plus the bank's total loan. The reviewer characterized the cash flow forecasts upon which the value was based as "very optimistic". The bank then produced a new plan for the property. In the result, the auditors agreed that no reserve should be taken and no reversal of interest taken into income, all because "CCB is attempting to locate an oil and gas property" for marriage into this nonperforming real estate loan. Again the loan was not on the list of waived provisions for 1984 even though the initial audit review indicated a suggested provision of between $2M and $4M. In the 14 March 1985 bailout review, CCB recommended a reserve of $7M against the principal amount of $8.9M while Tallman recommended "a total write-off".

These are but two illustrations of the hopeless situation produced by the combination of management's operational decisions with reference to nonperforming and nonearning loans and the high level of

auditor acceptance of those decisions with all the attendant accounting treatment.

The record is accurately summarized by observing that by reason of the continuing contacts between the external auditors and the OIGB, the OIGB was aware that CCB was using the concept of future value in its assessment of the value of its loan portfolio and that its capitalization and accrual of interest programs and its provisioning procedures were predicated upon such determinations of value. Both were equally aware that the bank's practices were not conservative. Inside the bank it is equally clear that throughout fiscal years 1983 and 1984 at least, the Audit Committee of the Board of Directors was made aware of the uneasiness experienced by the external auditors by reason of the aggressive accounting policies and operational decisions of management and that in the view of the auditors these policies were not "conservative". The Inspector General himself testified on this subject:

> We were finally satisfied as a result of the discussions with the bank and the auditors, that while the practices certainly were not conservative they were within that range. But having in mind always that the satisfaction was a satisfaction derived not from a detailed inspection of the documentation itself of the loans and appraisals, but as a result of a dialogue which finally did give us some degree of satisfaction. There is no doubt about that.

The communication of these matters by the external auditors to the Audit Committee is acknowledged by the Chairman of the Audit Committee, Hillman, who himself is a chartered accountant:

> So, I guess our immediate reaction to the auditors' memorandum was that we were pleased to note that they were prepared to sign the statement and were not proposing any adjustments based on the comments they had made in their memo. While the bank's accounting policies in their view, tended towards the less conservative end of the range, nevertheless, the financial statements apparently fairly presented the financial position at year end in accordance with prescribed accounting principles applicable to the bank industry. We recognize and the auditors also recognize that matters such as income recognition in specific loan loss provisions are based upon subjective judgments in the underlying security. We were comforted that the auditors recognized management's ability in this regard and agreed that it would be improper to base provisions on liquidation values. ... Finally, I guess, that while we were concerned that the bank's overall financial performance was poorer than the previous year, we were not unduly alarmed by the comments made by the auditors in the audit committee memo.
>
> . . .
>
> What we were concerned about was why we were reporting a much poorer position. Obviously we have our problems. Did the statements that we were examining present fairly the financial position of the bank at that particular moment in time? And we look to the auditors to express that view to us. The auditors said yes.

Q: They say less conservative but still fair; that is the effect of that is it?

Mr. Hillman: Yes.

Everyone in the tripartite system of responsibility took comfort from the other two members' action or inaction as the case may have been. Having thus discharged what they saw to be their communication obligation, the auditors certified the financial statements as fairly presenting the position of the bank and folded their hands to await whatever action the regulator or the Board of Directors might care to take. However, the *Bank Act* puts certain obligations upon auditors to report unsatisfactory conditions. Here the auditors made no such reports. This silence, plus the positive act of certification, induced in the submissions of the directors a false sense of security on their part. In turn, the Inspector General drew comfort from both the fact that the auditors certified the balance sheets and income statements and that the Board of Directors, through its Audit Committee, accepted these statements as fairly projecting the picture inside the bank. In its brief, the OIGB emphasizes the pivotal role played by the auditors in the supervisory system. Its basic position is that it received information from management and the auditors, and had no reason to question that information. It acted responsibly in cases where it received bad news, and received assurances from its first hand information sources which tended to restrain further action. While acknowledging its lack of awareness of the extent of imprudent practices in CCB, it argued that someone else had the duty to inform it of those matters which were required to be known in order to carry out its own statutory duty. The following quote from the brief of the OIGB deals with loss provisioning practices, but illustrates the tenor of its position in relation to all of the imprudent practices in the bank.

> The OIGB clearly knew that the CCB was deteriorating, but realistically was given no idea from any of its sources as to the true extent of the bank's problems. The auditors reports under s.242 of the *Bank Act* with respect to unsatisfactory conditions, and with respect to their opinion on losses of large loans, appear in retrospect to be incorrect. The auditors and management further failed to communicate a sense of the seriousness of the bank's problems on the inspection visits. These problems were further not communicated in the financial statements directly, nor by way of a note regarding unusual valuation policies.

Thus the triangle has become a self-absolving cycle wherein each member of the group of three might fail in some aspect of their duty, but nonetheless all is considered to be cured by the fact that the next person on the cycle committed a sequential and perhaps even greater breach of duty. The public is left to circumnavigate this circular chain of authority only to end up where it started; without very much protection in those cases where they need it.

Is this a reasonable interpretation of the pattern of regulation, corporate governance and audit functioning prescribed by the *Bank Act* in the provisions that have already been discussed in detail? The question cannot be answered in the affirmative, at least as regards some of the players on the field. The auditors, as discussed above, did not apply the standards and principles set forth by the trilogy of expert witnesses. They enslaved themselves to management decisions by a very narrow and comfortable interpretation of the principles of an auditor's responsibilities. It is necessary to conclude from all this that an auditor's restrictive interpretation of his role and an expansive interpretation of the role of management, including the directors, and of the role of the regulator, cannot exonerate the auditors for their failure to adhere to the principles of bank auditing as accepted in the profession when deciding whether or not to certify unconditionally management's financial statements. Because the financial statements as prepared by management for the fiscal year 1984 and probably for the fiscal year 1983 were not prepared in accordance with those accounting and auditing principles and practices pertaining to the audit of banks as described in the evidence by the experienced bank auditors in their appearance before this Commission, those statements did not fairly present the financial position of the bank at the end of fiscal year 1984 and probably did not do so at the end of fiscal year 1983. Accordingly, the auditors should not have issued their certificate of approval for these statements for 1984 and probably should not have done so for 1983. This is in essence the only function an auditor is called upon to discharge (apart from direct reports when requisitioned or mandated by the *Bank Act*) and in this function the CCB auditors failed. It is also clear from all the evidence that the auditors should have reported to the Inspector General as required by s.242(3) and (4)of the *Bank Act* on the conditions which they found to exist in the bank by the end of fiscal year 1983, and certainly by the end of fiscal year 1984. That section (already set out in Chapter 3 is for convenience repeated here) provides in part:

> (3) It is the duty of the auditors to report in writing, individually or jointly as they see fit ... 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 ... with respect to
>
> (a) ...
>
> (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. ...

(4) ... the auditors shall, at the time of transmitting the report to the chief executive officer and chief general manager, furnish a copy of the report to the Inspector.

It must be observed that this forum is, of course, not directly concerned with the resolution of the issue as to whether the auditors, or any of them, were in breach of a duty owed to anybody with respect to the events which have been investigated here. The sole function of this Commission of Inquiry is to determine the causes of failure of the two banks and to make recommendations with reference to any applicable laws or regulations or practices which might improve the situation in the years ahead. Therefore, this Commission expressly refrains from making any finding as to the violation of duty, if any, owed by the auditors to persons who have participated in these hearings or to any other persons. It is sufficient, therefore, in the discharge of duty of this Commission, to conclude, and on the record here such conclusion is unavoidable, that had these auditors applied the principles of bank auditing as enunciated in the record before the Commission, the financial statements for the year 1984, and probably 1983 as well, would not have been approved by the auditors. CCB would have been insolvent, and identified publicly as such prior to 1 September 1985. The financial statements of fiscal year 1984, if prepared in accordance with the policies of accounting and bank auditing principles to which reference has already been made, would in all likelihood have disclosed that the bank was insolvent at that time in the sense that it would have had a negative net worth.

All this is said with reference to the information compiled publicly by the Commission. It may be that another forum, not as free as a Commission of Inquiry to receive information from all sources, would be faced with a different record. The above conclusions are reached entirely on the basis of the record here without any attempt to ascertain what the result might be if other rules or processes applied.

4. The Inspector General

The position of the Inspector General in this picture can best be discerned by commencing with the statutory root of his power in s.246(2) of the *Bank Act*, which provides in part:

The Inspector ... shall make or cause to be made such examination ... into the business and affairs of each bank as the Inspector may deem to be necessary ... for the purpose of satisfying himself that the provisions of this Act having reference to the safety of the interests of the depositors, creditors and shareholders ... and other provisions of the bank are being duly observed and that the bank is in a sound financial condition ... and shall report thereon to the Minister.

This statutory authority has existed for over 60 years. The current Inspector General interprets "his principal role as one of 'prudential supervision', primarily ..." into the two areas mentioned in the above statutory excerpt, namely the protection of creditors and depositors and the maintenance of the health of and confidence in the banking system as a whole.

The OIGB was established shortly after the establishment of the twin auditor system. The system did not contemplate that the Inspector General would examine the loan portfolios in each bank. The very size of the establishment would indicate the extent of the examination contemplated by the statutory structure. By the time of the bailout the staff consisted of 33 and included 7 in the Inspection Division. These 7 inspectors were by statute called upon to make an annual inspection of each of the 72 banks in existence at the peak after the 1980 *Bank Act* amendments. Bearing in mind that an external audit consumed about 300 person auditor days in CCB in 1984, it can readily be seen that the statutory program mandated by Parliament contemplated something considerably less than the equivalent of an external audit for each Schedule A and Schedule B bank. Nothing much in fact seems to have changed since the explanation given to Parliament in 1923 at the time the office was established when it was contemplated that the Inspector General "would be able to obtain from studying reports of the inspectors of the banks [presumably the internal inspectors], the credit information files and also the reports of the shareholders' auditors" sufficient information to "view the situation comprehensively". Four or five years after the incorporation of CCB and Northland, 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 in the inspection and regulation of banks. 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. It is also notable that the Inspector General (as mentioned in Chapter 3), in an appearance before the House of Commons Finance Committee in 1982, stated that the staff of the OIGB was too small to cope with the increasing number of banks entering the system as allowed by the 1980 revision of the Act. On the same occasion, he expressed the view that the existing staff was sufficient to monitor adequately the general health of the banks although it would be "extremely difficult" to do so.

The latest comprehensive review of the banking system was conducted by the Porter Commission in 1964. The Commission did not devote very much of its examination or report to the inspection system, but it did state that the OIGB should rely heavily on self-regulation by the banks and should continue to rely upon the external auditors. It was a reaffirmation of the so-called tripartite prudential supervisory system. In more modern terminology the Assistant Inspector General, Macpherson, stated:

> ... moral suasion has some value in this whole system. That is the way the system has been for a long, long time.
>
> Q. Well, this is not a matter of morals is it?
>
> A. Well I never stopped to think about the precision of the language in that phrase, moral suasion. But if you would prefer the wink and the nod approach, then I think we still hope that that works and I think it did in this case [a reference to a loan].

Macpherson continued by stating that the enforcement by the "wink and the nod system" was but one string on the bow, the others being:

> ... The one sanction authority that we now have, really, is the ability of the Minister to direct a bank with respect to the levels of its capital and the levels of its liquid assets. That was put in the Act in 1980.
>
> Prior to that there had been nothing. Somewhat hopefully or perhaps naively, you might say, we thought that that was a very powerful weapon indeed in that if we did not like what a bank was doing, we could say, 'all right, we can't stop you from engaging in that sort of practice, but if you do follow such practices, you shall have certain levels of liquidity or certain levels of capital'. The only problem with that is, especially when you are talking about capital, is being able to see it through. If you are dissatisfied with a bank's level of capital, for one thing, the bank may not be able to increase its capital. If it cannot do that, the only alternative is to shrink its size, and that is something that will not occur over night either. So, it is not what we had hoped it would be, but that is really the only statutory sanction that we have at the moment.

Robert MacIntosh, speaking for the Canadian Bankers' Association, took a different view. The CBA considers that the OIGB had all the powers it needed even in the present circumstances and that there was no case for an increase in the regulatory powers.

> Moreover, the Inspector General and the Minister of Finance already have a broad range of powers at their disposal to correct problem situations, for example, moral suasion. To date, moral suasion has been an effective regulatory approach but is by no means the only one available to bank regulatory authorities. The Bank Act provides the Minister of Finance and the OIGB with the following comprehensive powers for the inspection of banks and for the application of remedies in unsatisfactory situations. ...

The criticism of the OIGB by the CBA went more to the need for a more expert staff who would have a familiarity with external market forces and their implications.

The basic procedures adopted by the OIGB have been detailed in Chapter 3. It is sufficient to state here by way of summary that annually the Inspector General makes a request to each bank prior to the annual inspection for data and information sufficient to enable the staff to analyze the various operational areas of the bank. Once this data and the data regularly received throughout the year from the bank is analyzed, the staff prepares a list of its specific concerns and communicates these to the bank. The annual on-site visit by the inspection staff is then undertaken and occupies from a day and a half to two days. In this inspection the bank is analyzed on the CAMEL system, standing for Capital, Assets, Management, Earnings, and Liquidity. In the view of the Inspector General this enables the inspection staff to assess the overall health of the bank and to focus upon the concerns identified in pre-inspection analysis or during inspection. It should be emphasized that specific loans may be reviewed by the inspection staff and may be discussed with the bank but the inspection team does not conduct an examination of the individual loan files comprising the loan portfolio.

As has been seen, the Inspector General takes the fundamental position that he is not only entitled to, but that by statute it is contemplated that he will rely upon, the external auditors and their report on the financial statements of the bank. Lord, speaking for the auditors of CCB, took quite a different position. He acknowledged that the Inspector General "communicates with us and we communicate with him. But his procedures are presumably directed to fill his responsibilities and ours are directed to the financial statements and the specific reports from us requested by the OIGB". On the other side of the issue, Grant stated that without full detailed knowledge of the files in question, the Inspector General is in no position to challenge any particular action by management.

> In discussing this with the bank it might very well have become evident that these were reasonable situations. We left these matters, sir, to the auditors of the bank. ... We depend to a very great extent on the external auditors to provide us with the comfort with respect to the quality of the bank's loan portfolio with respect to its accounting practices.

At least prior to 1980 there were very few banks in this country, all but a handful of which were very large, very strong and very successful on an international scale. A supervision system was required, perhaps, only to ensure the continuance of competitive practices in the banking

system and an overall control of what the public interest required of the banking industry in the international field, in specific lending areas such as mortgages, and in the sense of ensuring that the banking system was at all times harnessed to the public interest. Little purpose would have been served by a detailed regulatory audit of the loan portfolios of these large world-scale banks. With the advent of the new banks in the mid-1970s and the Schedule B banks authorized by the 1980 amendments, the picture and the need for supervision changed. The *Bank Act* of 1980 took none of this into account.

This is the simple picture if the OIGB knowledge or awareness is as limited in the case of each bank as the above excerpt from the evidence might indicate. Different considerations of course apply if the OIGB had actual detailed knowledge of the strategy employed by CCB management in attempting to lead the bank to survival and prevent intervening insolvency. The documentation and the evidence given by witnesses reveal a considerable flow of information between the auditors and the OIGB, and a large number of contacts between the two agencies over and above the annual inspection. Indeed, the exchange of information involved a great many contacts between the OIGB, CCB management, the directors, the external auditors, other sources in the banking system, and U.S. regulators involved with the CCB subsidiary and agency in California. There can be no doubt that the OIGB was very well informed about the worsening position of the bank through the years 1982 to 1985. The OIGB's response to all this evidence can be expressed in five propositions:

1. By reason of the knowledge in the OIGB that the position of the bank was worsening, it had the bank under close supervision.

2. The OIGB knew that:

   (a) CCB was aggressive in its income recognition program;

   (b) The loan loss provisioning practices of management were far from conservative; and

   (c) CCB was in all these practices predicating its actions and rationale on the adoption of a policy of attributing to its loan assets "future valuation", but the Inspector General "did not really have an impression of how significant some of these practices might have been in the loan portfolio as a whole". Eventually the Inspector General, after a long presentation spread over the entire hearings of the Inquiry, took the position that in any event these concepts of future value would be employed only over a

relatively short period of time after which CCB would be required to make provisions to reduce the face value of the bad loans to something approaching current market values.

3. The OIGB relied almost entirely on the auditors' inferred approval of the loan portfolio as assessed by management when they certified the financial statements without qualification. So long as this condition continued, the OIGB submitted it was inappropriate for the regulator to move in and close the bank.

4. Only by reason of evidence brought to the attention of the OIGB after 14 March 1985 did the OIGB realize that the actual position of the bank was worse than represented by all these sources.

5. The OIGB does not believe that there was anything that it could have done differently except that, with the benefit of hindsight, a cease and desist power (had it existed) could have been exerted to force the bank to take write-offs and reverse accrued interest taken into income, all of which would have closed the bank earlier.

Some insight into the regulator's view of the position of the bank, and the position of the public regulator in the public interest, is gained from some of the evidence dealing with action and inaction by the OIGB. By early 1985, the knowledge of, and the position taken by, the OIGB was described by Kennett:

> Clearly, the conclusion is that the bank is struggling, that its earnings are marginal and that it needs close supervision ... But in fact, for one reason or another, a bank ends up with a difficult portfolio, a portfolio that is full of trouble, there is no magic that will make it disappear. ... We were in a difficult situation. The bank still had adequate capital. There seemed to be a buffer there and that was adequate to handle the problems we understood were there at the time, and that gave us that consolation.

The view of the Inspector General of the aggressive stance of the bank which was evident by 1985 at the latest is revealed by the following questions and answers:

> Q. So whenever they are not paying interest you cannot capitalize?
>
> A. That depends on the value of the security, if there is lots of security there. But at that stage you should be valuing security on a very conservative basis.
>
> Q. Liquidation?
>
> A. Yes.
>
> Q. When did you learn that they were not doing it that way?

A. We were aware from time to time of individual circumstances that concerned us. The record is, I was going to say, riddled with questions about individual cases, matters of concern to be raised with the auditors, representations of concern from the auditors themselves, and discussions we had with the bank urging conservative practices on them.

He then went on to describe some of the instances where these practices had come to the attention of the OIGB through meetings with managers, auditors, and others, and led the Inspector General's staff to urge conservative practices on management:

But from our perspective, these were exceptions, if you like, that had come to our attention because of their size or because of their uniqueness. We were never in a position to scrutinize the loan portfolio as a whole to determine how [widespread] these practices might or might not have been.

As to the employment of baseline value in determining the value of the loan portfolio the Inspector General testified that this matter had come to the attention of his office at least in the month of May 1982 in a meeting with the auditors. His evidence in part on this point is as follows:

In instances where the bank and the clients, as I suggested before, are operating on a going concern basis, the security may be viewed on the basis of some kind of an intrinsic value that may not completely reflect full market value.

My feeling about that is that that kind of situation should only prevail for a relatively short period of time, that where there is a clear gap between whatever value seems to be reasonable for the security over a period of time and the market value that one would expect, as time went by — and I'm talking about quarters not years — that, if that gap did not narrow as a result of increasing value of the loan or the security, that the gap would diminish as a result of write-downs or provisions being taken on a loan. So I would not expect that the gap would prevail for a very long period of time.

It was the view of the Inspector General that the great awakening occurred with the release of the Hitchman Report. The Inspector General described that event in this way: "Well, I suppose the evidence that we found most disturbing was the Hitchman evidence". The detailed information reported by the Hitchman examination coincided apparently with a number of isolated or individual instances known theretofore by the Inspector General: "... but we did not really have any impression about how significant some of these practices might have been in the loan portfolio as a whole". The Inspector General consistently fell back upon the opening proposition enunciated earlier in this section:

We do not audit banks. We never have audited banks. Essentially, the fairness and accuracy of the financial statements is in the hands of the management of the bank itself and is reviewed by the auditors of the bank and certified fair by

the auditors. We have had good working relationship with these people we have discussed these kinds of problems with them. We were generally satisfied that the process was working.

. . .

... we were finally resting on the accuracy of the financial statements and the results of the audit.

From all of the information obtained during this Inquiry, the Inspector General ultimately concluded:

Assuming those facts, clearly the auditors are going to have to be a lot tougher in the practices they find acceptable and in the review of security values and I think that is happening. ...

Perhaps the reason for inaction, or more fairly put, lack of intervention by the regulator during 1983 through early 1985 can be found in the following statement by the Inspector General to the Inquiry:

But, finally, we were hoping and expecting, as the bank was and as other observers were, that this economy would turn around and the problems finally the most severe problems, would be short-lived. It turned out that the economy did not turn around.

During this period of hope and indecision perhaps induced thereby, the frame of mind of the regulator was revealed in the Inspector General's statement in evidence:

Through that whole period the bank was generally adequately capitalized. ... The earnings in 1984 became very spotty, small earnings or slightly in the red but, once again, while clearly a difficult situation and clearly a situation that we were watching very closely, not one that in our view warranted the closing down of the bank. It would have been completely unjustified on the basis of the information that was before us and before the public.

Indeed, because of its fundamental position of reliance upon the external auditors, the OIGB were in their view not even justified in invoking the authority in the *Bank Act* to enlarge the audit of the bank. The Inspector General stated:

Certainly, as far as we knew, the audit was a federal [full] audit and it never occurred to us that a further audit in the normal course of events of this bank was necessary. ...

It would be incomplete and unfair not to take the picture as projected by the Inspector General in his testimony to its conclusion. In hindsight, the Inspector General concluded that his office could have used a cease and desist power to bring about earlier conservative accounting treatment of some of the operational decisions and actions taken by the banks in the field of income recognition and loan loss write-offs. He continued:

> I think that if we had known more about the loan portfolio in detail and the lending practices in those earlier years, we might have disapproved of some of those practices, but we were looking at the bank and measuring the lending activity in a macro-prudential sense and because of the economic circumstances, which I have described previously, even where their lending practices might have been high risk, the problems were not emerging because of inflation.

Given the rapid rise to success of the bank during the mid-1970s and early 1980s, and given the long period of banking stability in this country, some of these conclusions cannot be said to be illogical or out of order. What remains surprising, however, is the fact that McLaughlan's revelations in Ottawa on 14 March clearly took the Inspector General's office by surprise, and caught them off balance and largely unprepared for the crisis that unfolded.

Two things stand out in the position and in the actions taken by the OIGB in the eleven days from 14 March to 25 March, 1985. First, the OIGB took some time to realize that a thorough check had to be made on the loans proposed for inclusion in the support package by management to ensure that the write-offs proposed by management for those loans were adequate, and on the balance of the loan portfolio to ascertain whether management was proposing a sufficiently comprehensive act of financial surgery in carving out of the loan portfolio the loans as proposed. Second, the OIGB, either by reason of institutional inadequacy or by breakdown in the functioning of key personnel, failed to link the information already at hand in the OIGB with the information flowing in from Edmonton from the loan examination processes taken during the 11-day period, so that the participants in the Support Program meetings could exercise their judgment as to whether to enter a rescue program, and if so, to establish the appropriate scale according to the latest and best information which was then available. These two salient features stand out above the rather chaotic scene which unfolded in the days leading up to the 25 March announcement. A third difficulty which flowed from the bailout, and some of which must be attributed to the OIGB, is the failure by its staff, as well as the Department of Finance staff, the Bank of Canada, and even perhaps the representatives of the major Canadian banks, to appreciate the short- and long-term significance of the wording adopted in the press release as approved by all parties (with the probable exception of the representatives of the major banks). The reference made to the "strong condition of solvency" of the CCB in combination with the Bank of Canada assertion that it would advance such moneys as needed or necessary to meet any liquidity problems, eventually and inexorably led the Government into the need to seriously consider a universal compensation program involving payment to all depositors of the bank, insured or uninsured.

From the extensive record gathered in the Inquiry and summarized in Appendix C, certain things have become evident. It is clear that the OIGB was aware, or had the means of becoming aware, that the CCB over the years, including as a minimum, 1983, 1984 and early 1985, had seriously augmented its income by including accrued interest and by capitalizing interest, had neglected to make adequate specific loan loss provisions, and had employed workout strategies on a wide scale to forestall lowering the classification of a loan, or to otherwise defer or avoid the taking of specific provisions. All these measures were predicated upon a liberal policy of determining that the principal and interest in question were, in the opinion of management, collectable, and on the adoption of future values in assessing the underlying value of the security held by the bank. Left to itself, bank management may be sorely tempted to cross over the boundary of appropriate accounting treatment in order to maintain, through synthetically enhanced income statements and protected balance sheets, the confidence that, in banking, is essential for survival. An inspection system which tolerates or ignores the operation of these practices by management, whether other elements in the system such as auditors perform their role or not, must accept a measure of responsibility for the development of the condition which culminates in bank failure. Should circumstances excuse the regulator from responsibility for the development of the causes of bank failure, there still remains the question of responsibility for failing to intervene and terminate the bank's operation as soon as such condition could or should have been detected. The courage to fight off oncoming insolvency is commendable but surely not in those instances where to do so is simply to prolong the existence of the bank to the serious detriment of those such as the investors and creditors who deal with it. An inspection service which allows management the latitude required to cross over the line must, in appraisal of the efficacy of the total system, share responsibility for the result.

The management of the bank was well aware, on the record before this Inquiry, of the need to overcome the reluctance of the auditors and the OIGB to accept the accounting treatment assigned to all these actions by management detailed above. Management was also aware of the need to avoid rejection by the regulators of prospectuses filed by the bank for the purpose of making an issue of securities to the public. The workout strategies became, in many instances, a device to avoid the reclassification of a loan in order to present a picture of the financial position of the bank as very much healthier than its true position, as known by management to exist. Fee-driven lending practices of management fall into the same category. Auditors' repeated and prolonged acceptance of practices designed to maintain income and

shield asset values, and the regulators' silence in the face of their awareness of these practices, unhappily had the effect of leaving management free to prolong the application of these improper policies. As the information rolled into the OIGB regarding the sinking condition of the bank and the practices employed to forestall this trend, the OIGB expressed concern. The concerns expressed, the action taken, and the occasional skepticism about the wisdom of the bank's strategies expressed by OIGB officers are detailed in Appendix C. The question then becomes, what should the Inspector General have done?

At the very least, the Inspector General should have brought these practices to a halt by a statement setting out the proper policies to be followed in the valuation of assets so as to enable all the banks to account for the impact of the recession on the same basis. The Government of Canada did so by Order in Council in September 1931, under which the banks were allowed to maintain stock values at market prices that had prevailed several months earlier. This was a recognition by public regulators of the transitory nature of the sudden and very near complete collapse of stock market values in 1931. Alternatively, the Inspector General could have defined clearly the time limit for projected value expectations, and the time limit for their maintenance at such levels by the bank. This may have had an unfortunate side effect in the money market, both here and abroad, but no consideration was even directed to the problem. Any such course of action, if adopted by the Inspector General, would have required a state of preparedness on the part of the OIGB to bring about a termination of the bank in the event of subsequent noncompliance with such direction. All this has nothing to do with the failure of the auditors to perform their designed function and discharge their responsibilities according to the principles of their profession. Nor was there any impediment to such action by the Inspector General because of a shortage of inspection staff. The information was at hand in the OIGB that the bank was in poor condition and drifting into worse. The Inspector General was aware of the variety of the inappropriate actions being taken by management as already described. The Inspector General was on notice and had all the means necessary to determine the scale of those practices. Perhaps most serious of all was the approval granted by the Inspector General to the issuance by the bank and its fiscal agent of a prospectus inviting the public to invest in the bank when it had been classified by the OIGB as being in "unsatisfactory condition", and when it was known that its financial statements were distorted as to both assets and income by reason of the many practices of management already enumerated. It comes down to the fact that the OIGB either knew and accepted these survival tactics in the bank and failed to respond, or did not know

because of a complete failure to recognize the clearest signals. It is a choice of losing alternatives.

All this relates to the 1983 and 1984 fiscal years. The failure of the OIGB in its regulatory responsibilities in CCB must go back to and include the Inspector General's allowance of the expansion of the loan portfolio by the bank in 1981 and 1982 in the face of the advent of a serious recession in its principal areas of operation. This occurred at a time when CCB was still a small and regionalized bank which was already showing symptoms of serious difficulties. The OIGB did nothing to rein in this growth, and to bring about a consolidation of the position of the bank until loan losses encountered from the first onset of the recession could be absorbed, and economies of operation effected.

The OIGB had an installed and functioning early warning system. All the key indicators of trouble flashed on. There was not a lack of awareness or information, but an apparent lack of will to act. The OIGB in its final submission places the responsibility for this inaction on a failure by the auditors to perform their role. 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 unbounded reliance upon others is a denial of any role in the regulator. This, coupled with the performance of the regulator in approving a prospectus, reveals an institutional fault, at least, which produced a lack of will to regulate the system where supervision has revealed the need, even if it may lead to a bank closure. As will be seen in Chapter 6, the Commission considers the condition was at least in part the product of the inadequacy of the institutions and their arrangement in the supervisory system.

5. The Bank of Canada

The involvement of the Bank of Canada in CCB's times of need dates back to early 1983 when the Governor assisted CCB in arranging

the liquidity support required to bridge the run of deposits occasioned by the Trust Companies Affair. Of particular interest is the role played by the Bank of Canada in bolstering confidence in CCB in the market. It was the Governor of the Bank of Canada, not the Inspector General of Banks, who at that time contacted various news agencies to assure the public that CCB was sound. The following press release was issued by the Bank of Canada:

> ... in response to a number of enquiries concerning the Canadian Commercial Bank which arose following the annual meeting of that bank in Edmonton yesterday, Gerald K. Bouey, Governor of the Bank of Canada, stated that the Canadian Commercial Bank is a solvent and profitable bank and if it requires any liquidity support, the Bank of Canada will provide it.

It is apparent that the representations contained in the release about CCB's condition were provided to the Governor by the OIGB. As has been seen, the perceived position of the Bank of Canada again had a role to play in the events surrounding the bailout of CCB.

The Bank of Canada, partly by the predominant position accorded to it in legislation and partly because of the way it is perceived by the other institutions in the banking system and by the public at large, found itself in an invidious position in the events surrounding the collapse of CCB. The Governor of the Bank of Canada was seen as the leader of the banking system. Naturally, therefore, he was looked to for leadership in this time of crisis. Indeed, it was taken for granted by all participants that the Governor of the Bank of Canada was the appropriate person to preside over the 22 and 24 March meetings to determine the fate of the CCB. Unfortunately, the Bank of Canada is not clothed with the necessary statutory powers or staff to select the appropriate program in such circumstances and to guide its performance. The Bank of Canada is the lender of last resort, the provider of liquidity advances where required by the chartered banks. In a press release issued by the Bank of Canada on 18 April 1985, this succinct statement was made about the position of the Bank of Canada in the system:

> The Governor noted that it is the role of the central bank to act as an ultimate source of liquidity for Canadian banks, and he reiterated that the Bank of Canada stands ready to provide the Canadian Commercial Bank with whatever amount of liquidity it may require.

When the Bank of Canada makes liquidity advances it does so on security taken from the beneficiary bank, usually in the form of an assignment of part or all of the loan portfolio. In this case, the Bank of Canada took an assignment of a loan portfolio of about $2B. It conducted no detailed inspection of the assets in the loan portfolio to

determine the strength of the assigned security, though the Comptroller of the Bank of Canada did examine, in a cursory way, along with internal legal counsel, the general state of the portfolio and the form of assignment proposed. Governor Bouey testified about the taking of this security that:

> We would normally have expected to work through the Inspector General; we would not expect to set up a separate or competitive inspection system.

The actual state of the Bank of Canada as the holder of security is somewhat difficult to describe with precision. First of all, the Comptroller, Mr. A.C. Lamb, stated:

> While we can rely on the Inspector General's office for the broad question of solvency, we must assure that adequate security for Bank of Canada advances has been secured.

He went on to say:

> However, we have not gone to individual lending offices to examine the actual loan security which is referred to in this documentation. Rather we have relied on the audit procedures followed by the external auditors of the bank to assure that the security does in fact exist as reported.

He concluded:

> ... on balance it now appears on fairly adverse assumptions that the bank is not likely to require Bank of Canada advances of more than a maximum of $1.3 billion which would represent 70% of the book value of the security now pledged. Indeed the probable peak is expected to occur by the beginning of November [and] to be less than $1.1 billion. On the basis of our review of the portfolio we have concluded that the existing ... agreement provides the necessary security for the probable level of advances with some margin of safety. If advances were required in excess of $1.5 billion it might be prudent to consider hiring consultants to provide a precise market valuation of the portfolio security. ...

It must be borne in mind that these cursory and preliminary examinations were undertaken prior to any complete hands-on inspection or examination of the loan portfolio by the agents appointed by the Inspector General. When these inspections were undertaken by the Inspector General, the Bank of Canada team which travelled to Edmonton to consider this security made little or no contact with the Inspector General's on-site inspectors. As it turned out, the Bank of Canada advanced in excess of the $1.3B security threshold but no alarm was expressed internally apparently because the Bank of Canada authorities expected to receive further insight into the quality and extent of security from the Hitchman assessment. Should that assessment turn out to be accurate or even conservative, the security held may not equal the funds advanced.

The entire relationship between the OIGB and the Bank of Canada on the subject of insolvency and liquidity advances is far from tight and solid. The Bank of Canada is wholly reliant upon the Inspector General for a determination of the state of insolvency of a bank. Once liquidity advances are made to a bank in a certified state of solvency, the Bank of Canada is again largely in the hands of the Inspector General as to the level of liquidity advances which may safely be made on the available security. The nature of the security in detail is another area in which the Bank of Canada must rely entirely upon the Inspector General. On the other hand, the extent of liquidity advances is a matter wholly within the prerogatives of the Bank of Canada and is not determined by the Inspector General. As we will see in the case of the Northland Bank, when the state of insolvency approaches, there is considerable confusion in this relationship because of the state of the law. Depending on the definition of insolvency the Bank of Canada by its liquidity advances may postpone the event. However, the Inspector General may, by determining that the bank is not "viable", bring about a termination of the liquidity advances. This, in some circumstances, will produce a state of insolvency by most definitions, and this indeed is the reciprocating process in which the parties indulged in order to advise the Minister of Finance of the insolvency of CCB.

Liquidity advances entitle the Bank of Canada to an overriding prior security against all comers. The effect is, as Governor Bouey testified: "The more we lend against security the less is left for other creditors". Where the liquidity advance is employed directly in the reduction of deposit indebtedness, it may not have a serious competitive effect on depositors and other creditors. Where, however, the recipient bank uses the liquidity advances to make loans (a practice which occurred at one time in Northland and which the Bank of Canada and the Inspector General immediately stopped), the position of all creditors of the bank is jeopardized by the prior Bank of Canada lien. The very presence of this prior paramount lien is of course at best a negative encouragement for any new depositors to come forward and place their money in the bank.

A further difficulty arises from the requirement in the *Bank Act* and in the *Bank of Canada Act* for the publication, weekly and monthly, of liquidity advances to banks. The beneficiary banks are identified. This matter is dealt with in recommendations which follow so that it need only be observed at this time that a liquidity advance is designed to promote stability and confidence in a bank, and hence, in the banking system. Where the bank is in and out of cash shortfalls for the retirement of maturing debts, it is a matter of no consequence. Where, as here, the liquidity difficulties are long term, the existence of

the advances becomes well known in the financial community, and generally throughout the country, long before the liquidity advances are scheduled or intended to be repaid. It is also important to point out that when fellow members of the banking system come forward to assist a bank in liquidity difficulties, no prior security is accorded to them.

Once the rescue issue arose, the Bank of Canada played a role of receding importance. The very opening observation by the Governor of the Bank at the beginning of the meeting of 22 March that the problem was solvency, not liquidity, relegated the Bank of Canada, from a legal viewpoint, to the role of a supporting player concerned, as it was, solely with liquidity advances, once the solvency of the bank had been assured. Initially, as we have seen, the Bank of Canada rallied the public and private components of the banking system to consider the revelations by the management of CCB. This same type of consultation occurred within the Board of the CDIC where again the Governor of the Bank of Canada presided. The Bank of Canada from the outset strongly favoured a program to save the bank, pointing out the serious repercussions at home and abroad of a bank failure. However, the Bank of Canada, as we have seen, was in no position to lead the discussion surrounding the formation of a rescue program because it did not have the mandate or the staff to provide the management information necessary to design such a proposal, and to advise for or against its adoption apart from pointing out the general effects it might have on the banking system.

Once the participants resolved to proceed with the rescue program, the Bank of Canada was associated with the press release which refers to "the long-term viability" and "the strong position of solvency" of the CCB which would result from the Support Program. The following exchange occurred between Commission counsel and the Governor of the Bank of Canada concerning that announcement:

> Q. Was it appreciated that this would be relied on by people dealing with the bank and if the bank failed later this might involve some liability on the part of the government?
>
> A. I think it is appreciated that the bank would not fail later at that stage. That side of it was not ever ...
>
> Q. You never contemplated that the bank might fail notwithstanding the bailout package?
>
> A. Well I suppose the risk is always there. As you know the banks want to be treated like other depositors in case anything did go wrong. But I think we all felt the bank was viable and viable for a very considerable time. ...

From the testimony received in the Inquiry and from the contents of reports issued by Committees in Parliament, it is clear that the seeds of a requirement to compensate injured depositors originated with this press release and the reliance thereon by the public in general and the financial community in particular. Bélanger, CEO of the National Bank, summarized the feelings of some of those from the big banks who participated in the rescue discussions when he said of the wording of the press release that he had no reason to doubt the solvency of the bank, but as to its "viability", the term may not have been prudent. The Bank of Canada's prestige in the financial world was used to give credibility to the Support Program; and this was perhaps the bank's greatest contribution.

The very limited position of the Bank of Canada in bank regulation and bank rescue is illustrated by the bank's intervention during the Support Program to persuade the major banks to continue their inter-bank credit with CCB. The bank's persuasive powers failed. It had no other power.

The overall position of the Bank of Canada is well put by Governor Bouey from whose speech in September 1985 the following excerpts have been taken:

> In this country the system of bank supervision based on an information network of external bank auditors, internal bank inspection systems and bank managements was designed by Parliament to operate separately from the Bank of Canada and the bank must rely on the judgments that emerge from it.

He continued:

> ... the Bank of Canada ... was not in a position to provide information to that part of the discussions bearing on the condition of the bank and therefore how large the support package needed to be. The judgment about the size of the support package required to make the bank solvent was based on the best information at the time a decision had to be made. And I regarded that judgment as reasonable in the circumstances. The Bank of Canada therefore wholeheartedly supported the effort to save the bank. That is why I stated publicly at the time, and repeated subsequently, that since the bank was judged to be solvent and viable the Bank of Canada would provide whatever liquidity support was required.

The only significant evidence of an active role of the Bank of Canada in the regulatory system was a memorandum of October 1982 from a member of the Bank of Canada staff which revealed something of the impending troubles in the bank. This memorandum was found in the files of the OIGB. The close relationship between the Bank of Canada and the OIGB on questions of supervisory matters is revealed

by the important, but unexplained, information given by the OIGB to the Bank of Canada of the impending meeting of 14 March 1985 which the OIGB has described in evidence as a "scheduled" and "routine" meeting with CCB.

Four questions remain unanswered concerning the Bank of Canada and its role in these matters. First, can liquidity advances made under the present statutory pattern in fact promote stability in particular banks and in the banking system? Second, can the Bank of Canada safely and securely advance liquidity moneys to a bank in trouble relying solely on assurances as to solvency and the value of the loan portfolio given by another agency of government, at the present time the OIGB, which does not itself examine and assess the value of the loan portfolio? Third, considering its limited statutory authority and absence of inspection staff, should the central bank be burdened with or take on the burden of announcements concerning the solvency, or otherwise, of chartered banks in Canada? Fourth, is there any merit in considering a combination of the inspection facilities and duties with the central bank as is done in the United Kingdom, and to some extent in the United States? These issues are dealt with in Chapter 6.

6. The Minister of Finance and the Minister of State (Finance)

The responsibility for the administration of the *Bank Act* resides in the Minister of Finance. By administrative arrangement, the Minister of Finance, through two letters dated 5 October 1984, delegated his duties and powers to the Minister of State (Finance). The Department of Finance does not have in its staff persons experienced in or assigned to the supervision of the administration of the *Bank Act* or the operations of the chartered banks. In matters pertaining to the *Bank Act*, the Department relies upon the Inspector General of Banks who has the status of a Deputy Minister and who reports to the Minister of Finance and/or the Minister of State (Finance).

Under the *Bank Act* the Inspector General is required to report to the Minister of Finance the state of each chartered bank not less frequently than annually. The report on CCB for 1984 was dated 24 September 1984 and was directed to the Minister of Finance who received it about two weeks prior to the delegation of authority to the Minister of State (Finance). The Minister of Finance testified that on receiving the report he understood that the bank was in a less than satisfactory condition but that the report contained a "reassuring

element". The Minister then had a discussion with the Inspector General which he described in evidence before the Inquiry as follows:

> In general terms we discussed the CCB and the problem with the Western banks. We discussed the general problems with the banking system and concerns about the less developed countries' debt problems. There were no red flags raised. It was more of a discussion to make me aware of the problems that he was aware of and he wanted me to be aware of.

The Minister, prior to receipt of this letter, had the benefit of an earlier transitional briefing session with the OIGB wherein the Minister was advised in part:

> The performances of Northland Bank and CCB remain substandard due almost entirely to the continuing weaknesses in the economies of Alberta and British Columbia.

This was the explanation accepted throughout these events by the Inspector General until the time when the first on-site inspections were received by him in detail and in writing in July 1985.

The briefing continued: "... the difficulties take the form of nonperforming loans which are not being serviced by the borrowers. In the banking system as a whole nonperforming loan levels are at historical high levels." This was the extent of the knowledge of the Minister of Finance of these matters prior to the onset of the rescue discussions shortly after 14 March 1985.

After her appointment, the Minister of State (Finance) met with the Inspector General on the average of once every two weeks and she, of course, was made aware of the issues raised in the briefing material and the Inspector General's September letter to the Minister of Finance. The Minister of State testified concerning her opening briefings on CCB: "... that management was attempting to work out of a difficult economic situation and that the bank was sound, fundamentally sound, and it required monitoring and supervision from the Inspector General's office". That was the extent of the Minister of State's information on this bank prior to the revelations of 14 March.

The bailout process has been described in detail earlier in this Chapter and in Appendix D. It should be noted first that the Minister of State did not attend any of the bailout meetings but relied on the presence of the Deputy Minister of Finance, the Inspector General, and the Governor of the Bank of Canada, together with their officials, to represent the Government viewpoint. Two features surrounding the bailout discussions stand out. First, the executive branch appeared to

have adopted a wait-and-see attitude as regards the major banks to determine what role, if any, they proposed to play in these events before determining whether the Government of Canada would favour a rescue program in contrast to a liquidation process, and if the former, would commit public funds. No such decision was in fact made on this essential point until Saturday, 23 March, nine days after McLaughlan's startling visit to the regulators. The second feature which stands out is the inability of the public agencies to mount a quick, comprehensive and authoritative examination of the condition of the loans comprising the loan portfolio, the principal asset, of the CCB prior to the fateful decision to adopt a rescue program on 24 March 1985.

The Minister of State was in charge and consideration must be given to the nature and timeliness of the executive branch's response to this crisis. The primary operational role is, of course, established by Parliament in the Inspector General. The Minister, however, has extensive powers under the statute and is the minister responsible for the Inspector General's office. On the other side of the ledger one must recall that the Minister had been in office only three or four months when these unique events unfolded. Furthermore, the Government was newly installed in office and these events raised issues of far-reaching and fundamental importance. The Minister of State observed in evidence:

> I am essentially a free enterprise soul and you cannot save every institution whole ... We were developing policies as we dealt with this situation.

There were, of course, many alternatives which had to be examined and related facts to be sifted out before the focus narrowed down to a bailout process. For example, the major banks had to be considered as merger candidates which, in the western world, is the route most frequently taken when a bank gets into solvency difficulties. All these things take time, particularly when several agencies in the public sector are involved and when there are at least six members of the banking community to be consulted.

There remains one other feature of some importance in these proceedings. CCB was really not consulted in the bailout process once the major banks were involved. CCB was not represented at the meetings in Ottawa after 22 March except at the first meeting, and then only to make a presentation and withdraw. CCB officers were not present in Ottawa during the formation of the actual Memorandum of Intent leading to the Participation Agreement. Indeed, CCB did not participate as a negotiating party in the Participation Agreement. Once the program had been agreed upon in general, the details were put to CCB on a take-it-or-leave-it basis. This may be an essential method of

proceeding because of the complexities and the number of people involved in determining the terms and conditions of a comprehensive rescue program. Nevertheless, the difficulties, examined above, which arose in the formation and execution of the bailout process, were enhanced considerably by the absence of CCB and its fund of information concerning the fine points to be settled.

One might make a number of suggestions in hindsight on actions which could have been taken by the executive branch of Government, but on the whole, considering the novelty of the crisis, the speed with which it landed on the doorstep of Government, the complexity of the necessary arrangements within the banking system for a rescue program, and the recent accession to office of the principal Ministers of the Crown concerned with this matter, it is difficult to reach any critical conclusions of the role played by the two Ministers in the determination of the public policies which had to be settled as a forerunner to the actual Support Program. It is difficult for an observer after the fact to determine whether the Ministers' conduct displayed caution appropriate to their role as custodian of public funds or on the contrary was delay adopted as bargaining "brinkmanship" to induce a contribution from the "Big Banks". There is no support in the evidence for the latter possible conclusion. The Deputy Minister revealed a clear reticence to expose public funds to such an enterprise. The Ministers acted only after the Government itself took this important decision.

The performance of the bailout program raises different considerations. Clearly there was a complete inadequacy of follow-through in obtaining the information necessary to produce the final Participation Agreement and to properly monitor the progress of the rescue program. In particular, the Minister of State appears to have made no effort to press for an early and organized hands-on examination of the loan assets of the bank. Many efforts were made by the OIGB on what appears to be a spasmodic and hit-or-miss basis, and communications of the results, commencing with the examination of 20-21 March and continuing through until the Hitchman Report, were not effective and immediate. The Minister of State (Finance), when faced with a very clear demand in mid-June from the major banks, did organize through the Inspector General the appointment of Hitchman and his team to examine the loan portfolio on site. This report was received in interim and final form by the Minister of State although she did not personally interview Hitchman when his work was completed to assess his mental picture of the financial health of the bank in mid-August during the rescue program.

There are surprisingly few documents, reports, memoranda and minutes of the action taken by the ministerial staff and by the Minister

of State (Finance) during the period from 25 March to 1 September. The Department looked to the OIGB as the administrative arm to guide the bailout process. This stands in sharp contrast to the detailed picture available in a comparable rescue program in the United States in 1984. In that program, provision was made for a second phase not unlike the formal Participation Agreement here, except that the second phase was a reconstituted program redesigned in the light of information coming to the surface after the initial bailout process had been inaugurated. The financial arrangements were retuned in this second phase and it really represented a new rescue endeavour based upon the facts then known. Here, the rescue program once designed stayed put. There was no reevaluation of the adequacy of the $255M infusion, no attempt made to clarify the status in law of those moneys or the respective rights and obligations of the parties to the program, and as already seen, a very slow examination of the principal assets of CCB. The bailout program seems to have been conducted more like the launching of a toboggan. Once it was placed on the slope its course, speed and destination were left to gravity and the toboggan. There was no steering mechanism and no machinery for change of direction or increased financial support or indeed any other adjustment, whatever risk may loom up. But this must be a critical observation on the performance of the Inspector General upon whom the Ministers were clearly entitled to rely. The Ministers gave the officials adequate guidance and support and properly left the execution to the administrators.

The precise instruments for the measurement of the bank's health were only installed in late August, and then only for the purpose of determining the extent of solvency. All this is somewhat difficult to comprehend given the clear press announcement which in essence stated that the Government would stand by this bank and see that it did not fail. By 8 July, the Minister of Finance had been advised: "There is sufficient risk of failure and winding up at CCB that consideration of the political and financial implications should be undertaken now". The record is silent, however, as to when these preparations were actually put in train. The Inspector General's evidence was that:

> We were actively seeking other alternatives and by August 13th we were beginning to plan for the possible liquidation of this bank ... You simply do not wake up one morning and decide that today we are going to close the bank. There is a lot of preparation that needs to be made, and you want to make very sure that you are not making any mistakes about that, that the evidence is indisputable and that the alternatives have been adequately canvassed.

By 23 August the Inspector General had eliminated the possibility of merger and was narrowing the alternatives down to the form of liquidation, that is the appointment of a curator or of a liquidator for the ultimate wind-up of both banks.

In the dying days of the bank, the treatment to be accorded uninsured depositors emerged as a key issue amongst the participants in the support group, particularly, of course, the public officials. The combination of the lack of information at the time the rescue program was adopted and announced, and the tenor of that announcement and subsequent statements by the Ministers made in the House of Commons shortly after the 25 March announcement, boxed the Government into a position where the only defensible alternative was universal compensation of creditors of the bank. The most serious comment to be made concerning this issue is the lack of awareness of the consequences of announcing a rescue program and particularly on the terms set forth in the various announcements starting with that of 25 March 1985. Again one turns to the experience in the United States where the public authorities first determine whether the ailing bank is "an essential bank" and if it is, a bailout or rescue program is initiated, usually in stages. In the course of this type of program, the public authorities make a clear unqualified announcement in which an assurance is given to the world that this bank will not fail. Unhappily, the case of the CCB was a hybrid. An announcement generally to that effect was made, but the program was not re-engineered when the required magnitude of intervention was properly assessed several months after the program was initiated. In the end, of course, the program was allowed to fail. Hence the dilemma as to the scale of compensation over and above the limits of insurance coverage through the CDIC program.

There are several items of unsatisfactory "fall-out" from the Support Program which lead to specific recommendations in Chapter 6. One of them is the expensive consequence of universal compensation of depositors above insurance limits which flowed from the lack of statutory and administrative precision in the supervisory structure as it purports to extend to bank support programs. Another unsatisfactory element was the uneven impact of loans outside the depositor class. This refers to the differential treatment which resulted when the Governments of Canada, Alberta and British Columbia bought out the debenture holders, while the participant banks were denied recovery of the $60M they advanced in the rescue program. This is the subject of a recommendation in Chapter 6.

Finally we come to the end of the day when on 1 September the communications set out in Appendix D passed between the Inspector General and the Governor of the Bank of Canada, followed by the Inspector General's advice to the Ministers to appoint a curator under s.278 of the *Bank Act*. From all this it is apparent that the responsible Ministers must, in fact, rely upon the Inspector General for all major decisions concerning the assistance to be advanced to a bank facing problems in insolvency. There is no departmental staff outside the office of the Inspector General qualified in this matter. The Bank of Canada

has no statutory role to play beyond the making of liquidity advances where the problem of the ailing bank is a transitory inability to meet liabilities when they fall due.

The relationship established by the statute between the Minister, the Inspector General and the Bank of Canada, with reference to the appointment of the curator, needs a complete reexamination. The Bank of Canada is confined in liquidity advances to payments to solvent banks. The Inspector General therefore must determine solvency of the bank, although the term is not defined in the statute. So long as liquidity advances continue, determination of insolvency is made difficult. The Minister, on the other hand, must in practice await the recommendation of the Inspector General for the appointment of a curator and again a recommendation that an application be made under appropriate statutes for the liquidation or winding up of the bank. All of this must be done on the basis of information available at the time which means that the Ministers responsible are very much in the hands of the professionals in the Inspector General's office. The limits of responsibility in the Ministers must be to install competent persons in the administrative structure and to ensure prompt discharge by those officials of their statutory and administrative duties. Here this principally relates to the Inspector General who had been in office for about 7 years before the Minister of Finance took office. The system beginning with the responsible Minister must rely on the Inspector General, his effective Deputy Minister in the field, for information on the regulation and operations of the bank. By the time government agencies and officials became fully aware of the state of affairs in these banks it was already too late for effective help at a reasonable cost.

The Inspector General as the chief of the supervisory system must be answerable for any shortcomings in performance of the inspection service other than those strictly occasioned by fault in statutory design. Here the OIGB failed to forecast the decline and fall of these banks. Until at least 14 March 1985, there was nothing reasonably evident to warrant any action by the Ministers with reference to these banks, or the structure or personnel of the OIGB. By the time any such matters became apparent, the damage had been done and the banks were for all practical purposes beyond retrieval. Apart from a delay in formulating government policy as to the intervention with public funds in a rescue program of the bank, (which might not have been "delay" but rather may well have been proper caution as earlier mentioned) and apart from a tardiness in directing the OIGB response to the request of the major banks for a detailed and comprehensive loan portfolio assessment, there is nothing in the evidence which leads to criticism of these Ministers.