Appendix D

The Support Program and the Collapse of the CCB

A. Background

1. Management's Outlook at the Outset of 1985
2. First Knowledge in the Executive Branch of Government
    - a. Pre-March 14 Information in OIGB
    - b. Pre-March 14 Information Available to Others Within the Federal Executive

B. Regulatory Response to the CCB Crisis of March 1985

1. CCB Presentations to OIGB and Bank of Canada — 14 March
2. Preparations for Bailout — 15 to 22 March
3. Inspections of the CCB
    - a. First Inspection: Grant and Tallman
    - b. Bank of Canada Security Assessment of CCB
4. Drafting and Interpretation of the Memorandum of Intent — 22 to 24 March
    - a. 22 March Meeting
    - b. Second Inspection: Grant and the Bankers Team — 24 March
    - c. 24 March Meeting and the Memorandum of Intent
5. Debenture Holders, Press Release, and CCB Assistance Act
    - a. Debenture Holders
    - b. The Press Release — 25 March
    - c. CCB Assistance Act

C. Preparation for the Participation Agreement

1. Bank of Canada Advances

Appendix D

The Support Program and the Collapse of the CCB

A. BACKGROUND

1. Management's Outlook at the Outset of 1985

At the outset of the bank's 1985 fiscal year, CCB officials reported a comparatively optimistic outlook on anticipated performance based upon their assessment of the overall economic environment and on internal factors. "The bank is anticipating a marked earning or improvement in fiscal 1985, although acceptable levels of profitability will not be reached until 1986 as a result of continuing but reducing high levels of nonearning loans and loan losses." Within the drilling rig sector, where a major part of CCB's U.S. activity was carried on, the fiscal 1985 outlook suggested "continuing improvement". "We were quite pleased with the performance of the drilling rig clients in the bank", and "the bank's drilling rig support program was delivering the planned results." Industry publications, and a Standard and Poor's survey dated 20 December 1984, support the suggestion that prospects for the U.S. energy industry were viewed favourably at this time. In testimony before the inquiry, CCB indicated that for the first quarter of 1985, overall financial performance actually exceeded the budget forecast, although the mix of taxable and tax exempt income differed from internal projections. Nevertheless, there were signs within CCB's U.S. division by 10 December 1984 that certain accounts were potential candidates for specific reservations in 1985. E.J.D. Pinder, Divisional Vice-President, Special Credits, estimated the requirements for specific reservations at $7.15M, $26.60M and $45.15M on a "best", "middle" and "worst" case, respectively. He stated in a memorandum of 10 December 1984 to Heisz:

> These numbers are not put forward in this format for shock effect as it is clear totals of the Best, Middle and Worst columns are not meaningful in and of themselves ...
>
> What is clear at this point is that some of our "old" names ... will require reservations this year and we should begin to factor this reality in our planning.

Concentration on the state of U.S. energy loans in late 1984 presents a somewhat distorted view of the total CCB picture. The bank had many other problems, and some were older and more serious. CCB's U.S. energy loans were under the direct management of the United States Special Credits group whose members tracked these accounts on an almost daily basis, and maintained frequent contact with borrowers and others familiar with the industry in order to keep informed of ongoing developments. Heisz reported several significant developments in the energy sector to senior management on 30 January 1985. Minutes of the meeting in which Heisz participated by phone read in part:

> The Comptroller of the Currency (Federal) in the U.S. has called on major banks to set aside additional reserves on loans related to the oil industry.
>
> Due to the falling OPEC prices U.S. companies are discontinuing development projects in the continental U.S. and Alaska. Heisz is very concerned about the U.S. Division's oil rig loans; there could be substantial additional write-offs in this area.

It should be noted that the U.S. regulator was calling for additional reserves, the earlier reserves having been required some two years earlier. CCB officials regarded the 30 January OPEC pricing decision as "reasonably good news" in that the posted price per barrel fell only $1 (U.S.) to $28 (U.S.), despite earlier predictions of price slashing. Nevertheless, in the light of continuing uncertainty about future oil prices, and other factors affecting the industry, the Special Credits group undertook a further reassessment of the bank's energy portfolio in mid-February.

Early in February, McLaughlan continued preparations for CCB's response to a U.S. FRB report on the Los Angeles agency, made after an inspection in October 1984, but effective 30 September 1984 (the bank year end in the United States). The report had not yet been received but was expected to require further reserves. In a memo to Heisz, dated 6 February 1985, McLaughlan wrote:

> While I have not yet received the most recent examination report, we do know that the Fed rated a large number of loans doubtful that will necessitate the provision of reserves. We now must determine how we will handle this situation, i.e. should the loans be transferred to Canada without reserves or should we book specifics and eliminate the reserves on our consolidated results. Please discuss this situation with P. Melnuk to ensure the strategy we adopt will be the most acceptable to our external auditors.
>
> In future, you should systematically conduct loan portfolio reviews of Commercial Centre Bank and CCB Agency to ensure borderline accounts are transferred to Canada prior to regulatory examinations.

This would seem to indicate that CCB found U.S. bank regulators more demanding than the OIGB. An overview of the energy portfolio reassessment, given to McLaughlan on 23 February, and presented to him in detail in California on 27 February, suggested an impact on the U.S. oil and gas industry that McLaughlan describes as "pretty sudden and pretty severe" in comparison with recent positive forecasts.

The report by Heisz presented a very negative picture of the current situation in domestic and world markets:

> While modest progress had been achieved in the Bank Sponsored Workout Program for specific contractor clients, it is clearly evident based on the current energy industry that times are getting worse and more setbacks are expected for energy-related companies and banks. During the 1982-83 era, most oil companies believed that by 1985, oil and gas prices would rise due to demand and supply factors improving the domestic markets. Instead, world market conditions have deteriorated which has caused the future to be bleak for refiners, distributors, drillers, and others in the energy chain. Since late 1984 to the present month, the oil-price set back has been another stiff blow for the staggering U.S. oil industry. Ebbing demand and OPEC's inability to deal with underselling and the oil glut have driven spot prices for the key U.S. crude oil to about $26.00 a barrel. Values of most reserves have again fallen dramatically and other oil-related assets have too, with some drilling rigs bringing 11 cents on the book value dollar recently at East Texas bank auctions. Drilling activity has dropped more sharply since mid-December 1984 than at almost any time in history, dooming many bankrupt operators who have been barely alive since 1982.

In fact, oil prices after taxes in Alberta had dropped in late 1980, and a world-wide decline in the oil industry came in late 1981. At approximately the same time as the Special Credits review of the U.S. energy situation was being carried out, other indications were emerging within the CCB's U.S. division that the problems in the bank's loan portfolio extended outside the energy sector.

McLaughlan testified that prior to 23 February, he was satisfied with improvements in the U.S. energy portfolio. After receiving the report on 27 February 1985, McLaughlan determined that further capital investment in the drilling rig support program would be an unacceptable business risk, and accepted the recommendation of the U.S. division that the portfolio would go into liquidation later in 1985 as contracts were concluded. For the CCB, as recognized by McLaughlan at this time, there would be a two-fold impact. First, to write the drilling industry loans down to liquidation value would involve a major charge against the bank's capital through the appropriations account, then estimated to be about $85 million and equivalent to about 70 per cent of CCB's capital. Second, a substantial increase in nonearning loans in the U.S. energy portfolio was anticipated. The estimate of approximately $100M in new nonearning loans would result in a further charge against earnings, an expense that was expected to be in the vicinity of $10M at a time when the annual earnings forecast was in the $4.5M range. The impact of the write-offs would be felt on both assets and earnings of the bank. The loss of interest revenue resulting from loans becoming nonearning would be a further blow to the income statement.

On 4 March 1985, the Loan Committee of the CCB Board met. Committee members were told that management expected to suffer a loss of $85M on the U.S. drilling rig loans. In addition, MULs within the bank were rising, the increase being mostly due to increasing NELs. The Loan Committee took no action as the same report was to be made to the Board of Directors the next day. On 5 March, an executive summary of the report was tabled at the meeting of the Board. Although the Board minutes do not reveal any reference by the President to the existence of the Heisz Report on the proposed write-off of $85M (Cdn.) on U.S. drilling loans, the executive summary paraphrases the Heisz report without revealing its existence. The summary noted "a sharp increase in NELs" and stated that "the outlook for the energy services sector has suddenly turned very negative". Crude prices had experienced an "overnight precipitous drop" and the quality of the BSDP loans "is eroding". McLaughlan's notes indicate that "the analysis is not completely definitive at this stage" and, according to the minutes, the President concluded with the statement: "If the U.S. energy services sector continues to deteriorate and liquidation is ultimately pursued, additional capital would be required later in the year."

CCB's Chairman, Paul Britton Paine, advised the Inquiry that the presentations had a quality of "iffyness" and that directors were anxious to determine "to what degree was this a reality, a current reality, or an apprehended future state of affairs". Paine testified that no reference was made to the Heisz Report as such in the Loan Committee meeting or the Audit Committee meeting of 4 March, or in the Board meeting on 5 March. Indeed the Heisz Report dated 25th February was not seen by the Chairman until some time after the month of March. He stated in evidence:

> My clear impression was that this [the Heisz Report] was absolutely new startling evidence. This is one of the reasons — I cannot speak for the rest of the Board but I think it was their impression as well — that we said as a group, 'Go away and find some hard facts and get back to us within two weeks so that we know where we are at'. ... I was unaware of it [Heisz Report]. It was a long time after, I think in preparation for this Commission, that I first saw it.

It is not without significance that the Heisz report itself was never presented to the Board or to the OIGB, yet management based the crisis which led to the revelations to the OIGB and the Bank of Canada on 14 March on the U.S. energy loan deficiencies revealed for the first time in the Heisz report. The Board in the end directed management to appraise the entire loan portfolio and to report back to the Board on the 19 March. As will be seen below, the Chairman of the Audit Committee had become aware, while visiting the Los Angeles Agency in mid-February, of troubles in the U.S. energy loans. As will be discussed shortly, the CCB also received in February a seriously adverse report from the FRB on the L.A. Branch. This report also was not revealed to the Board at the meetings of 4-5 March. Mr. J. Hillman, the Chairman of the Audit Committee, was aware of the report.

The Board, in its meeting of 5 March, and before any discussion arose as to the "U.S. Division nonearning loans" and nonearning loans in general, passed a resolution declaring a dividend. This decision was rescinded on 17 April.

McLaughlan stated, with respect to these events, that there was no doubt in his mind that the action directed by the Board was a review of the balance of the bank's loan portfolio less the U.S. energy loans which had already been appraised and reported upon to the Board. He further testified that this report was to be ready for the meeting of 19 March, and that in the meantime, he was to speak with the Government of Alberta and the Inspector General of Banks to disclose this problem.

On 13 March 1985, CCB's Canadian Banking Division completed a detailed analysis of the entire loan portfolio with a view to quantifying the extent of write-offs necessary to reflect current market conditions, and the impact of those conditions on the level of nonearning loans and partially earning loans over the planning horizon to 31 October 1987. On 14 March 1985, the United States Division completed a similar review. This material was presented on 17 March to a Special Committee of the Board which had been struck to review the problem. These analyses indicated write-offs totalling $252M on a "probable case" basis which were expected to occur on 30 April 1985 ($111M Cdn.) for the U.S. Division, and on 31 July 1985 ($141M) for the Canadian Division.

In his capacity as Chairman of the Audit Committee, Hillman planned to attend the offices of the Agency in Los Angeles between 11 February and 13 February 1985 to observe the inspection systems and controls which had been implemented at Westlands. Although a review of the loan portfolio was not planned as part of his agenda, Hillman did receive information from Boynton about the general condition of the U.S. portfolio. A draft report of Hillman's visit, prepared some time after his return (he did not report to management or the Board Chairman on his return except as to any remarks he may have made to the Committee and Board meetings on 4-5 March), discloses that the following comments and concerns regarding the quality of the loan portfolio were expressed to him by senior staff in the Agency:

1. tend to push problems forward on existing portfolio through accounting techniques such as interest and expense recapitalization;

2. creating borrowers;

3. lending platforms not quick to identify early symptoms of problem loans, reflecting the mixed calibre of loan officers and regional vice-presidents, and their natural tendency not to report trouble on loans they negotiated;

4. nonearning loans are worse than the directors understand them to be;

5. substantial reservations required on the portfolio;

6. reviewed the just received Federal Reserve letter of February 6, 1985, transmitting the report of the examination and commenting specifically on asset quality.

Hillman testified that he did not hear, during this visit, about the Heisz report which was in preparation at this time, nor was he informed of a sudden deterioration in the bank's drilling rig financing program. Hillman's notes from the visit contain no reference to suggest that these subjects were mentioned to him. Apparently, Hillman did not seek out or report upon specifics of the amount of write-down necessary in the U.S. portfolio as he considered this was a matter to be dealt with through the Chief Executive Officer of the bank. He returned to Canada on 13 February and arranged to meet with McLaughlan on 4 March 1986. Hillman for reasons unexplained brought back only the covering letters for the FRB report, but not the report. This report was very critical of the L.A. Agency. There is no evidence that Hillman advised the Loan Committee or the Board of this report at the 4-5 March meetings.

2. First Knowledge in the Executive Branch of Government

a. Pre-March 14 Information in OIGB

Information on the condition and affairs of the CCB prior to 14 March, the date on which McLaughlan met with regulatory officials in

Ottawa to report serious deterioration of the bank, was available to the OIGB from three sources: telephone calls from McLaughlan, a report by U.S. regulators concerning the California operations of the CCB, and the regular monitoring of the CCB conducted by OIGB personnel.

(i) McLaughlan Phone Calls: In early to mid-February, a meeting between officials of the OIGB and CCB representatives was scheduled for 14 March 1985 for the purpose of discussing CCB's 1985-1987 strategic business plan, its 1984 financial results, and the 1985 first quarter performance. Macpherson explained that a meeting in some form for routine purposes was actually contemplated as far back as November. McLaughlan has testified that he phoned the OIGB on 11 March to advise that the CCB energy loan situation and possible solutions should be added to the agenda. McLaughlan has testified that, after learning that the Inspector General and the Assistant Inspector General were absent, he spoke with Brossard, Director of Compliance at the OIGB and, "explained to him very briefly the new topic" and "just mentioned to him quickly" the three alternatives: recapitalization, merger, liquidation. McLaughlan testified that in a follow-up call on 12 March he spoke again with Brossard to identify possible merger candidates.

McLaughlan's communication with the OIGB took place about two weeks after he learned of Heisz' conclusions from the U.S. energy portfolio review. McLaughlan accounted for what appears to be a significant delay in advising the OIGB of changed circumstances by emphasizing his desire to assess the problem more fully himself: "I did not see any merit in a few days of hollering 'fire' when I did not know the magnitude of the potential solutions that were being considered." McLaughlan similarly explained his failure to refer to the sudden deterioration in the United States energy portfolio when he wrote Grant on 7 March, enclosing the report of the FRB on CCB's L.A. agency, although he knew of the California energy loan study on 23 February 1985 and was aware of its basic conclusions by 27 February 1985. It reported the need to write down these loans in the amount of $85M (Cdn.) which would represent a loss of about 70 per cent of the bank's capital.

The picture is further complicated by a memorandum prepared by the Bank of Canada on 8 March 1985 (discussed below) in preparation for the 14 March meeting. There is no explanation as to how or why the Bank of Canada had become involved in a meeting which all parties said was "routine" at least until McLaughlan expanded the agenda by his calls to the OIGB on the 11 and 12 of March. The 11 and 12 March phone calls do not appear in a chronology of events prepared by the

OIGB. The Inspector General testified that Brossard remembers only one call, around the 11th of March, and that Brossard recalls nothing in that call that particularly raised his concern or provided new information for the forthcoming meeting. Brossard testified on this matter in the Senate Committee hearings:

> As I said, the whole purpose was to confirm whether the meeting on the 14th was still on. I confirmed that the meeting was lined up and that the people who he wanted at the meeting would be there. It was a very short conversation. He did mention in confirming the meeting that the purpose would be to discuss the situation of the bank and that he thought the bank was in some difficulty. We agreed that we would discuss these matters on March 14, that that was the purpose of the meeting.

It should also be observed that the Inspector General was scheduled to be away at the time of the meeting on 14 March. This was known to McLaughlan but he did not ask that the Inspector General be alerted to the fact that the meeting would be faced with serious issues requiring the presence of the Inspector General himself.

(ii) FRB Calls of 15 and 20 February, and Report: FRB in Washington called the Inspector General on 15 February to express general concern about the condition of the CCB's U.S. Agency and to arrange further talks on the matter. The concerns of the FRB in Washington were based on a report received in Washington in early February. That report was based on an examination of the CCB's U.S. Agency carried out in October 1984 with reference to the financial position at 30 September 1984. This report, therefore, did not deal with the question of the U.S. energy portfolio.

The Inspector General called McLaughlan on 15 February at the CCB where the FRB report had been received on 12 February. Kennett described the information he received from McLaughlan as "rather upbeat". During the course of a later conference call on 20 February, the FRB advised the OIGB of its assessment of CCB's portfolio. The FRB classified about $100M of loans as unsatisfactory, including $40M rated doubtful. As a regular practice, the FRB expects doubtful loans to be written down by 50 per cent. The Inspector General understood that the FRB expected CCB to make a significant write-down in the U.S. Agency's loan portfolio. It was also indicated to the OIGB that "The Fed is considering that it may soon have to take some action". The OIGB requested a copy of the FRB Report which it received from the CCB on or about 7 March.

In testimony before this Inquiry, the Inspector General indicated that the 20 February FRB call did not produce a sense of urgency or suggest the need to embark upon a thorough examination of the CCB's loan accounts: "The call on 20 February did not, in any sense, create such apprehension that it would have required that kind of response." The Inspector General did not consider that the U.S. regulator's concern was "terribly high", and concluded that it was "not rushing desperately to act in these circumstances." As the Inspector General explained: "Well, it was not so alarming to the U.S. authorities that they got it to us on October 1. This was well into February. It was the first time they had been talking to us about this, and they were quite happy to have us discuss this matter with the bank and sort out a response on March 14". Reassurances from CCB based on detailed loan review, in contrast to the FRB's "broadbrush approach", and the age of the FRB assessment, it was said, supported the OIGB's view of the 20 February information: "It was not a matter of the greatest urgency and it was never regarded by us as being a matter that would bring down the bank." This is ironic as it was the position of CCB that the condition of the L. A. Agency loans forced the bank to seek aid in Ottawa on 14 March 1985. The Inspector General's comment is inapt for another reason. A memorandum prepared on 21 February 1985 concerning the call from the FRB on 20 February revealed, according to Kennett's testimony, that the FRB was concerned not only about the condition of the L. A. Agency but also about the effect of its bad loans on the entire bank.

The Minister of Finance has expressed the view that it is difficult to conclude clearly that more active measures should have been undertaken between 20 February and 14 March. "I think that the opportunity was there within a fairly short period of time for the Inspector General to get the whole picture together as opposed to simply looking at the California problem."

This does not take into account the following facts: this significant report had been in the hands of CCB head office since 12 February and the Inspector General had been notified by the FRB on 15 February of its adverse report; there was a general background of trouble, dating back at least to the May 1984 inspection of the bank by the Inspector General after which Grant, the Director of Inspection, graded the bank's condition as unsatisfactory; and Grant had written a memo to Macpherson on 6 March in which a merger was considered. None of this led to any special preparation for the 14 March meeting, or even to the inclusion in the agenda of the California report and the rising NELs in the bank, or its falling earnings. The meeting remained in the "routine category" because, while the OIGB considered that the bank might not survive indefinitely in its present form, the office assumed that CCB had months, and possibly years, to seek solutions to its problems.

The FRB report and the Heisz report reached CCB at the same time but the purport of the latter only reached the OIGB in the meeting with McLaughlan on 14 March. Management did not appear anxious to acquaint either its own Board of Directors or the OIGB with these two serious reports at the same time.

(iii) Regular Monitoring Post-1984 Fiscal Year End: The third source of information concerning the condition of the CCB was the regular monitoring, surveillance, and reporting practices of the bank inspection system. The Inspector General prepared for the Minister of Finance the following outline, dated 25 March 1985, of indications of difficulties prior to 14 March 1985:

> The key indicators used in following a bank are quarterly earnings, the level of nonearning loans and the level of loan losses.
>
> During 1984 the CCB presented an erratic earnings performance, earning money in the first and third quarters and losing money in the second and fourth.
>
> The Bank indicated ahead of time that the second quarter would be a loss and explained that this was due to loan write-downs in Westlands Bank located in Orange County, California. CCB then owned a minority interest in this bank.
>
> The third quarter results were profitable and acceptable given the Bank's burden of nonearning loans. They were also as we had been led to expect by management.
>
> Fourth quarter financial results were made available about the turn of the year and were disturbing as they were a loss and off expectation. Management indicated that unanticipated further write-downs had been taken in Westlands Bank which had become a wholly-owned subsidiary of CCB. Non earning loans continued to be a concern but it appeared that the Bank was able to carry them.
>
> Given our concern with the fourth quarter result, we began in February 1985 to seek indications of the results of the quarter ended January 31. We learned that nonearning loans had increased in the quarter and the quarterly results would be affected by this.

Grant had been directly involved in the follow-up of the auditor's report for the 1984 fiscal year. He expressed increasing concern with the state of the CCB following receipt of the first quarter 1985 results and the FRB report: "In the first quarter of 1985, when I learned that their profitability was rather marginal — about $200,000 — this concerned me more, and coupled with the call which we received from the Fed, I thought that I should look somewhat more closely then at what was going on." On 6 March, Grant wrote Macpherson to outline the basis for his concern and the possible options including merger and restructuring which he had begun to examine. On the following day, 7 March, the post-audit letter dated 1 March and accompanying materials, including CCB's comments on the auditors' findings and the FRB report, were received by the OIGB. Grant had requested the post-audit letter from the CCB on 11 January and again on 25 February.

The auditors, in a post-audit letter dated 1 March, indicated that CCB was "somewhat more aggressive in its accrual and capitalization of uncollected interest than we would prefer." Their report also stated:

> The recovery of a number of large credits would be endangered if the expected recovery in the Canadian and U.S. economies does not continue. They could also be endangered if the general level of interest rates was to rise significantly. Further, the Bank is exposed on several loans where the ultimate collectability depends on a significant recovery in the Alberta and British Columbia economies and in the energy sector in the U.S.

From the various sources of information available to it, the OIGB was aware that the CCB's condition was not strong. The OIGB concluded, however, on the basis of information from the auditors, CCB management and the FRB report dealing with the U.S. Agency, that the situation was not solvency-threatening.

b. Pre-March 14 Information Available to Others Within the Federal Executive

Governor Bouey testified that prior to 14 March, the Bank of Canada had no indication of current and acute problems at the CCB, although on the basis of contacts with the OIGB and from annual reports, Bank of Canada officials were aware that CCB was struggling and having problems. Vachon also indicated that McLaughlan's presentation on 14 March came as a surprise. However, about one week before the 14 March presentation, the Bank of Canada had received a general indication that in the view of the OIGB the future of the CCB was uncertain. A memo from Vachon to Governor Bouey, dated 8 March, states in part:

> The Office of the Inspector General of Banks has doubts about the long-term viability of the CCB given its present structure. These doubts stem mainly from the large portfolio of nonperforming loans, totalling some $220M. These loans, in turn, reflect the bank's exposure to the real estate sector in the western provinces as well as to energy sectors in Canada and the United States. The latter loans appear, in part, on the books of the CCB's agency in California. The large portfolio of doubtful loans has, to date, entailed an annual shortfall of revenue of some $18M and has been largely responsible for the bank's negative earnings performance (before tax credit) over the past several quarters. Given the rather bleak outlook for the real estate and energy sectors in both Canada and the United States, it is likely that the loan portfolio will continue to represent a drain on the earnings of the bank and undermine its ($150M) capital base. The Inspector General fears that a

> continuing negative earning performance could eventually undermine depositors' and investors' confidence in the bank and bring about the need for liquidity support from other chartered banks or the Bank of Canada, or both. Thus far, the CCB does not appear to have experienced any unusual funding difficulties.

This memorandum makes no mention of Grant's memorandum of 6 March which concluded that "the Bank will be hard pressed to survive in its present form." In tone, the two memoranda are remarkably similar. The Minister of State (Finance), also testified that she had not been alerted in what she describes as "any particular sort of danger-signalling sense" to developments at the CCB subsequent to an initial briefing in October 1984. There is no indication that the October 1984 briefing acquainted the Minister with the fact that the Director of Inspection for the OIGB had concluded, following the 1984 annual inspection, that the CCB was in an "unsatisfactory" condition or that she was advised as to the state of the CCB loan portfolio as then known. Nor was this information presented in the Inspector General's annual reporting letter on CCB to the Minister of Finance. Prior to 14 March, the Minister was familiar with the California branch of the CCB as a significant part of the bank's operations but not aware of the 20 February FRB telephone call or that the California situation might bring down the CCB. The Inspector General has confirmed that at meetings with the Minister of State on 5 February and 25 February he did not advise her of current discussions regarding the CCB: "Nothing had happened in that period that I considered to be so significant that I had to seek a special arrangement, a special meeting to inform her." The 25 February meeting between the Inspector General and the Minister of State dealt with "other subjects related to reworking of the financial system".

Similarly, it is the recollection of the Minister of Finance that the CCB California situation first came to his attention in mid-March: "I was made aware of the problem I believe the first time over the course of the weekend in Quebec City; that was the Summit". The Finance Minister understood that the cause of the CCB's March difficulties was the California situation (rather than a weak loan portfolio) and that the deterioration in California had occurred suddenly.

B. REGULATORY RESPONSE TO THE CCB CRISIS OF MARCH 1985

1. CCB Presentations to OIGB and Bank of Canada—14 March

Pursuant to the decisions taken at the CCB Board meeting of 5 March, McLaughlan had explored the options thought to be available (including discussions with the Government of Alberta) and had initiated a portfolio analysis of CCB's Canadian and U.S. divisions. McLaughlan did not seek a directive or authority from the Board to proceed to Ottawa in search of assistance to meets its financial crisis, and none was given.

In Ottawa on 14 March, the CCB President, accompanied by Messrs. Mann and Melnuk, met with Macpherson, Grant, Brossard and Ruxton of the OIGB. The Inspector General was then on vacation and did not have direct involvement in the CCB affair until 20 March. McLaughlan presented a review of the background to CCB's current situation and outlined the responses that had been considered to that point. The idea of a "rescue group" was also introduced. In a memorandum to the Minister of State (Finance) on the same day as the meeting with CCB, Assistant Inspector General Macpherson summarized the initial presentation:

> We were visited today by the Chief Executive Officer of the above bank, Mr. G.W.C. McLaughlan, to be advised of a serious deterioration in the loan portfolio of the bank in recent weeks. The principal reason is the decline in oil prices since year-end which has resulted in the nonviability of a number of the bank's oil-industry related borrowers in the U.S.A.
>
> At the present the bank has classified nearly 30 per cent of its loans as marginal or unsatisfactory. Of that amount, about $257M are nonproductive, yielding no income to the bank. The very recent worsening in the energy portfolio will raise the nonproductive loans to about $350M by the end of April. Apart from the energy loans, the bulk of the weak loans are in Alberta real estate situations. Management has, probably rightly, concluded that the Bank cannot long survive under that burden of nonproductive loans.

Macpherson also briefly described restructuring, merger, and liquidation as three possible approaches for dealing with the situation.

Before returning to Edmonton, the CCB delegation briefed Governor Bouey and other Bank of Canada officials on the CCB's situation and the solutions that had been examined. McLaughlan requested that the Bank of Canada establish a direct line of credit with the CCB despite the existence of existing irrevocable lines of credit with Canadian and U.S. banks. Governor Bouey was left with the impression that there was some urgency in the situation and that the CCB did not have very much time to arrange a solution before a due diligence report to a major U.S. bank and the release of second quarter results.

Evidence relating to an assessment or questioning of CCB's reference to the oil industry situation to explain the bank's change in circumstances is as follows. Vachon did not recall that any question was raised at a Bank of Canada meeting as to why the problems had surfaced at this particular time. There is similarly no indication that the OIGB comprehensively explored McLaughlan's analysis of the deterioration of the energy situation at the time of the 14 March discussions. The office was principally concerned with coordinating the response to the immediate crisis. However, the OIGB did devote some of its efforts to verifying the stated cause of the bank's problems, for the Inspector General received a memorandum on 27 March concerning the performance of the energy sector in which crude oil prices were set out on a quarterly basis for 1980 to first quarter 1985. (See Table D.1.)

Table D.1

Calendar Quarter Price of Saudi Arabian Light Crude Oil

	Q1	*Q2*	*Q3*	*Q4*
		($U.S. per barrel)		
1980	26.00	28.00	29.33	31.33
1981	32.00	32.00	32.00	34.00
1982	34.00	34.00	34.00	34.00
1983	31.00	29.00	29.00	29.00
1984	29.00	29.00	29.00	29.00
1985	28.33			

Allan Taylor, President of the Royal Bank of Canada, consulted certain Royal Bank officials with western oil credit experience to ask about problems with drilling rigs shortly before March 1985. He was informed that the early 1985 situation was "simply a continuation of what we had been witnessing right through '84" and testified that the Royal Bank "had this knowledge of the deteriorating position in the drilling side of the oil business for at least two years ... and had been making provisions for it through that time." From November 1981 to November 1985 Bruce Cockburn was Vice-President of National Accounts, Corporate Global Energy and Minerals for the Royal Bank of Canada. He testified that in early 1985, with the drop in oil prices, the oil rig count in the United States fell to about 1,600 from a high of 4,500 even though there was a belief as late as December 1984 that the process of decline had stabilized and the count would not go below 2,500.

2. Preparations for Bailout — 15 to 22 March

On 15 March, the Assistant Inspector General and Brossard met with the Minister of State (Finance) to brief her on the options then considered to be available to CCB — restructure, merger, and liquidation. Macpherson had already advised the Executive Assistant to the Minister of State (Finance) about the 14 March developments and he had prepared briefing materials for the Minister. Also on 15 March, at the suggestion of Bouey, the Board of CDIC was convened. Those in attendance at the CDIC meeting included Governor Bouey, the Deputy Minister of Finance, Macpherson and Vachon, all of whom were already familiar with the CCB situation. As reported by Macpherson, a range of views was expressed:

> The Governor strongly argued for saving the Bank. The Deputy would be pleased to save the Bank but would not commit government money to a rescue. The Superintendent was concerned about saving the Bank while allowing trust companies at a cost to depositors.

Supporters of assistance for the CCB were concerned that the cost be reasonable.

Allan Taylor, President of the Royal Bank of Canada, who was contacted by telephone on 15 March by the OIGB, indicated the unwillingness of his bank to participate in a "merger" except for the purpose of liquidating CCB. In the light of Taylor's position, the Governor and the Assistant Inspector General concluded that the merger alternative should be dropped.

Bouey and Macpherson decided on 16 March to invite the Chief Executive Officers of the major banks to Ottawa for a meeting in order to determine their views on the impact on the banking system of the closure of the CCB, and to consider their willingness to participate in some form of rescue plan for the CCB. Such a meeting was indeed held but not until 22 March. The Minister of State (Finance) did not wish this meeting to be held at the earlier date because she did not want the knowledge of CCB's trouble to go beyond the Royal Bank until the government had an opportunity to assess the potential solutions further. McLaughlan has testified that Macpherson indicated on Sunday, 17 March that liquidation "seemed to be the alternative that would be selected" because of disadvantages to the other options. In response to this, McLaughlan, with Melnuk's assistance, prepared several alternative recovery strategies, including a proposal similar in outline to the eventual support package, and communicated these to Macpherson by telephone. McLaughlan was called back to Ottawa by the OIGB, and the CCB Board meeting scheduled for 19 March was cancelled.

During this period the OIGB was operating on two tracks; liquidation and some possible means to save CCB.

While arrangements for a support package for the rescue of CCB were being considered, preparation involving the OIGB, legal counsel, and officials from the Department of Finance was under way to implement liquidation procedures if these eventually became necessary. Serious exploration of the technical aspects of the liquidation option was commenced on 17 March and, in that connection, the necessary evidence of the insolvency of the CCB was gathered. A curator was selected and dispatched to Edmonton on 24 March to await further instruction. On the assumption that there would not be agreement on the support package, the Inspector General advised the Minister of Finance in such an event to appoint a curator.

The OIGB then turned to the consideration of a "rescue operation" whereby CCB would continue to function as an independent bank. In essence, this plan was to transfer out of CCB to the six major banks an interest in the poorest loans in the portfolio of the bank, and to replace these loans with moneys to be advanced by the major banks and the CDIC. Such a plan avoided the need to raise new capital for CCB (an enterprise with very doubtful prospects at this time) and at the same time would hold out by share warrants or similar means an opportunity for the participants in the rescue program to realize some return for their efforts and for risking the moneys to be advanced to CCB. This plan was based on McLaughlan's proposal.

On Monday, 18 March, the Assistant Inspector General of Banks brought the Minister of State up-to-date concerning the weekend developments. He "suggested to her the revised support proposal and advised that it seemed the most attractive and likely to succeed". The earliest reaction from one of the larger banks was equivocal. The bank was prepared to assist in any reasonable program eventually agreed upon but it was "somewhat skeptical of the longer-term viability of the bank", partly in light of that bank's experience in the Western market.

The Assistant Inspector General was concerned with the impact the failure of CCB would have on other elements of the Canadian financial system. Small domestic banks "could experience a liquidity crisis and a flight to quality particularly by larger depositors". The failure of CCB "would have severe negative repercussions on smaller financial institutions, particularly those based in Western Canada." Trust companies and credit unions would sustain material losses. There were international implications for Canada and its banking system. The failure of a Schedule A bank could result in disruption of the inter-bank market and "undermine confidence of international depositors and investors." It was also observed that a liquidation of the CCB would be extremely disruptive for the bank's borrowers who were small- to medium-size private businesses, primarily in Western Canada.

In the ensuing discussion, government officials were faced with colliding considerations; a desire to avoid the investment of funds by the Government of Canada in a business enterprise, and yet a serious concern about the disruption of the CCB's borrowers in the event of a failure and the wave effect this would produce in the Western economy. Several other concerns floated to the surface: the importance of maintaining discipline in the economic/financial system, the international implications of the situation, Western financial aspirations and the consequences for the Western Canadian economy, the implications for small banks and other financial institutions, and the viability of the regional bank concept. Mr. M. Cohen, Deputy Minister of Finance, provided the following description of the collective response to the difficult CCB problem involving a series of counter-balancing factors where evidence was neither solid nor complete:

> I think I would describe it by saying to you, on a scale of zero to ten, if zero meant let the bank fail and ten meant save it, some of us were at four and some of us were at six. Nobody was at zero; nobody was at ten. ... By the time it all finished, we had all kind of come to an essential consensus at, what I would qualify, as five and a half to six; that is to say we had all reluctantly agreed that we should save this bank provided the price was acceptable and reasonable. But it was not a polarized affair for any of us.

The Inspector General returned to Ottawa on 20 March. He met during the day with the staff from the OIGB for briefing, with the Governor for discussion of the options and with the Minister of State who asked him to take charge of an interdepartmental working team on CCB. The Minister requested that the group should contain representatives of the Department of Finance, the Bank of Canada, CDIC, the Superintendent of Insurance, senior legal counsel from Finance, a senior communications advisor, and the Chiefs of Staff or their delegates from her office and from the office of the Minister of Finance. The Minister stated: "This group should work to provide the analysis of the situation and present the options available to CCB, the federal and provincial governments. In presenting those options, the costs, impact on the other financial institutions, legal requirements and where possible impact on the economy should be included." At this point the Government had not yet decided to save CCB and had not agreed to commit funds for the purpose.

The Province of Alberta had an obvious interest in the survival of the CCB. The principal investors and borrowers, as well as many depositors, were in Alberta. The head office and most of the bank's employees were there as well. The Province itself was a large depositor. The Deputy Treasurer of Alberta was on hand in Ottawa and was briefed by the Deputy Minister of Finance of Canada.

By the morning of 21 March, the government authorities, including the Minister of State (Finance), were inclined to attempt to save the bank by an arrangement whereby the CCB would sell off an interest in a bloc of nonearning loans to a consortium including the CDIC, the Government of Alberta, and the major chartered banks. The financial involvement of the Federal Government itself was not at that time contemplated. The CDIC Board passed a resolution that day enabling CDIC to participate to the extent of $75M in the proposed purchase of loans subject to four specific provisos:

1. that it be confirmed that the total of the insured deposits held by the bank is approximately $400M;

2. that the estimate of potential losses in the bank's assets as indicated in the report ($244M) are confirmed by the further examination of the bank's loans currently in progress;

3. that the combined contribution of the participating banks and the Province of Alberta be approximately equal to $170M; and

4. that the representatives of the participating banks have expressed their confidence that if the plan is put in place it should be successful in achieving the desired result.

There was otherwise still no commitment of government funds. The Minister of State viewed the willingness of the major banks to participate as a "litmus test" of the apprehended impact of CCB failure on the Canadian financial system, for the banks were better placed than government officials to assess intangible questions concerning confidence in the banking system.

3. Inspections of the CCB

a. First Inspection: Grant and Tallman

On 18 March, Mr. Neville Grant, Director of the Inspection Division of the OIGB left for Edmonton "to monitor and report upon the progress of funding at the Bank, review for reasonableness the financial projections developed by the Bank and begin a review of the nonperforming loans and estimated losses". In Grant's words the purpose of this inspection was "to determine what was the true condition of the bank", to "find out first hand what the situation is". To carry out the inspection, Grant was assisted in Edmonton by Mr. Gordon Tallman, Vice-President, Commercial Banking and National Accounts, of the Royal Bank of Canada. Tallman was made available by the Royal Bank at the request of the OIGB for assistance with the CCB investigation. Mr. James Anderson and Mr. Alister McArthur, also of the Royal Bank, were made available in the same way, to examine CCB loan files in the United States. They reported by telephone to Grant.

The Edmonton inspection dealt with Canadian loans (whether or not they became Support Package loans) for which the CCB had proposed write-offs of $1M or more. Grant stated he expected Tallman to look at the loans as he would do in his own bank and to assess on the basis that the borrower was a "going concern". Tallman has confirmed this general approach and his own understanding that continued operation of the CCB was also assumed. In some cases, Tallman concluded that files should be assessed on a liquidation basis. Where it was evident from the files that a particular client could not be regarded as a going concern, it was necessary to calculate the extent of the expected loss after security had been realized. Grant and Tallman examined 36 loan files falling within the designated parameters for the review in a period of one and a half days. The principal value of the loans examined is not immediately obvious on the evidence. An OIGB memorandum states that the two March reviews covered Canadian loans with a principal value of $900M, and there is a notation that the second of these two reviews covered $602M. Therefore, it would appear that Tallman reviewed loans having a principal value of $300M. The Edmonton inspection was done by Tallman with Grant recording his findings. Tallman examined the credit application, the most recent financial reports, recent asset appraisals where available, and the unsatisfactory loan reports prepared by the CCB. Various CCB officers were also consulted in the course of this review. The bank had identified losses of $141M on the nonperforming Canadian loans reviewed by Grant and Tallman. Their assessment, however, indicated that an additional $67M loss might be anticipated on a "worst scenario" basis. Approximately $48M of this amount was attributable to "significant variances in provisions" on five accounts. To resolve the discrepancies between Tallman's views and the bank's assessment, Grant had determined after lengthy discussions with CCB officials that "the truth is somewhere in between". Accordingly, he reduced the Tallman assessment by about $7M so that the total additional provisions for Canadian loan losses was about $60M. The $60M difference was reported to the OIGB on 21 March.

With respect to the U.S. loans, the Commission has not heard direct testimony. It appears that the Anderson examination corresponding to the Grant-Tallman review involved "100% of the energy loans identified as potential losses and 80% of real estate and commercial nonperforming loans." The Heisz report of February 1985 on CCB's U.S. position (or at least, its overall conclusion regarding estimated losses) was made available to the Anderson-McArthur inspection team in California on 20-21 March. The examination of the U.S. portfolio also resulted in an increased estimate of losses of about $20M (Cdn).

Grant reported the results of the first inspection to the Inspector General, the Assistant Inspector General, and Ruxton on Thursday 21 March 1985. The Inspector General took some comfort from the results as they were "within the broad framework of the bank's own analysis" although he was not provided with details of the review process itself. A memorandum from the Inspector General to the Ministers indicates that Grant's report covered both the Edmonton and California inspections, yet the Inspector General reported an additional $60M of write-offs to the bankers, as will be seen, while the actual results were $80M. Either Grant neglected to report the U.S. results to the office, or some confusion resulted in the report of the Canadian results. Had Tallman's assessment not been changed (and this review was to be an independent assessment), the figure would have been closer to $90M.

The result of the Grant-Tallman-Anderson loan examination was commented on in a memorandum written the morning of 22 March by Mr. W. Mackness, an officer of the Bank of Nova Scotia then serving in the Department of Finance, in which he informed the Minister of Finance that Grant's report from Edmonton "indicates large write-down $300 million versus $244 million". The Inspector General described Grant's first inspection results to the Finance Minister on 24 March as follows:

> On Friday, March 22, 1985 Mr. Grant reported both on his review and that of the banking officials in Los Angeles. Mr. Grant expressed an opinion supporting the views of the Bank that write-downs of $244 million would be necessary and that in the event that the Bank is liquidated, further losses would be experienced. Mr. McLaughlan agreed that the conclusions drawn by Mr. Grant were probable.

The Inspector General must be making reference to Grant's report on 21 March. He failed to point out the wide disparity between the examiner's valuation and that of the bank, even assuming Kennett was not aware of Grant's unilateral reduction of the former's assessment.

b. Bank of Canada Security Assessment of CCB

At the time of McLaughlan's 14 March presentation, Bank of Canada officials had been alerted to the need to supply liquidity support, and thus, to the requirement for an up-to-date security agreement with CCB. This agreement would provide the basis for Bank of Canada financing as it became necessary in the months to come. Governor Bouey has described the normal procedures whereby the Bank of Canada conducts investigations as to the adequacy of the security:

> [T]he starting point is normally an assurance from the Inspector General that the bank is in fact solid, that it has assets that exceed its liabilities. That means we feel that we can lend a substantial portion of the assets of the bank quite safely at that stage. ... Normally we would lend against the most marketable type of securities first: treasury bills, Government of Canada Bonds. Then we might have to go on, if the requirements were likely to be great, to lend against the loan portfolio. The most convenient way of doing that is to take an assignment against the loan portfolio. Then we do feel obliged to do enough work anyway to ensure that the loans do exist on the books of the bank and to find out a bit about them.

Mr. A.C. Lamb, Comptroller and Chief Accountant of the Bank of Canada, was in Edmonton from 18 to 21 March to assess the assets and to arrange the security agreement with CCB. He had previously been involved with CCB in relation to an earlier security agreement in 1983. He was accompanied by Mr. D. Woods (Staff Counsel). Lamb spent much of his time in Edmonton in legal discussions on the details of the security agreement and related questions of opinion letters. In a memorandum to file, Lamb summarized his work as follows:

> The details of the proposed write-down of loans and the general character of the current portfolio were reviewed along with the status of their funding sources. Reports are available regarding their 'overall strategy' and the details of the loans to be written down. The discussions centered on the cause and timing of the problem and on an evaluation of the reasonableness of the proposed amounts to be written down.

Grant was in Edmonton at the same time engaged in the first inspection of the loan portfolio. Lamb of the Bank of Canada and Grant of the OIGB were together on occasion in briefing sessions with CCB officials. Lamb was present on one occasion for an extended period while Grant and Tallman examined part of CCB's loan portfolio and raised detailed questions on the proposed write-downs. He did not discuss the loans and write-downs with Grant in any detail because Lamb's objective in March was to ascertain a general level of security for Bank of Canada advances.

> ... I was anxious to get a general feel for what the write-down was rather than having any particular focus on the portfolio at that stage.
>
> . . .

> What we are trying to do with this facility, ... was to take a very large amount where we could feel secure that we could make fairly substantial advances against it without having to get into detailed evaluation of the portfolio since it is not an area that we would have the people and would have to go out and hire somebody to come in and do that or find some other process of doing it.

In what he describes as "a very first cut and very raw numbers", Lamb concluded, in a memo to file of 23 March:

> The CCB's Canadian dollar General Loans total over $1.2 billion before the proposed write-downs which would enable the Bank to make advances approaching $1 billion with reasonable security.

Lamb did not discuss his conclusion with Grant or the Inspector General.

When, on 3 April, Lamb did have an opportunity to get Grant's impressions on the CCB loan portfolio, he learned of Grant's conclusion based on the first and second inspections that a larger write-down, around $300M, might have been appropriate in the Support Package. Lamb reported his discussion with Grant to Governor Bouey and expressed the view that:

> It is likely that all of these evaluations are conservative since there is little incentive for the individuals involved to underestimate the problem.

Lamb was not aware that the support group banks wanted the Inspector General to confirm the solvency of the CCB, or of the desire of the banks for a comprehensive examination of the CCB loans. When the Bank of Canada subsequently determined that a more detailed examination of the CCB loan portfolio was desirable, the Bank looked to the Hitchman investigation which the OIGB arranged in June: "We would normally have expected to work through the Inspector General; we would not expect to set up a separate or competitive inspection system." This is the extent of the evidence on the linkage between the two principal public agencies concerned with the state of the CCB loan portfolio, although there were also frequent discussions between the Inspector General and the Governor, and ongoing discussions between the two agencies at various levels on other matters related to the CCB.

4. Drafting and Interpretation of the Memorandum of Intent — 22 to 24 March

a. *22 March Meeting*

At the invitation of the Governor of the Bank of Canada and of the Government of Canada, the representatives of the six major banks met in Ottawa on 22 March 1985 to discuss the CCB situation. McLaughlan was present for part of the day's discussions, described to the meeting the state of affairs in the CCB, and then withdrew. The Inspector General outlined the alternatives that had been considered and described the support group proposal as previously formulated. The bankers also discussed background considerations and raised a series of concerns regarding the arrangements proposed to them, including the need for the debenture holders to subordinate their interests to those of the Support Package participants, a further examination of the CCB loan portfolio, and Government of Canada participation in the Support Package. The meeting was adjourned on the understanding that if solutions to the questions raised by the bankers' response to the program as proposed by government officials could be found, the parties would reconvene later in the weekend.

Some doubts concerning the communication of information on the extent of CCB's additional loan losses were raised during the course of the Inquiry. The evidence on this issue in relation to the 22 March meeting is as follows.

The Inspector General's speaking notes prepared for the 22 March meeting state:

> The write-offs proposed by the bank are in certain instances not the worst-case situations. To cover such fire sale liquidation values, another $50 million or so of write-offs could be taken. However, our view is that a program providing for a purchase of losses of $244 million will be adequate to secure the viability of the bank.

The Inspector General testified that this was essentially what he told the meeting concerning the Grant and Tallman review. Minutes completed in September 1985 by an official of the Bank of Canada who was present on 22 March indicate that the Inspector General told the meeting "that his own officers had indicated that under the worst-case scenario one might wish to add $60 million to the $244 million in write-offs the CCB wished to make in order to put its affairs on a sustainable basis. Nevertheless, this was in the range of needed write-offs estimated by the CCB, which suggested to him that the Bank's appraisal of the rest of its loan portfolio was not unrealistic." Governor Bouey testified that the Inspector General informed the meeting of an additional $50M to $60M in loan write-offs based on information from Grant. In fact the additional write-offs considered necessary by the professional bankers' inspection team in the L.A. Agency and the Edmonton Head Office were $87M (and reduced by Grant to $80M for no expressed reason other than compromise). This is a 35 to 40 per cent variance from CCB management's estimate.

Fullerton of the CIBC testified and produced notes which indicated that Grant and three Royal Bank inspectors conducted a review, that

Kennett believed \$300M was the worst case and that the range was \$240M plus or minus \$60M. Notes and the evidence of Bélanger of the National Bank of Canada and the testimony of Ritchie of the Bank of Nova Scotia also show that a worst case scenario could involve another \$60M above the \$244M. Korthals of the Toronto-Dominion Bank stated: "To my recollection, there was not a larger figure (than \$245M) in the absolute mentioned, but from time to time there was a conversation at various parts of the table whether another \$70M might be required or not". Taylor of the Royal Bank produced notes containing the following: "\$244MM – \$60MM fluctuates + or –. I.G. says worst scenario \$244MM 60 MM – confirmed management estimates ... 244 + (or –?) 60 – Inspector (of I.G.) and RB of C Officers confirm CCB estimates." These notes were discussed with Taylor during cross-examination:

> Q. I take it that your understanding was that that was information that he had obtained from the people who were looking at the loans out west? You understood that that was where it was coming from?
>
> A. Yes, I would believe that to be the case. This is what the Inspector General and his people are saying about this portfolio, with the note, "Confirmed management estimate". Presumably this was in keeping with what the management of the bank had been saying. I think that is consistent with what I have said about Mr. McLaughlan coming in at \$244 million.
>
> Q. Yes, and at that figure, the \$244 million plus the \$60 million, you were content that a package of \$255 million would provide solvency?
>
> A. Yes, we were.

It is clear that the seconded bankers working with Grant concluded that a greater write-down of the poor quality portion of the bank's loan portfolio was required than that which had been anticipated by the bank, and that the requirement was more like CCB's worst case estimate. Some of the difference in net value of the loans in the portfolio after such examination between these two different assessments, one by the bank itself and the other by the outside bankers seconded to the OIGB, can be attributed to the different assumptions of the two valuation teams. On some loans, the bank may have contemplated a fairly long workout period (as was their practice) during which the bank would retain the loan assets and realize on the borrower's covenant, or in some instances on the security held by the bank. The bankers working with the OIGB, on the other hand, appeared to take the approach that a present value of the loan was to be determined on the basis that it had been offered to another financial institution, or on the basis that the security had to be realized in an orderly way but over a shorter period of time.

There is some doubt as to precisely what information concerning the Grant and Tallman review reached the 22 March meeting. There is little doubt, however, that some information about this rather hasty valuation of 36 loans by the seconded bankers reached the 22 March meeting in Ottawa, and that those present were advised that the amount required, as revealed by the Grant and Tallman inspection, was in the range of $240M to $300M. It is reasonably clear that for reasons unknown the meeting did not learn of the true variance between the CCB estimate and that of the seconded bankers, however that variance came about.

In response to the program for the rescue of the CCB presented to the meeting by the Inspector General on 22 March, the bankers group, after separate consultation, set out terms and conditions for their participation. In his notes from the 22 March meeting, the Assistant Inspector General recorded the bankers group position as follows:

> Upon reconvening as a whole, the meeting was advised by Mulholland that the bankers had come to a unanimous position:

Banks' share of support	—	$60 MM
Governments	—	$120 MM
C.D.I.C.	—	$75 MM
		$255 MM

> No dividends on stock until advance repaid. Half of pre-tax profits to be paid out. No interest or principal payments on debentures. Banks would be in a first-out position. Warrants to represent 75% of stock at $1.00. Interest on performing part of participated assets to go to banks.

The notes of Mr. E. Fine of the Bank of Canada substantially agree with those of the OIGB. He recorded that "the banks expected that another third [$60M] would be provided by the Government of Canada and one-third by the Government of Alberta." With a significance which will later emerge he also recorded: "The interest and the repayment of the pooled assets would go to the banks first." The minutes of Fine refer to the response by the Deputy Minister of Finance:

> ... Mr. Cohen replied to the banks' proposal. He said that it did not appear possible to avoid paying interest on the debentures and to arrange the necessary formalities before the opening of business on Monday morning. Secondly, if the government were to entertain the banks' proposal, it could only be on the basis that all participants rank equally in principle. Thirdly, he said that he had no mandate to offer federal government participation beyond that available through the CDIC. Moreover, he was not sure whether Alberta would be agreeable. In conclusion, he suggested that the meeting should adjourn and that if the Government of Canada could change its view there would be another meeting either Saturday or Sunday.

b. Second Inspection: Grant and the Bankers Team — 24 March

On Friday, 22 March, Taylor and other bankers were anxious for some further assurance that the Support Package as contemplated would be sufficient to assure the viability of the CCB. They hoped on Friday for "a thorough inspection" to provide a satisfactory level of comfort. Nevertheless "the majority of us, and perhaps all of the bankers, had a full realization that there was no way that you could get that done in the two or three days — two days that were available to us". There is no dispute about the bankers' desire for a more comprehensive review. Indeed, Macpherson and Grant immediately arranged for CCB personnel to be present with Grant in Edmonton for an inspection by support group bankers on Saturday, March 23.

Several possible explanations for the bankers' interest in a further inspection appear in the transcripts:

1. lack of awareness of what Grant and Tallman had actually done;

2. desire to assure themselves in the interests of the shareholders they represented that the package would support CCB and that it was not too generous;

3. uncertainty regarding the auditors' results as of 31 October perhaps because of significant changes since then, or because the standards of bank credit officers and auditors differ, or because CCB's serious difficulties arose only four months after the auditors' unqualified certification of the bank's financial statements which reflected no indication of impending insolvency.

The bankers' interest in a comprehensive inspection carried through until at least June when the matter was raised by the senior management of these banks at a dinner meeting with the Minister of Finance. The Banks rejected a suggestion by the Minister of Finance that the CCB auditors do a loan portfolio assessment and expressed their preference that bank credit officers be used instead.

After some confusion surrounding the assembly of the bankers' inspection team was cleared away, the team of bankers began work on CCB files on Sunday morning, 24 March. Seven officials from the major banks worked in Edmonton while two officers carried out the U.S. review in California. The scope of the review was defined by Grant who hoped in one day "to do a review of as much of the bank's loan portfolio or as much of the performing loans as we could". Accordingly, he selected CCB loans of $4M or greater and which were not examined in the first review. The bank made these files available for review. In contrast with the first inspection of Canadian loan files which had been confined to loans on which CCB had already made provisions for losses, the second inspection covered good loans and did not include loans proposed for transfer out of the bank in the Support Package.

As to the nature of the review undertaken, one of the bankers who had been involved in the first inspection stated that the examination on 24 March involved "a different type of assessment". He reviewed six or seven files on 24 March and felt that the time available was satisfactory for him to provide a fair and reasoned assessment. However, another banker who participated in this inspection described the review as "very informal, very quick and hurried":

> I was there for a few hours. There was a truckload of files brought in, and you helped yourself to one off the top, and we would do a quick look at the file and make a quick decision on whether we thought there should be a reserve and how much.

He also described it as a "down and dirty" review. They reviewed 64 of CCB's Canadian loans representing a face value of $602M. The United States review covered about 50 loans, although "different" criteria were applied in the assessment. By this point, approximately 50 per cent of CCB's loan portfolio (measured by outstanding balances) had been examined in the two inspections. In summary, the first inspection team recommended additional reserves of $81M (after Grant's unilateral adjustment), and the second Canadian and U.S. reviews produced recommendations for additional reserves totalling $35M. $27.8M of those reserves were recommended for the Canadian loans examined, and of this amount about $20M was recommended by one examiner who examined "about six loans" of the 64 Canadian loans reviewed.

c. *24 March Meeting and the Memorandum of Intent*

On Sunday, 23 March, the Minister of Finance, the Minister of State (Finance), the Inspector General, Governor Bouey, and the Deputy Minister of Finance met with the Prime Minister. After an extensive review of all the available information, the Prime Minister approved the Government of Canada's participation in the program as an equal partner ($60M each) with the chartered banks and the Government of Alberta, for a total of $180M. A contribution of $75M by the CDIC completed the $255M funding in the program. On this basis, the meeting with the bankers' group was reconvened in Ottawa on

Sunday, 24 March in order to formulate the details of a bailout package. The deadline against which those at the meeting were working was generally understood by all present, as well as by McLaughlan in Edmonton, to be Monday morning, 9 a.m. AST. In the absence of a concluded agreement by this time, the bank would not be in a position to open for business in Halifax on Monday morning. News of the CCB's problems was believed to be "on the street" earlier in the week, and clearly so by Friday morning, 22 March. Since the meeting in Ottawa began about 1 o'clock Sunday afternoon, the participants had only 19 hours in which to complete their task. The OIGB in the meantime had made tentative arrangements for the appointment of a curator in case no rescue program was established for the bank.

The bankers arrived in Ottawa about midday to begin meetings with the Inspector General, Governor Bouey and the Deputy Minister of Finance, together with assorted advisors and lawyers. Counsel, though on hand, were not actually present for the discussion. A draft Memorandum of Intent was prepared by the legal advisors of the bankers' group and subsequently transmitted to CCB. The 24 March deliberations involved the transmission of a series of drafts of the Memorandum of Intent to Edmonton and simultaneous efforts to resolve the status of debenture holders whose position had been described as a "deal breaker" in the negotiations. McLaughlan had returned to Edmonton and was asked by telephone by the OIGB to attempt to work out an arrangement acceptable to the debenture holders which would be consistent with the condition imposed by the bankers. By the afternoon of 24 March, information about the condition of CCB's loans was available from three sources: the management assessment, the first inspection of 20-21 March (Grant, Tallman, Anderson, McArthur), and the second inspection of 24 March (Grant and bankers' group). The speed with which the second inspection group's results were reported on Sunday afternoon was surprising to the bankers and government officials then considering the details of the proposed rescue program.

From the assessment of the weakest portion of the loan portfolio, as well as some loans not theretofore the subject of a loss provision, it is clear that something in excess of $255M had to be written out of the balance sheet value for the loan portfolio. The amount was dependent upon conversion rates used with reference to U.S. dollar loans, the nearness of the delinquent borrower to liquidation, the realization time for security where liquidation must be contemplated, and other such matters. In any case, the consensus of the bankers appeared to have been that the off-loading of $255M in unproductive loans would give the bank a reasonable chance of recovery. A greater transfer of loans of this type might have increased the prospects of recovery of the CCB, but the banks were concerned with their obligation to their own shareholders not to devote their assets in this recovery program to an extent which would unduly reward the shareholders of CCB to the detriment of the shareholders of the major banks. There also was a concern, apparent from the notes of the meeting, about enlargement of the Support Package to the point where its cost would exceed the advantage of the Support Program over an outright liquidation. With certain exceptions, and on the basis of information available to them, the bankers regarded the bailout package as satisfactory to sustain the CCB. The Chief Executive Officer of the Bank of Nova Scotia stated that on the basis of the facts available at the time, CCB had some prospects for survival. The Chief Executive Officer of the CIBC stated:

> We very carefully considered our position and we felt if everything that we had been told, which was an important qualification here, was reasonably accurate, there was a chance that this bank could actually survive over a period of time and that is the basis on which we went in.

Robert Korthals, President of the Toronto-Dominion Bank, on the other hand, had very little optimism for the success of the package because of his view that management changes were required to sustain confidence in CCB in the money market and in the community generally. Mulholland, CEO of the Bank of Montreal, felt that the package would only buy time.

Governor Bouey testified: "I do not suppose everybody was entirely happy with the evidence we had for saving the bank, but we were certainly not happy with the evidence we had for letting the bank fail". Bouey later assessed the adequacy of knowledge available at the time of the Support Package by stating: "... the fact of the matter is that the condition of the CCB was seriously misjudged in the process that led to the establishment of the Support Package". The Minister of State (Finance) commented in testimony to the Inquiry on the same issue as follows:

> In March we felt we had adequate information and we made a decision on that basis. Once again, hindsight tells us we did not have either enough or the right information, but I think in addition there was some deterioration between March and September.

The Inspector General ultimately reached the same conclusion:

> ... we had clearly misunderstood and misstated the condition of the CCB when we went into the bailout. We did not understand, although we tried to understand in the context of timing and we went through that at an earlier session, but we had not understood the extent of the problem there. Consequently, the bailout had failed.

This is a very frank and accurate assessment of the process and its result. By reason of the number of people and organizations involved and the need to obtain authority to act, the process was necessarily slow. The fact is, however, that 10 days passed before the government decided to put public funds into a rescue program. There is no evidence that this was the result of "bargaining brinkmanship". It appeared to be a desire to act only on the basis of adequate evidence or caution. The result was, however, that only 19 hours remained after that decision was made for the design and adoption of a rescue program. This time-bind no doubt contributed to some of the problems which arose. There is no evidence that the result would have been different had a few more days been available to the parties to these meetings from 22 to 24 March. On 25 March, the parties entered into a Memorandum of Intent preliminary to an anticipated final agreement. This was done in order to facilitate the announcement on the morning of the 25th of the Support Program for CCB. In this Memorandum of Intent, the concept was for the participating banks, the Governments of Canada and Alberta, and the CDIC to band together and to purchase a $255M interest in a segment of the loan portfolio of CCB in respect of which the total principal sums outstanding were approximately $530M. CCB retained an interest in this segment of the portfolio amounting to approximately $275M. For its investment in the $255M, the participating bank or government received a participation unit for each dollar invested.

As the moneys were collected from this segment of the loan portfolio, which will be referred to for convenience as the Support Program, those receipts were divided between the participants and CCB as follows: all receipts, whether on account of interest or principal, were to be received and applied by CCB against the CCB participating interest in the Support Program, that is the $275M interest, until that portion was paid off in full; thereafter all further receipts were applied to the retirement of the investment of the participants in the Support Program until the amount advanced by them, that is $255M, was retired in full. In this provision for the distribution of proceeds on receipt, no account was taken of interest as a separate entity. In addition to the application of collections from the Support Program, CCB was required under another provision of the Memorandum of Intent to apply one-half of its income before taxes to the retirement of the moneys advanced by the participants to CCB.

The entire program for the support of CCB was made dependent upon the delivery of a written opinion by the Inspector General of Banks that upon receipt by the CCB of the purchase price for all the participation certificates issued to the participants, CCB would be solvent. The arrangement was also predicated upon the written waiver by all debenture holders of any right to principal or interest until the Support Group had recovered the moneys advanced under the Support Program.

By a final clause in the Memorandum, provision was made for the recovery of any unpaid balance owing to the participants in the event of insolvency by CCB from the estate of the bankrupt. In short, this clause made the advance by the participants to the Support Program a debt of the bank which would rank equally with any like claim by the participating governments remaining unpaid. This clause did not appear in the first draft of the Memorandum of Intent.

Certain provisions in the Memorandum of Intent have been criticized for their possible contribution to the ultimate collapse of the CCB. For this reason, comments on the development and interpretation of the provisions of the Memorandum of Intent are set out below. The procedure leading to the signature of the Memorandum of Intent by CCB and the participants in the program must be borne in mind. McLaughlan left the meeting before the Support Program was discussed, and never returned. When finally settled amongst the participants, it was forwarded to CCB for execution. Many of the points now reviewed were not discussed during the Sunday meeting because the party in interest, CCB, was not present to raise them.

The CCB was critical of certain terms of the draft memorandum including the size of the Support Program. McLaughlan was in Edmonton at the CCB Board meeting where the Support Package was being considered, and he was attempting to resolve the question of the debenture holders' status. He communicated his concerns about the proposed arrangements to the Inspector General in Ottawa:

> The Bank objected to number, pricing and exercise term of warrants and to treatment of amounts collected from weak accounts. Inspector General undertook to re-raise warrants questions with banks but held out little hope of change.

McLaughlan's eventual acceptance on behalf of CCB specified certain conditions regarding tax issues, and other items.

CCB continued to express concern about the impact of some provisions in the Memorandum of Intent as they were later developed in successive drafts of the Participation Agreement. Paine wrote the OIGB on 17 April with regard to the anticipated consequences of the indemnity clause:

> I am writing to you at the request of the Board of Directors of Canadian Commercial Bank. The Board has on 17 April reviewed, among other documents, the latest draft of the Participation Agreement. The concern the

> President has expressed on previous occasions to many of you in connection with the indemnity set out in section 8 of the Participation Agreement is shared by the Board.
>
> In particular, it is felt that section 8 of the Participation Agreement is considerably broader than the provisions of section 12 of the Memorandum of Intent, with the result that the ability of Canadian Commercial Bank to raise deposits necessary to fund its operations may be adversely affected.
>
> The President has explained to the Board that the concerns he has expressed on this point were not shared by members of the Bank Group, but that he was given assurance that if Canadian Commercial Bank's deposit raising activities were adversely affected, the matter would be reconsidered.
>
> The Board appreciates having received this assurance and has taken it into consideration in resolving to approve the Participation Agreement.

Bankers present at the 24 March deliberations have testified as follows:

1. Korthals testified about whether CCB should have been allowed to earn interest on the balance of the loan portfolio that was not being written down: "I do not recall that issue being raised."

2. Fullerton, when asked whether it was brought to his attention on March 24 that CCB wanted changes that would make it possible for the bank to do business after the bailout stated: "No."

3. Mulholland does not remember communications to the bankers about concerns expressed by McLaughlan regarding the terms of the bailout during the 22-24 March discussion.

4. Ritchie on tightening the terms and the warrants in particular stated:

   > I certainly did not have a feeling that the conditions that the banks were laying on the table to make this deal work varied that much from the original terms. I think, as you get into the drafting of the agreement, this has to be translated, obviously, into language that leaves no doubt in anyone's mind as to what the intent was.
   >
   > Insofar as the warrants were concerned, I guess that is a straight question of what the evaluation of those warrants were. Insofar as providing the income on the assets that the CCB were holding, I did not hear the complaint from Mr. McLaughlan that this was a problem.

   On the question of allocation of proceeds from the support group loans, Ritchie stated:

   > I believe as we moved along either Friday or as we moved on the weekend, certainly we in essence were buying the nonperforming or the write-down of that portfolio. It was always my understanding that CCB would have the first crack at the proceeds of those loans. I think this was outlined also

later on in the sense that we bought a package, but things were individually identified as to the portion that the CCB would carry. And the proceeds from pay-down of those individual loans were reapplied first to eliminate or liquidate the CCB portion of the principal, and the residual then be applied on the support groups' package.

5. Bélanger of the National Bank made notes of the 22 March discussion which contain references to particular terms of the bailout agreement. He commented on the evolution of those terms over the weekend:

Q. I see. If I can ask you to turn to page 25, please. The second last point at the bottom of the page says:

— all interest on 245MM of assets to banks and all proceeds from assets until paid out.

Can you explain to me, sir, what that term means?

A. What term?

Q. The term I just read. All interest on $245 million.

A. It means that if we are buying $245 million worth of bad loans, any income on these loans should be to us.

Several explanations or interpretations of the Memorandum of Intent were subsequently prepared for the advice of the Minister of Finance and the Minister of State (Finance). A memorandum from the Inspector General to the Ministers dated 24 March explained the repayment arrangements as follows:

CCB will repay the Support Group the full amount advanced in the following manner:

a) Any payments on any loan in the portfolio will first be applied to the outstanding balance of the particular loan on the books of CCB. Any additional amounts will be paid to Canada, Alberta and the Bank Group in proportion to their participation in the agreement until they are repaid in full. Any further amounts will be paid to CDIC, which is thus placed in a "last-out" position.

b) Regardless of what payments are received in respect of each loan, CCB must make quarterly instalments to the Support Group equal to 50 per cent of CCB's pre-tax income. These payments will be applied to the outstanding balance of the advance. The governments of Canada and Alberta and the Bank group will be paid in full first with subsequent payments being made to CDIC until it has also been repaid in full.

There will be no payments of interest on the funds advanced.

The Minister of Finance requested further detail on the treatment of weak loans which would be participated out by CCB to the support group. On 27 March the Assistant Inspector General replied as follows:

> The procedure will be as follows:
>
> 1) The Bank will identify a portfolio of weak loans with a carrying or book value of approximately $544 million.
> 2) The Support Group will pay $255 million for their participation in those loans. The $255 million is the equivalent of the amount required to write down the loans to realizable value.
> 3) Upon completion of the transaction, the Bank will receive $255 million in cash and reduce the carrying value of its loan portfolio. There will be no other changes to the balance sheet of the Bank. The total assets do not change. The Bank continues to carry the residual value of $289 million ($544 - 255) on its books.
> 4) The Bank will continue to manage the accounts attempting to realize on them. Any repayments in excess of $289 million will be paid to the Support Group. C.D.I.C. will not receive any such payments until the others in the Support Group have been fully paid.
> 5) The Bank will pay 50% of its annual pre-tax profits to the Support Group. These payments will be applied to the $255 million.
> 6) The participation certificates are purchased on a nonrecourse basis.

The note does not mention the disposition of any interest received.

The Deputy Minister of Finance forwarded to the Minister of State a summary of the Memorandum of Intent containing this explanation of the allocation of proceeds from the support group loans:

> The restructuring plan enables CCB to remove the provisions for loan losses from its balance sheet. The Memorandum of Intent provides for a large package of loans with different allocations going to the different members of the Support Group. This is intended to ensure that there are cash flows available to both CCB and the Support Group.
>
> *Allocation of Proceeds from Loan Portfolio*
>
> The loan portfolio is structured such that CCB's portion should yield sufficient revenues to allow it to write down its participation in the portfolio. (In effect, the agreement provides CCB with the loans most likely to perform profitably.) However, should conditions improve beyond expectations, and the revenues from CCB's portion of the portfolio exceed the bank's participation, the excess would first be allocated to the non-CDIC members of the Support Group. After the other members of the Support Group have been reimbursed, additional revenues from CCB's portion of the portfolio will be allocated to the Canada Deposit Insurance Corporation (CDIC).

In testimony, the Assistant Inspector General provided a succinct explanation of the evolution of this aspect of the Support Package, and the nature of its ultimate impact on CCB:

> I think it is essential to bear in mind that when the Support Package was conceived CCB indeed was saying we have this portfolio of weak accounts and we want to transform this volume of nonperforming or marginally performing loans into fully performing loans. And we will do that by selling to the

participant groups the loss portion of those loans. The remainder of the CCB portion would then be fully performing, that is they were written down to the level where it was expected that the remaining *tranche* of that package of loans would produce some income.

It was that expectation and that conception that enabled CCB to prepare projections of its future operations to indicate that the bank indeed would be profitable from an early point following the putting in place of the support arrangement.

The way that this section of the support agreement actually came out, however, meant that the CCB portion of the support assets would from that point forward be nonperforming forever or at least until such time as the full principal amount of those loans was recovered. That is CCB would never, in compliance with the terms of the agreement, be able to recognize any income from the CCB portion of the portfolio assets.

On 26 April 1985, as the Participation Agreement was nearing completion, the Inspector General set out his understanding of the ranking of creditors in the case of insolvency. CCB had expressed some concerns about the impact of this provision on its capacity to raise and retain deposits:

Section 8 and Section 13 deal with the ranking of creditors in the case of the insolvency of the CCB. Under the Agreement that I expect to be closed on 29 April, the Support Group, except for C.D.I.C., will be ranked *pari passu* with depositors in a liquidation. The Bank is concerned that this may impair its ability to raise deposits. They believe that the Support Group should be ranked after the depositors. The banking group have disagreed and have insisted on the existing ranking. There is an understanding, however, that if evidence emerges that this arrangement is hindering the funding of the Bank, then the ranking will be reconsidered by the participants in the Support Group. In these circumstances, I personally believe that it will be necessary to alter the agreement as the Bank has suggested.

5. Debenture Holders, Press Release, and CCB Assistance Act

a. Debenture Holders

Korthals explained the bankers' group view of the significance of the debenture holders' position to the Inquiry:

Debentures are part of a bank's capital in theory and they are subordinated to the other claimants, and it bothered us that we were coming in on a rescue package behind the debenture holders. I mean it was just structurally a wrong thing to do and it really would also, if that was the way that future rescues — heaven forbid that they would have to happen were — then the debenture holders really cannot be viewed — or debenture capital is really not capital for a bank. So we thought it was very important that the debenture holders come in behind the bank rescue package as being part of the capital of the bank.

Thus the position of the debenture holders remained a significant concern late on 24 March as the bankers' group continued to insist on the principle of subordination. The Inspector General had phoned McLaughlan on 23 March to advise him that there was a deal and requested him to use CCB's "best efforts" to get the agreement of the debenture holders to postpone. Through McLaughlan's efforts, a meeting with debenture holders had been arranged for 25 March in Edmonton, but this would not be in time for the decision needed. Governor Bouey and the Deputy Minister of Finance began to contact debenture holders directly on the evening of 24 March to explain the circumstances of the proposed bailout, and to seek the agreement of debenture holders to waive interest and principal payments. The debenture holders' rejection of this proposal led ultimately to a decision by the Governments of Canada, Alberta, and British Columbia to purchase at par $39M in outstanding debentures in order to permit the Support Package agreement to proceed.

b. The Press Release — 25 March

On 25 March, the Department of Finance issued a press release, "Support Package to Ensure Viability of Canadian Commercial Bank", to provide information on the arrangements that had been worked out. It was also an acknowledged purpose of the press release to inspire some measure of confidence in the public who depend on the banking system that the bailout package would be effective.

> The Honourable Barbara McDougall, Minister of State (Finance), announced today that a joint agreement has been reached to ensure the long term viability of the Canadian Commercial Bank. Parties to the agreement, which involves an infusion of capital with repayment provisions, include the Province of Alberta, six Canadian chartered banks, Canada Deposit Insurance Corporation and the Government of Canada.
>
> The Support Package is designed to provide the Canadian Commercial Bank with sufficient funds to ensure solvency following a recent and sharp deterioration in its U.S. loan portfolio.
>
> The agreement will result in the purchase by the support group of a package of nonperforming loans. This transaction will leave the bank in a strong position of solvency in order to support its deposit base.
>
> Representatives of the Canadian Commercial Bank notified the Office of the Inspector General of Banks on March 14, 1985, that the deterioration in its loan portfolio could place the bank in a position whereby it could be unable to meet its obligations to depositors and creditors.

Following analysis of the Canadian Commercial Bank's position, the Inspector General of Banks determined that an infusion of additional funds in the amount of $255 million would ensure that the bank could continue to play a key role in the western Canadian economy.

A restructuring package initiated by the Canadian Commercial Bank was negotiated by the Inspector General of Banks with the parties to the agreement.

The CDIC, which is funded by member deposit-taking institutions, will provide $75 million. The remaining $180 million will be shared equally by the Province of Alberta, the banking group and the Government of Canada in the amount of $60 million each.

The repayment program calls for the Canadian Commercial Bank to pay 50 per cent of its future pre-tax profits to the participating institutions until the capital is repaid in full. The remaining 50 per cent will be retained by the bank. No common or preferred share dividends will be paid until the repayment program is complete. As part of the transaction, members of the support group will be entitled to receive warrants and payment of principal and interest on subordinated debt will be postponed.

In a separate arrangement, the governments of Alberta, British Columbia, and Canada will be purchasing up to $39 million of the subordinated debt.

'I have full confidence that this cooperative Support Package involving Canada's largest chartered banks and the two Governments will permit the Canadian Commercial Bank to continue its active and important role in the growing economy of Western Canada', said Minister of State (Finance) Barbara McDougall. 'I have in addition been assured by Governor Gerald Bouey that as usual the Bank of Canada stands ready to provide liquidity for Canadian Commercial Bank, if requested, as well as for any other Canadian bank.'

The Minister concluded, 'This Support Package represents a strong collective vote of confidence in the health of the economy of Western Canada.'

The Minister of Finance, the Minister of State (Finance), the Inspector General, and the Governor of the Bank of Canada stated in evidence that the press release fairly reflects their conclusions and convictions at the time of the agreement. Bélanger commented on the press release by stating that he had no reason to doubt the strong position taken on the solvency of CCB but had some doubts about the expression of its ensured long term viability. With reference to the latter he concluded: "I would not argue that it was wrong, I think it may not have been prudent."

c. *CCB Assistance Act*

On 29 March, Bill C-37, the *Canadian Commercial Bank Assistance Act*, was passed. This legislation authorized the Minister of State (Finance) to make agreements as necessary in order to provide financial support to the CCB according to the terms of the Memorandum of Intent. In addition, the act authorized payment as required from the Consolidated Revenue Fund of $75M for the financial assistance of CCB.

C. PREPARATION FOR THE PARTICIPATION AGREEMENT

1. Bank of Canada Advances

On 29 March, Governor Bouey explained the process leading to the Support Package to members of the Board of Directors of the Bank of Canada and advised that very large advances to the CCB might be required in the weeks to come. The board minutes state:

> In the event that large scale support was required and appeared to be necessary for a considerable time, the Governor said that the Board might be called upon to approve the setting up of a reserve. This would involve delaying the transfer of Bank of Canada profits to the Receiver General.

Bank of Canada advances (Table D.2) increased rapidly through March and early April. The news media interpreted these figures as showing that the bailout was not a success. In an attempt to bolster confidence in CCB, the Bank of Canada, on 18 April, issued the following press statement:

> ... however, with the agreement of the Canadian Commercial Bank, the Governor, Mr. Gerald K. Bouey, confirmed that the Bank of Canada has been providing liquidity support to that chartered bank. The Governor noted that it is the role of the central bank to act as an ultimate source of liquidity for Canadian banks, and he reiterated that the Bank of Canada stands ready to provide the Canadian Commercial Bank with whatever amount of liquidity support it may require.

Bank of Canada advances to this point amounted to $649.9M. Governor Bouey reported to the Board of Directors of the Bank of Canada on May 3 that although this press release had been intended to confirm the liquidity support being made available by the Bank of Canada it "had been interpreted in some quarters as a 'second bailout' and had not helped the situation as much as hoped." The Governor then told the Board that "the struggle to establish the CCB's longer term viability was likely to be a protracted one."

Table D.2

Profile of Bank of Canada Advances to the CCB and Northland Bank—March-September 1985

1985		*Northland*	*CCB*
			($ millions)
March	27		15.0
	28		118.0
April	3		336.8
	10		470.3
	16	35.0	615.5
	17	35.0	649.9
	24	51.0	728.1
May	1	94.0	645.3[a]
	8	74.0	721.8
	15	64.0	748.9
	22	109.0	833.5
	29	111.0	875.0
June	5	167.0	936.8
	12	254.0	969.0
	19	343.0	1,034.5
	26	323.0	1,072.6
July	3	372.0	1,149.3
	10	347.0	1,211.5
	17	369.0	1,267.5
	24	417.0	1,254.5
	31	378.0	1,225.2
Aug.	7	452.0	1,288.0
	14	472.0	1,309.5
	21	510.0	1,299.6
	28	510.0	1,310.1
Sept.	4	510.0	1,316.0
	11	510.0	1,316.0
	18	515.5	1,272.3
	25	517.5	1,272.2

a. Net of repayment of $255 million provided by the Support Group on 30 April 1985

The Bank of Canada liquidity advances (Table D.2) which were contemplated by all parties present on 24 March, would, by virtue of the Bank of Canada's security agreement with CCB, have priority over the $255M advanced by the members of the support group. The result of all these procedures is somewhat anomalous. The debenture holders who were not depositors were paid out in full prior to the rescue operation's commencement. The banks who became unsecured creditors to finance the rescue operation have no priority over the Bank of Canada. And finally, the banks are ultimately not classed as depositors and therefore do not qualify for reimbursement under deposit insurance or under the extended compensation pursuant to the special Act enacted in April 1985. In the end, all the participants in the rescue lost their advances to the Support Program, although the debenture holders (whose debentures ranked as part of the capital of the bank according to the OIGB rules) were paid off in full.

2. The Inspector General's Solvency Letter—26 April

As a condition of their participation in the bailout, the support group banks sought a firm written assurance from the Inspector General that upon receipt of $255M the CCB would be solvent. Under cross-examination as to whether the support group banks expected the Inspector General to provide an assurance, a warranty, a certificate of solvency, or an opinion based on good judgment, Allan Taylor replied:

> I expected to get his opinion as to the solvency of the bank, given all the information that he had. But his opinion as the regulator of banks in Canada and with his responsibilities, we, the banking group, put a great deal of weight on that opinion.

On 26 April 1985, pursuant to para. 14 of the Participation Agreement, the Inspector General provided the letter required, stating: "In my opinion, Canadian Commercial Bank will, immediately upon receipt by it of $255,000,000 pursuant to the terms of the aforesaid Participation Agreement, be solvent." This opinion was not based on a comprehensive audit of the CCB's loan portfolio, but it was thought to be supported by the last audited financial statements, the new capital, and the March loan review of over 50 per cent of CCB's loan portfolio conducted by experienced credit personnel from Canada's major banks. In reality the $255M was applied to reduce the liability but itself became a repayable obligation.

3. The 29 April Participation Agreement and Related Documents

During the weeks following the completion of the Memorandum of Intent, the parties worked on a more comprehensive document intended to formalize and clarify the basic terms agreed to in late March. On 29 April, after the Parliament of Canada had enacted the *Canadian Commercial Bank Financial Assistance Act* authorizing the Government of Canada to enter into the Support Program, the parties executed a Participation Agreement. This agreement is in replacement of the Memorandum of Intent, and only those provisions which are novel or which are a variation of the provisions of the preceding Memorandum of Intent need be examined.

CCB warranted under the agreement that the portion of each loan retained by it in the Support Program represents the bank's best estimate of "the amount likely to be recovered from or with respect to that portfolio asset". When this total reserve interest by CCB is subtracted from the principal outstanding under all loans in the Support Program, the remaining amount is the participants' interest in the Support Package, namely $255M. In these provisions setting forth these calculations and representations, no mention was made of interest accrued, accumulating or otherwise, and the recovery of moneys from the borrowers in respect of these Support Package loans, was again subjected to an allocation program that made no distinction between a payment of interest and a payment of principal.

Nothing appears in the record to indicate that any further discussions were held on this subject. As to the terms of the Memorandum of Intent on this point, it is clear from the testimony of those present at the 24 March deliberations that CCB was truly in a position of having to take the proposal as worked out in the meeting or there would be no agreement for a Support Package at all. Consequently, the bankers present did not consider that they were in a negotiating meeting, but rather in a meeting to lay down the ground rules for the establishment and for the operation of the Support Program. McLaughlan maintained throughout the process, and indeed throughout the hearings, that one of the factors which brought about the failure of the Support Package was the inability of the bank to realize any income during the Support Program from the loans made subject to that program, and that this had a serious and, in his view, fatal effect on the prospects of the bank achieving a recovery. Without being able to report earnings, CCB could not attract deposits, and certainly could not attract new capital. The Agreement is even more explicit than the Memorandum in delineating CCB's obligation to deliver over to the participants those proceeds received from the borrowers in the Support Package loans, together with one-half of CCB's before-tax income, until the participants have received "an amount equal to the price paid by such participant for its participation certificate."

Again, the Participation Agreement, like the Memorandum, established the right of the participants in the Support Program, other than the CDIC, to rank *pari passu* with the right of the depositors of the CCB to payment in full of their advances under the Support Program. This right of recovery by the participants survives any insolvency of CCB. It is to be noted that Schedule 1 attached to the Participation Agreement makes no reference to accrued interest or capitalized interest but rather deals only with principal outstanding under each loan at 31 March 1985. This outstanding principal sum is then apportioned between the "syndicated portion" (the participants' interest) and the "CCB portion."

The Agreement makes provision for the designation by the Inspector General of two persons to act as his representatives in supervising the administration of this agreement "and the portfolio assets by CCB".

D. IMPLEMENTATION, OPERATION, AND MONITORING OF SUPPORT ARRANGEMENTS

1. Decision to Undertake Further Portfolio Review

Mr. Bruce Cockburn of the Royal Bank of Canada and Mr. J.R. Johnston of the Toronto-Dominion Bank were named as special representatives of the Inspector General pursuant to section 7 of the 29 April Participation Agreement. Section 7 defined the relationship of the representatives to other participants as follows: "The Special Representatives will report to the Inspector General, who will keep the participants fully informed." Sometime around 14 May, this "third inspection" team began work at the CCB. Cockburn and Johnston did not conduct a full review of CCB loans; instead they concentrated on support group loans until their appointment was terminated in June. Not until after they had left did a review of other loans get underway.

The terms and scope of the special representatives' appointment aroused some controversy in the hearings because of criticism of the length of time required for the OIGB to mount a full assessment of the CCB portfolio and because of Allan Taylor's assertion that the need for such a review was understood by the support group bankers in the meetings in March. The Memorandum of Intent contains no reference to a comprehensive review of CCB. Taylor's evidence on the issue of a review of nonsupport group loans is that as of Sunday, 24 March:

> We all believed that we had made the point sufficiently clear that there was to be a full inspection of this bank to be done by banking officers provided by the six banks. The agreement called for these two special representatives, and we believed that they would have played a part in this expanded review of the total bank.

Taylor assumed that the inspection ("a full examination of that bank's portfolio and the balance of the bank, the other assets of the bank") was a condition of the basic bailout arrangement and should have been in the agreement: "It was a complete oversight right through the piece in not getting it in writing". Taylor clarified this comment by stating:

> I meant that in hindsight, we all realized that it was an oversight not to put that into the agreement. I did not mean to leave anybody with the idea that we all had understood and it was agreed it would be in the agreement. That was not the case. But in hindsight we certainly did come to appreciate the fact that that was a very strong missing element from the agreement itself. It should have been a written condition of the deal.

Taylor says he often referred to the inspection in discussions with the OIGB but did not push the matter because of all the effort going into the participation agreement. Taylor had not expected the assessment to precede the flow of funds although he had expected that steps towards a full inspection would commence as soon as possible after 25 March.

Bélanger was not willing to say that a "further complete audit" was discussed in March, but he described the weekend inspection (the second inspection) as a "stop gap measure" and stated: "It was very important that all concerned would go to the bottom of this as soon as they could. If you left it in those words, I would say yes, this was discussed *ad nauseum* one way or the other".

Fullerton expected that "after the original rescue package went into place, the officers designated by the chartered banks to assist the Inspector General would go in and would examine the remainder of the portfolio that had not been examined". He indicated that the results would not have been available to the CIBC: "We had never had any right to go into that bank and never would". Rather, the results would have been available to the OIGB and "might have triggered additional action".

Mulholland testified that he did not complain about the absence of a full audit and indicated that although the Inspector General gave an undertaking to appoint some monitors, he did not give a detailed undertaking as to what they would do. Mulholland told the Inquiry that the supervisors "were urged repeatedly to conduct a complete inspection of the entire loan portfolio from 'A to izzard'," but "there was a generally sort of fuzzy response until the clock ran out. ... It did not get exactly an adamant refusal but it did not get a clear acquiescence either". Ritchie has no recollection of a specific discussion establishing that there would be a continuing audit of the CCB portfolio outside the

Support Package. Korthals stated: "I am a little hazy as I left the meeting on what my perception would have been, but I had the feeling, in looking back, that we had agreed that groups of officers from other banks would do more examination of the bank's loan portfolio. I think a lot of that was set up later." He also confirmed the view he expressed to the Blenkarn Committee that the further inspection was actually done "fairly quickly".

Taylor stated that the use of the special representatives to conduct the review of loans outside the Support Package was discussed in April. On 10 April 1985, following the regular semi-annual meeting between Governor Bouey and six bank CEOs, which had been scheduled six months earlier, there was some discussion of the CCB situation. Minutes state: "In any event, it was agreed that the two bank officers who would be stationed at the CCB for the purposes of the Inspector General would, in addition to their other duties, be used to improve knowledge about the quality of the loan portfolio". However, Bouey firmly restricted the scope of the examination intended by the reference in the minutes: "I would not regard that as anything like a comprehensive audit".

In mid-April, the bankers were looking for four more names to suggest as inspectors in addition to the two special representatives, but it was assumed there was no need to produce those names to the OIGB until the Participation Agreement was in place. The terms of reference for the inspectors could not be established before the Agreement was signed by all parties so it was not possible to put people from other banks in place. The names of bankers available for work at the CCB were not forwarded to the OIGB until sometime between 29 April and 3 May.

The actual terms of reference or instructions for the special representatives prepared by the OIGB in May appear to leave open the possibility that they might become involved in an inspection of nonsupport group loans. Those terms of reference state: "Because the Inspector General wishes to have continuing and up-to-date knowledge of the bank's portfolio, the Inspector General may ask the representatives to broaden the scope of their evaluation of loans beyond the portfolio assets." However, at a meeting involving Grant and senior officials from CCB it was agreed that the special representatives would not be requested to review CCB loan accounts outside the Support Package. If such a review were desired the Inspector General would engage noncompetitor representatives.

Allan Taylor indicated that on several occasions between 29 March and 14 June, he complained to both Ministers about delay in initiating the inspection. The Minister of State had no recollection of Taylor raising the further audit issue until about 20 May, and she stated: "I never had any sense of pressure or urgency about it if he did raise it earlier". Following the 20 May talk with Taylor, the Minister of State spoke with the Finance Minister about the audit as part of a broader look at CCB but she recalled no specific criticism by the Finance Minister at that time of OIGB failure to mount a full inspection. The Inspector General confirmed that the need for a loan review or full audit was raised from time to time by the bankers, but not pressed until June, and definitely not promised. No one ever suggested it be put in the Participation Agreement.

It has been argued that even if there really was no agreement with the banks in March, April, or May for a full review of CCB loans (whatever the banks understood that to be), nevertheless, some form of review of nonsupport group loans was by then long overdue, and ought to have been launched by the OIGB as prudent regulatory behaviour without pressure from the banks. The Inspector General stated in response to this suggestion that it did not appear necessary or prudent to launch a fuller inspection immediately after the March weekend because "we were preoccupied with other things" and because the appointment of special representatives would have provided a means to review all the loans "in an orderly way": "We certainly did not feel that that was a matter of desperate urgency". It also appears that the Inspector General actually considered that a full audit in April would have been damaging to public confidence and the success of the bailout:

> The public perception certainly would have been at least confused if, following the strong assurances that they were given, we would then be seen to be mounting a substantial audit or loan review in that bank.

The Inspector General suspected that the existence of a loan review with the help of active or retired bankers could not have been kept from the knowledge of the financial community.

2. Third Inspection: The Special Representatives

The Inspector General wrote Allan Taylor of the Royal Bank 3 May 1985 stating:

> At your request, in connection with the closing of the transaction contemplated by the Participation Agreement, I confirm that the Special Representatives will take an active role in relation to any material dealing by CCB or any person on its behalf with any Portfolio Assets.

As finally drafted in May 1985, the "Terms of Reference" provided in part that:

> The main responsibilities of the representatives are generally to supervise:
>
> 1) the administration of the Portfolio Assets of Canadian Commercial Bank (CCB), as defined in the agreement.
> 2) the administration of the Participation Agreement.

On 22 May 1985, Johnston, Manager of Toronto-Dominion Edmonton Commercial Branch, and Cockburn, a Vice-President of the Royal Bank of Canada then stationed in Calgary, were appointed by the Inspector General as Special Representatives pursuant to Paragraph 7 of the Participation Agreement. They actually began to function on 14 May.

Cockburn understood that representatives of the other support group banks were available if a decision was taken to proceed with a full-blown inspection. Johnston also understood that any review of loans outside the support group was to be left for further discussion. The Inspector General confirmed that the possibility was left open in correspondence that Cockburn and Johnston would carry on with a full review of CCB's portfolio. Macpherson testified to his assumption that at the outset Cockburn and Johnston were expected to be at CCB three or four months, and that they would eventually look at all the files. However, the review of nonsupport group assets was not undertaken as part of the Cockburn and Johnston effort.

At Grant's suggestion, Cockburn assumed responsibility for the U.S. side of the operation because of his energy-related background and because energy loans were considered a significant element of CCB's problem in the United States. Cockburn examined about 80 support group loan files from CCB U.S. platforms in San Francisco, Denver, Century City (Los Angeles), and Santa Ana. MARGUN reports for April were not adequately filled out but the May reports were complete, and continuing improvements in the quality of the reports were anticipated. Cockburn concluded that the U.S. staff, which was "very, very co-operative" and "very knowledgeable", had performed "very well" in liquidating the loans, especially in real estate, and that several other improvements were underway in the U.S. operations. Of the 72 May MARGUN reports on support group loans examined by Cockburn, only 10 of the loans were made after 1983.

Cockburn understood that his primary task was to monitor, not manage, the realization of the support group portfolio because it was originally felt there would be some recovery for support group participants. He did not view a further assessment of the adequacy of the provisions for loan losses as a formal responsibility under the terms of reference: "As I went through each individual file I noted for my information certain situations that looked like it sic could develop into further appropriations, but that was for my own information". Further:

> It was only after I came back from Santa Ana (24 May) when there was some suggestion about, you know, could there be further appropriations, that I went back in my files and prepared this list for Mr. Grant.

When he did so he reported to Grant that additional provisions totalling $7.25M (U.S.) were required on a conservative basis for thirteen of the support group loans in the United States. This information was given to Grant in Edmonton on 20-21 June when Cockburn also provided Grant with information on interest capitalization which he expected Grant to take up with the external auditors.

Grant also met with CCB's auditors on 20-21 June for discussions about the bank and provided Robert Lord of Clarkson, Gordon with details of the additional provisions required on the "Portfolio Assets" in the Support Package. Grant requested a report from the auditors on interest capitalization during the second quarter, 1985. The auditors had not, of course, performed an audit on this fiscal period but were able to report as follows:

> In our discussions with management, we raised the comments made by the special representatives of the Inspector General of Banks relating to the apparent capitalization of interest into certain of the loan balances included in the participation agreement. Management gave the following explanations ...
>
> 1. In the case of U.S. loans which were classified as earning loans prior to being included in the Support Package, interest was capitalized up to 28 February, 1985.
> 2. In the case of Canadian loans classified as earning and included in the Support Package, interest was capitalized up to 31 March, 1985.
> 3. No interest was taken into income on nonearning loans included in the Support Package. However, in the case of a few nonearning loans, interest which had previously been included in income and not capitalized for legal reasons was capitalized into the loan balance as of the date of the support arrangement. The most significant of these was [borrower name deleted] where the accrued interest capitalized into the loan balance in March, 1985 had been taken into income in 1983. Accrued interest on nonearning loans not previously taken into income was not capitalized into any loan balance.
>
> We have not carried out any audit procedures to verify the foregoing, the explanation would appear to be reasonable based on reported net loss for the second quarter.

This is but further evidence of the widespread practice in the bank of capitalizing interest on problem loans.

Johnston examined Canadian support group loans and reported to Grant periodically through June. Johnston treated the CCB as a going concern for purposes of his assessment of the support group loans: "My instructions — the approach to the bank was to preserve it and ensure that it remained a going concern, and I did not go in on the liquidation scenario." On 7 June, Johnston provided the first of his series of reports. He had by this time reviewed 58 support group loans and as "a provisional total only" recommended additional appropriations totalling $46M (over and above the $255M). Johnston emphasized his position by stating to the Inspector General:

> It is the writer's considered opinion that if CCB is to proceed expeditiously to liquidate its portion of the portfolio assets then additional provisions are necessary, failing which any degree of timeliness can largely be discarded.

Upon completion of his initial review of the smaller loans making up the remainder of the Canadian support group loans, Johnston concluded, in a report to the Inspector General dated 24 June, that overall "a grand total of $50,000,000 in round figures" should be added to the loss provisions. In light of new information made available at the 21 June meeting with CCB officials, Johnston thought that a further $20M (over and above the $50M) might be required. Johnston testified that the $20M figure for further provisions was arrived at "in my own mind". There is no indication that this assessment of the further $20M was relayed to the OIGB although Johnston did express to Grant some reservation that the $50M might be low. Johnston, as a monitor, had no authority to insist on further specific provisions. His views were, however, discussed at a meeting of Grant, Johnston, and senior credit officers of CCB. Grant participated in the negotiations, and the end result was that CCB agreed to book further provisions of $33M, being comprised of $14M in the third quarter of 1985 and $19M at year end. There is no evidence that any of this was reported to the support group participants by the OIGB.

In addition to his views on additional provisions, Johnston presented a series of criticisms of CCB management procedures and practices:

> In the main, the injuries suffered by CCB would appear to be self-inflicted in many instances with most lending decisions having been fee-driven even on 100% in-house financed restructures. The drive for business was well recognized in the field with account officers on a profit-sharing/bonus system at one time, tied to loan quotas. [There is no evidence on the record to support this statement and the liquidator issued a press release stating there was no evidence suggesting the existence of such a bonus system.]

> The Platform discretionary limits may have been (still are) too high and it was rare to see a Corporate "Decline" followed by approval on reworking. In other words Approvals were given with apparent scant regard for detailed examination of an application.
>
> Ongoing capitalization of interest is a major concern and has been detailed for you in the attached reports. It is unconscionable inflation of the balance sheet which is graphically illustrated in so-called workouts where land values, which appear in a Loan Realization Account, are manipulated upwards to fit, or suggestedly rationalize, the new credit approval.
>
> You will see that, in several instances, CCB actually has a recent appraisal or valuation but chooses to ignore it and opts for value based on "future potential", "replacement cost" or "take-back financing" etc. and thereby nullify the need for an appropriation. Indeed, as late as March 31, 1985, Platforms were rationalizing, in a plausible and unchallenged manner, the lack of need for appropriation and then substantial usage was made of the trough provided by the Support Group. It is very difficult to reconcile the two approaches.
>
> There was almost a venture capital air to certain situations where CCB stipulated a share in cost profits/sales proceeds or the acquisition of, or option for, shares in private companies.
>
> According to the information provided by CCB, the timely presentation of applicable Credits to the Board is somewhat of a 'hit and miss' situation and detail in that respect will be found in the attached 'Comment on Boarding'. The significance of Boarding is recognized and is treated as an inviolable requirement in the writer's recent environment. The 'Comment on Boarding' speaks for itself, and upon raising the obvious question the answer was that Directors are polled by telephone. One might feel that such deliberations would be formalized, in written form, as soon as possible thereafter but a culling of the files by CCB staff still produced only the results as attached. For Board Sheets, only the 1984 and 1985 files were searched.

It should be noted that on cross-examination, a number of practices or conditions within the bank were admitted by Johnston to be unsupported by evidence, supported by weak evidence, or possibly common within the banking industry but not within Johnston's own range of experience. In one specific case, the criticism regarding boarding practices, other witnesses were able to verify that, in fact, the loans had been boarded. Paine testified that Johnston's comments in relation to the "venture capital air" at CCB appeared to be the comments of somebody at the middle management level as opposed to the senior management level.

By late June, Cockburn felt that the continuing task of monitoring the support group loans could be accomplished in two days a month. He proposed to Grant that inspection of the remainder of the CCB portfolio should get underway so that the Bank of Canada, which was funding the exercise, would know what was there. Johnston also concluded his basic assessment of the Canadian Support Package loans in four or five weeks and was prepared to work outside the support group package on the remainder of the CCB portfolio. Johnston urged a fuller review on 7 June:

> Given the displayed state of affairs in the Portfolio Assets it is clearly indicated that, by your leave, an examination of other classified loans should take place in due course.

The Inspector General stated that he had originally expected the special representatives to be retired bankers, and was surprised when active bankers were made available. Notes of the March meetings indicate that "retired bankers" were specifically mentioned for the watchdog role in the Support Program. The Inspector General further stated that the OIGB would have kept Cockburn and Johnston on to do the full portfolio review and to help with Northland, except that both CCB and Northland objected. The Inspector General said that CCB "complained vigorously about having active and competitive bankers looking at its live portfolio" and that McLaughlan was "most unhappy". McLaughlan's testimony is more ambiguous in that he acknowledged expressing concern about live bankers and confirmed a preference for retired bankers but said it was "no big deal", "I certainly was not making anything substantial about it". Taylor suggested that declarations of secrecy should have resolved any concern that may have existed.

3. Fourth Inspection: Hitchman

In her efforts to find some new directors for CCB who would assist in some respects with representation of the taxpayers' interest, the Minister of State met on 22 May with George Hitchman, a retired Deputy Chairman of the Board of the Bank of Nova Scotia. Hitchman demurred, stating that he would need to know more about the asset side of the bank before deciding whether he had a contribution to make to the Board. He offered to look at the assets and report back. Hitchman contacted Paine, expecting that he would speak with Mr. R.A. Utting, Vice-Chairman of the Royal Bank of Canada, and would call him back. Utting had recently agreed to examine CCB's procedures and management on behalf of the bank. A few days later when Hitchman had not heard again from Paine, he left a phone message at the office of the Minister of State declining the board position.

The Finance Minister met with the heads of the six major banks in Toronto on 13 or 14 June to discuss several topics including the CCB and its net worth. They indicated their concerns about several factors "in a pretty forceful way". The Minister clearly understood "that they felt that it was very important that we come to grips with a clear understanding at an early date of the degree of solvency of the bank".

Taylor testified that he discussed the need for a fuller inspection of the loan portfolio with the Inspector General at a Canadian Bankers' Association meeting on 13 June and again on the following day with the Minister of Finance. On 19 June, the Minister of Finance and the Inspector General met. The Inspector General had begun to replace the two active bankers, Cockburn and Johnston, with two retired bankers, Farthing and Taylor. The Minister of Finance wanted Hitchman added to the review team, and asked for the loan examination process to be speeded up. The Minister significantly expressed concern for the security of funds being advanced to CCB by the Bank of Canada and asked that:

> ... the Inspector General ... put together a team, perhaps under the leadership of Mr. George Hitchman, to carry out a complete appraisal of the value of all of the assets of the Bank to confirm its net worth position. Such a team would have to have confidence of the banks in the support group.

The interrelationship of the Bank of Canada and the Office of the Inspector General in this whole process is illustrated by a memo prepared in the Bank of Canada:

> Mr. Kennett had requested the meeting to discuss a proposal for a detailed evaluation of the CCB's total loan portfolio. He reported that at a meeting with the Minister of Finance the previous day the Minister sought reassurance that the CCB was indeed solvent. Mr. Wilson had dinner with the six major banks a week ago and some banks suggested that it was unlikely that the CCB still had a net worth. Mr. Kennett had outlined the steps that had been taken to date but the Minister suggested that in view of the billion dollars in advances outstanding to the bank he was anxious to have an early and complete assessment of the bank's net worth. The Minister had noted that in earlier discussions with the Governor it was clear that the Bank of Canada relied on the Inspector of General of Banks to provide assurance of a bank's solvency.
>
> He [Kennett] noted that the Bank of Canada clearly had an interest in the valuation of the loan portfolio and he sought our support for the evaluation and wondered if we would be willing to underwrite a portion of the costs.
>
> Mr. Crow indicated that while we certainly had an interest in the study, it was important that the study be undertaken under the responsibility and direction of the Inspector General of Banks. The "jointness" of the Bank of Canada's involvement came from the fact that it would be very interested in the results of an evaluation of the CCB portfolio and would be pleased to provide assistance in the study and/or in funding part of the costs. Mr. Kennett said that suited him and that he would welcome our participation at whatever stage seemed to us appropriate and that the results would of course be provided to us.

In the result, Hitchman, Taylor, and Farthing were appointed by the Inspector General to review all the loan portfolio, other than the support group loans which had already been examined. According to their terms of reference these consultants were to act as agents for the OIGB for the fourth inspection of CCB. They were requested to "review credit files, accounting records and such other data as necessary to form an opinion on the quality of the loan portfolio and the adequacy of provision for losses". In addition, the Hitchman team was to review the CCB's credit authorization practices and control procedures applicable to unsatisfactory accounts, as well as the bank's then current practices on fee income and interest recognition.

Hitchman commenced his study on 2 July, and concluded as early as 15 July that there was "real cause for concern". He met with McLaughlan and Grant of the OIGB on 23 July for discussions of individual loan files which the team had reviewed. On 30 July, Hitchman provided to the Minister of State, in response to her request for prompt results, an oral interim report (accompanied by a package of completed loan reports) based on 34 loan accounts reviewed by Farthing and Taylor. Hitchman agreed to the Minister's request to proceed quickly toward a final report. The OIGB recorded the discussion at this meeting with Hitchman: "On the basis of extrapolation of their findings, it was their view that CCB should take write downs of as much as $500 million on their loan assets. Final report expected in mid-August '85". On 1 August, an adviser with extensive banking experience who was serving temporarily with the Department of Finance concluded from the Hitchman interim report that there was "an equity deficiency that will amount to several hundred million dollars", that "the bank has a very large negative net worth", and that "it is clear that the CCB is insolvent".

While the Minister of State did not see the Hitchman review as part of a merger option, she was interested in exploring the possibility of a merger of CCB with another bank.

4. Relationship of the Hitchman Group and Other CCB Investigations

There has been some criticism of the CCB inspection process mounted by the OIGB because of a suggested lack of communication or coordination between the four inspection teams and between the inspection teams and the auditors. Hitchman testified that he did not know and did not work with others who were examining CCB:

> Our assignment was to review the assets of that bank in accordance with the Terms of Reference. So, I was not frankly interested in anybody else's review.

Unfortunately, the OIGB did not coordinate or connect the various examinations, standardize their procedures, or define the standards to be applied in loan valuation with any degree of precision. Nor did it acquaint each team with the work of the other special examiners. In fairness to the OIGB, the terms of reference given to Hitchman included: "The agents may consult as required with the Auditors of the Bank and the former special representatives of the Inspector General." Hitchman did not look at the minutes of the Audit Committee of the Board of Directors of the bank and did not receive any correspondence or memoranda from the auditors to the Audit Committee regarding the 1983 or 1984 financial statements. He did meet with the auditors in Edmonton on 22 July in order "to discuss the procedures which the auditors used in their loan review". In any case, it had been made clear to the Inspector General, by the time the Hitchman team was appointed, that the bankers wanted bank credit officers and not the bank's auditors to examine the CCB loan portfolio. In a memorandum to the Minister of Finance of 26 June, the Assistant Inspector General stated: "Utting and Hitchman will consult one another to coordinate their separate efforts". This was not arranged as Kennett apparently felt that Utting would deal adequately with the business plan while Hitchman valued assets and credit procedures.

The extended audit provisions in the *Bank Act* were not utilized in March or April in connection with the support group arrangements and the Participation Agreement. The OIGB's reasons for not involving the auditors have already been reviewed and in the circumstances, the Ministers did not consider it appropriate to exercise powers under the *Bank Act* to extend the CCB audit. Following the Participation Agreement, the Inspector General did discuss quarterly statements and matters relating to the audit with the bank's auditors, but this was in the course of regular contacts with the bank and was not connected with the implementation and operation of the Support Program. The auditors were not engaged by the Inspector General to examine the CCB loan portfolio.

5. Utting Investigation and Report

Utting, a very experienced banker, was engaged by the Board of Directors of CCB by letter dated 16 May 1985:

> ... to enquire into and report upon the Bank's broad concepts and practices including but not limited to its controls, procedures, communications, credit granting, restructuring and workout of loans with full access to all personnel and areas of the Bank.

In addition, Paine had an unwritten understanding with Utting that he would provide the Board with an assessment of management. The OIGB shared this understanding that Utting would review the strength of CCB management and so advised the Minister of State on 31 May. The Inspector General described the Utting review as "a very positive step" and indicated that news of the appointment had been favourably received by a few of the CEOs of the major banks. Utting's notes state that although the judgments taken by management on workouts were reasonably supportable "and may not have been significantly different than judgments taken by many banks in North America, they were in fact high risk judgments requiring in most cases that virtually all subsequent developments be on the favourable side".

His review of the quality of management follows:

1. Generally good.
2. C.E.O. provides strong leadership. He recognizes need for added support and strength.
3. Communication — Very Good.
4. Remarkable dedication on part of middle and senior management.
5. Several pockets of good skills and competence within senior and middle management.
6. Planning processes presently underway rate out very well.
7. Credit policies and processes currently employed also rate out very well.

(Relative to #6 and 7 these people are saying all the right things. The real test will be in implementation.)

(The assessment in #6 and 7 may very well appear in contradiction of what will come out of the I.G.'s examination i.e. Hitchman report.)

8. There has been considerable turnover in the past 2/3 years but most middle and senior management posts are filled by experienced bankers and while there may be a shortage of outstanding star performers there do not appear to be areas of glaring weakness.
9. Financial Management is well supported by outside professional advisers and all aspects of problems are being addressed aggressively.
10. Overall a favourable impression is formed but the proof will only be assessable when results permit more precise approval of performance. There are many inherent or latent problems and targets set for the cleaning house as well as moving forward clearly contain an element of optimism and perhaps some over-optimism but this and the other is probably an essential ingredient if the very remarkable spirit and attitude of the management team is to be sustained.
11. Notwithstanding the favourable tone of the foregoing the public perception of management still continues to be a cross the Bank will have to bear until credibility and confidence can be restored.

6. Report of the Standing Committee on Finance, Trade and Economic Affairs

On 18 April, the Standing Committee on Finance, Trade and Economic Affairs was instructed to consider the circumstances leading up to the Support Program. On 3 June 1985 the Committee completed its review respecting circumstances relating to the Support Package offered to the Canadian Commercial Bank, and on 12 June it reported to the House of Commons. The Committee reported on the background and evolution of the CCB including the Westland's acquisition. It also examined credit and accounting practices within the bank. The Committee's assessment of the origins of the CCB's difficulty in the spring of 1985 was as follows:

> [T]he history of CCB has been marked by a series of imprudent lending policies, questionable accounting practices, inadequate information disclosure and lack of supervisory enforcement. It is the contention of the Committee that the present problems of the Bank are a consequence of its aggressive and imprudent lending policy dating back to the late 1970s. The difficult economic conditions in recent years only exacerbated the fallacies of that lending policy resulting in an ever greater temptation to use accounting techniques and selective information disclosure to show good financial performance.

In conclusion, the Committee indicated that its assessment of CCB's management capability "is clearly at variance with that of the Inspector General of Banks." The Committee reported that as of 7 May, the Inspector General had advised that the present management of CCB was "sound", and expressed his confidence in the bank's management. The Committee concluded its report by stating:

> [I]mplicit in the acceptance of the Inspector General's assessment is that management was fully aware of the implications of its decisions and actions. Events have shown that management accepted risks beyond the realm of prudence. The question then becomes whether supervision in this instance was adequate. In the final analysis, questionable accounting practices, inadequate disclosure and lack of supervision do not by themselves cause bank failures. Bad management and lack of credit practices do. Management alone carries the responsibility for all its decisions.

The CCB prepared an extensive response to this report. McLaughlan testified that it undermined the confidence which at the time CCB badly needed to survive:

> Well, again its very negative tone certainly undermined again confidence in the investment community. In terms of the bank ... it was very negative and, in my opinion, very misleading and based on several serious errors.
>
> Maybe just one point worth mentioning to the Commissioner. We have no idea where this ever started but it was the first time we had seen evidence of it. One of the serious criticisms and one that was widely published of this House of Commons Finance Committee Report was that this bank had paid its loan officers a commission to make loans. I recall one of the committee members spending a lot of time on Canada AM talking about, well, what would you expect from a bank that has its employees paid commissions to make loans. They are like life insurance salesmen running around selling policies.

Well, that particular criticism, I have no idea to this day where they ever came up with that particular conclusion. But it was very damaging, that amongst several others.

After the bank went into liquidation, the curator issued a press release stating that he and his staff had found no evidence whatsoever of loan officers ever having been paid a commission for making loans. All of the bank officers as well as long-time directors deny that the practice existed.

7. Relations of the Support Group Bankers with CCB

Canada's major banks were not only involved with the CCB as participants in the Support Program, they were in contact with CCB in the ordinary day-to-day operations of the banking system. Suggestions have been made that following the Support Program, several of the major banks sought to reduce their exposure to the CCB, and that their actions reflected a lack of confidence in the CCB which increased CCB's difficulties and contributed to its continuing deterioration and the eventual failure of the attempted rescue. The maintenance of existing credit relations between the CCB and the support group bankers was not discussed, let alone clarified, during the meetings of 22-24 March, 1986. The issues were not raised by the bankers themselves who would have been familiar with at least their own situation, by the Bank of Canada which had general knowledge of the matter, or by the OIGB which had no specific knowledge of the interbank credit but which in its ordinary inspection duties was aware of such arrangements in a general way. Governor Bouey assumed in March that after agreement on the Support Package, relations between the banks and CCB should return to "normal".

Immediately following the press release on 25 March, the CCB learned that certain existing lines of credit with other banks would not be renewed. The Toronto-Dominion Bank, for example, indicated that a $10M line of credit described as a Canadian Last Resort facility, which had expired 28 February, would not be renewed. It also capped an existing inter-branch guarantee at its current level. The CCB was advised in March that the Bank of Nova Scotia intended to cancel a $10M credit facility. Bank of Canada records also indicate that these lines of credit, and others with a number of Canadian and foreign banks, had been cancelled or were otherwise exhausted. McLaughlan stated that the cancellations had a two-fold effect. First, they increased the amount of borrowing the CCB required from the Bank of Canada to deal with liquidity problems, and second, the cancellation of interbank facilities made it difficult for a number of CCB's customers to operate their normal current accounts. The OIGB was concerned with the potential problem that would result if word got around that the major Canadian banks in the support group were no longer dealing with the CCB. The impact of this problem would be difficult to assess. On 10 April, Governor Bouey met with representatives of the six largest banks to discuss the Support Package. Notes of that meeting state:

> At the outset, the Governor expressed concern that banks, by showing in some instances unwillingness to deal normally with the CCB were threatening the confidence that the support group package had been designed to bolster.

In late May, with the knowledge and support of the Minister of Finance, Governor Bouey personally took action to assure normal relations by writing to each of the six major chartered banks.

Several possible explanations of the banks' failure to renew lines of credit with CCB as they came due emerged during the Inquiry. First, although the support group's participation was arranged on an agreed basis among the banks, the existing deposits/lines of credit had not been so arranged, and the risk might be considered inequitable. Second, the debenture holders had already been paid off in full but the bank participants in the support group did not have depositor status, and therefore were not led to expect compensation for losses as would be provided to both insured and uninsured depositors. Perhaps this exposure to loss, which the bankers did not consider to be fair treatment, was a further reason for the unwillingness of the major banks to extend their exposure to loss beyond that specified in the Support Program itself. Third, the lack of a full review of the CCB loan portfolio outside the Support Package left uncertainty regarding possible losses still unprovisioned. Finally, for security purposes Bank of Canada advances ranked ahead of normal deposits in the event of an insolvency. Thus, the increased liquidity advances from the Bank of Canada had the potential to undermine the prospects of recovery for other depositors, and certainly reduced the prospect of recovery for any losses incurred by the major banks in their participation in the Support Program. Accordingly, the banks may have believed it reasonable to have the Bank of Canada attend to any advances required by CCB beyond those specified in the Support Package.

Evidence before the Inquiry also indicates that representatives of support group banks actually regarded the withdrawal of interbank deposits as part of "normal" relations. This is so because interbank deposits are liquidity placements and because they are unconfirmed and unadvised; there is no obligation to renew the investment. Allan Taylor told the Inquiry: "I think it is very important to know that normal relations for the trader would be to discontinue placing funds with this bank on March 25. That would be normal relations. It would be abnormal to be carrying on, especially under the circumstances that we saw, continued drawing from the Bank of Canada, no restoration of confidence in evidence." In any event, Governor Bouey concluded that since CCB's problems were on the asset side rather than the liability side, the withdrawals "had no effect on the ultimate outcome". Macpherson testified that McLaughlan never complained that the withdrawals wrecked the bailout. The Inspector General stated that the run-off of deposits was "a relatively small factor".

8. Reassessments of CCB's Condition

a. August Meetings with CCB Representatives

The Inspector General and the Minister of State met with the CCB Chairman in Toronto on 9 August after the conclusions of Utting's review of CCB's management had become available to CCB and while Hitchman was preparing his final submission. The Inspector General in a memorandum of 15 August described the essence of the meeting.

> At that meeting, Mr. Paine explained that with the anticipated losses and write-offs, the Bank would be out of capital by year end. He reported that in Mr. Utting's view, management was competent and was doing what they could in the circumstances. However, the Alberta commercial real estate market was a disaster and this had to be taken into account in further write-offs.

The Minister of State testified:

> The bank itself then approached us on August 9 and said they felt at that point they had until the end of the year and suggested that more government support might be a good idea.

A further meeting occurred on 13 August of the Chairman and officers of the bank, the Governor and Senior Deputy Governor of the Bank of Canada, the Inspector General and the Assistant Inspector General of Banks. In preparation for this discussion, McLaughlan prepared a memorandum in which he stated:

> It is now clear that unless CCB obtains additional financial assistance, the Bank will be technically insolvent (no capital) at fiscal year-end 1985. Since the implementation of the March 1985 assistance program, an additional $200 million of loan losses have been identified (based on a worst case scenario) and the level and carrying costs of nonearning loans have increased.

McLaughlan reported that the objectives of the Support Program were not being achieved because CCB was unable to liquidate its nonperforming loans even at their written down levels. One-third of CCB assets were nonearning or partially earning. The Alberta real estate market was still in difficulty, and because of the obligation to repay the support group portion of the loans under the agreement, the bank was unable to recognize income on loans that it retained. At the meeting on 13 August, McLaughlan estimated that the costs of liquidation, including the costs of the liquidator, would amount to $750M together with the CDIC losses which were expected to reach $269M, including $75M of insured deposits. Therefore he concluded that, after the retirement of the prior claim of the Bank of Canada for liquidity advances, any other depositors in the bank would receive 25 cents on the dollar.

The notes of the 13 August meeting prepared by the Senior Deputy Governor of the Bank of Canada state in part:

> The initial presentation by McLaughlan centered on the fact that the objectives underlying the Support Package were not being realized. The Support Package was based on the view that the value of the $530 million in the Support Package when disposed of in the market would prove to be some 53 per cent of the book value. However, the amounts being realized were in the range of 30-35 per cent. If this was extrapolated through the whole $530 million, the deterioration against what had been forecast came to about $100 million. In addition, there was a running loss as a result of the lack of income-producing assets to the Bank. Looking forward, it appeared that the Bank's capital would be eliminated by the close of the fiscal year.

b. The Merger Option

The option of merger as a means to avert collapse of the CCB had been set aside in March at the time of the decision to implement the Support Package proposals. However, further consideration was given to the merger option during July and August although the view generally held by that time was that CCB was in a worse state than appreciated in the period of 14 to 25 March 1985. McLaughlan was not involved in any merger discussions between 25 March and 13 August. McLaughlan was advised by the Inspector General on 13 August that an interested merger candidate existed and that if other possibilities appeared, they would also be examined. McLaughlan then met with the potential merger candidate in Edmonton and outlined the portfolio as well as the potential losses on liquidation. Nothing came of this discussion. The Inspector General reported on the amalgamation option (in the case of both CCB and Northland) to the Minister of State on 23 August. The memorandum reads in part:

> No bank would be willing to amalgamate with them unless some third party (i.e., the CDIC or the government in some form or other) pays the larger bank. Payment could be by purchasing bad and nonearning loans at face value or by funding the nonearning loans and providing an indemnity against losses.

He added that the costs of such a payoff would have to be borne by the Government of Canada one way or another. He concluded: "Obviously, there is little to distinguish this from a liquidation approach. ..."

In late August, the Finance Minister was advised by another potential merger candidate, "Unfortunately there is just no point in us going ahead here. You have got a dead bank on your hands."

c. *Opinions on Solvency*

Opinions as to the solvency of the CCB evolved in response to continuing developments during the summer of 1985.

On 3 June, the Inspector General advised the major banks that all Canadian banks are solvent and deserve continued extension of normal banking relationship. About one week later, on 12 June, the Inspector General reported CCB's second quarter results — $21.7M net loss — to the Minister. Although these results were not encouraging, because of special circumstances they were also not a basis for forecasting and the Inspector General stated that he was "confident that the Bank is on the right track".

At approximately the same time (21-22 June) Grant, Johnston, Cockburn, and CCB personnel concluded that a $50M additional write-down was needed on the the support group loans. This was additional to the $255M provision assigned under the Support Package to the major banks. As already seen CCB was by now reporting deficiencies on realizations from disposal of security held in the Support Package loans. The Inspector General reported CCB difficulties to Mackness of the Department of Finance who in turn reported a "high risk" situation to Wilson. The Inspector General stated that the phrase "high risk" is not his, and further: "At this stage I had no reason to believe that it was insolvent. It was still operating on a considerable capital cushion". Yet the Inspector General says: "Our concern began to mount" from the time of the $50M write-down recommended by Johnston and Cockburn on Support Program loans, but he still believed the CCB was solvent.

On 10 July, during a tour of Western Canada, the Inspector General met with Mann, Smith, Gaudet, and Melnuk of CCB and subsequently with representatives of the auditors. The Inspector General's notes from these meetings are as follows:

July 10 — Edmonton

Canadian Commercial Bank — Mann, Smith, Gaudet, Melnuk — Al Taylor supportive of rescission of amalgamation with REIT unitholders — expects trouble selling it to other banks — wants 2-3 weeks — rescission may impair capital and require Order in Council — now expecting possible capital reduction of 50-65 million — every effort to reduce assets, sell written down loans — reducing overheads ... US has prohibited any upstream funding by Commercial Centre Bank — CCB agency —

CCB auditors

> — auditors reviewed 6 month figures — expect to be called in for 3rd quarter — in regular contact with Bank and helping in planning — Lord negative about return to profitability without further help re funding costs, debenture, etc. — pessimistic — very unhappy about parliamentary committee report and that whole experience. ...

As of 1 August, when he received the interim Hitchman report, the Inspector General explained: "I was satisfied still, on the basis of the bank's own figures, which was all I had, that the bank was solvent. I was not rushing to the view at this precise moment that the bank was insolvent. ... We were anxious to have every opportunity to view this situation and to review it thoroughly and to make sure that we had all the evidence in and could move with conviction before we moved".

The 9 August meeting with Paine and the Minister of State in Toronto, and the follow-up session on 13 August, were significant turning points in the OIGB's overall assessment. The Inspector General said that McLaughlan indicated CCB "would be insolvent" and stated "we were still collecting all the evidence", but he conceded that the bank was "pretty well" insolvent at this date. Nonetheless, the Inspector General wrote on 20 August: "My advice that the bank should carry on its deposit business as usual was based on the very thorough analysis by the Bank indicating that at this point in time it continues to be solvent. In that circumstance and having in mind the active search for an ultimate solution to the Bank's problems, it seemed unnecessary to me to limit deposits at that time." This letter was a follow-up to a phone call between the Inspector General and Paine in relation to the latter's letter of 13 August seeking confirmation of the Inspector General's view that CCB could continue to accept deposits over $60,000. The Inspector General explained the dilemma facing the bank supervisor in these circumstances:

> I was not in a position where I could advise the bank that it should take this action, that it should be partly opened in some sense, and that it should be behaving in a way that would put whatever additional risk there was in this situation entirely on the Canada Deposit Insurance Corporation. The bank should either be open and operating or should be closed, and obviously we were not ready at that particular point in time to close the bank.

McLaughlan did not admit that CCB was actually insolvent on 13 August when he met with public officials. The thrust of his presentation was that CCB was going to have its capital wiped out in the coming three to four months: "So it was headed for insolvency".

The Minister of State (Finance) had an adviser's memo of 1 August which stated: "On the basis of Hitchman's preliminary analysis and conversations with Mr. McLaughlan, it is clear that the CCB is insolvent, probably, to the tune of several hundred million dollars". The Minister of State was also present for part of the 13 August meeting when Paine and McLaughlan presented their conclusions, and she concluded at that point that the CCB was insolvent. The final Hitchman information and the collapse of the merger option confirmed to the Minister that liquidation was the only option. She says the same decision would have been reached without the Hitchman findings.

Mackness' conclusion of insolvency following the 30 July interim Hitchman report has already been discussed. Almost one month earlier Mackness had reported to the Finance Minister that the Inspector General's "greatest concern is that the basic situation is continuing to deteriorate vis-à-vis asset valuation and nonperforming loans". Mackness concluded at that time that the \$255M write-down from March should be \$40-\$50M higher and he advised the Minister of Finance that "There is a sufficient risk of failure and winding up at CCB that consideration of the political and financial implications should be undertaken now".

The Minister of Finance also indicated that the numbers presented at the 13 August meeting pointed to the conclusion that CCB was then insolvent. He also addressed the issue of whether CCB should have been taking uninsured deposits:

> Well, that is where you get to a very difficult area when a bank is in a very delicate position between solvency and insolvency.
>
> Up until then we had gone for over 60 years without a bank failure. There is I think a very strong tradition of a solid Canadian banking system, so that we wanted to make sure before we took action on this that there was further work that would be done by other people in order to confirm what Mr. Hitchman had said.

Minutes of the 18 June Board of Directors meeting of the Bank of Canada where the Governor set out his views on CCB read in part:

> In a more detailed briefing on the Alberta banks, the Governor said that, as expected, confidence in the CCB had remained weak, and had not been helped by the publicity surrounding the Report by the House of Commons Committee on Finance, Trade and Economic Affairs and the publication by that bank of a large, albeit expected, second quarter loss. ... The Bank of Canada had remained in close touch with the CCB and with its plans to improve its situation.
>
> He noted that the Inspector General of Banks continued to take the view that the CCB and the Northland were solvent and it was clear that a pick-up in the Alberta economy would help the situation of both banks. He added that it was likely that advances to these banks would continue to remain large for some time to come. Both the Alberta banks were attempting to broaden their retail base, but this took time.

Bouey received the preliminary Hitchman report, "a bunch of loose pages", about 6 August, and was in attendance at the 13 August meeting. In the hearing he said, in reference to his views at the time of the 13 August meeting: "I would say the bank was certainly headed for insolvency, that it was not insolvent at that moment in terms of net worth, but that is where it was headed". Although the Governor felt it was then possible for the Bank of Canada, without the advice of the Inspector General, to decide that the CCB was not viable and to cease lending, this was not done in order to allow further exploration of the merger option and consideration of what to do about the uninsured depositors. The Bank of Canada continued to make advances to the CCB on the basis of its stated commitment to maintain liquidity funding to any bank considered by the OIGB to be solvent.

9. Hitchman's Final Report

The final report of the group under Hitchman's direction appointed to examine the loan portfolio of the CCB was completed on 12 August 1985. The Hitchman Report was based on a review of 84 individual loans representing total CCB loans with an outstanding balance of $423,219,000. Hitchman reviewed no loans in the Support Package. It should be noted that the Support Package involved the write-down of some $255M on loans the outstanding balance of which amounted to $540M. These loans, plus those examined by Hitchman, amounted to approximately 40 per cent of the total portfolio. The report, together with appendices reporting on individual loans, was delivered to the Minister of State on or about 13 August 1985.

In a summary of his findings, Hitchman's 12 August report stated:

Summary

A. A substantial provision for losses on loans is required — whether it be $910,026,000 or $1,063,278,000 or some reasonable percentage of such figures. To this must be added operating losses for 1985 of some amount — not yet available until statement is audited.

B. When and how the outside auditors will give a "clear audit" for the October 31, 1985 statement, with the information now available — is also an unknown at this date.

C. The Bank is heavily indebted to and surviving on assistance from the Bank of Canada. As at June 30 the amount was $1,082,320,000 and the Bank had:

Demand deposits of	$ 194,841,000
Payable after Notice	5,866,000
Payable on fixed date	1,214,807,000
Total	$1,415,514,000

and has no predictable Cash Flow coming in from assets.

D. Time is of the essence to reach a decision on the future of the Bank.

The Hitchman Report presented several types of financial analysis of the condition of the CCB loan portfolio which were summarized as follows:

9. *Marginal/Unsatisfactory Loan Summary as prepared by C.C. Bank as at May 31, 1985*

Summary

Total Bank Loans — $2,363,705,000

Marginal/Unsatisfactory		
Canada	$531,405,000	
U.S. Division	191,491,000	$722,896,000 — or 30.5% of total loans
of which —		
Non Earning Loans		
Canada	$291,569,000	
U.S. Division	166,678,000	$458,247,000 — or 19.31% of total loans

These figures are AFTER TRANSFERRING $255,000,000 loans to the Support Group.

10. *Summary of Review of Loans made by the Hitchman Team*

Number of Accounts reviewed — 84 out of almost 550; that is 15%.

Total Amount of Accounts reviewed — $423,219,000 out of $2,363,705,000; that is 18%.

We rated accounts and established a provision for losses as follows:

Classification	No.	Amount	Provision for Losses	Provision as % of Amount
Good	23	$ 48,907,000	$ —	—
Weak	12	51,639,000	400,000	.8%
Doubtful	49	322,673,000	162,378,000	50.0%
Totals	84	$423,219,000	$162,778,000	38.5%

A critique of Hitchman's methodology identified several limitations in the exercise. The 84 loans selected were not statistically representative of the overall CCB portfolio and the sample may have been too small to provide an adequate reflection of the portfolio. Also, as the sample was weighted in favour of large dollar and higher risk loans in Alberta and the Maritimes, extrapolation may not properly reflect the loan condition of the overall portfolio.

The final Hitchman Report set out the following general comments:

> 13. *General Comments Based on our Review of C.C. Bank Loans*
>
> (1) Some loans were initially made on 100% of cost of real estate; T.V. Cable franchises; and other assets. Borrower had NO equity in asset.
>
> . . .
>
> (5) Moving problem or bad loans for substantial sums to a new name and then calling the loan current, is not a proper procedure to follow.
>
> (6) Re-writing loans and capitalizing past due interest and provision for future interest is just not acceptable.
>
> (7) Adding substantial fees to loans where collectability is in doubt, or re-writing loans and then taking such fees into profits, creates a false and improper short term profit picture.

The Hitchman Report also noted that bank management stated that "all energy is being devoted to collection — little or no marketing is being done", and concluded that this should mean a reduction in assets. The accounts of the bank revealed however that the loan portfolio increased $68M between 31 October 1984 and 30 June 1985. McLaughlan's evidence on this final point was that the CCB REIT merger increased the bank's loan portfolio by $47M while foreign exchange movement on the U.S. dollar assets added $35M to the asset totals. McLaughlan equated this $82M total with Hitchman's $68M figure to show an actual decline of $14M of bank loan assets during the period.

It should be noted that the criticisms contained in the Hitchman Report were vigorously attacked. The following is illustrative of the attacks mounted on the Hitchman Report by management and others during the Inquiry. Most criticisms regarding CCB procedures and documentation were subsequently shown to be without foundation. Hitchman admitted in cross-examination that the bank did not move bad loans to new names, so as to show them as good loans and disguise such moves. Hitchman's loan reviewers, Messrs. Taylor and Farthing, did not review branch files, and admitted that in some cases they lacked information, in which case they took a more pessimistic view of the loan. Taylor expressed his concern to Hitchman that he would prefer to visit the branches; however time constraints rendered this impossible, and given the choice to quit or stay on using Head Office files only, Taylor chose the latter. The Head Office files are often not nearly as detailed as the branch files. The reviewers did not meet the borrowers or view the security. Hitchman's sample and the method of extrapolation rendered the final dollar figures for reserves unreliable. He reported that the bank often engaged in 100 per cent financing, a bad practice, while other bankers testified as to the difficulty of avoiding this on workouts. Other criticisms were made.

It is fair to conclude from all this discussion that the real extent of losses in the bank is unknown, but what is clear is that the provisions for loan losses were understated, some banking and accounting practices were unconventional, and that CCB was in a bad condition which appeared to be terminal.

E. CCB CESSATION OF OPERATIONS

1. Appointment of a Curator

The Minister of Finance had been advised on 8 July that: "There is sufficient risk of failure and winding up at CCB that consideration of the political and financial implications should be undertaken now". It is not entirely clear from the record, however, when concrete steps were undertaken within the OIGB to prepare for the possibility of collapse. The decision making during the early summer was incremental rather than comprehensive, and the alternative possibility of a merger appeared to be open until mid-August. When asked whether the machinery to appoint a curator was activated on 13 August, the date of McLaughlan's presentation in Ottawa, the Inspector General replied:

> By July 10 I was talking to the Alberta Government about what alternatives might work because the situation surely did not look good, and there were no easy answers.
>
> We were actively seeking other alternatives, and by August 13th we were beginning to plan for the possible liquidation of this bank, yes.
>
> ... [W]hen you are dealing with banks and the confidence of the system, you simply do not wake up one morning and decide that today we are going to close the bank. There is a lot of preparation that needs to be made, and you want to make very sure that you are not making any mistakes about this, that the evidence is indisputable and that the alternatives have been adequately canvassed.
>
> We were very much in that stage by August 13.

The OIGB's exhibits contain no memoranda to the Ministers between 25 June and 23 August, and no reference during this period to arrangements for a curator, but the Inspector General and the Minister of State were both present at several meetings during the first half of August when the process was discussed. On 23 August, the Inspector General prepared a memorandum for the Minister of Finance and the Minister of State regarding the CCB and the Northland Bank "to outline proposals for action to deal with the mounting difficulties the banks are facing." He advised the Ministers:

> I am now convinced that solutions must quickly be formed to enable the assumption of control of both banks and their eventual disposition.

Also on 23 August, the Inspector General prepared a separate memo to the Minister of State. In these two memoranda the Inspector General reviewed the options then considered to be available; amalgamation, slow liquidation, and fast liquidation. He discussed the advantages and disadvantages of each and indicated that his own preference under the circumstances was for the appointment of a curator, provisional liquidator and liquidator leading to the winding-up of both banks.

The treatment of uninsured depositors emerged as a key issue in the deliberations of late August. While this is not an issue with which this Inquiry has been directly concerned, it is appropriate to note that public statements by Ministers and public officials supportive of the CCB were regarded by some commentators as a foundation for compensation claims by uninsured depositors.

At the time of the bailout, the Minister of Finance and the Minister of State (Finance) both expressed confidence in the condition of the CCB. The Minister of State (Finance) stated:

> In consultation with the support group, we are satisfied that this bank is now a viable bank, that it will be profitable in the future, and that we will be repaid, as will other members of the support group.

The Minister of Finance told the House:

> It is for that reason [the impact on Western Canada] we felt it important to do everything we can to ensure the ongoing viability of the bank. We believe the support operation that was put together over the weekend will achieve that.

Governor Bouey, on Sunday, 25 August in a meeting with the Ministers and by letter of 28 August, argued for compensation of uninsured depositors. The Governor of the Bank of Canada, in discussing with the Ministers the issue of compensation of depositors, reveals an assessment of the age of the causes of the failure of the CCB. He said:

> ... evidence [is] now becoming available that demonstrates clearly that the causes of the present situation already existed at the time the official assurances were given. ...

Following the decision to liquidate the CCB and to provide compensation for uninsured depositors, a number of the banks which had participated in the Support Program stated their claim to compensation on the basis of the understanding associated with the Memorandum of Intent and Participation Agreement. In the event, the banks were not compensated for their contribution to the Support Program for CCB. Bill C-79 providing compensation for uninsured depositors was introduced on 3 October 1985.

2. The Decision to Collapse CCB

As of 1 September 1985, Bank of Canada advances to the CCB amounted to approximately $1,310,000,000, or about 65 per cent of the total outstanding deposits of approximately $2.2B. The Inspector General wrote Governor Bouey on 1 September to advise him as follows:

> Based on continuing surveillance of the Canadian Commercial Bank by my office and on the information available to me, I have concluded that the Canadian Commercial Bank can no longer be considered a viable operation. Accordingly, I propose to report to the Minister under subsection 278(2) of the Bank Act that the Canadian Commercial Bank will not be able to pay its liabilities as they accrue, unless you advise me that the Bank of Canada intends to continue to provide funding so that such a report would be incorrect.

In reply on the same date, Governor Bouey stated:

> In the light of the information which you have conveyed to us in your letter, it is clear that the problems experienced by the Canadian Commercial Bank cannot be solved through the provision of liquidity, and we therefore are ceasing immediately to provide advances.

The Inspector General continued the "anvil chorus" on 1 September, reporting these developments to the Minister of Finance and the Minister of State (Finance), and recommending to them that a curator be appointed forthwith:

> In these circumstances, I am reporting to you that I am of the opinion that the Bank will not be able to pay its liabilities as they accrue.
>
> I recommend, therefore, that you forthwith appoint a curator to supervise the business and affairs of the Bank pursuant to subsection 278(2) of the Bank Act.

On the same day, the Minister of Finance took steps to appoint a curator for the CCB. The firm of Price Waterhouse was named as interim liquidator on 3 September.

Press releases dealing with the CCB and Northland Bank together announced the actions that had been taken. A press release from the Bank of Canada indicated that the Bank had "concluded that there is no longer a basis for further liquidity support of these two banks and accordingly is ceasing immediately to provide advances to them." The press statement also reported:

> The Governor stated that the difficulties experienced by these two banks do not reflect on the soundness of the rest of the Canadian banking system. He also reiterated that the Bank of Canada stands ready as always to provide liquidity if requested for any Canadian bank.

The Department of Finance press release confirmed that the Minister of Finance had taken action to appoint curators for both the CCB and Northland Bank. This release announced details for the transition in management effective 7 p.m. EDT, Sunday, 1 September, and described depositor reimbursement procedures to the maximum CDIC limit of $60,000 including interim efforts "to endeavour to make funds available in modest amounts to those insured depositors who find themselves facing serious and immediate financial hardship."

Appendix E

Formation and Evolution of the Northland Bank

A. The Original Concept and Organization of the Northland Bank

B. The Early Years of the Northland Bank

- **1.** The Pattern of Growth — 1976 to 1982
- **2.** Internal Control Systems
- **3.** Northland's Prospects and Financial Condition, 1982

C. New Management and the Recovery Strategy

- **1.** The 1983 Annual Inspection
- **2.** The Workout Strategy at Northland
  - **a.** Capital
  - **b.** Retail Deposits
  - **c.** Growth
  - **d.** Workout Arrangements
- **3.** The 1984 Annual Inspection

D. The Northland Bank at 1984 Fiscal Year End

- **1.** The Hay Report
- **2.** The Audit Examination
- **3.** The Write-down Proposal

E. Northland's Growth Strategy and Funding Issues, 1985

- **1.** The OIGB and the Growth Strategy
- **2.** Capital Issues
- **3.** Northland Funding after the CCB Support Program

F. Inspection and Continuing Supervision

- **1.** The 1985 Annual Inspection
- **2.** Changing Views

G. Northland's Search for a Solution

   1. Restructuring

   2. Rondix

   3. The Merger Option: The National Bank Review

H. Portfolio Assessments

   1. Cook and Adamsons

   2. Curator's Review

   3. Internal Inspectors

I. Cessation of Operations

Appendix E

Formation and Evolution of the Northland Bank

A. THE ORIGINAL CONCEPT AND ORGANIZATION OF THE NORTHLAND BANK

The founders of the Northland Bank shared the conviction of their counterparts at the Canadian Commercial Bank that distinctive needs of the prairie economy were not adequately served by existing financial institutions. They proposed to emphasize, as background documents on the Northland Bank demonstrate, "imaginative and innovative approaches to the financial aspect of economic development in the prairie provinces." It was intended that this specialized services approach would "from the very earliest moments of inception, allow for and permit the maximum input and impact (with due recognition of what is prudently possible) on the economy of the Prairie Region."

The original Northland Bank proposal as presented to Parliament was that the bank would be initiated and financed by cooperatives and credit union societies in western Canada. These funding organizations included cooperative insurance companies, cooperative credit societies, cooperative trust companies, as well as retail and wholesale cooperatives and a cooperative implement company, all located in the prairie provinces.

Mr. R.A. Willson, a founding director and first Chairman of Northland's Board of Directors, had been retained by the bank's promoters to study the concept in depth. Willson concluded that although the credit unions did not wish to enter the commercial lending field, they were prepared to make their retail deposits available to Northland for commercial lending. Credit union deposits were expected to provide a secure line of liquidity for the bank's commercial lending in the very early stages. Unfortunately, credit unions' deposits were not made available to the extent that had been anticipated because of a subsequent change of plans on their part.

As originally conceived, Northland's lending policies were to be directed towards assisting the expansion of the national economy with "special emphasis on the rapidly growing needs in the prairie provinces". The sponsors of the bank advised the Parliamentary Committees that the major business objective of the bank would be to concentrate upon industrial, commercial, and agri-business loans in the $200,000 to $2M range. Northland's planned lending orbit was concentrated on the prairies and its initial funding support from the credit union movement was gradually to decline in importance as new sources were utilized, so that in the long term, the credit union movement would be but a small participant in the bank. Lending funds, it must be emphasized, were not to come from retail deposits, but in the words of its Chairman, Mr. R.A. Willson, "we will be relying on our skill to buy and manage money as a wholesale bank". When the sponsors of the bank appeared before the Finance, Trade and Economic Affairs Committee of the House of Commons, the first President of the bank, Mr. Hugh Wilson, stated that the bank would secure its deposits from "the money markets across the nation" and from "bought deposits" from customers.

The President further explained that, while the founders could no doubt build a larger bank more quickly, they did not think it prudent to proceed at a faster pace which would see a total asset position of $343M at the end of five years. As will be seen from the subsequent history of the bank, this strategy was abandoned after the first one to two years, and major growth became the principal goal of the bank. Legislators were also repeatedly assured that the principal source of income would be interest from loans and not fees and commissions.

As in the case of CCB, the Inspector General of Banks appeared before the Banking, Trade and Commerce Committee of the Senate to record the fact that he had no objection to the passage of the incorporating Bill. The Special Act of Parliament incorporating the Northland Bank received Royal Assent and became effective on 20 December 1975. Northland received approval from the Governor in Council to commence the business of banking on 28 September 1976. The capital of the bank was authorized at $17M (1.7 million shares at a par value of $10). By December 1976, when operations were getting under way, 829,000 shares were outstanding and fully subscribed at $12.50 per share for a total paid-in capital of $10.7M.

Northland located its Head Office in Winnipeg and established executive offices in Calgary where its first full branch opened. It proposed immediate expansion to Edmonton, Regina, and Winnipeg by means of "development offices". In addition to R.A. Willson, the founding Chairman, and Hugh Wilson, Northland's first President and Chief Executive Officer, the original Board was heavily weighted with representatives of the co-ops and credit unions which had initiated the Northland proposal. Hugh Wilson came to Northland with almost three decades of domestic and international banking experience. He had branch office background in Manitoba, Saskatchewan, and Alberta, a range of senior management experience, and familiarity with the international environment from previous employment with the International Operation Division of the Toronto-Dominion Bank.

In an information memorandum dated December 1976, Northland presented a series of basic business policies which it intended to pursue in implementing its planned program of development:

1. Provide business in Manitoba, Saskatchewan, Alberta, British Columbia with operating capital and term loans, in keeping with regional conditions and needs.

2. Assist in the development of the Western Canadian money market.

3. Minimize consumer/retail services and the aggregation of savings deposits as a source of funds. Emphasize the purchasing of short and medium-term domestic and international funds in money markets at favourable rates to match loans.

4. Maintain firm control of the administrative, organizational and other overhead costs to offset any initial competitive advantage larger competitors may enjoy in purchasing funds at a lower cost.

5. Secure direct access to international and foreign exchange services through correspondent relationships with certain significant offshore and U.S. banking institutions, to enhance service to domestic clients.

6. Emphasize financial and management counsel to clients as a prime service feature.

7. Secure, develop and maintain managerial competence and experience to service natural resources, secondary industry, commerce and agri-business in Western Canada.

8. Adhere to a policy of sound asset/liability management to ensure flexibility and liquidity at all times.

B. THE EARLY YEARS OF THE NORTHLAND BANK

1. The Pattern of Growth — 1976 to 1982

Northland authorized its first loan on 15 November 1976. President Wilson, using the international connections he had developed before joining Northland, obtained invitations from major banks to participate in sovereign lending. As a result, Northland became far more heavily involved in sovereign loans than the original plan had intended; at one point, these loans reached about 50 per cent of the total loan portfolio. Through sovereign lending, the bank was able to deploy its capital quickly at reasonable rates and with little expense. As the spread on international lending was better than on domestic loans at the time, Northland's sovereign lending represented an attractive source of immediate income.

On 27 July 1979 (for reasons unrelated to Northland's international portfolio), Hugh Wilson's employment with the bank was terminated. Board minutes indicate that this was due to a deterioration in Wilson's relationship with other members of the management team attributed to perceived deficiencies in the President's personnel management capability. After Hugh Wilson left the bank, R.A. Willson became the President and CEO, in addition to keeping his position as Chairman. Chairman Willson has frankly acknowledged his lack of banking experience, and indicated that he had not sought the position of Chief Executive Officer of the bank.

The new President 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. The annual inspection reports produced by the OIGB for the years 1977, 1978, and 1979 reveal that in the early years of the bank, Hugh Wilson had maintained a conservative stance and guided the bank along a path of steady growth. Beginning in 1979, the OIGB reports show that the bank had begun to emphasize real estate lending, in part because such loans were easier to put on the books. By 1980, the bank had shifted its emphasis in terms of size of loans. The tendency to grant larger loans is illustrated by a loan booked in 1980 to finance real estate development in the Cayman Islands in the Caribbean in the amount of $6M. This loan exceeded 25 per cent of the bank's capital as of 31 October 1980. The 1980 post-inspection notes of the OIGB confirm the shift in loan size. Northland's Vice-President, Credit, is reported to have indicated that:

> ... in the past the bank's emphasis was on servicing the smaller $100,000 loan but now attention was being directed to the larger credits up to $3 million with

particular concern for connections between related corporations and outside guarantors.

Even loans up to the $3M level were regarded by management as a constraint on the growth of Northland's assets in 1980. The 1980 post-inspection notes also indicate that R.A. Willson expressed the view that by working within a loan limit of $2 to $3M the bank was finding it hard to accommodate business needs and to maintain customer confidence. Management had concluded that there was an immediate need to attract more capital in order to accommodate the bank's growth potential. The growth in the bank's total loans for the period 1977-82 is set out in Table E.1.

Table E.1

Northland Bank Total Loan Portfolio 1977-82

Years	*Total Loans*
1977	$26.7M
1978	$81.9M
1979	$131.1M
1980	$206.5M
1981	$397.9M
1982	$509.6M

It may be of historical relevance to note the 1980 dismissal of Touche, Ross and Co., the auditors. In 1979, Don Heasman, the engagement partner, gave the bank a choice of a specific loan loss provision on a certain account of $400,000 or a qualified statement. After heated discussion at the eleventh hour, the bank made the provision. In a discussion between the OIGB and Willson, the latter indicated that he did not think that any of the bank's officers would be acrimonious toward the external auditors as a result of the position taken. The OIGB commented in their record of the event, "This may be true for Bob Willson though I did not get the same view elsewhere." During the course of the annual inspection for 1980, Willson expressed concern over the critical approach of Heasman on this credit. Willson believed that the problems with this particular credit, and the weak credit follow-up procedures generally, were characteristic of new banks starting out. There was about the same time a difference between the bank and Touche, Ross over audit fees. Touche, Ross and Co. were on the audit panel for the fiscal year 1980, but the decision to remove them had actually been taken by the Audit Committee on 3 December 1979, shortly after the 1979 audit. The delay of one fiscal year in removing Touche, Ross and Co. appears to have resulted from the time required to locate another auditor. In the spring of 1980, the Audit Committee was considering presentations of other audit firms. At the time when Touche, Ross and Co. was released, the OIGB did not feel that this was connected to the position that Touche, Ross took with respect to the large provision, because auditors are rotated from time to time as the law requires. In hindsight, the Inspector General testified that Touche, Ross were "fired" because they insisted upon this specific provision. Years later, when discussing the appointment of a curator, Willson stated that Touche, Ross had been "fired" by the bank.

After Hugh Wilson's departure in mid-1979, Northland began to search for a career banker to assume the office of President and to replace R.A. Willson. Eighteen months later, on 16 January 1981, Walter A. Prisco joined Northland's management as President. Prisco had been a senior officer of Mercantile Bank and had a reputation as an excellent credit man. On 23 July 1981, Prisco also became Chief Executive Officer of the bank. R.A. Willson continued as Chairman of the Board.

Prisco found the Northland staff enthusiastic and ambitious. On the other hand, he concluded that leadership was weak and that few systems were in place to control credit authorization. In Prisco's view, great risks had been taken on and the quality of loans was substandard and inferior; 8 per cent of the portfolio was in serious difficulty.

On the financial side, Prisco planned to expand the loan portfolio by booking good business to reduce the proportion of unsatisfactory loans in the bank. He intended to proceed at a reasonable pace with the emphasis on quality and diversification. This would take the loan portfolio from about $400M in 1981 to $1B by 1984. Whether Prisco would have maintained his objective of a $1B loan portfolio in face of the deepening recession which began to set in at the end of 1981 will never be known, because Prisco was terminated in mid-1982.

2. Internal Control Systems

Northland, at least in its early years, lacked an effective internal inspection system. In 1978, an internal audit responsibility was established, and the post was filled by the Chief Accountant of the bank. It was not unexpected that his accounting duties were found to be more pressing than his internal audit duties. The office existed largely in theory. This continued to be a problem through 1981. Internal auditing personnel were mainly engaged in special studies rather than internal bank auditing and inspection. As a result, the internal auditors played a relatively minor role in the bank. The external auditors were not able to rely on their work in the conduct of the annual audit. Consequently, it was the auditors, not the bank's internal inspectors, who discovered major deficiencies in loan documentation, loan security held by the bank and approval procedures. Frequently the external auditors encountered an absence of the up-to-date financial statements and customer information which auditors look to in determining whether the borrower is in financial difficulty or loan recovery is otherwise at risk.

Prisco took a number of steps to remedy the problems he found in credit-granting practices and internal controls in the bank. Because the bank had tended to operate on an *ad hoc* basis in its day-to-day business, Prisco wrote a number of policies governing the conduct of daily business. He also established the office of Chief Inspector and clarified the loan granting procedures. To implement his reforms, Prisco virtually closed down new lending business in October and November of 1981, while problem accounts were isolated and appropriate reserves established.

On 8 March 1982, Prisco circulated a memorandum on credit to all officers of the bank:

> Our loan problems stemmed from poor credit judgement, faulty analysis, lack of foresight, and careless monitoring (follow-up) control, i.e. weak management. Some credit officers were shooting from the hip and didn't seem to realize that it's one thing to lend out money, but didn't think too much about the client's ability to repay.

The President went on to describe the bank as essentially an asset-based finance company and asserted that "Northland's credit granting record in its first five years of operation has been a poor one, by any standard". He admonished the staff to become more critical and banker oriented, and set out nine rules for the proper granting of credit which, in his view, had not been applied in the bank before his arrival. Henceforth, Northland was not to lend to anyone unable to provide up-to-date and audited financial statements, nor was credit to be granted on the security of the principal's residence. Credit officers were not to rely on replacement or historic value but should look to the economic value of assets in terms of their present and future cash flow. There were to be no realty lending unless cash flow serviced the debt, and no second mortgages. Prisco wanted to see "no loans without two ways out", "no more eleventh hour credit applications for answer yesterday" and "no more crystal-balling on rates". These rules were rudimentary and the fact they were needed in the bank reflects the new President's assessment of the state of affairs in the bank by 1982, and the quality of prior management.

In 1982, Prisco's relations with Chairman Willson and some Board members deteriorated. Disputes arose over two operational matters. First, Prisco introduced a proposal for the acquisition of a guarantee corporation. The corporation was financed by substantial shareholders and Prisco regarded it as a good acquisition for the purpose of obtaining capital. This led to the second matter of dispute. Because Prisco foresaw a potential loss on the Cayman loan mentioned above, as well as other large write-offs, he felt that it was necessary for the bank to increase its capital. Friction also developed on occasion from Prisco's belief that the Chairman required bank staff to carry out what the President considered to be worthless endeavours (one of which he described as a "dog and pony show" before the Regional Advisory Committees) during a period when they were urgently required to address the problems in the loan portfolio.

The Board disregarded Prisco's recommendations and voted against the acquisition of the guarantee company. Prisco, in an action which some Board members may have regarded as retaliatory, threatened to call a news conference to announce that "the bank would take a hit for $6 million" on the Cayman Islands loan. The Executive Committee terminated Prisco's appointment in June 1982 but resolved in a meeting two weeks later to propose to the Board that Prisco's lending skills and competence be retained by the bank. The resolution, strangely similar to the excuse for Wilson's termination, cited problems in inter-personal skills. In any event, Prisco departed and R.A. Willson again added the responsibilities of CEO and President to his work as Chairman. This time he held these offices until William E. Neapole, a banker who joined Northland in May 1983, became President in September 1983, and eventually CEO in August 1984.

Neapole's description of the early evolution of Northland's credit operations is consistent with Prisco's view that controls on the credit side were weak:

> In the late 1970s and up to 1981, Northland Bank participated in the prosperity of western Canada. During this period, Northland experienced strong, if not overwhelming demand for credit, primarily in the real estate development sector, which allowed the bank to earn generous fee income during the growth period.
>
> 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.

Criticisms about performance were also expressed by a director whose name was removed from the nomination list of directors in late 1982. This director stated:

> 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.

It must be noted, however, that this director had been associated with the guarantee company described above, and could have participated in the proposal for its acquisition. He would have received a $300,000 commission had the purchase gone through. Another Northland director resigned on 23 September 1982, again (according to Board Minutes) citing concerns about the performance of the bank officers, management, the executive committee and directors, and about a loan to a director and his associates.

3. Northland's Prospects and Financial Condition, 1982

Several assessments of Northland's prospects and financial condition were prepared in late 1982 by observers inside and outside the bank. Cumulatively, they indicate that Northland faced significant challenges to overcome the difficulties and weaknesses which emerged in its early years.

During his last tenure as Chief Executive Officer, Willson asked Northland's Chief Financial Officer to provide an analysis of the quality of the bank's interest income. The analysis indicated that the bank should reverse about $1M of interest that had previously been taken into income. This was done in the third quarter of 1982. Willson said that as a result, the bank went into a net loss position for the first time in its history.

Willson also requested the assistance of the Inspector General in finding a recently retired banker to provide direction and experienced counsel. The search was unsuccessful, but Willson was able to obtain, temporarily, the services of John McSherry, a recently retired Vice-President, Credit, of the Canadian Imperial Bank of Commerce. McSherry spent about three weeks analyzing the loan portfolio of the bank and examining the credit authorization process. He reported verbally to Willson that Northland's loan portfolio was risky, particularly due to the bank's concentration in real estate. He also reported that the bank management were competent and would not create further trouble. McSherry did not make a specific report on the level of loan loss provisions or on the level of nonperforming loans.

Files of the OIGB contain a memorandum "to file" dated 6 October 1982, dictated by a Bank of Canada employee. The agent for the Bank of Canada in Western Canada reported to an employee of the bank that "... he has heard from an institution in Calgary that has withdrawn $500,000 in funds from the Northland Bank because it did not like the profit picture of the Bank. When we visited the Bank last month we were assured that the Bank had not experienced any difficulties in attracting funds." No explanation of how this document reached the OIGB has been provided to the Commission, and there is no indication that any action was ever taken on it in that office.

The OIGB conducted a visit to the bank in October. OIGB files reveal that the inspectors raised several concerns as a result of their inspection. As of 30 September 1982, nonproductive loans stood at approximately $40M, or 7.5 per cent of all loans. There were substantial amounts of interest unpaid over 90 days which were still being accrued; the loans had not been classified as nonproductive. The inspectors concluded from their review of the reports made to the Board that the Board should have been apprised much more frequently about the quality of the loan portfolio. For example, on 25 March 1982, a report on noncurrent loans was made to the Board of Directors, but there was not another report until August 1982. The inspectors were also concerned to discover that a number of the noncurrent loans that were reported to the Board in March were apparently considered satisfactory by the following September because they had been omitted from the September nonperforming loans report, even though the amounts past due had either remained stable or increased, and the rationale for classing them current was strikingly similar to that described in the noncurrent loan report of 25 March 1982. This led them to conclude that senior management did not have full and sufficient knowledge of all loans in arrears in the bank. The inspectors were further concerned as to why this discrepancy existed at all in the absence of any improvement in the circumstances surrounding some of these loans. In addition, the OIGB inspectors reported that the value of collateral was not being adjusted to reflect deterioration in the economy. While the provisions for losses had increased substantially in the year, a number of accounts had gone many months without progress in reducing exposure and it appeared to the OIGB that more direction was required from head office in order to avoid any further losses. The inspectors also commented that an estimated $4.7M of interest taken into revenue either had not been paid or had been paid only through assistance by the bank. They commented that the policy regarding the accrual or reversal of unpaid interest allowed room for too many exceptions, and if continued, the inspectors noted, uncollected interest included in revenue had the potential to become unmanageable, particularly as the bank's own projections for the 1982 year indicated a net loss before tax adjustments of $4M. It was also reported that interest was being accrued for as long as ten months on some loans, and senior management of the bank were not sufficiently aware of all the loans 90 days or more in arrears.

The OIGB report based on the October inspection may be compared with a report by Mr. R. Tourigny, a private analyst, in September 1982. (This report was prepared at the request of one of Northland's directors. It was received by the Commission shortly before argument and was not subject to comment during the hearings.)

The analyst's report was based on financial statements (including quarterly statements) published by the bank, and on the writer's discussions of the bank in the money market community. The report summarized the views of "the better-respected analysts who had followed the Bank closely" as follows:

i. The Bank urgently needs additional permanent capital.

ii. A number of key staff have either left or are actively seeking employment elsewhere.

iii. The noninterest expenses of the Bank are rising too rapidly for the business in place.

iv. The loan loss potential is undoubtedly significantly higher than that which has been disclosed.

v. Tax recoveries in the current year relate to the expectation of profits in future years, are not represented by cash, and are very reminiscent of the activities of the [name deleted] Bank.

vi. The portfolio of preferred shares is only attractive to the Bank when it is in a taxable position. This is now some ways away and consequently the preferred portfolio is a cash flow drain on the Bank.

vii. The Bank has always relied on fee income to boost income which does tend to repeat in buoyant times, but is very difficult to come by in hard times and is very difficult to get from quality borrowers. When any attempt is made to upgrade the quality of the loan portfolio, it is quite often at the expense of fee income.

viii. It is an accepted fact that Mr. Willson is not a banker and there is concern that during a critical part of its life, the Bank lacks strong leadership and experience.

The analyst expressed reservations about a forecast by management which called for an additional $120M in loans to be put on the books in the fourth quarter of fiscal 1982:

While there are still a number of borrowers looking for finance, the quality is not there. Quality borrowers are deferring capital expenditures in an attempt to repair their severely battered balance sheets and any attempt to expand lending at the rate envisaged over a three month period would be aggressive in the extreme and if further deterioration is seen in the existing portfolio, the Bank may well not have sufficient capital base to support the leverage necessary to write an additional $120,000,000 of loans.

Referring to the liability side of the balance sheet and the source of bank funding, it was stated:

It would surprise me if the Bank is not already experiencing some slight difficulty in attracting deposits at fine rates which are, of course, the life blood of its operation. I noted with interest that according to a survey conducted on the 26th August (prior to the 3rd quarter earnings report) that Northland was offering the highest rate for funds out of twelve banks surveyed. In some cases, their rate was equal to other banks, but I think it indicates a higher cost of funds which of necessity will have a damaging effect on spreads and on the ability to write new loans.

The report then noted that the prior profits of the bank had in some years been the result of an application of tax credits under the *Income Tax Act*.

While I understand that the banking industry in general is allowed to take credit for future tax relief into its profit and loss account and statement of retained earnings, I do not believe that the Bank's regulatory body will allow this to go on for an indefinite period. I also believe that the reaction of industry analysts will be very negative. I further believe that in any issue of securities potential buyers and underwriters would look at the net asset value per share on a break up basis and would not give value for the future tax credits.

The report further indicated that on the basis of the bank's statements, unpaid interest at the end of July 1982 represented 15 per cent of the total underlying loans:

I appreciate that an amount has been recognized in the profit and loss account, but I am concerned that if things have been allowed to go on as long as they have, there may well need to be substantial write-offs against bad loans which could prove devastating for the balance sheet and to confidence in the Bank.

The analyst concluded that Northland's condition could only be alleviated with new equity capital. Accordingly, he discussed the problems of raising such capital through a secondary offering:

... it would be necessary for the board of directors to issue a full prospectus that would have to fully disclose the current position of the Bank and such disclosure would no doubt not only make an equity funding difficult and expensive for existing holders, in terms of dilution, it would also draw the attention of depositors to the shortcomings of the Bank's balance sheet and impair the Bank's ability to attract deposits.

Finally, the report calculated that an interest spread of 1.65 per cent at Northland would have been necessary to cover only overhead, and 1.98 per cent to break even in cash flow terms. However, when adequate provisions were made for loan losses and income recognition was placed on a sound accounting base, an interest spread of 3.10 per cent was required just to break even. Historically, however, the report observed, "The gross spread earned by the Bank would appear to have not exceeded 2.5 per cent", and on this basis an operating loss of $3.6M was the prospect for 1983. The report concluded:

> The problem is that the Bank does not presently have the capital base to support this level of business and needs approximately an additional $18 million to do so. ...
>
> If the Bank does nothing, it is difficult to see things improving as the fixed overheads are just too high for the business in place and lack of action could well erode the current position even further.

Willson requested H.G. Green, the Vice-President, Finance, to prepare a response to Tourigny. This response was circulated to the Board in late 1982, and argued that Tourigny prepared his report "from incomplete information base evidenced by the assumptions and opinions made". It is of interest, however, to note that many of Tourigny's conclusions were borne out by the evidence before this Inquiry, including the large turnover in senior management, the high undisclosed loan loss potential, and the heavy reliance on fee income to turn a profit. His conclusions are also roughly comparable to the contemporary conclusions of the OIGB. Perhaps this response to Tourigny was an early example of management's attitude that no outsider could truly understand Northland Bank.

C. NEW MANAGEMENT AND THE RECOVERY STRATEGY

1. The 1983 Annual Inspection

The OIGB annual inspection took place on 26 and 27 May 1983. A number of matters were discussed with various members of senior management and the auditors. First, Northland's new Chief Inspector, Mr. Stan Willy, reported that while he had only visited two branches since taking over the job in April, his ratings of loans were generally lower than those previously assigned. Willy also found that formal reviews of substandard loans were not up-dated on a regular basis, and that the system in place for identifying substandard loans was slow.

Second, the external auditors advised that they were in substantial agreement with the bank's loan loss provisions, and that they were satisfied that the amount of unpaid interest taken into income in 1982 was realistic. They also felt that the bank had been handling substandard loans with less firmness than in the past. However, more effort was being made to enhance managerial control over loans. The auditors also agreed with the observation of the OIGB that the inspection function had been largely nonfunctional since its inception, and it was not their intention to rely on the Inspection Department to any great extent for the 1983 fiscal year.

Third, discussions were held with Credit Department officers. Of note is the fact that the total number of reported substandard loans was $97M as defined by the OIGB, but only $66M as defined by the bank. The difference of $31M was made up of rearrangements of various kinds with the borrower, including reductions of interest rates; and sales of security to purchasers financed by the bank. In other cases, management of the bank simply expressed confidence in recovery of principal and interest and removed the loans in question from the substandard category. The OIGB concluded that while an improvement in loan quality was observed, Northland was somewhat less conservative than other banks in establishing specific provisions. For example, substandard loans were higher than other banks as a percentage of the portfolio but specific provisions were not. The bank was urged to be more conservative in making provisions for loan losses and in the recognition of unpaid interest income; unpaid interest then stood at $15M, of which approximately 50 per cent had been taken into income.

On 29 July 1983, the OIGB reported to the Minister of Finance on the Northland inspection as required by s. 246(2) of the *Bank Act*. The Inspector General advised that the provisions of the *Bank Act* having reference to the safety of the creditors and the shareholders of the bank were duly being observed and that the bank was in a sound financial position.

2. The Workout Strategy at Northland

Neapole had been at Northland for only a few days at the time of the OIGB annual inspection for 1983. He found the situation at the bank unsettled and somewhat disorganized. The loan portfolio was in difficulty caused, in Neapole's view, largely by the recession in Western Canada. Neapole also concluded that the existing problems stemmed from poor credit practices and weak management, although he disagreed with the emphasis that Prisco placed upon management problems as opposed to recessionary problems. The fact that the bank was almost exclusively funded by wholesale deposits, more than 50 per cent of which was obtained from investment dealers, was a further source of concern.

Martin Fortier, when he became a senior Vice-President in late 1983, was "shocked" by the condition of the loan portfolio. There was a large concentration in real estate, a lack of any concerted strategy to deal with troubled real estate loans, and the bank continued with the conventional banking method of "writing reports upon reports upon reports and no one ever dealing with any problems." There was some doubt in Fortier's mind that the bank would survive if some sort of strategy was not implemented.

In the continuing recession in Western Canada, the bank believed it essential to develop a strategy that would be responsive to the economic situation of the day. In order to overcome the asset problems, Northland's management, under the direction of Neapole, developed a coherent strategy whose dominant purpose was to reduce the exposure to loss by increasing the productivity of problem loans. The strategy included several related components: additional capital, development of a retail deposit base, expansion of the loan portfolio to dilute problem loans, and "workout strategy" to add value to the problem loans. Generally, Neapole testified that in implementing Northland's workout strategy it was necessary to assign priorities to the various problems in the bank. The first priority was the loan portfolio, along with funding of the bank.

a. Capital

The acquisition of capital was a significant component of the workout strategy. Some additions to capital occurred before 1983. In August, 1980, a rights issue to existing shareholders had increased the subscribed capital to $17.18M. By the fall of 1983, the bank's capital base stood at approximately $38M. A private placement of 2.8 million common shares was closed on 28 November 1983, providing an additional $17.5M in capital. Immediately following the private placement the bank completed a one-for-four rights issue which closed on 16 March 1984. This provided an additional $8M capital. A debenture issue in February 1984 raised $15M. As a result of this program, aggregate leverageable capital was increased by $39.2M to $77.2M.

Discussions started in December 1984 which led to the filing in late February 1985 of preliminary prospectuses for publicly issued convertible preference shares and floating rate debentures, the total of which was contemplated to amount to $35M. The details of the events of early 1985 are discussed below, but the end result was that the preference shares project was dropped on 26 March 1985 (when the CCB rescue program was announced), and on 31 May 1985 a $16M private floating rate debenture issue was closed. In total, from late 1983 the new management team raised $56M of new capital bringing the total capital of the bank, including debenture debt, to $101.5M. The trend of capital, reserves and accumulated surplus of the bank is shown in Table E.2.

Table E.2

The Trend of Capital, Reserves, and Accumulated Surplus

	1980[a]	*1981*	*1982*	*1983*	*1984*	*Aug. 31 1985*
				($M)		
Capital (including retained earnings)	20.5	23.4	31.2	31.4	57.1	58.9
Appropriations for contingencies	2.0	6.1	7.1	8.5	11.6	11.6
Subordinated debt	—	—	—	—	15.0	31.0
Total	22.5	29.5	38.3	39.9	83.7	101.5
Retained earnings	0.11	.27	.63	2.0	2.1	

a. Fiscal Year ends

b. Retail Deposits

Using both its branch offices and agency networks, Northland embarked on a campaign to develop a retail funding base in 1983. This initiative was designed to reduce the bank's dependence on wholesale money markets. As shown in Table E.3, retail deposits grew from approximately $2.0M in 1982 to $90.2M in 1983 and $228.6M in 1984. They continued to grow to a peak level approximating $500M in July 1985, but then began to drop as a result of adverse press and broadcast coverage of the bank. This peak and trail off is not reflected in Table E.3, which shows the historical trend of deposits over a longer time frame. The shift from wholesale to retail funding was largely inspired by a liquidity crisis in early 1983 brought on by trouble in CCB during the Trust Companies Affair. As mentioned in Chapter 5, the cost of the retail deposits eventually made the program unattractive as the interest spread virtually disappeared.

c. Growth

The combination of increases in retail deposits and capital permitted Northland to address the problems in its loan portfolio. On the lending side of the bank, the strategy had two major elements; growth and workouts.

Table E.3

Northland Bank: Retail and Wholesale Deposits

	Wholesale	*Retail*
	($M)	
Oct. 1981	475	0
Oct. 1982	590	2
Oct. 1983	600	90
Oct. 1984	750	225
Aug. 1985	250	450

Until 1983, the bank had never ventured east of Winnipeg. The bank now decided to diversify into southern Ontario. In August 1983, the bank established a Toronto office as a money market operation. Lending operations commenced shortly thereafter. By September 1985, the office had booked approximately $76M in loans. Total bank assets grew from $652.9M in 1982, to $741.7M in 1983, to $1,080.6M in 1984, and $1,372.1M as of 31 August 1985. Northland loans grew at similar rates, rising from $510M in 1982 to $622M in 1983. In 1984, loans totalled $945.8M and reached $1,183.2M at 31 August 1985. Table E.4 illustrates the overall growth rate in assets after Neapole joined the bank. Northland's growth rate raised some concerns on the part of the OIGB and resulted in conflict between the bank and the federal supervisors. This is discussed below.

Table E.4

Northland Bank: Asset Growth May 1983 to May 1985

May, 1983	$700 million
December, 1983	$800 million
May, 1984	$900 million
August, 1984	$1000 million
March, 1985	$1100 million
April, 1985	$1200 million
May, 1985	$1300 million

d. *Workout Arrangements*

The other component of Northland's strategy on the asset side was the workout approach to problem loans. Management established the Senior Management Assessment and Recovery Team (SMART), composed of senior line credit management, with a mandate to reinstate productivity of problem loans and thereby protect the bank's position. Northland Bank essentially required time to improve the portfolio and repair the damage which existed in 1983. An asset management strategy using a variety of workout schemes was developed. A cornerstone of the 1983 strategy was that income would be recognized, and decisions would be taken on whether or not to establish a loan loss provision, on the basis of the future values (the added value), rather than current values, of the assets underlying the loans as security. This future value would be determined with reference to a period of time, approximately three years, depending upon the circumstances of each individual loan in relation to the specific plan for the workout strategy on that loan. This strategy was based on a number of fundamental assumptions. Neapole required "system tolerance", which essentially boiled down to disclosure of the strategy to the regulators and the auditors without adverse response on their part. Second, there had to be improvement in the economy. Neapole testified that the bank would require a "reasonable economy" to survive; that is, a gradual improvement, although not a return to prices which existed during the boom period.

Like the CCB, Northland Bank employed aggressive policies in relation to the accrual and capitalization of interest. In some cases, new borrowers either bought assets from the bank or one of its subsidiaries after the asset had been realized by the bank upon default on the loan. In these cases, the bank's exposure would be increased and interest was brought into income by capitalization, usually by way of a working capital loan to service the interest. Management stressed that the key test of the propriety of interest capitalization is the ultimate collectability of the loan, both principal and interest. They stressed that this practice was common to other banks. However, it is important to recognize that in Northland Bank, the banker's judgment as to the ultimate collectability of the loan was based on the added value or investment value. The propriety of this concept is considered elsewhere. No figures have been compiled on the total amount of capitalized interest. Most of the purchases from Epicon (a workout vehicle examined in greater detail below) were wholly financed by the bank, with an added debt-servicing component. A review of the auditor's working papers reveals that often shell corporations bought the old assets that had been obtained by Northland Bank through foreclosure proceedings, without any guarantors or additional security.

Workouts undertaken by this bank were similar to those undertaken by CCB. In certain cases, the bank would foreclose on a property, or appoint a receiver and sell the asset at book value to a borrower financed wholly or substantially by the bank. In one case, the underlying asset went through two receiverships and was on its fourth borrower. Each turnover of the loan further exposed the bank because financing would include an amount to cover interest unpaid by the previous borrower, and to service the debt in the future. The final borrowers, however, did invest a small amount of equity, and after the sale out of the first receivership, the bank took an actual write-off of about $500,000. The most recent loan also involved very favourable financing. It was on a five-year term, starting with an interest rate of 2 per cent, increasing by 2 per cent per year, to a 10 per cent ceiling.

The bank also had a propensity to undertake workouts resulting in extremely large exposure in relation to the bank's capital. The most spectacular example is the Cayman Islands loan referred to earlier. With the assistance of Walker and Wettstein, two real estate developers who often assisted the bank with workouts, the land was purchased by a joint venture company known as Ellesmere Cayman Ltd., held 9 per cent by the bank and 91 per cent by Ellesmere Developments Ltd., a company owned 80 per cent by Agra Industries Ltd. and 20 per cent by Walsten Management Ltd. (which in turn is owned equally by Walker and Wettstein). The group then decided to create a resort consisting of a world-class hotel, golf course, and condominiums. The bank managed to increase its total exposure to $56M (U.S.), $11.25M (U.S.) of which was nonrecourse. No specific provision was ever taken on this loan. In fact, when the foreclosed property was transferred to the bank in 1983, the bank took the opportunity to recognize some $600,000 of previously unrecognized interest income. That income, on the evidence, was never reversed.

In another case, the bank loaned $12.5M against the security of a hotel in Edmonton. The hotel did not do well. The quality of its management was suspect and the entire project was over-leveraged. The Chief Inspector of the bank thought that the security was not strong, and that cash flow was deficient. In addition, its prospects were considered dim, as there was already a hotel district, somewhat removed from the location of this hotel, but on the same thoroughfare. Nevertheless, the bank committed an additional $17M for the purposes of renovation. The exposure was eventually driven to $29M.

The bank undertook mergers between real estate properties and oil and gas properties. Fortier described the essence of these deals as follows:

> ... you could inventory the real estate for a period of time, get a reasonable market return ... and ultimately work on the real estate, get the returns up and dispose of it and still have an acceptable pay out on your oil and gas investment.

The bank also incorporated, or caused to be incorporated, new corporations to aid in or to conduct the working-out of problem loans. The first such corporation was Epicon Properties Inc., created as a "bank service corporation" as defined in s.193 of the *Bank Act*. The function of the company was to design and administer workout programs for nonproductive real estate assets held as security or foreclosed by the bank, thereby reducing the demands on the bank's lending personnel (who were not in any case experts in the management of real estate), and allowing them to concentrate on the development of new lending.

Epicon was in existence as a concept before the arrival of Neapole, having been developed by Fortier, Walker, and Wettstein. The two latter individuals, who did not appear at the Inquiry, were real estate developers considered to be expert in such salvage operations. The company was owned 55 per cent by Northland Bank and 45 per cent by Ellesmere Development Ltd. There was $100 of common share capital. Further details of the company are found above in this Appendix and in Chapter 5.

The technique employed and the accounting treatment in the bank's records for Epicon transactions were as follows. Real estate assets (resulting from realization upon soft loans) were transferred to Epicon at a price established as the lesser of appraised value (as established by Walker and Wettstein), and the aggregate of amounts owing to the bank as principal, interest, and fees, payable by redeemable preference shares to be issued to the bank from the treasury of Epicon. Therefore, the maximum price paid by Epicon was the loan principal plus interest due and legal fees. While in some cases fair value was established at a lower amount, and was the price payable by Epicon, in most cases, the fair value exceeded the value of the loan plus interest that had previously been reversed or was currently accrued. As a result of the transfer to Epicon, it was possible to recognize all such interest as ultimately collectable. Through this method, approximately $850,000 of interest that had been reversed in 1982 was reinstated in revenue for 1983. A similar amount of interest which had been reversed early in 1983 was likewise reinstated, for a total reinstatement of interest income in 1983 in excess of $2M (there is some evidence that the figure is closer to $3.5M) although no moneys were received by the bank from the borrowers.

Because Epicon was consolidated in the financial statements of the bank, beginning in 1983, these financial statements did not disclose the difference in accounting treatment enabled by the revaluation of the properties. The assets transferred to Epicon remained on the bank's books but appeared in the financial statements as a replacement loan without being so labeled. Interest cannot be accrued on replacement loans. However, the increase in value through foreclosure and transfer allowed the bank to reinstate or recover accrued and reversed interest. It was the position of the bank's auditors that Epicon had no impact on accounting; it was the realization of the loans into "hard" assets which allowed the recapture of interest including that which was reversed in one fiscal year and reinstated in the following fiscal year with no new moneys coming into the bank from the borrower. Over the life of Epicon, assets representing security for $99.393M of loans were transferred from the bank to Epicon in this manner.

As mentioned above, Epicon's mandate was to improve the properties and sell them. The 1984 annual report stated that of the approximately $70M of real estate assets placed in Epicon, some $40M had been disposed of successfully. It did not report the amount of bank financing required to effect disposal. The 1985 Debenture Prospectus, discussed below, disclosed that the bank had provided loans to "essentially all" purchasers from Epicon. As of 31 August 1985, properties totalling $75,851,791.00 were sold by Epicon to purchasers financed by the bank. Northland financing amounted to $71,910,791.00 of purchase price loans, plus authorized additional loans of $35,864,736.00 to service the loan, and for other expenditures such as the development of the property and the take-out of prior charges. By 31 October 1985, five properties remained in Epicon with a book value of $15.5M and a market value of $6.8M as estimated by the curator. Epicon suffered a loss in every year of its operations.

The nature of the Epicon transactions was disclosed to the OIGB as early as 28 October 1983, when Courtright, an officer of the OIGB, contacted one of Northland's auditors. He was told that Northland would take interest on loans into income until such time as the capitalized value was equivalent to the "investment value" of the property in question. The OIGB was concerned that the "investment value" (the transfer value) would justify the capture of income that had not been previously recognized. Courtright, having discussed the matter with Northland officers, wrote:

> It is difficult if not impossible without a much greater knowledge of the details of each transaction and of the practices followed by other banks to state whether or not the Northland recovery of such interest income is out of line with general practice.

However, the OIGB believed that the underlying concept of the arrangement was probably sound. The Inspector General stated to the Inquiry:

> The establishment of Epicon we welcomed, as it was explained to us, but we did have a lot of trouble about the price at which the assets were transferred to Epicon and there was much discussion about that with the bank and with the auditors.

The bank's auditors have testified that the recapture of income would have occurred whether or not the Epicon transaction was undertaken. The OIGB officers, in the course of testimony, differed with this opinion; the value of the assets would be frozen on the books of the banks at the time interest accrual ceased. Their position would appear to be that while the assets were carried on a consolidated basis as loan replacements, the transfer enabled them to be carried at a higher amount than they otherwise would have been. The evidence is that, in most cases, the valuation of the transferred real estate exceeded the loan principal plus accrued interest and legal fees. Accordingly, interest was taken back into income. OIGB testimony therefore suggests that the Epicon transaction gave the bank the opportunity to do something it could not otherwise do: revalue loan replacements, leading to a higher value on the asset side of the balance sheet, and at the same time increase the revenue of the bank without any new moneys coming from new or old borrowers. However, Northland did revalue properties and recognize income in cases where there was no transfer to Epicon (the Cayman Islands loan is an example), and this policy was adopted after extensive consideration by the auditors, who concluded that it was acceptable.

The Dexleigh and Hees transactions were similar to Epicon. Neapole called them the "logical and next step". Poorly performing assets in the amount of $53.9M were sold to Dexleigh Corporation at book value. The bank took security on all the assets transferred, so that each asset was cross-collateralized. It financed the $53.9M purchase of properties by Dexleigh and made available an additional $22.7M to refinance prior charges on the properties transferred if they could not be favourably financed elsewhere. In addition, a credit facility of $53M was made to Hees International Corporation, an affiliate of Dexleigh. Dexleigh gave the bank a $6M irrevocable letter of credit payable in four years. Both loans were to bear interest at the lower of bank prime minus one-half, and 11 per cent, and were for 20 year terms. The Hees credit could be reduced by conversion, at the bank's option, to floating rate preference shares (to carry a dividend rate of 70 per cent of prime rate) of Hees or its associated corporations. In response to the length and size of the loans and the interest rate cap, management took the position that the bank received an immediate improvement in its revenue in exchange for a "significant long term yield curve risk". It is interesting to note that some of the properties that were, or had been, with Epicon were included in the sale to Dexleigh. This tends to suggest that Epicon was not as successful as management claimed, and that it was not entirely proper to recognize loans to purchasers of Epicon properties as new and performing. This topic is pursued further in relation to the auditors in Chapter 5.

The Dexleigh transaction illustrates the resolve of management to reject, if necessary, the "wink and nod" approach of the OIGB. The Assistant Inspector General contacted Neapole in March 1985 to express his concern that the entire transaction aggregated a potential exposure of $129M. In response, Neapole pointed out that the transaction would upgrade the bank's existing position and that the Dexleigh transaction should not be grouped with the Hees transaction, even though they were obviously "associated companies". He pointed out that Dexleigh was a stand-alone public company with equity exceeding $100M. In response, in early April 1985, the Assistant Inspector General wrote to Neapole to obtain confirmation that the bank would provide to the OIGB the terms and conditions of the letter of credit to be provided by Dexleigh, and that it would only recognize income on the transaction as cash and would not accrue interest in excess of $6M (the base value of the letter of credit). On the same day, Neapole wrote to the Inspector General to state that the bank intended to limit its exposure to Hees to a maximum of 50 per cent of its capital account. Significantly, he went on to say:

> We do not feel it is necessary for your department to control the deal externally in any way that would require an amendment to our prospectus or our loan agreements, copies of which are enclosed. The relationship with Hees is excellent and I am satisfied that we will have their full cooperation.

And:

> I realize that once again, that we are asking you to see it our way. Nevertheless, I believe the justification is there.

The final matter of note is fee income. The bank's activities generated both conventional fees and merchant banking fees. The latter were the focus of extensive evidence because of the size of the fees, which could approach 15 per cent of the authorized amount of a loan.

It is instructive to consider the large increase in "other income" after 1983. While in 1983 "other income" (mostly fee income) was approximately $2.4M, this increased in 1984, and in the first 10 months in 1985, to $8.1M and $8.0M respectively. A very large percentage of this "other income" was in relation to loan activity and to merchant banking. Management argued that the percentage of "other income" to total income (other income plus gross interest income) was similar to the percentage found in all the big banks. This is in fact true. However, the composition of "other income" varies between the big banks and Northland Bank. Other income of the large banks is composed of fees from many sources, both retail and commercial, and includes service charges, credit card fees, loan and commitment fees, securities commissions, foreign exchange revenue, bankers' acceptances, letters of credit and guarantee fees, and sundry items. In contrast, Northland Bank's other income consisted primarily of fees taken in relation to loan authorizations. Further, none of the large banks experienced the huge increase in other income which Northland did between 1983 and 1984.

The maintenance of fees as an income source requires, of course, continuing loan growth, for without new authorizations such income cannot be earned. The pursuit of fee income deflects the lending standard away from the quality of the loan to the size of the fee. Thus, the practice almost inherently produces a loan portfolio of lower quality than in conventional banking. Northland's aggressive growth strategy in a recessionary economy suggests that some loans were made just to earn fees from risky borrowers who could not get loans elsewhere. For example, one transaction involved a loan to two borrowers for the purchase of a hotel site in Hawaii. One borrower owned some property in Hawaii, and the other borrower was a drug store in Alberta. The latter received $1.15M. The former got a loan to take out a maturing agreement for sale on the property in the amount of $3.528M, secured against the property. Other bits and pieces of the loan were secured on other properties, and the gross financing amounted to $5.59M. A fee was taken of $650,000. Management stated that the large fee was justified because the deal was difficult to structure, and there were time constraints involved. The other view is that the bank simply refinanced the property. The borrower was unable to obtain financing elsewhere. There was some debate within the bank about the advisability of granting the loan in the first place. Iain McLeod, the then acting Vice-President of Credit, opposed the loan. Fortier was in favour. Neapole broke the deadlock when he put on his "businessman's hat" as opposed to his "banker's hat", and approved the loan. McLeod testified that the only merit in the deal was the fee.

Northland management admitted that if they could not make an above average profit on a deal, they were not interested. Neapole said, "... we are not a cheap bank". Management justified their merchant banking fees by illustrating some deals which they considered extraordinary. In simple terms, the bank could create the environment for a deal by using in-house expertise or by conducting the negotiations. When this was done, the fee was characterized as a "merchant banking" fee, it was considered earned and would be taken into income immediately, rather than amortized over the term of the loan.

A fascinating source of fee income was discovered by the bank in late 1984. Loans were made possible by a Government of Alberta program under which the government provided a 30 per cent rebate of investment eligible under the program. The procedure, in its most simplified form, was as follows. The bank would provide a loan to a company that would invest, through intervening corporations, in a small business equity corporation (SBEC). The Province of Alberta, once it approved the investment, would grant 30 per cent of the investment to the investor. Northland typically made a $5M loan, which yielded a $1.5M grant from the government, of which approximately $700,000 was paid to Northland as a fee. Moneys advanced by Northland, or rebated by the government, were used to purchase Northland Bank term deposits. These deposits were then pledged back to the bank as debt servicing deposits to service the interest cost on the initial $5M loan to the borrower company. The bank made loans of this type of about $42M, earning approximately $5.5M in fees. There is evidence that the bank made appropriate deferrals of these fees.

Both Morrison, the liquidator, and Adamsons, an OIGB inspector, were concerned about the long-term risk. The funds in the SBEC had to be used to acquire minority positions in small Alberta companies within two years. The security would therefore consist of minority equity investments in small companies, and was considered to be risky and illiquid. It is notable that two of the nine SBEC corporations were owned by Wettstein. On occasion, the SBEC borrower would invest in another Northland Bank customer. As of July 1985, five proposed investments had been identified, and were projected to be made by 30 September, 1985. Of those five, four were intended to be used to pay down the debt of existing bank customers.

The bank also paid a fee to itself. In late 1984, it was decided to move to new premises. The move was a good business decision. In order to make the move, the bank made a loan of about $6.8M on a building to be purchased by a Liechtenstein Anstalt (the ownership of which was unknown) and secured by a second mortgage. The first mortgage was $4.2M. Of the $6.8M, $3.2M was paid to the Anstalt, $1.6M was placed in trust to service interest, $200,000 went to the real estate agent, and $1M commitment and tenant inducement fees were paid to the bank. The bank was to move into the building as a tenant, and its presence would support a valuation high enough to cover the total exposure on the building of $11M. There is some evidence that, in the absence of the bank's own tenancy, the building would be valued at approximately $7.2M. The added value derived from the bank's tenancy depends upon the viability of the bank which in turn was becoming dependant on deals like this one which provided a facade of income in the bank. This income, in reality, was the bank's own money set in circular motion by the deal. In that event, the loan exposure would not be justified and the bank would not be able to get those fees. An offer to purchase the building for $11M was made by another borrower of the bank as part of a complicated proposed loan to be made at extremely favourable rates. The bank took the tenant inducement fee into income. The impropriety of the situation, if any, is the same as in the case of the practice of capitalizing interest.

On paper, the workout strategy appeared to be vindicated. There was a favourable trend in net income and in revenue, which could lead the casual observer to believe that the bank was coming out of the recession successfully. Table E.5 illustrates the bank's revenue and net income for the past few years. In addition, the loan loss experience was apparently coming under control. Table E.6 illustrates the trend in actual loan loss experience and the provision for losses charged to the income statement.

Table E.5

Revenue and Net Income

Year	*Revenue*	*Net Income*	*Percentage Return Revenue*
	($ 000)	($ 000)	
1980	27,300	1,300	4.8
1981	68,700	400	6.4
1982	91,500	1,800	2.0
1983	77,000	2,900	3.8
1984	105,800	3,300	3.1
1985 (July 31)	102,700	2,100	2.0

Table E.6

Loan Losses

Year	*Actual Loan Loss Experience*	*Provision for Losses Charged to Income Statement*
	($ 000)	
1980	294	153
1981	1,720	1,258
1982	2,776	2,231
1983	4,491	3,292
1984	4,021	4,586
1985	N/A	4,841

The bank was showing a fairly significant drop in nonperforming loans from 1983 to 1984. In the 1984 annual review, the bank reported the following figures for nonperforming loans:

1980	$ 5M
1981	$10.6M
1982	$44.7M
1983	$99M
1984	$75.2M

The 1983 and 1984 figures include loan replacements, which in turn include $43M and $25M of properties carried by Epicon for 1983 and 1984 respectively. The 1984 figure does not include renegotiated reduced rate loans of $19M. The bank represented further improvement in the position of nonperforming loans for 1985. As of 30 June 1985, the bank reported $48M in nonaccrual loans. As of 31 July 1985, the figure dropped to $43M. These figures did not include the $54M of properties and loans transferred to Dexleigh, some of which were nonaccrual, others underperforming. The $54M transfer to Dexleigh, in turn, included $17M of Epicon assets.

The Rondix deal will be described below. Had it closed, it would have removed from the books of the bank a further $15.7M of Epicon assets and other loan substitutes, $27.3M of nonproductive loans or loans with a high probability of going nonproductive, and $57M of performing loans which were highly vulnerable to becoming nonproductive. The bank reported, in its interim statements for the third quarter 1985, that nonproductive loans after the sale would fall to $6.7M. The bank also described the transaction as a sale of virtually all its substandard loans to a private arm's-length corporation.

3. The 1984 Annual Inspection

Upon receipt of the first quarter statements for 1984, an officer in the OIGB noticed that the premises expense of about $1M had virtually disappeared. The bank had received a lease inducement payment for agreeing to move into a building some time in the future (the fee from the Anstalt transaction), which was being netted against the bank's current rent expense. The officer inquired whether this was appropriate and wrote, in a memo of 4 April 1984, "It is obvious that the bank desperately needs earnings and any accounting treatment which can show these will be employed."

The 1984 annual inspection was conducted by the OIGB on 17 and 18 May. The "going-in" concerns of the OIGB were "sharp asset growth resulting in additional borrowings from the major banks under a line of credit, funding adequacy, cost of funds, minimal liquid assets, quality and concentration of loan portfolio, and quality of earnings". The post-inspection notes of 22 June summarized the principal findings of the inspection:

> Bank's loan portfolio not well diversified. B.C. and Alberta (whose economies are still flat) account for 90% of all outstanding loan business. Real estate 32% and energy 10%.
>
> Bank relatively well run. Senior management has been upgraded since last inspection.
>
> Loan workout team — Senior Management Assessment and Recovery Team — confident that they can reduce nonperforming loans by year end.
>
> Although the Bank has improved its funding sources over the past year, sharp asset growth continues to place pressure on funding capability.
>
> Bank attempting to address funding inadequacy with retail deposit initiatives and looking at off-shore funding possibilities.
>
> Asset liquidity continues to be weak. The Bank regards its borrowing facility with the major banks as its major source of liquidity.

Nonperforming loans totalled $109.7M, or 15 per cent of the outstanding loan portfolio, as of 29 February 1984. An interview with senior credit personnel led to the observation that "good reductions in nonperformings expected over the next year, but about $48M 'hard core' would be around for some time". Actual loan losses for fiscal 1983 were $4.5M compared to $2.8M in fiscal 1982 and an estimated $4.0M for 1984. In terms of an overall evaluation, the OIGB rated Northland as "marginally satisfactory" or three minus on a scale of 1 (poor) to 5 (excellent). The OIGB concluded that management appeared to be doing everying to return the bank to a strong financial position. However, in view of the number of nonperforming loans, and the concentration of assets in British Columbia and Alberta, the task was described as "formidable".

The Inspector General testified that in the course of discussions with CCB officials, including Fortier and Neapole, he got "a relatively optimistic sense of the bank". He was impressed with the loan workout team and felt that management's work on difficult credit situations was supported by the external auditors. While it is not mentioned in the post-inspection notes for 1984, the Inspector General testified that he was aware that the bank's profitability had improved, but that this was due in part to the use of the concept of future values.

On 25 May 1984, the Inspector General provided the Minister of Finance with an up-date on banking in which he noted Northland's "gradual but steady progress from its loss position in 1983", and indicated his satisfaction that "the Bank is in a sound condition". On 24 September 1984, following the change in government, the Inspector General reported to the new Minister of Finance on the Northland inspection. The report notes that, during the past year, profitability of the bank had been weak due to narrowing spreads caused by a high portion of nonperforming loans, and by increases in the loan loss provisions. However, it continued, "[T]he Bank's performance has been improving, its profitability has improved somewhat and the Bank is making progress in expanding its funding sources. Assets have been growing fairly steadily and as a result nonperforming loans have been reduced in relative terms. A concentrated effort will be required by management to return the bank to adequate profitability. ... In my opinion", the Inspector General concluded, "the Bank is in sound financial condition but will continue to require close supervision over the near and medium term."

The reporting letter does not disclose to the Minister that Northland was rated "marginally satisfactory" at the close of the 1984 annual inspection. A covering memorandum to the new Minister advises that the OIGB provides details of the findings of the examination only in cases where banks have problems and require special attention. The Inspector General explained to the Commission that he had discussed the condition of certain banks, including Northland, with the Minister at the time of the change in government and stated: "The very fact of this separate letter denotes a concern and a special effort".

D. THE NORTHLAND BANK AT 1984 FISCAL YEAR END

A series of developments near the end of the 1984 fiscal year indicated that Northland's course and rate of progress towards recovery remained unsettled and occasioned some uncertainty on the part of outside observers. An administrative review, conducted in November 1984, listed several deficiencies in Northland's operations. The bank's auditors directed special attention to the areas of interest income recognition and the treatment of income from merchant banking fees leading to certain adjustments in these areas. Northland inquired of the OIGB regarding a write-off of loans, and concerns about funding came to a head.

1. The Hay Report

Despite many changes in personnel, the bank's administration remained a concern. Fortier commissioned Hay Management Consultants to conduct a "frank" administrative review of the bank in November 1984. Management intentionally solicited harsh criticism through their instructions to Hay Management. The major findings of the review were embodied in a report submitted to the bank in December 1984.

The report stated that the Northland Bank lacked a goal necessary to allow it to "continue to experience the uncommon levels of productivity and growth that it has enjoyed in recent years." Management attributed this finding to Northland's recent experience in a survival mode of operation: "We had to constantly adjust to external factors, constantly adjust our business plan, and it could be easily interpreted by junior staff that this was confusion".

The Hay report also concluded that Northland's "culture" was out of balance in that there was a lack of understanding and respect between personnel in its commercial, treasury, retail deposit, and administrative departments. Fortier concluded that this problem was commonplace throughout the banking industry where the view has always prevailed that "if you were not a deal maker, if you were not a lender, you were not really a banker".

According to the administrative review, Northland's internal systems were in a state of crisis. "The data processing resources of the bank are inefficient and ineffective". The report found "no evidence of a long-term systems strategy" and indicated that "the disarray is now stunting the flexibility and growth of the bank's operation". This problem was acknowledged by the bank management, who attributed the difficulty to the rapid expansion of Northland's retail deposit operations. They indicated that steps were taken to relieve the situation.

The last of the major findings reported by the consultants was that a state of crisis existed in Northland's financial management:

> Systems problems and accounting priorities have left a virtual void in the area of financial management. ... Branches and departments receive financial reports that are frequently unreadable or inaccurate. Responses to expense inquiries appear not to be effective. Asset management, liability management and GAAP management tools are primitive. Money market information is cumbersome and untimely. Competitive information is sketchy.

These limitations in the management information systems area were also acknowledged by management and immediately addressed.

2. The Audit Examination

Thorne Riddell was the managing or lead auditor on the audit for fiscal year 1984. During October and November of 1984, the Calgary partners of the auditing firm of Clarkson Gordon, the other of the bank's two auditors at the time, raised a number of questions with respect to the audit. These questions, relating to accounting for fee income and accrued interest, were directed to James Peers, a partner in the firm's Toronto office and a banking specialist. Peers was concerned that Northland was operating in a highly volatile economy and had had a good deal of trouble with real estate and oil and gas credits. In the result, he and his colleagues considered the bank to be in a risky position. It was decided that Peers would go to Calgary, which he did in the last week of November, in order to make further inquiries and to assess the situation. Michael Mackenzie, another Toronto partner actively engaged in bank auditing, subsequently attended in Calgary in the absence of Peers. For present purposes, it is sufficient to note that the result was perceived to be a "rigorous audit" of the bank's fee and interest income. The Inspector General was kept informed, and as will be seen, his impression of the event influenced his actions in 1985.

There is some question whether this incident affected the appointment of auditors for 1985. The domination exercised by this bank over its auditors and chief inspectors is described in Chapter 5.

3. The Write-down Proposal

On 15 November 1984, Neapole, Fortier and other senior members of the bank visited with the OIGB to propose a capital restructuring and write-down program along the lines which had recently been carried out by another bank. Specifically, Northland wanted to determine whether the OIGB would agree to a write-off of $50M in loans (the OIGB was advised in the course of the 1984 inspection that there would be $48M of "hard core" nonperforming loans around for some time) and a simultaneous capital injection. Management was also concerned by the fact that another bank had benefitted greatly from a similar program and that this would make the junior banks suffer by comparison, and wanted to know whether the Inspector General's approval of the other transaction represented a change in his view of long-term workouts. Management, in testimony before the Commission, denied that the meeting with the Inspector General implied that management thought that a write-down of $50M was in order. Rather, they said, the prime motivation for the meeting was to assess the Inspector General's views regarding long-term workout strategies, and to determine whether those views had changed. Any reference to a concrete amount for a write-down was, they said, hypothetical, and the bank had prepared a hypothetical computer model to explain how such a write-down might affect the bank. During the course of the meeting, Kennett asked management whether they were telling him that they had "a big hole in the portfolio", to which management responded that the figures were hypothetical. OIGB records tend to confirm the "exploratory" position of management. The discussions recorded were wide-ranging and this particular topic received no special emphasis.

E. NORTHLAND'S GROWTH STRATEGY, AND FUNDING ISSUES, 1985

1. The OIGB and the Growth Strategy

On 4 December 1984, the Inspector General wrote to Northland's President to comment on a strategic plan for 1985 supplied to the OIGB by the bank. Asset growth of 53.9 per cent was projected for 1985, following an increase of 43.2 per cent in 1984. The Inspector General was of the view that this rate of growth would be difficult to sustain in view of the funding difficulties experienced by the bank. He concluded that asset growth should be restricted until the bank could eliminate its reliance on the special facility provided by the big five banks or on the Bank of Canada. In a further letter of 29 January 1985, the Inspector General requested that Neapole make the Board of Directors aware of the OIGB's concerns. The Inspector General also proposed a meeting with the objective of securing an undertaking from Northland to limit growth until the bank's funding capability and liquidity improved to levels commensurate with its assets.

On 5 February 1985, Neapole responded as follows to the OIGB's concerns:

> 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.

On 18 February 1985, the Inspector General again wrote Neapole to advise that he would be in touch with him shortly to arrange a meeting to discuss the priority growth targets and liquidity levels. This was followed by a letter of 13 May 1985 from the Assistant Inspector General of Banks to Neapole, in which he underlined the OIGB's concern about rapid growth of the bank in the first five months of fiscal 1985. By this time, the share offering mentioned by Neapole had been withdrawn. The OIGB viewed the growth rate with "alarm", and indicated that considerable attention would be given to this issue at the upcoming inspection of the bank. The Inspector General testified that his office encountered much difficulty in enforcing its suggestions to this bank at the time:

> This was a different kind of situation. It was an extremely difficult situation. The fact is that we found it difficult to really put the screws to them.

This issue appears to have been concluded on 17 May 1985 when Macpherson called Chairman Willson to express deepening concern over the continuing excessive growth rate of the bank. Willson responded that he shared Macpherson's view on growth and funding, that Fortier had imposed a cap on lending and that the Executive Committee of the Board endorsed that cap.

2. Capital Issues

Northland Bank decided to take two issues to the market in 1985, a debenture issue and a preference share issue for a total target of $35M. The firm of Wood Gundy acted as underwriter for both issues.

Preparations to take the issues to market commenced in January 1985. A pre-"due diligence" meeting was held with bank management in January 1985, at which the underwriters considered the bank's liquidity and the level of its nonperforming loans as areas of concern. The underwriters were told that the current level of nonperforming loans was $73M, a decrease from $118M at the last year end. The bank described its strategies to deal with nonperforming loans, including the rapid growth strategy, the establishment of SMART, and the use of

Epicon. The underwriters were told that the auditors were supportive of the bank's strategies regarding Epicon, and that the accounting treatment of the Epicon arrangements was not improper. The underwriters were also aware that Northland was engaged in merchant banking. As a result of this first preliminary meeting, the underwriters decided to proceed, and a preliminary prospectus was developed.

Although the OIGB was concerned with Northland's rate of growth, and consequently with the bank's ability to fund itself, in February 1985, the OIGB remained optimistic about its general state. This optimism was induced in part by the "rigorous audit" of 1984 by the external auditors. In response to queries made by Wood Gundy, the OIGB put forth a positive view of the bank, and advised Wood Gundy that the liquidity crunch was attributable to environmental changes to a larger extent than to problems within Northland, that the level of nonperforming loans was high but the trend was encouraging, that the bank showed imagination and energy in dealing with asset problems, that the Inspector General approved of the Epicon philosophy, and that the Inspector General was happy with the bank's reporting and compliance with regulations. The general impression conveyed was that the Inspector General was aware of the bank's strategies for dealing with the specific problems of liquidity and nonperforming loans, was supportive of the bank's strategy, and believed that it was suitable in the circumstances.

The Inspector General testified that the OIGB was still "basking a bit in the glow" of the previous May's inspection and Mackenzie's visit to the bank. It is notable that the Inspector General testified that he was unaware at the time that assets sold by Epicon were 100 per cent financed by the bank, and that additional loans were being made for the payment of interest. The Inspector General was under the impression that the sales were normal commercial sales. At one stage, the Inspector General was told by Willson that loans were being sold by Epicon at book value. There was, therefore, clear evidence in his view that the bank was justified in transferring those loans at that value into Epicon.

On 20, 21, and 26 February 1985, further due diligence sessions were held by the underwriters with bank officers and the auditors. The underwriters were advised by the auditors that the bank's methods for determination and treatment of nonproductive loans were consistent with other banking institutions. However, the underwriters were also aware that Northland's business strategy was different from that of other banks, and that the bank was pursuing a strategy of workout rather than liquidation. They understood that one of the factors enabling the bank to pursue that strategy was the fact that it was a small bank and quite flexible. The underwriters have stated that they concluded from their discussions with the auditors that the first quarter 1985 fiscal results were accurate. This is contested by the auditors. They contend that the underwriters were advised that only limited review procedures on the unaudited interim financial statements had been performed, and that, based upon the results of such procedures, nothing had come to their attention which caused them to believe that the interim consolidated financial statements were not presented fairly in accordance with accounting principles prescribed by the *Bank Act* applied on a basis consistent with that of the last audited consolidated financial statements. The auditors further testified that the procedures they performed did not constitute an audit and would not necessarily reveal material adjustments which might be required to present fairly in the interim statements the financial position of the bank, referring to their standard form comfort letter.

The preliminary prospectus was filed with the provincial securities commissions and the OIGB in late February 1985. The underwriters continued their due diligence procedures, discussed various large loans with the bank management, and instructed their lawyers to review approximately forty of the bank's loan files. Then an event known as the "road show" occurred. This was essentially a marketing program. By Friday, 22 March, the underwriters had elicited a good deal of interest in the purchase of both the preference shares and the debentures. However, the preference share issue was abandoned following the announcement of the CCB support package on 25 March, the underwriters having concluded that a preferred share sale could not be successfully completed at that time. On or about 19 April, the preliminary prospectuses for both issues were withdrawn. However, it was determined that a private placement for debentures could successfully be marketed. A confidential offering memorandum was signed on 22 April 1985. This method of issue is exempt from the prospectus filing requirements under s.154(a) of the *Bank Act* and from provincial filing requirements under the various provincial securities statutes. Accordingly, due diligence sessions continued with a view to closing a private placement of debentures.

To explore the potential impact of the CCB situation on Northland, the underwriters contacted the OIGB on 2 April 1985. The Inspector General described to the underwriters what had led to the bailout of the CCB, but restricted his description to facts known to the public at the time. He told the underwriters that he did not see any sign of a similar problem at Northland. At this point, the OIGB still believed assurances that the bank was having success in selling properties out of Epicon, and had the impression that such sales were normal commercial sales.

The underwriters again met with Northland's auditors on 1 April 1985. The auditors told the underwriters that the bank's mode of operation was one of workout, which had enjoyed some successes. The auditors were satisfied as to the financial presentation of the bank's operations for fiscal year end 1984, especially since Mackenzie had visited the bank from Toronto and reviewed some of the large interest income and fee income items. On 29 May 1985, the underwriters contacted the Assistant Inspector General. The annual inspection of the bank (described below) had been completed on 24 May. The Assistant Inspector General told them that the bank had a number of problems, but that it had a clear strategy and there was no reason to think that there were hidden problems. The OIGB was concerned with the fundamentals of the income statement: fee income exceeded net interest income for the first quarter of 1985, there was difficulty with the quality of the bank's earnings (but the bank had a plan to solve its problems and the OIGB would give the bank time to see the plans through), and in terms of the balance sheet, the values of underlying assets in Alberta were in question and loan loss recognition was somewhat lower than other banks. The OIGB was, however, accepting the bank's judgment at this stage. The underwriters also testified, and the same is recorded in their notes of the meeting, that the Assistant Inspector General stated that he was not aware of anything which would render it prudent not to close the deal. The Assistant Inspector General could not recall exactly what he had said.

In Macpherson's opinion, he was not telling the underwriters a great deal more than they could have deduced for themselves from publicly available information, except his statement that the OIGB would give the bank time to see its plans through. While the OIGB's concerns were disclosed, their general conclusion that the bank might need some form of assistance to survive was not. The Assistant Inspector General testified that he wished to restrict his comments to publicly available information because of the secrecy provision contained in s.251 of the *Bank Act*. The underwriters had been informed at the 2 April 1985 discussion that the OIGB was legally restricted in what could be revealed. The underwriters did not ask the OIGB specifically whether Northland was solvent. Macpherson did not tell Wood Gundy that the OIGB had classified the bank as unsatisfactory, or indeed, that the bank had been classified as "marginally satisfactory" the year before.

At due diligence meetings with the bank, the underwriters learned that Northland was considering paying down the credit facility from the major banks, and replacing it with borrowings from the Bank of Canada. They were aware that Northland expected to encounter difficulty in attempting to renew the lines with the major banks. One of those difficulties was that the banks would require their own due diligence examination of Northland. The underwriters were aware that publication of Bank of Canada advances could have adverse consequences.

In the end, the debenture issue closed on 31 May 1985, and \$16M was "paid" into the bank, although as discussed in Chapter 5, the bank itself effectively financed the purchase of \$7.5M of the debentures.

3. Northland Funding after the CCB Support Program

Immediately before the announcement of the CCB Support Program, and in response to a request from the Minister of Finance, the Inspector General provided information to the Ministers on Northland's current situation. The memorandum reported that "a rigorous audit of the bank's accounts, especially with respect to loan quality" was carried out by the auditors at the close of the 1984 fiscal year. The Inspector General outlined Northland's strategy through the planned asset growth to improve earnings, to diminish the proportion of nonproductive loans to total assets, and to develop noninterest sources of revenue such as fees for services and for commitment of funds. Northland had demonstrated improved profitability but had achieved "only about half the rate of profitability of all domestic banks". The Inspector General noted the impact on Northland of the recession which began in 1981, and outlined measures taken by the bank to solve its difficulty. He stated that the OIGB was maintaining regular contact with Northland and monitoring its funding activities several times a week. He concluded that "There has been no sign of liquidity problems lately."

By 22 March 1985, the Northland had used \$10M of its revolving credit facility of \$200M with the five largest banks, and had drawn down the whole of the \$25M credit it had established with the National Bank of Canada.

The announcement of the Support Program for the CCB produced severe funding difficulties for Northland. Wholesale deposits placed by investment dealers dropped from \$291M on 22 March 1985 to \$121M on 29 April 1985. Wholesale money deposited directly by the customer fell by approximately 10 per cent between 22 March 1985 and 29 April 1985. Deposits from other banks, excluding standby facilities, dropped from \$146M at 22 March 1985 to \$84M by 29 April 1985, and stood at approximately \$20M to \$30M at the end of August. By 18 April, the bank lines with the major banks had been drawn to the limit. Bank of Canada advances commenced on 16 April 1985 at \$85M, and steadily increased, as indicated in Table E.7.

Table E.7

Bank of Canada Advances to Northland Bank
April 1985 to August 1985

April 30	$85 million
May 31	$119 million
June 30	$339 million
July 31	$378 million
August 31	$540 million

Notwithstanding the CCB situation, Northland's retail deposits continued to grow. In April 1985, they increased by approximately $35M to $372M. They rose to approximately $510M at 9 July 1985. Retail deposits growth then started to flatten out, and ultimately, there was some decrease (see Table E.3). Adverse press coverage of the Northland Bank, commencing in mid-July, caused a further loss of wholesale deposits and brought to an end the growth in retail deposits. Neapole concluded in April that Northland was facing a long-term liquidity problem. The standby lines would no longer be adequate to allay the bank's need for Bank of Canada advances and the risk of further adverse consequences from the public disclosure of those advances. In view of the fact that the standby lines with the major banks bore higher rates of interest than Bank of Canada advances, Northland decided to terminate them. On 9 May, management visited the Inspector General to advise him of the proposed termination of the lines of credit. The Inspector General had no objection. On the same day, management met with Governor Bouey to discuss the move. The Governor concluded that it would be desirable to phase out the lines of credit over time in order to minimize adverse publicity, and recommended that Northland explore, with Allan Taylor of the Royal Bank, the possibility of prolonging some part of the lines of credit in order to assist the phasing out process. Taylor said there was no chance of the big five renewing the lines past the expiry date. Some of the major banks insisted that they be allowed to inspect Northland before credit could be extended but Northland objected. Two of the major banks' CEOs recommended that the lines be continued in order to preserve confidence in the market place on condition, however, that Northland arrange a joint hypothecation of assets with the Bank of Canada and the major banks. The Bank of Canada took the position that the lender of last resort role belongs exclusively to the Bank of Canada, and that while it was quite happy to see the other banks participate, if they wished to do so on a voluntary and unconditional basis (that is, without security and without inspection), the Bank of Canada would prefer to act as the only lender of last resort if special conditions were introduced. In the result, the standby lines from the major banks were allowed to expire on 15 June 1985.

It was during this time that Northland encountered what was described as a change in the basic rules and assumptions under which the bank had operated during the past two years. The change, Neapole stated, was reflected in the attitude of other Canadian bankers. Richard Thomson, Chairman of the Toronto-Dominion Bank, made a statement to a group of investment dealers, which subsequently became public, questioning the role of small regional banks and implying, in effect, that CCB should not have been rescued. Northland management also understood that the CEO of another bank had indicated in at least three meetings that Northland would surely fail. Finally, as mentioned above, some of the big five banks had sought as a condition of their extending credit to Northland, an opportunity to inspect it or participation in the OIGB's annual inspection. Ultimately, the standby lines not only expired, but the normal interbank "courtesy" bank lines of the big five banks were terminated by 28 May 1985.

F. INSPECTION AND CONTINUING SUPERVISION

1. The 1985 Annual Inspection

Management gave evidence that during the week of 8 April 1985, the bank sought and received assurances from its lead auditors and the OIGB that "the basic premise of going concern long-range values as were being clearly justified by the results of its workout strategies would continue to be acceptable". The Inspector General testified that he did not recall having given any such assurances to the bank, and that he never approved of "long-range values", although he stated the OIGB has always premised its view of assets on a going concern basis. Management further sought the assurance that the bank could continue with its strategies and efforts within a "constant (stable) framework", and the Inspector General agreed that, in April, such an assurance would have been a reasonable one for him to give.

On 8 May 1985, the OIGB advised the bank of its intention to extend its 1985 inspection to four days, the first two of which would be devoted to an intensive analysis of the bank's major credits by OIGB personnel and two individuals seconded from two major banks. These two individuals, Bruce Cockburn and J.R. Johnston, were the special representatives under the CCB participation agreement. Northland

Bank objected to the proposed arrangement, which it described as "a serious abuse of the regulatory process". Northland would not permit its competitors to have access to confidential client files, and the bank refused access to its records until it could be assured that the inspection would be carried out on the normal and traditional basis. Northland wanted it understood that the bank was to be regarded as a *bona fide* going concern and would be permitted to deal with its loan problems on this basis, that the results of the inspection would remain confidential as has been the customary practice, and that no member of the inspection team would be an employee of a competing bank, whether seconded or not. In the view of management, any deviation from normal regulatory practice would be a clear signal to the stock market and depositors that something was wrong at Northland Bank. The Inspector General took the position that the OIGB has the power in law to perform inspections in any way it chooses, but for some reason, the two seconded bank officials did not participate in the Northland inspection. The Director of the Inspection Division of the OIGB explained his interest in a fuller inspection on the basis that the OIGB had just been involved with CCB and had learned that the method of security valuation in use at that bank was on an "optimistic" basis. Therefore, it was deemed desirable to have experienced bankers examine the loans in the Northland portfolio. If these bankers had any reservations about the loan portfolio, the OIGB intended to undertake a full-scale inspection of Northland's credit files.

At the same time that it objected to inspection by seconded bankers, Northland provided to the OIGB an outline of the history of the bank, its workout strategy, and its concerns regarding a perceived change in the regulatory environment. The Inspector General could not recall reading this material, but presumed that he had done so. It was the evidence of management that they hand delivered this material to the Inspector General in the form of an appendix to a letter dated 13 May 1985. Management testified that the Inspector General had read the material and had made no comment.

The annual inspection was held on 21 through 24 May 1985. The office had the following "going-in concerns":

1. Asset growth was being financed through advances from the Bank of Canada.
2. There had been a decrease in the bank's net interest margin.
3. There was a 400 per cent increase in "other income" in the 1984 fiscal year to the point where it was the main income stream of the bank.
4. Need for timely recognition of losses.

5. Doubt whether the bank will be able to adequately build its general reserve by 1986 for its "sovereign" risks.
6. There was capitalized interest of $2.4M.

The "going-out concern" was described as follows:

> Our concerns prior to the inspection were intensified by our visit and we believe the bank may require some form of assistance to survive.

The OIGB rated the bank "unsatisfactory". The report noted that a policy of rapid growth had been adopted to dilute the effects of nonperforming loans, that the bank had elected to work out problem loans and not take losses that might otherwise be necessary, that in the workout process the bank accrued and capitalized interest, and that if fee income was not recognized as revenue, the bank could not report a profit. The OIGB was concerned about the degree to which the bank was using "investment value" in its security valuation in order to defend the absence of specific provisions for losses. "A substantial amount of loans are performing only because the bank declares them to be; unpaid interest is capitalized and/or accrued and taken into income." Interest margins or spreads had been decreasing since the second half of fiscal 1983 due to rising nonperforming loans and the higher costs of funds. Earnings were considered of very poor quality because of practices regarding the capitalization and accrual of interest, the small provisions, and the heavy reliance on fee income. The OIGB considered liquidity to be "nonexistent" since the CCB crisis.

2. Changing Views

The Assistant Inspector General explained to the Inquiry that "as the CCB affair unfolded and it became clear that perhaps the values that the CCB had attributed to some of the properties held as security were not entirely dissimilar to some of the properties that Northland had, it made the Office more skeptical of the values that Northland was attributing to the loans on their books in support of the continuation of interest income recognition".

On 18 June 1985, an officer of the OIGB, A.F. d'Entremont, reviewed the results of the annual inspection and recommended that Northland be given some sort of assistance in order to survive.

> In the long term, the biggest problem is asset quality. Non performing loans were 15.8% of the portfolio as at 31 October, 1983, reduced to 7.6% as at 31 October, 1984 and to 5.2% as at 30 April, 1985. However, much of this statistical improvement is due to growth in the portfolio.

Given the apparent success of the workout approach to date, and the fact that earnings were positive, d'Entremont recommended that assistance be in the form of a subsidy to support the bank's efforts to diversify funding sources. He suggested that assistance could be provided in the form of an interest-free deposit of $50M from the CDIC. Such a subsidy would enable Northland to increase its specific provisions and extend its branch network in order to increase retail deposit funding. It was also recommended that the growth in assets be capped at $1.5B. Unfortunately for Northland, this proposal was not acted upon. Rather, the time frame of Northland's workout approach would be shortened over the next month.

Participants in the Inquiry attributed considerable significance to communications between Northland and the OIGB concerning the bank's workout strategy, and to indications of the regulators' approval of the bank's approach to its difficulties. Management took the position that its workout strategy for marginal and unsatisfactory loans had been disclosed to the OIGB, and that the OIGB supported that strategy. The OIGB was, for at least two years, concerned with the bank's growth strategy, and its lack of conservatism in provisioning and the recognition of interest income. For the most part, the OIGB sought assurance from the bank's auditors that these practices were acceptable. The OIGB also received specific information on some transactions which disclosed or illustrated the workout strategy clearly. For example, it was advised, in late 1983, that the concept of "investment value" was in use in Epicon on a variable time frame of between one and three years, and was very thoroughly briefed on the workings of this company. The Inspector General testified about the trouble the OIGB had with the transfer values into Epicon. While the Inspector General testified that he thought the sales out of Epicon were normal commercial sales, in fact, it was reported in early 1984 to the OIGB that there had been a large swap of properties with a trust company which involved a large amount of bank financing, and in late 1984, it was reported to the OIGB that about 25 per cent of the dispositions had been by way of swap and that "outright sales accounted for about a 25% reduction in the portfolio". This information, as mentioned in Chapter 5, did not spur a further examination by the OIGB of Epicon's operations.

It was recognized by the OIGB as early as October 1983 that the bank was not a viable earning entity so long as it had to carry $100M of nonproductive assets out of a total asset base of $690M. At that time, the OIGB knew that the bank's strategy involved the restructuring of its nonearning loans in order to permit reclassification, and the dilution of noncurrent loans as a percentage of the total portfolio through substantial increase in outstanding loans. The difficulties with these approaches were recognized by the OIGB as early as October 1983 when Courtright wrote that the approaches could be more protracted than foreseen, require more provisions than booked, and be difficult to accomplish during the recession. In the concluding interview of the 1984 inspection, the OIGB approved of the new workout team (SMART) but cautioned the bank about rapid asset growth, and expressed concerns with asset quality, cost of funding and confidence. Subsequently, the evidence shows that the OIGB expressed concern to the bank regarding its growth rate, and sought an undertaking regarding the rate of growth of the bank. By the time of the 1984 inspection, the strategy that the bank was adopting had been made quite clear to the OIGB. However, there is no documentary evidence in the OIGB outlining a general understanding of the bank's practices in relation to the recognition of income and the taking of provisions, except for statements of concern regarding the accruing and capitalizing of interest. The Inspector General testified that recognition of income and provisioning was an area that always troubled the OIGB. However, no customized coherent reporting requirements were placed on the bank to determine exactly the ramifications of the various strategies.

Prior to May 1985, information regarding Northland's strategy came to the OIGB in a "piecemeal" fashion. Nevertheless, the OIGB was prepared to "see and live with the bank in an attempt to try and get through" the recessionary times, although it remained troubled by the need for growth. Prior to May 1985, the OIGB did not expressly advise the bank that it would at some point change its views as to whether it was prepared to go along with the bank's strategy. No one seems to have addressed the time frame of the bank's strategy. That may have been due to the expectation of many that the Western Canadian recession would be relatively short-lived. During the May 1985 inspection, there was a thorough discussion of the strategy, at which time the OIGB advised management that there was not much room in the loan portfolio to sustain income recognition and that the bank might be unable to continue to attract and hold retail deposits at the price they were having to pay. At the same time, the OIGB seriously doubted Northland's ability to generate fee income without further loan growth. In short, the OIGB concluded that time was running out.

This evolution in the OIGB's views of Northland's strategy is reflected in a meeting on 9 July 1985 at which the Inspector General discussed with the auditors the question of intrinsic values and suggested that time was running out. The recession in the West had been far more prolonged than expected, and there was no longer any reason to postpone the necessary action for another one to three years. It was time to start writing down loans to market value; time to "close the gap" was the expression used by Kennett in his testimony.

G. NORTHLAND'S SEARCH FOR A SOLUTION

1. Restructuring

As previously described, Neapole had concluded in mid-April that Northland had a long-term liquidity problem. Management continued to develop the bank's retail deposits and, on 10 July 1985, met with the Bank of Canada to discuss Northland's response to the effects of the CCB bailout on its funding. The bank presented projections for Bank of Canada advances, deposits, loans, and income to the end of the 1986 fiscal year. The Bank of Canada objected to Northland's use of liquidity advances to finance new loans, and obtained further assurances that Northland would not follow this practice. On the strength of these assurances, the bank's loan growth projections to the end of October 1985 were accepted. Northland's forecast that Bank of Canada advances would be reduced to $289M at the end of July, and to $188M by 31 October was, however, upset by a banker's "ultimate nightmare": press speculation, starting on 10 July 1985, precipitated a run on the bank. Neapole contacted the Minister of State (Finance) to arrange a meeting. Some solution for the loss of market confidence had to be found.

Management testified that as a result of the CCB bailout, the bank was facing a basic erosion of confidence, manifested in a loss of deposits and a fall in the share price. It would only be possible to restore market confidence by curing the liquidity problem and simultaneously dealing with the market perception of weakness in the quality of the bank's principal assets. Although management denied that Northland actually had a problem in asset quality, it recognized that, in banking, perception could become reality. Accordingly, management designed a proposal to meet the expectations of the market, which had recently seen the CCB and another bank take a large write-down in assets. Neapole and Fortier presented a major restructuring proposal to officers of the OIGB, the Bank of Canada, and the Department of Finance on 20 July. The proposal involved a capital component, an asset sale and government participation as follows:

1. $50M issue of common shares to the private sector;
2. issue of preference shares in the amount of $50M to be guaranteed by the Government of Alberta;
3. placement of a $20M, five year, interest-free deposit with the bank by the Government of Alberta; and
4. purchase by the federal government of a $250M segment of the loan portfolio, the proceeds of which would allow Northland to

write off some $50M in nonproductive loans, and make additional provisions for losses against other loans.

A second option suggested by Fortier included these elements:

1. placement of a large, interest-free deposit with Northland;

2. elimination of cash dividends on common shares;

3. renewed efforts to attract retail deposits; and

4. moderate loan expansion.

Minutes prepared by an official of the Bank of Canada state that the federal officials present on 20 July were of the view that Northland's current "liquidity and confidence problem did not warrant a restructuring proposal aimed at earnings, capital, and assets. Furthermore, the proposal, which would be viewed as a government bail-out operation, would heighten the perception that the true situation of the Northland, and of other small banks, was much worse than the public has been led to believe and could further undermine confidence in the Northland and possibly, in other small banks". Accordingly, the Minister of State (Finance) concluded that the proposed solution was not appropriate and premature. Before the meeting broke up, the Inspector General advised Northland that federal officials would meet during the next few days to review some measures to assist it, including a placement by the CDIC and Government of Alberta of noninterest bearing deposits with the bank, an attempt by the Inspector General to convince the large Canadian banks to restore normal banking relationships with Northland, and a possible press release by the federal authorities to reassure the public. The federal officials also discussed briefly, among themselves, the possibility of a merger between Northland and another bank.

The run on the bank continued throughout July. By August, Northland predicted a loss of a further $40M or $50M of wholesale deposits as they matured, and retail deposits were flattening out. A further meeting with federal officials was held on 1 August 1985. Officers of the Northland Bank, the Minister of State (Finance), other officers of the Department of Finance, the Inspector General, and the Governor of the Bank of Canada were present. The bank proposed that $260M of assets should be sold to a new company (owned by Gordon Dixon, a lawyer, and Chief Ron Derrickson, a director of Northland) which would be financed initially by Northland, and that this loan would then be syndicated to the Federal Business Development Bank and perhaps to the Alberta Treasury Branch. Northland would act as the agent bank of the syndicate, and provide $10M of the final financing, producing net receipts of $250M to the bank. In addition, a $100M interest-free loan would be made by the CDIC or the government to Northland, which would in turn be lent interest free to Epicon. Epicon would then purchase nonperforming loans of about $50M, plus another $25 or $30M of under-performing loans. By means of a Government of Canada couponless bond purchased out of part of the interest-free loan proceeds, the repayment of the loan to Epicon was to be guaranteed. Accordingly, it was said to be unnecessary to write down any of the related loan portfolio. The bank would at the same time endeavour to raise $40 to $50M of capital.

The Minister of State (Finance), the Inspector General, the Governor of the Bank of Canada, and G. King of the Department of Finance discussed the matter further in private. The 1 August proposal was rejected for essentially the same reasons as the rejection of the 20 July 1985 proposal. It was agreed that it could not be taken seriously and that a merger was likely to be the only feasible solution. Later in the day, the Inspector General informed management that the proposal would be rejected. By this point, the Inspector General had lost confidence in the management of the bank. Therefore, the only realistic solution was merger. He suggested that management consider a merger, and mentioned the National Bank as a potential candidate.

2. Rondix

Northland management, having concluded that they would receive no assistance from Ottawa, formulated the Rondix transaction. It was the position of management that this transaction would support existing recovery strategies by protecting the bank from the shortening of the acceptable time frame for long-term turnarounds. $100M of loan assets were to be sold to Rondix, the sale to be financed by the bank through an interest-free loan for a term of 15 years. The transaction had to receive certain accounting treatment to achieve the desired result on the bank's financial statements, but no accounting opinion was obtained. All this is discussed in detail in Chapter 5.

A meeting was held on 16 August 1985 for the purpose of discussing the Rondix proposal. At this point, the Inspector General had received the results of a special examination of the loan portfolio, and was concerned that the bank's income came predominantly from fees, that high risk loans were being made, that recovery on old loans was dependent on significant recovery in the Alberta real estate market, and that the bank was providing working capital loans to pay interest, coupled with 100 per cent financing of real estate workouts. In the opinion of the Inspector General, the bank could not carry on in such form. Willson, Neapole, Scarth (the bank's lawyer and a director) and Fortier joined the meeting. The OIGB outlined its concerns about the bank, questioned the bank's solvency, and urged it to contact the National Bank in regard to a merger. On the same day, the OIGB received a complete description of Rondix. The OIGB gave no opinion on the deal.

On 22 August 1985 the Rondix deal was presented to and approved by Northland's Board of Directors. Willson, the Chairman of the board, did not appreciate at the time that the entire value of this transaction to the bank turned on its the accounting treatment in the bank's statements. The Board had no opinion from any accountant that the arrangement would have the desired effect on the bank's statements. Management agreed that no opinion was sought from the external auditors. It was their plan to seek regulatory and eventually accounting indulgence by the fiscal year end.

On 23 August, Northland issued a press release about Rondix, and on that same day, John Crow, Senior Deputy Governor of the Bank of Canada, telephoned Neapole to point out that the loans to be transferred were subject to Bank of Canada security interests and, therefore, the consent of the Bank of Canada pursuant to the Hypothecation and Assignment Agreement would be required before disposition of the loans. Neapole agreed. The Bank of Canada then sent a confirming telex to the bank but never did consent to releasing its security in favour of Rondix. No representatives of the Bank of Canada were present at the 16 August meeting.

After the curator was appointed in September, an opinion on Rondix was obtained from senior bank auditors of the accounting firm Price Waterhouse. Essentially, the opinion stated that if the deal was as successful as it could be in theory, the bank would be left with an equity base of approximately $8M or $9M, calculated on the basis that the transaction would be present valued. In the worst case, the transaction would have left the bank insolvent in the amount of $18M. The opinion concluded that the accounting result sought by management could not be achieved. Assuming that the bank's auditors would have insisted on the same treatment, and that the bank had continued to operate, it would, as Neapole acknowledged, have finished the bank.

3. The Merger Option: The National Bank Review

Officers of the National Bank commenced a review of Northland on 19 August 1985 in connection with the possibility of merger. The

Inspector General was notified on 21 August 1985 that National estimated a necessary write-off in assets of $290M, an amount far in excess of the bank's capital. Much cross-examination was directed at the National Bank officer who testified, to demonstrate that the write-off would partly hinge on National's view of the market characteristics of loans it would be prepared to buy, rather than on the actual creditworthiness of the loans. On 23 August 1985, the National Bank advised the OIGB that it was not prepared to make or accept any offer for an amalgamation with Northland Bank as a going concern.

H. PORTFOLIO ASSESSMENTS

1. Cook and Adamsons

During the course of the 1985 annual inspection, two officers of the OIGB actually reviewed selected loan files of the Northland Bank. What they found indicated that there ought to be a follow-up review, and Northland Bank was advised accordingly. The review was to be carried out by Karl Adamsons, who had extensive experience in bank inspection and credit. Adamsons joined the OIGB in June 1985. His instructions were to review assets of the bank and make a determination of quality and adequacy of existing provisions. This was to involve a review of all nonperforming assets, all marginal, unsatisfactory and partially performing assets, and all other assets in excess of $2M. In addition, a sample of assets less than $2M was taken. Grant, the Director of the OIGB Inspections Division, instructed Adamsons that he need not visit the branches, and could limit his review to Head Office files. Fortier and Grant had extensive discussions about the proposed review. Adamsons was instructed to report to Fortier when he arrived at the bank, but did not have any instructions not to speak to anyone else. In carrying out his review, Adamsons limited his discussions to Mr. Guenette, the Vice-President of Credit, and did not speak to Neapole or Fortier, although he was free to do so. Because the review was restricted to Head Office files, Adamsons was unable to review actual borrower financial statements, receiver's reports, or appraisal documentation. Instead, he relied on the financial information submitted by branch officers to Head Office, along with the brief narrative which accompanied each credit application. For the most part, Adamsons relied on what he saw in the files. For example, where material on the file was insufficient in relation to security valuation, he would agree with the bank. In some instances, he admitted, he would arbitrarily discount the value of security where there was a lack of information in the file.

Adamsons reviewed Northland's loan files during the weeks of 15 and 22 July. His review encompassed $525M out of the total loan portfolio of $1.2B, as of 28 June 1985. The files reviewed were organized into six major classes.

Class A consisted of 31 loans with a principal value of $36.3M. Existing provisions were found to be $1.6M. In discussions with Guenette, it was agreed that these should be increased to $3.7M. Guenette testified that he only agreed to an additional provision of $1.55M relating to a single account. In any event, Adamsons suggested provisions on these accounts of between $5.6 and $6.7M. Capitalized interest amounting to $700,000 was identified.

The loans grouped under Class B, totalling $64.3M, were titled "potential nonaccrual loans". The majority were loans to development companies where the underlying value of the security was well below outstanding loan balances, and the interest was being either capitalized or accrued. Provisions of $4.4M were suggested, along with reversals of $4.6M of interest and $400,000 of fees. These loans were not classed nonaccrual by the bank.

Class C loans were those identified where Northland Bank had provided full financing. These were mostly in the real estate sector, and had a principal value of $254.8M. The security for loans in this category was thought in the long run on a going-concern basis to be sufficient to cover the outstanding loans. However, in a distress situation there would be a substantial shortfall. A significant portion of these borrowers could not service the debt, and if the Northland Bank were to discontinue its practice of providing working capital for debt servicing purposes, the loans would become nonaccrual. Commitment fees of $3.4M had been earned in the last twelve months.

Seven SBEC loans in Class D were reviewed, for a total principal amount of $32M, which earned fee income of $4.67M. Adamsons was concerned that the bank's security consisted of minority shareholdings in small business corporations, which had no other assets and only a nominal capitalization, and for which there was no likely market.

Classes E and F were considered to be acceptable in quality. Twenty loans totalling $84.1M in Class E were made to borrowers with positive net worth positions, a history of positive earnings and security that would provide full cover for loans. The Hees loan of $53M was an acceptable risk, but was classed separately because it was priced below the prime rate.

The report described a number of specific loans, followed by an overview of lending. Adamsons concluded:

1. Large portion of the bank's present problems can be attributed to excessive concentration in lending against marginal British Columbia and Alberta real estate projects. The bank is continuing this policy and frequently extends financing for the full cost of the project.

2. Workout policies frequently tend to increase the bank's exposure.

3. In the past six months, bank appears to be searching out projects that will generate high fee income, and it appears that analysis of the underlying value of the project and security is "given a back seat to fee income considerations".

4. Bank appears unwilling to make hard decisions regarding problem loans. Rather than accepting write-offs, workouts are pursued.

In wrap-up discussions with Guenette, the latter estimated that loan losses of $50M, $175M to 200M, or $300M would be experienced by the bank, depending on whether loan assets were worked out according to Northland's plan, sold in an orderly way, or sold in a quick wind-down of the portfolio. Adamsons noted that these comments represented a radical departure from Guenette's previous position that loan losses of the bank could be restricted to approximately $6M.

During the course of the hearings, Northland management, particularly Guenette, took exception to these comments. Senior management took issue with the comments attributed to Guenette by Adamsons. Guenette stated that he and Adamsons engaged in a philosophical discussion regarding the workout of relatively large loans (in terms of the bank's capital). While he acknowledged the accuracy of the larger figures, he stated that the $50M figure refers to the anticipated loan loss experience of the bank over a five-year period, and denied that it refers to an immediate required write-down of $50M.

In relation to 100 per cent financing, management argued that the acid test is the ultimate collectability of the loan. Virtually all of the 100 per cent financing was provided in workouts, and management argued that such financing was necessary as experts retained to work out problem loans do not put 25 per cent down and, management asserted, anybody who believes that they will is not living in the real world of commerce, particularly in Western Canada. Management also maintained that, in terms of materiality, the major banks do the same. Where the exposure of the large banks is small relative to their capital base, they take a very hard line. They take a different position in the case of large loans to borrowers such as Dome, Turbo or Massey Ferguson. Hence, management said, while there were many workouts in Northland Bank, a loan of $1M in difficulty, for example, would be of more significance to Northland than to the major banks.

Management also pointed out that Northland never took a fee on a restructured loan. In the case of new credits, they readily admitted that if they could not make an above average profit on a deal, they would not be interested. While Adamsons turned up certain fees which were much larger than the conventional negotiation fees he had seen in his previous employment, Northland's management took "merchant banking fees", which are much larger.

Northland management agreed that the bank had a heavy exposure in real estate, and provided full financing for projects, along with working capital. They also agreed that if the bank did not continue the practice of providing working capital for debt servicing purposes, a number of the Class C loans would have become nonaccrual. Given the accounting and financial consequences, this is a concession that the survival tactics of the bank were just that, and the only issues remaining concern who was not aware of this, and what damage was done by their attempts to save the bank.

Adamsons returned to Ottawa and reported to Grant, the Inspector General, and the Assistant Inspector General. On the strength of Adamsons' impressions, it was decided that a further review should be carried out. A second review was carried out 6 August to 16 August 1985, this time with the assistance of Mr. Cook for the two-week period, and Mr. Courtright, an officer of the OIGB, for the first week. Cook had retired after 42 years with the Canadian Imperial Bank of Commerce in various capacities. He had worked for about 30 years in Calgary.

The final report was based on a review of 173 accounts totalling $551.3M, the Dexleigh-Hees transactions, a recent credit authorization to "Blank" International Corporation and the Rondix agreement, totalling $323M. The final report encompassed loans considered during both the initial and second reviews, without indicating how many accounts were reviewed in each. It was estimated that loan losses of $49.6M would be incurred on the portfolio of $551M which was reviewed.

Loans reviewed were placed in three categories:

1. acceptable (competitive rate of interest, underlying security provides full coverage or company possesses sufficient resources to retire loans in an orderly fashion);

2. poor (deficiencies in security coverage, rate of interest below prime, or company experiencing operating losses. Principal losses

not expected; however, bank management would have to devote considerable time to avoid losses); and

3. doubtful (nonaccrual loans and loans where the security values have eroded significantly. High risk of principal loss).

Table E.8 illustrates Adamsons' conclusions.

Table E.8

Adamsons' Conclusions

	Acceptable	*Poor*	*Doubtful*	*Total*	*Provision*
			($ 000)		
Real estate	25,873	96,067	192,989	314,929	43,326
Energy	21,220	17,664	22,575	61,459	—
Manufacturing and misc.	43,250	2,240	3,695	76,185	5,980
Directors, shareholders	30,529	16,294	9,333	56,116	325
SBEC	—	42,400	—	42,400	—
Total	120,872	174,625	255,592	551,089	49,631
	22%	32%	46%	100%	9%

Adamsons' assessment of the bank's loan portfolio after this second review reflected his first examination's results, noted earlier. In addition, he commented negatively on the concentration of risk in single borrowers and the frequent lack of definition of a source of repayment.

Cook prepared a separate report. In testimony, he stated that he was very shocked by the practices he found in the bank; terms granted by the bank were largely unilateral in favour of the borrower. He criticized the bank on much the same grounds as Adamsons. He also noted that many accounts were problem loans which had been taken over from other banks without improvement in the borrower's financial status; that there were frequent instances of 100 per cent financing; that Northland had often agreed, contrary to standard banking practice, to carry term borrowing for several years with no reduction of principal; that "working capital loans" were often granted to cover a borrower's interest costs, held as a term deposit in the borrower's name and reduced as interest payments fell due, all deferring classification of the loan as bad; that in one instance, a "future performance" loan was granted despite a lack of assets, contracts, and earnings in the borrower;

and that entire loans were frequently granted on the strength of an "undertaking to provide security", again contrary to usual banking practices.

2. Curator's Review

The curator undertook a review of substantially all of the loans of the Northland Bank. This review was carried out by approximately forty Touche Ross and forty-five Royal Bank personnel. The Royal Bank personnel were senior credit and inspection officers who were instructed to review loans on the same basis as if they were examining a unit of their own organization. Loans in the various regions were assessed by regional personnel of the Royal Bank. Where practical, all findings were reviewed by the Touche Ross personnel with local management and the summary results were forwarded to the Head Office where they were consolidated to ensure consistency of approach. It is notable that branch files were reviewed, enabling Royal Bank personnel to consider the original application for the loan and the most recent statement of information on the files. The review was carried out on a liquidation or going concern basis (from the point of view of the borrower) as appropriate; that is, the reviewer employed a going-concern basis unless there was some valid reason for doing otherwise. The possibility of offsets between deposits and advances was considered. There were several loans where the amounts advanced included an amount to be set aside in a Northland term deposit, which deposit would be used to service the loan. Reviewers offset any deposit against the balance of the loan, and reduced the balance of the loan accordingly. Security was valued on a "realistic" basis, as assessed by Royal Bank officers who were familiar with the particular geographic region. Security valuation was not undertaken on a forced sale basis; rather, the valuation was described as taking a "balanced view".

Loans assessed were classified as safe, weak, doubtful or bad or any combination of these (for example, on a $3M account, $2M might be classified safe, $300,000 doubtful and $700,000 bad). The definitions of weak, doubtful and bad are:

> *Weak*: Appears to involve more than a normal degree of risk due to an unfavourable record or unsatisfactory characteristic. There exists a possibility of loss unless the account receives the careful and continued attention of management.
>
> *Doubtful*: It is probable that a loss will occur but the amount is uncertain, and not likely to be the full amount classified as doubtful.
>
> *Bad*: Reasonable to expect that all of the amount classified as bad will be written off.

On a preliminary basis, the curator found that the total of weak, doubtful and bad loans exceeded $300M. On 20 September 1985, the curator, Morrison, and one of his officers, Frank Brown, met with Fortier and Guenette to discuss the results of the review. The preliminary finding was given to management, and reference was also made to the summary prepared by the bank's internal inspector, Iain McLeod, which indicated weak, doubtful, and bad accounts in the amount of $343M. McLeod's review had been carried out over the preceding fourteen months, and it was his evidence that he gave the bank the benefit of the doubt where feasible and classified more loans in the weak and doubtful categories than the curator, who classified more in the doubtful and bad categories.

Management took away with them copies of the Royal Bank review notes (approximately 1000 customers), and prepared a rebuttal to the curator's findings, which was presented by Fortier, Guenette, and Wettstein over a period of four days commencing on 23 September 1985. The general thrust of the rebuttal was:

> ... that 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.

The rebuttal outlined some of the bank's improvement strategies and successes, examples of the progress which had been made in "making value" in the portfolio over a period of time. Of the $247M of loans classified by the curator as doubtful and bad, management classified as doubtful $13.2M, bad $11M, and Rondix $79.3M. (Management took the view that some loans to be transferred to Rondix should not be considered doubtful or bad if that deal closed.) The difference in the classification over the doubtful and bad categories was $143.5M. Time did not permit management to review those loans classified by the curator as weak. Management took exception to the curator's position that the review was carried out on a going-concern basis. Guenette, Senior Vice-President, Credit, stated that, in some cases, a loan was valued on the basis that the borrower was not a going concern, and in the circumstances such an evaluation would be an absurdity. Management also contended that, given that the bank was no longer a going concern because it was in curatorship, it was stretching the limits of imagination to believe that there was a "heads-up" going concern examination.

By 24 September 1985, the curator had updated its findings as follows:

Weak	$117M
Doubtful	$107.7M
Bad	$141.2M
Total	$366M

John Easton, the coordinator of the Royal Bank team, and Morrison met with the internal Chief Inspector, McLeod, on 26 September 1985. These parties reviewed those individual classifications where the curator differed with management by more than $1M. In situations where the Chief Inspector believed that the curator was too harsh, the classification was adjusted, resulting in the following revised analysis:

Weak	$114.1M
Doubtful	$98.8M
Bad	$129.5M
Total	$342.4M

Next, specific provisions were estimated by taking a range of percentages of the classified loans. The estimated range can be seen in Table E.9.

Table E.9

Range of Percentages of Classified Loans

	Loans Classified	*Low End of Range*		*High End of Range*	
Weak	$114.1M	(10%)	$11.4M	(25%)	$28.5M
Doubtful	$ 98.8M	(50%)	$49.4M	(75%)	$74.1M
Bad	$129.5M	(100%)	$129.5M	(100%)	$129.5M
Total	$342.4M		$190.3M		$232.1M

Given that the bank had an existing appropriation for contingencies account standing at $11.5M as of 31 July 1985, the curator concluded that additional provisions required would be in the range of $180M to $220M. It is apparent that even if the low end of provision required was recognized in the financial records, the existing capital and reserves including debentures outstanding would be eliminated. The curator's report also recorded a preliminary estimate of the level of actual NPLs of $325M.

Over the course of the review, a number of transactions were noted which involved bank participation in the disposal of its security, the use of newly incorporated borrower companies and the other measures already discussed in this Appendix. As described elsewhere, a number of large exposures exceeded 20 per cent of the bank's capital.

As of 1 October 1985, there were outstanding loans aggregating $7.4M to six directors and $2.1M to thirteen senior bank officers and two executives of Epicon. Of the officers' loans, $648,000 was in relation to a share purchase plan in November 1983. The curator stated that several officers indicated to him that such shares were acquired under pressure, but senior management denies that pressure was applied. Senior management contended that Northland's policy in relation to loans to its directors did not vary from industry practice, that the ultimate test was always the borrower's ability to pay, and that the provisions of the *Bank Act* were adhered to. The musical chair rotation of directors' moving and seconding resolutions authorizing such loans (discussed in Chapter 5) leaves an impression of literal but not substantial compliance with the *Bank Act*.

In those loans where the security was real estate, it was found that many files contained inadequate or out-dated appraisals. Apart from that, the Royal Bank team found that the files were satisfactory. Finally, the curator noted that during the 1984 fiscal year, and 1985 to date, fee and other income had become a significant contribution to the earnings of the bank. "Other income" for the nine months ending 31 July 1985 stood at $8.0M, and for fiscal year 1984, was $8.1M. All fees exceeding $50,000 booked in the 1985 fiscal year were identified by the curator. They totalled $10.721M, of which $5.420M was not recognized by the end of the third quarter of 1985. There were examples where fee income exceeded 10 per cent of the amount of the loan. Easton, the Vice-President, Credit Audit and Corporate Audit of the Royal Bank, stated that the usual commitment or negotiation fees in the Royal Bank amount to ¼ of 1 per cent or ½ of 1 per cent. It is, however, fair to note that the Royal Bank has a merchant banking division about which Easton knew little.

The liquidator, in his testimony before the Commission, was asked how the loans got into a state requiring provisions ranging from $190M or more. On this he deferred to Easton, who made the following comments:

1. Northland represented itself as being able to do deals that others could not do in a market which was extremely competitive. In his opinion, if one takes on transactions which others will not, one must get a larger share of bad loans.
2. Just as the Royal Bank suffered very heavily in the western recession, unquestionably Northland suffered from that as well, more particularly because of the geographic distribution of their portfolio with heavy representation in Alberta and B.C.
3. Too many instances of 100 per cent financing. The lending policy was generous and overly aggressive.
4. The size of the fees taken in the bank are unusual.
5. There were a large number of cases where the bank seemed to have been faced with a loss but did not take it; instead, more money was put up. These loans may work out, but the risks seem extremely high.

3. Internal Inspectors

While it was not a function of the internal inspectors of the Northland Bank to assign provisions to the loans, it was their practice to classify loans. In their testimony before the Commission, their classifications have been collected, and comments were solicited from them regarding lending practices at the bank.

Stan J.C. Willy became Chief Inspector of the bank in February 1983, a position he held until August 1983. During his tenure, he assessed the bank's branches in Vancouver, Prince George, Edmonton and Calgary. Loans were graded on a scale from one to five, defined as:

1. Good;
2. Minor deterioration (documentation not finalized, other questionable matters);
3. Major deterioration (fairly clear evidence that security value was deteriorating, or repayments were not being received as agreed);
4. Nonproductive (clearly a problem; should no longer be accruing interest); and
5. Unsatisfactory (all possibilities to realize on security are exhausted, or collection procedure is in process. There is still a possibility of getting some return, but it is becoming more remote. These loans are good candidates for a loss provision).

On 8 July 1983, Willy sent a memo to the policy committee of the bank to the effect that the profile presented by the loan classification reports, representing management's assessment of the quality profile of the bank's loan portfolio, was significantly different from that drawn by the Inspector's assessment of the loans. Neapole, a member of the policy committee, denied ever receiving this report, since it was not the custom of the policy committee to receive handwritten reports from its Chief

Inspector. In any event, Willy's report is indicative of his differences in relation to management loan quality assessment.

The loan portfolio profile shown by management records as of 31 May 1983 is shown in Table E.10.

In comparison, Table E.11 outlines the inspection grade assessment for the comparable dates. The Chief Inspector suggested that in his view, as of July 1983, approximately $175M, or 30 per cent of the bank's portfolio, could be regarded as essentially nonproductive or worse (that is, Class 4 and 5), whereas at 31 May 1983 the bank reported approximately $61M in nonproductive loans.

In order to put the above findings in perspective, it is necessary to note that Willy testified that, in the case of all his assessments, there was concurrence by each regional manager of the respective branch. It is also necessary to note that while Willy had no previous experience as an inspector (and indeed, his previous experience is not on the credit side of a bank), as of 26 April 1983, it had never been suggested to him that he lacked the necessary skill or ability to act as Chief Inspector. Willson was, on the contrary, quite complimentary about Willy's Vancouver reports. Willy testified that the practice of capitalizing interest appeared widespread, and that he felt it was happening far too frequently. He also said that it was common practice to charge a fee, and to provide for its payment in the overall loan amount.

The other Chief Inspector who gave evidence is Iain McLeod, who has held various positions on the credit side of banking, the most recent of which, before joining Northland in 1983, were in the Royal Bank. The results of McLeod's inspections, carried out over a 14-month period are summarized in Table E.12.

As can be seen from Table E.12, and from earlier discussion in this Appendix, there is little difference between the total amounts classified by the curator and McLeod. However, there is a large variation in the allocation within the categories of weak, doubtful, and bad. Several reasons are apparent. First, McLeod's inspections took place over a 14-month period, whereas the curator's inspection lasted just one month. Second, it was the evidence of the Chief Inspector that he gave management the benefit of the doubt in his assessment of accounts. If the Chief Inspector was wrong, he could make corrections in the following year.

The Chief Inspector testified that the provisions established by the bank were insufficient. McLeod commented on the lending practices of the bank which were much the same as the comments of Adamsons and Cook:

Table E.10

Loan Classification (Management Records) ($M)

	One		*Two*		*Three*		*Four*		*Five*	
Branch	$	%	$	%	$	%	$	%	$	%
Saskatoon	20.1	71.5	4.7	16.7	3.3	11.7	0.8	2.8	9.0	0
Winnipeg	30.9	56.7	6.9	12.7	3.4	6.2	0.9	1.6	13.2	24.2
Vancouver	21.5	24.7	5.2	6.0	38.8	44.6	4.1	4.7	17.3	19.9
Prince George	13.9	21.9	17.1	26.9	24.3	38.3	7.6	11.8	0.7	1.1
Edmonton	67.0	51.6	10.1	7.8	34.8	26.8	15.0	11.8	2.9	2.2
Calgary	82.3	55.9	18.8	12.8	32.5	22.1	8.2	5.6	5.5	3.7
Corp. lending	58.8	63.1	5.6	6.0	7.9	8.5	20.9	22.4	0	0
Total	294.5	48.8	68.4	11.3	145.0	24.0	57.4	9.5	39.6	6.6

Table E.11

Loan Classification (Inspection Grade Assessment) ($M)

	One		*Two*		*Three*		*Four*		*Five*	
Branch	$	%	$	%	$	%	$	%	$	%
Saskatoon	20.1	71.5	4.7	16.7	3.3	11.7	0.8	2.6	0	0
Winnipeg	30.9	56.7	6.9	12.7	3.4	6.2	0.9	1.6	13.2	24.2
Vancouver	6.8	9.4	15.6	21.4	15.2	21.0	5.5	7.6	24.7	35.9
Prince George	4.8	7.9	16.4	27.1	18.0	29.6	16.8	27.6	4.7	1.8
Edmonton	18.0	14.0	26.8	20.8	44.7	34.6	5.9	4.6	33.5	26.0
Calgary	20.4	13.9	39.1	26.6	37.5	25.5	20.8	14.1	29.3	19.9
Corp. lending	58.8	63.1	5.6	6.0	7.9	8.5	20.9	22.4	0	0
Total	159.8	27.6	115.1	19.0	130.0	22.5	71.6	12.4	105.1	18.2

Table E.12

Loan Classification (McLeod)($000's)

Branch	*Date of Inspection*	*Classification*						*Total Classified*	
		Weak		*Doubtful*		*Bad*			
Calgary	April 1985	78,694	29.5%	27,065	10.1%	3,060	1.2%	108,820	40.8%
Edmonton	April 1984	26,925	18.4%	11,133	7.6%	28,508	19.5%	66,566	45.5%
Prince George	June 1984	11,473	16.1%	10,380	14.5%	12,433	17.4%	34,286	48.0%
Toronto	November 1984	385	0.8%	4,008	8.3%	30	0.06%	4,423	9.1%
Vancouver	January 1985	17,144	19.6%	18,172	20.7%	5,249	6.0%	40,564	46.3%
Winnipeg	July 1984	2,350	3.9%	2,149	3.6%	103	0.1%	4,602	7.6%
Saskatoon	June 1985	12,711	24.9%	10,182	19.9%	3,294	6.5%	26,187	51.3%
Energy	July 1985	55,606	45.5%	647	0.5%	1,694	1.4%	57,947	47.4%
Total		205,288		83,736		54,371		343,395	

1. Excessive restructuring of loans;
2. Capitalization of interest plus provision of additional funds for future interest;
3. Sale of poor performing assets at book value, often 100 per cent financed by the bank at book value plus debt servicing;
4. Heavy concentration to a few borrowers for large amounts, in relation to the capital of the bank;
5. Speculative real estate transactions based on future events. If these events did not occur, repayment of the loans would be extremely difficult;
6. Rampant portfolio expansion at the time when other banks were retrenching;
7. Stubborn refusal to admit, recognize, or be financially able to make appropriate provisions for losses; and
8. In many instances, the granting of loans was fee-driven.

McLeod pointed out in his testimony that initially, if part of a loan was potentially classifiable, the entire amount of the loan was classified (the "two-by-four approach") to get management attention. Later, the procedure changed, and parts of loans could be classified in different categories. The inspection of the Vancouver branch of 14 November 1983 was carried out on the old basis, but apparently none of the others were. The Vancouver inspection results for 14 November 1983 are not included in the table of the inspection results. It is also fair to note that the above-mentioned lending practices in the bank mostly arose from the treatment of problem files, where the alternative was simply to write the loan off.

I. CESSATION OF OPERATIONS

On 28 August 1985, the Minister of State (Finance), one of her staff, the Inspector General, and the Minister's counsel met with Willson and Fortier. The Minister stated that at this point she had not finally decided on the course of action to be followed. The Inspector General, on the other hand, was of the view that the bank should be closed. Northland officials first briefed the government on various attempts to find a solution for the bank. Management had met with the Banking Committee of the Alberta Cabinet to request that the province guarantee Northland's commercial paper, invest in equity, and assist Northland in discussions with an international bank to pursue the object of converting Northland into a Schedule B foreign bank. In addition, discussions had been held with the Finance Minister of the Government of Saskatchewan to request an increase in Government of Saskatchewan deposits. Northland had also been in contact with the Hees company with the object of securing an agreement whereby Hees would "stamp" $250M of Northland's commercial paper, or guarantee it. A discussion developed as to whether Northland could survive a CCB insolvency. It was the view of the Minister that some solution would have to be developed for Northland before CCB was closed. The Minister was not persuaded by the potential solutions put forth by Northland because the bank could not produce any firm proposals. Subsequently, the Minister met with Allan Taylor of the Royal Bank to request that he canvass the Schedule A banks to determine whether one of them would be willing to merge with Northland Bank. None of the banks were interested.

The possibility of arranging a support package for Northland was rejected at this time. In a memorandum of 29 August 1985, the Deputy Minister of Finance advised the Ministers that a support package might be expected to cost upwards of $250M. It was also estimated that losses on realization could prove substantially larger than $300M. This would generally accord with information which the Minister had received from the National Bank review and from the OIGB.

The Ministers learned on 31 August 1985, that the Government of Alberta was unwilling to assist Northland as fully as the bank had hoped. At best, Alberta was willing to convert a $70M deposit into some other form of financing.

On 31 August 1985, the government was "pretty convinced" that a curator should be appointed, but desired one last meeting with management. Willson, Scarth, Neapole, Fortier, and Gordon proceeded to Ottawa and met with both Ministers, their counsel, and one of their staff. The bank was advised that CCB would be closed, and a discussion ensued about what would happen to Northland. Management felt that no curator should be appointed. While Northland would suffer in the short run upon the closing of CCB, it would, they thought, benefit in the long term because, finally, Northland would be seen as being different from CCB. This opinion was not accepted as plausible. When the meeting broke up, the government side met with the Inspector General and the Assistant Inspector General to discuss Adamsons' final report on the loan portfolio and the results of the National Bank review. The bank was then advised that the appointment of a curator would protect it from the negative effects of the CCB closure, and that the decision had been taken because the government had in its possession a report which indicated that no solution was possible. That report was the Adamsons report. Management were not given the opportunity to review it or respond to it. Hence, they were restricted to the assertion that, whatever was in that report, it would probably be embraced by Rondix. The Minister of State (Finance) did not view Rondix as a solution to the bank's problem; it was a bad deal. The meeting was adjourned to enable Northland officers to communicate with their

Board of Directors. In the course of a further meeting on 1 September 1985, the Ministers were advised that the Board would not acquiesce in the appointment of a curator. Northland believed that the assets of the bank would be better preserved by bank management in association with its auditors. The current drain on Northland's deposits was attributed to CCB's problems and, accordingly, the Bank of Canada funding facility, having been designed to protect banks against market influences of this kind, should continue to be available.

The provisions of s.278 of the *Bank Act* authorizing the Minister to appoint a curator specify certain preconditions in terms of the financial position of the bank in question. In particular, the Minister's authority to appoint a curator under s.278(2) is dependent on the opinion of the Inspector General that "a bank will not be able to pay its liabilities as they accrue".

On 1 September 1985, as in the case of CCB, the Governor of the Bank of Canada was informed by the Inspector General that the bank was no longer "viable". In the result, the Bank of Canada ceased funding the Northland Bank, so that it was unable to meet its liabilities as they came due. The Inspector General then reported to the Minister that the condition specified by s.278(2) existed. The OIGB had strong suspicions, but was not then in a position to demonstrate, that the bank was also insolvent in the sense that its liabilities exceeded its assets.

On 1 September 1985, a curator was appointed. A press release stated, in part, that the Ministers were prepared to accommodate the belief of the bank's Board of Directors that Northland's business might be preserved through reorganization or amalgamation. Consequently, it was agreed that the bank would be given limited time to seek to reorganize its affairs or amalgamate with another financial institution.

In order to assist Northland Bank in reorganizing its affairs, the government appointed Mr. R.E. Bellamy, an investment dealer, to evaluate proposals on behalf of the Minister, and to advise on their viability. Bellamy had, as of 23 September 1983, received and reviewed three written proposals for restructuring Northland's finances, and was aware of one other representation made by a major bank shareholder. The three written proposals shared certain common features, including participation by both the federal and Alberta governments, and the raising of additional capital for the bank. Bellamy concluded that "for confidence in the Bank to be restored it must be aligned with an institution or institutions of unquestioned financial strength, and market credibility". Major flaws were seen in all of the proposals. Bellamy conducted discussions with certain major international bankers presently operating as Schedule B banks in Canada, and concluded that the terms of any takeover of the bank's business operations would require a commitment by the government to cover losses on the loan portfolio. In the circumstances, it was concluded that such a commitment was not acceptable. Liquidation followed in early 1986.

Appendix F

Banking Practice and Auditing

A. General Audit Functions

- **1.** Overview
  - **a.** Objectivity
  - **b.** Audit Evidence
  - **c.** Materiality
  - **d.** Going Concern
- **2.** Application of GAAP
- **3.** Significant Bank Accounting Principles
  - **a.** Capitalization of Interest
  - **b.** Accrual of Interest
  - **c.** Loan Loss Provisions
  - **d.** Workouts and Loan Loss Provisions
  - **e.** One Hundred Percent Financing
  - **f.** Fee Income

B. Audit of Credit Decisions

C. Conclusions Regarding Bank Auditing Practices

D. Accounting Considerations Regarding Reporting

- **1.** Valuation
- **2.** Loan Characteristics for Regulatory Reporting

Appendix F

Banking Practice and Auditing

A. GENERAL AUDIT FUNCTIONS

1. Overview

The operations of an enterprise are under the control of management, which has the responsibility for the accurate recording of transactions and the preparation of financial statements in accordance with appropriate accounting policies. These responsibilities include designing and maintaining accounting records and internal controls, selecting and applying accounting policies, safeguarding assets and preventing and detecting fraud and error.

The purpose of an audit is to express an opinion as to whether the financial statements prepared by management fairly present the financial position of the bank at the specified date, and the results of operations for the period under review in accordance with generally accepted accounting principles (GAAP) as modified and extended by the *Bank Act*. Within GAAP are requirements that speak to the need for judgment. GAAP include a requirement that where the application of any particular recommendation of GAAP would give an unfair result, professional judgment should be exercised to the extent required to avoid such a result.

The auditors of a bank are subject, beyond their normal professional duties and principles, to the additional strictures of the *Bank Act*. Under the Act, bank auditors have at least one more constituent, the Inspector General (and through him, the Minister of Finance), than auditors generally have. It might also be said that bank auditors have one other constituent. A bank auditor has no statutory or contractual link with the depositors, but their presence, and the nature of their claim in law on the bank (and sometimes against the auditors as well) must be in the constant contemplation of the auditors. The auditor's decision to approve a bank's financial statement may affect the bank's stability, because of a bank's considerable exposure to the obligation to repay the deposits. The balance is frequently delicate and any tremors, though minor in another corporation, may in a bank set off a domino reaction with grave consequences.

The CICA Handbook states that the auditor's opinion is neither an assurance as to the future viability of an enterprise, nor an opinion as to the efficiency or effectiveness with which its operations have been conducted. The level of assurance provided is reasonable assurance that the financial statements taken as a whole are not materially misstated. Auditing procedures are designed on the assumption of management's good faith, and auditors exercise professional judgment regarding the extent to which they will rely on management systems. Absolute assurance is not obtainable because of the need for judgment, the use of testing, the inherent limitations of internal control, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

The concept of professional judgment embraces a number of principles which will now be discussed.

a. Objectivity

The audit examination must be performed by persons with an objective state of mind, free of any influence, interest or relationship in respect to the client's affairs which could impair their professional judgment.

b. Audit Evidence

Generally accepted auditing standards require the auditor, through his examination, to obtain sufficient and appropriate audit evidence to provide a reasonable basis for the opinion. Complete verification of every transaction is neither contemplated nor practicable. Instead, audit evidence is obtained by carrying out compliance and substantive procedures. Compliance procedures are designed to assure that prescribed internal controls are operating effectively. The degree of reliance that an auditor places on internal controls influences the extent of his substantive testing. Substantive procedures provide direct evidence as to the validity of the data produced by the accounting system. The exercise of professional judgment is involved at both stages in determining the scope of the examination and what constitutes sufficient and appropriate evidence as the basis for the auditor's opinion.

c. *Materiality*

Materiality, in the context of an auditor's decision making, refers to the quality of a statement or misstatement of a matter of accounting information in relation to the overall condition of the institution under examination. The general test was well stated by Dilworth and Broadhurst. The former stated that:

> ... materiality is a question as to whether or not the degree of error or the degree of potential error would affect the judgment of a reasonable person and influence his decision as a result of the information that he was reading.

Broadhurst on the same point stated:

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

Decisions as to materiality may, according to Dilworth, be affected by the condition or stability of an enterprise; as it gets into difficulty, materiality will have finer limits. In accordance with common sense, the nearer the precipice, the more the investor and depositor will want to know and the less room for error.

d. *Going Concern*

A fundamental initial assumption underlying the preparation of financial statements in accordance with GAAP is that the audited enterprise is a "going concern"; that is, that it will be able to realize assets and discharge liabilities in the normal course of business for the foreseeable future. One responsibility of the auditor is to satisfy himself that there is evidence to support this assumption. Conditions which may cast doubt on the ability of the enterprise to continue as a going concern include recurring losses from operations or serious deficiencies in working capital, inability to obtain financing sufficient to ensure continued operation, inability to comply with terms of existing loan agreements, the possibility of an adverse outcome of one or more contingencies, insufficient funds to meet liabilities, plans to curtail significantly or liquidate operations, and external factors that could force an otherwise solvent enterprise to cease operations. The auditor must make an assessment of the circumstances in each case to determine the extent to which the existence of such conditions may affect the enterprise's ability to realize the carried value of its assets and to continue as a going concern. If it is concluded that they pose a serious threat to the enterprise, disclosure must be made in the statements, or the auditor must qualify his opinion. It should be noted that the evidence needed to justify qualification of the financial statements in this way is good hard evidence raising very serious doubts. In any case, however, where there is uncertainty as to the likelihood of continuation, more conservative accounting principles should be used; for example, a shorter period for the valuation of assets, closer to realizable and liquidation values. As always, the auditor's responsibility is to review and assess the accounting treatment, disclosure and presentation to ensure fair presentation in accordance with GAAP.

The presumption that the enterprise is a going concern is consistent with the contention that the auditor's opinion is not an assurance of its future viability, on the basis that financial statements are drawn to present a picture of the enterprise at a particular point in its life.

2. Application of GAAP

There is no great departure from generally accepted accounting principles in relation to bank audits, although the CICA Handbook states:

> Handbook recommendations are intended to apply to all types of profit oriented enterprises. ... However, pending further study, the recommendations do not necessarily apply to the special problems of banks and insurance companies. No recommendation is intended to override the requirements of a governing statute.

The Audit Standards Committee of the CICA proposed in May 1985 that this exemption should be removed, reflecting the adoption and practice by members of the CICA of GAAP and other related Handbook recommendations as the framework for auditing banks. The OIGB expects banks to adhere to GAAP, at least in relation to the preparation of the Schedule J balance sheet prescribed by the *Bank Act*.

However, certain limited departures from GAAP are prescribed by the *Bank Act*. First, the form and content of bank financial statements are contained in the Act. Second, bank accounting principles depart from conventional accounting principles in the method of accounting for loan losses, the method of accounting for gains and losses on the disposal of certain debt securities, and the method of translating foreign currency transactions and financial statements.

The method of accounting for loan losses is the most fundamental of these differences. Loss adjustments (specific reserves) made to the loan accounts are charged to the "appropriations for contingencies" account reflected in the capital and reserve section of the balance sheet. The annual loan loss provision based on the five-year historical loan loss experience expressed as a percentage of the loans outstanding and applied to the year end balance of loans is credited to "appropriation for contingencies" and charged to the statement of income. The rationale for this smoothing effect is supposed to be the confidence factor in banking. This account assumed some prominence in the evidence concerning CCB.

3. Significant Bank Accounting Principles

a. Capitalization of Interest

Capitalization of interest refers to the advance of money by the bank to the borrower to enable him to pay the interest on his loan from the bank. Interest may be capitalized pursuant to the original loan agreement, or on an unplanned basis. Capitalization is planned where the bank and customer do not expect a revenue stream sufficient to service the loan to develop immediately. The most common example is the real estate development loan. It is a common and acceptable practice to include in such loan contracts provision for funds sufficient to pay interest during a defined operating period. Unplanned capitalization of interest, on the other hand, is considered to be a warning signal, because it indicates the borrower's inability to meet its loan obligations, perhaps in the long term.

Broadhurst testified that because interest capitalization, in some instances, is a decision to advance additional funds to the borrower, the decision to capitalize interest should be made on the same considerations as the original loan. In short, he said that a new credit assessment of the borrower should be made. The Assistant Inspector General expressed a less conservative test when he took the position that there is nothing wrong with capitalization of interest up to the value of the security, as long as this value is certain. The auditors of CCB, Lord and Carr, were of the view that the capitalization of interest on a loan restructuring is permissible where there is reasonable assurance about ultimate collectability of the loan. In contrast, Korthals said:

> ... when we restructure we want to make sure that our claim on the restructured company represents ... original principal plus unpaid interest, but we would never try and capitalize that in a way that we would recognize that as income. It would only be income when indeed we got paid cash.

Management of both CCB and Northland Bank have testified that their practices with respect to capitalizing interest were no different than the practices in other banks. As a result, the practice of the other banks was the subject of much discussion at the hearings. McLaughlan stated that capitalization would sometimes occur in a full service bank in another form, when cheques in payment of interest or fees to the bank overdraw a current account, triggering an operating line of credit. Since CCB did not offer a current account service for its customers, it simply tacked the interest on to the loan principal balance where collateral values covered the full amount. Neapole said it was common practice in his experience to debit and consider collected interest due to operating accounts. Korthals, in discussing this matter, was unsure whether such a debit to an operating account could be characterized as capitalization of interest and said that, in any event, this would not continue in a default situation. As CCB and Northland often capitalized interest on workouts after default, the McLaughlan and Neapole contention that the practices are equivalent is not valid.

The Toronto-Dominion Bank does not capitalize interest in restructuring a loan. When a loan is not in default, the bank will often lend money and pay interest to a borrower who is profitable and healthy. Thus the bank loan may grow every year, and in that sense the bank is capitalizing interest. If the company experiences a downturn, the bank may terminate such an arrangement. This position is summarized in the response of the Toronto-Dominion's General Manager and Chief Accountant, dated 12 March 1984, to an OIGB survey:

> It is normal practice to charge interest to loan principal or to create/increase an overdraft for the amount of the interest where the overall liability of the borrower is either within the authorized line of credit or is well secured. In such cases, the loan would be considered current and therefore should not be reported. ...

Mulholland, the Chairman and CEO of the Bank of Montreal, testified that the capitalizing of interest at that bank is forbidden, except in a "tiny chink" of cases, "one of which would be construction project loans". Interest may not be capitalized if the loan has been placed on a nonaccrual basis, or where capitalization would avoid placement of the loan on a nonaccrual basis.

Fullerton, the Chairman, President and CEO of the Canadian Imperial Bank of Commerce testified that at his bank, interest is never capitalized if the loan is in default, and that if management is uncomfortable with the loan, it would not be maintained as current by adding interest to principal. If the borrower is in default and desires a further advance as part of a restructuring, the further advance goes through the full loan application process. A letter from the Vice-

President and Chief Accountant of the bank, dated 14 March 1984, and written in response to the OIGB survey above mentioned, states the CIBC position:

> ... It is normal bank practice to permit the charging of interest to loan principal or an overdrawn account where the overall liability of the borrower is within an established line of credit or considered to be collectable. Under such circumstances the interest is considered to be paid. Furthermore, if there has been activity in the borrower's accounts how can it be said that the interest has not been paid?
>
> We would also point out that the proposed new guidelines will effectively control bank practice in this respect. If, perchance, a problem loan account is involved, the bank would of necessity be assessing the overall risk and past due interest would not be capitalized if collection of the enlarged principal outstanding was at risk; the loan would be placed on a non accrual basis.

At the Royal Bank of Canada, apart from those cases where the capitalization of interest is part of the original contract or arrangement, the rule is:

> Other exceptions may arise especially where it is clearly evident that our funds are safe and it is in the bank's interest to accommodate the claim. However, such situations must be supported by sound judgment and submitted for consideration on a case-by-case basis to the respective headquarters or head office as the case may be.

Capitalizing of interest is undertaken only where senior management is absolutely certain that the bank will recover all its money. This decision is made by a member of senior management who was not involved with the particular loan. However, stated Allan Taylor, it would not be usual for the bank to continue capitalization year after year because to do so would "distort ... overall accounting records."

Ritchie, Chairman and CEO of the Bank of Nova Scotia, testified that interest is very rarely capitalized on a nonaccrual loan. If the loan is classified as nonperforming, capitalization of interest would be unusual, especially in workout situations. However, the key is the underlying security value.

Bélanger testified that it is a policy of National Bank that borrowers must pay the interest and principal with their own funds in the normal course of business. Interest is not capitalized, except in some project loans.

It would appear from the above review that there are three practices regarding the capitalization of interest: (1) capitalization forbidden; (2) capitalization permitted on the basis of a new credit application, judged according to the bank's normal lending criteria; and

(3) capitalization permitted up to current market value of the security. The acceptability of the third practice is relevant to the Commission's mandate only in the context of the accuracy of the financial statements which were relied upon, rightly or wrongly, by the OIGB. Consideration of this matter is postponed until other banking practices are outlined, but it may be noted here, for reasons that are developed later, that the third practice is imprudent. MacKenzie testified that, at the very least, one should have a generally higher quality of security and collateral coverage when employing the third practice.

Some capitalization of interest may be acceptable to the auditors and justified from the point of view of the bank. In the unplanned capitalization case, the auditor should, according to Broadhurst, seek evidence of a further assessment of the overall loan situation to determine whether it is appropriate to advance further funds to be used for the payment of interest. Again according to Broadhurst, if there is *any* doubt about collection, interest should not be capitalized. Where interest is properly capitalized, it is his view that the practice does not artificially inflate the financial statements.

b. Accrual of Interest

Rules regarding the accrual of interest are now standardized in the OIGB Non Performing Loan Paper of June 1984, which applies to the 1985 and following fiscal years. However, CCB and Northland Bank did not finish fiscal 1985. Prior to 1985, absolute uniformity did not exist among Schedule A banks in relation to interest accrual, and there was no industry consensus on the subject. A common thread was that where interest was past due for a specified number of days, accrual ceased. For example, at the Toronto-Dominion Bank, any loan where interest was contractually past due 90 days was classified nonaccrual, unless the loan was insured or guaranteed by a Canadian government. Other loans which were not yet in arrears could be classified as nonaccrual where in management's opinion there was doubt about the ultimate collectability of any portion of the principal or interest. Once classed as nonaccrual, any interest accrued on the loan was reversed. There was no management override.

Other banks had a management override. The stated policy at the Royal Bank was to discontinue accrual of interest when payment was past due 90 days, or sooner if collectability was in doubt. In 1983, the note to the Financial Statement was changed to provide:

> Loans are placed on a nonaccrual basis ... when payment of interest is 90 days past due unless management determines that the collectability of principal and interest is not reasonably in doubt.

This change in wording was made for clarification only; the Royal Bank did not thereby become less conservative. The bank had always made rare exceptions to the 90-day rule where, notwithstanding that interest was past due more than 90 days, the valuation of the security was such that it clearly exceeded the amount of principal and interest owing. The rarity of this case is illustrated by the fact that, since 1 November 1984, the Royal Bank has had only one loan in excess of $4M for which interest continued to be accrued beyond 90 days. This loan was subsequently placed on a nonaccrual basis and all accrued interest was reversed.

Some banks reversed the interest on loans which had been determined to be nonaccrual during the current period. One bank ceased to accrue interest on loans 90 days past due, but did not reverse it until interest was overdue for 180 days. Some banks made exceptions to their general rules based upon a specific assessment of the account, including the underlying value of the security. Other banks would not admit to such exceptions. The divergence in accounting policies is illustrated by the practice of one bank, which reversed current year interest against income on nonproductive loans, but capitalized interest related to prior fiscal periods and considered such capitalized interest in the determination of loan loss provisions. Rarely would a bank continue to accrue interest past 90 days or 180 days, as the case may be, based on a specific management override. Mulholland said:

> ... we polled the operating groups to find anybody who could remember using the management override. We have been unsuccessful in finding anybody that had used it or can recall using it.

Starting in 1983, and culminating with the Inspector General's Non Performing Loan Paper of June 1984, several banks adopted policies in compliance with the rule that loans should be placed on a nonaccrual basis payment if interest is 90 days past due unless management determines that the collectability of principal and interest is not reasonably in doubt. The reasonable doubt qualification is known as the "management override". The degree to which the management override is used appears to vary among the banks. The bankers were agreed that use of the override is viewed as exceptional. Most of the banks regard it as rare.

The auditor, according to Mackenzie, reviews management's decision as to the accrual of interest according to the following factors quoted from a memorandum he authored on the subject:

> 1. Underlying security values were more than adequate to cover principal and interest.

2. There is a realistic probability that the borrower will in the reasonably near future be able to generate adequate cash flow to service the loan and that interest accruals whether capitalized or not are covered by collateral with present market values adequate to cover the interest. In other words, while it may be sufficient to value collateral related to principal amounts in a longer time frame in arriving at judgments as to the collectability of principal, the collateral security covering loans where interest is being accrued should be of good quality in terms of present market value. This is based on the general proposition that performing commercial loans could, if need arises, be sold on a nonrecourse basis to other leaders [sic: lenders] at their carrying value including accrued or capitalized interest.
3. The safety of the loan, including interest, should not depend on third party guarantees unless those guarantees are undoubted (e.g. a government guarantee or one from a corporation with a first class credit rating) or are themselves supported by good quality collateral.
4. Unpaid interest is not being booked on loans related to dormant projects such as vacant land where there is no active current sales program which is producing results or is reasonably likely to do so.
5. Where an unsatisfactory loan situation exists, there are refinancing, restructuring or other reorganizations in place (or almost certainly to be put in place) which will result in either:
   (i) providing in the near future cash flows adequate to service the loan, or
   (ii) additional good quality collateral is being put up to justify the capitalization of interest.
6. The Bank (or other creditors) have not put in and is not intending to put in a receiver to manage the affairs of the debtor.

c. *Loan Loss Provisions*

Practices regarding loan loss provisioning affect the carrying value of the loans as stated in the financial statements and income as reported in the income statement. Both CCB and Northland were, during the recession in Western Canada, faced with dramatic decline in the market value of assets taken as security for loans. The banks regarded this as an abnormal situation, and accordingly, they developed policies to deal with it. Instead of valuing assets held as collateral on a current market basis, the CCB considered that a more realistic value could be established by taking into account an expected recovery in the market from one to three years hence ("baseline value"). In Northland Bank's case, a "workout strategy" for the bank was devised which involved the establishment of specific plans to workout hard assets which had been acquired as a result of realizing on soft loans. Such assets, in the workout stage, were valued on a basis known as "investment value". Apart from terminology, the CCB and Northland schemes were essentially the same. Both overlooked the present market and attracted value to the assets by reason of assumed or hoped for improvement in market conditions in the undefined future. The propriety of the baseline value and investment value concepts are considered in some detail elsewhere; it is sufficient here to describe the attitude of the large banks toward them.

All of the CEOs and Presidents of the large banks who gave evidence on this subject disapproved of CCB's baseline values. One banker testified that the value, if there are no buyers, is "zero". Some of the bankers testified that where the value of the security has eroded due to economic conditions, the bank should take a rolling assessment, adjusting the provision as the value deteriorated. Taylor said:

> I would just add ... looking at that type of example where you talk about placing perhaps a zero value on a property where there is nobody out there, obviously, in the market prepared to buy, I do not know of any lenders who walk away from properties under those circumstances. That tells me that there is some ongoing value. ...

Expert auditing evidence also approved the use of such a rolling assessment. Broadhurst stated:

> When we are valuing security and our economy is on a down trend ... it would not be unusual to see a provision against a loan increase in successive years. ...
>
> ... similarly, it is not unusual to have made a specific provision ... to have the fortunes of that company or the economy improve, in which case, some or all of that provision will be reversed in a subsequent year. ...

Most of the bankers said that in determining whether there should be a provision, there are two issues; the ability of the borrower to pay, and the value of the security. If the borrower is a going concern, the value of the security is not immediately important. Where doubt arises as to the ability of the borrower to pay, or where the bank is supplying the ability to pay by advancing funds for this purpose, then the value of the security becomes a material consideration.

All of the bankers emphasized the judgmental nature of provisioning. Standards in this area, like most other accounting areas in banking, vary from bank to bank. Some bankers provision for "possible" losses, while others provision for "probable" or "likely" losses. The latter is an acceptable practice.

Only one bank, the Canadian Imperial Bank of Commerce, has written guidelines on this subject. The general rule is as follows:

> It is expected that you will apply conservative, objective, and realistic judgment to arrive at the proper estimate of the possible loss or estimated loss in each account.

The policy goes on to state:

> A specific provision should normally be established when there is reasonable doubt as to recovery and the outcome is dependent upon factors that cannot be forecast with reasonable assurance.
>
> Specific provisions should not be made to the extent of:
>
> (a) a conservative value of tangible security, or
>
> (b) a reasonable but conservative estimate of the amount collectable from assigned receivables or merchandise, collateral paper, endorsements, guarantees, or other similar security
>
> (c) if mortgage security is held, a conservative estimate — usually supported by a reliable appraisal — of the net amount recoverable,
>
> (d) a conservative estimate of the amount collectable from other sources including, on a highly selective basis, future income.

The Toronto-Dominion Bank employed a wholly different approach. Finding it very difficult to assess accurately the value of collateral, and in view of the low number of nonaccrual loans in the bank, the bank decided that the best way to reflect the financial position was to cease to accrue interest rather than to establish a loss provision, since nonrecognition of interest produces a far greater impact on the profit and loss statement for the year. This is true so long as the present rule providing for a five-year rolling average for loss provisions continues. By 1983, the bank had nonaccrual loans on the books for more than one year without any action having been taken. This had never happened before. In 1984, the bank wrote down all such nonaccrual loans by a minimum set percentage (25 per cent in Alberta and 10 per cent in British Columbia, with an increase in 1985 if circumstances did not change). This sectoral provision was applied only to nonaccrual loans in the sector, not to all loans, and was considered a minimum appropriation.

In addition to the evidence of the Presidents and CEOs of the large banks, the Commission heard evidence about provisioning from line bankers. Line bankers with credit experience in Alberta who had the opportunity to inspect CCB files testified that they had never seen baseline values used before. Tallman described the practice as unreasonable and unrealistic.

Broadhurst, asked for his opinion regarding security valuation methods, stated that he would be "concerned" with starting from an assumption that economic circumstances would improve significantly, and would examine each loan file to determine the degree of improvement expected and the reasons for the improvement. He said that "conservative valuations are the order of the day". The auditor should not completely ignore economic factors in trying to arrive at some reasonable valuation in a situation where the market for the underlying security is seriously depressed, as long as the judgment is reasonable when viewed both at the level of the individual loan and at the global level of the bank's loan portfolio. The auditor must exercise caution here; if very optimistic economic assumptions are widespread, the auditor must be "very significantly on guard" because such assumptions are dangerous. Broadhurst would be "alarmed" at this method of valuation.

d. *Workouts and Loan Loss Provisions*

It is standard banking practice in Canada to consider working out a problem loan; to write off a loan is a last resort. Workouts may involve a rescheduling of principal and interest, the conversion of debt into equity, or the granting of further loans to enable the debtor to work its way out of difficulty. In considering whether to restructure a loan, or to establish a specific provision, the bank considers the borrower's balance sheet and earnings record, the calibre of its management, the value of the security, and other relevant circumstances. Specific provisions on loans are also made with due consideration of the economic outlook, but less emphasis is placed on that.

It is important to distinguish the operational decision to work out a loan from the accounting consequences. The operational decision to work out a loan does not obviate the necessity of taking a provision where one would otherwise be required. MacGirr said, and Broadhurst agreed, that:

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

A provision need not be taken if the bank is satisfied that the borrower, although experiencing difficulties, will ultimately be able to repay fully the outstanding balance. However, when a borrower defaults, common sense implies that a loss is likely if security coverage valued on a current market value basis is inadequate, unless a workout can be established which will, in the end, result in ultimate collectability. It is worth stressing that the overall number and significance of workout loans in the portfolio has important implications for the auditor in the "stepping back" process he must perform. This point assumes some prominence in the evidence taken by this Inquiry.

Finally, the appropriations for contingency account is normally stated for unforeseen loan losses. It should not be viewed as a substitute for specific loan provisions.

e. One Hundred Per Cent Financing

The Commission heard much evidence about one hundred per cent financing, which typically, and sometimes unavoidably, occurred in a workout situation. If the borrower has substantial net worth, or other sources of repayment are identified, there is nothing pathological about unsecured or partially secured loans. Where the borrower has no substantial net worth or equity in the project, however, there is a warning to the auditors that a provision may be required because a lack of value in the security is indicated. Where there are many instances of such financing on the bank's books, the auditors must be on guard, and should test the overall adequacy of loan loss provisions. We shall return shortly to the auditing implications of one hundred per cent financing.

f. Fee Income

The appropriate banking treatment for fee income was not discussed in the evidence. Broadhurst testified that fees could properly be capitalized on the same basis as interest. The Commission heard that it was a practice of CCB, but not Northland, to charge a fee for restructuring a loan. At least one large Canadian bank charges fees on restructurings, but this fee income is "very small". Such fees, in another bank, appear to relate to legal or accounting expenses only. The Commission was told that all banks charge commitment fees of between one-half and one per cent of the loan authorization. Northland Bank often charged much larger fees, termed "merchant banking fees", of up to 15 per cent of the loan authorization. Witnesses testified that they had never seen such fees before their examination of Northland's affairs, but these were middle management personnel, not familiar with merchant banking practices. The Inspector General acknowledged that merchant banking goes beyond simply lending money, and involves the provision of services contributing something more to the process of a business deal than merely putting up money for which a bank is entitled to a fee, and that he knew that merchant banking so defined was not an unusal practice in relation to the commercial lending activity. He did say, however, that it is "less than clear exactly what merchant banking is about".

Fees connected with lending or other long term activities taken in lieu of interest are usually amortized, whereas "merchant banking" fees are usually included in income in the year in which the related services are rendered. Northland Bank acknowledged the distinction in a note to its 1984 financial statements:

> The bank generates fees from lending management arrangements and other business advisory services rendered to its customers. Fees connected with

> lending or other long term activities are amortized. Other fees are included in income in the year in which the related services are rendered.

The ambiguity of the distinction between a "fee connected with lending" and "other fees" is illustrated by Fortier's description of how fees were recognized in income:

> ... primarily ... if the deal could not happen — if we facilitated the happening of a transaction through our in-house people, the expertise that they had and they brought to the table and that they brought to the negotiations either with the borrower or with some third party that the borrower was negotiating with, then ... that fee was earned and we almost created the environment for the fee to happen.
>
> Otherwise, if that was not the case, then the fee would have to be amortized. ...

MacKenzie developed the following criteria to be applied in determining whether a fee was charged in lieu of interest, and therefore the appropriate method of taking it into income:

1. The merchant banking activity giving rise to the fee must be, in fact, a "value-added type of service".

2. The scope of the work and the approximate amount of the fees were agreed to by the client in advance.

3. There should be no collateral agreement with the client allowing a rebate of the fee or a subsequent adjustment of interest rates and so forth in order to rebate the fee.

4. That all the work and all the costs related to earning the fees had been incurred.

5. That each property to which the fee related were new properties of the bank, and that this was not merely a "refreshing" of old loans.

6. Finally, that the resulting loans were themselves fully performing on a cash basis with an appropriate interest rate (market rate applicable to that particular class of credit).

The basic test, Mackenzie opined, is whether the resulting loan is of such quality that it can be sold without discount to other financial institutions.

B. AUDIT OF CREDIT DECISIONS

No issue has been raised as to the auditors' physical examinations and procedures. Rather, the crucial issue is whether the auditors adequately responded to the information available to them. Nevertheless, auditors' procedures can usefully be reviewed.

Commercial loans are selected for review with reference to their size and classification. All loans over a certain amount are reviewed, as are loans over some smaller amount that are classified as unsatisfactory, noncurrent, or nonperforming. A test examination is made of the balance of the loans. In each case, the normal procedure is to acquire copies of the board sheets. In some cases, this will be the extent of the review. In others, a cursory review of the files will be made as well. In a third group, the files will be reviewed in detail, and will be discussed with the appropriate officers of the bank. Information is also collected regarding the concentration of the loan portfolio by region and industrial or commercial sector, the percentage of nonperforming loans, the number of restructured or workout loans and their overall significance, concentration of loans to connected borrowers, and any other trends noted in the financial statements or during the examination, including whether the bank has been less conservative in some of its "other income" measurements.

In conducting the audit, the auditor must identify the basis on which management and the internal auditors determined the borrower's ability to pay. The auditor expects to see in the file a rationale for the decision whether or not to take a provision. Broadhurst stated:

> You would have available to you why the credit management in the bank sees fit to make a provision and some indication as to how they arrived at the amount or, on the other side, why they feel, even though they are not looking at the security for one reason or other, there is some question about the ability, why they feel that the security would be adequate, and they would not need to make a provision at that time.

Disagreement on a matter of judgment as to provisioning on a loan-by-loan basis is normal and acceptable. However, the auditor must also "step back" and view the overall loan provision in light of the information collected, trends noted and judgments made. Broadhurst said:

> Insofar as provisioning of loans, I believe there are two essential approaches. One is the examination of certain individual loans, and the second is a stepping back and viewing the overall loan provision in the light of trends noted and judgments made in the examination of individual loans. For example, the more workouts that an auditor finds, the closer would be his examination of workouts. The larger the percentage of nonperforming loans, the more detailed would be his examination of such loans.

MacKenzie made a similar point. He stated that it is important to get an overall impression or "reasonable estimate" of the level of loans where the borrower is not paying interest in cash:

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

Broadhurst testified that if all the disagreements or assumptions were one way (to increase income and avoid provisions), that would cause him concern.

The auditor must be prepared, based on his own judgment, and in the context of his overall view of the loan provisioning, to disagree with management's judgment and consider qualifying the bank's accounts if the increases in specific provisions that he feels are necessary are not made. Qualification would only be required, however, if the provisions would be material. The auditor must determine whether, in light of the "soft" nature of the figures, the amount of additional provisions recommended is significant in the circumstances. Two subjective judgments are therefore involved: whether a loan provision is required, and whether, when all recommended loan provisions are aggregated, they are material.

The valuation of security underlying a loan is a highly subjective judgmental process. The auditor should look for evidence that the valuation assumes a reasonable time frame for disposition, and is based on assumptions that are reasonable, perhaps tending a little to the conservative side. Appraisals are an important element in the valuation of security, but they are not the final word or the only element. It is not standard practice for an auditor to obtain an independent appraisal.

The fundamental difficulty in loan valuation from the auditor's point of view was well expressed by Mr. Peter Smith of Coopers & Lybrand in England. He testified:

> I think we would have to say there will be circumstances where two banks, each with the same exposure to exactly the same customer on precisely the same terms and conditions ... would arrive at different views as to the recoverability of that particular loan, and both answers may be right, but one bank may decide to provide half the balance and another bank believes it is fully recoverable, but management of the bank has to analyze its exposure and honestly come to judgment based on the facts such as they are. The auditor is then in a position of having to assess whether the bank has acted diligently and come to a judgment in accordance with the facts and may well be able to accept because they are the management's accounts and not the auditor's accounts which could have two different answers in two different banks to what appears to be essentially the same problem.

C. CONCLUSIONS REGARDING BANK AUDITING PRACTICES

It is essential to recognize that the interests of the shareholders and depositors require conservative practices and accounting disclosure of the results of these practices.

In the circumstances disclosed by the evidence, the whole matter can be reduced to two issues: the valuation of security, and the propriety of practices consequent upon such valuation. CCB and Northland management emphasized and utilized the judgment required to determine ultimate collectability of particular loans based on the "three C's" of good credit practices; character, credit, and collateral. The "banker's judgment" was resorted to in the hearings to challenge critical reviews of the two banks' loan portfolios. It was said by witnesses in these banks that only management are familiar with two of these factors; character and credit. There is an element of truth to this. However, again as a matter of common sense, the loans principally occupying the attention of the Commission were workout loans, in which default had already occurred or was anticipated, and a loss would result if no workout was undertaken. No borrower was shown in evidence as willing or able to redeem his security. Many workouts were actually or effectively on a nonrecourse basis. The taking of loss provisions was avoided or at least postponed. Both banks accrued or capitalized interest, and often justified this practice by referring to the worth of the underlying security, adjusted upwards from present value by the addition of some "future value".

Security valuation proceeded in both banks by way of detailed plans to work out a loan or asset and/or on the basis of expected recovery in the economy. It is clear that security valuations based on assumptions about economic recovery are improper; the expert bankers said so and expert audit evidence confirmed it. Common sense favours the same conclusion.

Security valuations based on workout plans in place are also dangerous. It is obvious that not every workout will, in fact, be successful. The auditors must, in light of the number of workouts, assess the overall reasonableness of the picture presented by the financial statements.

Capitalization and accrual of interest and the taking of provisions hinge on the valuation of security. Given the security valuation methods employed, these practices in certain cases were clearly improper. Capitalization and accrual should not occur if there is any doubt about collectability. Doubt exists where collectability depends on unrealistic expectations that plans in place for the workout will be entirely successful. Further, as one approaches 100 per cent financing, Mackenzie's test requiring "more than adequate security coverage" is not met. In many cases coverage was not based on present market values and in some cases, even the least conservative tests for capitalization were not met.

The auditors testified that provisions were made for "likely" losses. However, provisions were rarely made on loan workouts. There are even instances in both banks where no provisions were taken because refinancing was "in progress", even though the arrangements were not yet finalized. In effect, the auditors were content to assume that workouts would succeed until there was evidence to the contrary. In the view of the Commission, this assumption cannot be justified. In a workout situation, where the loan is not well secured on a current market value basis, it is reasonable to presume a loss will occur because the borrower has in most cases already defaulted. A provision should therefore be established at that time, and only as the workout progresses from infancy and its success becomes apparent should the provision be removed. Because it is unreasonable to expect success in every case, the auditors must step back and view the reasonableness of the picture presented by the financial statements on a global basis, considering the frequency of 100 per cent financing and of workouts.

The same comments apply to accrual of interest. In addition, the periods of time over which interest was accrued were improper. It is not acceptable banking practice to accrue interest based on a management override for very long periods of time and in the face of such intervening events as the borrower's receivership.

D. ACCOUNTING CONSIDERATIONS REGARDING REPORTING

In the course of considering recommendations, the Commission has reviewed current reporting requirements and proposed additional ones. These issues are intimately related to the foregoing discussion of expert evidence, and accordingly are dealt with here.

1. Valuation

Valuation of the loan portfolio seems to include the valuation of the loan itself, the borrower's covenant, and the security underlying it as a totality. Once the covenant is dishonoured and thus has no value, valuation of the pledged security, most frequently real estate, is the only process at work. During the course of this Inquiry, the Minister of State (Finance) introduced Bill C-103 in the House of Commons, which proposed as an amendment to the *Bank Act* that the Inspector General have the authority to establish the value of a loan asset in a bank. However, none of the parties appearing before the Commission have sought, and some of them have opposed, such power in the regulator. The Bill, introduced after the major portion of the Commission hearings had been concluded, was not the subject of much direct evidence.

The proposed legislation does not reveal whether this section is in response to any condition laid bare by executive examination of bank regulation. The section is not accompanied by an explanation but simply by the word "new". It appears to be simply the extension to the *Bank Act* of an analogous power conferred on the Superintendent of Insurance with reference to real estate mortgage lending by licensed lenders in that field. In that case, however, the loan is granted in consideration of a conveyance of title, in some provinces called a mortgage, and it is understandable that the value of the mortgage is predominantly the value of the loan. Such is not generally the situation in banking, according to the evidence tendered at this Inquiry. The proposed provision is contained in s.175(3.1):

> Where an appraisal of any asset held by a bank or any of its subsidiaries has been made by the Inspector and the value determined by the Inspector to be the appropriate value of the asset having regard to the appraised value varies materially from the value placed by the bank or subsidiary on the asset, the Inspector shall send to the bank, the auditors of the bank and the audit committee of the bank a written notice of the appropriate value of the asset as determined by the Inspector.

The power of reappraisal granted to the regulator of banks under the proposed s.175(3.1) is much greater than the power granted in the Bill to the Superintendent of Insurance. In the latter case, reappraisals are limited to real estate assets, and the Superintendent is limited to the adoption of a qualified appraisal and cannot simply substitute his own judgment for that of an appraisal relied upon by the financial institution. The CBA urges that the Inspector General's powers be likewise limited. The second, more important position taken by the CBA, is that the regulator's reappraisal power should not be worded so as to enable a global reassessment of the value of all the assets of the bank, but rather should be limited to the valuation of real estate. This observation is based upon the acknowledged degree of judgment and discretion involved in loan valuation. The process is subjective in part, does not lend itself to third party verification, and is a product of the bank credit officer's experience with and understanding of the relationship between the lender and borrower.

It should be noted in passing that the section is ambiguous. The expression "an appraisal of any asset" is the opening description of the situation addressed by the section. Later in the proposed provision much is made of "the appraised value" and the variation between that quantity and "the value placed by the bank ... on the asset". In many fields of the law the word "appraisal" is associated principally with real estate. In general modern-day language usage the word "appraisal" and the verb "to appraise" no doubt can extend to things animate and inanimate, real and personal, corporeal and incorporeal. However, in law it is an unusual application of the verb "to appraise" to apply it to a promise or a covenant of a borrower. The section, though ambiguous, must be taken to include the valuation of all assets including loans secured and unsecured. The CBA would at least limit the proposed power to the valuation of real estate.

The section suffers from further want of clarity in providing that where the Inspector's valuation differs materially from that placed on the asset by the bank, "... the Inspector shall send to the bank, the auditors of the bank and the audit committee of the bank a written notice of the appropriate value of the asset as determined by the Inspector." No mention is made as to whether the Inspector's written notice is a directive comparable to that issued by the Minister under s.175(1) which, under the existing s.175(4), need not be revealed publicly. Nor is it clear whether the written notice under the proposed s.175(3.1) could be considered a directive concerning "unsound business practices" which the Inspector may issue under s.313.1 of the *Bank Act*, also proposed in Bill C-103. If it is, then a right of appeal to the Minister, and subsequently to the Court, is available to the bank. If the written notice in the proposed s.175(3.1) is not included in the new process to be authorized by s.313.1, there is no right of appeal. Of course, the new value would be without purpose even if not carried into financial statements and thence into prospectuses.

The section is a drastic intervention, even assuming the difficulty in solving the problem of valuation. It may be confiscatory, but is unaccompanied by the safeguards which have historically evolved to protect the individual in fields such as zoning and land use law, where legislative action may reduce property values, sometimes without compensation. In banking, if there is a demonstrated need for this power, it is clearly encompassed in the recommendation, made elsewhere in this Report, to include in arsenal of weapons of the regulator the power to issue a cease and refrain order. In the United States, the FDIC has the power to issue "cease and desist orders" dealing expressly with the valuation of loan assets. The basis or standard in law for such an order under the *Bank Act* would be the general power and duty of the regulator to ensure that the business of a bank is conducted prudently, with regard to the interests of shareholders and creditors, and in the public interest. Cease and refrain orders concerning asset valuation should only issue as part of a balanced regulatory scheme in which all interests are subject to scrutiny at the administrative and judicial levels. It should not be forgotten that we are here dealing with the vital issue of the integrity of the citizen's property.

The breadth of the amendments as currently worded approaches a grant of regulatory power akin to that possessed by U.S. on-site inspectors. Adoption of such an inspection system is rejected by the Commission elsewhere in this report. It may be incongruous to provide the wide powers of loan revaluation inherent in the proposed s.175(3.1) without at the same time establishing a "hands-on" bank inspection system. A regulator undertaking the revaluation of a loan assets must be familiar with the credit practices of the bank and the creditworthiness of the borrower in order to make an informed regulatory revaluation decision. The regulator's impact on the valuation process should be focused on supervision of lending and loan valuation practices, as communicated to it, and to the audit committee, by the bank's auditors. Management decisions, properly supervised, are preferable to regulatory fiat in the accepted Canadian tripartite system of bank regulation.

If there is a present compelling need for the extraordinary and startling power given by Bill C-103, it should first be demonstrated. The cease and refrain power should be given a trial run to see whether conventional administrative law processes are not sufficient to protect the interests of bank and community alike.

It is, in sum, the considered view of this Commission that the proposed administrative power to revalue a bank's assets is an extraordinary power in our legal and political system, and cannot without much more than has been seen in the evidence here be recommended. The grant of power, recommended elsewhere, to issue cease and refrain orders where the conduct of the bank is, in the opinion of the regulator, imprudent, is in the Commission's view sufficient.

2. Loan Characteristics for Regulatory Reporting

Regulatory reporting of problem loans is currently controlled by the OIGB Non Performing Loan Paper. The Commission's recommendations emphasize the cash flow reality of problem loans, and aim, in part, at remedying deficiencies in the Paper. To understand these recommendations in Chapter 6, the following background is presented.

"Substandard loans", a term adopted by the OIGB as an interim measure in the OIGB's 1983 pre-inspection questionnaire, was defined as the total of overdue loans (loans where interest had not been paid *by the borrower* for a period of 90 days or more, and other loans treated by the bank as being on a nonaccrual basis) plus "underperforming loans" (loans where the terms of the loan agreement had been renegotiated to provide for a reduction of interest payments due to the weakened financial condition of the borrower). The definition included situations where a bank continued to recognize income by capitalizing interest or accruing it as a receivable. As such, it may be similar to the recommendation made by the House of Commons Standing Committee on Finance, Trade and Economic Affairs in its 1982 study on bank profitability:

> The noncurrent loan category, as defined in the *Bank Act*, should be redefined so as to classify outstanding bank loans according to their contribution to bank income. All loans on which (1) future interest payments are not expected to be received or (2) interest payments have not been received for 90 days or (3) on which bank officials treat interest payments on a nonaccrual basis should be classified as noncontributing loans. All loans on which (1) contractual interest payments have not been made in full and on which (2) the differential is treated on a nonaccrual basis should be classified as partially contributing loans. All other loans should be classified as fully contributing loans. Such information should be included in each bank's annual report.

The OIGB's Non Performing Loan Paper was finalized in June 1984, and mandatory reporting under the new format commenced in 1985 fiscal year. The new reporting requirements are quite comprehensive. It should be noted that the discussion that follows focuses on loans to domestic borrowers, and thus is misleading to the extent that it ignores sovereign loans and claims other than loans. The paper defines various classes of loans as follows:

1. *Non accrual loans.* (NALs) Loans on which interest is not being accrued because of the existence of a reasonable doubt as to ultimate collectability of principal or interest (even if payments are not contractually past due). Loans where interest is contractually past due 90 days are automatically included in this category unless senior credit management determines that there is no reasonable doubt as to the ultimate collectability of principal or interest (the "management override").

2. *Renegotiated Reduced Rate Loans.* (RRRLs) Loans whose terms have been modified to provide for a reduction in the interest rate due to the weakened financial condition of the borrower. NALs and RRRLs are "Non Performing Loans".

3. *Other past due loans.* Loans on which interest is contractually 90 days past due, that have not been included in the NAL category because interest is being accrued pursuant to the management override. As a general rule, where interest is contractually in arrears 180 days, loans

must be classified NAL and removed from this category. Only in "extenuating circumstances" will any loan be permitted to remain in other past due status more than 180 days.

4. *Special surveillance — restructured loans.* Loans other than RRRLs where, due to the weakened financial condition of the borrower, the terms of the loan have been modified. These modifications were stated by the OIGB to include a reduction of principal or the amount payable at maturity, or accrued interest (including forgiveness), or by deferring or extending payments of interest and/or principal. The OIGB expresses the view that this definition will "usually apply for large private sector and sovereign risk loans, where more than one bank is at risk." A senior Canadian bank auditor testified before the Inquiry that "I am not even sure I know what that means".
5. *Special surveillance — loans with general provisions.* This category refers to sovereign loans.

The paper also prescribes income treatment for the various classes of loans. More relevant to the present purpose, the OIGB implemented regulatory reporting on a quarterly basis of these various classes of loans. The following items, among others, must be reported:

1. *NPL Data in the Aggregate.* This includes the total of NALs and RRLs, reported both on a gross basis and net of provisions. Specific provisions must also be reported.
2. *Other Past Due Loans.* These loans, defined above, must be reported in two categories (90-179 days and 180 or more days past due) showing the same information as for NPLs. For this classification, however, interest carried in "other assets" (accrued interest) must be reported.
3. *Trends in Special Surveillance Loans.* The totals of restructured loans and loans carrying general provisions newly classified in the quarter must be reported.

Some of these loans, in particular RRRLs, other past due loans, and special surveillance loans, need not be reported unless they exceed the greater of $500,000 and 1/10 per cent of the paid-in capital, contributed surplus and retained earnings of the bank.

Information other than the amounts of each class of loan is also reported, including:

1. Interest recorded as income on nonperforming loans and other past due loans. In the case of other past due loans, interest is reported for loans past due 90 to 179 days, and separately for loans past due 180 days or more. The current quarter reversal of interest accrued in prior periods on nonaccrual loans must also be reported.
2. Gross nonperforming and other past due claims and special surveillance loans of nonresidents by country.
3. Some newly classified restructured loans, and restructured loans reclassified to NAL must be reported by customer name (with gross balance and specific loan provisions).

In the Commission's view, significant gaps exist in the reporting system, due in part to the definitions in the Non Performing Loan Paper. This matter is pursued in the Recommendations in Chapter 6.

It is pointed out that regulatory reporting must recognize the deficiencies inherent in conventional presentation of financial statements. Difficulties in loan valuation should now be apparent to the reader. This is not, of course, a new issue. A publication entitled The *Elusive Art of Accounting,* offers the following succinct quotation from *The Economist* and comment thereon:

> Anyone who knows anything at all about accounts knows that at almost every turn — the value of stock, equipment and buildings; the method of accounting for research, development and publicity expenditure; the apportioning of tax — the book entries depend on judgments which may possess a large element of guesswork and certainly could have been, equally legitimately, expressed by a different method with totally different figures at the end.

This same publication concludes:

> In short, the only acceptable basis for net income determination is the "better off" view. It is not useful to anyone to claim that a company has earned a net profit of $1,000,000 unless it can be demonstrated that its value has increased by that amount.

This matter is considered further in the Recommendations.

Appendix G

Miscellaneous Data Concerning Conduct of the Inquiry

A. ORDER IN COUNCIL

The Committee of the Privy Council, on the recommendation of the Prime Minister, advise that a Commission do issue under Part I of the Inquiries Act appointing the Honourable Willard Z. Estey to be Commissioner to inquire into and report on the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank including

(a) an examination of all the circumstances and factors contributing to the condition of the banks and resulting in the cessation of their operations; and

(b) regulatory action in dealing with these conditions and circumstances taken by the Government of Canada and its agencies, including the Bank of Canada; and

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

The Committee further advise that

(a) the Commissioner be authorized to

(i) adopt such procedures and methods including the holding of hearings whether in public or in camera as he may consider expedient or necessary, for the proper conduct of the inquiry and to sit at such times and at such places within or outside of Canada as he may decide;

(ii) engage the services of such staff and counsel as he may consider necessary or advisable, at such rates of remuneration and reimbursement as may be approved by the Treasury Board;

(iii) engage the services of such experts and other persons as are referred to in section 11 of the Inquiries Act who shall receive such remuneration and reimbursement as may be approved by the Treasury Board;

(iv) rent office space and facilities for the Commission's purposes in accordance with Treasury Board policy; and

(v) submit from time to time to the Governor in Council, such interim reports as he may consider advisable; and

(vi) perform such other functions as may be necessary to carry out his duties;

(b) the Commissioner be directed to submit a report in both official languages to the Governor in Council embodying his findings, and recommendations as soon as possible and to file with the Clerk of the Privy Council his papers and records as soon as reasonably may be after the conclusion of the inquiry; and

(c) pursuant to section 37 of the Judges Act, the Honourable Willard Z. Estey be authorized to act as Commissioner in the inquiry.

B. WITNESSES AND INDIVIDUALS WHO APPEARED BEFORE THE INQUIRY

Karl Adamsons	—Inspector, OIGB
J. Wallace Beaton	—Real Estate Management and Consultant
Michel Bélanger	—Chairman and CEO, National Bank of Canada
Gerald Bouey	—Governor, Bank of Canada
André Brossard	—Director, Compliance Division, OIGB
Edward Ernst Brauer	—President and CEO, Universal Industries, Lloydminster

William H. Broadhurst	—Chairman and Senior Partner, Price Waterhouse, Toronto
Harvey Brooks	—Vice-President, Western Division, National Bank of Canada
G. Douglas Carr	—Partner-in-Charge, Audit Practice, Peat, Marwick, Mitchell & Co., Toronto Office
John Carchrae	—Assistant Director, Accounting Standards, CICA
Bruce Cockburn	—Vice-President, World Corporate Banking, Royal Bank of Canada
Marshall A. (Mickey) Cohen	—Former Deputy Minister of Finance Government of Canada
Stanley Cook	—Contract Inspector, OIGB (retired, formerly CIBC)
Joseph W. Courtright	—Inspector, OIGB
Jean-Pierre Cristel	—Quebec Securities Commission
W.K. (Bill) Detlefsen	—Partner, Thorne Riddell, Calgary
John T. DesBrisay	—Director, CCB
Alan J. Dilworth	—Senior Partner, Touche Ross and Company
John Easton	—Vice-President, Credit Audit and Corporate Audit, Royal Bank of Canada
Ira Milton Farthing	—Bank of Nova Scotia, retired
Rowland Frazee	—Chairman, Royal Bank of Canada
M. Fortier	—Chief Operating Officer, Northland Bank

R. Donald Fullerton	—Chairman, President and CEO, Canadian Imperial Bank of Commerce
J. Maurice Gaudet	—Senior Vice-President, Special Credits, CCB
Robert Gemmell	—Assistant Vice-President, Wood Gundy, Calgary
Prof. Charles Albert Eric Goodhart	—Chief Economic Advisor, Bank of England
Robert Grandy	—Vice-President and Director, Wood Gundy, Calgary
Neville Grant	—Director, Inspection Division, OIGB
Charles F. Green	—General Manager & Director, Financial Control Division, National Westminster Bank, London
R. Guenette	—Vice-President, Credit, Northland Bank
A. Guetta	—Mathematician
Paul Guy	—President, Quebec Securities Commission
Dr. Hu Harries	—Economic Consultant
James A. Hillman	—Director, CCB
George C. Hitchman	—Deputy Chairman of the Board, Bank of Nova Scotia, retired
Richard Humphreys	—Superintendent of Insurance, retired
Mel Hurtig	—Publisher, Edmonton
W. J. Inwood	—General Counsel and Secretary, Royal Trustco Limited

J.R. Johnston	—Commercial Branch Manager, Toronto-Dominion Bank, Edmonton
Lucille M. Johnstone	—Director, Northland Bank
William A. Kennett	—Inspector General of Banks, OIGB
Gordon W. King	—Director, Capital Markets Division, Department of Finance
R. W. Korthals	—President, Toronto-Dominion Bank
William Krehm	—Author and Economist
R.G.D. Lafferty	—Lafferty, Harwood and Partners, Montreal
A.C. Lamb	—Comptroller and Chief Accountant, Bank of Canada
R.W. Lawson	—former Senior Deputy Governor, Bank of Canada
H. Graham LeBourveau	—Partner, Clarkson Gordon, Calgary
Robert E. Lord	—Managing Partner, Clarkson Gordon, Edmonton
Garth MacGirr	—National Insolvency Partner, Price Waterhouse Limited; Liquidator of CCB
Robert M. MacIntosh	—President, Canadian Bankers' Association
Michael A. MacKenzie	—Partner, Clarkson Gordon, Toronto
Donald M. Macpherson	—Assistant Inspector General of Banks, OIGB
Barbara McDougall	—Minister of State for Finance, Government of Canada
Roderick J. McKay	—Partner, Thorne Riddell, Calgary
Iain McLeod	—Chief Inspector, Northland Bank

Gerald McLaughlan	—President and CEO, CCB
Paul Melnuk	—Vice-President, Controller, CCB
Bill Mitchell	—Partner, Price Waterhouse, Toronto
James A. Morrison	—Senior Partner, Touche Ross and Company, Toronto; Liquidator of Northland Bank
William D. Mulholland	—Chairman and CEO, Bank of Montreal
Steve Mullie	—Assistant Vice-President, Wood Gundy, Calgary
William Neapole	—President and CEO, Northland Bank
A. Opstad	—Consulting Electrical Engineer
Paul B. Paine	—Chairman, CCB
Walter A. Prisco	—President and CEO, Northland Bank (1981-1982)
Cedric Ritchie	—Chairman and CEO, Bank of Nova Scotia
Prof. Brian L. Scarfe	—Professor of Economics, University of Alberta
Prof. Hal Stewart Scott	—Professor of Law, Harvard University
Edward J. Shaske	—Accredited Appraiser, Appraisal Institute of Canada
Guy Shedleur	—Quebec Securities Commission
John M. Sherman	—Independent Businessman and Consultant
Robert V. Shumway	—Director, Division of Bank Supervision, FDIC

D. Skagen	—Director, Northland Bank; Vice-Chairman of the Board, Northland Bank
J. Crawford Smith	—Partner, Clarkson Gordon, Calgary
David E. Smith	—Executive Vice-President, Canadian Credit, CCB
P.A. Smith	—Partner, Coopers and Lybrand, London
Robert Steen	—Deputy Director, Corporate Finance, Ontario Securities Commission
Gordon Tallman	—Vice-President, Commercial Banking and National Accounts for Alberta, Royal Bank of Canada
Allan Taylor	—President and COO (now CEO and Chairman), Royal Bank of Canada
Robert James Taylor	—Royal Bank of Canada, retired
Serge Vachon	—Chairman, Canadian Payments Association, Adviser to Governor of Bank of Canada
R.A. Willson	—Chairman, Northland Bank
Stan Willy	—Chief Inspector, Northland Bank (1983)
Michael Wilson	—Minister of Finance, Government of Canada

C. INDIVIDUALS WHO MADE SUBMISSIONS BUT DID NOT APPEAR BEFORE THE INQUIRY

Professor J. Fisher
School of Business and Economics
Wilfrid Laurier University
Waterloo, Ontario

Edmonton Chamber of Commerce
Sun Life Place
600 - 10123 - 99 Street
Edmonton, Alberta

J.G.M. Clark, F.C.A.
143 Rochester Avenue
Toronto, Ontario

Mr. Alton R. Dahlstrom, LL.B.
Barrister and Solicitor
Rossland, B.C.

Mr. F.K. Drees
Apt. 1201, Queen Elizabeth Hospital
550 University Avenue
Montreal, Quebec

Money and Banking Class 23 AK1
Sheridan College of Applied
Arts and Technology
Oakville, Ontario
Jonathan Wilde, Instructor

John L. Robinson, P. Eng.(ret.),
John D. Robinson, C.A., and
Deborah L. Meyers, C.A.
660-1414 8th Street S.W.
Calgary, Alberta

Mr. O. William Steele, AACI, FRI, CPM
Sterling Real Estate Investment Services
105 - 72 Donald Street
Winnipeg, Manitoba

Mr. Charles H. Teicher
Switzerland

Mr. Milton Weber
6615 Montgomery Street
Vancouver, B.C.

Mr. Alan Welsh, C.C.A.

The Commission received a considerable volume of other correspondence which made no formal submissions.

D. COUNSEL APPEARING AT THE INQUIRY

Government of Canada	Edgar Sexton, Q.C., Toronto M.L. Phelan, Ottawa L.P. Lowenstein, Toronto Ian Binnie, Q.C., Ottawa Graham R. Garton, Ottawa Peter J. Dey Q.C., Toronto
Bank of Canada	Gordon F. Henderson, Q.C., Ottawa Robert M. Nelson, Ottawa George N. Addy, Ottawa
Office of the Inspector General of Banks	Claude R. Thomson, Q.C., Toronto Donald E. Short, Toronto T.B.O.E. McKeag, Q.C., Toronto R. Staley, Toronto
Canada Deposit Insurance Corporation	Charles F. Scott, Toronto
Clarkson Gordon and Thorne Riddell, Auditors of Northland Bank	J.C. Major, Q.C., Calgary
Clarkson Gordon and Peat Marwick, Mitchell Auditors of CCB	J.E. Redmond, Q.C., Edmonton J.W. Beames, Q.C., Edmonton
Certain CCB Directors	Pierre Genest, Q.C., Toronto W.E. Pepall, Toronto K.K. Bell, Toronto
Certain CCB Management	A.T. Murray, Q.C., Edmonton M.J. Trussler, Edmonton D.C. Rolf, Edmonton
The Bank of Nova Scotia and the Canadian Imperial Bank of Commerce	A.J. MacIntosh, Q.C., Toronto W.J. Mandzia
The Royal Bank of Canada	L.Y. Fortier, Q.C., Montreal C.A. Carron, Montreal Joseph A. Day, Ottawa

Northland Bank Directors	J.R. Smith, Q.C., Calgary
Northland Bank Management	T.F. McMahon, Q.C., Calgary S.F. Blyth, Calgary
Her Majesty's Loyal Opposition	A. Lutfy, Ottawa
Price, Waterhouse Limited	E.A. Goodman, Q.C., Toronto J. Ryan, Toronto A. Jacques, Toronto T. Saskin, Toronto B.W. Ashley R. Howard
Mr. H. Brooks	M.A. Putnam, Q.C., Calgary
Bank of Montreal	C.L. Campbell, Q.C., Toronto M. Freiman
Canadian Bankers' Association	J. Frances D. Phillips
Mr. James A. Morrison (Liquidator of Northland Bank), Mr. John Easton, and Mr. Iain McLeod	P.B.C. Pepper, Q.C., Toronto B. Chambers, Q.C.

E. INQUIRY STAFF

Counsel

John Sopinka, Q.C.
Peter Howard
Nigel Campbell
D. McDermott, Q.C.
R. Wildeboer

Executive Secretary

Paul Ollivier, Q.C.

Legal Staff

Jamie Benidickson
David Cohen
James T. Eamon
Katherine J. Young

Bank Auditing Advisor

Vernon Turley

Accounting and Economic Advisors

Gordon A. Brown
Jacques Singer

Assistant Secretary

Donna Stebbing

Supervision of Translation

François Patenaude

F. INQUIRY SCHEDULE

Hearings: Commenced:	WEDNESDAY, OCTOBER 2, 1985
Closed:	THURSDAY, MAY 22, 1986
Total No. of Days of Hearings:	75
Hearing Dates:	Week 1: OCTOBER 2, 1985 (Preliminary Hearing)
	Week 2: OCTOBER 7-9, 1985
	Week 3: OCTOBER 21-24, 1985
	Week 4: OCTOBER 28-31, NOVEMBER 1, 1985
	Week 5: NOVEMBER 4 & 8, 1985
	Week 6: NOVEMBER 18-22, 1985
	Week 7: NOVEMBER 25-30, 1985
	Week 8: DECEMBER 5 & 6, 1985
	Week 9: DECEMBER 9-13, 1985
	Week 10: JANUARY 20-24, 1986

Week 11: JANUARY 27-31, 1986

Week 12: FEBRUARY 3, 6 & 7, 1986

Week 13: FEBRUARY 26 & 27, 1986

Week 14: MARCH 3-7, 1986

Week 15: MARCH 10-14, 1986

Week 16: MARCH 17-21, 1986

Week 17: MARCH 24-27, 1986

Week 18: MAY 12-16, 1986

Week 19: MAY 20-22, 1986

Hearings Held at:

Commission of Inquiry on the Collapse of the CCB and Northland Bank
20th Floor West Tower
L'Esplanade Laurier
300 Laurier Avenue West
Ottawa, Ontario

Supreme Court Building
East Court Room
Wellington Street
Ottawa, Ontario
(October 2 & 7, 1985)

Convention Centre
9797 Jasper Avenue
Edmonton, Alberta
(November 18-22 & 25 & 26, 1985)

Four Seasons Hotel
10235 101 Street
Edmonton, Alberta
(November 27-29, 1985)

	Law Courts Building Edmonton, Alberta (November 30, 1985)
	Palliser Hotel 133 9th Avenue S.E. Calgary, Alberta (Weeks 14, 15, 16, 17 and 19)
Transcripts:	75 VOLUMES Approx. 13,591 pages — public hearings 65 pages — in camera hearings
Exhibits:	Total No. of Exhibits: 249 (plus numerous sub-exhibits)
Witnesses:	Total No. of Witnesses and Individuals who made Submissions to the Inquiry: 85

DUE DATE

16/8/94			

201-6503 Printed in USA