Chapter 5

Northland Bank: Commentary and Analysis

Chpater 5

Northland Bank: Commentary and Analysis

This Chapter contains commentary on the causes of collapse of the Northland Bank and on the conduct throughout the events in question of the parties closely connected to these events. Appendix E sets out a factual synthesis of the evidence heard before the Commission. Some of the descriptive material is repeated here for clarity and convenience. Many of the institutional issues in relation to various governmental agencies, including the role of the Bank of Canada and the development and philosophy of supervision of the OIGB, in relation to CCB have been covered in Chapter 4. Likewise, the background of the Western Canadian recession has been discussed in Chapter 4. These matters, although equally applicable here, will not be repeated.

A. CAUSES OF THE COLLAPSE OF NORTHLAND BANK

1. Original Concept

Although Northland Bank was the product of philosophies that differed in some respects from CCB, it appears to have been born with several of the same potentially fatal weaknesses embedded in its corporate genes.

Northland Bank was conceived at about the time of the Western Economic Opportunities Conference as a regional bank designed to service the needs of the mid-size commercial and wholesale operations in Western Canada. Its founders considered that the large national banks did not service the small business operations characteristic of Western Canada. This was to be Northland Bank's market niche, and it led inevitably to the establishment of a loan portfolio concentrated geographically in Western Canada and sectorally in real estate and resource-based operations. Lending was to be in the commercial mid-market with loans ranging from $100,000 to $2M, although the latter ceiling was removed in the second fiscal year. In the original descriptions of the bank, the founders announced that it was the intention that the bank should be a "boutique" for business rather than a big bank "supermarket".

As in the case of CCB, there was an identity between many of the directors and the large shareholders. In the case of Northland these were credit unions. An intention to phase this identity out is evidenced by the fact that the bank in its earliest years was listed on the Alberta stock exchange with a view to establishing a widely held bank stock. Initially, it was anticipated that there would be a flow of deposit moneys from the credit union movement. Shortly after Northland was formed, however, the credit unions created a national liquidity management pool for the credit union system, and that source of deposit moneys for Northland Bank dried up. This drove the bank to the wholesale money market very early in its history. Eventually, the bank found the volatility of that market too difficult to live with and accordingly, beginning in 1983, it actively sought retail deposits, showing, as in CCB, a belated recognition of the dangers of the wholesale money market as a source of funding in Canadian banking.

At the outset it was intended that Northland Bank should operate, at least in part, as a merchant bank in the style of the British merchant banks. Such a venture was planned but never launched, although in later years, Northland Bank did develop the business of charging fees for providing lending services in the sense of initiating business transactions and bringing together potential venturers. In the last three years of the bank under the leadership of Mr. W.E. Neapole, the bank had, in his words, developed into a unique combination of a traditional bank and a merchant bank.

Legislators reviewing the proposal to incorporate the Northland Bank in 1975 understood and appreciated the perceived need in Western Canada for regionally-based financial institutions, as the comments of the Honourable Donald Cameron at the second reading of the Bill confirm:

> I think it is evidence of the burgeoning growth of Alberta and western Canada as a whole that there is a widespread feeling that there is a place for another western financial institution.
>
> The concept of a regional bank in the western provinces is not new. The proposed Northland Bank is the latest of a long series of proposals that have been made since the 1960s to the effect that some financial institutions should have their main roots in western Canada. This proposal today is the result of the considered judgement of a number of very responsible and well known business leaders in the four western provinces.
>
> The feeling has developed that there is a place for a new financial institution which will have its roots in western Canada and which will be charged with the responsibility of assisting in the provision of credit, financial advice and other money-related services. This feeling has been confirmed by a number of

> commissions and has been strongly supported over the years by the western cooperative organization whose memberships represent about 1.5 million western Canadians.

Evidence was also presented to the Senate to indicate how the bank intended to operate. Senator Cameron continued:

> ... the bank, through its personnel, will stress imaginative and innovative methods of providing finance to an expanding economy while maintaining the highest standards of accepted banking practices.

The wholesale funding concept was disclosed to the legislators. As in the case of CCB, the Inspector General of the day appeared before the legislative committees to record that he had no objection to the passage of the incorporating Bill. Accordingly, the bank received the blessing of the legislators, exposed as it was to be to geographic and sectoral development and to funding at least in part from the wholesale markets.

It is clear in retrospect that the original design for this bank was fundamentally unsound in that the founders intended to operate principally in the western provinces and in cyclical, relatively high-risk sectors such as real estate and resource development. The bank, therefore, would lack a diversified loan portfolio. The proposed customers were small to medium-sized clients without diversification in their business and without access to the equity markets in their own right. Furthermore, it is extremely doubtful whether an aperture existed in this part of the market by reason of its neglect by the major banks. It is more likely that imprudent and optimistic lending practices artificially expanded or created the market than that the operations of Northland Bank demonstrated that such a perceived market existed. Finally, the wholesale funding plan was a hazardous base on which to build a small regional bank.

2. The Early Period: November 1976 to May 1983

The directors and management of Northland Bank have consistently taken the position that the western recession, induced by a collapse in oil prices and high interest rates, was the basic reason for the eventual failure of Northland Bank. There are other factors, however, which must be examined before one draws any conclusion as to the causes of failure of this bank. Some of these factors have their roots in the early years.

An overview of the management ranks of the bank in the early years indicates that it went through at least three stages. In the first years, the bank was more conservative in its domestic loans. The first CEO, Mr. Hugh Wilson, was knowledgeable in international banking, and accordingly the bank put 50 per cent of its loans out in the sovereign loan field. This strategy was abandoned on his departure in 1979, and sovereign lending gradually diminished to about 7 per cent of the bank's loan portfolio. Wilson was terminated in 1979, and the Chairman, Mr. R.A. Willson, became CEO. This was the second stage and was described by Neapole as one in which "the overall strategy in retrospect was to grow as quickly as possible". The third stage, to be discussed later, was the period in which Neapole served as CEO. In that stage the bank was principally concerned with the development and refinement of survival tactics which have been variously described as entrepreneurial and aggressive. It certainly was not conservative banking.

Overall, the bank's loan assets grew from $27M in 1977 to $510M by the end of the sixth fiscal year. During the same period the capital base grew from $10M to $31M. There is no doubt that in the period ending 1979, apart from its overconcentration in sovereign loans, the position of Northland Bank appeared to be reasonably sound. Its ratio of net income to total assets was good, even higher than in CCB. However, as CEO Mr. Walter A. Prisco observed in 1982: "Anyone who failed in Alberta in those years [1977-1980] must have been outright stupid".

The first crack in the wall appeared with the dismissal of Hugh Wilson. The cause of dismissal appearing in the directors' minutes was "deficiencies in interpersonal skills". He was succeeded as CEO by R. A. Willson, who was to serve as CEO until an experienced individual could be found. Willson adopted an approach to Northland's growth which differed significantly from the slow and steady approach Hugh Wilson had explained to the Senate Banking Committee prior to the bank's incorporation in 1975. Willson distributed a message to the bank's shareholders shortly after his accession to office, which stated in part:

> ... while Northland has moved quickly to establish its name in the international inter-bank family, the Board has felt that our major opportunity and priority lies in rapid penetration of the western Canadian market. ...
>
> The Board has therefore sought to change the style of executive leadership, stressing the building and development of a strong western team, ... It was felt that Hugh's skills were best suited to international banking. While not a banker, I am advised by my fellow Directors the Board's appointment of myself is predicated on my extensive management expertise in Canada and abroad as a senior executive, teacher and consultant, including counsel to other banks in the past.

During Willson's tenure as CEO, loans grew from $82M at the end of fiscal 1978 to $398M at the end of fiscal 1981, with most of this growth being concentrated in fiscal 1981. The bank had begun to emphasize real estate lending in 1979 in part because such loans were easier to put on the books, and by 1980, the bank's attention had shifted to larger loans. Willson's view was that by working within a loan limit of $2M to $3M the bank was finding it difficult to accommodate business needs and to maintain customer confidence.

It may not be without historical relevance to mention the dismissal of the auditors, Touche Ross & Co., who were dropped from the rotation at the end of fiscal 1980. The record indicates that a partner of Touche Ross, D. Heasman, had insisted successfully upon the establishment of a $400,000 reserve on a single loan. Management was opposed and a heated debate ensued at the eleventh hour. There is some evidence that a dispute arose about the same time between the management and the auditors about fees. The Inspector General expressed the view that it was the reserve issue which led to the removal of Touche Ross, and in September 1985, Willson is recorded as having said that Touche Ross had been "fired" as auditor of Northland Bank. Further details are provided in Appendix E. It is a reasonable conclusion that, notwithstanding their status as auditors for the shareholders, the management of Northland Bank effectively controlled the audit appointment and brought about the termination of the relationship of Touche Ross. Reference will be made later to a second management-auditors episode.

Walter Prisco, an experienced banker, joined the bank as President in January 1981. In mid-July 1981, he became CEO. In his assessment, Northland Bank had been run as "a Mom and Pop shop", and was devoid of meaningful policies. He sharply criticized the lending practices. Despite an apparently successful start with Northland, Prisco was discharged in mid-1982 over a dispute concerning the acquisition of a guarantee corporation by the bank and the valuation of a bank loan in the Cayman Islands. While there is no doubt that a power struggle preceded Prisco's departure, it would be of no assistance to this Commission in the discharge of its mandate to attempt to assess the rights and the wrongs in this dispute. In the end, one director (Mr. W. W. Siebens) resigned and another (Mr. K.M. Stephenson) was not nominated for re-election at the end of 1982. Willson again resumed the office of CEO.

Before resigning, Mr. W.W. Siebens commissioned Mr. R. Tourigny, a financial analyst in Calgary, to report to him on the financial position of the Northland Bank. The report is detailed in Appendix E. It was based entirely upon financial information obtained from Siebens or from the public market. It was very critical of the bank's capitalization, the high rate of turnover of key staff, a serious loan loss potential not disclosed in the financial statements, and the bank's overreliance on fee income. This report, written in the late summer of 1982, turned out to be prophetic. It was circulated to the Board and Willson circulated a response.

Mr. K.M. Stephenson, a director, also expressed concerns about the bank in a speech delivered to the Board. Willson testified that Stephenson, who was connected with the power struggle mentioned above, delivered his comments in an abusive fashion. The comments do, however, draw a graphic distinction between the bank's paper position and its cash position.

> Let's talk about results for a minute in very succinct terms. After six years of the Chairman's management of the bank the stock is trading at a little over half of its issue price. The bank's earnings would be in a significant loss position if it wasn't for the mickey mouse treatment of taxes. Tell me any other business where you can book future profits, currently, especially when the same future profits are in substantial jeopardy for a number of reasons, one of which is the loan losses related to loans booked when the Chairman was directly in charge. I don't care what the auditors recognize, the bank simply did not make the money, and we can't spend it.

After Prisco had departed no action was taken by Willson as CEO to undo Prisco's work in the establishment of lending guidelines. Willson was active in examining the practices in Northland Bank as to the treatment of interest income and indeed, in the third quarter of fiscal year 1982 he caused about $1M of accrued and recognized interest to be reversed. The bank thereby suffered in that quarter its first loss. Willson also sought the assistance of a retired credit officer of the Canadian Imperial Bank of Commerce to comment on the lending policies. Apparently a general report was made which revealed no serious problems in the management of the bank.

The turnover in leadership at Northland Bank may illuminate some of the troubles which developed in that bank. In its short history, the bank had four CEOs, at least four executive or senior Vice-Presidents, four internal inspectors and four Vice-Presidents of Credit. Of even more significance is the parade of CEOs. The first CEO, Wilson, served from 1976 to 1979. He was followed by Willson who was not a banker and who served from 1979 to mid-1981. Walter Prisco, an experienced banker, assumed that position in mid-1981 and served until dismissed in mid-1982. At that time, Willson resumed the position and served until mid-1984. Neapole, also an experienced banker, became CEO in mid-1984 and served until the bank was liquidated. The bank was in business slightly less than nine years, for more than half of which it was led by a CEO who had no experience in banking. It surely is not impossible for any given organization in almost any field to be led by a person not versed in that field. It must be equally true, however, that a new organization setting out in the field of banking should be guided by a person with considerable experience in banking. Willson appears to have had a general expertise in business at large, and he was, of course, connected with the bank from its pre-incorporation formative years. Indeed, he helped guide the project through the Committees of the House of Commons and the Senate at the time of the statutory incorporation of the bank. However, he brought no knowledge of banking to Northland Bank's most important position.

The evidence before the Inquiry is replete with references from a variety of sources indicating that early management in the bank was ineffective or worse, and applied imprudent policies. Lucille Johnstone, who joined the Board of Directors in 1978, considered that one element of the bank's weakness was the turnover in the CEO position which was "a disruptive type of situation" and "... it is very difficult to build a team as each CEO comes aboard with his own ideas and preferences in people". In her time, she saw Wilson depart and Prisco come and go. Without tracking the several departures from high executive positions in the bank, it can accurately be stated in summary that the pattern of management turnover may have slackened somewhat in later years, but continued until 1985. The result was that when the recession hit the west in general, and this bank in particular, there was no experienced management team securely entrenched in office. A view of the record reveals a parade of persons including Siebens, Neapole, Prisco, and Mr. M. Mackenzie, an auditor, who stated, sometimes in their own right and sometimes referring to the statements of others, that management of the bank was "weak". Mackenzie stated, "Neapole made no secret to us that the bank had a history of bad management". Neapole himself stated:

> ... the overall strategy in retrospect was to grow as quickly as possible. Internal credit policies were more optimistic than prudent and the general euphoria of the day led to the granting of virtually 100 per cent of the loans that became later problems.

Prisco, in a memorandum dated 8 March 1982, before his troubles with Willson and members of the Board had flared up, stated:

> Our loan problems stemmed from poor judgment, faulty analysis, lack of foresight, and careless monitoring (follow-up) control, i.e. weak management.
>
> . . .
>
> When I arrived here last year what this Bank was, was essentially an asset-based financing [sic: finance] company. ... Not enough attention was being paid by our credit officers to the quality of management, the strength of those to whom we lend to withstand adversity. ...

Northland Bank's credit granting record in its first 5 years of operation has been a poor one, by any standard.

The record reveals that Prisco inaugurated some guidelines on lending practices with which Willson and Neapole agreed although the former expressed considerable reservation as to Prisco's methods. These guidelines condemned practices such as 100 per cent financing and failures by the credit officers to assess the cash flow of security and the creditworthiness of the borrower himself. Whether these guidelines were applied is another question which will be reviewed shortly. By the close of the Willson years, the bank had a domestic loan portfolio of which about 57 per cent was located in Alberta and 25 per cent in British Columbia, and which was concentrated principally in the areas of real estate and energy. Willson testified that such a lack of diversification coupled with the small size of the bank dictated more conservative lending practices. As will be seen, such did not turn out to be the case.

At the close of this period, the bank found itself with many problems in its loan portfolio and a serious absence of experienced bankers in its upper leadership ranks. This condition impelled several commentators, including Prisco, Siebens, Stephenson and Mr. Stan Willy, a Chief Inspector of the bank, to warn of an impending doom. Succeeding management seemed to appreciate the gravity of the situation and directed their energies to the development of survival tactics in the hope of pulling the bank through these serious and perhaps terminal conditions. It is not apparent that the OIGB and the external auditors had a similar awareness, and the absence of that awareness is difficult to explain.

The Commission is driven to the conclusion that the bank suffered greatly in its formative years from a lack of stable and experienced leadership at the top and in the senior levels of management. This management, as earlier discussed, pursued business in a market slot which probably did not exist, in a narrow geographical region, and in cyclical industries. The vulnerability of the bank was greatly increased by a lack of conservatism and prudent lending practices in its operations from 1979 onwards, and by its reliance for funding on the wholesale money market.

3. The Neapole Years: May 1983 to 25 March 1985

a. Development of the Strategy

There can be no question on the evidence that Northland in 1983 was facing very substantial financial problems. The evidence is abundant. Mr. M. Fortier, who became a senior Vice President in 1983, was "shocked" at the state of the loan portfolio. The internal inspector, Mr. Iain McLeod, who joined Northland Bank in September 1983, described the loan portfolio as a "time bomb". Indeed, so overwhelmed was he by the condition of the portfolio that he tendered his resignation in his first week and had to be persuaded by Neapole to return and help salvage the situation. Neapole himself stated that the loan portfolio was "having difficulty".

The evidence of Neapole is the most instructive source on the conditions existing in the bank in 1983. The bank was at that time faced with a large number of nonperforming loans so that, in the words of Neapole, "The fundamentals of the income statement ceased to make any sense". He was acutely aware that he needed to somehow obtain the time to improve the portfolio and repair the damage that had been inflicted upon it. In this critical condition he acknowledged the importance of market confidence, and that the bank could not afford to suffer a loss. He stated in part:

> There is no question that the market awaits your financial results from time to time. Obviously good news is better than bad news.

It was therefore necessary to devise a workout strategy. Neapole and others described in varying ways the dominant purpose of the cohesive strategy which he and his fellow top management had adopted in these circumstances. The dominant purpose was to undertake an asset management program which would, by various methods of workouts, add value to the problem loans and the security held by the bank, so as to postpone their liquidation, maintain confidence in the bank, and thereby enable it to survive until the damage in the loan portfolio could be repaired. Often expertise from the industry in question was sought to complement the bank's own resources in the workout of problem loans. A phrase common in all this testimony was "managing the bank's income statement". This included, in Neapole's understanding, controlling the taking of specific provisions against losses. Associated with that activity was the need to bring about growth of new loans in the portfolio so as to dilute existing problem loans. The upshot of all this was that the condition of the bank was so brittle, or in such delicate equilibrium, that "our ability to absorb hits, as you put it, is a function of some arithmetic". The following exchange with Commission counsel paints in an important part of the picture:

> Q. Now, a cornerstone of this strategy I suggest was that income was recognized not on the basis of current values of the assets underlying the loans as security, but on the future values of the assets, the added value, that value that would be added over a period of probably three years?
>
> A. (Neapole) You mean in terms of income recognition?

> Q. Yes.
>
> A. (Neapole) I suppose maybe you are also talking about provisioning as well, but in any event, we have talked at some length in specific instances earlier in the past few days about the validity of the income recognition case by case, and to the extent that all comes back into this kind of a question, I guess the answer is yes.

Neapole said of the process of adding value, "... I guess the proof in the pudding is where you end up at the end of the day, assuming that you get to the end of the day". He added that in this process "certainly earnings is part of keeping confidence". The question was then put to him:

> Q. ... You said, on the way through the strategy the right number for provisioning income is the number that works and the vindication of those numbers would be at the end of the turn around process; is that a fair statement?
>
> A. Assuming you could define precisely when the end of the turn around had happened, yes.

Turning to another aspect of the crisis management which Neapole was in the process of installing in 1983, he stated that it was necessary to assess the level of tolerance which would be exhibited towards these management tactics:

> ... Somehow I had to try to measure what level of tolerance there was out there for a turnaround. Tolerance in the minds of auditors, regulators, depositors, other banks, the system if you like.

In his judgment there was tolerance for his strategies and in his testimony he stated that the regulators and the auditors of course would have to know what those strategies were.

In summary, a major part of the strategy of the bank in the Neapole era was to apply accounting procedures to management's policies and actions that would maintain the appearance of health through the bank's financial statements in order to survive until the salvage workouts could succeed. It was in this era that the "loan warehouse" concept of workout or rehabilitation of unsatisfactory loans was shifted into high gear. Epicon was such a case. It was established for the purpose of receiving from the bank about $100M in bad loans or recovered security taken by the bank on loans which had turned bad. Epicon's mandate was to turn these unsatisfactory real estate loans into assets of positive value by development, realization or otherwise. Epicon will be considered in more detail shortly. It can be seen from the most casual examination of the lengthy testimony on these issues that, like CCB, Northland Bank's management was treading water so as to stay alive until the recession passed away and prosperity returned to Western Canada, the theatre of the bank's operations. How the two banks managed to stay afloat has been a matter of much discussion in Chapter 4, and only the differences between the two banks will here be touched upon. While there are, of course, terminological differences, there would not appear to be much difference in substance between the present evaluation of future prospects as applied in CCB and Northland's technique of adding value to the present by reason of future expectations from workouts and related developments.

Other components of the Northland strategy were the development of a retail funding base and addition to the bank's capital. Northland had not proceeded very far into the 1983 fiscal period before liquidity problems were encountered by reason of the ricochet effect of the Eaton-Rosenberg episode in CCB. Support for Northland came in the form of a $250M credit facility with the five large Schedule A banks, which remained in place with renewals from time to time until June 1985. About the same time, Northland management realized that the design plan of reliance upon wholesale funding was defective. Accordingly, a program was commenced in late 1982 to raise retail deposit funds, and gradually through 1983 and 1984, these deposits increased to more than $500M by July 1985. This was a beneficial development except that the start-up costs for the retail deposit-gathering system are not known. While it is known that Northland Bank's cost of money was higher than other banks, it is unclear how much this adversely affected the interest spread in the bank.

Unfortunately, a planned increase of capital through the sale of $35M in preference shares and debentures scheduled for March 1985 was cancelled as it was impossible to go to the public for funds after the announcement of the CCB rescue program. In the meantime, the bank had raised by private placements and debenture issues in 1983 and 1984 some $40M, and in May 1985, a private placement of $16M in debentures was closed. It is a measure of the difficulties in which the bank was wallowing in these years that, given a reasonable leverage of 20 times, the $56M new capital would have supported a loan portfolio of some $1.1B. At an interest spread of one per cent, the new loans would produce net earnings before taxes of $11M annually. No such returns were gathered because the bank could not produce an interest spread at that rate, and could not put out slightly over $1B (apparently) without creating a burden of bad loans, or at least loans of little or no productivity.

Indeed, the strategy of dilution of NPLs by adding new loans was adopted during the depths of the recession when good loans were difficult to find. The other banks in the face of this recession had curtailed lending. During this period, however, the loans grew at an amazing rate. From $510M in fiscal 1982, the portfolio expanded to $622M in 1983, $945M in 1984, and peaked at 31 August 1985 at $1.183B. This increase of loan portfolio by two and one quarter times occurred at the height of a recession which both banks strenuously submitted was the cause of their respective ultimate collapses. To put out such significant sums in the face of this adverse economic climate raises considerable doubt about the wisdom of the aggressive and innovative approach of management in this troubled bank. The Inspector General observed that such growth increased the risk exposure of the bank and appeared to be partly motivated by a desire to take on new business in order to generate fees to fatten the income statement. An unknown proportion of these new loan moneys appear to have poured out of the bank into workout situations. This increased the exposure of the bank but supported the bank's insistence upon maintenance of classification of the loans in question, and the postponement, if not the indefinite avoidance, of the taking of specific loss provisions. These criticisms must be moderated to some extent by the fact that Northland created some of this new lending through the Toronto office which opened in late 1983. Presumably the success record in this lending was much better than the bank's experience in the older Alberta loans, as the evidence was that the recession moderated much more quickly in Ontario than in Alberta.

Much evidence was devoted by management of both banks to demonstrating that sound banking policies and practices were put in place and that manuals detailing credit-granting procedures were adopted, revamped and up-dated. However, as Commission counsel said, it is one thing to have a document as perfect as the Russian Constitution, but quite another thing to put it into daily practice. Neapole testified that he never did read these manuals because the management of a small bank was aware of what was happening in the bank, and manuals in this scale of operation were unnecessary. The same philosophy extended, as will be seen shortly, to the treatment by senior management of the internal inspector's report.

There is a serious overriding question as to whether latitude should have been accorded to the management of Northland to embark upon these survival strategies and thereby put at unnecessary or enhanced risk those who had occasion thereafter to deal with the bank. The issue of tolerance and acquiescence in these practices by regulators and auditors is the same in the case of both banks. The perhaps unanswerable question is how much the depositors, other creditors and investors lost because Northland did not go into liquidation by reason of undiscovered insolvency at some date earlier than 1 September 1985 (or more accurately, 20 January 1986).

Mention should be made of a report by Hay and Associates Limited which was the result of a study commissioned by management in late 1984 on the corporate and management structure of the bank. There is no question that senior management, when commissioning this report, instructed the consultant "to be tough in his assessment". The report was delivered in December 1984. In summary, it found that the bank had no goal other than survival, that its "culture" was out of balance, that a senior officer should be fired, and that the management information and financial management systems were in a state of crisis. There is no doubt that many of the recommendations in this report were implemented by the Neapole management. The significant value of this report, however, is that it clearly demonstrated in its very direct message that real and serious problems abounded in the bank even as late as December 1984. The content and tenor of the report is, furthermore, a ringing condemnation of the management which had gone before. It is equally difficult to understand how a bank could be in the condition described by the Hay Report without having prompted similar comments in the annual inspections and interim reports by the Inspector General.

b. Management of the Loan Portfolio

If the Northland Bank were measured by conventional banking standards, many of its loans would not have met normal tests of prudential judgment, and as such, would not have supported their historical carrying value in the balance sheet. To survive, management required time to improve the loan portfolio by patching up the damage, and in so doing, the conventional tests of loan valuation, the ability of the borrower to pay and the value of the underlying security, were not truly reflected in the bank's assessments of its loans. By conventional standards the bank could have closed its doors sometime in 1983. It did not do so but rather adopted a strategy of asset management which included the management of the income statement. The principal instrument in doing so was the adoption of workout schemes of one form and another. This strategy, of course, required an adaptation of the concept of the "banker's final judgment" as to the ultimate collectability of the loan. On the Neapole formula, this meant selecting a value which would work. This value, however it may have been described, was computed with reference to future values augmented by a real or fictional element reflecting the added value which was thought to adhere automatically to the asset once the workout program was instituted. This enabled the bank to avoid provisions and to recognize in its income accrued interest. Whether or not the borrower was able to support the loan from its own resources seemed to be an irrelevancy, and the absence of such capability did not in any way embarrass the management.

The whole business was based upon a series of fundamental assumptions by management. First, in the words of Neapole, the bank had to assume a generous measurement of "system tolerance". This meant acceptance of these concepts first by the external auditors and then, by what appears to have been a much easier process, by the regulator, the OIGB. Management drew considerable comfort from the fact that both the regulator and the auditor knew of the workout strategy and the foregoing assumption. Second, but much less importantly, management had to assume some improvement in the economy. So long as system tolerance permitted, management possessed an open-ended licence to continue operating at least until the paper accumulation choked the cash box and there was not enough hard currency to meet current obligations.

The system falls down completely not so much on a loan-by-loan analysis but on considering the overall impression of a neutral observer who "stands back", in the words of Broadhurst. This observer would recognize that the bank could not afford to take major reserves for bad loans. The application and reapplication of workouts are then seen simply as a device to trigger the necessary favourable accounting treatment needed to create the facade of acceptable financial statements. The requisite end figure dictated the magnitude of the formula and therefore the process was never wrong. Probably the greatest ally this managerial philosophy or doctrine had was the abhorrence of any person, be he regulator or auditor, of being the instrument which brought about the closing of the doors of a bank. Abhorrence is another expression for system tolerance, and management of Northland Bank played it for all it was worth.

It is unnecessary to dig into the inner workings of the schemes adopted. It is sufficient to recognize, for example, that according to the doctrines of Northland Bank as applied by their principal advocate Neapole (and sometimes generously approved by the external auditors), an NPL does not necessarily require a provision, the level of loan loss provisions in the financial statement does not necessarily reflect the actual number of NPLs in the loan portfolio, and a loan need not be classified as nonperforming if some workout plan can be devised to produce a future security value that justifies advances by the bank of funds to service the loan in the meantime. These doctrines allow the bank to drift away from a cash basis which the financial statements thereafter never reveal.

According to the rules created by Northland Bank (but not applied), only the lowest loan grade, No. 5, mandated a reserve. The statistical result in the managed accounts reveals an interesting picture. In fiscal year 1982, nonperforming loans amounted to 11.7 per cent of total loans, the provisions for loan losses reported in the financial statements for the year were $2.2M, and specific provisions booked were $3.85M. In fiscal year 1983, the nonperforming loans amounted to 17.2 per cent of the total loans, provisions for loan losses at year end were $3.29M, and specific provisions booked were $6.99M. In fiscal year 1984, the level of NPLs fell to 8.4 per cent of the total loan portfolio, provisions for loan losses were $4.6M, and specific provisions booked fell to $6.7M. Expressed in percentage terms, provisions for loan losses as compared with total loans went from 0.43 per cent in 1982 up to 0.53 per cent in 1983 and down to 0.49 per cent in 1984. This picture reflected a stable condition of provisions expressed as a percentage of the total portfolio. There was also a slight improvement in NPLs through these three fiscal periods expressed both absolutely and relatively. The magic wand was the workout. In the hands of management, loans which might otherwise move into the NPL category did not so move, with the beneficial consequences that capitalized and accrued interest continued to be recognized and provisions were avoided. The reader of the financial statements and the annual report for fiscal year 1984 might well go away with the impression that the bank had survived the crisis, was out of danger, and was a reasonable institution in which to invest or deposit funds. The question is, however, whether the bank had so managed its asset and income statements by using arbitrary numbers for provisioning, accrual of interest, and loan classification as to produce a survival formula. Whether this is so depends upon the reality of the condition of the bank as determined by independent, qualified reviewers. We shall return to this shortly.

The key to all this, of course, is the variable valuation concept variously referred to as future value, investment value, or baseline value. In Northland Bank, the term "added value" is preferred. Neapole agreed that the future value of assets, that is the current market value plus the "added value", could be accumulated over a period of three years. This figure sustained the management override in order to continue the recognition of accrued interest income and enabled management to ordain that there was no doubt about the ultimate collectability of principal and interest because the magic floating quantity of future value always seemed to rise to the occasion and exceed the principal sum of the loan plus accrued and capitalized interest. Mr. R. Guenette, one of the principal officers of the bank, was asked about this process and gave the following answer:

Q. Is it the fact that in valuing this piece of property for security purposes, the bank's valuation figure was its estimate or the purchaser's estimate that the property would bring two years hence?

A. Yes, sir, that is correct.

Carried to its logical conclusion, this concept would destroy the underlying assumption in all financial statements that the financial statements can, by the application of a series of constant rules, depict with reasonable accuracy the financial position of the business entity and the results of its operations at the fiscal year end. In the language of many witnesses, a snapshot of the bank at that time, in the form of financial statements, should depict the position of the bank according to the GAAP rules as modified by the *Bank Act*. The Neapole management team, on the other hand, took the view that, by reason of the conditions in which the bank found itself, it was misleading and inappropriate to take a snapshot of the bank, and particularly its loan portfolio, at a specified point in time. Subsequently, the curator concluded that the specific provisions on loans taken by the bank were grossly inadequate. Senior management's response to the curator's assessment of the survival tactics illustrates their view:

> ... it is inappropriate to take a snapshot of our portfolio at one given point in time. We feel that it is not possible to properly judge the quality of the portfolio and the appropriate carrying value on the books of the bank, without measuring the progress made to date by Northland's management and staff against the business strategies employed. We feel that these factors are understood by those that really know and understand the bank, such as our auditors, our clients, third parties who have completed significant transactions with us such as Hees International, and others who are active within the difficult markets in which we have operated.

Management seemed to prefer the moving target concept whereby the loan in question could be moved back and forth in order to avoid the oncoming need to take a loan loss provision, or to cease interest accrual and reverse prior accrued interest. The workout was seen as the final *coup de grâce* of any requirement for valuation of the loan or the underlying security at the time specified in the financial statement. Neapole explained:

> As I said earlier, the basic commodity in the business in terms of asset management is judgment and judgment, because of reporting requirements, has to be quantified annually, audited and so on, a set of numbers must be produced, and those numbers, in essence, reflect the aggregate of all of those judgments.
>
> . . .
>
> What it does do, essentially, is say, use your best judgment.

This is the ultimate in flexibility, injecting into accounting an infinite elasticity in the valuation process, and in all the quantities which flow therefrom including loss provisions. From there on the valuation process is a battle of words and self-defining terms. For example, according to Mr. R.J. Mackay of Thorne Riddell, one of the bank's auditors, there are various expressions all to the same end such as "the expectation of future values". But sometimes the policy or proviso was described differently:

> ... investment value did not mean the current forced sale price of a property but rather the value which could be derived from the reasonably expected price of the property within a reasonable time frame.

This description does not square with the practice in the banking industry as evidenced by memoranda and testimony. The hard reality cutting through the evidentiary debate about the distinction between going concern value and liquidation value is that the value of the bank's assets at the date stated in the financial statements should not, according to generally accepted accounting principles, depend upon "future values" predicated upon a revival in the economy or some uncertain expectation in the undefined future. All of this was described by a very long line-up of witnesses with extensive experience as bank credit officers. Some were retired; some were active bankers. None were able to report that any such concept had been applied in the bank where they work or had worked over the years. Perhaps even more fundamental is the recognition that no operational decision by management can necessarily mandate the accounting treatment which must be applied by the external auditors when determining whether the financial statement advanced by management fairly reflects the financial position of the bank. In the words of Garth MacGirr, the liquidator of CCB, if such were not the case, a bank could forever avoid cessation of recognition of accrued interest or the taking of a loss provision against the carried value of a loan.

c. *Capitalization of Interest*

The subject of capitalization of interest was fully canvassed in connection with CCB, and, apart from the fact that no compilation of capitalized interest was found in the records of Northland, the situation in the two banks would appear to be approximately the same. Northland, in its loan warehousing and workout arrangements, made a considerable practice of advancing money to new borrowers to acquire assets from the bank or from a receiver of a borrower, and these new moneys included "operating loans" and other advances to carry interest either then in arrears or accumulating in the period after the loan arrangements were made. In these cases, the bank's exposure for both principal and interest advanced was increased. The arrangements reached such proportions that Willy, a Chief Inspector of the bank, and Mr. Stan Cook, a retired banker who joined the OIGB, both commented that it would be difficult for a borrower to fall into default. As in the case of CCB, ultimate collectability was an exercise of bank management's judgment that interest may be capitalized, and this judgment was in turn based ultimately upon the determination of the future values of the property in question. Different terminology produced the same result in both banks.

Mr. R.W. Korthals, President of the Toronto-Dominion Bank, in discussing loan provisioning and its relationship to recognition of income, made the interesting observation that in his bank the decisions to terminate accruals of interest and reverse theretofore recognized income were taken automatically when the collectability of the loan came into doubt, rather than taking a loan provision. The latter, because of the five-year averaging formula, had a reduced impact on current earnings and therefore the establishment of a nonaccrual status had a more salutary and realistic effect on the income of the bank in the year in question. (This policy was recently supplemented by an additional minimum loss provision to encourage the adjustment of original loan values to current values.) Had this same thinking been applied in Northland, and indeed in CCB, capitalization and accrual practices would not have been allowed to intervene and distort the presentation of the bank's financial position in its statements.

While it is difficult to be precise, the activities in Epicon and like operations and the extensive workout arrangements, give some insight into the extent of the practices of recognizing accrued interest and of capitalizing interest in Northland. There is also evidence in the OIGB files that, during the first 2 quarters of 1985, the bank had capitalized $12M on loans totalling $289M, of which $8M was capitalized on $103M of restructured loans. It is reasonable to conclude that the extent of capitalization of interest (whether in arrears or upon the sale of a repossessed asset to a new buyer from Epicon or the bank in what was essentially a workout) and income recognition practices generally were at least at the same level as in CCB, and indeed, may well have been proportionally higher.

d. Nonperforming Loans

The classification of nonperforming loans presents an interesting insight into the workings of management in Northland Bank. A memorandum on the subject of nonperforming loans described the rule in the Willson era:

> ... the Inspector General has asked us to designate any loan, for which interest is 90 days in arrears, as nonproductive. At that point interest ceases to be accrued, except in rare instances where interest recovery is adjudged by the vice-president, credit, and the senior vice-president, to be imminent ....

That policy was changed near the beginning of the Neapole era, undoubtedly in response to the pressure of increasing nonperforming loans. The change in the definition of NPL is reflected in a note to the 1984 financial statements (which is almost identical to the note to the 1983 statements):

> Loans are classified as nonproductive when, in the opinion of management, there is significant doubt as to collectability of principal and/or interest, in whole or in part. At the date when a loan is classified as nonproductive, the accrual of interest ceases. After taking into consideration loan security and other factors, previous interest accruals may be reversed and a specific provision for loan loss may be made.

The auditors pointed out that in the Neapole era, as it was not necessary to take a provision on an NPL, the level of provisions in the financial statements may not match the level of the NPLs. Even faced with this, Neapole did not agree that the bank, in changing the definition of an NPL, moved to a less conservative accounting basis. The auditors, Thorne Riddell, however, advised the OIGB that, "The bank had followed a very conservative policy in ceasing the capitalization of income once the loan stopped paying for 90 days" and that this was no longer the case. The OIGB agreed.

The most significant element in the process was the recognition by the auditors that the final decision on whether a loan should be placed in the NPL category resided in senior management. This is illustrated by the chain of events commencing in August 1983 when Willy wrote Willson, drawing to his attention a significant error in the 1982 annual report:

> ... Accrued but uncollected interest is reversed whenever loans are considered nonproductive. The Bank classifies a loan as nonproductive when, in the opinion of management, there is significant doubt as to collectability of principal and/or interest, in whole or in part.

Willy pointed out that the bank's records indicated that an amount of uncollected and unreversed interest had accrued on NPL loans and that the first sentence in the above quotation was not being applied. The external auditors, however, reminded him that the second sentence in the above quotation left with senior management the exclusive power to determine ultimate collectability and hence the classification of a loan. The auditor, Mr. W.K. Detlefsen, of Thorne Riddell, concluded that the records which Willy had examined did not reflect the exercise of judgment by senior management on collectability. The bank was therefore left in the strange position that its accounting records, and the classifications by lower management reflected in those records, differed from the final classification, although the accounts later were not corrected. This illustrates the frequent use of the management override, and accordingly it is reasonable to assume that the condition of the loan portfolio, at least as regards those loans which were truly nonperforming, was not adequately reflected in the financial statements commencing in 1982. This was most certainly the case by 1983. In 1983, for example, Willy estimated that, in the four loan platforms or branches inspected by him in that year, a total of almost $2M of unreversed interest was reflected on nonperforming loans. In the light of the bank's before tax earnings of $2M in that year, that is a very material sum. The level of NPLs, as already noted, declined from the 1983 fiscal year to the 1984 fiscal year, and indeed, by the third quarter of 1985, the bank's financial statements revealed only $43.4M in NPLs.

The liquidator, on the other hand, assisted by Royal Bank personnel, estimated that actual NPLs in the bank were about $325M, much higher than reflected in 1983 through 1985. If this was so, and there is no reason to question the accuracy of the liquidator's analysis (which is supported by McLeod's and other independent assessors' figures) of the status of loans in the portfolio of the bank, then the only conclusion is that the exercise of managerial override and other devices enabled the bank to avoid classification of loans as NPL on a large scale for the reasons set out above as part of survival accounting tactics. The true level of NPLs explains the woeful condition of the bank which was dragging it inexorably into liquidation. It also leads to the conclusion that by 1984 the financial statements of the bank had seriously departed from reality.

e. Loan Loss Provisioning

Loan loss provisioning, like classification of bad loans and interest accrual, was, in the hands of Northland management, an elasticized accounting procedure whereby the level of income revealed in the bank's statements could, in its latter years of existence, be regulated according to the bank's needs. One variable element was the proposition that no provision need be taken so long as security values, based of course upon future anticipated economic levels, were sufficient to make principal and interest ultimately collectable in the view of management. In the case of workouts, the auditors' testimony was that no provision was considered necessary if management's expectation that the workout would be a success was reasonable. Epicon, as described by Neapole in a discussion paper presented to the Board of Directors, would have such a cushioning effect on the bank's statements and would be "a significant factor in determining final provisions" for the year, and indeed, would permit "the bank to show a profit for the year". Management's philosophical view of the entire provisioning process is discernible from their adoption, on at least two occasions, of the proposition that the bank might properly set a level of provisions for a given period and hold loan loss reservations to that level. Consequently, the bank would be able to transfer any "freed-up" loss provisions arising from unexpected loss recoveries for application to other loans. This is revealed in a memorandum by a Vice-President in December 1983. It also is apparent from a conversation between the Vice-President of Finance, Mr. H.G. Green and Mr. J. Courtright of the OIGB, wherein Green stated: "The freed-up specifics would be applied to other loans in the portfolio". This subject is later discussed in more detail.

f. One Hundred Per Cent Bank Financing

Mention has already been made of the practice of 100 per cent financing by the bank through the purchase by shell corporations of security held or recovered by the bank. Sometimes, of course, 100 per cent financing is entirely proper and innocent. It may occur, for example, after a loan has been made, if the value of the security taken or the value of the subject of the entire transaction has shrunk in the market to the level of the loan or lower. There are many instances, however, in Northland accounts where the original borrower or successor borrowers in the same transaction or project, with the aid of subsequent advances by the bank, put none of their own money into the business. Without exception, those who have had occasion to review or examine the loan portfolio of Northland Bank have reported the alarming level of loans where the borrower, original or ultimate, had "no equity" in the project. One of the Inspector General's inspectors critically commented on the practice: the banker's role was to assist with a project, not buy it. Management, of course, contended that the realities of the recession in Alberta and British Columbia were such that no person in the business world would come forward and join a workout where he is knowingly succeeding to the position of a failed borrower if the transaction involves any investment of his own money. His investment is his time, his skill, and his energy. There is truth in this side of the story, however, the financial statements of the bank must fairly present its position. A provision must be taken where the ordinary rules of bank accounting so require whether or not the loan is an example of 100 per cent financing. That feature is neither irrelevant nor controlling on the issue. The judgment must be made having regard to the presence of 100 per cent financing as a factor.

g. *Fee Income*

Fee income is another item in the banking business which, if improperly or unconventionally treated in the records of the bank and in its financial statements, can distort the latter. There are two basic problems. First, some fee income is a charge in lieu of interest, or is a reward charged by the banker for granting the loan. Such charges are inaptly described as fee income and ought to be labelled as interest charges. Other fee income originates from the provision of services by the banker to the borrower not traditionally related to the granting of the loan itself. For example, the banker might, in the sense of merchant banking, bring partners or joint venturers together for the purpose of the transaction in question, retire or consolidate pre-existing indebtedness, or provide some other organizational service not traditionally associated with the bare making of a loan. Fees in the latter sense can be taken into the income of the bank in the year in which the services were rendered. Payments received in lieu of interest must, however, according to generally accepted accounting principles, be amortized over the life of the indebtedness. This was acknowledged by the bank in its 1984 financial statements.

The problem is whether these principles were consistently applied by the bank and its auditors. There is no question on the evidence that banks in Canada have moved into that aspect of merchant banking which generates fees which are truly independent of their loan-related activities. Neapole has stated that Northland Bank so emphasized this part of its business that it became a hybrid, a mixture of a traditional bank and a merchant bank. Two of the retired bank credit officers engaged by the Inspector General to examine the loan portfolio of the bank concluded that the fee income of Northland Bank was inordinately high and that there appeared to be many cases where the opportunity to exact a fee from the transaction was the overriding consideration in making the loan. One of these examiners, Mr. Karl Adamsons, stated:

> In these cases, it appears that an analysis of the underlying value of the project and security is given a back seat to fee income considerations.

Other income (in this bank, mostly fee income from loan business and merchant banking) in the 1983 fiscal year was $2.4M, as compared to $8.1M in 1984. By the end of the third quarter of 1985, "other income" was $8M. This substantial fee income made the difference between a profit and significant losses in the 1984 fiscal year and in the 10-month period ending 31 August 1985. Discussions between the external auditors and the bank in connection with the 1984 audit resulted in the reduction of the amount of fees charged directly to income without amortization by some $400,000. This matter is dealt with in connection with the auditors' activities later.

An example of the bank's pursuit of fee income is illustrated by a loan where the acting Vice-President, Credit (and Chief Inspector of the bank), McLeod, opposed the granting of a loan to the proprietor of a drug store in Alberta for the purpose of purchasing land for a hotel site in Hawaii. The loan was eventually made in the amount of $6M and included a $650,000 fee to the bank. The loan was not complicated and there seems to be no reasonable basis for a fee of that magnitude, unless it was in lieu of interest. McLeod viewed the loan as unattractive from a credit viewpoint while Fortier took the opposite view. Neapole approved the loan by a tie-breaking vote wearing, as he put it, his "businessman's hat" as opposed to his "banker's hat". McLeod to the end maintained the view that the only merit in the loan was the fee, which, of course, was paid to the bank from its own money.

Fee income similarly seems to have been the main attraction in a series of loans made under the SBEC program established by an Alberta statute. These loans threw off a considerable flow of fees, although the exact amount seems to be in doubt on the evidence. Adamsons reported on the SBEC loans as follows: "The danger is obvious. After two years, bank security will consist of minority equity investments in small companies". The most reasonable conclusion available on the evidence is that the purpose of the bank in entering into this extensive program was to generate fees in order to pump up its income statement in these perilous years.

Other substantial loans were made by the bank under circumstances that lead the Commission to conclude that such transactions were "fee driven". The Inspector General, shortly before the closing of the bank, observed that Northland Bank was "playing games with fee income". The auditors took a different view, and apart from the one incident already noted, saw no reason to conclude that the fee income, as treated by management, had distorted the financial picture of the bank contained in its financial statements.

h. Epicon Properties Inc.

To best dispose of sterile assets, namely bad and unsatisfactory real estate loans and repossessed security in the form of real estate, management decided to interest an expert or experts in real estate in a joint venture. This they did by the formation of a company, Epicon, 55 per cent of the common shares of which were held by the bank and 45 per cent of which were held by another company, Ellsmere Developments Ltd., of which 80 per cent was owned by a public company, Agra Industries Limited, and 20 per cent by a company owned by two real estate entrepreneurs, Messrs. Wettstein and Walker. There was $100 of common equity issued. The bank paid all the administrative costs of operating Epicon, including a fee to Walsten Management Ltd., the corporate vehicle of the two real estate entrepreneurs. These gentlemen were also by contract accorded all the perquisites and status of senior officers of the bank. Thus Epicon was financed entirely by the bank. The other venturers advanced nothing except the time of the real estate entrepreneurs for which they were compensated by the bank.

The plan was simple. The bank would transfer real estate assets to Epicon for a transfer price agreed to be the lesser of fair value of the properties as determined by the appraisal of Messrs. Walker and Wettstein and the book value of the bank (principal plus capitalized or accrued interest). The auditors testified that, in most cases, the transfer price was the latter. A considerable amount of evidence dealt with the "fair value" established for these assets by Wettstein and Walker. It was agreed by all witnesses concerned with Epicon that the properties themselves did not increase in value from 1982 to 1983, the year of the transfer. Rather, the underlying value of the security was valued differently by Messrs. Wettstein and Walker, and this was relied upon by the bank and the bank's auditors in setting aside a reversal of accrued interest which had occurred in the bank's accounts in 1982. In 1982, some accrued interest was taken out of interest income or reversed because the loan was in default and the value of the security would not then support the recognition of the accrued interest. In 1983, this excluded interest was put back into the income of the bank because of the value then assigned to the security by Epicon management. The difference in value brought about by the tranferee's "appraisals" was effectively taken into the bank's income through what an OIGB inspector described as "the retroactive booking of the accrued interest".

The auditors justified their approval of these accounting gymnastics on various grounds. Detlefsen thought that the initial reversal had been overly conservative and that the ultimate correction proceeded on the basis of the adoption by the bank of reasonably conservative practices allowing the bank to recognize that the principal and accrued interest did not exceed the "fair or realistic value of the property". McKay did not recall any discussion concerning the degrees of conservatism exhibited by the bank from time to time, but rather adopted a new concept, namely "investment value" which, if not exceeded by the combined principal and capitalized interest, would justify the retroactive recognition of uncollected interest. Management was more forthright, and simply stated that at the time of the transfer they had exercised a "fresh judgment" on the value of the transferred assets, and as this new value exceeded the value of the assets on the books of the bank, the recognition of accrued interest could be renewed.

All of this accounting was by no means incidental to the formation of Epicon, and it can only be reasonably concluded that one of the purposes of Epicon was to permit on a large scale these accounting practices which produced new income in the bank's financial statement for 1983. All this was done in spite of the fact that no one at any time throughout these hearings argued that there had been any significant improvement in real estate values in the Province of Alberta in the continuing recession of 1982 and 1983. The end purpose and driving thrust of Epicon was to postpone or defer the taking of major write-downs of loans and recovered assets. In short, it was a protective shroud over both the balance sheet and the income statement of the bank in the fiscal years 1983 and onwards.

Management announced from time to time that Epicon was successfully disposing of assets. In almost all cases, however, dispositions were to a new borrower, created for the purpose of purchasing the property, who would borrow from the bank not only an amount equal to the book value of the security for the purchase price but also such additional moneys by way of an "operating loan" which would allow for the "payment" of interest to the bank until the workout plan came to fruition. The result of this additional step was the creation of a new current loan which would remain current through the use of the bank's own funds for the next accounting period. Current loans would thus be reflected in the financial statements even though the position of the bank vis-à-vis the security was precisely the same as before the property was transferred to Epicon. The bank's accounting position was thereby greatly improved in that it could again recognize income. The fact that Epicon's "disposals" were at the expense of the bank was not appreciated by Willson and probably also not by the Board.

It must be wondered why it was necessary to interpose Epicon at all in this wholly internal and artificial transaction. In at least one instance which the Inquiry examined in detail, the rollover transaction was repeated twice after Epicon, each time by the use of a shell company which held only one asset, namely the security which the bank had foreclosed in the pre-Epicon stage of the loan. Epicon was not necessary in the second and third jump of the property. Values did not increase in the market sense but only in the book sense, and only then by capitalizing interest. Epicon was truly analogous to a used car dealer set up to take over the trade-ins by a franchise dealer. Occasionally, the used car dealer might, at the expense of the franchise holder, repaint a car, but otherwise its function was simply to house the vehicles pending disposal, hopefully to the public. That last stage rarely occurred so far as the records before this Commission show.

The justification for all this procedure according to the bank was that the combination of real estate expertise and the real estate security in the hands of the bank was necessary to maximize recovery from these troubled loans. Qualified partners, it was said, could only be interested in such a project for a participation in end products. This was doubtless a "second intent" and without more, this process would be acceptable. The interposition of Epicon, and all that flowed therefrom, served other purposes. The financial statements and the bank's financial condition were on diverging courses.

Mr. J. Morrison, the liquidator, having examined these transactions, came to the conclusion that the transfer to Epicon and subsequent rollovers to shell companies did not improve the position of the bank. The effect of Epicon was simply to burden the bank with the overhead of operating the company and to freeze the bank's interest to recovery of its book value through redemption of the preference shares received from Epicon, plus 55 per cent of any extra recovery net of expenses which Epicon might effect, and less the expenses of Epicon paid by the bank.

When the bank closed, the properties remaining in Epicon had a book value of about $16M. The liquidator considered there would be a shortfall on realization of this property of $10M. The liquidator also estimated that on the properties rolled out of Epicon under 100 per cent bank financing, the loss would be about $31M. Financial statements of Epicon produced from bank records showed that it never made a profit. There is nothing in all this evidence to indicate that the venture of Epicon added any value to anything except possibly to those on the payroll of Epicon. In at least two instances, the properties transferred from the bank to Epicon eventually rolled through two newly set-up borrowers and into a proposed disposition to a company known as Rondix which was to be established by the bank as the ultimate burial ground of all the bank's worst loans. Epicon appears to have been only one section of the pipeline through which these bad loans were ultimately scheduled to be drained into Rondix. Some Epicon properties also drained into Dexleigh, another large transaction. Of "added value" in these transactions there is little or no evidence. The bank's exposure through these loans continued to rise with the creation of debt servicing loans but the underlying security values did not seem to improve. If Epicon was a success, it was so only because it performed the accounting magic of restoring loans to accrual status and permitted avoiding the need to take provisions; both of which were, by themselves, valuable results for the bank.

i. Other Workouts

There are many other examples of workouts through the use of intervening companies whose assets consisted only of the property under workout. The fate of many of them was, from the bank's viewpoint, precisely the same as Epicon. Clearly the bank preferred to disobey the old banking adage that "your first loss is your lowest loss" so as to be able to end up with a new performing loan, rather than an NPL, and to avoid write-downs and write-offs or, at the very least, postpone them to the last possible moment.

This process had a deadly by-product. Through sequential rollovers and debt servicing loans, recognition of accrued income and other like practices, the bank exposure grew and grew. Indeed, on occasion, the bank was encouraged, either by prospects of commercial success or in desperation, to move the loan along one more time, to grant extensive loan increases of which the most spectacular example is the loan in the Cayman Islands. This loan grew from a $2M (U.S.) exposure in 1980 to $56M (U.S.) today. Each step is entirely explainable, at least in the eyes of some witnesses, yet no turn of the road produced any return of capital, or even interest, to the bank. Even today there are witnesses who will speak glowingly of the commercial prospects of the secured properties. The hard fact is that the bank, at the end of the day, had about 50 per cent of its total capital invested in a hotel and golf course property in the Cayman Islands in the Gulf of Mexico. Diversification sometimes comes at a high cost.

These are but a few of the examples of the end-of-the-line survival banking carried on by Northland Bank in its last years. Sometimes these moves took on the appearance of pure desperation, for example, the granting of two huge 20-year loans with an interest cap of 11 per cent, but in no case more than the bank prime rate less 1/2 of 1 per cent, in return for involvement in real estate deals which held out the advantage, however remote, of a market for some of the repossessed security in the hands of the bank.

Management's resolve to pursue the workout strategy manifested itself as well in its dealings with the OIGB. If the required "system tolerance" did not exist, management was prepared to create it or at least help it along. When faced with the Inspector General's concerns about the bank's growth strategy and his suggestion that the bank enter an undertaking regarding the growth rate, Neapole responded:

> While I am quite prepared to meet with you and members of your staff at any time to review and discuss the Bank's current status and near term plans, I would resist strongly, entering into any undertakings to restrict growth beyond the type of assurances we provided to the big banks and to the Bank of Canada

> and Mr. Grant in our presentation. Certainly with us preparing a prospectus and about to seek a credit rating, I believe any customized regulatory constraints on the Bank would be counter-productive and risk undoing a considerable amount of the repair work of the past 18 months.

The Inspector General responded by stating that the OIGB would shortly be in touch with the bank to arrange a meeting to discuss growth rates. That never occurred.

It is difficult in hindsight to condemn management when their energies were devoted entirely to a struggle to overcome the fully appreciated realities of the bank's adverse position. There is no suggestion in the record that there was any motive at all improper, or any personal advantage or gain to any manager for undertaking these measures, some of which can charitably be described as bizarre. They were, it is suggested, the product of an intense effort on the part of senior management with broad banking experience who were endeavouring to stay within the rules, stretched though they may be, while still carrying the bank across a very long and dangerously thin strip of ice. However, there is a line which management is never entitled to cross, the point where to prolong the life of the bank further is to expose to danger the assets and well-being of those who unwittingly deal with it. Courageous bank management is one thing but complete and accurate disclosure according to the rules of the road in banking must be at all times present. Here, that line was crossed, probably as early as 1982, but certainly by 1984.

4. Impact of the CCB Collapse

There are many contradictions and conundrums in the scene at Northland Bank at the time of the fateful announcement that the CCB had encountered serious troubles and was to be the subject of a rescue program. The immediate effect on Northland was nearly fatal. Here was an even smaller bank, more concentrated in Western Canada than CCB, more exposed to Alberta real estate and energy loans, with a history of less stable and less experienced bank management than the CCB. The financial markets must surely have wondered whether the Northland Bank portfolio would, on close analysis, reveal the same conditions as were becoming apparent in CCB. It was natural to expect investors to react as they did. Depositors fled to higher ground. A proposed securities issue by Northland Bank was grounded indefinitely.

Northland Bank management assert one other serious fall-out effect from the CCB development. From 25 March onward, in their view, the regulatory environment changed and the regulators looked upon Northland Bank quite differently. In the result, the bank's workout strategies were criticized, the bank's growth in loan assets was viewed with increasing alarm, and the bank was forced to jettison some of its programs just before the anticipated profits were to be reaped, or so it was argued. Perhaps left to itself and without the earthquake at CCB, Northland Bank would have struggled along and gained the time necessary to straighten out its loan asset problems. As Commission counsel has said, however, the effect, even without a CCB collapse, of the recent oil price reductions on Northland would require a strong constitution to contemplate.

It is true that, viewed superficially, the picture was getting a little rosier at Northland Bank up until 25 March. The annual report in October 1984 highlighted some of the apparent gains in recent times. These developments included the substantial growth in loan assets, the reduction of NPL levels, the increase in net income, the success of the retail deposit program, the generation of fees by the merchant banking group, the apparent workout successes including Epicon, the stabilization of loan losses, the slight improvement in the general economy, the elimination of interbank borrowings, and the successful preparation for a preference share and debenture issue scheduled for 27 March 1985. Some of this can be corroborated. For example, Wood Gundy, the bank's underwriter, had canvassed the regulators, the auditors, the Bank of Canada, and the market, and were satisfied, on the basis of positive responses to the bank's plans, management and general financial condition, that the securities issue proposed by the bank would be well received. It is strange that Wood Gundy, following meetings with these bodies, was able to report that there had been little discussion of loan portfolio problems in the bank. It was the calm before the storm for, as will be seen, by July and August there was little else to be talked about at the bank.

On 25 March, therefore, the only clear and immediate effect that could be seen from the CCB announcement was a liquidity problem brought about because the public would inevitably associate the two banks, and some of the depositors would take their moneys elsewhere. In fact, dealer deposits fell from $291M just before the CCB announcement to $121M by the end of April. At the same time, liquidity support from the Bank of Canada amounted to $85M by 29 April and grew to $540M by the end of August. It perhaps is not surprising that during this period retail deposits grew from $335M at the time of the CCB collapse to their all-time high of approximately $500M by 9 July.

Even in its last partial fiscal year the bank's loan portfolio continued to expand. An additional $250M of loans were booked from the beginning of the 1985 fiscal year to 31 August 1985, when the loan portfolio stood at $1.18B. Presumably, much of the 1985 loan growth was occasioned through workouts and refinancing. In the same period, however, the bank managed to earn some income, amounting before taxes to $2.5M. This was the result of taking into income $8M in "other income" which was mainly fees. From a cash point of view the bank was clearly in a loss position in 1985.

Of the loan portfolio at the end of the bank's existence, 43 of 1798 loans were over $5M, this small block representing 30 per cent of the book value of the whole portfolio. The portfolio remained heavily concentrated in Alberta and British Columbia, although the Toronto office had put out some $200M in loans. Real estate represented almost 45 per cent of the portfolio, an increase over the year before. Because of the accounting treatment accorded to the survival tactics adopted by management in that last fiscal period, it is difficult to discern the true characteristics of its banking operations in its last days.

Nevertheless, in all these difficulties, Northland proceeded with its capital issuance project of $35M in preference shares and debentures, and fatefully scheduled the closing on a date which turned out to be two days after the announcement of CCB's rescue program. It is not difficult to see that this timing was more unfortunate for the bank than for the potential purchasers of the new securities. Had the bank been able to take in $35M in new capital as originally planned (the ultimate issue was $16M of debentures and was issued privately) without the intervention of the CCB collapse, it would have been in a somewhat better position to continue its struggle for survival.

Shortly after the CCB announcement, Wood Gundy in its investigation of the possibility of a private securities issue, met with the auditors, the Inspector General, the Bank of Canada and others. It formed the conclusions that the auditors had not misled them or withheld any information, and that management was competent and trustworthy. Discussions with the Inspector General were more crucial. The Wood Gundy witnesses took notes of these discussions and from those notes and testimony by all concerned it appears that Wood Gundy had the impression that the CCB bailout was unique and that Northland Bank was not exposed to similar problems. The Inspector General did not give an opinion on the status of Northland's loan portfolio, write-offs, and so on, but rather referred Wood Gundy to the auditors. The Wood Gundy notes state in part, "The OIGB keeps an eye on Northland's restructured loans and the Epicon deals and the Northland's auditors have taken a very hard look at the bank's assets", "Difficulty with quality of earnings but have heard bank's plan to solve problem; will give bank time to see plans through". This might well have been taken by the underwriter as a clear signal that there was some problem at hand in the bank of sufficient gravity that the regulator either did not believe it could not be worked out or was willing to allow the launching of an attempted solution but had no full expectation of success. In short, the unclear comment might well have been read as a clear warning that if all did not go well the bank might be closed. However, the note continues, "Doesn't think that there is anything which would make it prudent not to close". This conversation occurred against the background of a recently completed annual inspection in which the bank's rating was changed from marginally satisfactory to unsatisfactory and in which apprehension about the bank's future was expressed by the inspectors. No firm conclusion had been made, however, by the OIGB as to whether the bank should be closed, supported, or put on some kind of performance probation. The notes taken by the underwriters and the testimony given by the Inspector General and the Assistant Inspector General would indicate that the regulator was anxious not to leave the impression that the underwriter should not proceed, as the result might well submerge the bank. The fear that an indecisive answer might be taken by the underwriter as an adverse opinion may have led the OIGB to say either too much or too little. On the other hand, witnesses from the OIGB took the position that they had raised flags in the interview which the underwriter should have seen and understood. According to Wood Gundy, the OIGB left the impression that it would not be imprudent to close the debenture transaction and they proceeded on the assumption that the OIGB was encouraging the transaction. The Assistant Inspector General left the meetings with a retrospective view that it might have been better to have said nothing rather than to have given a short guarded reply which lent itself to misunderstanding.

The Inspector General and the Assistant Inspector General at no time revealed that after the latest inspection of the bank the OIGB had classified this bank as "unsatisfactory". The Inspector General and his staff appearing before the Commission have throughout consistently taken the view that the OIGB relies upon the auditors in all financial matters. Indeed, once the financial statements have been certified without condition by the auditors, the Inspector General professes no interest in going behind that certificate whether or not subsequent events might be seen as putting the Inspector General on notice to inquire. Yet here the Inspector General expressed his own views and his staff expressed the OIGB's views to the underwriters without stating that they were based entirely in reliance upon that which the auditors had certified. To be consistent with the position taken before the

Commission, the OIGB would have simply referred the underwriters to the auditors for any financial information which they might require.

The underwriters examined one major loan recently booked by the bank, reviewed somewhat superficially nine of the largest loans in the bank, and had their legal counsel examine files relating to about 40 loans. In none of these examinations did the underwriters purport to bring to the review of the portfolio a banker's judgment, nor was a conscious effort made to reopen management's judgment on loan loss provisioning, loan classification, the treatment of interest, and so on. The debenture issue went to a handful of large subscribers, one of whom was a Credit Union with which the bank had had considerable dealings. A very complex series of transactions with the Credit Union at the time of the debenture issue is open to the interpretation that the bank itself thereby financed the purchase of $7.5M of its $16M debenture issue. It is not necessary to burden this report with the details of the transaction and the correspondence back and forth. In summary, the Credit Union seems to have transferred to the bank a serious loss potential in connection with a real estate development, and in return for that favour by the bank, agreed to subscribe for the bank's debentures. Much turns upon whether the transactions are fully related. The Credit Union treated as one transaction the various undertakings exchanged between the parties so that one obligation was linked to the next entitlement. The Commission considers, having examined the exchange of telexes and the loan documentation, that this is indeed the correct interpretation. In the result, the bank participated in funding its own program for the marketing of debt securities, and thereby, increased its capital which in turn allowed the bank to increase its deposit funding, all to the end of increasing the permitted size of the loan portfolio. The bank had financed part of its own growth. The proceeds of this debenture issue were ranked by the OIGB standards as part of the bank's capital. Because a bank, through the leverage ratios, can create loan assets in a permitted multiple of its capital base, the capital base is a very important element in the bank's financial structure. At a reasonable leverage ratio of 20 to 1, it can be readily appreciated that a small addition to the bank's capital opens up a considerable horizon for loan portfolio enlargement. Thus it is of considerable importance that the practice known as "cycling" be prohibited because it allows a bank to determine its own maximum level of outstanding loan assets.

The Inspector General is indeed in an invidious position when as regulator he is called upon to opine on the advisability of a capital issue. It is, of course, in the interests of the bank to take in new capital so as to permit its growth or the establishment of lower and more stable ratios between debt and equity, and assets and capital. The statute puts a burden upon the regulator to pass upon invitations by banks to the public to subscribe to its securities. The Inspector General cannot discharge that duty by complete silence. On the other hand there is no duty in the Inspector General to give any assurances to underwriters that the issuer of the securities (the bank) will survive for the lifetime of the indebtedness and be able to repay it. This is so especially where, as here, the issue is a private placement not accompanied by a prospectus. Indeed the *Bank Act* prohibits the the release of information by the regulator to third parties. It would have been the wiser course for the OIGB officers to have refrained from expressing any conclusions which could be taken to connote advice or encouragement. To supply part of the information in the possession of the OIGB, but not other information which might reasonably be taken to put a serious qualification upon the disclosed information, is a much less satisfactory position for the public regulator to assume.

In the 1984 inspection, the OIGB had rated the bank "marginally satisfactory". By the time of the 1985 inspection, the OIGB staff had started to become skeptical about the quality of Northland's loan portfolio. Accordingly, it was proposed that the Inspector General second to his inspection team two bankers from the major Canadian banks. To this proposal the management of Northland Bank strenuously objected, for the expressed reason that they felt it signalled a change in the basic approach or attitude of the OIGB to the bank. Management sensed that this might foretell a departure from the going concern "long-term value" concept, a change which management must by this time have been aware would be fatal to the bank. The bank won the argument, and the proposal to add seconded bankers to the team was dropped. By May 1985, the OIGB internal memoranda directing its inspection staff revealed at last an acute awareness in the OIGB of the problems in the bank concerning asset growth (meaning loan growth) funded in part by Bank of Canada liquidity advances, a decrease in the bank's interest spread, a considerable increase in fee income, the timeliness of the management's recognition of specific loan losses, and capitalized interest, which had reached $2.4M in the last fiscal period to the Inspector General's knowledge.

This was the first OIGB inspection report to raise a serious signal of the bank's impending death. It stated in part: "We believe the bank may require some form of assistance to survive". The inspectors also recognized for the first time the strong probability that a number of poor quality loans were maintained in stable condition simply by the bank's failure to declare them to be NPL. The OIGB also, for the first time in writing, revealed an awareness or conviction that the end of the reasonable period for testing workout loan values had arrived and that something had to be done to reduce the difference between the carried value in the financial statements and the real underlying value of the portfolio assets. The report stated in part: "... the biggest concern is whether the strategy of growth and loan workout was the right one".

Notwithstanding these stern realizations, however, the letter from the Inspector General to the Minister of State (Finance) of 5 June 1985, although reporting on the workout approach and the other concerns already mentioned, contained no warning that the bank would need outside help if it were to survive. This was the very information and advice which the responsible Minister required to perform the duty of the executive branch of government in implementing and enforcing the *Bank Act*. Fortunately, by this stage, events had developed their own momentum. This serious omission may have delayed executive action only for a few weeks.

Up until June 1985, Northland Bank had been relying upon credit extended to it by the major banks. These interbank accommodations were coming to an end. In the course of its contacts with these banks, Northland Bank came to realize that at least some of them would require a monitoring arrangement if the credit theretofore granted was to be extended. Another suggestion was that if the "Big 5" were to extend the facility, some hypothecation of assets to them would be required, and this of course would collide with the Bank of Canada's claim of prior rights as a lender of last resort. There was, of course, a practical consideration as well. The lending rates of the Bank of Canada were about one-half of one per cent lower than the rates extended to Northland Bank by the major banks. Minutes of a meeting in May between a representative of the Bank of Canada and Neapole indicate that Northland intended to resist any condition that advances from the major banks would carry with them the right to inspect. This is a continuation of Northland's attitude to outside bank inspectors having access to the loan portfolio during the annual OIGB inspection. Neapole was very much aware that extensive borrowing from the Bank of Canada would deter other depositors, because every time the Bank of Canada made a liquidity advance it took some more security. Further harm would be done as the state of the account with the Bank of Canada was published in the *Canada Gazette*. While it is difficult to be certain as to why, in the face of these conflicting considerations, Northland switched from the Big 5 to the Bank of Canada for its exclusive liquidity support, it is reasonable to conclude that Northland Bank had a justifiable fear of big bank scrutiny of its loan assets in their then state. In fact, later inspections of Northland's loan portfolio by representatives of the major banks led all the examiners to form the opinion that extensive write-offs were required and in many cases long overdue.

In July, changes in the attitude of the OIGB began to become more evident. In early July, Adamsons, an OIGB employee formerly with the Canadian Imperial Bank of Commerce, was sent to examine more intensively the quality of the loan portfolio. Meetings took place between the Inspector General and the bank auditors, and the Inspector General and Bank of Canada officials, and in early July a memorandum in the OIGB recorded: "The view about workout time must change and write-downs occur". The bank was persuaded to limit loan growth and not to use Bank of Canada advances for that purpose. Unfortunately, to the dread of any banker, newspaper articles began to appear in mid-July in which the shaky condition of Northland Bank was discussed. A new run on the deposits of the bank began, this time including some retail deposits. A public vote of confidence by the Inspector General was to no avail.

This liquidity crisis precipitated a meeting on 20 July of Neapole and Fortier, the Governor and officers from the Bank of Canada, the Inspector General and one or two of his officers, and members of the staff of the Department of Finance. Neapole advanced a plan for the major reconstruction of the bank as a solution "to the confidence problem it was experiencing". Two other banks, including CCB, had recently taken write-downs on their portfolios and, Neapole believed, the market wanted to see Northland do the same. This proposal involved the sale or public issue of common stock, an issue of preferred stock to be guaranteed by Alberta, and a sale to the federal government of a substantial part of the loan portfolio said to consist of inferior loans. Altogether this amounted to an infusion of some $300M into the bank. Management maintained that its proposal was not an acknowledgement of deterioration of the loan portfolio, and did not presage an insolvency crisis. According to the minutes, the Bank of Canada still believed that Northland's condition was one of liquidity resulting from a perception problem and, although serious losses of income had been encountered and the bank needed help, that it was not in the same condition as CCB.

In the meantime, the OIGB appeared to be showing signs of extreme wariness about Northland. This may have been induced in part by the state of shock in the OIGB which the collapse of CCB had earlier produced. Indeed, the Inspector General indicated that 20 July was a meeting of crucial importance and that Neapole's confessions at that meeting paralleled McLaughlan's exposé of the CCB's serious internal condition on 14 March. In the Inspector General's words, "... there is an urgent problem here that has to be dealt with and it is a problem that goes beyond just a pure liquidity problem". Burdened by the recurring difficulties encountered in the CCB bailout design, implementation and execution, and faced with the strong intimations coming from

Northland of parallel difficulties, the Inspector General began to swing around to a recognition that the Northland Bank was on its last legs.

By 1 August, when a further meeting was held in Ottawa, liquidity advances from the Bank of Canada stood at $380M. More significantly, Adamsons had reported to the OIGB, by way of a brief summary, his preliminary findings that write-offs, write-downs, and reversals of interest on accounts totalling some $13M had to be undertaken in respect of the $525M of Northland Bank loans which he had examined out of a total portfolio of about $1.2B. He also criticized the lending practices existing in the bank. Management presented another proposal at this meeting for the restructuring of the bank which involved the sale of assets to a new company to be owned by Messrs. Dixon and Derrickson (who shall be introduced shortly), which sale would be financed initially by the bank and subsequently syndicated to a federal government agency, sale of other loans recognized to be soft to Epicon, and the use of strip bonds as a long-term insurance for the repayment to the bank of the principal sum of the loan to Epicon thereby avoiding, in management's view, any write-downs. As will be seen, this became a feature of the proposals of bank management in the dying days of Northland Bank. The only result which came from the meeting of 1 August was an agreement by the Bank of Canada to postpone until 24 August the publication of liquidity advances in the Canada Gazette because Fortier, speaking for management, indicated to the meeting that such disclosure at this time would "kill off" the bank. The Adamsons preliminary report together with other comments at this meeting awakened in the Bank of Canada a recognition that more than liquidity aches and pains were present in Northland. The Governor's notes refer to a remark made by the Inspector General: "... the bank had played games by taking fees into income rather than amortizing them over the life of a loan and had thus overstated current profits at the expense of the future". The Inspector General, while indicating privately to the Governor that he had lost confidence in Northland's management, asked the bank to seek out a possible merger candidate and proposed the National Bank. Neapole's response was that the problem had become political. The bailout program for CCB had been ill-advised, poorly designed, and badly executed. In his words it had produced an "Edsel". In Neapole's view, this had produced in the public mind the perception that Northland Bank and CCB were in similar condition, and this had hurt the Northland Bank.

It certainly appears from the internal records in the OIGB that by this time, having regard to the seriously declining condition of CCB, the regulators had come to see these two banks as in the same class and category. The Minister of State (Finance), who was present at this meeting, acknowledged that any adverse events in CCB at this time, particularly its failure, would have an impact on Northland, but stoutly denied that any decision had been made by the Government that if one bank went the other must fail as well so that the political heat could be taken at the one time for one event.

The OIGB's continued examination of the internal records of the bank produced the final cold recognition by at least one of the inspectors that when the bank adopted "a workout situation" for a loan, the auditors acquiesced in the use of future values in assessing its worth and that of the underlying security, with all the fateful results that entailed as regards postponement of provisioning and continuation of the recognition of accrued interest. This inspector further noted that the auditors used current values of loans and loan security only when a liquidation approach was adopted by the bank. All of this was a much delayed recognition by the inspection staff despite the numerous signals in the reports, minutes, records, and conversations with management and auditors regarding these practices over the preceding two years. At about the same time, the auditors responded to the Inspector General's concerns: "We not only understand your concern, we also share your concern. Given the facts the concern is fully founded". This apparent evidence of a final awakening by the auditors was, however, explained in testimony as only meaning that the auditors were concerned if the Inspector General was concerned, but that the words did not mean what they otherwise plainly indicated. Management and the bank's external auditors maintained a solid front on these practices to the very end of the bank and in the face of all evidence to the contrary.

As a final last desperate fling at solution by way of a private bailout in contrast to the mixture of public and private bailout in CCB, Northland's management produced a proposal which is referred to in the testimony at some length as the Rondix deal. On 16 August 1985, it was presented to the OIGB inspection staff. It is not without significance that Willson, attending as Chairman of the Board at that general meeting, declined to join in the subsequent special meeting of the technical staffs to examine the Rondix proposal on the grounds that he was not "a banker".

The two principals of Rondix were Ronald Derrickson and Gordon Dixon. Chief Derrickson was a director of Northland until 22 August 1985, the date of the Board meeting at which Northland's directors authorized the Rondix transaction. Derrickson's resignation was tendered immediately before the authorizing resolution. Derrickson was also the principal of corporations which already had loans from Northland Bank. Dixon, a Calgary lawyer, had a number of dealings with Northland Bank, including a recently restructured loan known in the hearings as CA12. His law partner, Ritchey Love, was a Northland Bank director. Love absented himself from the deliberations of the Board with respect to Rondix.

The transaction is complex and detailed but the fundamental structure may be summarized as follows. Northland Bank was to sell $100M of interests in poorly performing assets at book value to Rondix. The $100M was comprised of about $16M in property owned by Northland Bank as a result of foreclosures, about $25M in loan assets to be sold outright, and approximately $57M in junior fully subordinated beneficial interests in a number of other Northland Bank loans. The loan transactions involved about 75 loan accounts with a total face value of approximately $205M, the bank retaining an interest in some of the loans. Rondix would manage all the loans involved. In addition, Rondix would purchase for $25M stripped Government of Canada bonds maturing in 15 years, with a maturity value totalling $125M. The purchases by Rondix were to be financed by an interest-free 15-year loan by Northland Bank to Rondix in the amount of $125M. In addition, the bank would grant a further interest-free $6.25M loan to Rondix, $5M of which was to be used as operating capital by Rondix, and $1.25M to purchase a second group of stripped Government of Canada bonds maturing in 15 years with a face value of $6.25M. The total credit facility provided by Northland Bank to Rondix was thus a $131.25M interest-free loan, maturing in 15 years. Actual cash laid out by the bank was $31.25M, the cost of purchasing all the bonds and the provision of operating capital. As security for the loan, Northland took back a pledge on all the assets and a pledge of the stripped bonds.

The purpose of the strip bond feature is of some importance. As the face value of the bonds equalled the loans made by the bank to Rondix, the repayment of those loans, 15 years hence, was assured. According to both Guenette and Adamsons, the purpose of the Rondix loan was to allow Northland to amortize losses over a 15-year period. Rondix also agreed to pledge "additional security" of certain property alleged to be valued at $7.2M. Most of that property, according to Touche Ross, was already financed and secured to Northland. Indeed some of that property was in the process of reappraisal which was expected to increase its value and result in some equity over and above Northland financing. There is no evidence of circumstances tending to increase the value of that property, which had been restructured only a year or so earlier. Derrickson and Dixon were to manage the assets in return for a fee of $1M per year. Northland and Rondix would share equally in any recovery on the assets. If there were a complete recovery on each asset, Rondix's principals would receive $50M.

The transaction (and another one of a somewhat similar nature) was explained to Macpherson and Adamsons of the OIGB during the meeting of 16 August 1985. They did not offer any opinion, either positive or negative, on the transaction at that time. The Rondix deal was presented to the Board of Directors and approved on 22 August 1985. Neither management nor the directors insisted on an opinion of the bank's auditors as to the accounting treatment the bank could employ with respect to the loan to Rondix, although the ability to carry the entire $131.25M loan at its face value on the Northland Bank books was crucial to the success of the transaction. In fact, so far as Northland Bank was concerned, this was the *raison d'être* for the transaction. Northland Bank was seeking to stretch to an absurd degree the rule that the carrying value of the loan need not take into account the time value of money. In the circumstances, it strains credulity and must be seen as a measure of the desperation of Northland's management and the ineffectiveness of its directors that no audit opinion was obtained or required in advance of approval.

Morrison, then the curator, and Adamsons did not accept the proposition that the Rondix deal was an appropriate transaction. Adamsons concluded that "the rollover of the loan assets and properties to a new corporate entity does not materially improve the Northland Bank's position. ..." He also pointed out that Rondix had provided no down payment. Morrison, the liquidator, readily agreed that Rondix was in effect "a layer of paint" intended to transform bad assets of Northland into a good loan to Rondix. In his view, the intervention of Rondix was of little or no value to Northland, which could have purchased the strip bonds by way of insurance against ultimate losses as readily itself as indirectly through Rondix. The later review by the National Bank reflected a similar assessment.

An opinion on the Rondix transaction was obtained by the CDIC from Price Waterhouse in January 1986. Price Waterhouse's opinion was to the effect that the transaction would not allow Northland Bank to amortize its losses over the 15-year period. Under the accounting treatment proposed by Northland, according to Price Waterhouse, the sale proceeds of the transaction and the amount of the loan recorded in Northland's books would be improperly overstated if carried at face value. In the result, even assuming a best case scenario, Northland Bank would have to recognize a loss of slightly over $50M, and if the assets were only 50 per cent collectable, the loss to be recognized would be $75M.

The risk undertaken by management is astounding. The assets to be transferred to Rondix were classified as loan substitutes, Epicon assets, nonproductive, and loans with a high probability of going nonproductive. These were not healthy assets. Neapole said, in effect, that no one knew how successful Rondix would be; the top side was the \$50M fee, the bottom was zero, and the actual degree of success was a function of "success and market conditions, the efforts and so on applied over the long pull". The danger of receiving an unfavourable accounting opinion is graphically illustrated by the following exchange about the Price Waterhouse opinion between Mr. Scott, counsel for the CDIC, and Mr. Neapole:

> Q.: And if it worked out in the worst case, not even in the worst case, if it only worked 25 per cent, you would not have any capital reserves, you would be in the hole 18 million?
>
> A: (Neapole) I have seen the opinion and I understand the arithmetic.
>
> Q.: The point is that if you had got that opinion from your accountants from the time of your 1985 financials, your bank was finished.
>
> A: (Neapole) Assuming that the regulators and accountants were all in accord that that was the appropriate accounting treatment, I guess you could argue that, yes.
>
> Q: Not you could argue, that was going to be the case?
>
> A: (Neapole) Clearly. ... There is no mystery.

There is no doubt that the Rondix transaction did nothing for OIGB confidence in management. The speed at which the proposal was put in place, the size of the deal, the lack of an accounting opinion, the failure to inform the Bank of Canada about the sale of already hypothecated assets, the short period to closing, and the proposed effect of the transaction on Northland Bank's financial statements all showed the desperation of Northland management. In short, the proposal forced the hand of the regulators. Neapole, in testimony, acknowledged that the "indulgence" of the regulators would be required. It is difficult to envision how Northland Bank could hope to carry a no-interest loan of \$131.25M for 15 years. It may be that at this stage Northland management had little to lose as the closure handwriting was on the wall.

5. Appointment of the Curator

In the eyes of the Inspector General, the Rondix proposal represented an accurate measure of the desperation experienced by management in keeping the bank going at this time. He concluded that there were but two alternatives. Northland could be merged with another bank (which would really take the form of a liquidation since it was of doubtful attraction to a major Canadian bank), or it could be liquidated directly.

The Inspector General had already indicated to management that National was the only possible merger candidate. National's management, on being approached, examined the Northland Bank portfolio through a four-man team and concluded that a write-off of about $300M or about 25 per cent of the value of the portfolio would be required. In fact, the National inspection staff were of the view, after two days' inspection, that only about $500M of the $1.2B loans in the portfolio were in normal bank condition. The National Bank stated that they were not interested in a merger. While management attacked the National Bank's approach to the valuation task with vigour, the fact remains that its inspectors were highly qualified bankers, and indeed, the National Bank had successfully merged in the past with other banks. Its conclusions about Northland's loan values, and the general condition of the bank, are far from irrelevant. They join a stream of similar valuations, analyses and conclusions by a large group of qualified persons.

The Inspector General reported to the Minister of State (Finance) that a merger was not available, and went on to report that if Northland Bank were liquidated there would probably be a substantial negative net worth amounting on a fast liquidation basis to some $300M, which was in line with both the National Bank appraisal and Adamsons' final report. The Adamsons report concluded that the bank's "present situation is untenable ... the bank's management, both past and present, has laid the groundwork for its present difficulties. ..." The Inspector General recommended to the Minister that curators be placed in both Northland Bank and CCB. Last ditch attempts to find another solution were made on 28 August at a meeting in Ottawa of Willson and Fortier from the Northland Bank, the Minister of State (Finance), the Inspector General, and their advisors.

On 29 August the Deputy Minister of Finance reported to both Ministers that he estimated the losses on liquidation of Northland Bank would be $300M (the same as and probably drawn from the OIGB report), and that a support package would cost over $250M. In passing, it was observed in this that the CCB bailout experience did not encourage another attempt here. This report, the Minister of State (Finance) concluded, was the last salvo which sank the Northland Bank.

Up to this time the OIGB had not disclosed to the management of the bank its intention to appoint a curator or that the bank was one way or another going to cease operations. This silence by the regulator was explained by Kennett:

> For fear we might open up the possibility of abuse, insider information and insider abuse. We wanted the situation to remain in some kind of normalcy until we were prepared to act.

The decision was communicated to management on 31 August 1985. The curator was appointed on 1 September 1985, although at that time it was agreed by the Government to accord to the bank a limited period of time in which to restructure itself with another financial institution.

The difficulties which surrounded the terms employed in the *Bank Act* concerning the actual termination of the operations of the bank have already been mentioned in connection with CCB in Chapter 4. It may be, of course, that the Governor of the Bank of Canada was in error when he stated that the Inspector General "really could not use the *Bank Act* definition of insolvency in his letter to me as long as I was funding the bank". A much sounder solution to the problem is a revision of the *Bank Act* rather than a finely balanced argument as to what the present provision of the *Bank Act* means. This is discussed in Chapter 6.

Immediately upon the curator's appointment, he commenced to review the bank's loan portfolio, and for this purpose, he engaged the assistance of Royal Bank credit personnel. By 27 September, he was able to report to the Inspector General and the Minister of State (Finance) that the portfolio did not reflect adequate provisions for losses, and accordingly, "it appears to us that the amount required to give recognition to such loan losses would exceed the amount of Northland's capital base ... [and] ... such accounts would show that the liabilities of Northland exceed its assets. ..." By almost any test, and certainly including the test at common law, the bank was insolvent on 1 September 1985 in the view of the curator and those reporting to him. Accordingly, he recommended an orderly liquidation. In the meantime, the special adviser appointed by the Minister to assist in the search for some financial institution which might bring about a reorganization of the bank's affairs was unable to find any solution which he could recommend to the Minister.

To all these processes, management of the bank took violent objection. In their view the bank was not insolvent and its troubles were due to events at CCB, particularly the events surrounding the design and performance of the bailout in which Northland Bank had not been invited to participate. Management had, in their view, provided the Government with a workable solution in the form of the Rondix deal, or in the alternative, some other form of bailout analogous to that in CCB.

It is clear that by this time the CCB pattern of bailout, even if it were appropriate to Northland Bank, could not have been engineered because the private sector involvement would have been impossible to organize. No doubt there was also a new wariness on the part of the political element in the process of anything approaching Government participation in a bailout by reason of the experience in CCB. The overriding consideration, however, appears to have been the appreciation of the fact that the bank was insolvent and no help would likely be forthcoming from the other banks.

The decline of Northland Bank into its curatorship status and eventual liquidation climaxed on 1 September. Its existence immediately prior to that had been precarious and was based entirely on the regulator's (and indeed the bank's auditors') willingness to allow the bank to unilaterally salvage a loan from NPL classification by the adoption of a workout strategy in any of a variety of forms, again unilaterally selected by the bank. As the Inspector General and his staff hardened in their view of these workouts, and as time went by without production of tangible results, these survival tactics, theretofore considered to hold promise of success, fell into disrepute. There can be no reasonable doubt that when all the reports and studies then at hand were reviewed, this bank was insolvent by any of the conventional definitions. The report of 27 September was a final confirmation of this fact.

Whether these survival tactics were thrust on management of necessity by circumstances existing prior to the introduction of this new management is not relevant to the final determination as to whether the bank was properly put in the custody of the curator on 1 September 1985. Neither, however, does it necessarily follow that it was bad management in the bank in 1984-1985 which precipitated its ultimate liquidation. Again, the timing of the curatorship depended upon the time of realization by the Inspector General that the bank was insolvent. Certainly one thing is clear, and that is, the closer the Inspector General got to an eyeball examination of the loan portfolio, the closer the bank came, in his view, to liquidation. Other sources of information available prior to that time had, for some reason, not impelled the Inspector General to the conclusion of insolvency. The Adamsons report and the National Bank inspection seem to have produced a belief in the OIGB that an actual examination of the bank's loans by banking credit officers had revealed a much more serious condition than had been made clear through management, the external auditors, and indeed through its own inspections.

B. EVALUATION OF THE SUPERVISORY PROCESS

1. Management

Several questions remain to be discussed in relation to Northland management. What were the faults, if any, of management in creating the conditions which led to the failure of the bank? To what extent did management contribute to the lack of reaction by the auditors and the regulator to the true state of Northland's financial condition? The record reveals, as we have seen, that in the pre-Neapole management stage imprudent if not improper lending practices and weak constantly changing management created a loan portfolio the ultimate decay of which led to the fall of the bank. The Neapole era, on the record gathered by this Inquiry, saw a continuation of that type of management which added to the difficulties in the loan portfolio. More characteristic of that era, however, was the design and execution of unconventional banking policies and practices and related accounting treatment which disguised, masked or suppressed a correct and full view of the financial situation in the bank, all to the end of buying time to allow the introduction of remedial measures which might save the bank. This was the epoch of survival techniques openly devised and installed, in the main, for the avowed purpose of restoring market confidence and buying time. Time was needed, for example, to shift from volatile wholesale money market deposits to retail deposits, and to dilute the proportion of NPLs in the loan portfolio by the granting of new loans.

There is no doubt that the design and the business plan early adopted by the bank, as it set out on the road as a conventional bank, was inherently risky, was proven to be improvident, and led to a failure which, if not already inevitable, was made so by this plan. There is serious doubt as to whether a market niche, as seen by the bank's planners, ever existed. If collapse were not inevitable by design, it was made so by management's choice of business strategy which made the bank vulnerable to the inevitable cycles of the businesses and region with which and in which it operated. The constant changes in the senior positions delayed fatally the formation and consolidation of an experienced, professional, and cohesive team. In a small bank this must surely be, from all that has been seen in this Inquiry, a condition precedent to survival. In the opening years of this small bank, this management produced a principal asset, its loan portfolio, of very doubtful quality. The onset of the recession in Alberta caught the bank without any proper, balanced, and experienced professional banking management in place. The evidence indicates that very early in the Alberta recession, and clearly by early fiscal 1983, the bank was insolvent in the sense that its liabilities exceeded the true worth of its assets in the market then existing in its region of operations. This is what the Prisco team probably, and the Neapole team certainly, inherited. Either the defective loan assets or the serious and lengthy recession might have brought the bank down. Their combination produced an atmosphere of inevitability, at least in retrospect.

Recognizing these realities, Neapole, Fortier *et al.* consciously adopted a management style and a banking policy which, while it held some promise of buying time to bring the bank around, had the effect of increasing the banking problems and the unsatisfactory condition of the outstanding loans. The most that can be said for this decision was that the bank had nothing to lose from adopting a wide-scale practice of workouts, rapid loan growth and all that flowed therefrom, since the alternative was simply to allow the bank to succumb to insolvency. To this, one exception should be made. The prospect of a worthwhile merger was much greater in 1982-83 than by 1985. This lost opportunity may have been the price of the gamble taken by the survival or delaying tactics. The evidence indicates that conventional banking and accounting techniques applied from early 1983 onward would certainly have laid bare a situation that would have frightened off depositors and investors, and brought about a run on the bank's deposits with the inevitable consequence of bank failure. The criticism that inevitably falls out of an examination of the documents and testimonial evidence is that the bank crossed the line of propriety frequently, consistently, and eventually, permanently in its operational decisions, in its workout strategy, and in all the decisions along that path. Once these decisions were in place, management set out on a program to persuade the two potential objectors in its path, the auditors and the Inspector General, to go along with these strategies on the basis that the workouts would create value where value no longer existed in the loan portfolio, and would thus protect the income statement and balance sheet. In short, management was saying, these practices are acceptable and no one is being hurt by them. Therefore the auditors and the regulators should approve, or at least not interfere. They did both. None of this could have been detected by a reader of the financial statements from fiscal year 1982 onwards. Eventually, these financial statements verged into fiction and the price of survival from that point on was paid not by management but by those who dealt with the bank, and ultimately, the public.

The various practices adopted by Northland management from 1983 onwards were, in the main, predicated on a fortress mentality that if outsiders could be held at bay by one accounting treatment or another, which would shore up the balance sheet, and income statement, good times would return, values would flow back into the bank's balance sheet, and the bank would survive. The process reduced itself to a test of nerves to see how far these experiments could be carried by management without the necessity of revealing the true financial condition of the bank as measured by both its earnings and its assets. The extent and the success of management in holding the auditors and the Inspector General in line is topped by the fact that the Chairman of the Board, Willson himself, apparently did not fully appreciate the magnitude of the reach, and the consequences of management's decision to undertake novel, though energetic and imaginative programs of loan reconstruction. It never seemed to dawn upon the Chairman, or indeed several other Board members, that the valuation assumption underlying all these managerial decisions led to an inflated set of values which inevitably destroyed the accuracy of the financial statements. Indeed, the continued rollover of middle management through the Neapole era to the dying days of the bank may have been due in part to the difficulty of securing and retaining the services of experienced bank middle managers once they realized the consequences of the implementation and continuation of the workout and related strategies to the disregard of conventional banking approaches. They were perilous practices, adopted of necessity, and their success could at best be a deferral of a collapse predestined by all the mistakes that went before.

More will be said shortly about the position in all this of the external auditors, the directors, and the Inspector General. At the moment, it is sufficient to observe that while there may have been varying degrees of awareness of the tactics and all their infinite shadings, designed and introduced by management, there was no clear appreciation of the results these tactics would produce. Certainly this was so until early 1985.

Throughout this period, the different sectors of the public associated with the bank did not seem to appreciate what was happening in the bank. Neapole, at the end, was able to state that:

> I think our 1984 report was the first time that we made a concerted effort to tell the outside world what we thought we were and what we were trying to be and evolved into. I think we described ourselves at that point as a hybrid kind of a combination traditional bank and private bank, merchant bank. We thought there was a role for that kind of an [sic] institution, and we were doing our best to fill it.

It should be observed in passing, however, that the 1984 financial statements did not reveal, by themselves, the essential fact that in the Epicon grand scale workout, the dispositions of which the bank spoke so proudly, were in turn financed entirely by the bank. The bad loans never left the bank. They just changed their names. In short, management was digging the hole deeper. It is remarkable that even the Chairman of the

Board did not see this fatal characteristic of such activities of Epicon, nor apparently did the Inspector General.

2. The Internal Inspection System

The internal inspector in the Northland Bank acted as a radiator of information up through senior management and, for a time, out to the external auditors, the directors, and the Audit Committee. The internal inspector's task of classifying loans and reviewing loan provisioning did not last long in the Neapole era. The internal inspector was directed to confine himself to matters of which the senior management was unaware (mostly loan administration and accounting) and not to deal with the loan portfolio where, in a small bank, management needed no assistance as they were already well aware of its details. In short, it was made known to the Chief Inspector that loan loss provisioning was the exclusive preserve of management and not for him.

Stan Willy, the Chief Inspector from February to August 1983, was directed not to include assessments of the loan portfolio in his reports. There is also some evidence that similar pressure was placed on Willy's predecessor after Prisco's departure. Iain McLeod, who was internal inspector after Willy, was asked not to continue the practice of circulating summaries of the classification of the loan portfolio which he had theretofore distributed to senior management, the auditors, and the Audit Committee. McLeod concluded that this directive was issued because his reports were causing troubles for senior management in discussing loan loss provisioning and income recognition with the Audit Committee of the Board or with the external auditors, or both. From that time forward, the Audit Committee did not discuss the internal inspector's findings with him, and the auditors considered the inspection function inside the bank was too limited to be of any assistance in conducting the annual audit. Notably, while the Audit Committee was aware of the change in McLeod's format, its members viewed the reports as primarily useful to management and the auditors. It took no steps to determine why the format had changed.

It is a tribute to the dedication of the last Chief Inspector, McLeod, that faced with these limitations from senior management, he continued to analyze, classify, and report to that management. In the course of this work he classified a total of 40 per cent of the loans at the branch level as unsatisfactory or worse. He did not, however, send these reports to the destinations described earlier, nor did he deliver them to the Inspector General, but he did discuss the essential features of his work with the OIGB staff during their inspection of the bank. There is nothing, of course, in the *Bank Act* entitling the internal inspector to take it upon himself to make confessions on behalf of the bank to the Inspector General concerning the state of the loan portfolio. Also, one must bear in mind that the Chairman of the Audit Committee and the external auditors had access at all times to all of McLeod's work and files. Either the Chairman of the Audit Committee or the external auditors could have uncovered all of this information and, in the case of the Audit Committee at least, could have confronted management.

This much can be said for the position taken by management on this question: the needs of a small bank are not those of a large bank. Neapole had worked in both. The layers of management are few and the distance between the top level of the bank and those conducting its operations in the front line is short. The senior executives are necessarily much more aware in a small bank of individual loans than in a major bank. Thus, the need of management for some of this information is different in a small bank. However, this overlooks the essential need for and purpose of the internal inspection service, which Mr. R. Frazee, as Chairman of the Royal Bank of Canada, said allowed him to sleep at nights. A new small bank is much more vulnerable to one bad loan than is a large bank. A small group of bad loans can sink a new small bank. The inspection system is a constant process and a check visible to the bank staff and especially nonmanagement members of the Board who have no other independent sources of information on lending and loan management practices. Without this, the build-up of pressure from unproductive loan assets may reach lethal proportions before bank management and Board members, or at least the members of the Audit Committee, become aware of the problem, and make repairs. In Northland, however, the troubles were so pervasive, deep, and life-threatening to the bank by the time Neapole took office that the contribution of the inspection system, and its defects, were much diminished in scale as compared to the other problems of the bank.

3. The Board of Directors

A total of 42 persons were members of the Board in the bank's ten year history, and only five of these directors were present for the duration. The evidence received in the Inquiry and the documents' analysis throw up two salient features of the Board's operations. It relied very heavily, and throughout the life of the bank, on the expertise of the people in charge of the operations of the bank. The directors also relied on the auditors to check on actions taken by management. Certainly, whenever the auditors supported management, the directors were at once satisfied. There seems in all this to have been little left for the Board itself to do as an element in the government of the corporation.

R.A. Willson, the long-time Chairman, appears to have had a profound influence upon the Board's deliberations. This was perhaps natural. He prepared the study which led to the formation of the bank, was its first Chairman and was the CEO for more than half the life of the bank. He alone was in executive and board positions throughout the history of the bank. On the other hand, the Board seemed entirely impervious to warnings expressed, some very loudly, by Messrs. Prisco, Stephenson, Siebens, Willy, McLeod and Tourigny, the financial adviser whose report was presented to the Board by Siebens. None of these warnings seemed to have been translated by the Board into any action with reference to the quality of management which is, of course, the ultimate and prime responsibility of a board of directors.

It would be remiss to omit consideration of the positive signals the Board received. In 1979, most of the concerns expressed by the Inspector General were systems-related, expressed in the context of start-up problems in a new bank. However, by 1982 a number of concerns were being raised by the OIGB. For example, on 22 October 1982, OIGB officers Grant and d'Entremont met with Willson and Green. The officers made the following points among others:

1. disappointed that the Board had not been kept fully aware of the deteriorating loan situation, although apparently, steps were being taken to solve this problem.
2. concerned about the extent of accrued interest, capitalized interest, and whether or not collateral values were up to date and realistic.

Some idea of the signals which the OIGB would have conveyed to the directors (via the Chairman) can be gained from the testimony of Kennett regarding the early days of the bank:

> ... In the early days of this bank, there were a number of problems. ... There were problems with the accounting; there were problems to some degree in relation to changing management. I recall in the early days being concerned because the bank did not seem to be developing in the way that was suggested by the entrepreneurs who had established the bank when they were before Parliament to receive their Charters.
>
> So, there were a number of issues that were raised from time to time.
>
> On the other hand, I think it is fair to say that my recollection of those early days is that we were not unduly concerned about the lending practices of the bank....
>
> Our impression was that those lending practices were reasonably conservative ... so that we felt, in the circumstances, that they were being reasonably careful.

As to management the Inspector General observed:

> ... Mr. Willson himself did not have a banking background. He generally had people working for him who did. The first President, Hugh Wilson, was a

banker with considerable experience. Mr. Eric Young was also a banker with considerable experience. Walter Prisco had a good reputation as a banker.

While we felt that the group was not particularly dynamic, it did have an adequate banking background to run the bank in a reasonable way, and our feeling, as I said before in the very early years was that it was running itself in a fairly conservative fashion.

The directors also received signals from the auditors which provided a measure of reassurance. Although the auditors continually expressed their concern with the bank's lack of control, they advised the Audit Committee at the November 1979 meeting that they were satisfied that the bank generally took a prudent approach on all loans. There is a similar reference in the Audit Committee minutes for 1 December 1982, where it is reported that the auditors had done extensive work on the portfolio and were satisfied that loan loss provisions were adequate. And, of course, the bank received an unqualified opinion on its financial statements every year.

In the Neapole years, the Board was well aware in general terms of management's workout strategy. Willson noted that Neapole had explained his strategy to the entire Board. Johnstone described the Epicon concept, expressed by Neapole to be the most important part of the bank's workout strategy, as a prudent plan. Indeed, at the Board meeting held on 26 May 1983, when the Epicon proposal was put to the Board, management advised that the real estate subsidiary was one part of a total strategy and would provide the necessary expertise to deal with problem loans. The Board was told that management's initial concern was with how best to strengthen the bank by adding value to the existing portfolio in the shortest possible time.

The Board received rosy reports from management regarding workout loans. At the 2 November 1983 meeting, management discussed a $19M loan, and reported that the bank could proceed to syndication of the loan, which was expected by February 1984, with restoration of Northland's position by April or May 1984. This never occurred. The loan referred to in the hearings as CA12 was discussed. It was another "bad" loan, but "management was engaged in a very concrete process of restructuring financing" which it hoped to have completed and documented by January 1984. In another loan, in the Cayman Islands, the Board was told that management was "optimistic" that the loan might be paid out as early as the spring of 1984. This also never occurred. When all this discussion was completed Mr. D. Skagen, a director, moved the Board to recognize the "magnificent job" done by management on the various projects underway. And, at the 23 May 1984 Board meeting, the Board received a short report regarding the annual inspection of the Inspector General:

The Chairman reported briefly on the annual inspection by the Inspector General, who had expressed satisfaction with the significantly stronger position of the bank, particularly in lending operations. He concurred with the bank's recognition of liquidity as the current top priority.

The Board was continually advised by management of its success in the workout strategy. For example, at the Board meeting of 21 August 1984 it was reported:

... Loan production had exceeded forecast by approximately $150 million. Nonproductive assets projected at $75.2 million at October, 1984 were currently at $71 million, with the decline being a direct result of SMART activity. Reduction had occurred in all regions ... In reply to Mr. Gordon's question, Mr. Fortier stated that he would be comfortable with 30% of the portfolio in real estate related loans. Mr. Neapole added that the real key was quality loans, without focussing unduly on any one sector.

It would be evident to the Board if no further disclosure were made that management's strategies were successful. All this is indicative or explanatory of the Board's extreme reliance on management.

It has been mentioned elsewhere that the OIGB took comfort from the more extensive audit carried out at the end of 1984 fiscal year. The same may be said of the directors. The following appears in the minutes for 4 December 1984:

At the invitation of the Chairman, Mr. Detlefsen explained the reasons for the delay in finalizing the fiscal 1984 financial statements. He observed that the review process had been very intensive, that the auditors were satisfied with the quality of earnings, and that the outstanding issues had been adequately responded to by management. The management presentations made had left the auditors collectively with a great deal of confidence in what they saw to be a decidedly effective team. Mr. Scarth thanked Mr. Detlefsen for his comments and also for his long years of association with the bank.

At the Board meeting of 27 February 1985, the Dexleigh-Hees transaction was authorized and approved. There was also an up-date on the Cayman loan, and one director observed that this had been more than a loan workout: "It symbolized the turn-around that management had achieved for the bank", and, on behalf of the Board, this director thanked management for it.

The directors were also led to believe that the credit-granting process was rigorous. A presentation was made to the Board at a meeting held on 23 May 1984 by Guenette, who stated:

An examination of the bank's total lending activities from May 1, 1982 through to and including April 30, 1984 has been conducted and has demonstrated ... that the credit approval process works eminently well. During the past 24 months, total loan authorizations including renewals of matured credits numbered 720 accounts for an aggregate principal balance of

> $643,930,000, thereby generating total fees of $4,710,200. A concurrent investigation was carried out so as to ascertain the present status of the above-noted credit volumes. Of the total of 720 accounts authorized over the past 24 months, a total of four accounts aggregating current outstanding balances at $3,979,000 have turned out to be, in some form or manner, problem accounts. ... It is interesting to note that all of the loans remain productive and no loss is anticipated on any of the four accounts. These four accounts represent all loans authorized during the period which have presented problems or are presently 30 days or more in arrears.

Willson made similar comments to the directors by way of a memorandum dated 14 May 1984. He attributed the bank's problems to the 1980-81 era, when all other lenders made similarly imprudent loans in Western Canada and were suffering similar portfolio problems. He maintained this position throughout his testimony before the Inquiry. It is obvious that if this was an accurate picture of the bank at that time, either there was little or no interest spread in these loans or the balance of the bank's loans were in far worse condition than the financial statements indicated.

The boarding procedure for loans also demonstrates the Board's exposure to the lending practices of the bank. The full Board approved only employee loans. Directors were provided with condensed reports of all loans over $3M for review. The Executive Committee reviewed all loans in excess of $7.5M, and approved loans over $10M and director-related loans. Less evidence was presented to the Commission about the operational structure of Northland. Management had little interest in the structure and perhaps it was less rigourously adhered to than in CCB. It is clear, however, that the directors were aware, in a broad fashion, of the workout strategies employed in the bank through the numerous reports of operations (which often focused on the success of the workout strategy) and the discussions of large workout situations. The Board also received an operations report at each meeting, which was a statistical analysis of the bank's operations. The content, as it appears from the Board minutes, changed from time to time.

What is absent from this review of the evidence is any serious consideration of the aforementioned loud protests. There seemed to be no desire to hear the bad news while good news was warmly received. Perhaps characteristic of the directors' reliance on management was Willson's move in May 1984 to change to a more summary reporting format of loans for Executive Committee review, and his expressed view that the directors should not interfere in lending decisions. There is little indication in the record that the Board ever disagreed with management after Prisco's departure. Numerous significant transactions were paraded past the Board or its Committees and were approved, including the Cayman workout and the income inclusion of interest on that loan over the auditors' protests, the restructured loan described above as CA12, and the Epicon, Dexleigh and Hees, and Rondix transactions. There is evidence, to be discussed shortly, that the directors failed to descend from the mountain of generality to the valley of the specific in relation to the important transactions in the bank.

The constant explanation threading its way through all the testimony relating to this bank, especially the evidence of Neapole, is that because of its lending policies and the management of its assets Northland had become an unusual or unique bank. It employed strategies which were well known to its own Board of Directors though perhaps not fully comprehended by the auditors and by the Inspector General. The record does indeed reveal that members of the Board made themselves familiar with Epicon and other concepts. One Board member, Johnstone, is an accountant and was Chairman of the Audit Committee. There was no question but that she was present at Board meetings where Neapole and others explained the workout strategies. Willson, as Chairman, of course was present throughout. Nonetheless it is clear that Willson, for one, was not aware of the reversal of the interest reversal, already discussed. Even if doubt is resolved in his favour and he was aware of the fact, his testimony reveals that he did not understand these transactions. The same applies with reference to all the directors who testified, including Willson, Skagen, and Johnstone, as regards the bank financing of all the "sales" made by Epicon. It is abundantly clear that the Board, or certainly its majority, did not have a grip on the survival tactics of the bank in its last three years, or their consequences. It is less clear, but still probable, that their knowledge of the lending policies in the first era of the bank was equally incomplete. It is trite to observe that if Willson, with his long experience as CEO and as Chairman of the Board, did not understand the true impact of Epicon, no one else on the Board was likely to have understood it either. Neapole observed in his testimony that it would be Utopian to expect that outside directors would understand Northland Bank's operations.

This was a Schedule A bank operating under the same *Bank Act* and supervised by the same OIGB as all the banks in the system, yet management convinced themselves of their uniqueness, and of their isolation from the rules and conventions of banking. The ends, certainly meritorious, were taken as justification for the means. All other elements in the system, starting with their own Board of Directors and including their external auditors and the regulators, were tolerated most of the time and disregarded some of the time. Management did furnish information to all these elements. It is difficult to determine whether the failure of the other units in the system to appreciate the workings of the management strategies was due to their inattention or incapacity, or was the result of a technically qualified bank management who were also very effective persuaders or salesmen. Probably some combination of each condition contributed to the result.

It is enlightening to note that one member of the Board, Mr. Thomas Assaly, a well-known businessman in Ottawa and a beneficial owner of 10 per cent of the outstanding stock of the bank, submitted a written list of comments and questions to the Board. He inquired, for example, as to why the bank classed a loan as productive when interest was in arrears more than 90 days. Management's reaction through Neapole can be summed up as a rejection of this kind of inquiry as evidencing a desire by a director to get into management instead of confining himself to broad questions of policy. Assaly's foray was substantially without success. This may have had a profound impact upon the other members of the Board who were not substantial shareholders and not as well versed in business in considering whether to take on management. Hence it would have appeared prudent for a director of lesser qualifications to remain silent. Siebens' departure may also have been contributory to the Board's declining position in the bank.

The role of the Audit Committee is more difficult to understand. The Committee, of course, had access to both the Chief Inspector and to the auditors. However, the Committee took the view that senior management was responsible for provisions, and that where the auditors supported the judgment of senior management that was the end of the matter, notwithstanding the Chief Inspector's reports. Johnstone said, in relation to the McLeod reports:

> We did indeed receive those and found them helpful, but the credit adjudication and the loss provisioning, as a result of that, were responsibilities of management and, through the management, the external auditors to inspect and decide whether the loan provisionings were in fact fair and reasonable as the management had decided.

That this conflict did not spark interest in the Board is all the more surprising when one realizes that on their surface, the Chief Inspector's reports made it evident that his calculations and records were fully borne out by management at the branch level, and were quite contrary to the constant flow of good news from senior management.

The evidence of Johnstone indicates that the Audit Committee, which met only twice in 1984, and not at all in 1985, should have met more frequently, and that in "hindsight", larger loan loss provisions should have been taken by management and required by the external auditors. Johnstone stated that McLeod should have taken his complaints regarding inadequate loss provisioning to the Audit Committee. This overlooks the fact that management was present at the Audit Committee meetings, something which Chairman Willson stated in retrospect should not have been allowed. There is no alternative but to conclude that the Audit Committee had ample opportunity to observe the levels of provisioning, to witness the challenge to senior management's position floating up all the way from branch management, and to take an active part at Board meetings in calling upon management to explain the level of provisioning and the practices in respect of income recognition. It is elemental that the Audit Committee, aware of the conflict between senior management and the Chief Inspector, should have put the same question to the external auditors. None of these actions were taken either at the Audit Committee or at the Board level, all to the great detriment eventually of the bank. The only explanation apparent on the record is the undue servility of the Board to management.

This quality in the Board is easily illustrated. In 1983, a recommendation by management to recognize a considerable amount of interest on a loan in the Cayman Islands was opposed by the auditors. The auditors were, however, overridden by the Audit Committee. The auditors recorded the Audit Committee's reasons for its decision as "it is imperative that Northland show as 'good a picture as can be justified' given the problem that small banks, including Northland, are having in obtaining funding to support loan portfolios". The matter was resolved at year end but it is illustrative of the willingness, if not eagerness, of the Board to follow along uncritically in the track of management.

Another example of the Board's relationship with management is found in the difficulties arising in connection with the nomination of external auditors. In January 1984, the Executive Committee of the Board accepted a recommendation from Neapole that Thorne Riddell be nominated as permanent lead auditor. That firm's familiarity with the bank held out the prospects of lower annual audit fees. The Board in turn accepted the recommendation of the Executive Committee to do so in February 1984. On 4 December 1984, however, the Board resolved to nominate Clarkson, Gordon and Deloitte, Haskins & Sells as auditors for 1985. The next day, Fortier, in a written memorandum to Neapole, said that to nominate Clarkson, Gordon as auditors of the bank would "put the bank at risk". On 17 December 1984, the Executive Committee, without reference to the full Board, resolved that in view of management's recommendation, the nomination of auditors by the Board would be changed to Thorne Riddell and Deloitte Haskins & Sells. This was an amendment of the Board resolution by the Executive Committee. The minutes of the Executive Committee indicate that

Chairman Willson had reported that the management recommendation for the change was "on the basis of new evidence" although the Chairman at the hearings could not recall what that new evidence was. The meeting was carried out by telephone conference, and there was no other business transacted at the meeting. There had been an episode, to be described in greater detail below, involving heated eleventh-hour discusions over differences between the auditors, principally Clarkson, Gordon, and management with respect to the accounting treatment of some fees and accrued interest which management wished to take into income as reported in the financial statements for fiscal year 1984. These differences were settled on 3 December. In light of all this, it is difficult to accept Neapole's explanation that he punished the lead auditor, cooled off and returned to the January 1984 plan, or to divorce his decision from Fortier's views. The matter is raised here to underline the evidence that the Board of Directors became a mere cipher in the hands of management, at least, where the question was said by management to be important.

Sometimes a board of directors renders itself ineffective in governing a company because its members become obligated to management of that company for preferences or perquisites granted to them. One such perquisite in connection with a bank is the ability to borrow money from it. Of the fourteen directors on the Board in the bank's final fiscal year, six had borrowed substantially from the bank, almost $7.5M in total. By the end of the bank's existence, its officers had borrowed $2.1M. Some of these borrowings occurred in the following fashion:

1. *22 May 1984*. On motion by Skagen, seconded by Neapole, Derrickson received a renewal of a $1M loan to assist the investment in the CA12 loan. Love, on the motion of Skagen, seconded by Assaly, received a loan for $968,750 bringing his total authorization to $1.168M.

2. *5 July 1984 meeting*. On motion by Assaly, seconded by Love, it was resolved (R.B. MacMillan dissenting) that interest-free loans be granted to Willson ($200,000), Neapole ($200,000), Fortier ($160,000), and to the bank's senior employees Scott ($135,000), Hayne ($125,000), Kellington ($100,000), Guenette ($100,000), and Naylor ($70,000). Walker and Wettstein of Epicon each received loans for $80,000 at prime rate.

3. *7 August 1984 meeting*. On motion by Love, seconded by Assaly, CA12 was further restructured, decreasing the required shareholders equity, and increasing the income debenture and

operating credit. The borrower was owned by Derrickson (then a director) and Dixon (who was Love's law partner).

4. *20 August 1984 meeting.* On motion by Barker, seconded by Love, Assaly's corporation received a loan of $7.5M to provide working capital. On motion by Assaly, seconded by Neapole, Love received a loan of $1.237M.

5. *26 February 1985 meeting.* On motion by Skagen, seconded by Beber, Love received a loan of $310,000. Other director-related credits were approved, including a loan of $1.75M to a director-related company, and a loan of $3M to another company, apparently related to the same director.

6. *22 August 1985 meeting.* The Rondix transaction was authorized. It was to be owned by Derrickson and Dixon. In the course of the meeting and prior to the vote, Derrickson resigned from the Board and withdrew. Most of the equity to be provided to Rondix by Derrickson and Dixon consisted of shares of the borrower in loan CA12.

These practices raise serious doubts as to the ultimate impartiality and the ability of the members of the Board to serve the shareholders and creditors as a neutral, effective element of corporate management of the bank. The directors' personal exposure on loans might have produced in some of the directors a condition of wilful blindness to the grave state of affairs in the bank from early 1984 onwards. It may be flaunting reality to expect a beneficiary of a lending or loan collecting policy to be a critic of those policies at a board meeting. This is a factor even where no default has occurred. The failure of the bank can certainly not be traced to these practices. They are, however, a factor which must be put into the scales and weighed along with all the others.

When the bank was put into curatorship on 1 September, the directors, including the Chairman, objected strongly. None of these objections appear to have been based upon any detailed knowledge of the state of affairs of the bank and, in particular, the state of the loans. The level of their informed understanding of the affairs of the bank in general, and the affairs of the bank on the issue of insolvency in particular, approximates their understanding in detail of the Rondix proposal.

This subject cannot be closed without observing that, as in the case of CCB's board or any other board, the Board of Northland Bank acted through a dynamic shifting majority in the actions it takes or fails to take. Some directors exercised their vote of disapproval of the bank's development by resignation. Another took steps to require from management more meaningful information. That attempt failed and may have discouraged others from taking similar steps. It has also been mentioned that inattention or incapacity to act may have been a cause for failure to appreciate the workings of the management strategies but that a contributing factor may have been the persuasiveness of management. While each director's circumstances would have to be assessed individually, it is the conclusion of the Commission that, overall, the Board showed undue servility to management in some of the steps it took as a group or failed to take. This conclusion leads the Commission to suggest changes for the future, as is seen in Chapter 6.

A discussion of the question of Board domination by management in this bank would be unfairly incomplete without a reference to the fact that Chairman Willson energetically advanced the view that board performance in every bank would be improved if the CEO were not also the Chairman of the Board. Kennett has long espoused a similar viewpoint. While Willson himself did not follow this practice, it is pointed out that he did not start out as CEO of the bank but moved to that post on the departure of two CEOs, and held the position during the searches for a replacement.

4. The Auditors

The expert evidence presented to the Inquiry on bank accounting and auditing practices is set out in Appendix F and reviewed briefly in Chapter 4. The following discussion proceeds against that same background, which shall not be repeated here. As was the case with the auditors of CCB, Northland's auditors, as individuals, had never undertaken a bank audit before their engagement with this bank. They communicated with other offices within their firm where bank audits were performed to obtain information and to build up an experience base. No issue has been raised about the proficiency with which the audit planning and procedures themselves were carried out.

The prime issue of importance is the auditors' treatment of the bank's assertions about security values and the earning status of the loan portfolio. In some cases the auditors were able to base their conclusions on appraisals of the loan security. Epicon is an illustration of this process. The auditors required appraisals of the properties transferred to Epicon. Those were provided by Messrs. Walker and Wettstein. The auditors relied "pretty heavily" on the expertise which Messrs. Walker and Wettstein were represented as possessing. No other appraisals were obtained. As mentioned in the description of Epicon elsewhere, properties were valued on an "investment value" or "added value" basis; these were "future value" concepts. Similarly, when these properties were sold by Epicon with bank financing, these concepts were used to justify the financing by the bank of the "purchaser" of the property as well as the financing by the bank of debt servicing, that is future interest payments by the borrower to the bank.

The fundamental issue is whether the auditors, possessed as they were of all the facts, should have relied on the Walker and Wettstein appraisals and the assurances of bank management. Walsten, the vehicle through which Walker and Wettstein participated in Epicon as already described, was paid a substantial net management fee by Epicon. In addition, Walker and Wettstein were each individually eligible to receive from Epicon such perquisites as were from time to time provided to senior officers of the bank. The bank provided Epicon with operating funds for the purpose of managing the properties. In essence, the bank paid the expenses of operating Epicon just as though it were a department of the bank. Bank nominees held three of the five director positions. Walker and Wettstein were associated with the bank in other workouts, and appeared at Board meetings on occasion to explain some workouts. Wettstein was the principal behind some of the SBEC loans discussed earlier. Finally, both Walker and Wettstein had personal loans from the bank in excess of $350,000 each. In short, Walker and Wettstein were both principals of the purchaser (Epicon) and closely associated with the bank which financed the entire cycle of the planned "disposition". The auditors contended that the Epicon principals would be inclined to depress the transfer price as far as possible in order to maximize their return in the upside gain, and that Walker and Wettstein, as principals of an equity contributor to Epicon (namely, Walsten), would tend to be independent. However, the equity contribution of Walsten was minuscule (20 per cent of $45.00). Walker and Wettstein were on both sides of the transaction in the sense of receiving compensation from the bank and participation in the transfers through the minority interest positions. The transaction either stands on its own or it falls, and internal appraisals can add nothing to the value of the bank. It should also be borne in mind as a fundamental fact of this arrangement that Epicon's and the bank's financial statements were consolidated so that an intercorporate transfer could not affect the original values at which these properties were carried by the bank. These "appraisals" were made much of by the auditors but, bearing in mind the fiduciary position of these entrepreneurs, their statement as to value, whether correct or not, should not have been relied upon by the auditors.

The evidence is that many of the properties were transferred out of Epicon to new borrowers with 100 per cent bank financing and more. In fact, the purchaser/borrower was a shell company with no other assets and no capital. No debt guarantees by the shareholders were provided to the bank. If the properties were so valuable, one would expect the bank to have insisted upon a contribution of equity by the borrower. When this question was raised with management, Fortier stated that in these workout situations, 100 per cent financing is inevitable, and that nobody in the real world of commerce would expect any other result. As discussed earlier, there is some truth in this but the explanation must be that in these transactions there is some uncertainty that, until the workout is successfully completed, the appraised value will materialize. Because of that serious risk the borrower is not willing to invest any equity in the project. The facts show that the valuations were too high and were in reality designed for the purposes of determining ultimate collectability of loans. The reviews carried out by the Royal Bank personnel under the direction of the curator, and the curator's opinion as to the value of the assets remaining in Epicon, support the conclusion that the properties were overvalued. Consequently the basic issue was whether a loss provision should not have been taken at once, whether or not the transfer prices had been reduced.

These longer-term values were not restricted to Epicon. The following, taken from OIGB files, is a general description of the audit approach on credit matters:

> ... The auditors stated that the bank does not lend money with the idea that it can get it back almost immediately. Rather most of its loans will take three or more years to come back. *In this regard Northland is probably different from other banks.* Recognizing this, the auditors do not take a forced liquidation approach to valuing security and loans. They listen to management's plans and expectations for each situation. Where liquidation was the approach assets were valued at current prices. *Where the bank looked upon the situation as a workout or longer term hold, future values were used.* (emphasis added).

The auditors testified that the "expectation of future value was certainly a very important ingredient" in valuing security.

Two questions arise from the foregoing. First, if Northland was "probably different" from other banks, would this be ascertainable from the financial statements? Second, did the Inspector General ever authorize the different accounting treatment and, if so, would such action affect the position of the auditors? Northland was engaged in a workout strategy. Mr. J.C. Smith of Clarkson, Gordon testified that the auditors certainly were made aware of the workout strategy during 1983. He said: "I guess no one was fooling themselves that the bank, however, was in great shape with respect to its loans." As late as April 1985, the auditors had indicated to bank management that they would continue to do what they had done in mid-1983 when the workout strategy of the bank was initially adopted; that is, they would monitor, observe and seek evidence on the progress that was being made on the workout strategies with respect to the loans. Given that the bank's general strategy continued to be its attempt to work the loans out, and that the bank felt progress was being made, the auditors simply continued within this framework. They did not set the clock running on even the largest loans where exposure to loss was considerable.

The auditors' general approach in light of the bank's workout strategy was well described in the following exchange with Detlefsen as to the reasons for the apparent drastic change in the state of the loan portfolio between fiscal year end 1984 and August 1985:

> A. ... the whole posture of support for the bank from the various sources, the regulator in terms of funding difficulties had changed, and the bank itself seemed to have taken steps that were getting away from long term resolution of the problem into short term solutions.
>
> Rondix, I do not think had happened at the time but that was a subsequent example. The time frame in August seemed to have compressed and [sic: but] the loan portfolio was dependent on something longer than a short term time frame. That was crucial to the bank's strategy.
>
> Q. Can I summarize that by saying the molten core of this bank, the loan portfolio, had not been itself organically changed but the view taken of it changed. ...
>
> A. I think essentially, that there must have also been changes in the loan portfolio. ...
>
> Q. There would be a little bit but it is hard to believe we have such a cataclysmic change as to say the bank cannot carry on. ... You are not suggesting that that kind of organic shift occurred in the makeup of the loans.
>
> A. No.

The auditors had accepted changes in accounting policy regarding the accrual of interest in 1983. Previously, the bank ceased accrual once interest was 90 days in arrears, except in rare instances where interest recovery was adjudged to be imminent. The bank amended its procedures to continue to accrue interest on loans where that interest was in arrears for more than 90 days and the bank had confidence in the management of the customer to "work out" the loan, where there was sufficient spread between the principal and interest, and the value of the security held, and where arrangements were made with the customer to make specific time payments, and those agreed payments were not in arrears. Apparently it was not a practice to require that all three conditions be met. Rather, the decision was a matter of judgment having regard to these three criteria. The second change to accounting policy was built on the first. It was the bank's opinion that its established accounting policies had to be "enhanced" to take into consideration the changed economic circumstances and the substantial amount of real estate being acquired under the bank's loan security. The bank decided to modify its policies in relation to foreclosed property. As the bank foreclosed on a particular property, its fair value would be determined and the bank would recognize in its financial statements as interest revenue the amount of accrued interest which had previously been unrecorded as a result of the troubled loan being considered "nonproductive". This would even include the recognition of interest which had been accrued but not recorded in periods prior to foreclosure. Essentially, the bank was reviewing its security at the date at which it decided to commence foreclosure proceedings, and recorded the value of the asset received on the basis of future considerations and potential.

In addition to the Epicon transfers, another similar accounting transaction within the bank came up for discussion in 1983. This was the recently restructured Cayman loan. The bank proposed to include approximately $600,000 of interest into income for the 1983 second quarter on the basis that the restructuring had resulted in an increase in the security value sufficient to support the inclusion of this interest in the bank's income, even though the loan had been and continued to be carried as nonproductive. The point of contention expressed by the auditors was the impropriety of bringing these amounts into income solely as a result of a restructuring transaction. Management decided to take the accrued interest (by definition, uncollected) into income because it was imperative that Northland show as good a picture as could be justified, and because bank management was satisfied that there was sufficient support for the principal and accrued interest in the value attributed to the security in the restructure program. This interest income apparently was never reversed and was treated in a manner similar to the Epicon transfers; that is, the property was foreclosed, revalued, restructured, and interest previously accrued was taken into revenue.

In the result it is clear that the accounting practices adopted in 1983 were less conservative than theretofore. The auditors appeared to recognize the dangers involved in this accounting change. One of them, McKay, in a memorandum dated 29 August 1983, wrote:

> Despite the acceptability of the accounting policy on a conceptual basis, we indicated the general concern of both Clarkson Gordon and Thorne Riddell as to the aggressive nature of income recognition to the maximum of the lesser of fair value of the property or the Bank's investment therein. Such concern was related to the stability of the Bank, especially in light of its problems in the latter part of 1982 and early fiscal 1983. Green and Naylor [both senior bank financial officers] seemed to share that concern.

That the auditors would allow such transactions, with full information, and an awareness of the bank's worsening condition, is very difficult to understand.

The Northland concept of added value is said not to be the same as CCB's baseline value. Whereas CCB premised future values on significant improvement in the economy, Northland management based its future values on the values that would be added by application of workout strategies and a general improvement in the economy as well. In view of the large number of workouts undertaken by the bank, and in view of the fact that the largest portion of the bank's problem loans were in real estate, it is self-evident that the economy would be required to improve to justify higher values on all these properties. It is simply impossible to believe that Walker and Wettstein, and SMART, could deliver the planned results in all cases. Fortier described Walker and Wettstein as "pretty smart guys". However, the strategy required them to perform major miracles in relation to all this real estate in the extremely depressed markets in Alberta and British Columbia, where most of the bank's loans were concentrated. McLeod testified before the Commission that one of the poor practices that existed within the bank was the entry into speculative real estate transactions based on future events. If such events did not occur, repayment of the loans would become extremely difficult. Neapole also testified that the success of the bank's strategy required a "reasonable economy" or a gradual improvement, and the Inspector General in his meeting with the auditors of 9 July 1985 regarded the recession as the rationale for the use of future values. There is, in result, no real difference between the valuation practices employed in CCB and Northland.

On the record here, the auditors, both Clarkson Gordon and Thorne Riddell, were familiar with the management policies with reference to workouts and were fully aware that the bank founded its program of income recognition and loan loss provisioning on the employment of predicted workout values and future values. There is no question of any interference with or impediment placed in the way of the auditors by management in the discharge of their duties and functions as auditors. There is also no suggestion that these auditors, who exceeded their time budgets in the 1983 and 1984 audits, had not exposed themselves adequately to the bank's records and staff.

Clarkson, Gordon were auditors of both banks. Both banks dealt in the future tense in connection with loan valuation because the present tense, by 1983 at least, represented insolvency. Terminological differences are unbecoming in a field as precise and demanding as accounting. No difference in substance can be perceived in the use of future values, even though the process is described in the two banks by different managerial vocabulary. Management of the Northland Bank talked about "added value" as the result of management of the unsatisfactory loans in workouts. CCB spoke of "baseline values" as being the value of the asset in question at some loosely defined future time, without any reduction in that value when it is brought back into current financial statements. Both concepts necessarily permit management, in conducting the valuation process, to take into account their expectations of economic conditions at some unascertained time in the future. Both processes offend the assertion in corporate financial statements that the balance sheet and the income statement are expressed as at the announced date, namely the last day of the last completed fiscal year. It is clear that the CCB management, by their workout strategy, did not intend to subtract value, and nothing was to be gained in maintaining value at what was assumed to be almost zero at the preworkout level. The only difference in practice that may be real rather than apparent between the two banks is that workouts were the rule in Northland Bank, whereas in CCB the level of workout loans as a percentage of the total loan portfolio might have been slightly lower. In both cases, valuation of an asset was simply a judgment passed by management at its convenience in order to postpone, avert, delay, or forever avoid the taking of a specific loss provision against a loan, or to enable the bank to continue to take into its income statement accrued or capitalized interest. To do otherwise would entail a drop in income and a drop in asset value at a time when the fate of the bank hung in the balance. The bank would be more able to attract replacement deposits. In both cases, the strategy was simply to buy time in the hope, and sometimes in the belief, that economic levels of business in Alberta and British Columbia would improve and return to something like the glory days of the late 1970s. Where the auditors went along with management's appraisal of value on this basis, they did so in violation of the edicts pronounced in the testimony before this Inquiry by Mr. Broadhurst and the other professional accountants whose evidence has already been described.

As has already been seen, the bank auditing experts all testified that valuations by management must be reviewed by the auditors by applying conservative accounting principles. Where the loan in question is in default, those judgments must be even more conservative. The auditors for Northland Bank admitted in their evidence that the bank was not conservative. Detlefsen, speaking for the auditors, said this:

> ... I recall [referring to the 4 December 1984 call to the OIGB] that we did advise the Inspector General on a scale of acceptability of 1 to 10, I think we used that analogy, that we rated the degree of conservatism in the loan

portfolio at about 3. It was certainly within the acceptable range, but at the lower end of the scale, not conservative but within range of acceptability.

There is no reference in the documents to the auditors making a proposal with reference to loan loss provisions for 1983 or 1984. Nor is there a listing or aggregation of judgment differences. The furthest the auditors appear to have gone in scrutinizing these operational decisions made by management as they affected the accounting decisions to be reached in setting up financial statements, is found in the evidence, again of Detlefsen, where he stated:

Q. So that you say it is an acceptable rule if there is a workout and you adjudge the workout to be reasonable and it will eventually be worked out, that is a basis for saying no provision is necessary?

A. Yes.

What must be put against the auditors is that, notwithstanding the vast scale upon which loans were placed into workout, there was a very low level of specific provisions taken against loans in workout. Given the default condition of any loan going into workout, the severity of the Western Canadian recession, and the high proportion of the loan portfolio in workout modes, the failure to require adequate specific loss provisions is unwarranted. That failure results directly in an overstatement of assets in the balance sheet and of income in the statement of income. It was transparently an artificial state adopted as a survival expedient. The acceptance of these practices by the auditors was a failure on their part to comply with the principles of bank auditing as described to the Commission by several leaders in the profession.

Some explanation of the compliant nature of the auditors in Northland Bank may be found in the evidence of one of the auditors, Smith, who stated that since the financial statements are those of management and not of the auditors, it is management who must agree before any suggestions by the auditors can be taken into the financial statements. The process is, of course, quite the opposite. Unless the auditors can report to the shareholders that the financial statements proposed by management fairly present the financial position of the bank, the auditors may not approve those statements. It is a positive step which the auditors must take. They have no onus to demonstrate the negative.

There is another reason why it is difficult to understand why the auditors would be so susceptible to management proposals in this bank. Again, it is Detlefsen who stated:

We went into a very large percentage of the total loan portfolio to determine on an item-by-item, loan-by-loan basis the extent of provisioning and the appropriateness of provisioning.

On the basis of this high proportion of loans examined, it is difficult to understand why the auditors would not have compiled a serious and long list of incidents where capitalization of interest had occurred, accrued interest had continued to be taken into earnings after the borrower went into receivership, and no specific provision had been taken on workout loans even though in some instances the workouts had worked through a series of borrowers without any recovery by the bank. Had the auditors taken a very small sample of the loan portfolio, one might expect there would be a wide margin of error or an inability of the auditors to gather the evidence necessary to put the case to management. Such is certainly not the case on the record here. Indeed the evidence is that the auditors in some cases exceeded their time budget for the audit by a considerable margin.

Perhaps this is all but an extended illustration of the failure of these auditors to apply the "stepping back" principle enunciated by Mr. Broadhurst. One does not need to go to the Detlefsen evidence quoted above to reach this conclusion. The auditors' approval of the Epicon transaction is perhaps a more dramatic instance where a stepping back would have enabled them to give much more weight to the end-of-the-road position where the sales by Epicon to third parties were wholly financed by the bank. The ever-increasing upward spiral of bank exposure still passed without any challenge from the auditors.

Further indication of a lack of stepping back is the auditors' failure to concern themselves with the quality of the lending practices. McKay stated:

> ... We did not think we were passing judgment on good or bad or indifferent lending practices. It was our view that during the scope of the audit we determined the Bank had established procedures by which they loaned money to borrowers. As long as those procedures were sufficient to obtain the proper approval ... we were satisfied that the bank had established procedures, internal controls, to ensure or to help ensure that good lending practices would follow.

A number of allegedly bad lending practices were reviewed with the auditors. In many cases, they responded that they had no basis to judge whether such practices were very common, not so common, or rare. It is difficult to understand how the auditors could perform a "stepping back" if they were not familiar with the frequency of certain practices within the bank. In this case, there is no documentary evidence to show that the auditors accumulated their judgment differences for those cases where the auditors acquiesced in managements' accounting treatment of a loan transaction. The minutes of Audit Committee meetings show that the auditors only occasionally expressed concern over judgment differences with management, and then ineffectively.

Reference should be made in more detail to the Mackenzie episode in December 1984 in connection with the completion of the year-end audit for fiscal 1984. In response to concerns voiced by the audit partners of Clarkson, Gordon, a member of that firm in the Toronto office, James Peers, had gone to Calgary to look at the audit evidence, and had raised serious queries about certain fee income and interest recognition in the financial statements proposed by management. These matters had been discussed by the Calgary partners in charge of the audit with Peers and on the unavailability of Peers, Mackenzie, a senior partner of Clarkson in Toronto, was chosen to take his place in these discussions. Before leaving for Calgary, Mackenzie and another partner, Mr. W. Farlinger, spoke to the Assistant Inspector General. He was advised that a bank (not named at the time) was capitalizing and taking into income interest accruing over periods of two years, on the basis that the real estate security held by the bank had been valued at a level which supported the loan principal plus accrued or capitalized interest. The auditors advised that they would not suggest loan loss provisions be made to reflect current market values of some of the properties. The Assistant Inspector General agreed with them that such an approach was reasonable. The auditors also expressed their hope to convince their client to take a more conservative approach to the recognition in the bank's income statement of interest income. The Assistant Inspector General responded, "we would support them in the event of a confrontation with the bank."

Mackenzie, armed with Peers' notes, went to Calgary and reviewed with the local auditors the loans in question, which raised the issue of about $2.5M proposed interest reversals and $2.4M of fee income deferrals. If these reversals and deferrals were put into effect, it would mean a loss of income sufficient to result in a nominal loss for the year. This matter arose in the dying days of the audit, presumably after management had concluded that the auditors would approve their statements which showed a reasonable income for the year. The ensuing debate with management was described as "vigorous and negative". In addition to being annoyed at the lateness in the day when this matter was raised, Neapole expressed his objections on the basis that since the 1984 results were better than those in 1983, the financial statements should reflect that improvement. Both sides to the debate undertook to discuss the matter with the Inspector General, and did so. Kennett left it to management and the auditors for resolution and showed unquestioning relief when this was achieved. In the end, a bargain was struck between management and the auditors which resulted in a reversal of $550,000 instead of about $5M as originally proposed. This left the bank's income statement in a profit position.

Was the Mackenzie visit a "stepping back" or of meaningful assistance to the local auditors in their "stepping back", if any? It is clear that Mackenzie was aware of the bank's problems in a broad sense. Following his visit at the bank, he wrote a memorandum which identified the substantial amount of interest on the books of the bank which had been accrued or capitalized and thereby taken into income. It identified uncollected interest overdue by more than 90 days, and the total principal amount of nonaccrual loans at year end. Mackenzie also recognized the question of future values, and addressed the issue of justification for no provisions where security was valued on that basis, and the unscheduled capitalization of interest in unsatisfactory loan situations. The difference in the impressions of the overall quality of the loan portfolio of the local auditors and Mackenzie sheds some light on the problem. The difficult loan situations in the bank were brought to Mackenzie's attention by the Calgary auditors. Mackenzie, in his record of the visit, described the two largest loan situations where interest overdue 90 days was accrued as the "least satisfactory of the large loans reviewed". On the other hand, McKay's record of the visit describes these same loans as regarded by Mr. H.G. LeBourveau of Clarkson, Gordon, and McKay as "being typical of the loans ... where interest income was being recognized. Also, such loans were regarded as ones where the Bank's posture may be regarded as aggressive relative to income recognition". Mackenzie testified that he did not get the impression that these two loans were typical loan situations in the bank and that his "concern level would heighten" if he knew there were a large number of such loans. Further, if the Calgary auditors were unable to quantify or even hazard a guess at the frequency of poor lending practices in the bank which would be required to perform a stepping back, then it was impossible for Mackenzie to do so. Because the evidence is that these auditors had not accumulated the data necessary to perform the stepping back process, Mackenzie's assistance was illusory.

In fairness to Mackenzie, it must also be said that his review of the loan portfolio was entirely limited to the three or four loan files concerned with the interest reversal and a handful of files relating to the fee income deferral. In all this he was largely in the hands of the local auditors. It was they who had examined the branch office files whereas Mackenzie, in the short time he was in Calgary, was limited to an examination, or to a discussion based upon the examination, of some Head Office files.

All of this appears to have led to the dropping by management of Clarkson, Gordon from the audit rotation for the year 1985 as earlier discussed. When these events are assessed with a similar incident in

1980, they greatly reinforce the conclusion that bank management effectively controlled the appointment of auditors according to their own interests and not necessarily those of the shareholders who appoint them.

This raises a more sinister problem with the present provision in the *Bank Act* providing for dual auditors rotating from a panel of three or more audit firms. Where, as is now the increasing practice, one audit firm is a permanent "lead auditor", the rotation effectively involves only the change every other year of the junior partner in the dual audit scheme. An auditor can be dropped by simply changing his position on the rotation, without the formalities applicable under s.240 of the *Bank Act* to situations where auditors have been dismissed by the stockholders. In the recommendations made later, remedies for this situation will be discussed. Interference by management in the process of the appointment by shareholders of auditors in the bank makes a farce out of the theory that the auditors are appointed by and for the benefit of the shareholders. As a minimum this type of action by management requires some explanation to the shareholders on the appointment of auditors, and under the *Bank Act*, to the regulator as well.

The dealings with the Inspector General in the course of this episode are perhaps equally disturbing. As mentioned earlier, the Assistant Inspector General initially promised support for the auditors in the event of a confrontation. It was the evidence of Mackenzie that he would have preferred support from the OIGB on these reversals, and he stated that the result at the end of the day left him rather uncomfortable. However, when the auditors called Kennett and received no support from him in their stand, they, in the words of the testimony, "left the field" in short order. All of this may have left the Inspector General with a misplaced sense of assurance. Here the experienced bank auditor from Clarkson Gordon's head office had gone to Calgary, met with management and put the seal of approval on the financial statements for the year 1984, a crucial year in the history of the bank. There is nothing to indicate any penetrating inquiry by the OIGB to determine the extent of the differences between management and the auditors. There is not even much evidence of curiosity to determine how such a material issue (profit or loss for the year) could arise so late and be settled so quickly. More serious is the question why, when the Inspector General avowedly relies upon the external auditor to inspect the bank's loan portfolio and the appropriateness of the accounting treatment of the bank's transactions reflected in its financial statements, he did not support the auditor in this issue, or at least have someone in attendance to observe its resolution. These events did not appear to shake the OIGB's complete reliance on the auditor's certification.

If we "stand back", in the words of Mr. Broadhurst, it is evident that something must be wrong with a system which can produce financial statements for a bank, approved as being fair by external auditors and showing an improvement in the condition of that bank, when the true situation revealed by a close examination by neutral examiners of the loan portfolio is quite the opposite. In the case of CCB, the trend in financial statements was down through the last critical years of the bank's history. In Northland Bank, the last financial statements in fact showed some improvement. The underlying facts belied this representation. This result must have followed the sad sequence of events commencing with the almost automatic decisions taken by management to place bad loans into workouts and to accord to the transaction an accounting treatment favourable to the bank's struggling position, and continuing with the auditors' acceptance of the accounting treatment proposed because they could not challenge the underlying operational decisions of the bank's management. All this is in contravention of the principle enunciated by Mr. A.J. Dilworth, representing the CICA, who said that where there is an apparent threat to the existence of the bank as a going concern by reason of an extremely large proportion of its loan assets being in arrears in one way or another, the auditors should use even more conservative valuation practices. That test clearly was not met here.

Few illustrations need be advanced to demonstrate this lack of conservatism by the auditors in reviewing actions taken by management in working out an unsatisfactory loan. Two will be briefly outlined. The first loan originated in 1980 and fell into default shortly thereafter. Restructuring and juggling persisted through the next two years. This took it into the era of Prisco who, on reviewing the matter, referred to the principal of the borrower company as a "crumb-bum". By the end of 1982, the loan had been placed on the NPL list and \$150,000 in recognized interest had been reversed. \$2.5M in principal, plus a considerable amount of interest due, remained outstanding. By the time the bank went under the control of the curator, it was determined that the bank had been losing about \$400,000 per year on this loan during a four-year period, and even though a receiver and manager had been appointed in 1983, and a bank officer had calculated a liquidation shortfall on the security of \$1.15M in 1982, interest had consistently been accrued or capitalized and recognized as income since 1983, and no specific provision had been taken. The bank's internal inspector awarded the loan his lowest rating class. The bank had never realized on the security held, and its exposure continued to climb throughout. All this was justified, according to management, by an enhancement from time to time of the underlying security value based on appraisals, rejected offers, and other transactions, and restructuring proposals which never closed. It was not until July 1985 that the auditors and management had judgment differences in respect of the accounting treatment for this loan.

The second loan is an example of the noncash loans set up on workouts where funds were advanced for interest servicing, justified by an optimistic view of the workout schemes. This loan was secured by a piece of property in downtown Saskatoon. The property was sold by Epicon for $2.1M, but the bank provided $3M of financing, there being an additional $900,000 to enable the borrower, among other things, to pay future accruing interest. Walker and Wettstein projected that should the proposed development go ahead, the value of the property would be just slightly in excess of $2M. The borrower was a new company, and the principal behind the borrower was a well-connected local entrepreneur. He is described in bank documents as "truly a friend of the bank, sitting on the Saskatoon Regional Advisory Council where he plays a most active role in the bank and having recently acquired 50,000 shares of the bank". The principal was also said to be well connected in Federal Government circles and chaired a board in charge of realty owned by the Government. Thus, the bank was certain that with his Government connections, the principal would be able to complete his development plans for the property in a short period of time. Guenette testified that the purchaser demonstrated to the bank that within two or three years, he would have successfully negotiated "very material leases". There was an appraisal indicating that the value of the property was $1.56M, leaving a shortfall to the bank of $1.47M. The appraisal was considered to be very conservative due to the prime location of the property. Since negotiations for an office complex were "in advanced stages", the auditors decided that a more optimistic security evaluation was justifiable, and deducting the term deposit held to meet interest payments, there was a shortfall of $229,000. The effect on current year pretax income was approximately $46,000, which was not considered material. There did not appear to the auditors to be sufficient ground to record a provision.

Other loan reviewers were less optimistic. The Royal Bank team identified offers received for the property of $1.75M (verbal), $1.5M (written) and $700,000 (verbal). They valued the asset at $1.3M, established a loan value of $975,000, added in the term deposit, and classified $1.7M of the loan as bad, and $400,000 as doubtful. McLeod reviewed the account in June 1985. He stated that demand for such property is not good, and described the deal as "a workout situation predicated on a return to more buoyant pricing". Management, in their response to the curator's assessment, remarked that $1.7M of the loan was to be transferred to Rondix; once more through the washing machine.

There were many other such loans. All of them fall into perhaps an imprecise description in the accounting world, but a telling one in the real world, that is, a noncash loan. Such loans produced no cash income throughout all these years and yet sustained the reported income of the bank. The carried value in the balance sheet. It may not be easily depicted in accounting terms, but the picture of noncash loans on the scale found in the Northland loan portfolio is a bleak one indeed, which, by some adjustment to accounting rules, must be reflected in the financial statements of any bank which may subsequently fall into the condition of Northland Bank. To permit otherwise is to allow two banks to exist in one; one as depicted in the financial statements, and the other as it exists in market reality.

The auditors during these years had considerable contact with both the OIGB and the Audit Committee of Northland. This has been detailed elsewhere. In the course of these contacts with the Audit Committee, for example, in 1983 and again in 1984, discussions were held in connection with recognition of interest income and loan loss provisions. In none of the year end discussions did the auditors inform the Audit Committee of any disagreement with the management approach to the treatment of loans and to the preparation of financial statements for the bank. There was one disagreement in the course of mid-year discussions (the income inclusion on the Caymans loan), but this only "culminated in a review of accounting policies", and by year end was considered acceptable. This acquiescence, if not outright approval by the external auditors, robbed the Audit Committee of any zest it might have felt for a challenge to management on major loans known to the Audit Committee or on the general issue of income treatment by bank management. Indeed, the Mackenzie episode, and perhaps more particularly the Inspector General's acquiescence in its outcome, again must have had a similar impact on the Audit Committee's curiosity or perhaps its aggressiveness in its dealings with management on the treatment of the loan portfolio in the financial statements of the bank.

The auditors take more specific reassurance from some of the comments by members of the OIGB, with reference to an understanding that a reasonable approach must be taken towards current market values and the accounting treatment to be accorded to workout loans. No one lifted the discussion to the level of making the Inspector General a partner with management in these adventures, but the testimony of the auditors comes close. The high water mark was the failure by the Inspector General to join in support of Mackenzie when he was seeking that support in a serious debate with management on a quantity of income recognition which was material to the earnings of this small bank. The Inspector General's neutrality and stand-off position again must have been taken by the Audit Committee and by all spectators to the event that management was, in these difficult times in the bank, on a track which was known to and approved by the Inspector General.

The auditors' position in final form was simply that they had but one drastic remedy at hand, namely the withholding of approval of the proposed financial statements. This, of course, would be tantamount to a closing of the bank by the auditors. They professed no such power, and indeed, claimed that they were not in possession of evidence or information sufficiently drastic in nature to warrant such a drastic remedy. All of that, of course, overlooks their only duty, namely the examination of the proposed financial statements to determine whether they are, in accordance with applicable accounting principles, a fair representation of the financial position and results of operations of the bank. Whatever the consequences may be, this is the auditor's solemn duty. The difficulty of their position is recognized by all but that is small comfort to an auditor who, for an appropriate consideration, is called upon to exercise this grave and lonely duty. The auditors, on the documentary and testimonial evidence before the Commission, clearly failed to apply in their judgment on the fairness of these financial statements as prepared by management in the year 1984, and probably as well in the year 1983, those accounting and auditing principles and practices pertaining to the audit of banks. The Northland Bank statements did not, on the basis of the information revealed in this record, fairly present the financial position of the bank at the 1984 fiscal year end, and probably at the 1983 fiscal year end as well. Accordingly, the auditors should not have issued their certificate of approval of these statements for 1984, and probably should not have done so for 1983. This is not an assessment of circumstances exercised in hindsight and based upon loan reviews after the appointment of the curator, but rather a judgment which must necessarily be passed on the basis of the record as revealed and known to the auditors by 31 October 1984.

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 Northland Bank 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 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. The Northland Bank 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 have disclosed that the bank was insolvent at that time in the sense that it would have had a negative net worth. No precise conclusion on the record before the Commission can be made with reference to fiscal year endings prior thereto but it is reasonable to conclude that, in all probability, the same situation would have been revealed at fiscal year end 1983.

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.

5. The Inspector General

It should be determined, if possible, whether the Inspector General had actual knowledge of the situation in Northland which, correctly construed, would have led to a finding of insolvency in the bank, probably at year end 1984, but most certainly well ahead of 1 September 1985. There may well be a different situation revealed. While short of actual knowledge of the entire program initiated by management and approved by external auditors, the Inspector General may have been necessarily aware, from the information laid before him, of the ramifications of these actions and the consequences they posed for depositors and investors in Northland. In short, the innumerable contacts heretofore examined between the OIGB and management, directors and auditors may disclose a growing awareness in the Inspector General, over the years in which the bank operated, of the true inherent financial condition of the bank and of some of management's practices which contributed to that condition.

In the early years of the existence of this small bank the OIGB appeared eager to treat it on the same basis as the major banks, to accept management as being adequate to the task and to assess the results as being conventional and consistent with the balance of the banking industry. What deficiencies were noted were not followed up effectively by the Inspector General. This is the appearance of the state of supervision from the evidence, but without a full-scale examination of the inspection activities of the Inspector General in the other banks during this period, one cannot say this is more than "an appearance".

As has been seen, the Inspector General, early in the years of serious difficulty of the Northland Bank, commencing in 1982-83, became aware of the survival tactics adopted by management, including primarily the invocation of the practice of establishing security values using undiscounted future values for that purpose, all to the end of gaining some time for what was regarded as the inevitable return of good economic conditions to Alberta and British Columbia, which would restore value to the bank's loans then classed as unsatisfactory in one way or another. The process may not have been fully understood by the Inspector General, but there was an awareness of the gap which had arisen between actual present market value of assets and the value perceived by the bank by looking ahead to some unascertained time in the future.

None of the contacts by the OIGB with the bank assumed the proportions of the later hands-on examination of loans in the bank's portfolio. The awareness of the OIGB was limited to that which could be learned from discussions with the external auditors and management, and from the annual inspection which did not descend to the level of loan file examination. Consistent with the pattern into which the OIGB lapsed in its supervision of this bank, the inspectors relied heavily on management's explanation of the workout programs in the bank and even more heavily on the auditor's acceptance of the accounting treatment of the practices which flowed from the various workout strategies.

After the beginning of the CCB bailout process and the revelations connected therewith, the Inspector General gradually moved to a fuller understanding of the details surrounding the loans comprising the bank's loan portfolio. With that awareness came an unease resulting from the knowledge that there was a considerable gap between values assigned to bank assets under workout and the then current realizable market value.

In the final analysis, the OIGB adopted the position that the missing values in the loan portfolio were occasioned by the effect of the serious and prolonged recession in Western Canada and that the regulatory system could advance no magic solutions. Only an economic upturn could save the bank. The OIGB appears to have accepted the fact that the missing values were not detected because of the traditional reliance on the auditors' approval of the financial statements, and because the auditors failed to properly perform their functions when approving the statements of this bank in its later years.

Over all these considerations hangs a failure by the Inspector General from the earliest days of these two banks to appreciate that these small regional banks, however designed and launched, presented a different regulatory problem and challenge than did the existing Schedule A banks. Nowhere did the OIGB reveal an intention to establish criteria for supervision designed precisely for the needs of this small, regional, Western Canada oriented bank, engaged heavily as it was almost from the outset in investment in local industry which was predominantly real estate and energy of one kind or another. For example, the Inspector General in his testimony said:

> I recall in the early days being concerned because the bank did not seem to be developing in the way that was suggested by the entrepreneurs who had established the bank when they were before Parliament to receive their charter. ... On the other hand, ... we were not particularly concerned about the lending practices of the bank. ... Our impression was that those lending practices were reasonably conservative. ... I must say we were, perhaps, ... overly impressed by the management of this bank. On the other hand, they were experienced in some degree and I felt that their careful growth represented a realistic appraisal of their own capabilities in the circumstances.

On the precise issue of the extent of the Inspector General's familiarity with the basic strategy adopted by the bank in order to gain time sufficient to restore value to the loan portfolio and confidence in the market, the Inspector General testified in part as follows:

> I cannot recall exactly when the strategy was set out before my office. I suspect it developed a bit piecemeal through time, but certainly part of the strategy was to keep the bank capitalized. ...
>
> Another strategy was to grow out of the problems. The book is full of evidence about the growth strategy and the concerns we had about the growth strategy, but the growth strategy, I had hoped, insofar as it was being pursued and we were not recommending it, was to lead to a greater diversification of loans and was to lead to a strengthening of the credit portfolio . ...

Mr. Kennett then acknowledged an awareness of the Epicon transaction and described it as "bundling the real estate loans and finding the best possible management the bank could for those loans to try to retain or restore values and eventually to market them and to keep the bank whole by that process". He concluded that, "... the basic strategy seemed sound and we welcomed the concept ... of finding the best possible management for the package of nonperforming or difficult real estate loans". He then stated, in response to a description of the bank's treatment of loan loss provisioning and income recognition:

> That was not explained as clearly as you have set it out to us; at least I do not recall that. ... But that was an area that troubled us and indeed it led to a considerable discussion in relation to the establishment of Epicon to focus it on a particular instance.

The Assistant Inspector General, Mr. Macpherson, joined the discussion in the Commission and added the following:

> First, we recognized the restructuring approach that the bank was taking to try to work out of its troubled loan situations, that we knew that inherent in that was a certain forward-looking approach to establishing values of the properties that were concerned, and also that in the course of that there was a degree of interest capitalization or income recognition, but that we also believed and we understood that they believed that there was a finite limit to that. You had to stop doing that sooner or later, so there was a timeframe around that.

These and other comments in the evidence indicated that the OIGB, rightly or wrongly, understood throughout that the workout strategy would involve a valuation basis of assets concerned which reflected the process of workout but which was subject to an overall time limit. The evidence is very imprecise as to what that time limit was or when that understanding was attained by the OIGB. The Inspector General and his staff recognized that all of these workout strategy ramifications were unfolding at the same time as the bank was endeavouring to shift its reliance from wholesale funding to retail funding. This raised separate concerns in the Inspector General's office: "We roughly calculated that the cost of the new money in that form was at or perhaps even above the bank's prime rate so clearly there was no room for any material spread". At the same time, the Inspector General was made aware that the bank was endeavouring to generate significant fees from merchant banking without any increase in the bank's balance sheet. Macpherson then concluded, on this aspect of his testimony:

> In our view, in May, [1985] all of those three key factors had to produce results, satisfactory results, within a very short time. I believe that we made it as clear as we could that we felt that time was indeed running out, that there was not that much more ability in the asset portfolio to sustain income recognition, that we queried whether the bank indeed would be able to continue to attract and hold retail deposits at the prices they were having to pay, and we seriously doubted the ability of the bank to generate fee income without adding to the asset side of the balance sheet. ...

All these latter discussions were held in the month of May which was very late in the day, of course, for Northland, and for a recognition by the regulators of the state of affairs in that bank. Macpherson continued, in response to this question from Commission counsel:

Q. I gather that in May of '85, you were not having the strategy explained to you for the first time; you were aware of the strategy, but you were telling the bank that time was running out?

A. Yes, sir.

Mr. Macpherson later testified, in answer to a question as to when the Inspector General first became aware of this program in detail: "I think back in 1983 we were prepared to see and live with the bank in an attempt to get through this period". He made it clear, however, that he did not believe the OIGB ever precisely put the bank on notice that the OIGB reserved the right to say that the time was up for all these survival tactics, "... prior to perhaps ... May of '85".

Q. They complain that they were misled that you went along with this strategy and then suddenly blew the whistle.

A. That may be their view, but I think again as we were going through the various inspection reports, we continued to see expressions of our concern regarding growth, regarding provision policy, regarding reliance on noninterest income and the other different difficulties that we regularly brought to the attention of the senior management.

This slow realization of the true import of the workout strategies and the need for some curbing activity by the Inspector General can be seen in the succession of memoranda prepared in the OIGB, including one in April 1984 which stated in part: "It is obvious that the bank desperately needs earnings and any accounting treatment which can show these will be employed". It should have been no surprise for the OIGB, therefore, to discover the reversal of interest reversal episode discussed earlier.

There are other instances of inaction in relation to disturbing information, or failure to acquire information. For example, the OIGB recorded that Prisco advised them in May 1981 that "loan quality remains high". This statement is not consistent with Prisco's testimony about the bank's condition. It may be that this statement is the conclusion of the OIGB officer drawn from the discussion of one particular loan, and Prisco's assessment of the condition of the loan portfolio was not challenged by OIGB counsel in cross-examination. In any event, by 1982, after the recession set in, the OIGB annual inspection revealed the auditors' observations that there had been some weakening of loans, and Prisco's view that the lending process had to be tightened. In an October 1982 visit, Grant questioned the bank's income recognition practices and its failure to adjust collateral value to reflect the deterioration in the economy. While Macpherson had visited the bank on 1 October 1982 and learned of a senior bank officer's "thorough review" of the loan portfolio and the bank's satisfaction that "the portfolio contains no more surprises", he seems to have expressed no strong reaction to Grant's findings which came but 3 weeks later. He simply wrote on Grant's report "As for [sic] CCB, extent of income recognition is dubious".

The OIGB was also aware of the future value philosophy employed in the Epicon transactions. While the Inspector General testified that he thought the sales out of Epicon were normal commercial sales which would lend credence to those values, OIGB files show that it was reported in early 1984 that there had been a large swap of properties with a trust company which involved a large amount of bank financing. In late 1984, the OIGB learned that about 25 per cent of the Epicon dispositions had been by way of swap and that "outright sales accounted for about a 25 per cent reduction in the portfolio". As discussed earlier, the true facts are that the transfers out of Epicon, whether by trade or sale, were predominantly financed by the bank. In any case, the material on the OIGB files, while not fully reflective of the true position, should have been sufficient to cause the OIGB to question much more closely the operations of Epicon.

It is notable that the OIGB initially expressed skepticism about the bank's workout and dilution strategy. A memorandum of October 1983 states in part:

> Neither of the above approaches is without difficulty. The restructuring of nonearning assets may be more protracted than foreseen or involve the need for greater provisions than already made. Careful judgment is required in the decision as to when a loan should be restored to the current category with the possible "recovery" of substantial interest not previously taken into income. If the loan should subsequently fall back into difficulties and become either nonearning or require a provision management could face criticism.
>
> The dilution through rapid (approximately 40%) growth approach to the Bank's problems requires that it be significantly more successful in its credit judgments than it has been in the past. It must also be recognized that the Bank's previous growth was achieved in a period of rapid lending growth by all banks particularly in the Alberta and British Columbia markets. The general impression gained on our recent Western trip was that the return of this epoch is not imminent and the the Alberta economy in particular will continued to be slow to recover.

Many other similar concerns punctuate the record. It is clear that the OIGB had been concerned about loan loss provisioning and income treatment since 1982. It knew the bank aggressively pursued workouts and was desperate for earnings. It knew that management justification for income treatment was based on intangible factors such as "changes in the near future". It knew the bank tended to grant large loans. What it did not seem to know was the impact of all of this in hard figures. It never attempted, until the summer of 1985, to implement any sort of strategy to particularize its concerns. There was a lack of follow up, as evidenced by the lack of any coherent stream of data on particular subjects from time to time. This was a small and vulnerable bank. When it undertook the significant workout strategy it surely would have been prudent for the regulator to require detailed, timely, and customized information to assess the strategy rather than "piece-meal" information. This is particularly important where as here the bank was so heavily dependent on a very large number of workouts; indeed a significant fraction of its loans was in this state. Similarly, the OIGB somehow failed to discover anything in its inspection visits about McLeod's reports which clearly showed the portfolio's condition to be worsening. The evidence of the Inspector General, however, was that through all these years up to May 1985, the OIGB did not become aware of the condition of the loan portfolio. He acknowledged that the evidence must have been rolling into the OIGB from 1982 onwards as the recession deepened, and that problems were piling up in the bank loans, but:

> We were not in a position to measure that ... but we could feel it in certain specific instances that came to our attention. ... [F]inally, by the time we got into 1985 we began to get information with greater precision. We saw the bank itself struggling more visibly to sustain itself. The jig was up. We recognized finally the extent of the damage of the portfolio. ...

All of this appears to result in an indirect acknowledgement of the effectiveness of some kind of hands-on inspection or check-up at least once in a while and in some banks. On 25 May 1984, the Inspector General wrote to the Minister of Finance stating: "I inspected the Northland Bank last week and am satisfied that the Bank is in a sound condition". When questioned about this report, the Inspector General's reply was:

> I suspect, and I can only suspect, Mr. Sopinka, but if we had sent in a team of experienced credit officers from the bank, from banks, that we would have got a much more bearish report than I would have reason to believe that at that time. That is hypothetical.

In contrast, the Inspector General had, in fact, been relying extensively, if not completely, upon the auditors' approval of the bank's financial statements in the years 1983 and 1984. He said we "took comfort from what the auditors said" and he "was certainly guided by the professional accountants in this matter". The OIGB brief to the Inquiry ascribed the failure of the tripartite system of inspection and regulation to the failure by the auditors to perform their function properly. The brief refers often to instances where the OIGB sought assurances from the auditors and the general position appears to be as follows:

> Until the summer of '85, OIGB had accepted the external auditors' certificate as an assurance that the statement of assets in the Bank's balance sheet was realistic. Further and specific assurances were sought from them during the inspection visits. ... However, increasing skepticism led Macpherson in June '85 to challenge the external auditors' acceptance of the financial statements of '84. ... Even at that late date, Clarkson Gordon had no qualification to make.
>
> As is now known ... OIGB's skepticism was not unfounded.

The debate reduced itself to a contest between two corners of the triangle as to whether the reliance was misplaced or was ever revealed to those upon whom reliance was placed, namely the auditors. The OIGB was not always consistent in taking this position. As we have already seen, the Inspector General did not support Mackenzie in his confrontation with management on the settlement of the 1984 statements. He did not question the validity of the resulting statements even though he was fully aware of a serious difference between management and the auditors as to the fairness of the financial statements as prepared by management. How then could the Inspector General thereafter blindly rely on these statements for the answers to all his concerns about the bank?

The same inconsistency arose in the dealings between the Inspector General and Wood Gundy, the underwriters, concerning the condition of the bank prior to the last public offering of securities by the bank. The Inspector General did not refer any of the questions put by the underwriter relating to the financial condition of the bank to the auditors but purported to provide the requested information himself or through his staff. The answers provided related both to detailed questions and to general conclusions. No mention was made according to the evidence taken by the Inquiry of any reference to or reliance upon the auditors.

Like the auditors, the Inspector General too fell into the habit of accepting management's decisions and expectations. The same situation developed in CCB, as has already been seen. For example, the Inspector General had slipped into acceptance of management's open-ended workout practices (as had the auditors), perhaps recognizing inwardly that a time limit was implied or inferred or must necessarily exist, but never overtly advising management that such was the thinking of the Inspector General. Clearly the workout policy was approved at a time when there seemed to be no reasonable alternative for a bank facing the depths of a lengthy recession, and with no other course of action available than to accept the inevitable and surrender to liquidation. The management plan, put at its highest, was to work out the losses, stay with the borrower, hope for a return of prosperity and a turnaround in cyclical industries (mainly real estate and energy loans) and generally to reflect the workout strategy in the accounting of the bank in the way most likely to encourage confidence in that bank, but all the while consistent with the applicable accounting principles. However, the Inspector General never does answer the precise question why this workout strategy program was approved by him without telling the bank at that time, or reasonably soon thereafter, that the workout program as a means of forestalling reduction in loans values in financial statements and protection of income in those statements must have a term on its life. The explanation given was as follows:

> But an implication to that was that there was some postponement in the recognition of market values and in the provisioning process. That postponement could only occur, in my view, over a relatively short period of time. When two or three years later we were still exercising that same kind of strategy largely in relation to those same kinds of assets and provisions were not being taken, that situation had to change. As I said before, that gap between market values and intrinsic values or however you want to express it had to narrow, and it was not narrowing. The market was not coming up rapidly to meet those anticipated values and something had to be done.

In hindsight it is easy to see the error. It is not so easy to see what the regulator might otherwise have done, dependent as he was upon the tripartite system of regulation, starting with management, and passing on to the external auditors' approval. Furthermore, it is true that the workout plan was at least partly sound. Faced with a deep recession across its whole operating area (except for a new off-shoot in Ontario), what could Northland have done but undertake workouts of bad loans. This plan lost its prudential base, however, when it was applied across a high proportion of the bank's loans and, frequently, for the ulterior purpose of protecting the income and asset statements, not primarily to achieve significant recovery from effort and money invested in bad loans.

Events combined to force the imposition of a finite time limit on the workout program. That limit in reality was, of course, the necessity to recognize insolvency when it was written in such large print. The "wink and nod" system of regulation was bent around to a wink and nod system about solvency itself. When indications of insolvency became too intense and too distinct for anyone to ignore, the regulators, the Bank of Canada, and the Department of Finance came at about the same time to a final, last-ditch, no-alternative realization that the end of the road had been reached. At that time, of course, everyone concerned cast their eyes backwards and began to wonder why this act was allowed to play itself out to this end over such a long period of time and to such damage to many of the persons involved.

The workout program did not bring the bank down. The workout program simply delayed the collapse. The culpability of those who permitted the program, starting with management, is not an issue before this Commission. We are simply determining conditions contributing to failure and the workout program contributed only to the postponement of the inevitable. All this is very frankly discussed by Mr. Kennett in the following exchange:

> Q. ... My second question is not wholly unrelated, and that is, given the state of affairs that we have just now discussed, what regulatory system could have saved this bank starting in 1982, if any?
>
> A. As you have put the question, none, in my view. The die was cast. With the deep and prolonged recession, the bank was caught in its asset structure and concentrations, and nothing but significant recovery in the economy could have saved the bank.
>
> That could have saved it had we had what I might characterize as a normal business cycle, it would have come out of it within time frames that would have been acceptable, but we were not in a normal business cycle in this circumstance.
>
> We had got into the problem through a period of prolonged prosperity with mounting inflation and then with a considerable amount of speculation in the real estate market in this province [Alberta] followed by a very severe recession that turned into a very prolonged recession, and indeed, with what is happening now to oil prices may be still more prolonged. I think the answer is that no regulatory supervisory system beginning in '82 could have saved this bank.
>
> Q. My last question is: We have heard a great deal with a wide variety of adjectives about the strategies and plans, programs, devices, procedures, one thing or another, adopted by this bank and CCB. Did the regulators in assessing the work of those plans and programs and their acceptability in the overall banking system in our Canadian community, was the regulator influenced by the fact that if the Alberta economy had come back in '83, '84, that the bank probably would have staggered back? Was that an influence which you took into account in permitting or not prohibiting some of these measures?
>
> A. It was certainly an attitude, and I will speak for myself, sir, I think personally if I may. That was an attitude that influenced us in these determinations.

Clearly, two events coincided. The first was the fact that Northland simply ran out of money. The bank was putting into the cash box IOUs which could not be collected while simultaneously taking out of the cash box what little cash remained to pay the operations costs of the bank. Eventually the paper well ran dry. This was about the time of management's confessions to the Inspector General on 20 July 1985. A similar sequence of events had driven CCB to the same confessional on 14 March. The second event was the implementation by the Inspector General of measures to obtain a first-hand knowledge of the state of the Northland's loan portfolio. The bank's economic paralysis was then seen in stark reality and events in the OIGB marched rapidly from that time onwards to the final determination and appointment of the curator on 1 September 1985.

There is virtually nothing in the evidence, documentary and testimonial, before this Inquiry to indicate that the decision made in late August for the appointment of the curator was erroneous or could thereafter have been reversed. That it should have been made sooner is now obvious, although it might not have been to those embroiled in the events of the summer of 1985. The unwillingness of the management of the bank to see their bank die was natural, and their zeal and efforts to the very last to keep it going cannot, by themselves, be criticized. As observed earlier, where those efforts and that zeal carried the bank beyond the rim of accounting and banking prudence and propriety, different issues arise. All this having been said, it becomes apparent on a close and detailed examination of this voluminous record that the OIGB did not effectively bring its investigative and statutory powers to bear on the problem soon enough. The evidence was before the inspectors at least before the end of fiscal year 1984, and probably in fiscal year 1983, to draw the curtains on this bank before it had damaged those many businesses and persons who came to deal with it.

6. The Bank of Canada and the Ministers

The issues relating to these two bodies are nearly identical to those in relation to the same bodies in CCB. The salient facts have been referred to throughout this Chapter. The Commission comes to the same conclusions as to their respective roles in the CCB story, and accordingly, they are discussed here but briefly.

The Minister of State (Finance) received hopeful information about Northland in the Inspector General's September 1984 report. In March 1985, the Inspector General further reported on the rigorous audit of 1984 and the bank's improving profit picture. The Minister was made aware of the workout strategy in June and of the future values in August 1985. Based on the July and August discussions with Northland management, the failure to effect a merger, and information received from the Inspector General from the OIGB portfolio assessment, the Minister decided to close the bank. There is little evidence to suggest that Northland was closed in order to "take the political heat" for the two bank failures at one time. Simply put, the bank was insolvent and no workable solution was available. All this is verified by the curator's later detailed analysis of the loans. The Minister took the right decision and could not have been expected to act earlier given the information provided by the OIGB, and upon which, the two Ministers, in all the circumstances, were entitled to rely.

The role of the Bank of Canada has been referred to throughout. The same issues arise here as did in relation to CCB, and the same comments made there apply here.

Chapter 6

Recommendations

A. Introduction: the Tripartite System

B. The Structure of the Regulatory Framework for Bank Supervision

   1. Consolidation of Federal Regulators
   2. Location of Regulatory Authority
   3. Regulatory Personnel
   4. Funding of the Regulator
   5. Advisory Committee

C. Internal Bank Management

   1. The Structure and Composition of the Board of Directors
   2. The Standard of Care and Fiduciary Obligations of Directors
   3. Directors' Criminal Liability
   4. The Audit Committee
   5. Management Qualifications
   6. Internal Inspection System

D. Auditors and Bank Auditing

   1. Appointment of Auditors
   2. Auditor Communication with Federal Regulators
   3. Accounting Principles
      a. Generally Accepted Accounting Principles
      b. Loan Valuation
      c. Loan Loss Provisioning
      d. Accounting Treatment of Loan Losses
      e. Accounting Treatment of Accrued or Capitalized Interest and Fee Income

E. Regulatory Powers and Supervision

1. Introduction
2. Incorporation and Licensing
3. Reporting Requirements
   a. Loan Classification
   b. Nonperforming Loans
   c. Workout Disclosure
   d. Principal Factors in an Early Warning System
4. Selective Supervision
5. On-Site Inspections
6. Annual Inspections
7. Cease and Refrain Orders
8. Asset Valuation
9. Substitution of Management and Directors
10. Control of Self-Dealing
11. Regulation of Lending Practices
    a. Loan Concentrations to Individual or Connected Borrowers
    b. Regional and Sectoral Lending
    c. Workouts
12. Reports from Foreign Regulators

F. Bank Assistance Programs

1. Introduction
2. Institutional Capability
3. Elements of a Bank Assistance Program

G. Securities Regulation and Disclosure

H. Miscellaneous

1. Role of the Regulator as Liquidator
2. Liquidity Advances
3. Deposit Insurance Coverage
4. Direct Rights of Action against a Bank and Others

Chapter 6

Recommendations

A. INTRODUCTION: THE TRIPARTITE SYSTEM

This Commission was asked to inquire into the causes of the failures of the Canadian Commercial Bank and the Northland Bank, and to make recommendations for changes in the regulatory framework insofar as they were called for by the evidence and submissions. The two banks investigated, by assets, represent a failure of less than one per cent of the Canadian banking system. The large banks in the system clearly are not exposed to the same serious risks which developed in CCB and Northland. The lessons which can be learned from the preceding narrative and findings relate mainly to the effectiveness and accountability of the regulatory processes and institutions which are entrusted with the supervision of the banking industry. Broader questions relating to the Canadian banking system and its associated regulatory environment, the ownership of Canadian financial institutions, the segregation of banking from other financial activities, the establishment of bank holding companies, and associated changes to financial institutions in Canada, are beyond this Commission's mandate.

The basic issue to be faced by the community is whether a bank is any different from any other commercial enterprise so far as government intervention in the case of insolvency is concerned. If the bank is seen as a quasi-public institution, analogous to a public utility, then the response is quite different than where the bank is seen as an ordinary example of private commercial enterprise. Most recently, this issue has been seen in debate in the United States. In that country, debate has moved into a second level. Assuming that there is a high degree of public interest in banking, such as distinguishes a bank from an ordinary trading corporation in the private enterprise market, is it even then permissible to segregate the banks into two groups, one group being seen as essential to the welfare of the community, and therefore placed in a "fail safe" or "no risk" banking category, and all other banks being classed as ordinary private commercial enterprises. Allowing investment in a bank which has been placed in one or the other category, when the investor does not know which category, raises a serious question of fairness. On the other hand, an investor in the banking field, knowing that the ultimate "fail safe" category will not be assigned to any bank until necessity brought on by imminent failure arises, will take his chances in investing in banking in the same way as he does in any other industry where risk prevails. Banking would then be a two risk industry. There is first the risk that the investor will choose the wrong category, and second, the normal risk that the bank chosen will go into default. However, the situation is not as unusual or unfair as that would indicate because in "essential bank" rescue programs, the investor of capital, as broadly hereinafter defined, loses out in the first round of the rescue. Where the troubled bank falls into the "nonrescue" category, the investor again will lose his investment depending upon the availability and extent of reorganization of the bank by private means. The depositor is insured in both cases so that his loss will depend upon the size of the deposit (except where made in a bank which thereafter comes under a bank assistance program as discussed later in this Chapter).

This nation already has a rough and rather primitive process for selection of banks for rescue. In the case of CCB and Northland, this selection and rejection was done at the political level where the responsible Ministers with prior government approval determined to rescue one bank, and later, not to rescue the other. In the United States, this decision is made administratively by the regulatory authorities. In England, the decision is made behind the thick screen of the Bank of England, and it is therefore difficult to determine the extent which the government of the day directs the decision of the Bank whether to rescue or not to rescue a bank on the brink of or in insolvency.

Lying at the bottom of all these considerations are political policies well beyond the mandate of this Commission. The extent of the regulatory system involving the licensing of new banks and its reach in the case of impending insolvency depends upon a number of factors including: (a) the degree of competition desired by the government in the banking system; (b) the need in regions of the country for locally based or locally oriented banks in order to extend the service beyond the larger centers of population; (c) the view taken by the government of the importance of the Canadian banking system in its international relations which may feed back into and enhance the desire to maintain the integrity of the banking system in the domestic arena; and (d) whether the government should adopt a policy of universal compensation for all depositors and investors other than equity holders in a bank such that the aperture of the rescue program will be much larger and the aperture for new entrants into the banking system much narrower.

Once it had been ordained that CCB would be the beneficiary of a rescue program and this decision was announced to the public, it became logically and perhaps politically inevitable that the government would either maintain the existence of CCB at all costs, or alternatively, would compensate all depositors of the bank should it ultimately fail. Thus, what has developed from this crisis is not so much a policy of universal compensation of creditors caught up in a bank failure, but the recognition that a decision to save a bank carries with it, almost inevitably, the obligation to either see the bank through the crisis one way or another, or to pay off in full all persons at loss in the failure, other than capital investors broadly defined.

So long as banks are to be commercial enterprises as now provided in the *Bank Act* they should be regulated so far as reasonably possible as being mortal in the same way as any other free enterprise. In some circumstances it will be in the interests of the community to let a bank fail. This is a bedrock discipline in the incentive system of commerce. If it is to be otherwise there would be no need for proprietary banks. It follows that an inspection system should not be so designed as to assure that whatever the cost no bank shall fail. Nor should the supervisor be so all-powerful and omnipresent as to effectively replace management and strip the bank of all enterprise. Ordinarly, free enterprise connotes the risk of failure. Banks should not be an exception to the theorem. The regulatory system is required to protect those who deal with the bank from impropriety and incompetence so far as reasonably possible. Some responsibility for reasonable conduct in their own affairs must be left in those who deal with the bank in whatever role or capacity. There is as well the need to balance the cost of a regulatory system against the risks to which the community should be exposed. This is a balance which has been long sought here and in other countries, and the recommendations which follow are advanced in the hope that a reasonable balance between risk and safeguards can be restored under the banking legislation.

For the purposes of proceeding with the development of a recommended design of a modified regulatory system, this Commission has assumed that the policies currently adopted, expressly or inferentially, will remain in effect in the foreseeable future. Therefore, it is assumed that the confidential supervisory system applicable to banks at present will be continued, and that given the appropriate circumstances in the future, the government of the day may determine to come to the aid of an ailing bank where its continued existence is considered necessary and advisable in the public interest. Other banks may be allowed to disappear through merger or liquidation or, most rare of all, by a simple surrender of charter.

Before dealing with the proposed structure for the confidential supervision of banks the alternative degrees of supervision should be examined. Much was heard in evidence of the contrast between the regulation of banks in the United Kingdom and in the United States, each of which have comparable financial institutions. As will be seen in Appendix B to this Report, the U.K. system upon which the Canadian regulatory agency was based at the outset, is a function of the central bank, the Bank of England. The central bank's inspection staff is small. The inspection concept is based upon moral suasion by the regulator and reliance by the regulator on management and on the external auditors for its information concerning the bank's operations. This is an economical system and appears, at least until recent years, to have served its constituency well. An increasing number of failures since the early 1970s, culminating in one serious and expensive failure in 1984, led to a re-examination of the concept in operation of the central bank's inspection service. Many of the recommendations made by a Bank of England review committee in 1985 and incorporated in a subsequent White Paper reveal a trend towards a more penetrating observation process in the bank supervision branch of the central bank, at least where the bank in question is assigned an unsatisfactory rating by the inspectors. The proposals made in the United Kingdom will, if adopted, partially separate bank supervision from the other functions of the Central Bank. They will also move the thrust and mechanics of bank inspections somewhat closer to the U.S. philosophy of inspection. The Inquiry has adopted some of the proposals of the Committee made in the U.K. studies in the following recommendations where those proposals would complement and fortify the Canadian format.

The U.S. federal bank supervision procedures are much more heavily slanted to the administrative process and involve very little political input from either the executive or the legislative branch. The inspection of banks, while confidential and based upon the prudential banking principles as in the United Kingdom, is not reliant upon management or external auditors for information, and indeed, the latter are rarely brought into the process at all. The public inspector performs a "hands-on" assessment, through its own staff, of the loan portfolio and loan management practices, and of the accounting principles applied by management in the preparation of the financial statements of the bank. This is a large and expensive business, although much of the cost at the federal level is borne by an assessment on the banks themselves. The cost is many times the proportionate cost of the Canadian system, where the costs are borne in the same way.

The federal/state constitutional authority is settled in a manner not dissimilar to the Canadian constitutional situation. What is very different is the proliferation of federal agencies engaged in banking supervision with some overlap and some confusion as to responsibilities. The several States likewise have supervisory agencies. Through a semi-formal association, the federal agencies have minimized the friction this complex machinery produces, although one expert from the United States described all this to the Inquiry as a "Rube Goldberg device that they would not wish on anyone". The relation between the federal regulators and state incorporated banks is contractual. State banks wishing to avail themselves of federal services, such as deposit insurance, voluntarily submit to federal supervision as a term of the plan. State and federal inspection of the state banks is coordinated on a semi-formal, but apparently effective, basis.

Because the U.S. supervision system is so expensive, and because of the relative smallness of the Canadian banking community, some of the features of the U.S. hands-on inspection philosophy are not here recommended. The Commission concludes that, on the evidence, the present basic principle of the tripartite system, as described in Chapter 3, should be retained. Radical change is not indicated. Defects exposed by these failures call for many adjustments as proposed below, but neither a return to the older English system nor the adoption of the "hands-on" U.S. system is recommended. While several elements of the U.S. federal regulatory system and some proposals in the U.K. White Paper seem appropriate for adoption in our country, and these are recommended below, this Commission has heard nothing in its review of the causes of failure of a small percentage of the banking system in this country which justifies the adoption of a fundamentally different kind of regulatory system. The question, really, is how to improve the present system and how to instill in the regulator the will to respond to the trouble signals.

The Commission has assumed, for the purpose of making these recommendations, that the existing structure of the financial markets and the overall design of the regulatory framework applicable to financial institutions will continue to exist in Canada. There are simply too many uncertainties regarding the future of Canadian financial institutions, including the retention of the "four pillars" philosophy, the impact of proposals for free trade in goods and services, and the development of international financial markets, to premise recommendations on what can only be a guess as to the outcome of the many current studies and proposals.

In addition to the evidence relating to the operation of CCB and Northland, the Commission has reviewed a considerable number of private and government studies of Canadian financial institutions and the regulatory environment within which they operate. While some of the reports dealt only with nonbanking financial institutions, several considered, in a detailed fashion, the supervisory regulation of banks along with other financial institutions. The Commission has drawn on these reports for the purpose of informing itself of current proposals for statutory amendment. The studies and legislation which have been reviewed are:

1. Interim Report of the Royal Commission to Inquire Into and Report Upon the Affairs of the Home Bank of Canada, 1924.

2. Report of the Royal Commission on Banking and Currency in Canada (1933) (The Macmillan Commission).

3. Report of the Royal Commission on Banking and Finance (1964) (The Porter Commission).

4. The Regulation of Canadian Financial Institutions: Proposals for Discussion, Department of Finance (April 1985) (The Green Paper).

5. Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC), submitted to the Minister of State (Finance), (April 1985) (Wyman Report).

6. Report on the Canadian Commercial Bank, House of Commons Standing Committee on Finance, Trade and Economic Affairs (June 1985).

7. "Canadian Financial Institutions", Report of the Standing Committee on Finance, Trade and Economic Affairs, respecting a Document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion", (November 1985).

8. The Ontario Task Force on Financial Institutions – Final Report (December 1985) (Dupré Report).

9. Report: Subject-Matter of C-79, *Financial Institutions Depositors Compensation Act*, Thirteenth Report, Standing Senate Committee on Banking, Trade and Commerce (December 1985).

10. A study to Assess the Current Mandate and Operations of the Offices of the Inspector General of Banks (April 1986), prepared by Coopers & Lybrand for the Department of Finance.

11. Proposed amendments to the *Loan Companies Act*, the *Trust Companies Act*, the *Bank Act* and the *Quebec Savings Banks Act* in respect of certain regulatory matters, (April 1986) (Bill C-103).

12. Towards a More Competitive Financial Environment, Sixteenth Report, Standing Senate Committee on Banking, Trade and Commerce, 1 May 1986.

13. Financial Institutions in Transition: An Analysis and Commentary on Recent Proposals for Reform of Canadian Financial Institutions, prepared by Clarkson Gordon/Woods Gordon.

14. Report of the Committee Set up to Consider the System of Banking Supervision (United Kingdom) (The Leigh-Pemberton Report, June 1985).

15. White Paper on Banking Supervision (United Kingdom) (Cmnd. 9695, December 1985).

16. Blue Print for Reform: The Report of the Task Group on Regulation of Financial Services (July 1984) (The Bush Report).

17. Continental Illinois National Bank: Report of an Inquiry into its Federal Supervision and Assistance.

18. Staff Report to the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, H.R., 99 Cong. (1st Session) July 1985.

B. THE STRUCTURE OF THE REGULATORY FRAMEWORK FOR BANK SUPERVISION

1. Consolidation of Federal Regulators

The institutional structure for the federal bank regulatory system was the subject of a brief review in the Report of the Royal Commission on Banking and Finance in 1964, the main thrust of which did not concern the examination of loan portfolios, bank accounting and other matters associated with bank failures. Debate on the regulation of banking has recently been revived by the publication of the Green Paper on The Regulation of Canadian Financial Institutions in April 1985, after the CCB Support Program was in place. The Green Paper proposed the consolidation of the trust and loan company supervisory functions, now allocated to the Superintendent of Insurance, with the supervisory functions of the OIGB. The House of Commons Standing Committee, in its response to the Green Paper, went further, recommending the consolidation of the OIGB, the Department of Insurance and the CDIC into a single regulatory body performing supervisory, regulatory and insurance functions in relation to insurance companies, federal trust and loan companies, and banks. The Senate Committee, in direct contradiction to that recommendation, opposed a "single, all-powerful regulatory body", and recommended the retention of the existing regulatory structure.

There are five basic alternatives for the structure of bank supervision in this country:

1. Retain the Inspector General as a regulatory officer responsible to the Minister of Finance, separate from the central bank and insurance functions, perhaps with enhanced accountability through the establishment of an independent board of directors or similar internal governance structure.

2. Integrate the Inspector General's bank supervisory function into the Bank of Canada, coupled with the establishment of a committee of the Bank of Canada's Board of Governors to oversee the new supervisory function.

3. Establish a super-regulatory agency with jurisdiction over banks, insurance companies, and trust and loan companies as recommended by the House of Commons Standing Committee on Finance, Trade and Economic Affairs.

4. Adopt a market model of regulation through the establishment of a disclosure system at the national level which would regulate distribution of and trading in bank securities in the same way as any other business enterprise.

5. Combine the Inspector General's supervisory functions with the CDIC, which, as the insurer of the public's deposits, would determine its exposure to risk by its own supervisory activities.

This Commission heard considerable testimony and argument on the basic structure of bank regulation, and received briefs from many of the Inquiry's participants on this issue. The only conclusion which can be drawn from the materials considered is that no clear majority position has developed. The entire range of alternatives has been considered, without anything approaching unanimity from the major players in the Canadian financial industry. At the same time, it is recognized that the continued existence of a number of supervisory regulators can lead to unnecessary costs, and duplication of regulatory activities.

There was, admittedly, some support for the first option. The Royal Bank of Canada concluded that the OIGB should be combined neither with the Superintendent of Insurance nor with the CDIC. Several of the experienced bank auditors who appeared at the Inquiry similarly opted for the first alternative of leaving the inspection, insurance, and central bank functions separate. The Minister of Finance took the position that the functions of the Inspector General and the Superintendent of Insurance should be combined, leaving the present regulatory structure otherwise intact.

Notwithstanding those submissions, the present regulatory structure clearly has not succeeded in preventing the considerable expense associated with a serious disruption of Canada's banking system. The major difficulty appears to be not the lack of adequate information-gathering systems, but rather the failure of the Inspector General to respond to the signals as received. The question therefore reduces itself to this: How can one build into the present system the incentive and the will to intervene in a timely fashion so as to reduce to a minimum the risks to depositors and investors, and the cost to the community associated with the liquidation of a bank? The present system clearly does not represent the answer, and simply combining the functions of the Superintendent of Insurance with those of the Inspector General would probably be equally ineffective.

Nor is the alternative of reorganizing the OIGB to include an independent board of directors attractive. It would be difficult to interest experienced people with the qualifications necessary to make the agency more responsive to its designated responsibilities, but without conflicts of interest, to devote sufficient time and effort to the responsibilities of the office. Active bankers would, of course, have a direct conflict of interest of major concern if they were privy to current information from the regulated financial enterprises. Representatives of the other federal financial regulatory agencies would not experience this type of conflict, but would suffer from an added supervisory burden unrelated to their primary responsibilities. The business community would no doubt be the most fertile ground to explore for nominees to a supervisory board, but it would be difficult to find people whose experience would contribute to bank supervision. The position of a part-time member of such a board of directors would not likely be an attractive appointment in the minds of business and professional leaders, particularly where the board would have a very restricted policy input.

There was no support for the second alternative in any of the submissions to or testimony at the Inquiry. The major banks were ambivalent towards, and the CBA would not recommend, combining the primary regulator with the Bank of Canada. Similarly, the Minister of Finance, through his counsel, did not recommend this consolidation. Finally, the Bank of Canada itself, through the Governor's testimony, pointed out that there was perhaps an inherent conflict between the bank supervisory function and the role of advisor to the Government of Canada on monetary policy. However, the Bank of Canada and the primary regulator of banks come routinely into immediate contact and a large measure of harmonious cooperation between them is necessary. The Bank of Canada requires, and in fact obtains, details of the operations of the chartered banks which it reviews in connection with its functions relating to monetary policy and fiscal management of the national debt as the Government of Canada's agent. As well, the Bank of Canada must turn to the Inspector General under the present regulatory system for advice on the issue of bank solvency in deciding on the wisdom of continuing liquidity support. Further, when it requires information from the Inspector General pertaining to the value of the security, it must, under the *Bank of Canada Act*, take to protect the short-term loans it makes to banks as the lender of last resort. The Bank of Canada's need for advice and information with respect to members of the banking system on these matters is exemplified by the events surrounding the collapse of the CCB and the Northland Bank. Consolidation of the supervisory and liquidity support functions would have eliminated the exchange of correspondence, which took on almost comical proportions, between the Inspector General and the Bank of Canada concerning the solvency of these banks on 1 September 1985.

Despite these advantages of consolidation of regulatory functions in the central bank, the fact remains that the Bank of Canada's operations, as described in Chapter 3, seem to be devoted principally to the development of monetary policy, to advising the Government of Canada in that connection, and to the management of the national debt. There would seem to be very little mutuality of interest in regulatory and central bank functions, and very little in the way of mutual support between them. Indeed, as the Governor of the Bank of Canada and others in testimony and submissions have pointed out, an actual conflict of interest may easily arise if they are combined in the same body. Finally, the lack of enthusiasm for this solution amongst the leaders of the banking institutions, both public and private, cannot lightly be disregarded. While central bank and regulatory functions are combined, apparently without serious adverse consequences, in the United Kingdom in the Bank of England, and to some extent in the United States in the Federal Reserve Board (for further details on these systems, see Appendix B), evidence before this Inquiry does not reveal compelling reasons for restructuring the Canadian banking regulatory system along similar lines. It is noteworthy that in the United Kingdom, a partial separation between the inspection and central banking functions of the Bank of England has recently been recommended. Both the Leigh-Pemberton Report and the government White Paper on Banking Supervision recommended the installation of a semi-autonomous committee within the Bank to advise the Governor on the banking supervision function. That proposal is a blatant compromise between the desire to segregate inspection from central banking, and the desire to continue the traditional concentration of authority in the Bank of England. The experience in the United States is likewise of little persuasive value. There, the Federal Reserve Board, acting through its regional Federal Reserve Banks, is the lender of last resort and acts as the central bank, advising the government on fiscal issues and monetary policy. It also regulates state-chartered member banks in the Federal Reserve System through hands-on inspections. It is of some significance, however, that the principal inspection function in the United States, with regard to the nationally chartered banks, is discharged not by the FRB but by the Office of the Comptroller of the Currency. The FDIC supervises state banks which are not members of the Federal Reserve System but which voluntarily join the FDIC insurance scheme. The actual overlap between the central bank and inspection and regulation functions is not, therefore, as extensive as it would at first appear to be. There are, however, three federal inspection forces, one of which is operated by the FRB, the central bank.

As discussed in Chapter 4, it seemed natural in the eyes of all participants at the onset of the crisis of the CCB in March 1985, to turn to the Bank of Canada as a dominant central institution in the restructuring of the bank, and in the protection of the banking industry as a whole. However, the Bank of Canada had neither the statutory mandate nor the staff to lead in the design and implementation of a rescue program. Nor could it have supervised the ultimate liquidation of the two banks. The central bank had its own problems as a ranking secured creditor of these banks. The consolidation of primary bank regulatory functions currently performed by the OIGB in the Bank of Canada is therefore not recommended.

The mandate of this Commission of Inquiry is not sufficiently broad to require the examination of all the considerations which should be examined in order to form a judgment on the advisability of the third option, creation of a super agency at the federal level for the supervision, regulation, and control of all financial institutions. The Commission has, however, encountered functional considerations which appear to militate against the combining of the regulation of the essential banking functions and other financial, but otherwise wholly unrelated, functions of businesses such as insurance companies. This issue also raises constitutional and other important questions relating to federal-provincial policies with respect to the sharing of the administration of a field where there is increasing overlap in the market place between federally and provincially organized undertakings. No recommendation is here made in respect of this issue in view of the limited terms of reference of this Inquiry. It should be said, however, that nothing in the extensive record here established supports this third alternative.

The shift from confidential prudential supervision, which is the current basis of bank regulation in this country, to a surveillance and regulation of the banking system through a disclosure system oriented to security trading, is the fourth option. It, too, is well beyond the mandate of this Commission. The constitutional and other considerations associated with the issue of national securities distribution and administration are complex, extensive, and important, and have not been examined by this Commission of Inquiry. It may be noted that this matter has been under serious discussion in the United States, but the ultimate solution has yet to emerge.

Precedent can be found for the fifth alternative in the Federal Deposit Insurance Corporation in the United States. As will be seen in Appendix B, this is a large and highly regarded element of the federal regulatory system concerned primarily with the insurance of deposits in both federal and state banks, the latter being on a voluntary basis. The FDIC has built up a very substantial inspection service of some 1,500 inspectors who engage in the so-called hands-on supervisory system in the inspection of some 9,000 state banks. The FDIC also functions as the liquidator upon the insolvency of banks insured by it, however incorporated, and is the principal directing force in those rescue programs instituted where the federal agencies, mainly the FDIC itself, have determined that the bank in question is an "essential bank". Because we do not have the proliferation of federal agencies involved in the various elements of control of the banking system, in Canada the scene is much simpler, and the proposals which the Commission advances bring very little complication to the presently existing structure. The recommendation, as intimated above, commences with a basic acceptance of the present tripartite confidential supervision of the banks with modification of techniques and roles of the several participants, as indicated below.

After extensive deliberation, the Commission has concluded that, notwithstanding the absence of support for this concept from the federal agencies and departments, the most logical of the alternative courses of action identified above would be to transfer the OIGB, complete with its present powers, organization, and personnel, to the CDIC, to form in that agency an inspection division. This alternative alone offers both efficiency and a structure that would be responsive to the danger signals emitted by a troubled bank. It is suggested that the new agency should be named the Canada Deposit Insurance Commission (CDIC).

There should be no doubt that the consolidated regulator-insurer should enjoy all the regulatory powers currently exercised by the OIGB. It will also exercise additional regulatory powers, to be discussed below, in association with related issues and problems. As the existence, structure, and funding levels of the insurance function are beyond the terms of reference of this Inquiry, discussion of this alternative assumes the continuation of deposit insurance in its present form. Consolidating regulatory and deposit insurance functions would eliminate the conflicts of interest which present themselves in the second proposal considered above. Furthermore, by putting the insurer in a position to protect itself effectively through confidential supervision of the insured banks, this alternative recognizes and appeals to natural human instincts. It recognizes that the insurer has the incentive to act on information received to reduce to a minimum the risks it faces in any failure. It is precisely this incentive or will to act which was so graphically illustrated to be lacking in the institutional forms of the existing regulatory scheme.

The decision as to when liquidity advances should cease, and liquidation and insurance consequences begin, also seems naturally to center in the insurer. Although changes to the existing regime will be recommended, it is noted that under ss.27 and 29 of the *CDIC Act*, the CDIC may make application under the *Winding-up Act* for the appointment of a liquidator and may act as liquidator. In fact, the CDIC has not played this latter role, but rather has caused the appointment by the courts of an auditor-liquidator, or has acted as *de facto* liquidator itself when it is determined that the more economic route is the run-down of the assets and the ultimate surrender of the bank's charter instead of formal liquidation. Thus, the present law provides two routes which may be followed in dealing with an apparently insolvent bank. If clearly insolvent, the insurer can now, under its statute, institute the liquidation process on its own motion. If not clearly insolvent, or, if for any reason it may be impolitic to pursue this legally clear route, this issue may be transferred to the Minister of Finance by the Inspector General's recommendation for the appointment of a curator, and perhaps the commencement of liquidation proceedings. This approximates a crude and not very workable form of the "essential" bank process employed in the United States under the FDIC legislation. However, the U.S. pattern of decision-making relating to the termination of a bank is focused at the administrative, rather than at the political level.

In view of the considerations underlying its recommendations to consolidate regulatory and insurance functions, it is the view of the Commission that the new regulatory body should be subject to the direction and management of a small, highly skilled group of individuals. The CDIC will, as discussed below, inherit the function of the Inspector General of approving a prospectus in connection with the issuance of bank securities under the *Bank Act*. This is not so much a policy function as a protective procedure, administrative in nature, to ensure that investors in banks make their investment decisions on all relevant information. This same function is exercised by the provincial securities commissions. The bank supervisory function is also a protective function entailing little in the field of policy development. The supervisor is thus engaged principally in administering legislative policy as detailed in the *Bank Act*. These functions do not fit easily into the mould of a policy-oriented Crown corporation administered by a part-time board of directors. For these reasons the organization is recommended to be in the nature of a three-member commission, operational in nature, appointed on a full-time basis for fixed terms by Order in Council.

It is possible that the same self-interest which would motivate the CDIC to act expeditiously to enforce prudential banking standards might also, in certain circumstances, tend to lead it to disregard wider community interests which might be served by different practices. The *CDIC Act* currently provides, in s.11, that the CDIC may place public funds at risk only for the purpose of reducing a risk to itself. No such restriction on the provision of assistance to financially troubled banks should be included in legislation creating an insurer with primary regulatory functions. Rather, the legislation should provide that, in insuring a deposit-taking corporation, and in deciding whether and how to invoke regulatory powers in relation to such a corporation, or whether to recommend to the Minister the liquidation or termination of its business, the CDIC should have regard to a wide range of factors, including the national interest in the stability of the banking system as well as the likelihood of loss to itself. This would formally recognize in the system the so-called "essential bank concept" as a conscious step in the administrative processing of serious liquidity and solvency problems in a bank.

Recommendation 1

It is recommended that the supervisory functions now exercised by the OIGB be consolidated with the insurance functions now exercised by the CDIC in a newly constituted Canada Deposit Insurance Commission.

Recommendation 2

It is recommended that the regulator be a three-person commission, the members of which would be appointed by Order in Council and serve as full-time Commissioners for an appropriate term of not less than five years. The statute should provide that one such appointee shall be a banker of not less than ten years' experience in senior bank management; that a second shall be a member of the accounting profession and shall have not less than five years' experience in bank auditing; and that the third shall either be appointed from the insurance business with a minimum of five years' experience in senior management, or from the general business, professional or senior government service community. The Chairman of the Commission should be designated by Governor in Council, should serve for a term of five years subject to renewal for a further term of five years, and should also be the chief executive officer. The Chairman shall report and be responsible to the Minister of Finance or his delegate, the Minister of State (Finance).

Recommendation 3

It is recommended that the new agency be directed to take into account all factors affecting the public interest in exercising its regulatory responsibilities with reference to the financial conditions and continued existence of a bank.

2. Location of Regulatory Authority

At present, the offices of the Inspector General are located in Ottawa. However, the principal centers of banking are located elsewhere. By s.4 of its Act, the CDIC's Head Office is in Ottawa, but it may establish regional offices. All parties who have addressed the issue of the location of the regulator, including the OIGB, the Minister of Finance, and some of the major chartered banks, have recommended that regional offices be established. The same conclusion was reached by Coopers & Lybrand in their comprehensive study of the functioning of the OIGB. Decentralization of the regulator is the practice in the United States.

Recommendation 4

It is recommended that legislation constituting the regulator adopt the policy inherent in s.4 of the CDIC Act. The headquarters of the primary bank regulator should continue to be located in Ottawa, to facilitate the necessary dialogue between it and the responsible branches of government and the Bank of Canada, but the regulatory authority should be authorized by statute to establish branch offices anywhere in the country as required to assist in its inspection and supervisory functions.

3. Regulatory Personnel

The Commission has received detailed submissions on the staffing of the bank regulatory body. The present staff complement of the OIGB is widely perceived to be inadequate to the task of regulating the large number of Schedule A and B banks. To remedy this, it was proposed by the Canadian Bankers' Association, the OIGB itself, and other parties, that the staff of the regulatory body be augmented by the appointment of professional bankers and bank credit officers, auditors, financial analysts, appraisers, economists, and statisticians. The Coopers & Lybrand report on the OIGB recommended that the staff be increased from 42 to 73 members, and it would appear from submissions to the Commission that such an increase has been approved and that the engagement of suitably experienced personnel has commenced. The CDIC presently has a small staff of about 25. This represents a significant expansion in recent years. The insurer has developed considerable expertise in management of bank assets and is advised by a committee of real estate experts.

Since the events of 14 March 1985, the Inspector General, as well as the banks themselves, has acknowledged the need on occasion to perform on-site an examination of loan files of a bank. This move away from the U.K. tradition of supervision to something closer to the U.S. system is acknowledged by all players in the events leading to the closure of CCB, including the major banks who participated in the support program. It seems to be a permanent adjustment to the tripartite system of supervision and regulation, at least in the case of small or new banks where loan portfolios may not be diversified. This change should be reflected in the size and nature of qualifications of the staff of the bank regulator.

In the Commission's view, it is essential that the expertise referred to above be represented on the staff of the regulator on a permanent basis. However, its personnel requirements need not all be satisfied by the appointment of permanent staff members. Persons with experience as bank managers or executives, for example, may not realistically be available to the regulator on a permanent basis. As matters now stand, personnel of the OIGB are subject to Public Service Commission guidelines, and public service salaries in the relevant categories are not always competitive with those in the financial industry. Testimony from Canadian bankers and U.S. regulators recognized the difficulty of attracting and retaining such personnel in the regulatory staff. An executive interchange program currently in place in the Public Service Commission, whereby experienced individuals from the private sector are temporarily seconded to the public sector, has been extended to the OIGB. In submissions to the Inquiry, it has been recommended that this program be maintained and expanded. Other forms of exchange with the private sector are already in place or were recommended. The OIGB is presently making use of training programs sponsored by the CBA, by Canadian and U.S. banks, and by foreign (mostly U.S.) regulatory agencies. The Minister of Finance has indicated that an "executive interchange" program, which contemplates temporary secondment of permanent executive members of the regulator's staff to the private sector for training purposes, as well as the inflow of private sector executives to the regulator, is in the process of being implemented. A similar two-way secondment program was recommended for the British system in the Leigh-Pemberton Report. A group of recently retired bank credit personnel has been formed to assist the OIGB in loan examinations. Members of this group are being engaged as needed on personal service contracts to undertake special credit reviews. This source of the requisite skills has the advantages of availability and the absence of conflicts of interest.

It is agreed that there is a need for an increase in both the numbers and the expertise of regulatory staff, and for flexibility in achieving staffing requirements. The aim should be to establish a small but highly competent team of regulators, supported by a pool of independent, qualified personnel, for bank inspection as required. Two-way secondment between the regulatory staff and the banks would be mutually advantageous. This will entail the increase of both permanent staff and personnel engaged by contract for specific tasks.

Recommendation 5

It is recommended that the inspection staff of the regulator be increased by the addition of qualified and experienced bank auditors and bank credit officers. Existing staff expertise should be upgraded through access to appropriate training programs, whether developed by the regulatory body or offered

by private industry or foreign regulators. There should be maintained a program of personnel and executive exchange, either by two-way secondment or other arrangement between the regulator and the regulated banks, as well as a regular program whereby bank credit and audit personnel are used on a temporary or recurring basis in the examination of bank loans and other assets. Where use of active personnel is not practical, retired bank personnel should be engaged by the regulator as required.

4. Funding of the Regulator

At the present time, the cost of the inspection service of the OIGB is paid by levy on the banks. There has been no submission to this Commission that this system of bearing the cost be changed. The inspection service is no doubt run in the community's interest in sound banking as well as for the benefit of the banks themselves. Historically, the cost of service has been reimbursed from the banking system itself, although the scale of staffing and salaries has been determined by the Treasury Board. This system has perhaps provided a check or balance on the regulator and the Treasury Board in the establishment of appropriate staff levels. The Commission does not make any recommendations for change. By the continuance of the tripartite confidential supervisory system, the considerable cost of "hands-on" supervision in the U.S. style can be avoided, and the cost of bank supervision can continue to be borne by the banking industry, as at present. Likewise, nothing has been brought forward which indicates that the present system of funding deposit insurance should not be continued. As said at the outset, a continuation of the present depositor insurance is assumed for the purpose of considering matters within the mandate of this Inquiry.

Recommendation 6

It is recommended that the present system, whereby the cost of deposit insurance and of bank supervision is recovered by levies on the financial institutions covered by these services, be continued.

It can reasonably be anticipated that when the regulator in its newly-established form has absorbed the regulatory staff and functions of the OIGB, and consolidated its organization, it may well be determined appropriate for it to take over the inspection and administration on the same prudential supervision basis (modified as herein recommended) of all deposit-taking institutions within the jurisdiction of Parliament together with any other deposit-taking institutions established by a province where that province has entered into an agreement with the CDIC providing for the insurance and inspection of the corporations. The organization here recommended would be capable of undertaking the additional responsibilities.

5. Advisory Committee

The role of the regulator, constituted as described in the foregoing sections, will be important in maintaining the strength and stability of the Canadian banking industry. It is recognized, however, that the regulatory body must be responsive to the needs and realities of that industry as it constantly adjusts to the needs of the community as well as to Canada's international banking interests.

In light of the rapid transformation of the financial services sector and development of new investment instruments, it is unlikely that the regulator could, on its own, maintain full awareness of the developments in the industry. Once the essentials of the inspection and external audit system as described in later recommendations are in place, there should be established an Advisory Committee to assist the regulator in the performance of its regulatory responsibilities. While none of the reports which the Commission reviewed contain recommendations for the establishment of an Advisory Committee as such, some of the banks and other parties proposed the establishment of an advisory body of some kind. The CICA informed the Commission that it, in cooperation with the CBA and the OIGB, has established a task force to develop an Issues Paper to identify and examine the rationale behind the accounting principles and practices followed by Canadian banks. The bank auditor witnesses discussed the need for constant development of accounting and audit principles for the better administration of banking and bank supervision. The Commission agrees with these views and recommends the establishment of an Advisory Committee to function as an element in the regulator, providing support and advice on a continuing basis, relating particularly to the preparation and adoption of technical guidelines and the settlement of the many differences which arise in the application of the principles of accounting to banking and bank auditing.

The membership of the Advisory Committee should include representatives from banking, including bank management, auditors, and internal inspectors, from the auditing profession at large, and from the legal profession, and may also include representatives of the community interest generally. Appointment of its constituent members should be made by Order in Council. In particular, the Advisory Committee should be directed to respond to questions submitted by the regulator and to make on its own initiative recommendations concerning bank regulation, the supervisory system in all its phases, and principles of accounting applicable to deposit-taking institutions or which are generally applicable in the discharge of the statutory duties of the regulator. In addition to the specific issues which are herein recommended for referral to the Committee, the general responsibilities of the Committee should include the development of guidelines for bank accounting, internal control and audit systems and standards for bank auditing, the development of early warning systems for regulators and banks, and the provision of information to regulators about current developments in the financial services industry.

The Advisory Committee should have such staff, or access to such staff, as may be appropriate to its activities from time to time.

Recommendation 7

It is recommended that an Advisory Committee be established, comprised of bankers, bank auditors, internal bank inspectors and accountants, lawyers and representatives of the community at large, to assist in the development of uniform guidelines for bank accounting, internal controls, and auditing, in the design of early warning systems and other returns, and in the improvement of published financial statements, and to provide the regulator with current information regarding the financial services industry. Appointment to the Committee should be by Order in Council on a part-time basis. As circumstances may from time to time require, the Committee shall have, or shall have access to, appropriate staff.

C. INTERNAL BANK MANAGEMENT

1. The Structure and Composition of the Board of Directors

Currently, the *Bank Act* imposes few requirements on the composition and structure of banks' boards of directors. Restrictions on personal suitability are limited to requirements that bank directors be over the age of eighteen, be of sound mind, be natural persons, and not have the status of a bankrupt. Interlocking directorships with other financial institutions are prohibited.

Several proposals in relation to the structure of the board were made to this Commission. Specifically, it was proposed that the board of directors be required to establish committees to deal with sensitive or critical areas of operation in the bank, including non-arm's length and conflict-of-interest transactions, among other matters. The Senate Standing Committee on Banking, Trade and Commerce, in its report on the Green Paper, recommended a three-person business conduct review committee to review all non-arm's length transactions. The Dupré Report, on the other hand, suggested that such a committee would be inadequate to guard against self-dealing abuses.

A proliferation of committees on a board of directors is not necessarily a sound solution to specific problems. Where there is a non-arm's length transaction, the board sitting as such would appear to be the more appropriate forum, and the same considerations apply in connection with conflicts of interest. Certainly, there is merit in providing guidelines for the resolution of non-arm's length and conflict-of-interest issues, but there are no obvious advantages associated with delegating responsibility for these matters to a sub-group of the board.

Recommendation 8

It is not recommended that the Bank Act be amended to require the establishment of a committee of the board to review self-dealing and conflict-of-interest transactions.

A submission which does have merit would require that where the board of directors does establish a committee, the specific mandate of the committee should be filed with the federal regulatory body. This would afford the regulator a firm basis upon which to assess the committee's performance of its assigned responsibilities within the corporate government.

Recommendation 9

It is recommended that where the board of directors establishes a committee, the mandate of the committee should be filed with the federal regulatory body.

The Inspector General and the directors of the CCB and the Northland Bank have submitted that the Chairman of the board of directors of a bank should not also be its Chief Executive Officer. All of the major banks take the opposite viewpoint. Much can be said on both sides of this proposal. The Chairman who sits as CEO is indeed an imposing member of the board, and may perhaps be in a position to exert undue pressure on board members when matters critical of management are raised. On the other hand, the effectiveness of the board is no doubt enhanced by the leadership afforded by the CEO sitting as Chairman. The proposal would not, of course, exclude the CEO from the board, but would simply preclude the same person being the Chairman. While it is considered that this issue is an important one, no sufficiently clear case has been made out for such a legislative amendment.

Recommendation 10

It is not recommended that the Bank Act be amended to prohibit a bank's Chief Executive Officer from also holding the position of Chairman of the board.

In addition to these matters relating to board structure, the composition of the board membership raises interesting and important problems, particularly in a country of the size and diversity of Canada. The *Bank Act* is silent as to geographic representation and as to representation of major bank customers. In the CCB, the shareholders, by agreement and corporate provision, initially had the right to representation on the Board commensurate with their shareholding investment. By contrast, in the major banks there is no relationship between particular directors and particular shareholder interests.

Considerable testimony was heard at the Inquiry as to the advisability of avoiding what may be referred to, for the sake of brevity, as the "CCB organization" of the board of directors. The Green Paper proposal, which was adopted in the submission of the Minister of State (Finance), would require that directors have "an appropriate blend of expertise, experience, and personal suitability". The Commons Standing Committee would go even further, and would mandate the establishment of a governmental registry of "suitable" persons who could become bank directors.

Some submissions proposed instead mandatory regional representation, while the majority of submissions argued that no legislative action was required. It is concluded that there is merit in the practice of the major banks of ensuring a wide range of business and geographical representation on the board, but that it would be impossible to legislate a uniform standard of board composition for the private financial sector. The Commission does not consider that the evidence indicates a need for any specific statutory qualifications for bank directors other than the usual requirement that board members have the capacity to discharge their duty of care under s.54 of the Act. Section 35 of the present Act establishes a number of qualifications and disqualifications for directors, and the Commission sees no need to extend or modify those provisions.

Recommendation 11

It is not proposed that the Bank Act be amended to require additional director qualifications or particular board structures.

Section 36(3) of the *Bank Act* limits the permitted number of directors who are also officers or employees of the bank or of an affiliate of the bank, to 15 per cent of the board. This is required by the necessity for independent directors for functions such as membership on the audit committee. Section 36(3), however, additionally provides that "up to four persons who are officers or employees of the bank or of an affiliate of the bank may be directors of the bank if those directors constitute not more than one-half of the directors of the bank". This provision is sufficiently ambiguous to require revision. It may be that the regulator should be able to relieve against the 15 per cent requirement in special circumstances, but as the Act now stands it permits a bank to have 50 per cent of its directors drawn from the ranks of its employees provided that the board of directors does not exceed eight in number. Surely this is arbitrary and serves no purpose.

Recommendation 12

It is recommended that s.36(3) of the Bank Act be amended to provide that employees and officers can constitute a maximum of 15 per cent of the board, subject to exemption on the authorization of the regulator.

2. The Standard of Care and Fiduciary Obligations of Directors

Various submissions have been made to this Commission and in the numerous reports relating to regulatory amendment to the effect that the standard of care of directors stated by s.54 of the *Bank Act* in managing and supervising the affairs of the bank is in need of change. Section 54(1) of the *Bank Act* states that the directors must, in exercising their functions, "act honestly and in good faith with a view to the best interests of the bank" and "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." The first provision states the director's fiduciary obligation. The second, which is the only statutory statement by which the conduct of the board and its members may be measured, establishes the statutory standard of care in negligence.

The Green Paper proposed that the standard of care of directors be reformulated as that of "an experienced business person qualified to be a director of a regulated financial institution". As well, the Green Paper proposed that the standard of diligence be increased by requiring attendance at three-quarters of board meetings, and by requiring that directors be well informed of the affairs of the company, and question the accuracy of information where the experience of the director would suggest that it was open to question. The report of the House of Commons Standing Committee, although it differs in detail, also recommended increasing the standard of care of directors, as well as the required degree of attention to the affairs of the bank.

There are several serious shortcomings in these proposals. First, they are made without reference to their ultimate purpose. The proposals make no reference to the person or institution to whom the directors are to owe this duty. If the duty is to continue to be owed to the corporation, the proposals should say so. If the director is to be made responsible to his electors, the shareholders, the provisions should be drafted with that express object. Similarly, a proposal that the directors should owe a duty of care to depositors, as was suggested in some of the submissions at this Inquiry, should explicitly so provide. Under the current common law rules, the corporation itself has a right of action against the directors, enforceable directly by corporate decision or by a shareholder's derivative action in limited circumstances. The standard of care is meaningless without consideration of its ultimate beneficiary, and without consideration of the legal methods of enforcement of the legal responsibility. Although none of the submissions at this Inquiry have raised the issue directly, the procedural and practical aspects of enforcing existing legal duties are undoubtedly as important as a reformulation of the standard of care.

Second, it is necessary to appreciate the limited ability of the courts to review, with reference to an increased standard of care, the business judgment of directors and managers of private enterprises. Nor is it clear that it is appropriate for the courts to engage in that task in circumstances not involving dishonesty or abdication of responsibility known to the law.

Third, changes to the legal duties of directors must have regard to their practical limits. For example, if the burden upon a director is too high, either in criminal or civil law, then the likelihood of electing responsible, competent citizens to the board of directors diminishes. This is particularly so where the person in question may have assets which would be exposed to liability, and where there is uncertainty as to the availability or coverage of directors' insurance, whether due to the economics of the insurance industry or to legal impediment. The bare threat of exposure to litigation is serious. Even a victory in court can be financially crippling today.

Fourth, a real difficulty facing the legislature in these circumstances is the question whether the standard of care for members of the board of directors of a bank should be universal and equally applicable to all directors regardless of their experience, professional training, or position on the board. For example, it may be that a chartered accountant acting as chairman of the audit committee should have a higher standard of care than a member of a consumer's group, selected by reason of that interest or position in the community, who does not serve on a committee. It is not clear that revising or raising the standard of care alone would produce any worthwhile results.

Finally, it is not clear that the standard of care suggested in the Green Paper would in fact significantly change the judicial interpretation of the existing standard. The latter, as it is expressed in general terms, is capable of considerable flexibility as the circumstances of the case warrant. It is true that there is a dearth of case law holding bank and other corporate directors liable in negligence rather than for breach of their fiduciary duties. This would appear to indicate, however, not that the existing standard of care is inadequate to the task, but that the courts are, as noted above, properly reluctant to second-guess *bona fide* business decisions.

The majority of those presenting submissions to the Inquiry expressed themselves as being content with the present provisions of the Act. The Inquiry has not been persuaded that any significant benefit to the community would result from redrafting the legislative standard of care.

Recommendation 13

It is recommended that no change be made to the standard of care of directors expressed in s.54(1) of the Bank Act.

There remains the important issue as to what persons should be entitled to recover for losses occasioned by breach of the director's duty of care. The Commission is of the view that the identity of the beneficiaries of the existing statutory obligations owed by directors is of paramount importance, since it is through enforcement of private rights of action that the directors and officers of a bank will be disciplined. The current derivative and corporate actions are inadequate, and it would seem that the persons actually injured by a director's default, whether shareholders, depositors, or the bank itself, should be able to pursue legal remedies for compensation. Thus, the duty in the directors as described in the present Act should be maintained, but the Act should be amended to extend the duty owed by a director.

Recommendation 14

It is recommended that the Bank Act be amended to provide that directors owe their duty of care to the corporation itself,

to the shareholders and to the depositors. The enforcement of the right arising from the duty should be by way of civil action.

The question of enforcement of directors' responsibilities and duties in law is entwined with the position of others connected to corporate operations such as auditors, underwriters, officers and regulators. It is appropriate to deal with these questions at one time and this is done in connection with Recommendation 46.

3. Directors' Criminal Liability

It has been proposed to this Commission that criminal liability be established in the *Bank Act* for gross negligence or willful disregard of the statutory standards governing the conduct of directors. The House of Commons Committee recommended, along similar lines, that the *Criminal Code* be amended to impose liability for gross negligence and for the making of reports which create "gross misunderstanding".

There is, however, no serious gap in the existing criminal law which the suggested offence would fill. The existing *Criminal Code* provisions relating to fraud are applicable to the actions of bank directors, insofar as the bank is thereby dishonestly deprived of assets. As well, the issuance of a prospectus which fails to provide full disclosure of material facts may constitute an offence under s.358(1)(a) of the *Code* to the extent that the prospectus is intended to induce a person to purchase shares. Other *Code* provisions are applicable where appropriate. There are also relevant offence-creating provisions in provincial legislation including those regulating the issuance and trading in securities.

The majority of representations to this Inquiry have not favoured an expansion of the criminal law to regulate banking activities, and it has not been demonstrated that the ordinary criminal laws and provincial laws that apply to the conduct of members of the board of directors are in any sense inadequate.

Recommendation 15

No changes or additions to the existing criminal law provisions applicable to corporate directors are required, and none are recommended.

4. The Audit Committee

A considered and serious proposal was made to the Commission concerning the right and duty of directors to communicate directly to the federal regulatory body. In particular, extensive discussion centered around the responsibilities of the audit committee required by s.243 of the *Bank Act*. At present the Act is silent as to the responsibilities of the audit committee except that s.243(3) requires it to review the annual financial statement and other financial statements required to be submitted to the shareholders. The Act requires that it be composed solely of outside directors.

The audit committee, as an independent arm of the board entrusted by Parliament with special statutory responsibilities, represents a critical junction in the flow of information to the regulators from the auditors, the bank's internal inspection system and management. Both the important prudential functions of the audit committee and its links as a representative body of the bank with the regulatory body require amplification in legislation. In addition, its independence from management should be strengthened by a power to exclude management from its meetings.

Recommendation 16

It is recommended that the Bank Act be amended to state the terms of reference, in a general way, of the audit committee. These statutory responsibilities should include, as well as their existing responsibility to review the audited financial statements in consultation with the auditors, the review of the bank's policies in loan loss provisioning, asset valuation, income recognition by accrual or capitalization of interest and the taking of and accounting for fees, and the capability of the management information system to reveal potential problems in a timely fashion. As well, the audit committee should be under a duty to satisfy itself that the bank's internal audit and inspection systems are adequate and functioning properly. The audit committee should be required to meet with the bank's internal inspectors or auditors at least yearly and at any time upon request, and to report on such meetings to the board. The audit committee may in its discretion meet with or without management present.

An essential adjunct to these information gathering activities is the communication of that information to the federal regulator. Currently, under ss.242(3) and (4) of the *Bank Act*, it is the duty of the auditors to report to the Inspector General, "any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification", and clarification and enhancement of those reporting responsibilities will be recommended. The audit committee should be under analogous reporting responsibilities. The committee also should have a clear statutory right to communicate with the regulator at any time, and should be obliged to meet with the regulator in connection with the annual inspection of the bank. As well, the regulator should be able to meet with the audit committee and to attend any meeting of the board of directors.

Recommendation 17

It is recommended that the Bank Act be amended:

(a) to add a duty in the audit committee comparable to that provided in ss.242(3) and (4) of the Bank Act in the case of the auditors;

(b) to expressly authorize the audit committee to communicate with the regulatory body;

(c) to require the Committee to meet, and the regulator to attend the meeting of the Committee, after the annual inspection of the bank, at which time a detailed summary of the regulator's findings should be communicated;

(d) to provide that the regulator or the audit committee may requisition a meeting of the board of directors at any time on reasonable notice; and

(e) to grant to the regulator the right to attend any meeting of the board of directors of a bank.

5. Management Qualifications

It is trite to acknowledge that experienced and competent management are essential to the success of a bank and constitute the first line of defence against bank problems. Indeed this was acknowledged by all who testified on the subject before this Commission. However, no formal mechanism by which the suitability of management may be made the subject of regulatory investigation or approval presently exists. Under s.28 of the *Bank Act*, the right to carry on the business of banking and to exercise the powers set out in Part V of the Act is conditional upon approval or deemed approval of the Governor in Council, but no rules governing the exercise of this discretion are set out in the legislation. Only foreign bank subsidiaries must obtain an actual license in order to carry on business as a bank. The Green Paper suggests that, in the decision to grant or renew a license to operate a financial institution other than a bank, the appropriate regulatory authority should consider the sufficiency of skills, knowledge and experience, and the past performance of senior members of management. Such factors may be considered on an informal basis in the incorporation process applicable to banks as well, but clearly need not be under existing legislation.

Submissions at this Inquiry have recommended that the engagement of competent management with a demonstrated record in head office and branch banking, including competence and experience in loan valuation and credit management, should be a prerequisite to authorization to incorporate a new bank and carry on the business of banking. The Commission is in accord with these suggestions.

Recommendation 18

It is recommended that the Bank Act be amended to specify that no approval for the incorporation or commencement in business of a bank or for the renewal of its licence will be granted without confirmation by the applicant, on a confidential basis, that qualified senior personnel with banking experience, particularly in the field of bank credit management, have been or will be retained on a permanent basis.

6. Internal Inspection System

The *Bank Act* does not require an internal inspection and audit department or the appointment of a Chief Inspector by the board of directors of a chartered bank. As was stated in Chapter 3, however, it is nevertheless the universal practice among schedule A banks to appoint a Chief Inspector and a substantial inspection force, or equivalent internal department, to monitor the accuracy of financial results through development and policing of internal control systems. In addition, the Schedule A banks possess a credit audit system, which may be combined with the inspection department or may exist separately in some other department.

Submissions at this Inquiry by the Inspector General, the Minister of Finance and some of the major banks have proposed that appointment of an officer to head an internal audit or inspection system of the bank should be stipulated by the *Bank Act* in order to strengthen the internal inspection division's independence and authority. Further, it has been suggested that the legislation should set out the essentials of this officer's duty and functions. These would be to examine and evaluate the lending process, credit limits, and control systems generally. In order to discharge these functions, this officer would require access to detailed and statistical information concerning, among other things, nonperforming or other unsatisfactory loans, diversification of bank assets, the deposit base, loan loss provisions and write-offs, and general economic information and inter-bank comparative studies in the possession of the bank.

The head of internal inspection or audit should, according to these submissions, have access to all relevant bank records and be required to report to management on all matters of concern. The Act should clearly provide as well that he is under a statutory duty to file reports relating to his functions with the external auditors, the CEO, and the audit committee of the board of directors, without reference to management. The Commission concurs in these proposals.

Recommendation 19

It is recommended that the Bank Act be amended to require that internal audit and inspection systems be established in each bank for the examination and evaluation of the loan portfolio, lending practices, credit limits and control systems of the bank, including the management information system. Personnel performing these functions should have access to all information in the possession of the bank necessary to permit fulfillment of these functions. The Bank Act should permit the Chief of these services to report directly to the CEO, the external auditors and the audit committee, as circumstances require, in respect of matters assigned to him, and to be available to the regulator at all times.

D. AUDITORS AND BANK AUDITING

1. Appointment of Auditors

No one with experience in bank auditing who made submissions at this Inquiry has recommended the abandonment of the current dual auditor system. One bank auditing firm did, however, suggest that a panel of three auditors should provide the requisite two auditors on a rotating basis, and the Inspector General argued that the current practice of using a permanent lead auditor undermines the original purpose of the dual auditor system, which was to maintain a strong measure of independence of bank auditors.

The Senate Standing Committee on Banking, Trade and Commerce in its reports on the Green Paper and on Bill C-79, recommended that one of the two bank auditors be appointed by the regulator in order to enhance the independence of the outside auditors, and to introduce an audit perspective that takes into account the interests of depositors as well as shareholders. The House of Commons Standing Committee's Report on the same subject made similar recommendations, proposing that an auditor be appointed by and report to the federal regulator, arguing that this "regulatory auditor" would enhance the ability of the regulator to monitor the financial institution and introduce the prudential concerns of the supervisor into the annual audit. The Inspector General and Minister of Finance recommended the so-called Belgium system, involving the appointment of one auditor by the bank's shareholders, and another by the Inspector General. This second auditor would report directly to the Inspector General.

No other parties appearing before the Commission supported the proposal that this system be adopted, and several considerations militate against it. The Coopers & Lybrand study of the operations of the OIGB suggests that the introduction of "regulatory auditors" would require the development of an auditing mandate and auditing responsibilities which are different from those employed by professional auditors. As well, the existence of two auditing standards would make difficult the coordination necessary to develop joint opinions on financial statements, and indeed, would create additional problems in resolving any impasse arising between the two auditors' reports. The proposal would engender additional costs associated with overlapping responsibilities, and may present risks of political influence. It would additionally create difficulties in resolving the conflict of interest which arises when a bank auditor must value its client's loan from a client bank, although the ability of the present, two auditor system to solve this problem, given that each auditor has a duty to discharge its functions vis-à-vis the bank unfettered by other responsibilities, may be overstated. Finally, the *Bank Act* already provides in s.238 for the independence from the bank of the shareholders' auditors, and if the recommendations made in this Report which call for improved communication between the regulator and the auditors; clarification and strengthening of the reporting obligations of the auditors, and regulatory examination of the essential elements of the banks' loan portfolio are adopted, there would be little need for the appointment of an auditor by the regulator.

Since 1923, when the present pattern of bank supervision was established in Canada, the banks have engaged the services of two auditors instead of one as in ordinary business corporations, subject to the statutory rule that, if the same two audit firms have served for two consecutive years, one of the firms may not be appointed for the next year. In practice, most banks establish a pool of three or more audit firms who rotate through the two-year cycle. In recent times, there has been a trend at the major banks to appoint annually, but on a continuous basis, the same audit firm to act as lead auditor. Thus the rotation pool is reduced to two, and supplies only the second auditor. None of the banks saw any need for change in this pattern. On the other hand, the Commission has found nothing in the evidence or the documentary record to indicate any significant return to the bank or to the community at large from the presence of a second auditor, particularly where the lead auditor is effectively permanently installed through its reappointment year after year. In the two banks under investigation, the presence of two auditors did not seem to strengthen their position in settling differences with management relating to the financial statements. However, all persons who were directly experienced in the operation and in the audit of a bank strongly recommended against any change in the current provisions of the *Bank Act*.

Professional ethics ordinarily restrain auditors from acting in the audit of competitors. In banking, this does not seem to be a factor. The rotation heretofore has resulted in one firm being lead auditor or second auditor for more than one bank. With so many Schedule A and B banks, and so few experienced bank auditors, this is the inevitable result. There is more at issue here than the client's interest having regard to competitive and other considerations. It is a practical problem thus far without demonstrated deleterious impact on the public interest for which there appears to be no practical solution. With the practice of appointing lead auditors, the conflict will become more significant, where such an appointee serves in a like position for another bank, either Schedule A or Schedule B. The issue is less serious than would appear. Because of the scale of work entailed in the audit of a major bank, the appointments of bank auditors have devolved upon large audit firms. The designated partner/auditor will be different for each bank so that the work for each audit can be isolated. This appears to be the practical answer accepted by the bank clients.

Recommendation 20

It is recommended that no change be made to the dual auditor system as provided by s.237 of the Bank Act.

There are, however, two matters which do call for legislative consideration. First, it has been pointed out that the procedures set out in s.240 of the *Bank Act* are defective in several respects. This section permits, but does not require an auditor who resigns or is replaced, to report on the reasons therefor, and on the reasons why the auditor opposes any proposed action or resolution. This procedure does not apply where an auditor is simply dropped from the list of firms on the bank's normal rotation panel. Further, there is no requirement that the regulator interview the dismissed auditor.

The Commission accepts the importance of the role of the auditor in monitoring the financial position of a bank, and considers that it is imperative for the regulator to be apprised of the decision of a bank to replace an auditor, whether currently active or not.

Recommendation 21

To facilitate the protection of members of the panel of auditors, it is recommended that the Bank Act be amended to require a bank to maintain a panel of auditors from which its auditors will be recommended for appointment by the shareholders. Whenever an auditor is dropped from the panel or the rotation, the bank should be required to notify, in writing, the regulator, the members of its board of directors, and the auditor affected. The notice should include a statement of the reasons for dismissal or for the dropping of the auditor from the nomination rotation.

The regulator should be required to interview any auditor who is replaced or retired, to determine whether:

(a) there has been improper management interference with the performance of his auditing responsibilities under the Act; and

(b) the auditor was dropped or set aside for reasons other than his failure to discharge his professional responsibilities to the bank.

Some remarks must be made regarding the qualifications currently required of auditors. Section 238(1) of the *Bank Act* provides, *inter alia*, that at least two members of the firm of accountants appointed as a bank auditor must be "members in good standing of an institute or association of accountants" incorporated under provincial legislation, and have practised the accounting profession in Canada for six consecutive years immediately preceding the appointment of the firm. Under s.238(3), the auditor who is designated as the person who conducts the audit must specifically meet those qualifications.

The House of Commons Standing Committee, in commenting on the Green Paper, recommended that the federal regulator maintain a list of qualified auditors, and that the engagement of an auditor by a financial institution be subject to prior government approval. However, nothing that this Commission has heard suggests that the banking community or the accounting profession's self-regulatory procedures, and more importantly, the public interest, are in need of such extensive government assistance. The possibility of improper interference, perhaps politically motivated, hangs over such a proposal. The auditor is required by the shareholders and the investing public. The regulator is required by the public at large. The two needs and the two bodies with respective mandates to meet these needs are separate and distinct, and should be kept so. Nothing heard in the extensive sessions of this Inquiry indicated a need for government intervention in the process of appointing shareholders' auditors or that the public interest would be served by such intervention.

Nonetheless, the level of bank audit experience is an important requirement if the auditor is to perform properly his responsibilities under the Act. The Coopers & Lybrand study has recommended that bank shareholder auditors be required to have extensive bank auditing experience. The Commission is in substantial agreement. On the other hand, regulations should not be so restrictive as to foreclose appointment of accountants who do not now audit a bank.

Recommendation 22

It is recommended that the Bank Act be amended to require that the auditor who is in active charge of the audit of the bank should have at least five years experience in the performance at a senior level of bank audits or audits of other deposit-taking financial institutions.

2. Auditor Communication with Federal Regulators

Effective communication between the auditor and regulator lies at the heart of the regulatory process. In order for the regulator to perform effectively, the Act must be clarified so as to authorize mutual access between the regulator and the shareholders' auditors. Statutory direction and authority are necessary in order to free the auditor from the professional restrictions on release of client information. Sections 242(3) and (4) of the *Bank Act* require auditors to report to the OIGB on any transactions or conditions affecting the well-being of the bank that, in their opinion, are not satisfactory and which require rectification. Apparently no report has been filed in many years.

Some parties at the Inquiry took the position that s.242 did not necessarily create a positive duty in the auditors to make the reports described in the subsection. It is recommended that this section be amended to make it clear and certain that the auditor's duty to make reports under s.242 is positive, and that the auditor must, therefore, make such reports as are necessary to communicate the matters described in the section.

The Act should confirm that the shareholders' auditors do more than report on issues important to shareholders. Effectively, their reports are of interest as well to creditors, including depositors, the regulators and the general public. This may be achieved through increased and regular reporting by the auditors to the regulators. The Coopers & Lybrand study suggests that the OIGB should issue formal guidelines regarding the information and conditions on which the shareholders' auditors must report in fulfilling their statutory duties under s.242. The Commission supports this clarification of responsibilities.

Recommendation 23

It is recommended that s.242 of the Bank Act be amended to provide that the auditors be expressly required to report annually to the federal regulatory body as to the adequacy of the internal controls and inspections, the extent of the auditors' review of the bank's loan portfolio, any change in the bank's accounting policy, other matters specifically required by the Bank Act, and generally as to any matters which materially affect the bank's financial position. The auditors should be required to include in such annual report a statement that there are no other matters as described in the Act which require their comment, or, where no matters need be reported upon, the auditors shall so state in writing.

There is no validity in the argument that under the *Bank Act*, the regulator has insufficient power to ascertain particular aspects of the bank's business, including loan provisioning assumptions, security valuation practices, and the degree of fiscal conservatism characteristic of management. Section 242(2) permits the Minister to enlarge or extend the scope of the audit, and to direct any other examination to be made of the affairs of the bank, the expenses of which are charged to the bank. Section 246(5) authorizes the Inspector General to require information and explanations pertaining to the bank as he may require. Those sections are comprehensive in their scope, and while the powers expressed thereunder may not have been exercised in the case of the two banks under investigation, violation or failure to invoke is not an argument for a change in the statute. Accordingly, this Commission makes no recommendation in respect of those sections.

Communication flowing in the other direction from the regulator to the auditor is of equal importance. At present, the auditors are not necessarily cognizant of information relating to the bank in the hands of regulators. The *Bank Act* should be amended to require that the regulator inform the shareholders' auditors, as well as the bank, when the bank has been placed on a "watch list", and likewise inform the board of directors and auditors of the rating given to the bank at the annual inspection. This recommendation would complement Recommendation 30, which would require disclosure to the auditors of the regulator's findings after the inspection.

Recommendation 24

It is recommended that the Bank Act be amended to require that the regulator inform the shareholders' auditors, the Chief Executive Officer, and the board of directors of:

(a) the fact that the bank has been placed on a "watch list"; and

(b) the rating of the bank at the annual inspection, and any changes thereto on an on-going basis.

3. Accounting Principles

These were the subject of much evidence at the Inquiry. In some cases, difficulties were easy to define but solutions were not easy to develop. The important matters are reviewed here, and should be considered in conjunction with the current accounting principles, and the difficulties inherent in them and in financial statement presentation generally, as outlined in Appendix F. The more important items are gathered together in this section.

a. Generally Accepted Accounting Principles

Considerable testimony at this Inquiry described the differences between the accounting requirements of the banking industry and those of industrial and commercial enterprises in general. The result of these differences, some of which are expressly provided for in the *Bank Act*, is that the GAAP rules of the CICA are not entirely adopted in, or applicable to, the banking community. The Inspector General, some of the major banks, and several bank auditors have submitted that an advisory body should establish, so far as possible, bank accounting principles based on GAAP. The Commission accepts the validity of these submissions which are echoed by proposals in the Wyman Report and the Coopers & Lybrand study. The CBA goes perhaps further in adopting the premise that public disclosure by proper accounting principles is an important regulatory tool which brings market discipline to bear on the behaviour of banks. This is indeed the trend in the United States, and in self-imposed practices in bank reporting in annual and quarterly statements and reports in this country. Interpretation of financial reports will be facilitated by improvements which will bring bank practices and GAAP into conformity as far as is practicable. Of special importance is disclosure of the banks' financial status insofar as it relates to the generation of cash flow in contrast to reported income.

b. *Loan Valuation*

Loan valuation represents a sophisticated and complex exercise of judgment and experience. It lies at the heart of the assessment of the financial condition of the bank. When the debtor has defaulted or is expected to default in the foreseeable future, it presents considerably greater problems. These problems are magnified in view of the number and diversity of the loans comprising a bank loan portfolio. Considerable evidence was led describing the difficulties in determining the proper procedure to be followed in reflecting in a bank balance sheet the appropriate value of its loan portfolio. In the Commission's view, the evidence establishes that it is not possible to codify the exercise of judgment and experience inherent in the valuation of a borrower's covenant or the security underlying the covenant, where the former is unenforceable. This inability to codify opens up the possibility that the right to make the judgment will be abused if there are no standards by which to measure its exercise. In fact, it was the abuse of this "banker's judgment" that allowed these two banks to continue in operation in 1983, 1984, and through 1985. The solution may be a reduction of the process to general guidelines supported by clear prohibitions and illustrations of that which is acceptable.

A number of standards are applied in the industry in valuation of loan security. These include "current value", "market value", "liquidation value", "forced sale value", "going concern value", "realizable value", and "base line value". Meaningful terms which will satisfy the vocabulary habits of the banking, accounting and legal professions are difficult to find. This causes some of the confusion surrounding the whole valuation issue. Loan security valuation standards are required which recognize the need for a balanced and even-handed approach to asset valuation, in order to avoid precipitous securities rating and regulatory action. These principles and standards should not be established by legislative regulation, but should be the subject of guidelines issued by the regulator after industry consultation through the Advisory Committee.

Some generalizations applicable to the case where the value of the loan depends only on the value of the underlying security are possible. Evidence at this Inquiry suggests that it is generally unsound to base loan valuation on the valuer's optimistic view of the prospects of economic recovery in a region or industry. It is equally unsound, notwithstanding the recommendations of the Senate Committee's reports on the Green Paper and Bill C-79, to require that financial statements reflect only the current or market value of bank assets regardless of the state of the market which is generating that information. Valuation of real estate or other security should reflect the range of possible future experiences of the debtor, as well as the probability of their occurrence. It must be applied within a reasonable time frame, conservatively estimated. Where the collection of loans depends on planned events or probable developments, the valuation of such loans at the date of the financial statement should take into consideration the risks attendant on the forecasting of future events.

c. *Loan Loss Provisioning*

Considerable evidence was led at this Inquiry regarding the extent to which banks should be required to make provisions in the case of specific loans as well as in the case of entire industries or regions which may be subject to financial distress. This Commission accepts the recommendations of a number of the chartered banks, the CBA and bank auditing experts called by Commission Counsel, that there exists a range of acceptable amounts for any particular loan loss provision. To attempt to legislate loan loss provisioning would be, in effect, to attempt to legislate in detail the lending practices of the industry.

It is impossible to codify the exercise of judgment and experience inherent in loan loss provisioning. Rules, if they are to be effective, must be general and few. Provisions may vary from year to year, and must reflect the current status of each loan. They may be increased or decreased as circumstances require on an incremental basis, but they must always reflect sound, realistic, and somewhat conservative judgment.

d. *Accounting Treatment of Loan Losses*

One of the most confusing aspects of bank financial statements is the reporting of loan losses via the appropriations for contingencies account on the balance sheet. Under s.215(3)(c) of the *Bank Act* and the Rules for the Determination of the Appropriations for Contingencies of a Bank issued pursuant to s.308, loan loss experience is charged to the "appropriations for contingencies" account carried in the "Capital and Reserves" section of the balance sheet. The provision for loan losses, based on a five-year moving average of the loan loss experience, is then credited to the appropriations for contingencies account and charged to the statement of income. This has the effect of smoothing sudden increases in any given year in the loan loss experience of the bank.

In the case of the CCB, the appropriations for contingencies account declined in the financial statement for the 1984 fiscal year. At the same time, loan quality was deteriorating, and management was taking additional provisions against losses. All but the most sophisticated readers of the financial statement would understand this to mean that the bank's financial condition was improving when in reality it was deteriorating. This potentially misleading accounting device is unknown in the United States and the United Kingdom. In Canada, it is noteworthy that bond rating agencies, and no doubt most others in the investment business, when analyzing a bank's financial statements, immediately convert the figures to accord with ordinary accounting for bad debts and debt reserves. They thereby penetrate the fog surrounding the existing accounting procedures.

e. Accounting Treatment of Accrued or Capitalized Interest and Fee Income

Recognition of interest and fee income in bank accounting has been a major issue at this Inquiry. The use of less than conservative accounting practices involving the capitalization of interest and fees may result in the recognition of income of questionable collectability, and if so, these practices present acute problems in determining whether the resulting financial statements fairly and accurately represent the financial position of the bank. A descriptive disclosure of the quantified results of these practices would improve considerably the ability of the financial community and the general public to analyze the state of affairs of a bank. The further the statement of income diverges from a portrayal of the bank on the basis of its cash flow, the less useful it becomes. This is discussed later in this chapter. The Inspector General's Non Performing Loan Paper, which is briefly reviewed in Appendix F and further on in these recommendations, should be amended to reflect the additional income inclusion items disclosed by the evidence which are not dealt with in the Paper, and the methods disclosed in the evidence which could be used to ensure that various transactions fall outside the definitions contained in the Paper.

In this Section 3 of Chapter 6, the accounting and bank audit principles and practices most frequently discussed in the hearings have been reviewed. In the case of each of them, there is a history of professional development of the related accounting principles or doctrines. Any decision or recommendation relating to these highly technical matters should, if benefit is to be derived, come from a body trained in this discipline. Accordingly, the Commission has gathered up all these issues, and the discussions which have swirled around them, and now proposes that they be the subject of appropriate extensive professional study in the recommended Advisory Committee.

Recommendation 25

It is recommended that the Advisory Committee undertake a review of the following matters and report thereon to the regulator:

(a) Bank accounting principles which do not comply with GAAP, with a view to developing principles based to the extent considered desirable on GAAP;

(b) Loan valuation procedures;

(c) Loan loss provisioning practices;

(d) The abolition of the five-year loan loss averaging formula and its related apparatus; and,

(e) The capitalization of interest, the recognition of accrued interest, accounting for fee income, and the refinement of the Non Performing Loan Paper.

E. REGULATORY POWERS AND SUPERVISION

1. Introduction

Under the *Bank Act*, as outlined in Chapter 3, extensive regulatory powers are conferred upon the Minister and the Inspector General. As well, certain powers are conferred on the CDIC under its Act. In effect, these provisions provide the regulator and the insurer with power to obtain information and to levy the ultimate sanction: to terminate a bank's business. Neither the *Bank Act* nor the *CDIC Act* provides explicitly for an intermediate power to take early steps to avert disaster on the basis of information received. Nevertheless, submissions to the Commission by some of the chartered banks, the CBA and the CCB auditors indicated satisfaction with the present regulatory powers, and agreement that, in fact, the regulators and the Minister possess sufficient authority to regulate fully the banking system. McLaughlan, on the other hand, doubted that the existing powers were sufficient given the proliferation of Schedule A and B banks. There are instances in the evidence of the OIGB of difficulty in regulating Northland under existing powers, although this may be attributable more to a lack of will to act on the part of the OIGB than to a paucity of power.

Viewing the matter on the basis of pure legal theory, the Commission is inclined to agree with the assessment of the CBA, some of the chartered banks, and the CCB Auditors. However, even the fact of the debate itself regarding the extent of current regulatory authority leads the Commission to believe that more statutory precision would be desirable. In particular, the Commission has concluded that the regulator should be granted the express power to issue cease and refrain orders with appropriate appeal rights. More specific or precise requirements for regular routine filing by the banks of accounting information relating to noncurrent loans, workout arrangements, sale or transfer of assets on a non-arm's length basis or on an arm's length basis with significant bank financing, self-dealing, and other like matters should also be instituted.

In general, and with these limited reservations, the Commission is of the opinion that the present Act does indeed clothe the executive branch of government and the regulator of banks with sufficient powers to govern the banking system in the interests of the community. Equipped with ancillary powers and more express authority for intermediate intervention, the regulator would find more flexibility in the performance of his role. The more drastic the measure to be taken, the more reticence to take it. Degrees of response available to the supervisor will increase the frequency of response. This should promote the goal of timely intervention. This may be remedied most appropriately by institutional reorganization rather than by heaping powers upon the regulator. The following recommendations thus assume that the institutional reorganization recommended above, in particular, the consolidation of the federal bank supervisory authority and the CDIC, is implemented.

2. Incorporation and Licensing

Under the *Bank Act*, the decision whether to issue letters patent incorporating a Schedule A bank or to issue a license to a Schedule B bank is in the sole discretion of the executive branch. In the Commission's view, this branch of government should continue to be ultimately responsible for the decision to permit the establishment of a new bank. The experienced gained and lessons learned from the establishment of banks in the 1970s and 1980s strongly suggest that this decision should not be made without consideration of how the proposed new bank will operate in and affect the existing banking community. There are, at this stage, three relevant considerations. First, the proposed bank's objectives and intended business plan must be assessed realistically with regard to the existing market. Second, it must be established, as indicated earlier, that competent, experienced management will be in place from the date of the commencement of the bank's business. Third, the bank must be adequately capitalized. The Commission is of the view that these factors should be reviewed and reported on by the regulator to the Minister responsible before any decision is made on the application for letters patent or a license, as the case may be.

An increase in the capitalization now informally required of entrants to the banking market is recommended in the Wyman Report and by the Senate in its response to the Green Paper. Suggestions in the same vein have been made to this Commission by the Minister of Finance. The argument against imposing minimum capitalization requirements at the incorporation or licensing stage is that high capital requirements would exclude all but the largest institutions of the community from banking, and would tend to concentrate banking in the hands of a few established banks. Furthermore, capital requirements may fluctuate considerably once the business of the bank is underway.

Recommendation 26

It is recommended that no bank be established without consideration by the Minister of the views and recommendations of the regulator with respect to the proposed bank's objects, operational plans, management (including availability thereof), capitalization, and such other considerations as may be deemed relevant by the regulator.

3. Reporting Requirements

Reporting is the first phase of regulatory action. While the evidence does not reveal that the flow of information reported to the OIGB was a real problem in the failures of the CCB and Northland, it is nevertheless considered that the reporting systems now in place can be improved.

The premise of proposals to adopt an early warning system is that the collapse of a financial institution is a progressive process, rather than a sudden occurrence, and that it is possible to identify the decay of a bank's financial health at a relatively early stage. Early warning systems have, with the unexplained exception of the House of Commons Standing Committee's Report on the Green Paper, universally been acknowledged as an essential component of any effective regulatory process.

The early warning system now employed by the OIGB is made up of a multitude of ratios designed to assess capital adequacy, asset quality, management quality, earnings quality, and liquidity (CAMEL) prepared quarterly from returns submitted by the bank. It assumes that performance by the external auditors of their statutory responsibilities will reveal the condition of the bank's loan portfolio, and is dependent upon management's integrity for the accuracy of the information supplied. It cannot reveal management errors or improprieties relating, for instance, to inadequate loan loss provisioning or overly optimistic loan security valuations. Nor can it supply the will to act, or act as a substitute for judgment. What is required is the receipt of information from sources both inside and outside each bank. That information must be adequately organized once it reaches the regulator and must include the kinds of information vital to the assessment of the operations of the bank.

The banks suggest that an early warning system should concentrate on external signals independent of management judgment including interest rate spreads, cash earnings (in contrast to accrued earnings), the amount and cost of wholesale deposits expressed as a proportion of total deposits, and excessive loan concentrations by economic sector, geographical region, and borrower. Expert evidence on audit practices was to the effect that earning trends, the amount of capitalized and accrued interest, the number of loan workouts, the number of nonperforming loans and interest rate spreads were of special importance in developing an effective early warning system.

The banks also pointed out that signals appropriate to regional or newer banks may not be relevant to older, nationally diversified banks. The submissions of bank auditors emphasized the need for the computerized flow of information to the regulator. The Coopers & Lybrand study made the same point. At the present time, the OIGB has only just completed the expensive and lengthy task of converting from manual returns to computerized returns and analysis.

The Commission has earlier recommended expansion of the reporting responsibilities of auditors, the audit committee, and directors. Beyond that, a code of reporting requirements would be so complex, if it were to reflect all shades and nuances of what might be considered to be improper banking practices, as to be unwieldy. Indeed, in some cases it could operate as a serious impediment to managerial freedom, and would certainly generate substantial regulatory compliance costs. However, some order must be established so that all participants in the banking system, bankers and regulators, are aware of the rules of the game. Some banking practices have been described in the testimony as "bizarre", and must somehow be made the subject of mandatory reporting requirements to the regulator. The following subjects assumed some prominence in the evidence and the following potential defects were noted.

a. Loan Classification

Shortly put, not all bankers speak the same language. Appropriate regulatory response to information supplied by the banks would be facilitated by the establishment of a uniform system of loan classification to apply across the banking industry. Such a system would not be intended to act as a substitute for or to direct substantive management decisions as to the worth or riskiness of a loan. Rather, it is suggested that a uniform nomenclature be introduced to describe those management decisions.

A uniform classification system should evolve from recommendations of the Advisory Committee, and might take into account the views of this Commission regarding the definition of nonperforming loans as described below.

b. Nonperforming Loans

In 1983, in an attempt to supplement s.58(2) of the *Bank Act*, and standardize the reporting of problem loans by all banks, the OIGB developed the concept of a "substandard loan", which was used during 1983 and 1984 inspections. In 1984, the OIGB issued its Non Performing Loan Paper, which established expanded reporting requirements of nonperforming loans as therein defined.

The OIGB now accumulates quarterly reports, described in Appendix F, on loans on which interest is being accrued for more than 90 days. The reporting requirements present a reasonably accurate picture of the amount of nonaccrual loans, restructured loans, renegotiated reduced-rate loans, and accrued interest. While the reporting requirements now in place represent an improvement, they are deficient in some respects. Reporting based on loan classifications defined in terms of the accrual of interest can be avoided through capitalizing interest so that it is no longer regarded as contractually past due. Further, a loan might not be reported even though the borrower is not servicing it from his own resources.

It is essential to define a nonperforming loan so as to identify properly, on a statistical basis, truly damaging loans at the earliest possible time. The current definition of noncurrent loans in s.58(2) of the *Bank Act* is a good starting point because it focuses on payment required from the borrower's own resources, and has the virtue of imposing some discipline through requiring cash flow disclosure. However, the period of permitted arrears is too long for such loans to be effective as early warning signals. Various definitions were used in the CCB and Northland to allow them to carry a loan as satisfactory or performing, even though the borrower was not servicing the loan from his or her own resources. Such a practice may hide the rot in the loan portfolio until it is too late for the regulator to be of any help. It is recognized that overdrafts, independent loans, and other arrangements may cause a loan to fall into the noncurrent category without any impropriety so that no signal of loan weakness should be sounded. However, such arrangements, once disclosed, could readily be justified, and the requirement of explanation may itself be a helpful discipline. Some witnesses testified that while the concept of tracking loans not being serviced from the borrower's own resources is a good one, the mechanics of developing such a system, and the definitional problems inherent in it, were complex and would require further study.

c. *Workout Disclosure*

Loan workouts were these two banks' usually colourful and always ingenious and energetic attempts to nurse a bad loan along to the point where the borrower is able at least to meet his interest obligations. The Commission considers that potential workout abuses can be controlled by appropriate regulatory response to full disclosure. The monitoring of loan workouts is critical to an ability to assess the quality of the bank's loan portfolio, and thus the financial position of the bank. As noted in Appendix F, the current Non Performing Loan Paper issued by the OIGB does not apparently contemplate that all workout loans will be included within the definition of "restructured loans" required to be reported. Loans which are reclassified as coming from a different borrower, when that borrower has been funded by money coming from the bank, are apparently omitted. The reporting requirements should be expanded to encompass all workout arrangements. The definition of a workout arrangement should be designed by the regulator after consultation with the Advisory Committee on an ongoing basis. The Advisory Committee should have regard to all arrangements involving the renegotiation of a loan and any new loan to the original borrower or to a third party entered into after or in anticipation of default with a view to avoiding or minimizing a loss to the bank. Regard should be had to practices disclosed by the evidence, such as nonrecourse or effectively nonrecourse lending, and to the monitoring of the disposal activities of bank related or bank funded corporations having the mandate to dispose of bank security.

d. Principal Factors in an Early Warning System

The effectiveness of an early warning system will depend on whether it reflects, at the earliest possible time, a deterioration of the financial health of the bank. Information not vital to the detection of problems will glut the system. The main task, therefore, in designing an early warning system is to weed out information which does not reveal the health of the bank, or which by its nature comes too late to assist the process. The choice of constituent elements of an early warning system is an extraordinarily sophisticated and complex task. This Commission received submissions from the banks, the OIGB and the bank auditors on the components of the early warning system which should be implemented in Canada. The Coopers & Lybrand study also offered detailed recommendations on this issue.

It is not clear that the current practice of weighting all factors in the system equally should be retained. From the vast flow of data currently required from inspected banks, a number of principal signals should be isolated and emphasized. Evidence given by witnesses who testified on this matter suggests that these signals should include:

(i) Nonperforming or Unsatisfactory Loans: Reporting of loans in this category is the single most revealing factor in a bank, because the condition of the loan portfolio is the most important indicator of the bank's condition. Returns should reveal the net increase or decrease in nonperforming loans during the period reported on together with the number of such loans on the bank's books at the end of the period and the percentage of the loan portfolio they represent. The modifications that should be considered in defining these loans have already been discussed.

(ii) Interest Rate Spread: Banks should be required to report monthly, or even weekly, if feasible, the interest rates charged to borrowers and paid or offered to their various classes of depositors. This information will act as an early indicator that a bank is attracting deposits at uneconomic rates and/or making improvident loans. In view of the number of types of deposits, consideration should be given to reporting the rate for each class and the dollar amount in each class.

(iii) Accrued Interest: Accrued interest must be reported in a manner which reveals its age.

(iv) Capitalization of Interest and Fee Income: Compilation of capitalized income on an on-going basis is said to present none of the difficulties inherent in attempting to determine the amount of capitalized interest on a retrospective basis.

Guidelines and reporting procedures should be developed to identify interest and fee income recorded but not collected without bank funding. The reports should differentiate between fee income which is being amortized and that which is not, all to the end of revealing a fee income driven lending policy. Total capitalized and accrued interest differentiating between planned and unplanned capitalization, and total fee income in lieu of interest or received for *bona fide* services actually rendered must be reported so as to enable the regulator to assess the income statement of the bank as frequently as is feasible, but at least on a monthly basis.

(v) Loan Portfolio Growth and Diversification: Rapid growth in a bank's loan portfolio may represent substantial risks to the bank. Thus, any changes in the rate of the bank's growth should be reported to the regulator. Loans should be segregated by industry sector, geographical region, and borrower concentration.

(vi) Off-Balance Sheet Risks: Returns should reveal indirect liabilities, including guarantees and other commitments, direct and indirect, choate and inchoate, conditional and unconditional.

(vii) Loan Loss Experience: Loan losses recognized in each reporting period should be reported and compared to prior accounting periods both in absolute terms, as a proportion of the loan portfolio, and on a cumulative basis. A separate return should record the number and amount of nonperforming loans in respect of which no loan loss provision is taken.

(viii) Workouts: The number, and aggregate amount of loan workouts, as discussed earlier, should be reported. Data should indicate all workouts entered into in the reporting period as well as the total of such loans on the bank's books at the end of the period. Returns should net out worked out loans which have been restored to full performance and report these separately.

(ix) Earnings: The regulator should be able to generate a comparative analysis of earnings, showing trends in earnings in the bank, the ratio of earnings to assets, the ratio of noncash receipts to cash receipts, return on equity, and the differentiation between interest and noninterest sources of income. Noninterest income could usefully be broken down to its component parts.

(x) Liquidity: Exposure to liquidity risks is of major concern to deposit-taking institutions. Accordingly, the regulator should receive data describing the matching of the maturities of loan assets and deposit liabilities. Cash flow forecasts should disclose all assumptions.

(xi) Personnel: The regulator should monitor changes in directors, senior management, and auditors. Where changes are significant or indicate a trend, the regulator should determine the causes.

Much of the foregoing information is currently funneled into the present early warning system of the Inspector General. The emphasis now must be on highlighting, by a weighting system, the more revealing pieces of information such as the aging of accruals, the aggregating of unplanned capitalization of interest, and the deferral of provisioning against loans in partial and nonperforming categories.

Recommendation 27

It is recommended that the existing OIGB reporting systems be modified and extended to focus on factors of critical significance in a timely fashion. This should be implemented as follows:

(a) The Advisory Committee should have regard to the suggestions made above in formulating rules or guidelines relating to:
- ***(i) Loan Classification***
- ***(ii) Nonperforming Loans***
- ***(iii) Workout disclosure***

(b) The Advisory Committee should have regard to the evidence disclosed in the Inquiry, summarized above, in considering whether the currently existing early warning system should be streamlined and supplemented by the input of more meaningful information.

(c) The Advisory Committee should be directed to consider the advisability of a requirement that a bank, at the request of the regulator, should have all or some of its returns of information to the regulator certified by the external auditors, or, at the election of the regulator, by a senior officer of the bank.

4. Selective Supervision

Experienced bankers and banking auditors testifying at the Inquiry were uniformly of the view that the intensity of regulatory supervision, and the frequency and nature of inspections should reflect the quality, stature, experience, and other characteristics of each regulated bank. Newly established banks may require something approaching the U.S. system of hands-on supervision. On the other hand, the large banks with long established staffs and operating systems require much less supervision, perhaps requiring comprehensive inspections less frequently than annually in something approaching the existing Canadian system modified as recommended. Generally, in the case of mature banks the regulators may be able to rely to a considerable extent on information supplied through the established banks' auditors and internal systems, with recourse to loan examination only exceptionally or on a test basis. In the case of new banks or banks which concern the regulator for any reason or are on a watch list, however, a different intensity of supervision must be considered. The level of inspection should represent a variable scope of activity and not a fixed standard of intensity. Accordingly, the regulator should develop a spectrum of inspection activity for all the banks under its supervision. The scale and form of supervision will vary according to the position on this spectrum of each bank at the time in question.

Recommendation 28

It is recommended that supervisory and investigative powers be exercised in a manner responsive to the financial condition of the bank, its maturity, size, asset quality, the diversification of its loan portfolio, and its condition as revealed in the early warning system.

5. On-Site Inspections

The Commission does not recommend the abandonment of the basic tripartite system of bank regulation. However, one of the lessons to be learned from the difficulties surrounding the CCB and Northland Bank is that the regulator must have the resource capacity to move into the bank and satisfy itself of the true condition of the loan portfolio when circumstances warrant. The OIGB, in 1985, responded to the need to evaluate the loan portfolios of these two banks through the employment of active or former bank credit officers during the planning and operational stages of the CCB support program and in assessment of Northland Bank. The evidence is clear that an earlier outside and objective assessment of the banks' loan portfolios would have caused the OIGB to change its view of these banks radically, and at an earlier date. As described in Chapter 3, the practice of on-site inspections has grown through 1985 and 1986, and has been extended to all banks in the system, even the major national banks. It is noted that the United Kingdom is seeking to modify its regulatory system to incorporate similar on-site inspection powers and capacity.

The on-site inspection power suggested here will be of use in conjunction with the system of selective supervision described above. It should be used as required through the life of the bank as well as in pre-liquidation loan portfolio valuation, as it is certain that if on-site inspections become associated solely with emergency situations, as suggested in the House of Commons Finance Committee's Report, they will merely become a signal to the financial community of impending failure, and the deposit run will be on. The omnipresent realization in a bank of possible unannounced loan examinations would by itself exert a salutary influence on the conduct of a bank's business.

Recommendation 29

It is recommended that the OIGB continue to enlist, on a contract basis, the services of active and retired bank credit and management personnel in supplement of its own inspection staff as required, for the performance of on-site assessments of the banks' loan portfolios. On-site inspections should occur throughout the life of each bank at frequencies reflective of the bank's condition as earlier recommended, and should not be reserved solely for emergency situations. (See also Recommendation 5, above.)

6. Annual Inspections

It is currently not the practice for the report prepared by the OIGB following the annual inspection of the bank to be communicated to or reviewed with representatives of the bank, although regulatory personnel do conduct "wrap-up" discussions with senior bank officers. The CCB auditors have submitted that the results of the annual report should be communicated directly to the CEO of each bank and to the shareholders' auditors. The OIGB has indicated that it intends to send letters detailing its inspection findings to the banks. For greater certainty, amendment to s.251 of the *Bank Act* may be necessary or advisable to allow expressly this and other communication recommended earlier between the regulator and the bank and its auditors.

Recommendation 30

It is recommended that the regulator be required to disclose to the bank a summary of its findings after the annual inspection. The summary should include the rating of the bank and should be directed to the senior management of the bank and to its shareholders' auditors. This summary should be the subject of a meeting of the audit committee, attended by the regulator, as earlier recommended. The disclosure of this information by the banks, in turn, will be as directed by the regulator on the same basis as in the case of a cease and refrain order. (See also Recommendations 17 and 24, above.)

7. Cease and Refrain Orders

Throughout the hearings before this Inquiry, much was made of the power of the FDIC to issue "cease and desist orders" such as the order issued against Westlands Bank. The FDIC order was detailed and comprehensive, and expressly dealt with valuation of loan assets in the bank, along with a series of related measures aimed at restoring the bank to financial health. In fact, this objective was achieved. While all of the reports on regulatory change have advocated the adoption of this regulatory tool, there was a sharp division of opinion before the Commission as to whether it should now be expressly granted to Canadian regulatory authorities, and not left to inference. The OIGB proposed for clarity and certainty that the *Bank Act* be amended to include the power to issue "cease and refrain" orders.

Most of the major banks and the CBA have proposed that any power to issue cease and refrain orders should be limited to issues of insolvency (although the Inspector General testified that at that stage, cease and refrain orders are of little value), that they be confidential, and that there be a right of appeal. Bill C-103 would authorize a "direction of compliance" to be issued to stop, prevent, or require action to revise "an unsafe or unsound practice in conducting the business of the bank". Such a directive would not be required to be made public, and would be subject to appeal.

It is the Commission's view that effective regulation requires the regulator to have the proposed range of enforcement tools available throughout the bank's life in addition to the ultimate power now given by the Act to close the bank.

Recommendation 31

It is recommended that as contemplated by Bill C-103, express authority to issue cease and refrain orders should be provided to the regulator. Use of this power should not be restricted to cases of threatened insolvency. Rather the regulator should be encouraged to use its powers at an early stage when improper practices may still be successfully reversed. Any such orders should be subject to appeal.

A difficult issue arises with respect to whether cease and refrain orders should be made public. Unquestionably, without statutory or regulatory exemption, a cease and refrain order, depending of course on its content, would have to be disclosed in a prospectus or as a "material change" under securities legislation, which focuses on public disclosure and therefore requires the revelation of all outstanding orders, obligations, undertakings and requirements which are deemed to be material. A further question arises whether cease and refrain orders, when taken to a court on appeal or review, should be made public. The issue is important because a comprehensive cease and refrain order would in all probability indicate severe weaknesses in the bank and could prompt a run on even a large and well established bank. All these matters have been extensively discussed in regulatory circles in the United States, as reviewed in detail in Appendix B.

In view of the provincial regulation of securities in this country, if cease and refrain orders are to be adopted under the *Bank Act*, protective provisions may be required to avoid premature disclosure of the existence of an order. The consequence of disclosure in banking might, in some circumstances, cause a run on deposits. On the other hand, any restriction on publication would penalize, or at least jeopardize, investors who would be kept in the dark about matters sufficiently serious to trigger the issuance of a cease and refrain order. Parliament will appreciate this serious practical problem, and that a compromise or balance must be achieved between full access to information by the share investor on the one hand, and systemic integrity of confidential supervision on the other. It has been suggested that a compromise might be to grant protection from disclosure unless the order is taken to judicial proceedings by appeal or review. Some information supplied to the Commission indicated that this was the solution in the United States. However, as described in Appendix B, this does not appear to be the case today. On reflection, the Commission has concluded that the potential impact of a cease and refrain order will ensure its use only when real need is demonstrated. In such circumstances, a bank which faces this drastic remedy should face the consequences of its recalcitrance and previous noncompliance with informal directives. This is the very basis of the system of protective surveillance. Of the other investigations and examinations made in the regulatory framework, which have not been reduced to a cease and refrain order or directive, no disclosure by the regulator or the bank (unless so directed by the regulator) should be required.

Recommendation 32

It is recommended that cease and refrain orders be disclosed forthwith upon their issuance unless otherwise ordered by the regulator as the circumstances may require; but administrative action by the regulator not resulting in a cease and refrain order will not be disclosed by the regulator or by the bank except as directed by the regulator.

8. Asset Valuation

Considerable discussion arose in the course of the hearings as to the practices of the CCB and Northland Bank in valuing their loan portfolios. Difficulties arose from a number of issues, the more important of which related to loan restructuring, loan loss provisioning, and recognition and capitalization of interest and fee income. In all these processes the same problem arose, namely determining the worth of the collateral, usually real estate. Very few submissions were made, and fewer proposals offered, as to the solution to the problem of valuation, whose complexity in the circumstances of an ailing bank is amply demonstrated by the evidence before the Commission.

Bill C-103, the deficiencies and impact of which are considered in Appendix F, proposes to arm the Inspector General with power to determine the value of a bank's assets. The power is ambiguous as proposed, and in any case, reaches far beyond anything which has been suggested to the Commission as being necessary for the advancement of either the banking system or the public's interest therein.

The Commission is of the view that cease and refrain authority will enable the regulator to control security valuation practices so as to ensure the prudent conduct of the business of banking. This authority should be given a fair trial in the regulatory system before a measure as drastic as the power to actually restate the value of an asset is given to a public authority. Consistent with the Commission's affirmation of the basic tripartite structure of the Canadian banking system, prudent and appropriate loan valuation procedures will best be ensured through competent bank management decisions rather than through regulatory fiat.

Recommendation 33

It is recommended that the proposed amendment to s.175 of the Bank Act in Bill C-103 to empower the regulator to determine the value of a loan not be adopted.

9. Substitution of Management and Directors

The Department of Finance in the Green Paper, and the Minister of Finance at this Inquiry, have recommended that the regulator be given the power to replace management and members of the board of directors. This general power is possessed by some U.S. regulators. The Commission recommends below that this power be accorded to the Minister of Finance in a bank assistance program only. There is nothing in the extensive record to warrant a conclusion that the Canadian banking system requires, in the public interest, this unusual and serious invasion by regulatory authority in circumstances other than in a bank assistance program. Indeed, having regard to the dramatically different make-up of the banking scene in the United States and Canada, such a measure seems wholly inappropriate to Canadian circumstances at this time. In the one instance where the regulator had occasion to consider the removal of a senior officer in a bank (CCB), the desired result was achieved through the existing regulator-management relationship without the existence of any specific power in the regulator.

More importantly, the Commission has recommended the power in the regulator to issue cease and refrain orders. Such power has been employed on occasion in other jurisdictions to achieve the removal of management or directors. This new authority should be given an opportunity to function before resort is taken to the extreme extent proposed in the Green Paper.

10. Control of Self-Dealing

Self-dealing in the form of transactions between the bank and its directors and officers, or persons or corporations related to its directors and officers, may amount to a breach of the fiduciary obligations imposed by s.54(1)(a). Such transactions are, however, permitted by the *Bank Act* in certain circumstances. Section 174(2)(f) imposes limitations on the terms and conditions of loans to inside directors and officers. Such loans must either be secured by a mortgage or hypothec on the ordinary residence of the debtor, or not be in excess of the debtor's annual salary paid by the bank or $25,000, whichever is greater. Section 174(2)(g) is directed to loans to outside directors, and provides that they must be made on terms and conditions applicable to loans made in the ordinary course of business. Such loans are also subject to a monetary limit expressed in terms of the total capital and surplus of the bank. The aggregate amount of loans outstanding to directors is information required to be kept at the bank's head office and made available to the public upon request under s.215(7) of the *Bank Act*.

Control of self-dealing in its various forms has been the subject of recommendations in the Green Paper and the reports following it. The authors of the Green Paper proposed that self-dealing should be presumptively banned, with very limited exceptions. The industry's response to this proposal, as reflected in submissions at this Inquiry, has been negative. The chartered banks asserted that self-dealing can most effectively be controlled through maintaining the ownership restrictions applicable to Canadian banks. According to testimony given by several of the CEOs of these banks, the first line of defence against improprieties is sound management, beginning with the board of directors and including the senior officers of the bank and its chief inspector and inspection department. They have testified that when this system of managerial discipline breaks down, it is difficult to prescribe a substitute in the form of third party regulation.

There is no clear demonstration in the record that any financial evil befell the CCB, Northland Bank, or anyone involved in the banks by reason of borrowing by directors or officers. There is, however, the obvious consideration that a director or senior officer who is significantly indebted to the bank must lose some independence and credibility in the ongoing debates in the bank concerning other loans, and loan granting and collection practices among other subjects. In Northland Bank, loans to directors amounted to about $7.5M by 1985. Loans to officers at the same time amounted to over $2M. The details of these activities are found in Chapter 5. The manner in which some of these loans were authorized by the Board of Directors raises serious questions about the susceptibility to control of this type of lending in a small bank such as Northland. While this may not be a problem for large banks, the Commission has concluded that loans to outside directors should be prohibited. This has the clear advantage of ease of administration. It is not considered feasible without much further study of the problem to attempt to control further loans to entities controlled by directors. The provision in s.174(2)(f) is adequate to protect against abuse in loans to inside directors and officers. An exception should be made to this ban, however, where the purpose of the loan is to enable the director to purchase shares in the bank. Under s.42 of the *Canada Business Corporations Act*, a solvent corporation may make loans for this purpose to its directors.

While some proposals were received by the Commission with respect to the control of lending by banks to affiliated companies, no evidence was directed to this issue because neither bank made such loans to any significant extent. Certainly nothing in the evidence reveals any connection between these bank failures and improper loans to subsidiaries (other than in the workout situation and Westlands, both addressed elsewhere) justifying a recommendation on this aspect of the subject.

A ban on all outside loans to directors will not prevent them from obtaining justifiable terms from other institutions. Of course the banks may syndicate their lending to officers and directors among themselves so that no bank makes loans to its own directors but may make loans to those of other banks. Even if this were done on a reciprocal basis, it would at least remove the fetter on the freedom of debate and vote at board meetings. If favourable terms are sometimes viewed as partial remuneration of members of the board, there is nothing to prevent more direct means being adopted to achieve the same ends.

Recommendation 34

It is recommended that the Bank Act be amended to prohibit banks from making loans, on whatever terms, to nonemployee members of its board of directors, except for the purchase of shares in the bank by the director. The restrictions on loans to employee board members which are now imposed by the Bank Act should be retained.

11. Regulation of Lending Practices

a. Loan Concentrations to Individual or Connected Borrowers

Lending substantial amounts to single, or to related or connected borrowers, leads to concentration of loans and is an obvious risk to the stability of a bank. At present, there are no statutory limitations on the amount or percentage of a bank's capital that can be loaned to any one borrower or group of connected borrowers, although bank auditors have a duty, pursuant to s.242(3)(b), to report on the existence of loans to one person exceeding 0.5 per cent of the total of paid-in capital, contributed surplus and retained earnings of the bank where, in the auditors' opinion, loss in respect of those loans is likely to occur. This may be contrasted with the position in the United States where, under 12 U.S.C., s.84, no national bank may lend to any person, co-partnership, association or corporation more than 15 per cent of its unimpaired capital stock and surplus.

Various proposals have been made to the Commission recommending the implementation of similar limits on Canadian chartered banks. The Commission is in agreement with these submissions.

Recommendation 35

It is recommended that the regulator, after consultation with the Advisory Committee, recommend to the Minister that regulations be made to establish reasonable limits on lending to individual or connected borrowers, expressed as a percentage of defined capital.

b. Regional and Sectoral Lending

Evidence as to the impact of the economic recession in Alberta and British Columbia on the CCB and the Northland Bank led to argument and submissions relating to the application of loan loss provisioning on a sectoral basis, much as provisioning is required in relation to sovereign loans pursuant to guidelines promulgated by the Inspector General. The Coopers & Lybrand study concluded that certain industrial and economic sectors lend themselves to general provisioning. Only one submission to this Commission adopts a comparable view. The Toronto-Dominion Bank's practice is to take minimum provisions automatically on nonperforming loans in specified sectors and regions. U.S. regulators recently authorized sectoral provisioning in agriculture and energy industry loans. Other submissions have indicated that there would be value in general limitations on the powers of a bank to concentrate lending to borrowers in cyclical economic sectors or in certain geographic regions.

The Commission is of the opinion that no such limitations should be imposed. Either mandatory provisioning or restrictions on lending, without reference to the state of the individual loan would, as testimony offered on behalf of some of the chartered banks indicates, be seen as penalties limiting the growth of these economic sectors or regions. Risks inherent in lending exposure concentrated in this way may be controlled to the extent necessary by adoption of appropriate internal prudential management practices, and surveillance and regulatory action where necessary. Loan concentrations will be reported to the regulator as part of the early warning system, and significant sectoral or geographic exposure will be considered by the regulator in determining appropriate levels of capital and leverage ratios for each institution.

Recommendation 36

It is not recommended that statutory amendments restrict bank lending in particular sectors or geographic regions. Nor should the statute require automatic loan provisioning on a sectoral or regional basis.

c. Workouts

Some of the chartered banks have submitted that a bank should be unimpeded by legislation in its decision as to how workout arrangements are to be structured, and particularly in its decision whether to take an equity position in the workout scheme. The bank, it is said, should be free to take whatever steps are reasonably and prudently necessary to afford the borrower an opportunity to meet his obligations. The freedom of the bank to enter into restructuring agreements, corporate reorganizations, and other remedial measures, instead of resorting to foreclosure or other loan enforcement mechanisms, is said to be essential to good banking practice, and to be in the community interest as well. The Commission agrees with this submission, and considers that potential workout abuses can be controlled by appropriate accounting rules and by increased regulatory surveillance leading, where appropriate, to write-offs or provisioning. These matters have been discussed earlier.

Recommendation 37

It is recommended that banks should not be constrained in the development of workout strategies, subject always to full reporting as earlier recommended.

12. Reports from Foreign Regulators

CCB's auditors have submitted that Canadian bank regulators should routinely forward information received from foreign regulatory bodies concerning specific banks to the auditors of those banks. This is a delicate problem, as some foreign regulators, notably those in the United States, may attach strict conditions to the use of information they disclose to Canadian bank regulators. The FDIC and FRB stoutly refuse to allow the Canadian head office of a bank operating in the United States, or a Canadian regulator of such a bank, to retain copies of annual or special reports by their agencies. U.S. regulators see no need for reciprocal disclosure by Canadian regulators. The result is that the Canadian bank regulators can rely on very little continuous support from U.S. regulators.

This issue raises complex questions pertaining to the relationship, at the international level, of regulatory bodies. It is readily apparent, however, that where a Canadian bank has expanded its operations into the United States or some other jurisdiction, assessment of the health of that institution cannot accurately be achieved without complete and reliable information concerning the operations of the bank in the foreign jurisdiction. Vital information may frequently be in the hands of a foreign regulator. This was, in fact, true in the case of the CCB. It should be emphasized, however, that the bank's collapse was not due to the U.S. regulators' refusal to cooperate with the Canadian authorities. Rather, the OIGB's failure to respond adequately, and in sufficient time, to the U.S. reports it did receive, delayed the inevitable realization of the CCB's true state.

Additionally, the foreign regulator may, on the strength of the information it possesses, be inclined to order that corrective measures be taken by the subject bank. These corrective measures may, as was true in the cease and desist order issued to Westlands Bank, have material consequences for the bank's Canadian operations. Clearly, knowledge both as to the state of health of the bank's foreign operations, and the remedial options likely to be pursued by the foreign regulator, would assist Canadian bank regulators in their own program. With the rise in the scale of operations of the foreign-owned Schedule B banks, the mutuality of interest in bank examination in the U.S. and Canadian regulators which is a natural forerunner of a mutual interest in the exchange of information between these regulators, will come into being.

Recommendation 38

It is recommended that the executive branch of government or the regulator, as its delegate, endeavour to develop a system of reciprocal exchange of information between Canadian and foreign bank regulators, protecting, as may be necessary, the confidentiality of the exchanged information, so as to permit full assessment by the Canadian regulator of the financial condition of a foreign subsidiary, affiliate, or branch of a Canadian chartered bank.

F. BANK ASSISTANCE PROGRAMS

1. Introduction

Much of the detail of the discussion which follows will prove unnecessary if the Canadian banking system is to be confined to a relatively small number of full service, Schedule A banks and a limited number of Schedule B banks. On the other hand, if access by new banks is to be maintained on a reasonable basis so as to ensure a competitive banking service in the country, a more elaborate plan must be maintained within the statutory structure to meet liquidity and solvency crises. It is on the assumption that the present policies in this area will continue that bank assistance programs, as hereinafter proposed, are dealt with in some detail.

When liquidity problems drift into insolvency problems, the real test of the banking regulatory system begins. It is not necessarily helpful to the community simply to bring into play the bankruptcy processes under the *Winding-up Act*, or the *Bankruptcy Act* if it were applicable to banks. Where the failure of the bank could have a serious impact upon the community or upon the Canadian banking system at home or abroad, the bank must in the public interest be kept operating by a reorganization of its assets, liabilities, management, and ownership.

There must, in the language of Sir Lyman Duff spoken long ago in an insolvency proceeding, be a law which will "deal with the existing condition of insolvency in itself to enable arrangements to be made in view of the insolvent condition of the company under judicial authority which, otherwise, might not be valid prior to the initiation of proceedings in bankruptcy". There must be some way provided in law whereby a bank can be kept operating, despite insolvency, where it is in the interest of the country to do so. The *Companies' Creditors Arrangement Act*, which was enacted many years ago to permit a company to rearrange its relationship with its creditors, when in or faced with insolvency, does not apply to banks. The statute does, however, afford an interesting parallel which might well be followed in the statutory scheme for the regulation of banks in troubled circumstances. The Act was based upon an English statute, enacted in 1929, which provided for a judicially approved compromise or arrangement between the company and its creditors and/or between the company and its shareholders. The compromise or arrangement could be imposed whether or not the company in question was insolvent. There is no such legislation in Canada today, although in the past, we have had similar provisions in various corporate statutes such as s.134 of the now repealed *Canada Corporations Act, 1971*. It will be proposed shortly that a somewhat similar program be installed in the *CDIC Act*. In the result, the amended *Bank Act* and *CDIC Act* would be a self-contained code for the corporate administration of a bank from birth to death.

When the banking regulator is faced with serious troubles in a bank, there are three basic alternatives available. The most obvious and drastic is to seek authority to place the bank in liquidation. The second alternative is to assess the extent of the damage in the troubled bank, and determine whether a merger with a healthy (and probably larger) bank would be an appropriate solution. The third alternative, a rescue program, as established for CCB, may involve a restructuring or reorganization of the bank in one of a great variety of ways with a view to restoring it to financial health and retaining it in the banking community. That rescue operation may employ public or private funds, or a combination of both. In the statutory plan proposed by the Commission, the regulator would have the responsibility by statute to recommend which course of action is appropriate in the circumstance, and to seek the authority of the Minister of Finance to proceed. As the body in charge of supervision and inspection of the banks, the regulator would be the appropriate agency in which to place this responsibility. It will possess all the information flowing from the bank through the frequent contacts between the regulator and the bank and its external auditors. As the insurer, the new regulator will have additional sources of information to feed into the decision-making process, and above all, it will be experienced in the liquidation process.

It is the intent and purpose of these recommendations concerning bank assistance programs that such programs shall be designed, instituted (subject to prior ministerial authority), and administered throughout by the regulator, subject to judicial intervention where holders of interests in the bank's capital claim compensation for any loss of rights or value suffered under the program. In order to efficiently facilitate the assistance program, a curator, or some like official, should remain in control of the bank as the agent of the regulator, with the authority in the regulator to perform such function, if warranted in the circumstances. Necessary capital funding would be provided or organized by the regulator who may take debt or equity securities, beneficially or on behalf of others. Finally, it is the overall purpose of these recommendations by the Commission to ensure that a bank designated under a bank assistance program does not fail, and is ultimately either returned to private ownership according to the then provisions of the *Bank Act*; or, where the Minister of Finance deems it appropriate, after having considered the recommendation of the regulator, merged with another existing and solvent bank. Where, in the course of a bank assistance program, circumstances make it appropriate in the opinion of the Minister of Finance acting on the recommendation of the regulator, a bank may be placed in liquidation, but in such circumstances, there should be compensation in full for any depositors and debt security holders of the bank, saving only those who have invested capital, as defined in the statute, in the bank.

Inherent in the program to be proposed are three characteristics: (a) provision would be made for the continuation of the operations of the bank, albeit under new senior management put in place by the CDIC, under arrangements which would assure the depositors that their funds were secure and would be repaid in the ordinary course of the bank's business; (b) if all outstanding debt and equity capital is to be cancelled, a nominal number of shares would be issued from treasury to the CDIC to preserve the continuance of a functioning corporation, all as approved by the Minister in the bank assistance program; and (c) any rights lost, surrendered, or cancelled which were theretofore held or enjoyed by capital investors would, if found to be of value, be compensated, such compensation (if any) to be determined by a superior court in the jurisdiction where the head office of the bank is situated. Any such compensation determined by the court to be payable would be paid by the regulator. All amendments to the *Bank Act* required to facilitate the implementation of the program are recommended.

Continuity of the bank's operation is a condition precedent to all provisions made for this program in the statutory plan. The right of the investors of capital to compensation for the loss of their interests in the bank as a part of one of these programs would, for example, entitle the interest holder to his day in court to have his right to compensation determined and to have that compensation, if any, assessed; but that judicial process would proceed entirely outside the bank assistance program and would not interfere with the continuous operation of the bank.

2. Institutional Capability

One of the critical reasons for the failure of the CCB Support Program was the lack of statutory identification of an office or agency responsible for the decision whether to recommend to the Minister of Finance that the bank be liquidated or be saved. A second deficiency was the lack of an office or agency responsible for the coordination, design, implementation, monitoring, and revision, if necessary, of the Support Program, once a rescue operation had been determined by the Minister to be appropriate.

Under the Parliamentary system of government, and particularly the version thereof developed in this country, the executive branch, represented by the responsible Minister, ordinarily has the right to make such decisions as the grant of a licence or authority to operate a bank, or whether, at the other end of its life, the bank's existence should be terminated. However, under the present *CDIC Act*, the CDIC has the authority to institute proceedings to bring about the winding up of the bank if it is insolvent or about to become insolvent. The Wyman Committee for one has approved of this power in the CDIC, there are precedents outside our country, such as in the United States, where this administrative level of decision is indeed the basis of banking regulation. The *Winding-up Act*, as presently constituted, permits any creditor with a claim in excess of $1,000 to initiate winding-up proceedings of a bank. The Commission considers it more appropriate in the Canadian administrative pattern to leave the basic decision to rescue or to liquidate to the executive branch, that is to say the Minister. The responsibility in the administrator, the banking system regulator, is to make recommendations to the Minister as to which course should be followed in the circumstances. The authority to make the ultimate decision must, in this view, reside at the ministerial level. Consequently, s.29 and perhaps other provisions of the *CDIC Act*, and those provisions in the *Winding-up Act* already mentioned should be repealed, as these are inconsistent with the administrative program recommended herein, and indeed with the regime established under the *Bank Act*.

In short, the statutory plan proposed authorizes and directs the regulator to recommend to the Minister of Finance the liquidation, merger, or rescue of a bank with liquidity or solvency troubles.[6] The decision of the Minister will set in motion the statutory machinery whereunder the regulator initiates and conducts the appropriate action. Where it is determined by the Minister that the bank should be assisted through its liquidity or solvency problems, the regulator should propose a comprehensive bank assistance program for ministerial approval. Where, in the view of the regulator, the bank is insolvent or faces immediate and inevitable insolvency, the regulator may (and no doubt in practice, invariably will) include in the recommended bank assistance program provision for the cancellation or reduction of the capital investors' interests as may be appropriate in the circumstances. The statute should, for the purpose of a bank assistance program, define capital as including all securities issued under the *Bank Act*, that is both share and debt securities. The Minister should only have authority to approve such a term in a bank assistance program where he finds that the bank is insolvent, or faces immediate and inevitable insolvency. Upon the approval of such a bank assistance program by the Minister, any cancellation or reduction of the interests of an investor in the bank's securities shall be deemed to have occurred, and the corporate status, the incorporating documentation, and financial statements shall be deemed to have been revised accordingly. A capital investor affected by such a provision of an assistance program may apply to the appropriate superior court for the determination of the solvency of the bank, and should the court determine the bank to be solvent (whatever conclusion the Minister and the regulator may have reached in adopting the bank assistance program), the court shall then assess the value of the loss of interest or rights suffered by the holder of an interest in the capital of the bank by reason of the bank assistance program. The compensation for such loss shall thereupon be paid to the capital investors by the regulator. The order of the court should be subject to a right of appeal by the holder of an interest in capital in the bank, or by the regulator, as the case may be, but the order of the Minister approving the bank assistance program should not be the subject of judicial review under s.28 of the *Federal Court Act* or otherwise, or be affected by any determination by the court in the valuation proceedings. A bank assistance program, where only liquidity problems have been encountered, would not be concerned with the cancellation of the interests of capital investors and all its consequences as above discussed.

In order to illustrate how the proposed program would function, it must be assumed that the first alternative of liquidation is rejected, and that a merger is not available or appropriate. In these circumstances, the regulator would recommend, under the existing provisions of the

Bank Act, that the Minister appoint a curator or some other like official to take over the management and direction of the bank on an interim basis.[0] As part of the process, the regulator would then prepare a bank assistance program, taking into account the information then at hand. The program will form the basis of the recommendation to the Minister for the rescue of the bank. So far, this is much the same process on a more formal basis as that followed in CCB, except that the plan is designed by the agency in possession of all the information, and is a step outlined in the statutory program when other remedies are found to be inappropriate. The consequence of adoption by the Minister of a bank assistance program is tantamount to the determination by the FDIC under comparable legislation in the United States that the bank in question is an "essential bank". Once the bank assistance program is inaugurated, in order for it to succeed, it must most clearly bear the stamp of approval of the Government of Canada which, by the adoption of this plan, would signal to the investment community and the community at large, that this bank will not be allowed to fail, or at least will not fail at a cost to be paid by the depositors. Where this consequence is not desired by the executive branch of government, then merger or liquidation are the alternatives to be followed. The consequence of turning back from a failed program to save a bank is, in the practical political world, prompt compensation of necessity to all depositors and to those creditors whose interest is not embraced in the defined capital of the bank.

Recommendation 39

It is recommended that the CDIC, reconstituted as discussed earlier, be authorized and directed by revisions to its parent statute to design, implement and execute, all subject to the prior approval of the Minister of Finance, all bank assistance programs.

3. Elements of a Bank Assistance Program

The following is a more detailed description of the bank assistance program already sketched in outline. A bank assistance program must contain many elements, the most important of which is funding. This can be done by direct loans or by purchases of securities by the CDIC alone or in company with elements of the banking system if, in the circumstances, this is deemed to be appropriate and acceptable to those other elements including the banks, subject, except in the case of the CDIC, to ownership restrictions in the *Bank Act*. The regulator might, for the financial assistance of a bank, purchase unsatisfactory loans from the troubled bank as was purported to have been done on one interpretation of the CCB rescue contract; and as is regularly done by the FDIC in the United States. A funding measure common in the reorganization of corporate structure is the conversion of outstanding debt to equity. This cannot generally be practiced in the reorganization of banks because of the restrictions on ownership and concentration of ownership imposed by the *Bank Act*.

Another feature which has been found elsewhere to be vital for a successful bank assistance program is the partial or complete replacement of directors and management by the regulator. In some jurisdictions, this is a statutory power and indeed it has been recommended by the House of Commons Committee, and others appearing before this Commission, that this power be granted to the regulatory authority, however constituted. Where a rescue program is launched, the immediate aim is to restore public confidence so that the bank can attract deposits. The market, seeing the losses suffered by existing management, will, according to the evidence here, expect new management to be installed before new money is advanced to the bank. Whether the regulator should have such power outside an assistance program is debatable, and there being nothing in the record which indicates the need, such is not here recommended. It is the recommendation of this Commission that, where such action is required to be taken in a bank assistance program, it should be included in the program when authorized by the Minister.

The most difficult aspect of an assistance program in this, or any other jurisdiction similarly organized, is the question of the treatment properly to be accorded to those who have invested in capital (as defined in the revised statutory plan). By the OIGB guidelines, capital of a bank includes common and preference shares and long-term debt in the form of debentures. The *Bank Act* restricts the latter to subordinate unsecured obligations in the nature of a simple bond. All the components of a bank's capital, both debt and share capital, should be accorded equal treatment except as to priority in sharing any net worth in the bank as determined by the court, and the statutory plan should so provide. This is essential to the efficacy and fairness of such a program. Unless all capital is treated alike, one class could impede or block the rescue of a bank as it moves into a condition of insolvency, and force its liquidation, whatever may be the interest of the community in its continuance. This was the case in CCB, and it became necessary for governments to intervene and acquire the debt interest at the last minute.

It is important to note that in this chapter, the terms "investors' interest in the capital" or "the capital of the bank" refer to and include both share and debt capital. It has already been mentioned that the statutory plan for bank assistance programs should so provide. Consideration should be given to including in the statutory plan a requirement that instruments of debt capital should include a reference to the status of such debt in a bank assistance program.

The holder of each unit or element in the bank's capital should be entitled to institute the judicial process already described in the event such interest holder contends that, at the time of the adoption of the bank assistance program, the unit or element of capital held by the claimant had some value by reason of the fact that the bank was, at that moment, not insolvent. The court, by the statutory pattern, would be required to value such elements of capital, other than common and preference shares, in priority to share capital so that any value in the capital account of the bank at the date in question would be applied by the court first to the compensation of capital holders other than shareholders, and any residue shall then be applied to the preference, and finally, to the common shares, all in a priority analogous to a liquidation proceeding.

Where it is deemed by the regulator and the appropriate political authority that a bank rescue program should be inaugurated, it will, almost without exception, be done in circumstances where the bank is either insolvent or insolvency is imminent and inevitable. That being the case the banks' capital will, by definition, have been exhausted. Therefore, it would be inappropriate, if not fiscally immoral, to call upon the taxpayer or the shareholders of competitor banks to advance money to restore financial health to the ailing bank, all to the benefit of the investors in that bank who have, at this stage of affairs, ceased to have an existing financial interest in the bank. Their investment gamble has been lost.

In the United Kingdom and the United States, recent bank rehabilitation programs have been accompanied by a simultaneous acquisition by the regulator of the shares of the troubled bank or an agreement whereby the regulator will succeed to those shares, either absolutely or conditionally upon a continued decline in the affairs of the bank. It is essential, in order to treat equitably all contributors to the rescue, be they state or private, that the interests, if any, of capital investors be settled at the outset. Because of the sometimes enormous difficulties in getting agreement on such a matter, the Commission proposes that where the rights of any such investors are affected by a proposed bank assistance program, the statutory scheme should provide for the determination of the value, if any, by a judicial process of any such interests which have been cancelled or reduced by the provisions of the bank assistance program. If the regulator can demonstrate actual insolvency or imminent and inevitable insolvency, that is, that all capital of the bank has been, or is about to be dissipated, the court would make no award. However, should the court's assessment of the solvency of the bank differ from that of the Minister and the regulator, the court would then value the cancelled or reduced investors' interest. In this circumstance, the court might well, depending on the precise terms of the statute, find that the investor's loss included the loss of the right to continue as a shareholder in a solvent bank, and value the shareholder's losses accordingly.

Great difficulty was encountered in the case of CCB, and has been encountered in other countries with like regulatory systems, in determining precisely if and when a bank has become insolvent. The basic test, of course, is to determine whether the bank has any net worth in the sense that assets exceed liabilities in value. When the liabilities equal the assets there is, of course, no capital remaining in the bank, and the bank is insolvent. In order to determine whether the equation in any particular bank has produced insolvency, it is fundamental to determine the value of the loan portfolio because that is the principal asset of a bank. This entails assessing the worth of loans one by one to determine the value of the covenant of the borrower and the collateral security held by the bank. Such a route is hazardous, expensive, slow, and highly undesirable. What is required is some objective yardstick which might be easily and fairly administered as a summary technique in the determination of solvency or insolvency in a bank. One such yardstick might be the ratio of liquidity advances taken in by the bank in replacement of withdrawn deposits to the debt and equity capital of the bank. Where that ratio exceeds a range of 10 or 12 to 1 it is difficult to seriously argue that the bank is solvent, or if so, will remain in that condition very long.

There may well be other and better summary tests to determine, at least on a *prima facie* basis, the solvency or insolvency of a bank. The statute should, if possible, contain such a summary route. Otherwise the parties wishing to assert a residual value in their capital interest at the time of the adoption of the bank assistance program will be thrown back on the expensive process of valuing the loan portfolio by a detailed judicial examination. If the court finds the bank to be insolvent, this long and expensive asset valuation process will no longer be required, but failing that, a claimant for compensation will be faced with an expensive process.

No doubt the authors of a bank assistance program will on occasion consider that circumstances warrant the inclusion of an opportunity for the old capital investors to invest in new shares from the bank's treasury on the same financial basis as proposed for the public agency under the plan.

It will be noted that the proposed statutory process does not contemplate a shareholders' meeting or, if there be debt capital, a bondholders' meeting, for approval of the bank assistance program. The process requires the formulation of the plan by the regulator, approval by the Minister (who thereby determines the continuance of the bank as essential in the public interest), and the determination by the Court of the value, if any, in the capital interests which are to be cancelled by the plan. It would be a meaningless procedure, if not a charade, to require the capital investors to confirm their own execution. Parallels exist elsewhere in the law. Under present and past federal company legislation, provincial statutes, and legislation in the United Kingdom, an offeror, who in a take-over bid has acquired not less than 90 per cent of the shares of a company by class, may, by judicial process, obtain the remaining outstanding shares in such class upon payment therefor of the fair value of the shares as determined by a court if not settled by the parties. Another parallel is found in the *Canada Business Corporations Act* (and in provincial statutes, and in some states in the United States) where a dissenting shareholder may call upon the corporation in certain circumstances, such as on the adoption of a proposal for the sale of all corporate assets, to purchase his shares. The fair value payable for these shares by the company remains once again to be determined by judicial process failing settlement by the parties.

Liquidity support may be required by a bank on a short or long-term basis, the need in the former case having been occasioned by a momentary lapse in the matching of maturing obligations with liquid assets to meet them. Sometimes, as in the case of CCB and Northland, the requirement for liquidity support may be longstanding. The present statute provides that these advances may be made by the Bank of Canada as the lender of last resort. The Bank of Canada has the funds adequate for such extensive operations, and it is appropriate that this continue to be the source of liquidity financing in bank assistance programs. The awkward position of the Bank of Canada has elsewhere been discussed. It has the obligation as lender of last resort and it has a statutory obligation to take security for its advances. It does not have the apparatus to determine the extent of the value of the assets being taken in security. This value is known to the regulator, at least in theory, but not to the Bank of Canada. Therefore, as a matter of mechanics, the Commission recommends that (a) short-term liquidity needs arising outside a bank assistance program should be met as under the present law by advances from the Bank of Canada; and (b) when made under a bank assistance program, they should be made by way of requisition on the Bank of Canada by the CDIC as part of the bank assistance program, and that ministerial authorization should be required so that limits to these liquidity advances can be established and varied from time to time. The responsibility of the Bank of Canada under this procedure would be limited to complying with requisitions from the regulator who would be responsible for appropriate security being made available to the Bank of Canada.

Other funding required in the restoration of the financial health of a bank would be raised and administered by the CDIC through loans from the Government of Canada, other banks and other sources as circumstances may require or permit. Variations of such programs might be conceived, such as the purchase by CDIC of troubled loans from the bank in consideration for the assumption by the CDIC of appropriate amounts of the bank's indebtedness to the Bank of Canada for liquidity advances. The CDIC in turn would make an arrangement with the Bank of Canada for a fixed term for retirement of the debt so assumed by CDIC. This, in effect, creates an immediate pool of funds available to the regulator directing a bank assistance program.

It may be necessary, as has been found in both the United Kingdom and the United States, and as is evident from the CCB rescue story, to refocus a bank assistance program in mid-stream. With the additional information flowing into the regulator from a curator in possession and new management in office, the comprehension in the regulator of the nature and extent of the banking difficulties may frequently be quite different from the earlier apprehension. The scale and nature of the remedies to be prescribed may need variation or redesign if the bank is to be restored to health. This may require ministerial approval if further exposure of public funds is entailed or if the terms upon which public funds are placed in the troubled bank are significantly varied. Again the burden of revising the program and of seeking further ministerial approval would fall upon the regulator. Midway course corrections have been required in recovery programs in other countries recently and indeed might well have been considered in the case of CCB. Provision for this capability should be made in the statutory plan.

Once the executive branch or its agencies have launched a bank assistance program, its success depends to a large measure on the atmosphere created in the banking community by that process itself. Where, for example, it is perceived by the financial institutions in the marketplace to be an inadequate proposal, or otherwise unlikely to achieve success, the program is doomed almost before its launch. One difficulty encountered in the CCB experience was that immediately after the announcement of the rescue program, the House of Commons Standing Committee on Finance, Trade and Economic Affairs commenced hearings into matters surrounding the rescue program and the collapse of the bank. The program itself started on 25 March 1985 and the House of Commons Committee sessions commenced in early April 1985 and continued until the report of the Committee in June. The program came to an end with the liquidation of the bank on 1 September. Hearings of the Committee inevitably attracted considerable coverage by print and broadcast journalists and undoubtedly damaged the chances of success of the rescue program. Such is the evidence before this Inquiry. The legislative branch of course must operate in the discharge of its role under the Constitution without hindrance or interference, including other branches of government. Functional overlap and interference, on occasion, are inevitable. However, the evidence assembled by this Commission calls for the observation that the legislature, under the leadership of the government, should exercise considerable caution in conducting public discussion of a bank assistance program during its operation. Banking, as has been seen elsewhere in this report, is a subtle mixture of reality and perception. Critical examination of a bank in the daily press is hostile to the success of a program whose principal objective is to restore confidence in the bank in the financial markets and in the public generally. A hearing of any kind is a magnet to the media. Democracy can only thrive by the exchange of information. It would be constructive if some process could be designed so that this exchange could proceed later when the patient can better survive the treatment. If the bank assistance program is institutionalized in the statute, of course, the need for Parliamentary Committee review may disappear.

One extreme consequence of a bank assistance program is that which befell the CCB bailout. Liquidation there became inevitable and, with ministerial authority, the CDIC made application for the appointment of a liquidator. It must be recognized that not all rescue programs succeed. This was seen in the case of CCB. Nothing in the field of financial restructuring, particularly in banking, can be a guaranteed success. As already mentioned, however, where the bank assistance program is terminated by an application for liquidation, then the statute may well provide that those depositors and lenders of moneys not within the definition of bank capital, as established in the statute, should be compensated for their dealings with the bank. In both Canada and the United States, public reliance on the prospects of success of a bank rehabilitation program has led to full compensation of loss by depositors. This is both fair and, probably, politically inevitable, but it also should be said that such a practice would sap the strength of selfdiscipline in the system if it were to lead to universal compensation on an institutionalized basis. The establishment of a bank assistance program, however, would seem to be at least one instance where failure of a bank should bring compensation for loss to depositors.

Ordinarily a bank assistance program would be terminated when the presence of a curator on the premises of the bank is no longer required and where the bank has retired its obligations incurred in the course of the assistance program. Where the bank has recovered by reason of the program to the extent that the regulator, with ministerial authority, determines that the bank can be returned to general ownership in the community, the bank assistance program may be terminated or replaced by other fixed arrangements with the regulator, and the regulator, with prior ministerial approval, would then proceed to dispose of its stock and/or its debt securities in the bank. The buyers, of course, must be those qualified under the *Bank Act* to hold shares. The manner of disposition may vary in the circumstances, from public offering on the one hand to a merger on the other, all subject to ministerial approval. If everything proceeds according to plan, the public investment would be recovered, and the community would have been spared the loss of a bank. This is a general outline of the statutory structure herein recommended for the preservation of the integrity of the banking system as a whole.

There are many related issues which spring up around a bank assistance program. For example, the statute should contain a definition of insolvency. No comprehensive definition is contained in the *Bank Act* although s.276 provides that suspension for 90 days by a bank of payment of its liabilities as they become due constitutes the bank insolvent. The *Bankruptcy Act* defines insolvency both in terms of an inability to meet obligations as they generally become due and as negative net worth. Under s.3(1) of the *Winding-up Act*, insolvency depends, among other things, on the company's inability to pay its debts as they become due. It would be of assistance to the community if the *Bank Act* definition of insolvency could be coordinated with that found in the *Bankruptcy Act* and the *Winding-up Act*. However, because liquidity support payments will always enable a bank to meet its obligations as they become due, any test which focuses on an inability to pay liabilities when due is, at base, unhelpful in defining bank insolvency. It is the view of the Commission that the definition of insolvency should be the simple and traditional definition in most bankruptcy legislation, namely, that liabilities have come to exceed assets. An alternative is to retain the inferred definition in s.278(2) of the *Bank Act* by simply adding thereto the proposition that, in determining whether the bank can meet its liabilities as they fall due, funds supplied by way of liquidity advances from the Bank of Canada shall not be taken into account as having retired the liability in question. This is superficially attractive but would lay any bank open to the possibility of proceedings in liquidation where some very short-term and very small liquidity support is required. Any difficulties which flow from the application of the simple definition of insolvency as mentioned may be overcome in the context of a bank assistance program and its ancillary judicial process by a deeming provision, as already discussed.

The *Bank Act* must, of course, be revised to permit the CDIC to own or control, as part of a bank assistance program, all or any part of the outstanding shares and, for greater certainty, debt capital of a bank. In the CCB bailout program, the major banks were involved financially and received warrants to acquire shares of CCB in the future. In other jurisdictions, banks have been involved in financial participation in a rescue without ultimate or immediate reward in the form of shares or the right to acquire shares in the rescued bank. It is inappropriate, in the view of the Commission, to grant, directly or indirectly, permanently or transitionally, to competitor banks equity in the bank which is the subject of the program. In the CCB program, the warrants initially were to be issued to the CDIC. The major banks shared in this aspect of the program when they subsequently joined it. In the view of the Commission, the consideration, in the legal sense of the term, for the participation of other banks in a rescue program is their vital interest in the integrity of the banking system upon which they depend for their existence. Their reward is recovery of their advances, but far more important is the restoration of public confidence in the national banking system of which they form a part. They will directly benefit in that most important way, and that is sufficient.

Recommendation 40

It is recommended that the statutory structure authorizing the implementation of bank assistance programs should provide;

(a) for the cancellation or reduction of any interest in the capital of the bank as defined in the statute with compensation if applicable;

(b) for the replacement of members of the board of directors and management of the bank;

(c) for liquidity advances to be provided by the Bank of Canada, and other funding appropriate to the program by public agencies and the banking system as appropriate in the circumstances; and

(d) *for the interim modification of, and adjustment to, the bank assistance program in the course of its implementation.*

Recommendation 41

It is recommended that the legislation supporting the bank assistance program concept should also provide:

(a) *for liquidity advances to be provided to the bank by the Bank of Canada on the requisition of the regulator, all subject to prior ministerial approval, with security for such advances to be arranged by the regulator and posted by the bank with the Bank of Canada;*

(b) *for the temporary ownership by the regulator of share and debt securities in the bank during the operation of the bank assistance program;*

(c) *for a judicial process for the determination of any claim for compensation by the holder of an interest in the capital of the bank, as defined for these purposes by the statute. The procedure should include a statutory presumption to facilitate the disposition of the preliminary issue of the solvency of the bank; and*

(d) *for the ultimate disposition of the bank on termination of the bank assistance program.*

G. SECURITIES REGULATION AND DISCLOSURE

Sections 145 to 154 of the *Bank Act* constitute a code of directives to the financial community and the bank regulator concerning issuance of and trading in bank securities. These sections represent federal involvement in the securities exchange field otherwise almost exclusively occupied by the provinces. None of the federal agencies testifying or making submissions at the Inquiry proposed a withdrawal by the federal authority from bank securities regulation. The provinces of Quebec and Ontario, on the other hand, have showed varying degrees of aggressiveness towards the regulation of trading in bank securities. The basic question presented to this Commission concerns provincial requirements of full disclosure of financial and management matters relating to banks through prospectuses and other releases. The requirement of disclosure under provincial securities laws may prejudice the federal confidential supervisory system. For example, the reports made by the federal regulator are made confidential by s.251 of the *Bank Act*. The provincial agencies consider them part of the information to be disclosed to the investors. In the United States, the federal securities regulators have moved gradually to review bank activities through regulation of the issuance of securities of bank holding companies to the prejudice of the traditional system of confidential supervision.

It is inherent in the position of the bank regulator under the aforementioned sections of the *Bank Act* that a conflict of interest arises upon the application by a bank for authority to publish a prospectus in connection with initial and secondary trading in bank securities. There is a desire on the part of the confidential supervisory body to maintain the confidence of the information accumulated or produced by the regulator in his supervisory role, and not to force disclosure of it through prospectuses supporting security sales. We have seen one instance where the prospectus as approved by the OIGB gave no indication that the bank had recently been classed as unsatisfactory by the regulator. These conflicts cannot be resolved in our present system where the same body, the banking supervisor, is responsible for both the confidential supervision of the banks and for the regulation at the federal level of documentation surrounding the sale of securities in the bank to the public. A second conflict arises between the provincial regulators of trading in securities and the managers of the confidential supervision of banks as to what must be revealed to the investing public concerning such matters as the regulator's reports on the bank. In the United States those conflicts are wholly between regulatory agencies at the federal level.

Where a bank is experiencing liquidity problems, or has a loan portfolio characterized by a significant element of unsatisfactory loans, it may be attractive to a regulator to permit the bank to attract additional resources through the issuance of shares or debentures. In addition, where the bank, for example, is the subject of an unsatisfactory report by the regulator, the regulator must decide whether the prospectus should be required to reveal such a fact. It has earlier been recommended that the federal regulator should be empowered in some circumstances to order that cease and refrain orders not be disclosed. Confidence in the banking system may be seriously eroded by disclosure requirements, including those which may be required by provincial authorities. It may be, and has been strenuously argued, that decisions as to the limits of disclosure must, in a constitutional sense, be exclusively within federal jurisdiction, otherwise effective and complete regulation of banking by federal authorities would not be possible. This Commission is not driven by its mandate to resolve such a weighty issue. This is compatible with the recommendation concerning disclosure of cease and refrain orders as discussed earlier in this chapter. The

Commission for the purposes of its task must assume that the authority resides in the federal Parliament to regulate exclusively banking in all its aspects including the offering and trading in bank securities.

These problems arising within the federal regulator's area of responsibility are soluble by the employment of experienced and qualified personnel in the office in question. Where such a person is confronted with a duty to scrutinize and approve prospectus material, and at the same time conduct the confidential supervision of the bank, the clashing interest will have to be reconciled by the regulator in the public interest. The Commission sees no alternative to this under the present state of our administrative structure, and indeed draws comfort from the fact that this kind of conflict arising elsewhere in our federal administrative jurisdiction is solved on this basis. Given that no federal securities agency exists in this country, the *Bank Act* must continue to govern bank securities issues to the extent necessary to protect the interests of the banking industry. The authority of the regulator should be expressly extended if necessary to protect the bank from disclosure which would expose the bank or the banking system to injury.

Recommendation 42

It is recommended that the Bank Act provisions regarding the issuance and trading of bank securities continue to place the authority to approve bank prospectuses in the regulator of banks; and that the regulator be empowered to protect a bank from disclosure of information and material associated with the bank supervisory and regulatory system, where necessary in the interests of the banking system as a whole.

H. MISCELLANEOUS

1. Role of the Regulator as Liquidator

Another issue arising in the administration of assistance to a troubled bank is the role of the CDIC as liquidator. Its Act presently authorizes the CDIC to act in that capacity. In practice, the CDIC has not done so, and in hearings before this Inquiry has taken the position that it should not do so in ordinary circumstances. There is, of course, an inherent conflict between the single agency acting as a liquidator and as a claimant against the assets of the insolvent bank by subrogation. The submission of the CDIC goes further and points out that the necessity for a public liquidator in some countries does not apply in this country where the tradition in commercial liquidation proceedings has developed a specialized division of the accounting profession, the auditor-liquidator, auditor-receiver, or auditor-trustee. It is the view of the CDIC that this practice should be followed, and indeed it was followed in the case of both CCB and Northland, and the Commission concurs in this conclusion.

2. Liquidity Advances

Until the regulator with ministerial authority implements a bank assistance program, the responsibility as a lender of last resort for liquidity funds should continue to be in the Bank of Canada. Limits may be required to ensure participation by the regulator in the process at an early stage in order to anticipate the need for a more formal assistance program and to protect the Bank of Canada's interest by the progressive taking of adequate security.

At the present time, as we have already seen, the fact and the amount of liquidity advances are published with reasonable promptness in the Canada Gazette. There are two immediate problems arising out of the manner in which liquidity support is provided under the present system. First, the Bank of Canada takes prior security against all comers, thus discouraging other depositors from coming forward and placing their funds in the bank recoverable in liquidation only after the claim of the central bank. Second, the fact that liquidity advances are publicized at least unsettles the investing public's view of the bank, and may precipitate, as it has in the past precipitated, a run by depositors away from the bank. All these developments of course occur at the time when deposits are most needed. These facts also inhibit other banks from providing liquidity support at the very time when the troubled bank may wish to take advantage of this private source of assistance so as to avoid the mandatory publication which follows the receipt of Bank of Canada funds.

The nature of a liquidity advance is to enable a bank to remain in business when it is unable to pay its indebtedness as it matures despite the fact that its assets may exceed its liabilities by a wide margin. The reason such advances are necessary is inherent in the nature of the banking business, which, unlike most other commercial activities, is acutely sensitive to loss of confidence by the investing or money-lending public. Knowledge, or even suspicion of illiquidity, frequently, if not invariably, triggers a "flight to quality" in which depositors, whether professional money managers or members of the public, simply pull their money out of the bank and go to what are seen as safer depositories. The result may be a "contagion" of nonconfidence and a run in which the bank loses much of its deposit base. The bank moves into a condition of extreme illiquidity, and would collapse in a state of apparent insolvency but for support by the central bank or other lenders who come in and replace the departing depositors. Here, the line between loss of liquidity and insolvency becomes, because of the run phenomenon, very thin and indistinct.

Where liquidity support is given to solve acute liquidity problems, such as those which prompted the CCB Support Program, it is obviously counter-productive to require publication of central bank liquidity advances. Such publication merely makes it known in the financial community that the bank is in straitened circumstances and exacerbates the contagion effect. It is curious to note that this phenomenon has been clearly recognized by those who drafted the *Bank Act*. In s.175(4), and in the proposed new s.313.1(5), ministerial directives relating to the sensitive matters of capital adequacy and the existence of imprudent or improper banking practices are exempted from legislation which would otherwise require them to be made available to the public upon request. There is an odd conflict in philosophy which permits secret regulation of some matters vital to the bank's success and stability, yet requires publication in great detail of other matters which are equally sensitive.

The publication requirements currently embodied in the *Bank Act* have, despite their inherent dangers to the stability of banks receiving liquidity support, been justified as the right of the community to know how public funds are being used and, in particular, that public funds have been placed in a commercial enterprise as unstable as a bank in trouble. It is notable, however, that the Crown puts money into a great many commercial enterprises, and little or no notice is given. It has also been said, by way of explanation, that potential investors and depositors should be made aware of the nature of the institution into which they are placing their funds. This can hardly be a valid explanation, however, when no such requirement is established in the statutes at the present time where those same liquidity funds for the same purposes come from the other chartered banks. The principal statutory requirement relating to disclosure of such investments should be an annual report by the recipient of the payments, and some reference in the annual public accounts. Similarly, publication of the Bank of Canada's annual statements will reveal the amount at that date of liquidity advances to banks in general. Publication of the recipient bank's annual audited financial statements would also reveal amounts advanced to the bank at the date of the statement. It should, in the Commission's view, be a matter for the regulator to settle by an appropriate general guideline or a specific order whether liquidity advances should be specifically identified in a recipient bank's year end statements.

Recommendation 43

It is recommended that the present statutory provision requiring publication of liquidity advances by the Bank of Canada be repealed, and that publication of liquidity advances be limited to the annual financial statements of the Bank of Canada which shall report all such advances to the banks in total, and to the annual financial statements of each recipient bank. In each case the financial statements shall report liquidity advances outstanding at the end of each month in the course of the fiscal year, provided that there be appropriate amendments to all applicable federal legislation so as to authorize the regulator on the application of a bank to suspend all or part of the obligation in a bank to so publish receipt of liquidity advances by the bank for a period not exceeding twelve months.

Under ss. 173(1)(p) and 277(2) of the *Bank Act*, short-term lenders of liquidity funds who take security for such loans are entitled to first priority in the event of the recipient bank's insolvency. Although nothing in the *Bank Act* or in the *Bank of Canada Act* explicitly so provides, the Bank of Canada in practice invariably ranks as the first such secured creditor. In part this is due to the fact that under s.19 of its Act, the Bank of Canada is required to take security for all moneys it advances, whereas other banks need not, and indeed do not, do so in many cases. This probably also flows in part from the Bank of Canada's lending practices.

There are two possible alternatives to the system whereby the Bank of Canada inevitably possesses a prior charge in respect of its liquidity advances. First, the statute could provide for the joint or equal ranking of all providers of liquidity support, whether the provider is the Bank of Canada or any other chartered bank. Secondly, the statute could give the Bank of Canada power to assign its priority to a chartered bank which undertakes to make the required liquidity advances to another bank. No suggestion that the positions of the Bank of Canada and other lenders be equalized by prohibiting the taking of security by the central bank can be adopted, for the reasons given in the submissions of the Minister of Finance and the Bank of Canada. Public funds advanced to commercial undertakings should be secured. Liquidity advances must be made available quickly, and the central bank would be less willing to make the necessary advances of public funds if these were not appropriately secured. The purpose of liquidity advances is to enable the bank to continue to operate and to regain investor confidence. The conflict without answer arises because the Bank of Canada's prior security for liquidity advances or deposits frightens off the much needed money market depositors who are then aware that on a liquidation there would be few assets to settle their claims. The bait frightens off the quarry.

The availability of liquidity funding from sources other than the Bank of Canada is neither inherently harmful nor undesirable. The banks are free to take security for such advances. The practice of mutual support among the chartered banks is valuable and ought to be encouraged.

Recommendation 44

It is recommended that no change be made in the Bank Act provisions for the taking of security for advances by the Bank of Canada to a bank.

3. Deposit Insurance Coverage

Related to the problems on insolvency, real or impending, is the quantum of deposit insurance coverage under the *CDIC Act* (presently $60,000). Although the structure and funding of the deposit insurance scheme presently prescribed by the *CDIC Act* would appear to fall outside the Commission's mandate, this topic was extensively addressed in counsels' submissions in the course of the hearings.

The existence of insurance is regarded in the commercial community as an essential back-up for the well-being of a business. However, the extent of available coverage is limited by the insurer's need to minimize loss, and sometimes deductible amounts are incorporated so as to simplify administration and prevent abuse. These would not appear to be indicated as essential features of a bank deposit insurance scheme. Rather, what may be essential to such a scheme is a limit on coverage so as to retain the discipline of the market-place and the investment business. Limitations on insurable amounts have been proposed and implemented in order to create an incentive in the user or beneficiary of the system to look after his or her assets in a proper and prudent manner. The limit under the *FDIC Act* in the United States is $100,000(U.S.). In the absence of such limits, the direct relationship between institutional risk and rate of return would encourage the user to place funds in the least stable institutions, thereby creating the greatest potential for loss to the insurer. Such a policy when applied to an employee funds manager would reverse his duty under the laws of negligence. Where he formerly was under duty to minimize his employer's risk of loss, he must now make his investment decision so as to maximize the return to the employer, the risk of loss having been removed.

The Wyman Committee concluded that market discipline would be further increased by the introduction of depositor co-insurance from the first dollar. The House of Commons Standing Committee recommended against any co-insurance. The Royal Bank has submitted that a graduated coverage system, by which 100 per cent of the first $20,000, and thereafter, 75 per cent of only the next $50,000 would be insured, should be adopted.

Assuming for the purpose of dealing with submissions made to this Commission on the subject that these questions are within the Commission's mandate, it is recommended that a limit on the insurable amount such as the present limit of $60,000 should be maintained for the reasons already outlined. This limit would appear to be adequate to cover the average consumer's deposits which must be the essential purpose for the insurance scheme in the first place. The ceiling of $60,000 was only recently established and the Commission has heard no evidence which would indicate the circumstances have changed since that time.

It is convenient to discuss in association with deposit insurance generally the proposal made by the Royal Bank and others that each identifiable group of deposit-taking institutions who come under the insurance plan of the CDIC should be grouped into a pool so that a rate for premiums payable by members of that pool can be struck so as to reflect the loss experience of those members. The analogy is the typical workers' compensation statute in the provinces.

Recommendation 45

It is recommended that the statutory authority, the CDIC, consult with the appropriate insurance authorities on the proposition that premiums should correspond to the cost of each class of risk insured and that if the CDIC considers, on the basis of the advice taken, that the proposal can be instituted to the profit of the community at large, appropriate regulations should be issued by the CDIC.

4. Direct Rights of Action Against a Bank and Others

Mention has been made of the enforcement by CDIC of its subrogated rights arising in its role of insurer. No change to the present statutory provisions is necessary. No broad power is granted to the insurer in the *CDIC Act* to enforce directly duties owed to the bank by its directors, officers, auditors, or others. This situation may be contrasted with the position of the FDIC which in addition to its subrogation rights as insurer is, under 12 U.S.C., ss.1821(c) and (d), required to act as liquidator of a failed bank and to enforce "the individual liability of the stockholders and directors thereof." The record reveals that the FDIC has instituted many such suits in the past, and has many presently outstanding.

Apart from claims by a bank in its own name for recovery of losses suffered by the bank, there are claims which may arise directly in the investor in bank securities. The investor may make such a claim against the bank, the underwriters, the auditors, directors, officers, legal advisers, and perhaps others somehow connected to the process of issuance of, or trading in, securities. Such a claim may procedurally evolve into a class action. Another alternative procedure may be through a statutory nominal plaintiff who would make a claim on behalf of the investors. The Commission received information from small-scale investors in these two banks who lost their entire investment which had, in some cases, been made in these banks after assurances to the public about the condition of these banks. Independent action by small investors is expensive and likely uneconomic. What is considered to be required now is an efficacious procedure for the enforcement of the rights of depositors and shareholders which now exist and which would be created under recommendations hereinbefore made.

The class action is in theory a solution, but by reason of the uneven nature of that procedure across the provinces, it is generally considered ineffective. Class actions are difficult to organize and to prosecute. This type of action has proved unsatisfactory in the United States. Consideration should therefore be given to the advisability of including in the legislation provisions, devices or processes designed to render more economical the assertion of rights in this field. Procedures in the *Canada Business Corporations Act*, some comparable provincial statutes, and the *Ontario Securities Act* and other statutes governing provincial securities regulatory bodies, embody the concept of suit by a public official as nominal plaintiff in the circumstances permitted by the various statutes. In some statutes, such as the *Canada Business Corporations Act*, the public authority has standing to sue under various sections. In others, such as the Ontario *Securities Act*, s.132, the Commission may only sue in limited circumstances, and even then, must be authorized to do so by a Superior Court judge.

It should be added that claims arising in the bank itself against all the persons mentioned above require no special treatment in banking legislation. These are direct causes of action, and may be enforced by the bank or derivatively by others in civil actions in the civil courts.

The following recommendation is made by the Commission in the realization that a balance must be maintained between the right of the public to protection and its co-existing interest in being served by willing and qualified persons in the role of director, manager, auditor, and perhaps other roles as well. Directors for example are mainly part-time. They are in a different relationship in their role from that of auditors, underwriters, and officers. The duties and risks of board members should not be made so onerous or civil action so easily available that suitable and responsible individuals may refuse to serve due to the risk of exposure to expensive, lengthy, and perhaps unfounded, but nevertheless expensive litigation.

All this reduces itself to the final consideration of the appropriate nominal plaintiff. The regulator is ineligible because of the possibility that a claim asserted by an investor or depositor may run against the regulator, alone or in association with others. The liquidator may be appropriate to the role if the bank is, in fact, in liquidation at the time, however the investors' claims may well arise before the advent of liquidation. This process of elimination leads one to currently established public officials. Perhaps the most appropriate from amongst that group is the Director under the *Canada Business Corporations Act* already mentioned.

No attempt is made to draw up a catalogue of all potentially eligible defendants in actions for the enforcement of the several rights and duties which have been discussed. All this will be determined by the plaintiff however the action is structured, and the cast of defendants will vary with the circumstances in each case.

Recommendation 46

It is recommended that a statutory scheme be established to enable the enforcement of the rights against directors of banks recommended under Recommendation 14, and other claims related to the operation of banks and the trading in bank securities, including direct causes of action by investors in those securities. These claims should be enforceable by action brought on behalf of and for the benefit of the holders of those rights and claims, by a nominal plaintiff appointed by statute such as the Director, appointed under the Canada Business Corporations Act, or other appropriate public official.

Nothing herein contained is intended as a proposal to impede the enforcement process for long existing rights of the bank and its shareholders against directors and others where such action may presently be taken.

Chapter 7

CONCLUSION

The Commission has examined the operations of the banks, CCB and Northland, from their inception until the decision to put them into liquidation. This report deals with those operations and the causes of their collapse. From these events, conclusions have been drawn and recommendations made. Throughout it has been made clear that all which is contained in this report found its source in the evidence of the history of these two small banks. This has not been a general review of Canada's banking institutions. Such would be entirely outside the Inquiry mandate.

The Commission enjoyed the happy experience of receiving testimony from a great number of persons in banking and related businesses, both public and private, who brought considerable talent to their task. These witnesses spoke with candour and complete frankness, including some in the public service who might have been considered to be under the intense scrutiny or curiosity of the press. Underlying the findings and recommendations in this report is a recognition that these troubles arose, not by reason of inherent lack of required qualities in the administrators and in the participants in the system, but rather, in the inadequacies of the structure of the supervisory establishment. It should also be recorded that the Commission was not denied access to any documents or records or witnesses, public or private, throughout this entire investigation. This cooperation made it possible to thoroughly examine all these agencies and banks and their voluminous records in a short space of time.

There has been nothing revealed in all these proceedings to indicate the immediate need to conduct a similar study in depth into the business operations of Canadian banks generally. Nothing has been uncovered which shows a systemic weakness requiring any such investigation. From all that has been studied here, the Canadian banking system is sound, well led, and is recognized outside this country as standing in the front ranks of world banking. A loss of one per cent of its operating entities has not occasioned alarm abroad, and should not cause Canadians to lose confidence in their banking industry.

What does come through in this study is the need to continue the studies going on elsewhere in the government of the financial business and its institutions, of which banking is a part. This scene is changing rapidly here and abroad. Communications have led world financing, its pressures, shifts and changes, to everyone's doorstep on a daily, even hourly, basis. What was clearly banking or insurance or trust business or factoring or discounting or underwriting, and so on, is now not so easily defined and marked off. The significant integration in recent years may well continue and will have a large impact on the form and substance of the bank regulatory institution. This presents a number of challenges to national regulation. In a federally organized community such as Canada, the scope and scale of these activities raise questions of constitutional authority and inter-plenary cooperation. When the *Bank Act* is again reopened, it will no doubt be opportune to attempt a definition of functions, a realignment of institutions, and the adoption of an interfunctional set of rules. Perhaps the same operations should everywhere come under the same supervision and regulation. All this is evident all along the fringe of the journey this Inquiry has taken. The recommendations deal with the core area of the Commission's mandate, and this observation is volunteered, simply in the hope that it may assist in the evolving reviews elsewhere underway.

The loss of these two banks was regionally a serious development of considerable impact. Losses have been suffered by many. Enterprise, however, goes on and new institutions and organizations will continue to emerge. The overriding impression from a national point of view is that banking is still a business in which Canadians excel, and the national system as a whole still ranks with the leaders on the world scene.