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A Study to Assess the Current Mandate and Operations of The Office of the Inspector General of Banks

Submitted to
The Honourable Barbara McDougall
Minister of State (Finance)
by Coopers & Lybrand

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April 1986

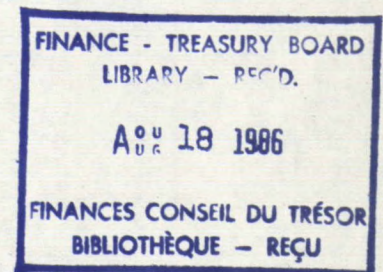


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Chapter 1. Executive Summary

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1.0 Introduction

- 1.0.1 The purpose of this chapter is to provide a brief summary of our main conclusions and key recommendations. We also provide summaries of our terms of reference, the scope of our work and the structure of our report.

1.1 Terms of Reference

- 1.1.1 On November 29, 1985, the Minister of State for Finance, the Honourable Barbara McDougall, announced a study by Coopers & Lybrand under the direction of Warren Chippindale, Chairman and Chief Executive Officer, to "assess the current mandate and operations of the Office of the Inspector General of Banks, with particular emphasis on inspection and related regulatory action and make recommendations for improvement to the overall system of oversight of banks".
- 1.1.2 Our mandate did not include assessment of the issues to be considered in evaluating what changes would be required to accommodate the federal government's proposals under consideration for changes in the regulation of financial institutions. We did not analyze the alternative mandates and organizational structures which could be utilized to achieve the government's policy objectives. We understand these matters will be dealt with subsequently.

1.2 Scope of our Work

- 1.2.1 The general framework for our analysis began with the identification of key issues through a review of the legislation and interviews with senior participants in the banking industry, together with a comprehensive review of Canadian and foreign literature relating to banking regulation. We then examined the existing institutional support system comprising the Office of the Inspector General of Banks (OIGB), bank management, audit committees of boards of directors, the internal auditors, and the shareholders' auditors. Concurrently, we conducted an extensive examination of the operations of the OIGB. This included a review of the organization structure, personnel policies and staffing requirements of the OIGB with a view to assessing its capability to carry out its mandate.

1.3 Structure of the Report

- 1.3.1 We have structured our report to provide a basic understanding of the mandate of the Inspector General of Banks (Inspector), the context in which it has been established, and the results of our evaluation of the current effectiveness of bank supervision and regulation leading to our recommendations. More specifically:
- Chapter 2 provides a brief overview of bank legislation, evolution of Canadian Chartered Banks and the system of supervision and inspection;

- Chapter 3 contains a review of the key issues involved in bank supervision;
- Chapter 4 contains an analysis of the current statutory and operational framework of the OIGB and our observations and recommendations;
- Chapter 5 contains an analysis of bank responsibilities in the supervision and regulatory process, including those of the chief executive officer, audit committee and internal audit department, along with our observations and recommendations;
- Chapter 6 contains a description of the existing structure and nature of shareholders' audit activities and our observations and recommendations; and
- Chapter 7 provides a summary of the implications and effect of our recommendations for improvement to the overall system of oversight of banks on each of the participants.

1.4 Main Conclusions

- 1.4.1 Our study has led us to conclude that the basic "tripartite" structure of bank supervision, under which the OIGB places reliance on assertions by management and on the work of the internal and external auditors, is an appropriate structure for the Canadian banking system. However, we believe there is an urgent need to:
- expand the scope of the OIGB's inspection activities;
 - strengthen the OIGB; and
 - strengthen the chain of accountability among the participants in the system.
- 1.4.2 To provide an appropriate basis for the OIGB's reliance on the work of the internal and shareholders' auditors, we recommend that it should significantly increase the scope of its inspection activity to review and test the work of the internal and shareholders' auditors in sufficient depth to justify its reliance thereon and, where deemed necessary, to conduct additional tests on the bank's financial records.
- 1.4.3 To strengthen the OIGB, we have made recommendations to:
- reorganize the functions of the office;
 - improve the qualifications and experience of staff;
 - increase the staff complement;
 - enhance the training and development of staff;
 - improve the methodologies, practices and programs over:
 - incorporation and licensing;
 - monitoring;
 - research and standards setting;
 - inspection activities;
 - compliance, supervision and regulation; and
 - develop a system of executive interchange.

- 1.4.4 We have also recommended that the Inspection division be relocated to Toronto.
- 1.4.5 To improve the chain of accountability for supervision and inspection, we have recommended a system under which:
- senior bank management would be required to make a written report of assertions to the OIGB with respect to policies and internal controls over main areas of risk;
 - internal auditors would be required to report to the OIGB on the results of their work to monitor compliance with stated policies and to assess the adequacy of the related systems of internal control over the main areas of risk; and
 - the shareholders' auditors would be required to report to the OIGB on their review of management assertions and tests of the above work of the internal auditors.
- 1.4.6 In further support of our main conclusions and recommendations, we have made recommendations to change the provisions of the Bank Act (the Act) to:
- improve the accountability of the Inspector in the exercise of his supervisory responsibilities by assigning to him extended authority and enforcement powers;
 - change the method of obtaining approvals for OIGB budgets and staff requirements;
 - remove the requirement that staff of the OIGB be appointed in compliance with the Public Service Employment Act; and
 - provide that partners of the shareholders' audit firms in charge of bank audits have reasonably extensive experience in auditing banks or similar financial institutions.
- 1.4.7 We have also recommended that the Inspector should request that the Canadian Institute of Chartered Accountants join with him in establishing a joint bank accounting research panel with the object of harmonizing accounting principles for banks with generally accepted accounting principles (GAAP).
- 1.4.8 Despite the recent failure of two small western banks, our study indicated that the quality and stability of the Canadian banking system and related regulatory structure are the envy of other countries. This was particularly evident in our discussions with banking experts in the United States and United Kingdom.
- 1.4.9 We believe that successful implementation of our recommendations would result in the establishment and maintenance of an efficient and effective level of overall system of regulation and supervision of Canadian banks.

1.5 Chronology of Recommendations

- 1.5.0 Having set out our main conclusions, we now list our individual recommendations which are keyed in to the appropriate sections of the report from which they are taken.

Chapter 4. Office of the Inspector General of Banks

4.1 Position of the Inspector

- 4.1.6 The assignment of responsibilities for operational and supervisory matters between the Inspector and the Minister should be reviewed at the next revision of the Act with a view to providing the Inspector with a clearer accountability.

4.5 An analysis of the relationships between the OIGB and other participants

4.5.3 The OIGB should:

- ensure there is a common understanding of the procedures performed by the shareholders' auditors, the bank's internal auditors and the OIGB and their interrelationships;
- communicate in writing the extent of its intention to rely on all or certain of these procedures; and
- carry out such review and examination of the procedures performed so as to ensure they are adequate for purposes of its reliance and to ensure that it is aware of the results of the procedures performed.

4.6 Establishing a requirement for and a basis of reliance on the assertions of management

4.6.5 The OIGB should establish guidelines on internal control over areas of risk. These guidelines would have the following components:

- (a) a requirement for senior bank management to:
- i) identify the key areas of risk which face the bank;
 - ii) outline the key elements of each of these areas of risk including:
 - the relevant bank policies,
 - the significant controls in place to ensure adherence to these policies,
 - the current status of adherence to the stated policies, and
 - planned remedial action to be taken to ensure adhered to stated policies;
 - iii) report to the OIGB on the manner in which the policies and related internal control procedures of the bank operate to:
 - monitor and provide for the timely and effective management of these areas of risk, and
 - ensure the accuracy of the related financial reports submitted to the OIGB;

- (b) a requirement for the bank's internal auditors to examine the components of (a) above and report on their findings to the OIGB; and
- (c) a requirement for the shareholders' auditors to review the management assertions and test the work of the internal auditors, and to report to the OIGB on their findings.

4.7.2 Incorporation and licensing

4.7.2.1 More definitive criteria should be established as a basis for evaluating incorporation applications. Clear statements of the requirements or conditions which could be applied as bases for approvals and rejections would clarify the guidelines for reviewing the applications.

4.7.2.2 There should also be a more systematic provision for conveying any commitments by the bank (such as the business plan) or conditions of approval to the Inspection division for follow-up as the bank establishes business. In the case of Schedule B banks, which are subject to licence renewal reviews, findings from both the monitoring system and the inspection field work will need to be systematically conveyed to the Compliance division to support licence renewal decisions.

4.7.3 Monitoring

4.7.3.2 The database supporting the Early Warning System, which is maintained by the OIGB to serve its own analytical requirements, should be expanded to cover all banks and be developed to provide analyses, ratios and trends which facilitate performance monitoring. The results of bank inspections should be incorporated in the database, together with a rating prepared from consultations between the divisional directors. This would call for a reassessment of current arrangements for data processing and reporting. In addition, the analyses which are prepared should provide commentary and interpretations designed to assist the Inspection and Compliance divisions.

4.7.3.3 We have included in Appendix K, suggestions regarding the review of systems and information requirements, together with an assessment of the contents of the Manual of Reporting Forms and reviews of the division's Quarterly Products Book (the book which contains selected financial information on the banks).

These include:

- (a) Systems and information requirements
 - i) investigating alternatives so as to produce reports in a more timely manner;

- ii) identifying potential applications for computerization; and
 - iii) reviewing current systems arrangements of the office which currently consist of internal and external systems.
- (b) Manual of Reporting Forms
 - i) eliminate redundant reports;
 - ii) expand reporting to include necessary reports (for example, maturity profiles of assets and liabilities);
 - iii) simplify the design of forms in conjunction with those preparing the reports to improve accuracy and reduce preparation time; and
 - iv) as much as possible, eliminate obtaining database information from banks by telephone.
- (c) Quarterly Products Book (financial analysis book)
 - i) establish peer groups for comparative analysis and reporting;
 - ii) develop standardized 8-10 page reports consisting of financial analysis by peer group with significantly upgraded content;
 - iii) reduce time required to produce the quarterly book to 45 days after each quarter-end;
 - iv) establish quality controls and written procedures in connection with preparation of the book; and
 - v) distribute the book to all professional staff within the OIGB.

4.7.3.4 A regular review should be conducted of the reports being requested from the banks to ensure that they are adequate and currently useful, that the related instructions for their preparation are clear and that the reports are being properly completed.

4.7.4 Research and standards setting

4.7.4.1 Internal arrangements should be made to provide regular interaction with representatives of the other divisions to obtain input and comments on research topics and issues should be established.

4.7.4.2 A more formal process for obtaining industry input and response to proposed guidelines and regulations should be established.

4.7.4.3 Finally, the objective served should be clearly outlined in the preamble of each "Exposure Draft" and subsequent guidelines to provide a point of reference for better understanding the specific requirements of what is being proposed or promulgated.

4.7.5 Inspection activities

4.7.5.5 The methodology and level of documentation employed should be structured in a more comprehensive and rigorous manner, so as to provide for:

- (a) the determination of the scope and frequency of the individual inspections to be based on the information provided by the OIGB's internal risk rating and Early Warning Systems;
- (b) more extensive pre-inspection preparation;
- (c) the establishment of specific objectives for each inspection;
- (d) the use of tailored inspection programs to achieve these objectives;
- (e) the use of standardized programs, compliance questionnaires and preferred practice checklists as a means of ensuring the completeness of the recurring areas of the inspection coverage;
- (f) the preparation of written reports covering the results of the inspection and matters requiring further action, which reports would then be distributed to the bank's audit committee and management, the shareholders' auditors and the other concerned divisions within the OIGB; and
- (g) provision for the timely follow-up of the matters requiring further action noted in (f) above.

4.7.5.6 We recommend:

- (a) the Inspection division's mandate be clarified and amplified; and
- (b) definitive and documented divisional policies and procedures be established.

4.7.6 Compliance activities

4.7.6.1 More formal policies and procedures covering the method by which the OIGB should handle different applications and respond to various types of non-compliance and problem situations should be established.

4.7.6.2 A director should be appointed to be responsible for coordinating an Inspector's Advisory Group of experienced personnel to be selected from the banking industry and the professions.

4.8 Organization, mandates and structures

4.8.1 More emphasis should be placed on the divisional mandates of expected results, with additional guidelines on matters such as reporting and relationships which would contribute to the achievement of results.

4.8.2 Standards manuals should be developed in order to provide amplification of each division's mandate.

4.8.3 More formal arrangements should be made in regard to monitoring and channelling communications between the OIGB and the banks in order to ensure a consistency of interpretation, to establish a record of these communications and to provide a point of contact within the OIGB.

4.8.5 The following organization structure changes should be implemented:

- (a) the establishment of a separate Statistical Analysis and Database Management division devoted exclusively to administering, analyzing and reporting meaningful results from the reports required from the banks;
- (b) the establishment of an Inspector's Advisory Group to plan, maintain and carry out programs to assist in the resolution of serious bank problems which may require the use of internal and/or outside specialists;
- (c) the establishment of an Office Services and Records Group to provide administrative, recruiting and personnel support to the OIGB;
- (d) the expansion of the Inspection division to provide middle management and supervisory positions to improve the effectiveness of planning, execution and follow-up of field work;
- (e) the reassignment of responsibilities for bank rehabilitation from the Research division to the Inspector's Advisory Group;
- (f) the reassignment of responsibility for the examination of representative offices of foreign banks from the Compliance division to the Inspection division; and

- (g) the establishment of a committee under the chairmanship of the Assistant Inspector and including the division directors, to review applications and to provide decisions on capital leverage ratios.

4.9 Staffing, personnel and training

- 4.9.1 The OIGB staff should be increased to carry out expanded program requirements and to be able to deal effectively with the issues, problems and concerns which it must address. In overall terms, we would expect the staff to increase from its current complement of about 42 to an expanded complement of about 73.
- 4.9.2 The number of division directors should be increased by two to provide for a director, Inspector's Advisory Group and a director, Statistical Analysis and Database Management division.
- 4.9.3 The director, Statistical Analysis and Database Management division will require an incumbent with extensive analytical training and experience, who is conversant with the technical and reporting issues associated with banks and who can provide leadership in developing systems to provide meaningful and expeditious information.
- 4.9.4 An administrative assistant will be required to support the director of the Inspector's Advisory Group.
- 4.9.5 The Inspection division should be expanded by adding two assistant directors to divide the work of planning, coordinating and directing the field inspection work, which should be expanded as discussed above.
- 4.9.6 The Inspection division should be expanded from eleven to thirty staff, of which about six should be recruited or selected to serve as "in-charge" inspectors with field supervisory and on-the-job staff development responsibilities.
- 4.9.7 The pool of inspection staff should consist of a mix of experienced bank auditors, credit and systems personnel.
- 4.9.8 The Inspection division should also expand its administrative support group by one general secretary and two to three word processing staff to accommodate the additional workload which will arise from the larger inspection group.
- 4.9.9 The importance of the inspection function and the style of inspection, focusing as it does on a management level review, will require senior level skill and experience from its director. We would envisage the incumbent having a profile similar to an audit partner directing bank audits.
- 4.9.10 The Research division, which we have recommended should not be responsible for the monitoring system, should be expanded to reinforce the requirement for well researched advice, guidelines and direction to those who rely on its work.
- 4.9.11 The Research division requires an increase in staff of perhaps two people, but this requirement should be decided upon after having reassessed the qualifications of current staff in relation to anticipated research project needs.

- 4.9.12 The proposed Statistical Analysis and Database Management division which we have recommended be established, should have a director (Section 4.9.2) and two assistant directors.
- 4.9.14 An executive interchange program should be entered into to fill the key positions.
- 4.9.15 An orientation and indoctrination training program for new staff should be established. In addition, a listing should be established of appropriate training programs which can be used in the development of staff. One or more persons within the OIGB should be given responsibility for planning and coordinating the conduct of and participation in training programs.
- 4.10 Recruiting and budgets
 - 4.10.2 The appointment of OIGB staff in accordance with the Public Service Employment Act should be reconsidered as soon as possible.
 - 4.10.3 More flexible arrangements should be made for budget and staff complement approvals which are more suitable to the needs of the office.
- 4.11 Location of offices
 - 4.11.4 A Toronto office should be established to conduct inspection and selected research and compliance activities.

Chapter 5. The Chartered Banks

- 5.1 The Chief Executive Officer ("CEO") and the OIGB
 - 5.1.3 The Inspector should:
 - i) issue a regular written report to the CEOs on the status of various matters under discussion between his office and the various Canadian Bankers' Association (CBA) committees; and
 - ii) undertake a regular program of formal or informal meetings with the CEOs, either individually or, perhaps in the case of the smaller Schedule B banks on a group basis, in addition to the regular meetings currently held between the OIGB and the CBA Executive Council.
 - 5.2.7 The audit committee and the OIGB
 - 5.2.7.3 The Inspector should:
 - (a) issue guidelines setting out the particular procedures his office believes should be followed by an audit committee in discharging its duties under Section 243(3) of the Act. Such guidelines should cover:
 - the composition of the committee;
 - the role of the committee;

- the role of the shareholders' auditors;
- the role of the internal auditors;
- timing of and attendance at meetings;
- review of annual financial statements and the shareholders' auditors report;
- review of the internal auditor's report;
- review of the shareholders' auditors letters to management on internal control; and
- documentation of meetings; and

- (b) undertake a program of meetings with the audit committees, either individually or with groups of audit committee chairmen, to discuss their expectations as set out in the above guidelines and any other concerns that may exist with either party.

5.2.7.4 The OIGB should ensure that a written copy of its annual examination report is sent to the bank's audit committee.

5.3.9 The Chief Internal Auditor and the OIGB

5.3.9.3 The OIGB should develop a consultative process for the issuance of guidelines on preferred practices for internal auditing of banks.

5.3.9.4 The scope of the audit work of the shareholders' auditors should be extended to enable them to report directly to the OIGB on the degree of adherence to any OIGB internal audit guidelines that might be issued and the results of the internal audit work performed.

5.3.9.5 Steps should be undertaken by the OIGB to ensure that, in the case of foreign bank subsidiaries, similar work is undertaken by the parent bank internal auditors and appropriately reported on or, in the absence of such an arrangement, that the shareholders' auditors perform the necessary work.

5.3.9.8 Direct internal audit reporting responsibilities to the OIGB should be implemented, such as:

- (a) on the work performed on identified areas of risk of significant financial loss to the bank in question (e.g. credit and foreign exchange risk);
- (b) on the work performed on areas of potential concern to the OIGB (e.g. the determination of non-performing loan identification and reporting);

- (c) on specific statutory returns submitted by the bank to the OIGB where specific concerns exist (e.g. interest rate risk and asset/liability management); and
- (d) on those sections of the pre-inspection package submitted by the bank to the OIGB on which additional assurance is considered to be necessary.

Chapter 6. The Shareholders' Auditors

6.1 Shareholders' auditors function

- 6.1.1.6 Consideration should be given to amending the Act to require that one of the partners of each of the firms who is to be responsible for the conduct of the audit have reasonably extensive experience in the audits of banks or similar deposit-taking financial institutions.

6.2 The shareholders' auditors and the OIGB

- 6.2.2.2 The OIGB's expressed concerns over its ability to rely on the shareholders' auditors should be more adequately, effectively and efficiently met by:
 - (a) clarification and amendment of the responsibilities of the shareholders' auditors as currently set out in the Act;
 - (b) improvement in the communication between the OIGB and the shareholders' auditors; and
 - (c) the review by the OIGB of the work of the shareholders' auditors to establish a basis for reliance on its results.
- 6.2.3.2 The OIGB should issue guidelines which set out its expectations in respect of reports from the shareholders' auditors and, prior to the issuance of such guidelines, discuss them with its Advisory Committee of Bank Auditors so as to ensure the practicality of its expectations being met.
- 6.2.3.5 The OIGB should:
 - (a) where it is felt to be necessary, meet with the shareholders' auditors prior to the commencement of their audit to ensure that any concerns it may have will be addressed during the course of the work (or, if necessary, that an extension to such work is requested in accordance with Section 242(2) of the Act); and

- (b) undertake a review of the shareholders' auditors working paper files after the completion of the audit.

6.2.3.6 Should there be any question by either the OIGB or the shareholders' auditors as to the accounting principles to be applied, they should so notify each other and resolve the matter as soon as practicable. Where there is some doubt as to the effect of the application of alternative principles, the OIGB should ensure that an extension of the shareholders' auditors work is requested in accordance with Section 242(2) so as to make such a determination.

6.2.3.10 Where the OIGB has specific identified concerns relating to loan loss provisions, they should be addressed with both senior management and the shareholders' auditors of the bank in question. Where the concerns of the OIGB are more general and prudential in nature, then consideration should be given by the OIGB to the issuance of guidelines, as was done in the case of provisioning against sovereign risk loans.

6.2.3.11 The shareholders' auditors should be required to carry out such additional procedures as may be required to enable them to report on the bank's quarterly financial statements. As a practical matter, such reporting could take the form similar to the "negative assurance" rendered on quarterly financial information filed by U.S. corporations with the S.E.C. Since the shareholders' auditors of the major banks usually undertake an informational review of such statements to provide themselves with guidance in the conduct of their annual audit, the framework for the procedures required to enable them to report to the OIGB could most probably be established through an extension of their current activities.

6.3 Accounting principles for banks

6.3.3 The Inspector should request that the Canadian Institute of Chartered Accountants (CICA) join with him in establishing a joint bank accounting research panel to make recommendations to him as to any special accounting considerations that are required for banks, with a view to harmonizing the standard setting process with Generally Accepted Accounting Principles (GAAP). Such a panel should comprise members from the banks, the shareholders' auditors, the investment community and the OIGB.

Chapter 2. Introduction and Background

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2.0 Introduction

- 2.0.1 In this chapter, we summarize the legislative framework for the regulation and supervision of Canadian banks and then give an overview of the Canadian banks, the Bank of Canada and the Canada Deposit Insurance Corporation. We comment upon the tripartite supervisory process and, in particular, on the OIGB. The terms of reference of this study, the scope of our work, and the structure of the report are then set out.

2.1 The Bank Act (Statutes of Canada, 1980-81, Chapter 40) ("The Act")

- 2.1.1 The Act is the primary federal law regulating chartered banks in Canada.⁽¹⁾ The Act is the charter for each of the entities authorized to be a bank, as evidenced by their names being listed in Schedule A or B to the Act.
- 2.1.2 The Act establishes a system of regulation and supervision and the appointment of an Inspector General of Banks.
- 2.1.3 The Act provides a number of prudential measures intended to reduce the potential for problems and to increase the likelihood of adherence to the Act. Some of these provisions are outlined as follows:

Share ownership in Schedule A banks is limited to a maximum of ten percent of the issued and outstanding shares of any class by a single person or associated group (Section 110(1)). This provision is intended to remove the conditions under which a shareholder's ownership of shares would be sufficient to promote his self-interest over the interests of other shareholders, depositors and creditors. The shareholders elect the directors who, in turn, appoint management. The provisions relating to share ownership of Schedule B banks (Section 174(2e)) are less stringent to accommodate foreign bank subsidiaries and the establishment of closely held domestic banks, but such banks are faced with limitations in permissible growth.

- 2.1.4 Section 35 of the Act provides for limitations on the composition of the Board of Directors to avoid undue representation by officers and employees, or from the boards of other Canadian corporations. It also prohibits a director, officer or major shareholder of certain other Canadian financial institutions from becoming a director of a Canadian bank. This provision is intended to strengthen the potential for the board of a bank to be independent.
- 2.1.5 Section 243 of the Act provides for the establishment of an audit committee composed of not less than three directors of the bank, none of whom are officers or employees of either the bank or any of its affiliates. The potential effect of this

⁽¹⁾ The *Quebec Savings Bank Act*, Statutes of Canada, 1980-81, Chapter 40, conforms generally to the provisions of the *Bank Act* and covers the operations of a single savings bank in Quebec.

arrangement is intended to be a further scrutiny of the work and results of the internal and external auditors to reinforce provisions of prudent policies, systems and reports.

- 2.1.6 Part VIII of the Act provides for the establishment of a panel of at least two shareholders' auditors, one of which is to rotate off the audit every two years. This provision is intended to provide a system of checks and balances within the panel of shareholders' auditors. It also provides a greater level of experience and judgement and reduces the potential for conflicts of interest.

2.2 The Chartered Banks

- 2.2.1 The Banks' charters are renewed every ten years in conjunction with the decennial Bank Act revision. As one of the four pillars of the Canadian financial services industry (banks, investment dealers, trust and insurance companies), banks are permitted to accept deposits, to make demand and term loans, including mortgages to individuals and companies, and to invest in securities. They are specifically prohibited from offering trust services and generally prohibited from providing insurance and investment counselling and underwriting services.
- 2.2.2 At October 31, 1985, there were sixty-nine active banks in Canada offering their services through approximately 7,000 Canadian branches as well as many foreign branches. There were 11 Schedule A banks and 58 Schedule B banks. Schedule A banks have an individual ownership limit of 10 per cent and a foreign ownership limit of 25 per cent, while Schedule B banks have no ownership limitations but are restricted as to permissible growth.
- 2.2.3 The banks as a whole are the largest participants in the Canadian financial services industry. Currently, they represent approximately 40 per cent of the total assets of all Canadian financial institutions. Their total domestic and foreign assets were \$434 billion at October 31, 1985, of which \$404 billion were attributable to the Schedule A banks. Total earnings of all the banks for the year ended on that date were \$2.2 billion. The banks range in size from the five largest Schedule A banks, each with assets exceeding \$50 billion and each with branch networks exceeding 1,000, to the five smallest Schedule B banks, each with assets of less than \$75 million. (Appendix A contains selected financial statistics for the individual Canadian banks).

2.3 Bank of Canada and Canada Deposit Insurance Corporation

- 2.3.1 The Bank of Canada, the central bank, has responsibility for monetary policy; acts as the federal government's fiscal agent; and provides liquidity to the banks in its role as lender of last resort. It does not have any bank supervisory responsibilities. The Canada Deposit Insurance Corporation is responsible for insuring depositors at banks and certain other deposit institutions to a \$60,000 limit. It relies on the Inspector General to carry out a number of functions relating to the solvency of its bank members.

2.4 The Regulatory and Supervisory Process

- 2.4.1 The various participants involved in the supervisory and regulatory process are as follows:
- the banks

- the banks' audit committees
 - the Chief Executive Officer, Chief General Manager, Chief Accountant and Chief Internal Auditor of each of the banks
 - the government
 - the Governor in Council
 - the Minister
 - the Inspector
 - the external auditors
 - the shareholders' auditors
- 2.4.2 The supervisory and regulatory arrangements in Canada are referred to as a tripartite surveillance system.
- 2.4.3 The first part is provided within each bank. The 1980 Act required the creation of a bank audit committee comprising independent members of its board of directors to provide a continuing link between the board and its shareholders' auditors. In addition, for many years, the major banks have had internal audit departments, staffed by experienced banking personnel, to carry out audits of branches and head office departments.
- 2.4.4 The second part in the inspection system is provided by the Inspector. As provided in the Act, he has full powers to examine the banks, but relies heavily on the shareholders' auditors and, through them, on each bank's own inspection system in order to carry out his duties.
- 2.4.5 The third part, also created by the Act, is provided by the annual appointment of two external auditors by the bank's shareholders. They report to the shareholders on the financial position of the bank at its year-end and the results of its operations for the year. They also report to the Inspector with respect to large loans on which a loss is likely to occur and on matters which, in their opinion, may affect the well-being of the bank.

2.5 Office of the Inspector General of Banks

- 2.5.1 The supervision of the Canadian banks, the single Canadian savings bank and the Canadian Payments Association, together with the administration of the Act, is the responsibility of the Inspector General of Banks. The Inspector reports to the Minister of Finance and has Deputy Minister status.
- 2.5.2 The Office of the Inspector General of Banks was created in response to the failure of the Home Bank of Canada in 1923. At the time, there were concerns with the concept of a government inspection system on the grounds of cost, efficiency and duplication of work performed by internal and external auditors. Accordingly, the system established was patterned on the United Kingdom method which did not include on-site examinations by the supervisory authorities. For these reasons, and as a result of the small number of Canadian banks and the relative stability of the Canadian banking system, the Inspector's office operated with a very small staff. At March 31, 1974, for example, the total staff complement was four.

- 2.5.3 As a result of changes in competition policy with respect to the provision of financial services as reflected in the 1967 and 1980 Act revisions, the powers of the banks were extended and, more particularly, the number of banks increased dramatically from nine in 1967 to sixty-nine active banks at the end of 1985. The staff complement in the OIGB increased gradually from the mid-1970s and is currently forty-three.
- 2.5.4 The OIGB is organized into three divisions:
- Compliance;
 - Inspection; and
 - Research.
- 2.5.5 The Compliance division is responsible for:
- enforcing standards imposed by the Act;
 - drafting legal documents;
 - advising banks and approving bank activities;
 - representing the OIGB in the legislative process; and
 - carrying out the research required to enable the Inspector to advise the Governor in Council or Minister on applications for the incorporation of new banks.
- 2.5.6 The Inspection division is responsible for:
- maintaining a prudential inspection program to monitor solvency; and
 - assessing compliance with the Act.
- 2.5.7 The Research division is responsible for:
- monitoring the health of the individual banks and of the banking system;
 - developing background positions to support prudential policy and regulatory decisions;
 - developing bank accounting rules and guidelines;
 - monitoring the statistical reports received from the banks; and
 - maintaining the related computerized database.

2.6 The Banking and Supervisory Environment

- 2.6.1 The economic uncertainty resulting from high levels of inflation, extremely high and volatile interest rates and the recession that ensued, created significant problems within the Canadian and international financial systems. As well, efforts to achieve greater competition and efficiency in the financial services industry through deregulation have not been accompanied by a corresponding strengthening of the regulatory system. These and other factors have led to a number of insolvencies of financial institutions in recent years including, in 1985, two banks.

- 2.6.2 The importance of a strong and stable financial system cannot be underestimated. Paul A. Volker, Chairman, Board of Governors of the U.S. Federal Reserve System recently stated:

“Banking is, of course, a business. But it’s not, in my judgement, ‘just another business’. We are the custodians of the money supply and the payments mechanism. The stability and reliability of that system underlies the stability of the financial system and the country.”

2.7 Terms of Reference

- 2.7.1 On November 29, 1985, the Minister of State for Finance, the Honourable Barbara McDougall, announced that a “management consultant study of the operations of the Office of the Inspector General of Banks will be carried out by the national accounting firm of Coopers & Lybrand. It will be directed by Warren Chippindale, Chairman and Chief Executive Officer of the firm, and will be carried out in close consultation with the Department of Finance and the Inspector General of Banks.” “The discussion paper last April recognized the need for broad policies to strengthen the system of inspection and regulation of all financial institutions,” she said. “This detailed management study by Coopers & Lybrand is designed to help provide the information needed by government in developing policies and effective operating procedures in this area.”
- 2.7.2 The specific terms of this assignment are to:
- “assess the current mandate and operations of the Office of the Inspector General of Banks, with particular emphasis on inspection and related regulatory action and make recommendations for improvement to the overall system of oversight of banks”.
- 2.7.3 It was not our mandate to assess the issues to be considered in evaluating what changes would need to be made to accommodate the federal government’s proposals under consideration for changes in the regulation of financial institutions, nor did we analyze the alternative mandates and organizational structures which could be utilized to achieve the government’s policy objectives. We understand these matters will be dealt with subsequently.
- 2.7.4 The partners and senior staff members of the Firm who have participated in this study are listed in Appendix B.

2.8 Scope of our Work

- 2.8.1 The general framework for our analysis began with the identification of key issues through a review of the legislation, interviews with key participants in the banking industry together with a review of Canadian and foreign literature relating to banking regulation. We then examined the existing institutional support system comprising the OIGB, the shareholders’ auditors, the internal auditors, bank management, and audit committees of boards of directors.
- 2.8.2 For any system of supervision and regulation to function effectively and efficiently, it is essential that each of the participants involved in the process have a clear and common understanding of their respective roles and that any concerns they have be addressed and resolved in a manner which enhances their ability to function in a cooperative manner.

- 2.8.3 In order to obtain the views of these participants we:
- reviewed the testimony of the Ministers and the Inspector to the Estey Commission, the House Finance Committee and the Senate Banking Committee;
 - conducted interviews with:
 - the Inspector;
 - four chairmen of bank audit committees;
 - bank management comprising:
 - ten Chief Executive Officers, and
 - four Chief Internal Auditors,from whom we gathered the collective views of the senior management of their banks; and
 - senior partners of four of the other major firms of bank shareholders' auditors.
- 2.8.4 In addition, in order to broaden the base of our understanding of the regulatory process, we interviewed:
- the Governor of the Bank of Canada;
 - the Chairman of the Canada Deposit Insurance Corporation;
 - the federal Superintendent of Insurance; and
 - the Chairman of the Canadian Bankers' Association.
- 2.8.5 The complete list of those interviewed is set out in Appendix C.
- 2.8.6 We conducted an extensive examination of the operations of the OIGB. Our examination included the following:
- interviews with senior and middle management staff;
 - a review of the adequacy of the compliance procedures;
 - a review of the inspection process, including a review of inspection files for three Schedule A banks and three Schedule B banks;
 - consideration of the adequacy of the current inflow of information and the financial institution database;
 - a review of the standards and policy determination system;
 - a review of the early warning and risk assessment process; and
 - a review of the adequacy of the reporting systems within the OIGB.
- 2.8.7 We reviewed the organization structure, personnel policies and staffing requirements of the OIGB with a view to assessing its capability to carry out its mandate.
- 2.8.8 We reviewed the inspection manuals of the U.S. Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

- 2.8.9 We also performed an extensive review of Canadian, United Kingdom, United States and other literature relating to existing regulatory systems and proposed changes thereto. A bibliography of the literature reviewed is set out in Appendix D. A comparison of bank regulation systems is set out in Appendix E, and a comparison of proposed changes currently under consideration to financial institution supervision is set out in Appendix F. A comparison of selected operating statistics relating to Canadian and United States supervisors and deposit insurers is set out in Appendix G.
- 2.8.10 Finally, we developed our recommendations.

2.9 Structure of the Report

- 2.9.1 We have structured our report to provide an understanding of the mandate of the Inspector, the context in which it has been established, and the results of our evaluation of the current effectiveness of bank supervision and regulation.
- 2.9.2 In Chapter 3 we discuss the key issues which must be dealt with in a bank supervisory system. In Chapter 4 we provide an analysis of the legal framework and operations of the OIGB and present our recommendations for strengthening the OIGB. In Chapter 5 we review the role of banks in the supervisory system. In Chapter 6 we review the role of the shareholders' auditors, including its professional accounting body. In Chapter 7 we summarize the effect of our recommendations on the roles and responsibilities of the main participants.

Chapter 3. The Key Issues Involved in Bank Supervision

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3.0 Introduction

- 3.0.1 The Act is the point of reference for understanding the mandate of the OIGB. Translating that mandate into workable programs and accountabilities requires a recognition of the basic issues and risks inherent in the banking industry. In this chapter, we discuss the key issues which have become apparent from our research and interviews.

3.1 Banking Risks and Government Competition Policy

- 3.1.1 There are inherent risks in government policy initiatives to increase competition within the banking industry by encouraging the formation of new banks. These institutions, being new and small, are often formed and initially operated without the advantage of adequate portfolio diversification or a stable deposit base. These may be goals which management will strive for, but are likely to take some time to achieve. Accordingly, the OIGB must evaluate the risks inherent in these situations at the time of reviewing the application for incorporation and during its formative years. The prudential requirements which would likely be imposed by the OIGB on these banks to limit their vulnerability to risks could constrain their ability to grow. The OIGB may, for example, require a higher ratio of capital to assets to increase the bank's capacity to absorb losses which would limit its growth.
- 3.1.2 A key conceptual issue is the degree of flexibility the OIGB should have in the application of normal prudential requirements to the formation and operations of banks.

3.2 The Major Areas of Risk

- 3.2.1 The business of banking is essentially the management of risk. The management of a bank is responsible for containing risks within the financial capacity of the bank. One role of the OIGB is to understand and monitor the various classes of risks which could cause a bank to experience serious financial difficulties. The key issue in this regard is the extent to which the major risks are understood and effectively monitored.
- 3.2.2 There is a widespread practice among international banking regulators of focusing on the following classifications of performance criteria:
- capital adequacy;
 - asset quality;
 - management quality;
 - earnings quality; and
 - liquidity.

This convenient classification system, referred to as CAMEL, is based on the premise that the financial performance and position of a bank could be directly influenced by weaknesses and deficiencies identified in these groupings. A brief description of the considerations which can be associated with each class is presented for illustrative purposes.

3.2.2.1 Capital Adequacy

- The sufficiency of capital in relation to the bank's deposit and other actual and contingent liabilities and the quality of its assets.
- The composition of the capital structure, the ranking of claims by class, the permanency, the cost, and the nature of interest and dividend commitments.
- The ability to sustain growth through adequate earnings and retention thereof.

3.2.2.2 Asset Quality

- The quality of existing assets in respect of default risk including income, collectability and quality of underlying security.
- The extent and quality of security for assets and lending commitments not recorded on the balance sheet.
- The nature of the exposure to interest rate risk and the extent of portfolio diversification in terms of individual borrower, industry and geographic concentration.
- The extent of delinquency and losses.
- The adequacy of prudential provisions for future losses.

3.2.2.3 Management Quality

- The character and experience of senior management in key positions.
- The historical pattern of decisions and results.
- The commitment to effective controls and prudential policies.
- The quality of strategic and operational plans and budgets.
- Market share trends.
- The credit rating of the bank and evaluations by financial analysts.
- Commitment to and control over technological change.

3.2.2.4 Earnings Quality

- The exposure to risk from adverse interest rate and foreign exchange rate changes.
- The extent of overhead and other non-interest operating costs.
- The size and stability of interest margins and net profits.

- The pattern of unexpected performance variances.
- The extent and adequacy of contingency planning.

3.2.2.5 Liquidity

- The pattern of asset and liability maturities.
- The adequacy of liquidity resources.
- The extent of provisions for operating liquidity over and above statutory requirements.
- The quality and diversification of funding.

3.2.3 This list of considerations has been abbreviated and is merely indicative of the kinds of considerations involved in monitoring the performance and position of banks.

3.2.4 A key issue is the extent of specific arrangements required within the OIGB to enable it to monitor reported information on these areas of potential vulnerability, and to ensure that they are effectively examined and evaluated on a timely basis as part of the supervisory process.

3.3 Stages in the Supervisory Process

3.3.1 There are three basic stages in the supervisory process:

- incorporation and licensing;
- monitoring and inspection; and
- responding to evidence of problems.

3.3.2 A key conceptual issue is the extent to which the OIGB is organized adequately in terms of the quality and quantity of staff to satisfy the different needs in each of these areas.

3.4 Authorizing Bank Incorporations and Issuing Licences

3.4.1 The authorization of bank incorporations and the issuance of licences to conduct banking are important responsibilities and have a bearing on the potential risk profile of the industry. The recommendations of the Inspector at this stage of the supervisory process are critical to containing the threat of undue risk to the stability of the banking system. Accordingly, the criteria established for authorizing new entrants to the industry, and the procedures employed in ensuring that the criteria are met, are important issues.

3.4.2 There are two sets of considerations which are involved in the evaluation of bank incorporation applications. One set relates to the character, business experience, banking experience, financial capacity and other characteristics of the principals associated with the application and their proposed role in management and the board of directors. The second set relates to the feasibility of the business plans of the proposed bank in regard to its funding, asset development, portfolio diversification, capitalization and back-up financial support. An evaluation of these considerations against a checklist of some established minimum requirements

should be made by the OIGB in order to minimize the prospect of bank failures and future supervisory difficulties.

- 3.4.3 It is also important for the OIGB to monitor adherence to the proposed business plan. Deviations from the plan of any significance, particularly in regard to changes in key personnel, funding sources, overall risk profile and capitalization, may warrant early corrective action at the instigation of the Inspector. This will also be the case where banks are involved in conversions, amalgamations and mergers.
- 3.4.4 The key conceptual issues with respect to new entrants are the determination of minimum entry criteria and the close monitoring of performance subsequent to incorporation or merger/amalgamation.

3.5 Monitoring and Inspection

3.5.1 Role of OIGB

- 3.5.1.1 A primary role of the OIGB is to supervise the banks to identify emerging problems early enough to be able to initiate timely and effective corrective action. There are three basic areas of activity:
 - (a) receipt and analysis of required reported information directly from the banks;
 - (b) monitoring information received from sources other than the reporting banks (for example, information on national and regional economic trends, international problems and each bank's deposit interest rates); and
 - (c) conducting inspections or examinations of the banks to make on-site evaluations of their affairs.
- 3.5.1.2 The supervisory focus must be to ensure compliance with the prudential requirements of the Act, as well as the regulations, directives and guidelines, with the ultimate objective of maintaining the solvency of the institution and the system. Accordingly, the supervisory process needs to be supported by a capacity to research and issue appropriate requirements which serve as bench marks for compliance.
- 3.5.1.3 The conceptual issue with respect to monitoring and inspection is that these functions must be managed as an integrated and related set of activities in order to provide a current and realistic indication of the financial condition and performance of each bank and the likelihood of its encountering problems.

3.5.2 The monitoring role

- 3.5.2.1 The conceptual issue which is central to the monitoring role is the nature, frequency, content and reliability of the information required to be reported to the OIGB. This information serves as a major reference point for monitoring the financial position and performance of each bank. It needs to contain those elements which reflect the major risks and trends being experienced by each bank. The results of the analysis of this information should provide the OIGB with the earliest indications of emerging unfavorable trends,

problems and other concerns. Such data will be important to the field inspection staff or others engaged by the OIGB, to follow up on specific areas of concern to ensure that they are being dealt with satisfactorily by the bank in question.

3.5.2.2 The information required to be reported to the OIGB should consist of two basic types:

- the required financial and statistical information for analysis; and
- information which indicates the prospects of future changes in the personnel or operations of the bank (for example, notifications of changes in the board of directors, senior management, organization structure or major areas of business).

3.5.2.3 Experience in other regulatory jurisdictions has indicated that these kinds of changes are often very early indicators of future problems and warrant being monitored and reviewed.

3.5.2.4 Provisions need to exist to ensure that the information received is appropriate, complete and accurate. It may well be the case for some banks that the information required by the OIGB cannot be taken directly from the formal financial records of the bank in a way which would render it easily reconcilable to the bank's regular financial reports. Furthermore, if a bank were to begin to experience financial difficulties, particularly in regard to the quality of asset portfolios, management may not be sufficiently diligent in reporting the facts to the OIGB in a manner which meets its requirements.

3.5.3 The inspection role

3.5.3.1 In addition to the OIGB, there are a number of participants involved in the conduct of examinations and inspections of banks. These include the audit committee of the board of directors of each bank, the bank's internal audit department, and the shareholders' auditors. A key issue is the extent to which the OIGB can reasonably rely on the examination work done by these other participants. A related issue is the extent of inspection required by the OIGB to establish a satisfactory basis for such reliance.

3.5.3.2 The arrangements for bank supervision and the extent of on-site bank examinations vary considerably between countries. There are four basic alternative approaches to bank regulation and supervision.

3.5.3.2.1 The first approach is for the supervisor to rely on the work of the internal and shareholders' auditors, with little or no work being carried out to establish the basis for such reliance. The United Kingdom system is based on this approach. It does not result in the supervisor having established any basis for reliance on the work of the other participants in the system.

3.5.3.2.2 The second approach is for the supervisor to rely on the work of the internal and shareholders' auditors and to carry out the work necessary to establish a basis for such reliance. This approach, if effectively carried out, establishes such a basis for reliance.

The Canadian system is theoretically based on the this approach, but the work carried out to establish a basis for reliance is completely inadequate.

3.5.3.2.3 The third approach is for the supervisor to engage the services of an independent auditor to carry out an examination of those areas already reported on by the bank's internal and shareholders' auditors and any other areas of concern to the supervisor. This approach is used in Belgium.

3.5.3.2.4 The fourth approach is for the supervisor to carry out an examination of those areas which may or may not have already been reported on by the bank's internal and shareholders' auditors and any other areas of concern to the supervisor. This approach is used in the United States.

3.5.3.2.5 The third and fourth approaches are based on the assumption that a basis for reliance on the work of the other participants in the system cannot be established and, either because such work does not exist or because of the low quality of the work which does exist, it is not feasible to establish a basis for reliance.

3.5.3.3 While there is an extensive amount of internal and shareholders' audit work being carried out in the Canadian banking industry, recent events have indicated an obvious need for the OIGB to establish an adequate basis for its reliance on the work of these other participants in the system. Our study has indicated that the OIGB must carry out the work necessary to establish a basis for its reliance.

3.5.3.4 It stands to reason that with respect to banks experiencing serious difficulties, the OIGB may need to conduct or have conducted, extended in-depth, on-site examinations in order to become thoroughly apprised of their nature. Because the incidence and timing of such difficulties cannot be forecast with accuracy, a further issue is the extent to which the OIGB should maintain a full complement of personnel to conduct these examinations or whether it should adopt a coordinating role, using outside resources which could be engaged as required.

3.5.4 Research, standards and guidelines

3.5.4.1 The effectiveness of reporting to the OIGB will depend on the relevance of the issues to be reported on, the clarity with which the requirements for the reports are made known to the banks and the extent to which the OIGB conducts meaningful analyses of the information reported. Furthermore, there is a need to set prudential standards for accounting and reporting to the public as well as to the OIGB. The issue inherent in these basic requirements is the adequacy of the accounting standards applied to banks and of the guidelines and accounting directives provided by the OIGB.

3.5.4.2 Two aspects of this issue are of particular importance. One is the effectiveness with which technical concerns are identified and dealt

with in the OIGB guidelines and directives. The other is the process by which the guidelines and directives are developed and field tested to achieve both understanding by the banks and acceptance that they deal satisfactorily with the areas of concern.

3.6 Responding to the Evidence of Problems

- 3.6.1 A key issue in assessing the effectiveness of the supervisory and regulatory roles is the extent to which information identifying emerging problems is responded to promptly and appropriately. It is not sufficient merely to identify that the problem exists. Accordingly, there must be provision for various types of responses as required by different situations. The level and extent of the response need to reflect the nature and seriousness of the identified problem. In the end, specific directives may be required, or, in more serious situations, the appointment of a curator or a liquidator may be called for. Whatever the situation, a related issue is the effectiveness with which the OIGB can enforce the required changes in situations of disagreement over the appropriate corrective action.

3.7 Roles and Mandates in Problem Situations

- 3.7.1 There is further need for clarification of the roles and responsibilities of the Bank of Canada, the Canadian Payments Association and the Canada Deposit Insurance Corporation in relation to the Inspector under various sets of circumstances. For the overall system of supervision and regulation to function effectively, there needs to be a clear understanding of when and how each participant becomes involved and what his specific responsibilities and accountabilities are.
- 3.7.2 For example, as a bank begins to experience liquidity difficulties and draws on the Bank of Canada for support, we would expect a formal communication to occur between the Bank of Canada and the Inspector. Further, a specific response would be required by the Inspector outlining the intended investigation to be undertaken where the credit accommodation has exceeded either a specified dollar value, or remains outstanding beyond a specified period of time.
- 3.7.3 Similarly, when a bank's financial difficulties reach a stage where its solvency is threatened, we would expect to see a formal communication between the Inspector and the CDIC leading to the latter's participation in discussions concerning remedial action or action resulting in the appointment of a curator or liquidator.
- 3.7.4 In the same way, we would expect that the Inspector would enter into formal communications with the Canadian Payments Association in the event that serious financial difficulties are encountered by a bank which could threaten its ability to meet its clearing obligations.
- 3.7.5 There is a need for arrangements to be in place which clearly delineate the roles and responsibilities of each of the key participants in the supervisory and regulatory process under each of the kinds of problem situations which can be envisaged. However, this is not within the scope of this study.

3.8 Concluding Comments

- 3.8.1 The key issues which have been identified in this chapter provide an important point of reference for evaluating the adequacy and effectiveness of the supervisory and regulatory process relating to banks. These issues are summarized below:

1. the degree of flexibility the OIGB should have in the application of normal prudential requirements to the formation and operation of banks;
2. the extent of specific arrangements required within the OIGB to enable it to monitor, examine and evaluate reported information on key risk areas;
3. the extent to which the OIGB is organized adequately and has the quality and quantity of staff to meet the needs inherent in the supervisory process;
4. the determination of minimum entry criteria for new entrants into the banking system and the close monitoring of performance subsequent to incorporation or merger/amalgamation;
5. the management of the inspection and monitoring roles within the OIGB as an integrated and related set of activities in order to provide a current and realistic indication of the financial condition and performance of each bank and the likelihood of its encountering problems;
6. the adequacy of the accounting standards applied to banks and of the guidelines and accounting directives provided by the OIGB;
7. the extent to which information identifying emerging problems is responded to promptly and appropriately; and
8. a need to clarify the roles in problem situations of other participants in the system including the Bank of Canada, the Canadian Payments Association and the Canada Deposit Insurance Corporation.

Chapter 4. Office of the Inspector General of Banks

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4.0 Introduction

- 4.0.1 The Act provides that the government, represented by the Minister, has an overall accountability for regulating banks and banking in Canada. This is the context within which the role of the Inspector is defined. In this chapter, we examine the legal framework surrounding the role and operations of the OIGB; its interpretation of its responsibilities and its chosen style of management; conditions leading to the need for change in the OIGB and, based upon our field work, recommendations to strengthen the organization structure, staffing and programs of the OIGB.

4.1 Position of the Inspector

- 4.1.1 Part IX of the Act, entitled, "Supervision", provides that the Governor in Council, on the recommendation of the Minister "shall appoint a person who in his opinion has had proper training and experience to be the Inspector General of Banks" (Section 245(1)). Furthermore, he shall "hold office during good behaviour" (Section 245(2)). The Act goes on to require that "the order in council providing for the removal of the Inspector General of Banks and documents relating thereto shall be laid before Parliament" (Section 245(3)). The Inspector General of Banks "shall be an officer of the Department of Finance" (Section 245(6)) and "shall be responsible to the Minister generally for the administration of this Act" (Section 246(1)).
- 4.1.2 The Act provides that the Inspector be a senior appointment, at the deputy ministerial level, of a person with directly relevant training and experience who will function with some measure of independence in the supervision of banks and banking. The reference to holding the office during "good behaviour" is such that the cause for removal must be "misbehaviour, incapacity, inability or failure to perform properly" (Section 245(2)), rather than a loss of favour of the government. The reference to the need to lay the documents before Parliament relating to the removal of the Inspector indicates further a provision for open scrutiny of the circumstances which led to the removal. These provisions serve to reinforce a measure of independence of the Inspector from the need to be unduly influenced by political considerations.
- 4.1.3 The Act provides that it will be the Minister (and/or the Governor in Council) who will be the authority for most major decisions in regard to regulating banks. For example, it is the Minister who issues letters patent incorporating a bank (Section 7(2)) or enlarges or extends the scope of a shareholders' auditors audit where the public interest may require (Section 242(2)) or makes regulations governing banking (Section 315). In Part X it provides for Ministerial approval of applications for conversions, amalgamations and the sale of assets on winding up a bank. The Act further provides for the establishment of regulations (Section 315) and directives (e.g. Section 175(1)) by the Minister which can be designed to establish basic prudential requirements for all banks. Accordingly, the Act provides the potential for a considerable degree of involvement in bank regulation by the Minister.
- 4.1.4 The Inspector's responsibility is depicted as being more restrictively that of a supervisor, examiner and administrator. However, the day-to-day work of the

Inspector and his staff has included extensive involvement in regulation, albeit mainly by "moral suasion". It could be argued that the sharp division of responsibility in the Act between regulatory authority and supervisory authority could lead to situations where the role of the Inspector could be perceived to have been weakened by the need to obtain Ministerial authority for enforcement.

4.1.5 The government has published draft amendments⁽²⁾ to the Act which would provide the Inspector with much increased powers of enforcement. Proposed changes to Section 313.1(1) would provide that

- "Where, in the opinion of the Inspector, a bank or any person in respect of a bank is committing or pursuing or is about to commit or pursue any act or course of conduct that is an unsafe or unsound business practice, the Inspector may direct the bank or person to:
 - (a) cease or refrain from doing the act or pursuing the course of conduct; or
 - (b) perform such acts as in the opinion of the Inspector are necessary to remedy the situation."

4.1.6 The proposed amendments in Section 313.2 provide for an appeal to the Minister regarding the directive issued by the Inspector. This arrangement of responsibilities between the Inspector and the Minister appears to us to be more practical and functional than that currently provided in the Act. Accordingly, **we recommend that the assignment of responsibilities for operational and supervisory matters between the Inspector and the Minister be reviewed at the next revision of the Act with a view to providing the Inspector with a clearer accountability.** Policy responsibilities and those relating to major regulatory decisions which could affect the financial markets would continue to be assigned to the Minister.

4.2 OIGB Powers to Carry Out Its Mandate

4.2.1 Specific provision is made for the Inspector to make an annual "examination and inquiry into the business and affairs of each bank as the Inspector may deem to be necessary or expedient" (Section 246(2)). The purposes of the examination and inquiry are specifically outlined in that Section as follows:

- "satisfying himself that the provisions of this Act having reference to the safety of the interests of the depositors, creditors and shareholders of the bank and other provisions of this Act are being duly observed", and
- "that each bank is in a sound financial condition" and "at the conclusion of each examination and inquiry shall report to the Minister on his findings" (Section 246(2)).

4.2.2 The Act reinforces the right of examination by the Inspector, or a person acting under his direction, by giving him the right to access all the records and securities held by a bank and by entitling him to require that the directors, officers and auditors of a bank furnish such information and explanations as he may require pertaining to the bank or any corporation included in the bank's consolidated financial statements (Section 246(5)). The Inspector is also provided with the

⁽²⁾ Proposed amendments to the *Loan Companies Act*, the *Trust Companies Act*, the *Bank Act* and the *Quebec Savings Banks Act* in respect of certain regulatory matters, November 29, 1985, The Minister of State (Finance).

powers of a commissioner appointed under Part II of the Inquiries Act to obtain evidence under oath if he so wishes (Section 246(6)).

- 4.2.3 The Act makes several provisions which are intended to enforce compliance with the Act. Some examples are given as follows:
- the Minister may issue directives to a bank to require compliance with capital adequacy and liquidity matters (Section 175(1));
 - the Minister may also make regulations for carrying out the provisions of the Act (Section 315);
 - the Inspector may seize the assets of a bank in order to enable him to conduct the examination and inquiry he deems necessary (Section 246(2));
 - in the case of a Schedule B bank, which must operate under a short-term licence, the Minister may set restrictions and conditions on carrying on business, may change the duration of the licence or may decide not to renew it (Section 28(5,6,7)); and
 - if a bank becomes insolvent, the Minister may appoint a curator to protect the public interest, which may then lead to the court appointment of a liquidator, where appropriate (Sections 276 to 282).
- 4.2.4 Section 314, along with other sections relating to specific situations, provides generally for fines or imprisonment for those convicted of any offences under the Act not provided for specifically.
- 4.2.5 The Act assigns considerable authority to the Minister to ensure bank compliance with its specific requirements. By monitoring the financial performance and condition of the banks, the OIGB may identify situations requiring either the publication of general regulations or the issuance of directives to specific banks to ensure the adequacy of capital or liquidity. Should the Minister want additional information on the affairs of a bank, the Inspector may be directed to make an examination or inquiry (Section 246(2)) or the shareholders' auditors may be directed to extend the scope of their work (Section 242(2)). Based on what is learned, the Minister may then require the bank to correct the problem situation. Should the bank not respond to a simple request to do so, the formal authority of the Minister under the Act may be exercised by issuing a directive or publishing regulations and then requiring compliance. In extreme cases the Minister may initiate legal proceedings under one of the sections providing for fines or imprisonment for offences.
- 4.2.6 There appears to be a view which indicates further that the powers of enforcement provided in the Act could be difficult to execute if they were challenged in court, with the result of at least slowing down, if not preventing, the Inspector from achieving the desired corrective action within a problem bank.
- 4.2.7 The recent draft amendments to the Act referred to in section 4.1.5 appear to deal with these concerns.

4.3 The OIGB's Interpretation of its Responsibilities and its Chosen Style of Supervision

- 4.3.1 In sections 4.1 and 4.2 above, we have outlined the statutory authorities and responsibilities of the Inspector. Based on an analysis of the OIGB submission to the Estey Commission and on our discussions with the Inspector, his understanding

and interpretation of the role of his office and the chosen style of supervision can be summarized as follows:⁽³⁾

- (a) The authority and responsibilities of the OIGB are:
 - to administer the Act;
 - to examine the business and affairs of each bank in the interest of the safety of its depositors, creditors and shareholders;
 - to advise the Minister on policy matters respecting banks and banking; and
 - to bring questions of compliance with the Act or the level or quality of service to the attention of individual banks (as a result of enquiries or complaints from the public). (This is not a legislated responsibility and the OIGB has no powers in this regard.)
- (b) The principal role of the OIGB is one of "prudential supervision", primarily in respect of:
 - "(1) the protection of the interests of creditors and, even more importantly, depositors of each banking institution in Canada; and
 - (2) the maintenance of the health of, and public confidence in, the banking system as a whole."
- (c) To achieve this role requires:
 - "regular monitoring of factors pertinent to the assessment of both systemic health and the condition of particular banking institutions, including:
 - (1) trends and developments in national and international banking practice;
 - (2) ramifications for the overall system of the condition of troubled banks;
 - (3) the overall health of the system as revealed by aggregated bank financial information;
 - (4) economic and financial trends and developments and conditions both nationally and internationally."
 - "Monitoring of both aspects of prudential concern (supervision) is effected through a complex of regulatory techniques directed at both the collection and analysis of a mass of information and at the exercise of influence on bank behaviour."
- (d) The regulatory approach of the OIGB has been to attempt to strike an appropriate balance between the independence of the Inspector (as set out in the Act) and the responsibility to the Minister for the administration of the Act.
- (e) The OIGB sees the most significant policy underlying the Act as being "that banks are to operate in an environment independent of excessive

⁽³⁾ Quotations used in Section 4.3 are from the OIGB submission to the Estey Commission.

government regulation". (This policy is viewed by the OIGB as emphasizing the importance to banking of competition and market discipline.)

- (f) As background to an explanation of its chosen style of supervision, the OIGB makes reference to the Porter Commission Report of 1964, wherein it is stated:

"The main job of the government authority must be to stimulate the financial institutions to create their own internal regulation. The authorities should rely heavily on such self-regulation and on the shareholders' or members' audit once satisfactory standards have been developed. Such an approach is both more effective and more economical than building up a large and costly staff which would unnecessarily duplicate work already done."

- (g) As recommended by the Porter Commission, the OIGB has continued to use moral suasion as "the regulatory instrument of choice". While some participants have described the resultant OIGB style as being "reactive" and therefore unsatisfactory, the Inspector sees a clear difference between being "reactive" and being "passive". To the Inspector, being reactive means "making it clear that it is the responsibility of management to ensure the bank is well and prudently run."

In the view of the Inspector, it is the responsibility of the OIGB "to evaluate how well management is performing its responsibilities and encouraging improvements where necessary" – to react to "demonstrated performance."

- (h) In the view of the OIGB "there are two important considerations which influence the appropriate regulatory approach to the Act: confidentiality and resources." In its view:

- confidentiality has played an important role in maintaining both borrower and depositor confidence; and
- restrictions on the personnel and funding available to the OIGB have imposed practical limitations on the manner in which information is gathered about banks, and on the manner in which bank behaviour is sought to be influenced.

Having stated this, it nevertheless questions whether significantly more resources and a more rigid regulatory framework could actually prevent bank failures.

- 4.3.2 In summation, the OIGB notes that "the ability and effectiveness of the Inspector in fostering the ideal of a self-regulating banking system is dependent on the existence of various "statutory" and "institutional" supports to the supervisory process. The adequacy of supervision thus depends not only on the effectiveness of the operations of the OIGB, but also on the integrity and efficiency of other participants as well. The supervisory system created by the Act is thus not so much a single authority as it is a system of checks and balances."

4.4 The Conditions Leading to the Need for Change in the OIGB

- 4.4.1 The expansion since 1967 of the number of banks operating in Canada and the kinds of changes in financial markets and technologies affecting the banking

industry have given rise to the need to upgrade and alter the provisions within the OIGB for bank supervision and regulation. While this upgrading process is well underway and a number of positive changes have been initiated by the OIGB, the process must be expanded with a significantly greater sense of urgency. With respect to the tripartite system, we have found that there is a need to clarify the interdependencies between the three participants and their respective accountabilities. The OIGB will need to be strengthened in its capacity to monitor, inspect and regulate the banking industry. This will also call for new requirements for bank management, audit committees, internal auditors and shareholders' auditors.

4.5 An Analysis of the Relationships Between the OIGB and the Other Participants

- 4.5.1 The understanding of each of the participants in the banking industry as to their individual roles and responsibilities in regard to bank supervision and regulation is based on their interpretation of the Act as well as on the day-to-day practices that have developed in their dealings with the OIGB, the shareholders' auditors and each of the other participants in the banking system involved in the process. In the interests of the efficient and effective functioning of the system, there must be a common understanding between the OIGB and each of the participants with whom he deals in the course of the regulatory and supervisory process.
- 4.5.2 A comparison of the shareholders' audit fees and internal audit costs to the annual operating budget of the OIGB of \$2.3 million, reveals that over 97 per cent of the resources being devoted to audit and supervision of Canadian banks is external to the OIGB. In the interests of efficiency and effectiveness, we believe that the OIGB should make the greatest possible use of the work performed by both the internal and external auditors and of the review procedures performed by the audit committees. For this reason, we have rejected the United States system of extensive examination by government inspectors as being a duplication of effort.
- 4.5.3 Recent experience dictates the need for the OIGB to establish a sound and well documented basis for such reliance. **Accordingly, we recommend that the OIGB should:**
- **ensure there is a common understanding of the procedures performed by the shareholders' auditors, the bank's internal auditors and the OIGB and their interrelationships;**
 - **communicate in writing the extent of its intention to rely on all or certain of these procedures; and**
 - **carry out such review and examination of the procedures performed so as to ensure they are adequate for purposes of its reliance and to ensure that it is aware of the results of the procedures performed.**
- 4.5.4 Our detailed recommendations on the action to be taken by the OIGB in this regard are set out below.

4.6 Establishing a Requirement for and a Basis for Reliance on the Assertions of Management

- 4.6.1 In Chapter 3 we addressed the issues which the OIGB currently faces in relation to its reliance on bank audit committees, bank management and the shareholders' auditors, and indicated a need for the OIGB to establish a basis for its reliance on

the work of these participants and on the resulting financial information being received. Our specific recommendations are set out in Section 4.7.

4.6.2 To enhance the ability of the OIGB to rely on the financial information produced by the banks which has not yet been subjected to audit procedures (i.e. current information on conditions and trends being monitored by the OIGB), it must establish a basis for reliance on the effectiveness and continued operation of the policies and internal control systems of the individual banks and on the information produced by those systems.

4.6.3 In establishing such reliance, the OIGB needs to have a reasonable level of assurance that:

- (a) the individual banks have properly identified the key areas of risk with which they are faced; and
- (b) adequate policies and systems of internal control exist and are in use to:
 - i) monitor and allow for the timely and effective management of those areas of risk; and
 - ii) ensure the accuracy of the related financial reports submitted to the OIGB.

4.6.4 Since the required elements for the evaluation of such risk control mechanisms already exist in the work of the internal auditors, the shareholders' auditors and the audit committees, the OIGB should seek to gain the assurance it requires through the use of the work of these participants.

4.6.5 **Specifically, we recommend that the OIGB establish guidelines on internal control reporting over areas of risk. These guidelines would have the following components:**

- (a) **a requirement for senior bank management to:**
 - i) **identify the key areas of risk which face the bank;**
 - ii) **outline the key elements of each of these areas of risk including;**
 - **the relevant bank policies,**
 - **the significant controls in place to ensure adherence to these policies,**
 - **the current status of adherence to the stated policies, and**
 - **planned remedial action to be taken to ensure adherence to stated policies;**
 - iii) **report to the OIGB on the manner in which the policies and related internal control procedures of the bank operate to:**
 - **monitor and provide for the timely and effective management of these areas of risk, and**
 - **ensure the accuracy of the related financial reports submitted to the OIGB;**
- (b) **a requirement for the bank's internal auditors to examine the components of (a) above and report on their findings to the OIGB; and**

- (c) **a requirement for the shareholders' auditors to review the management assertions and test the work of the internal auditors, and to report to the OIGB on their findings.**
- 4.6.6 In Appendix H, we set out an illustrative example of how such reporting might be structured, as well as some of the issues therein that would need to be addressed.
- 4.6.7 Although the institution of such requirements will require consultation with the banks and the shareholders' auditors on the reporting issues that will likely arise, we believe that such a system represents a workable and economical method of providing the OIGB with the assurance it needs on the key areas of risk within the banking system.

4.7 Improving Supervisory and Regulatory Programs

- 4.7.1 In Chapter 3 we outlined the key issues associated with the supervision and regulation of banks and discussed various aspects of the required programs and activities. Against this background, our detailed evaluation of the operations and programs of the OIGB has indicated that several improvements should be made to enhance their effectiveness. The recommended operational and program changes are outlined in this section.
- 4.7.2 **Incorporation and licensing**
 - 4.7.2.1 This function is currently performed by the Compliance division. **We recommend that more definitive criteria should be established as a basis for evaluating incorporation applications. Clear statements of the requirements or conditions which could be applied as bases for approvals and rejections would clarify the guidelines for reviewing the applications.**
 - 4.7.2.2 **There should also be a more systematic provision for conveying any commitments by the bank (such as the business plan) or conditions of approval to the Inspection division for follow-up as the bank establishes business. In the case of Schedule B banks, which are subject to licence renewal reviews, findings from both the monitoring system and the inspection field work will need to be systematically conveyed to the Compliance division to support licence renewal decisions.**
- 4.7.3 **Monitoring**
 - 4.7.3.1 The monitoring system is currently administered by the Research division. Reports are submitted to the OIGB and checked, most of which are then forwarded to the Bank of Canada and processed on its computer. Consolidated financial report information on all banks is then returned to the Research division, copies of which are distributed to the banking industry. Selected information from the Schedule A bank reports is used by the division to rate each bank in relation to financial position and performance.
 - 4.7.3.2 The monitoring system is in need of further development to provide more effective and timely information to support divisional programs. Our detailed recommendations are set out in Appendix K. The focus of the system should be to monitor performance trends, particularly in regard to risks and financial conditions. This will call for reports more specifically tailored to serve this objective. **We**

recommend that the database supporting the Early Warning System, which is maintained by the OIGB to serve its own analytical requirements, should be expanded to cover all banks and be developed to provide analyses, ratios and trends which facilitate performance monitoring.

The results of bank inspections should be incorporated in the database, together with a rating prepared from consultations between the divisional directors. This would call for a reassessment of current arrangements for data processing and reporting. In addition, the analyses which are prepared should provide commentary and interpretations designed to assist the Inspection and Compliance divisions.

4.7.3.3

We have included in Appendix K, suggestions regarding the review of systems and information requirements, together with an assessment of the contents of the Manual of Reporting Forms and reviews of the division's Quarterly Products Book (the book which contains selected financial information on the banks).

These include:

- (a) Systems and information requirements
 - i) investigating alternatives so as to produce reports in a more timely manner;
 - ii) identifying potential applications for computerization; and
 - iii) reviewing current systems arrangements of the office which currently consist of internal and external systems.
- (b) Manual of Reporting Forms
 - i) eliminate redundant reports;
 - ii) expand reporting to include necessary reports (for example, maturity profiles of assets and liabilities);
 - iii) simplify design of forms in conjunction with those preparing the reports to improve accuracy and reduce preparation time; and
 - iv) as much as possible, eliminate obtaining database information from banks by telephone.
- (c) Quarterly Products Book (financial analysis book)
 - i) establish peer groups for comparative analysis and reporting;
 - ii) develop standardized 8-10 page reports consisting of financial analysis by peer group with significantly upgraded content;
 - iii) reduce time required to produce the quarterly book to 45 days after quarter-end;

- iv) **establish quality controls and written procedures in connection with preparation of the book; and**
- v) **distribute the book to all professional staff within the OIGB.**

4.7.3.4 **Finally, we recommend that a regular review be conducted of the reports being requested from the banks to ensure that they are adequate and currently useful, that the related instructions for their preparation are clear and that the reports are being properly completed.** In the very long term, it may become feasible for the OIGB to establish direct computer access to the banks' financial and operating systems to obtain information as required. However, the technological difficulties presented by such an approach are significant at the present time and for the foreseeable future.

4.7.4. Research and standards setting

4.7.4.1 The Research division conducts numerous studies of technical and industry issues with a view to advising the Minister, preparing guidelines for bank compliance and providing direction to other divisions of the OIGB. Our review of this function indicated the need for some expansion of its activities, particularly to provide for a required regular personal contact with regulators in other countries and professional organizations which could contribute to the identification and research of important issues. **We recommend that internal arrangements be made to provide regular interaction with representatives of the other divisions to obtain input and comments on research topics and issues.**

4.7.4.2 **We also recommend the establishment of a more formal process for obtaining industry input and response to proposed guidelines and regulations.** This could take the form of an "Exposure Draft" issued to all parties (Canadian Bankers' Association, banks, shareholders' auditors, etc.) who will be required to respond within specified time limitations.

4.7.4.3 **Finally, we recommend that the objective served be clearly outlined in the preamble of each exposure draft and subsequent guidelines to provide a point of reference for better understanding the specific requirements of what is being proposed or promulgated.**

4.7.5 Inspection activities

4.7.5.1 As required by the Act, the OIGB carries out an annual examination of each bank to meet the requirements of the Act and, conceptually at least, to establish a basis for reliance on the financial and other information being received from the banks.

4.7.5.2 In Appendix I we outline the current organization and activities of the Inspection division of the OIGB, including an outline of the inspection process.

4.7.5.3 The inspections carried out are categorized by the OIGB as "management inspections", as they consist primarily of a review of financial and other information submitted by the bank, discussions with management and an interview with the shareholders' auditors.

4.7.5.4 In order to establish a meaningful basis for its reliance on the work of other participants and on the information on which it is relying, it is important that the nature, scope and timing of the inspection process reflect this objective.

4.7.5.5 Based on our review of the current OIGB inspection process and the objectives discussed above, **we recommend that the methodology and level of documentation employed be structured in a more comprehensive and rigorous manner, so as to provide for:**

- (a) **the determination of the scope and frequency of the individual inspections to be based on the information provided by the OIGB's internal risk rating and Early Warning systems;**
- (b) **more extensive pre-inspection preparation;**
- (c) **the establishment of specific objectives for each inspection;**
- (d) **the use of tailored inspection programs to achieve these objectives;**
- (e) **the use of standardized programs, compliance questionnaires and preferred practice checklists as a means of ensuring the completeness of the recurring areas of the inspection coverage;**
- (f) **the preparation of written reports covering the results of the inspection and matters requiring further action, which reports would then be distributed to the bank's audit committee and management, the shareholders' auditors and the other concerned divisions within the OIGB; and**
- (g) **provision for the timely follow-up of the matters requiring further action noted in (f) above.**

4.7.5.6 For these objectives to be achieved, we recommend:

- (a) **the Inspection division's mandate be clarified and amplified; and**
- (b) **definitive and documented divisional policies and procedures be established.**

4.7.5.7 Our detailed recommendations on these matters are set out in Appendix J.

4.7.6 Compliance activities

4.7.6.1 **We recommend the establishment of more formal policies and procedures covering the method by which the OIGB should handle different applications and respond to various types of non-compliance and problem situations. This is an important area in which accountability for effective responses to problems and the achievement of resolutions are fundamental to the supervisory and regulatory roles of the OIGB.**

4.7.6.2 **We recommend the appointment of a director responsible for coordinating an Inspector's Advisory Group of experienced**

personnel to be selected from the banking industry and the professions. The objective should be to have access when needed to a pool of prequalified personnel who can provide meaningful assistance to resolve difficult problem situations with banks. The support group could include personnel with experience in bank auditing, credit, appraisals, work-outs and reorganizations. However, we do not believe it would be feasible or economical to attempt to maintain all the required expertise and experience on a full-time basis at the OIGB.

- 4.7.6.3 We have included in Appendix K a more detailed proposal for an Inspector's Advisory Group.
- 4.7.6.4 The program changes outlined above are intended to direct attention to areas in which improvement will contribute to raising the overall effectiveness of the OIGB in identifying and resolving bank problems and providing prudential guidelines and informed direction to the banking industry.

4.8 Organization, Mandates and Structures

- 4.8.1 Our evaluation of the OIGB has led us to conclude that the mandates of the divisions and organization units should be clarified and expanded to provide a clearer understanding of objectives and accountabilities. **We recommend placing more emphasis on the divisional mandates of expected results, with additional guidelines on matters such as reporting and relationships which would contribute to the achievement of results.** Suggestions on improving the mandate statements for the divisions are outlined in Appendix K.
- 4.8.2 **We recommend the development of standards manuals, as outlined in Appendix K, in order to provide amplification of each division's mandate.**
- 4.8.3 **We further recommend that more formal arrangements be made in regard to monitoring and channelling communications between the OIGB and the banks in order to ensure a consistency of interpretation, to establish a record of these communications and to provide a point of contact within the OIGB.**
- 4.8.4 The program changes discussed above in Section 4.7 can best be implemented by modifying the organization structure of the OIGB. Organization charts reflecting the current and recommended structures are presented in Appendix L.
- 4.8.5 **Specifically, we recommend the following organization structure changes:**
 - (a) **The establishment of a separate Statistical Analysis and Database Management division devoted exclusively to administering, analyzing and reporting meaningful results from the reports required from the banks.**
 - (b) **The establishment of an Inspector's Advisory Group to plan, maintain and carry out programs to assist in the resolution of serious bank problems which may require the use of internal and/or outside specialists.**
 - (c) **The establishment of an Office Services and Records Group to provide administrative, recruiting and personnel support to the OIGB.**
 - (d) **The expansion of the Inspection division to provide middle management and supervisory positions to improve the effectiveness of planning, execution and follow-up of field work.**

- (e) **The reassignment of responsibilities for bank rehabilitation from the Research division to the Inspector's Advisory Group.**
 - (f) **The reassignment of responsibility for the examination of representative offices of foreign banks from the Compliance division to the Inspection division.**
 - (g) **The establishment of a committee under the chairmanship of the Assistant Inspector, and including the division directors, to review applications and to provide decisions on capital leverage ratios.**
- 4.8.6 These organizational changes will serve to provide an improved arrangement of responsibilities with a view to providing better focus and effectiveness.

4.9 Staffing, Personnel and Training

- 4.9.1 **We recommend the OIGB staff be increased to carry out expanded program requirements and to be able to deal effectively with the issues, problems and concerns which it must address. In overall terms, we would expect the staff to increase from its current complement of about 42 to an expanded complement of about 73. The details of current and proposed staff complements are presented in Appendix L. The recommended changes are outlined below.**
- 4.9.2 **The number of division directors should be increased by two to provide for a director, Inspector's Advisory Group and a director, Statistical Analysis and Database Management division. The former position will likely require a senior level person with experience in receivership, "work-out" situations and the ability to deal effectively with senior bankers and professionals who may become involved in representing either the banks or the OIGB.**
- 4.9.3 **The director, Statistical Analysis and Database Management division will require an incumbent with extensive analytical training and experience, who is conversant with the technical and reporting issues associated with banks and who can provide leadership in developing systems to provide meaningful and expeditious information.**
- 4.9.4 **An administrative assistant will be required to support the director, Inspector's Advisory Group. The incumbent should also have had experience in work-out situations or possess complementary skills to those of the director.**
- 4.9.5 **The Inspection division should be expanded by adding two assistant directors to divide the work of planning, coordinating and directing the field inspection work, which should be expanded as discussed above. These positions will require the incumbents to have had senior level experience in the planning, direction and execution of bank audits with the maturity and background to deal credibly with senior bank management.**
- 4.9.6 **The Inspection division should be expanded from eleven to thirty staff, of which about six should be recruited or selected to serve as "in-charge" inspectors with field supervisory and on-the-job staff development responsibilities. The incumbents should be experienced in the conduct of bank audits or inspections, be suitably qualified to perform audits and be knowledgeable of the issues, risks and operational settings in which the likely concerns are to be identified. They will need to be effective in project management and able to relate effectively with senior bankers and representatives of the audit profession.**
- 4.9.7 **The pool of inspection staff should consist of a mix of experienced bank auditors, credit and systems personnel.**

- 4.9.8 **The Inspection division should also expand its administrative support group by one general secretary and two to three word processing staff to accommodate the additional work load which will arise from the larger inspection group.**
- 4.9.9 **The importance of the inspection function and the style of inspection, focusing as it does on a management level review, will require senior level skill and experience from its director. We would envisage the incumbent having a profile similar to an audit partner directing bank audits. We believe this kind of background will be important to the credibility of the inspection process, to reinforcing the effectiveness of problem identification and resolution, and to applying the judgement required to deal with special situations which may arise.**
- 4.9.10 **The Research division, which we have recommended should not be responsible for the monitoring system, should be expanded to reinforce the requirement for well researched advice, guidelines and direction to those who rely on its work. The position of director will require the incumbent to have an extensive knowledge of economic, financial, taxation and banking research experience and familiarity with the technical complexities involved in developing rulings and guidelines for an industry.**
- 4.9.11 **The Research division requires an increase in staff of perhaps two people, but this requirement should be decided upon after having reassessed the qualifications of current staff in relation to anticipated research project needs.**
- 4.9.12 **The proposed Statistical Analysis and Database Management division function which we have recommended be established, should have a director (Section 4.9.2) and two assistant directors. One assistant director should oversee the development and management of an analytical function and will require a strong background in bank financial analysis and statistics. The other should be responsible for the development and maintenance of the database and the provision of systems support. This latter function will require a sound knowledge of systems design and the ability to provide leadership in maintaining an efficient and timely system support capability covering both the monitoring system and other applications which would be useful in rendering the OIGB more efficient and productive.**
- 4.9.13 **The analysis function should consist of staff with backgrounds in financial analysis and training in bank analysis. The systems function should be staffed with people who have strong backgrounds in data processing and systems analysis.**
- 4.9.14 **We recognize that the current guidelines of the Public Service Employment Commission will render it difficult to recruit the qualified staff we are recommending. Until this matter can be resolved, we recommend that an executive interchange program should be entered into to fill the key positions. It will be important for the banking industry and the accounting profession to support this program by providing the required calibre and number of resources. The OIGB should consider consulting with the Canadian Bankers' Association and the Advisory Committee of Bank Auditors on methods of addressing the concerns that will arise from such a program, such as the potential for conflict of interest.**
- 4.9.15 **The addition of new staff and the normal turnover of personnel will require enhancements to training programs and arrangements. We recommend the establishment of an orientation and indoctrination training program for new staff. In addition, a listing should be established of appropriate training programs which can be used in the development of staff. One or more persons within the OIGB should be given responsibility for planning and coordinating the conduct of and participation in training programs.**

Further information on training and education is provided in Appendix L.

- 4.9.16 The above recommendations will provide the resources and training support which will be necessary to improve the capacity of the OIGB to deal fully with the requirements of its mandate. A listing of the suggested qualifications of key positions in each of the divisions (except the Inspector's Advisory Group dealt with above) is included in Appendix L.

4.10 Recruiting and Budgets

- 4.10.1 Officers and employees engaged by the OIGB are appointed in accordance with the Public Service Employment Act (Section 245(8)). As a practical matter, resource requirements are budgeted and subjected to the same review and approval process as those of the Department of Finance. However, the costs of the office are recouped from the banking industry (Section 247) and the Canadian Payments Association (Section 248(2)).
- 4.10.2 The current requirement that officers and employees of the OIGB be appointed in accordance with the Public Service Employment Act presents a number of practical difficulties in view of the qualifications which are called for to perform the complex task of supervising the banking industry. Accordingly, **we recommend that the appointment of OIGB staff in accordance with the Public Service Employment Act be reconsidered as soon as possible.**
- 4.10.3 The practice of requiring that the budget and resource requests of the OIGB be submitted for review on the same basis as other government ministries subjected to general fiscal constraints does not appear to be justified because the operating costs of the office are fully recouped. We recognize the need to provide for a resource requirement review process, but **recommend that more flexible arrangements should be made for budget and staff complement approvals which are more suitable to the needs of the office.**

4.11 Location of Offices

- 4.11.1 Financial markets are fast moving, sophisticated and relatively efficient in communicating information. Monitoring these markets for information such as wholesale deposit rates can offer indications of performance difficulties much earlier than other sources, including reports from the banks themselves.
- 4.11.2 The OIGB should avail itself of various kinds of market information on banks and bank performance. Our interviews and observations made during a study of the operations of the OIGB have caused us to believe that some of the OIGB staff are at a disadvantage by not being located physically close to the main financial markets. Establishing an office in Toronto would facilitate the gathering of this kind of information and reinforce the OIGB's sensitivity to market changes.
- 4.11.3 Other benefits may be gained from the establishment of an office in Toronto which include the following:
- (a) There is a greater likelihood of being able to recruit staff with strong backgrounds in banking and bank auditing. At present, the staff does not include a sufficient representation of these backgrounds;
 - (b) Travel costs incurred in the conduct of inspections would be reduced because most bank head offices are located in Toronto. This will become more significant as the scope of inspection work expands; and

- (c) Regular interaction with senior bank management would be facilitated. This could contribute to improving OIGB staff understanding of bank situations and banking issues and of the condition of the individual banks.
- 4.11.4 Accordingly, we **recommend establishing a Toronto office to conduct inspection and selected research and compliance activities.**

4.12 Concluding Comments

- 4.12.1 The recommendations outlined in this chapter are intended to strengthen the organization structure, staffing and programs of the OIGB to improve the effectiveness of bank supervision and regulation.

Chapter 5. The Chartered Banks

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5.0 Introduction

- 5.0.1 Each bank is responsible at all times for compliance with the Act and the related regulations and guidelines. In this chapter, we comment upon and make recommendations to improve the bank's corporate governance system in three key areas: the Chief Executive Officer, the audit committee of the bank's board of directors and the Internal Audit Department.

5.1 The Chief Executive Officer ("CEO") and the OIGB

- 5.1.1 Both the Inspector and the CEOs have a common understanding of the need for clear and frequent two-way communication between them to discuss matters of mutual concern. The Inspector is concerned that as the banks have grown in size and complexity such contact has become less frequent than is desirable.
- 5.1.2 The CEOs are anxious to ensure not only that the OIGB has the necessary contact with their banks, but also that it understands that the CEO is the principal spokesman for the bank. This latter concern underlines the need for the Inspector and the CEOs to ensure they are in regular contact with each other to review matters of mutual concern and to ensure that there is a mutual understanding as to the status of the matters being dealt with between the OIGB, the individual banks and the various technical committees of the Canadian Bankers' Association (CBA). While there would be a benefit to having such contact formalized, it was the view of the CEOs that their relationship with the OIGB would be enhanced if there were more opportunities for informal contact, a matter made more difficult by the increased number of banks and the fact that the Inspector is located away from the major banking centres.
- 5.1.3 To ensure that there is the required level and frequency of communication between the Inspector and the CEOs, **we recommend that the Inspector should:**
- i) **issue a regular written report to the CEOs on the status of various matters under discussion between his office and the various CBA committees; and**
 - ii) **undertake a regular program of formal or informal meetings with the CEOs, either individually or, perhaps in the case of the smaller Schedule B banks on a group basis, in addition to the regular meetings currently held between the OIGB and the CBA Executive Council.**

5.2 The Audit Committee of the Board of Directors

- 5.2.1 The structure and nature of audit committees are reviewed in the following paragraphs.
- 5.2.2 The requirements in the Act for an audit committee are set out in Section 243(1) which states:

“...the directors of a bank shall appoint an audit committee composed of not less than three directors of the bank, none of whom are officers or employees of the bank or any of its affiliates.”

- 5.2.3 The Minister has the power to allow a bank to dispense with an audit committee if he is satisfied that the public interest will not be prejudiced. As a practical matter, the Minister has only allowed this to occur during the first year or so of the operations of foreign bank subsidiaries.
- 5.2.4 The shareholders' auditors have the right to (and may be required to) attend every meeting of the committee and be heard thereat. Either the shareholders' auditors or a member of the committee may call a meeting.
- 5.2.5 As a practical matter, bank audit committees will meet from one to five times per year, depending on the size of the bank and the number and complexity of matters to be dealt with.
- 5.2.6 In addition to discussions with the shareholders' auditors (which are outlined in paragraph 6.1.13), the committee will also:
 - (a) receive and review the report of the chief inspector (if one is appointed) or, in the case of most of the foreign bank subsidiaries, any available reports by the internal audit department of the parent bank, and assess any corrective action taken or to be taken;
 - (b) review the corrective action taken or to be taken on any recommendations made by the shareholders' auditors;and may also:
 - (c) receive and review reports by senior management on areas of significant risk such as the adequacy of loan loss provisions, foreign exchange transaction controls or insurance coverage; and
 - (d) review specific senior management expense accounts.

5.2.7 The audit committee and the OIGB

- 5.2.7.1 Whereas there is no statutory reporting responsibility, the Inspector does view the audit committees as the most logical vehicle through which to conduct liaison with the board of directors. He views his relationships with these committees as in need of enhancement.
- 5.2.7.2 The audit committee chairmen we interviewed were of the opinion that the Inspector should meet with them whenever he feels it worthwhile to discuss matters of concern. Given the number of banks and his other responsibilities, it is felt that to meet with them on a regular basis would be too onerous a task for the Inspector, given the importance of his personal involvement in such discussions.
- 5.2.7.3 Since the duties of the audit committee are not set out in any detail in the Act, **we recommend that the Inspector should:**
 - (a) **issue guidelines setting out the particular procedures his office believes should be followed by an audit committee in discharging its duties under Section 243(3) of the Act. Such guidelines should cover:⁽⁴⁾**

⁽⁴⁾ Our publication “A Handbook for Bank Audit Committees” sets out guidance for directors in their role as members of a bank's audit committee.

- the composition of the committee;
- the role of the committee;
- the role of the shareholders' auditors;
- the role of the internal auditors;
- timing of and attendance at meetings;
- review of annual financial statements and the shareholders' auditors report;
- review of the internal auditor's report;
- review of the shareholders' auditors letters to management on internal control; and
- documentation of meetings.

(b) undertake a program of meetings with the audit committees, either individually or with groups of audit committee chairmen, to discuss their expectations as set out in the above guidelines and any other concerns that may exist with either party.

5.2.7.4 In addition, to enable the audit committees to effectively carry out their duties with respect to their review of the bank's financial statements, and in the interests of clear communication, we **recommend that the OIGB should ensure that a written copy of its annual examination report is sent to the bank's audit committee.**

5.3 Internal Audit

5.3.1 The structure and nature of internal audit activities in the banking industry are described in the following paragraphs.

5.3.2 While there is no requirement in the Act for the performance of internal audit activities, in order to give management the assurance it requires as to the *ongoing* adherence to the bank's systems of internal control and to prescribed policies, such functions have become an integral part of Canadian bank operations for a number of reasons, including:

- (a) the geographic dispersion of most banks' branch and management systems;
- (b) the negotiable nature of many bank assets and liabilities (e.g. cash, securities and bearer discount notes);
- (c) the high volume of transactions processed; and
- (d) the sheer financial size of the banks (the total assets of the six largest banks was \$389 billion at October 31, 1985).

5.3.3 Since there are no statutory requirements regarding internal audit activities, the mandates of these functions will vary from bank to bank, but may be generally categorized as being to evaluate the continued operation and effectiveness of the bank's internal controls for the purpose of safeguarding its assets and ensuring the accuracy of its financial and other records.

- 5.3.4 The officer in charge of the internal audit function, often known as the Chief Inspector, will usually report administratively to the president or an executive vice-president and functionally (i.e. on the results of his work) to the Chief Executive Officer (who is usually the chairman of the board of directors) and to the audit committee.
- 5.3.5 In order to fulfill its mandate, the internal audit department will carry out such examination work as it considers necessary to report on the bank's systems. This work will normally include:
- (a) an identification of the significance of each of the bank's internal control systems based on the risks to the bank of a weakness or breakdown in their operation. This would include an assessment of such factors as negotiability of the items in question, volume of transactions processed, effect on customer relations, degree of judgement required in establishing values, and the geographic distribution of the control points in the system;
 - (b) a determination of the nature, scope and frequency of the tests to be performed on the individual systems. (If it is reasonable to do so, this work may be performed in a manner and a time frame so as to assist the shareholders' auditors in the conduct of their work.);
 - (c) the documentation and review of the key controls within each system under examination and the performance of such tests as are necessary to form an opinion on their operations;
 - (d) assisting the bank's accounting and data processing functions in evaluating internal controls in design and implementation of new systems (or changes to existing systems);
 - (e) the review with operating management of their findings and the issuance of reports to senior management on matters requiring attention and/or correction and on follow-up to ensure appropriate action has been taken within a reasonable time frame;
 - (f) reporting to the CEO and to the audit committee as to the results of the work performed and the corrective action taken; and
 - (g) reviewing with the shareholders' auditors the results of the work performed and assisting them during their attendance at internal audit examinations.
- 5.3.6 Although such data is not publicly available, our own experience and discussions with industry officials would indicate that each of the five largest banks have internal audit departments of 150 to 300 staff and annual operating budgets in the range of \$10 million to \$14 million.
- 5.3.7 Only the larger of the Schedule B banks have internal audit functions. The others rely on the internal audit departments of their parent banks. Information on the internal audit services to these banks is not readily available. However, our own experience and discussions with those involved would indicate that, in total, they would be in the order of \$1 million per year.
- 5.3.8 Accordingly, we estimate the total annual cost of internal audit to all of the Canadian banks to be in the range of \$65 million to \$70 million.

5.3.9 The Chief Internal Auditor and the OIGB

- 5.3.9.1 While there is no statutory reporting responsibility, both the Inspector and the banks recognize the need for the OIGB to have the necessary access to the Chief Internal Auditors.
- 5.3.9.2 Historically, such access has been largely limited to meetings with them at the time of the annual examination of the individual banks. The Inspector is of the view that while there is no particular need for their reporting responsibility to be set out in the Act, it is important to ensure that they do have direct reporting responsibility to their bank's audit committee. Such is not always the case. In many instances the Chief Internal Auditor may have several reporting responsibilities: administratively, to a senior vice-president; functionally, to the president and/or chief executive officer on a routine basis; and, formally, to the audit committee on a semi-annual or annual basis. The historical and organizational structures of each bank may well dictate the most satisfactory reporting arrangements for its individual circumstances. However, since the Inspector will wish to be able to place the greatest reasonable amount of reliance on their work, he requires evidence that there is a high standard of work performed. The key issues to be addressed are as follows:
- (a) the degree of independence of the Chief Internal Auditor in reporting to the CEO and to the audit committee as well as in his dealings with the shareholders' auditors;
 - (b) the effectiveness of his mandate, including the degree of support the chief inspector has from the CEO and the audit committee in obtaining the necessary resources and in having the necessary access to the bank's records and officials to carry out his mandate;
 - (c) the qualifications of the Chief Internal Auditor and his staff;
 - (d) the coverage, completeness, timeliness and quality of documentation of the internal audit work performed and the reports thereon to the CEO and the audit committee; and
 - (e) the effectiveness and timeliness of management responses to internal audit recommendations.
- 5.3.9.3 To ensure that these issues are appropriately addressed, **we recommend that the OIGB should develop a consultative process for the issuance of guidelines on preferred practices for internal auditing of banks.**
- 5.3.9.4 Since this is an area of defined interest and expertise of the shareholders' auditors, **we recommend that the scope of their audit work should be extended to enable them to report directly to the OIGB on the degree of adherence to any OIGB internal audit guidelines that might be issued and the results of the internal audit work performed.**
- 5.3.9.5 For those smaller banks where size does not economically permit the existence of an internal audit function, **we recommend steps should be undertaken by the OIGB to ensure that, in the case of foreign**

bank subsidiaries, similar work is undertaken by the parent bank internal auditors and appropriately reported on or, in the absence of such an arrangement, that the shareholders' auditors perform the necessary work.

5.3.9.6 The Chief Internal Auditors have expressed the view that their contact with the OIGB during its annual examination has often been very superficial. This has arisen from the lack of a defined set of standards by which to evaluate internal audit performance and the lack of expertise of many of its staff in this area.

5.3.9.7 We have concluded that the following actions would address the concerns of all participants involved:

- more interaction with the Chief Internal Auditors and with their CBA committee;
- the dissemination of a workable set of internal audit standards for banks;
- the acquisition by the OIGB of staff members with expertise in this area; and
- the extension of the shareholders' auditors work to enable them to report on the effectiveness and results of the internal audit work.

5.3.9.8 If action is taken to create a sufficient degree of standardization of internal audit work (or its equivalent by the shareholders' auditors) to ensure the coverage of all areas of significant risk in each bank, **we recommend the implementation of direct internal audit reporting responsibilities to the OIGB, such as:**

- (a) **on the work performed on identified areas of risk of significant financial loss to the bank in question (e.g. credit and foreign exchange risk);**
- (b) **on the work performed on areas of potential concern to the OIGB (e.g. the determination of non-performing loan identification and reporting);**
- (c) **on specific statutory returns submitted by the bank to the OIGB where specific concerns exist (e.g. interest rate risk and asset/liability management); and**
- (d) **on those sections of the pre-inspection package submitted by the bank to the OIGB on which additional assurance is considered to be necessary.**

5.4 Conclusion

5.4.1 The banks have the primary responsibility for their continuing compliance with the Act and its regulations and, internally, have a number of mechanisms to verify this on an ongoing basis. The Inspector needs to strengthen his communications with the bank's CEO, its audit committee and its internal audit department to more effectively carry out his mandate.

Chapter 6. The Shareholders' Auditors

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6.0 Introduction

- 6.0.1 The purpose of this chapter is to describe the existing structure and nature of the shareholders' audit function in the Canadian banking industry and make recommendations for improvement.

6.1 Shareholders' Audit Function

- 6.1.1 The requirements in the Act for an independent shareholders' audit are set out in the following paragraphs.
- 6.1.1.1 The requirement for each bank to appoint independent shareholders' auditors is set out in Section 237(1), which states:
- “The shareholders of a bank shall, by ordinary resolution at the first annual meeting of shareholders and at each succeeding annual meeting, appoint two firms of accountants to be the auditors of the bank until the next annual meeting.”
- 6.1.1.2 In order to ensure the independence of the auditors, Section 238(2) further requires a rotation of at least one of the two firms at least every two years by stating:
- “If the same two firms of accountants have been appointed for two consecutive years as auditors of a bank, one such firm shall not be appointed as auditor of the bank for the period of two years next following the expiration of the term for which that firm was last appointed.”
- 6.1.1.3 In addition, the Act provides that either the shareholders or the Minister may at any time revoke the appointment of an auditor.
- 6.1.1.4 The qualifications of an auditor are set out in Section 238(1) which states that:
- “A firm of accountants is qualified to be an auditor of a bank if two or more of the members thereof are accountants who:
- (a) are members in good standing of an institute or association of accountants incorporated by or under an Act of the legislature of a province;
 - (b) are ordinarily resident in Canada and are Canadian citizens;
 - (c) have practised the accounting profession in Canada continuously during the six consecutive years immediately preceding the appointment of the firm as auditor of the bank; and

- (d) are independent of the bank and of any corporation the financial statements of which are consolidated with the financial statements of the bank..."

6.1.1.5 The Act further requires that the bank shall designate a member of each firm who meets the above qualifications to conduct the audit of the bank and so notify the Minister.

6.1.1.6 In the interests of ensuring the appointment of auditors with the appropriate level of experience in the auditing of the operations found in banks, **we recommend that consideration be given to amending the Act to require that one of the partners of each of the firms who is to be responsible for the conduct of the audit has reasonably extensive experience in the audits of banks or similar deposit-taking financial institutions.**

6.1.1.7 The responsibilities of the shareholders' auditors are contained in Sections 238 to 244 and can be summarized as follows:

- (a) to be independent of the bank (i.e. not to be a director, officer or employee or to have any direct or indirect investment in the bank);
- (b) to attend meetings of shareholders if requested by any director or shareholder and to answer questions relating to its duties as auditor;
- (c) to make the examination that is in their opinion necessary to enable them to report on whether the annual consolidated financial statements of the bank present fairly the financial position and results of operations of the bank;
- (d) to notify the directors if they become aware of an error or misstatement in a financial statement on which they have previously reported; and
- (e) to report to the CEO and Chief General Manager (with a copy to the Inspector) on any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification, including:
 - i) transactions of the bank that have come under their notice that, in their opinion, have not been within the powers of the bank, and
 - ii) loans owing to the bank in excess of 1/2 of 1 per cent of shareholders' equity, in respect of which, in their opinion, loss to the bank is likely to occur.

6.1.1.8 The Inspector has stated, and it is well-known by the shareholders' auditors, that he relies on their audit opinion on the bank's annual consolidated financial statements as well as on any reports they may issue in regard to the two matters described in 6.1.7(e) above. Since the auditors are usually engaged only to report on the bank's annual consolidated financial statements, any matters reported to the Inspector will of necessity be those that will arise during the course of the annual audit.

- 6.1.1.9 In order to conduct their audit, the Act gives the auditors the right to such information and records of the bank that is in the opinion of the auditors necessary to enable them to perform their duties.
- 6.1.1.10 In addition, the Minister has the power to enlarge or extend the scope of the audit to direct any other particular examination to be made or procedure to be established "as, in his opinion, the public interest may require..."
- 6.1.1.11 This power has been used most frequently to require the auditors to report on the Return of Insured Deposits and selected monthly Returns of Reserves for the individual banks.
- 6.1.1.12 The method by which the shareholders' auditors carry out their responsibilities is set out in the following paragraphs.
- 6.1.1.12.1 Purpose
- The work performed by the shareholders' auditors in order to enable them to report on the bank's annual consolidated financial statements is conducted in accordance with generally accepted auditing standards which are set out in the Handbook of the Canadian Institute of Chartered Accountants, as follows:
- 6.1.1.12.2 General standard
- The examination should be performed and the report prepared by a person or persons having adequate technical training and proficiency in auditing, with due care and with an objective state of mind.
- 6.1.1.12.3 Examination standards
- i) The work should be adequately planned and properly executed. If assistants are employed they should be properly supervised.
 - ii) There should be an appropriately organized study and evaluation of those internal controls on which the auditor subsequently relies in determining the nature, extent and timing of auditing procedures.
 - iii) Sufficient appropriate audit evidence should be obtained, by such means as inspection, observation, enquiry, confirmation, computation and analysis, to afford a reasonable basis to support the content of the report.
- 6.1.1.12.4 Reporting standards
- i) The scope of the auditor's examination should be referred to in the report.

- ii) The report should contain either an expression of opinion on the financial statements or an assertion that an opinion cannot be expressed. In the latter case, the reasons therefore should be stated.
- iii) Where an opinion is expressed, it should indicate whether the financial statements present fairly the financial position, results of operations and changes in financial position in accordance with an appropriate disclosed basis of accounting which, except in special circumstances, should be generally accepted accounting principles. The report should provide adequate explanation with respect to any reservation contained in such opinion.
- iv) Where an opinion is expressed, the report should also indicate whether the application of the disclosed basis of accounting is consistent with that of the preceding period. Where the basis or its application is not consistent, the report should provide adequate explanation of the nature and effect of the inconsistency.

6.1.1.13 As a practical matter, the work performed by the shareholders' auditors will include:

- (a) obtaining sufficient knowledge of the bank's business to provide them with an understanding of the events, transactions and practices that may have a significant effect on their examination of the financial statements. This will include a general knowledge of the economy and the banking industry and a more particular knowledge of the bank and its accounting systems;
- (b) determining the significant internal controls in the bank's systems which record and monitor the bank's transactions;
- (c) examining and testing the work performed by the bank's internal auditors on the significant internal controls in the bank's systems to determine the degree of reliance to be placed on that work;
- (d) carrying out such additional tests as are deemed necessary on the significant internal controls in the bank's systems to determine the degree of reliance to be placed on their operation;
- (e) evaluating the results of the above work to determine the nature, scope and timing of the audit procedures to be performed on the bank's financial statements (including the explanatory notes to those statements) and then performing and documenting those procedures;
- (f) reviewing and resolving with management (and, where significant, with the bank's audit committee of the board of

directors) any apparent discrepancies or differences of opinion resulting from the audit procedures performed (for example, loan loss provision amounts); and

- (g) rendering the resultant audit opinion on the financial statements (which have at that point been approved by the directors for submission to the shareholders).

6.1.1.14 The primary mandate of the shareholders' auditors and their main objective in performing the above-mentioned procedures is to enable them to render their opinion on the bank's annual consolidated financial statements. While they will render the required additional reports to the Inspector, they have no statutory or contractual mandate to conduct other than an annual audit. Consequently, they are not in a position to render their opinion on the bank's financial position other than at its year-end. Also the auditors may not be able to comment on the quality of all aspects of the bank's systems of internal control nor on the prudence of its management and business strategies, such matters being the sole responsibility of the bank. To take some liberties with a well-known cliché, the statutory and contractual mandate of the shareholders' auditors is to be an annual watchdog, not a year-round bloodhound.

6.1.1.15 As there are significant differences in the sizes of banks, there are also corresponding differences in the nature of their operations and the related systems of internal control and internal audit. The work performed on the audit of a large Schedule A bank with extensive foreign operations will of necessity include the use of the shareholders' auditors resources such as computer audit software and audit staff from their offices in other countries. On the other hand, the audit of a small Schedule B bank with only one office and no retail deposit base may well be performed by the audit partners and a few members of their immediate staff.

6.1.1.16 Since there are two firms of accountants appointed to conduct the audit, given their joint and several liability for their audit opinion, they will make the necessary arrangements to divide the work to be performed between their staff and to review the work performed by each other. This results in some duplication of work, but it is largely at the most senior levels.

6.1.1.17 In the course of performing the above work, the shareholders' auditors will have met with the bank's audit committee and will usually have discussed with them:

- (a) the audit plan;
- (b) the results of the audit of the bank's:
 - financial statements; and
 - loan portfolio (due to its significance in most bank's financial statements); and
- (c) any significant observations made on the internal audit procedures and systems of internal control.

6.1.1.18 Although the published audit fees of the banks may not be representative in that they may not include the fees for work performed

on subsidiaries through which many of the large Schedule A banks conduct a significant portion of their operations, our discussions with those involved indicate that the total audit fees charged to each of the five largest banks for the work necessary to render an opinion on their annual consolidated financial statements would be in the range of \$1.0 million to \$1.5 million. The annual audit fees for the Schedule B banks would range from \$20,000 to \$250,000. In the aggregate, we estimate that the total annual audit fees for all of the banks are in the range of \$11 million to \$12 million.

- 6.1.1.19 In addition to the annual audit of the bank's financial statements, as noted above, the auditors will usually be requested by the Inspector to report on certain other statutory returns made by the bank and may, from time to time, be requested by the bank to render advice on specific accounting or income tax matters.

6.2 The Shareholders' Auditors and the OIGB

- 6.2.1 We believe that the Inspector and the shareholders' auditors are in agreement that the OIGB must be in a position to rely on the results of the work of the shareholder's auditors. There have been, however, differences in their understanding as to:

- i) the procedures that should be followed by the OIGB to provide a basis for its reliance;
- ii) the extent of the reliance that it is reasonable to place on the shareholders' auditors work, given their mandate and the annual nature of their work; and
- iii) the degree to which there is a need to more specifically define the matters on which the OIGB expects the shareholders' auditors to report.

6.2.2 Who the shareholders' auditors clients are

- 6.2.2.1 The Inspector has suggested that part of the problem may be that some shareholders' auditors perceive that their primary loyalty should lie with their client, the bank, by whose shareholders they have been appointed. He has further suggested that this could be resolved if the Act were amended so that one of the shareholders' auditors were appointed by the OIGB and required to report directly to it. While this suggestion may be appealing from a regulatory perspective, there are a number of practical problems associated with it which must be considered, as follows:

- (a) there would be a need to define the extent to which the OIGB appointed auditor's mandate, objectives and reporting responsibilities differ from that of the auditor appointed by the shareholders;
- (b) it is very doubtful that their respective objectives and legal and reporting responsibilities could be reconciled to allow them to coordinate their work and their findings so as to render a joint opinion on the bank's financial statements;
- (c) there would necessarily be significant overlap in their work which would add significantly to the cost of supervision;

- (d) there would be a strong probability that OIGB appointments would be viewed as being "political" in nature;
- (e) the degree of independence from management which derives from the joint audit function would be eroded; and
- (f) the practice of precluding a bank auditor from evaluating loans to other audit clients would be negated.

6.2.2.2 **We recommend that the OIGB's expressed concerns over its ability to rely on the shareholders' auditors be more adequately, effectively and efficiently met by:**

- (a) **clarification and amendment of the responsibilities of the shareholders' auditors as currently set out in the Act;**
- (b) **improvement in the communication between the OIGB and the shareholders' auditors; and**
- (c) **the review by the OIGB of the work of the shareholders' auditors to establish a basis for reliance on its results.**

6.2.2.3 An analysis of the issues which support this conclusion is set out in the following paragraphs.

6.2.3 **The shareholders' auditors reporting responsibilities**

6.2.3.1 The Act is reasonably clear in defining the reporting responsibilities of the shareholders' auditors to the OIGB as being in respect of:

- (a) any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification, including:
 - i) transactions of the bank that have come under their notice that, in their opinion, have not been within the powers of the bank, and
 - ii) loans owing to the bank in excess of 1/2 of 1 per cent of shareholders' equity, in respect of which, in their opinion, loss to the bank is likely to occur;
- (b) their opinion on the bank's annual consolidated financial statements; and
- (c) any other particular examinations which the Minister may request the auditors to perform (most usually, specific procedures in respect of insured deposits and deposit reserves).

6.2.3.2 Nevertheless, there are some aspects of these reporting requirements that would benefit from greater clarification, as follows:

- (a) the phrase "any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification" can be interpreted rather broadly; in fact, so broadly, that it can become meaningless as a reporting framework unless the conditions which were contemplated during its drafting are enunciated. It may be for this reason that the shareholders' auditors have, as a

matter of practice, limited the conditions which they consider for reporting to the two inclusions specified in the Act, namely transactions outside the powers of the bank and expected loan losses. **We recommend, therefore, that the OIGB issue guidelines which set out its expectations in respect of reports from the shareholders' auditors and, prior to the issuance of such guidelines, discuss them with its Advisory Committee of Bank Auditors so as to ensure the practicality of its expectations being met.**

- (b) as stated in the shareholders' auditors report, their opinion on the financial statements of a bank is based on:
 - i) work performed in accordance with generally accepted auditing standards; and
 - ii) the application of prescribed⁽⁵⁾ accounting principles in the preparation of those statements.

6.2.3.4 In addition, it must be understood that their opinion is expressed on the financial statements taken as a whole and not on each of its components. Accordingly, in forming their opinion, they will assess the significance of identified errors and differences in judgement as to their likely effect on the reader's understanding of the bank's financial position and results of operations.

6.2.3.5 As discussed in Section 6.1.12, generally accepted auditing standards are as set out in the CICA Handbook, and comprise those particular procedures as the auditors deem necessary in each bank's particular circumstances. In order to ensure the completeness of its understanding of the audit procedures and to be satisfied as to their adequacy, **we recommend that the OIGB should:**

- (a) **where it is felt to be necessary, meet with the shareholders' auditors prior to the commencement of their audit to ensure that any concerns it may have will be addressed during the course of the work (or, if necessary, that an extension to such work is requested in accordance with Section 242(2) of the Act); and**
- (b) **undertake a review of the shareholders' auditors working paper files after the completion of the audit.** The suggested content of such a review is set out in Appendix J.

6.2.3.6 The application of prescribed accounting principles is dependent on the assumption that the bank in question is a going concern and, accordingly, that it will realize its assets and discharge its liabilities in the normal course of business. Where this is not a valid assumption, then its financial statements must be prepared on the basis of liquidation values. **We recommend that should there be any question**

⁽⁵⁾ Prescribed accounting principles for banks are generally accepted accounting principles as set out in the CICA Handbook, as amended by guidelines issued under the authority of the Minister of Finance, principally in respect of financial statement format, the accounting for loan losses, gains and losses on foreign currency translation and gains and losses on securities. A reasonably comprehensive comparison of prescribed generally accepted accounting principles is set out in our publication *Canadian Bank Accounting Principles & Regulatory Reporting Guidelines – A Guide for Executives and Directors*.

by either the OIGB or the shareholders' auditors as to the accounting principles to be applied, they should so notify each other and resolve the matter as soon as practicable. Where there is some doubt⁽⁶⁾ as to the effect of the application of alternative principles, the OIGB should ensure that an extension of the shareholders' auditors work is requested in accordance with Section 242(2) so as to make such a determination.

- 6.2.3.7 Since the opinion of the shareholders' auditors is given on the financial statements taken as a whole and not on its individual components, any disagreement by the auditors on the amount at which any of the components is shown on the financial statements must be measured as to the effect it has on the fair presentation of the financial statements.
- 6.2.3.8 From time to time the OIGB has expressed concern to the shareholders' auditors about variations in the amounts of loan loss provisions set up by different banks against the same risk (for example, against a portion of a loan syndicated between several banks).
- 6.2.3.9 There may be a range of acceptable amounts for any individual loan loss provision for a number of reasons:
- such provisions are usually based on estimates of actual losses which may be realized at some future date;
 - there can be legitimate differences of opinion as to the realizable value of any underlying security;
 - the amount of the loan (and, any offsetting provision for loss) can vary in its significance to a bank's financial statements; and
 - the auditors must also judge the relative adequacy of all other provisions for loan losses in forming their opinion.
- 6.2.3.10 Nevertheless, we recommend that where the OIGB has specific identified concerns relating to loan loss provisions, they should be addressed with both senior management and the shareholders' auditors of the bank in question. Where the concerns of the OIGB are more general and prudential in nature, then consideration should be given by the OIGB to the issuance of guidelines, as was done in the case of provisioning against sovereign risk loans.
- 6.2.3.11 To the extent that the OIGB concludes an audit of the bank's annual financial statements does not provide a sufficiently frequent basis for reporting, we recommend the shareholders' auditors be required to carry out such additional procedures as may be required to enable them to report on the bank's quarterly financial statements. As a practical matter, such reporting could take the form similar to the "negative assurance" rendered on quarterly financial information filed by U.S. corporations with the Securities and Exchange Commission. Since the shareholders' auditors of the major banks

⁽⁶⁾ The evidence that such doubt might exist would be a "Five" rating of the bank on the OIGB's Early Warning System, which system is more fully explained in section 4.7.3.

usually undertake an informational review of such statements to provide themselves with guidance in the conduct of their annual audit, the framework for the procedures required to enable them to report to the OIGB could most probably be established through an extension of their current activities.

6.3 Accounting Principles for Banks

- 6.3.1 There is a concern among a number of shareholders' auditors and, indeed, among senior management of many of the banks that there should not be separately prescribed accounting principles for banks — that the financial statements of banks should be prepared in accordance with GAAP. As stated earlier, the major differences between the accounting principles prescribed by the Minister and GAAP are in the areas of:
- financial statement format;
 - accounting for loan losses;
 - accounting for gains and losses on foreign currency translation; and
 - accounting for gains and losses on securities.
- 6.3.2 Without attempting an analysis in this study of the individual differences and the merits of each set of principles, it would seem to be prudent to consider whether, in the interests of public understanding of bank financial statements, the accounting principles to be applied in their preparation should be GAAP, as is normal commercial practice (e.g. the Canada Business Corporations Act requires its use). The fact that financial analysts in the investment community who follow banks convert bank financial results to GAAP in preparing their commentaries may suggest that little is achieved by having banks adhere to different accounting principles.
- 6.3.3 In Canada GAAP is set by the CICA. Accordingly, we recommend that the Inspector should request that the CICA join with him in establishing a joint bank accounting research panel to make recommendations to him as to any special accounting considerations that are required for banks, with a view to harmonizing the standard setting process with GAAP. Such a panel should comprise members from the banks, the shareholders' auditors, the investment community and the OIGB.

Chapter 7. The Effect of our Recommendations on the Roles and Responsibilities of the Participants

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7.0 The Context for our Recommendations

- 7.0.1 Based on our study, we believe that there is a serious gap between the work performed by the OIGB and the work required for it to adequately fulfill its mandate. We have found a need for extensive changes to improve the effectiveness of bank supervision and regulation.
- 7.0.2 Whereas, conceptually, the current system of interdependence between the banks, the shareholders' auditors and the OIGB is essentially sound, changes are required in the roles and responsibilities of each of the participants to strengthen accountabilities. Furthermore, if the OIGB is to conduct an effective "management" inspection, there must be a much clearer basis on which to establish a reliance on the work, reports and representations of the banks and external auditors.
- 7.0.3 For the supervisory approach of the OIGB to be effective, it will also need to enhance the qualifications and numbers of its staff and the thoroughness and disciplines of its monitoring and inspection methodologies. The extent and nature of the work required by the OIGB in situations where problems have been identified will need to be specifically designed to achieve resolutions to the problems.
- 7.0.4 In this chapter, we present a synopsis of how our recommendations will affect the roles and responsibilities of each of the participants in the system of regulation and supervision.

7.1 The OIGB

- 7.1.1 The major impact of our recommendations is on the mandate, structure and operations of the OIGB. Significant upgrading of staff, policies and programs is required.
- 7.1.2 We have recommended that the mandate of the Inspector as set out in the Act in respect of his supervisory authority and enforcement powers be reviewed with a view to holding him fully accountable for the normal operational responsibilities associated with bank supervision and regulation. We have also recommended changes to the processes for obtaining approvals of budgets and staff requirements to achieve greater flexibility to respond to changing conditions. The requirement to obtain staff in accordance with the provisions of the Public Service Employment Act will also need to be changed to enable the OIGB to obtain the calibre of staff which is needed.
- 7.1.3 The OIGB as an organization needs to be strengthened to be more effective in fulfilling its role. This will require additional and more highly qualified personnel, and alterations in organization structure. We have recommended changes aimed at establishing a basis of reliance on the work and representations of others and adjusting its field work to the condition of each bank. We have also recommended the establishment of an Inspector's Advisory Group within the OIGB which would consist of experts brought in on a contract basis, as required, to deal with problem

situations. The monitoring system needs to be expanded and better focused to serve the needs of the OIGB. And we have recommended the establishment of an office in Toronto to accommodate most, if not all, of the Inspection division personnel.

7.2 Senior Bank Management

- 7.2.1 Senior management of banks are responsible for decisions regarding the assumption and containment of risk. The risks a bank is faced with are major factors affecting its financial condition. Accordingly, we have recommended that bank management be required to make assertions to the OIGB regarding the nature and extent of the risks undertaken; the systems and controls in place to monitor them; the provisions for timely and effective management of the risks and the accuracy of the related financial reports which are submitted to the OIGB. Standard minimum requirements will need to be developed to guide the preparation of these assertions.

7.3 Chief Internal Auditors

- 7.3.1 We have recommended that the OIGB establish guidelines and minimum standards for the internal audit function of banks. The particular programs and tests carried out in banks may differ, but there is a need to ensure that the internal audit function meets the needs of the OIGB to justify reliance being placed on the results of the internal audit work.
- 7.3.2 We have recommended that the internal auditors should also be required to report to the OIGB on their degree of adherence to the guidelines on prudential internal audit practices which guidelines would cover such areas as:
- the nature, scope and timing of internal audit examinations of the bank's systems of internal control; and
 - the depth and extent of internal audit reporting of its findings and recommendations to the bank's management and audit committee, and to the shareholders' auditors.
- 7.3.3 The internal auditors will also be required to carry out sufficient work to provide assurances to the OIGB regarding management's risk assertions. The work supporting these assurances will be required to be examined by the shareholders' auditors.

7.4 Audit Committees

- 7.4.1 We have recommended that the OIGB develop and provide guidelines and minimum standards regarding the duties of audit committees. In particular, the audit committees should receive and review the reports made by the internal auditors and the shareholders' auditors regarding their work and findings on the bank's financial position and systems of internal control.

7.5 Shareholders' Auditors

- 7.5.1 We have recommended that the provisions of the Act be clarified in relation to the shareholders' auditors reporting responsibilities to the OIGB and to require the

shareholders' auditors to be experienced in the auditing of banks or similar deposit-taking financial institutions.

- 7.5.2 Furthermore, we recommend requiring the shareholders' auditors to report to the OIGB on the results of their examination of management assertions on the adequacy of the bank's policies and systems of internal control over its key areas of risk, and the internal auditor's examination thereof.

7.6 Concluding Comments

- 7.6.1 We have concluded that the system of supervision and regulation must be more fully developed to ensure that the conditions under which it can operate successfully are fully met in the case of each bank. Where these conditions cannot be met, the OIGB will need to resort to more thorough and rigorous examinations. In the same way, for its management inspections to be effective, it will require well developed procedures and highly qualified personnel. We believe that implementation of our recommendations will result in the establishment of a system which ensures effective bank supervision and regulation.

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Appendix A

Canadian Banks – Selected Financial Statistics

	Total Assets ⁽¹⁾ as at October 31, 1985	Net Income ⁽²⁾ for the year ended October 31, 1985
(millions of dollars)		
Domestic Banks		
The Royal Bank of Canada	96,017	488
Bank of Montreal	82,420	339
Canadian Imperial Bank of Commerce	75,834	361
The Bank of Nova Scotia	61,069	304
The Toronto-Dominion Bank	50,218	416
National Bank of Canada	23,340	154
Continental Bank of Canada	6,193	18
The Mercantile Bank of Canada	3,926	16
Bank of British Columbia	3,250	8
Northland Bank ⁽³⁾	1,391	—
Morguard Bank of Canada ⁽⁴⁾	272	1
Western & Pacific Bank of Canada	164	*
Bank of Alberta	106	2
	404,200	2,107

Foreign Bank Subsidiaries

Citibank Canada	4,607	33
Barclays Bank of Canada	1,618	4
Chemical Bank of Canada	1,359	6
Banque Nationale de Paris (Canada)	1,244	1
National Westminster Bank of Canada	1,237	4
Morgan Bank of Canada	1,089	6
Crédit Lyonnais Canada	1,015	2
Bank of America Canada	990	5
Crédit Suisse Canada	918	5
Société Générale (Canada)	764	2
Swiss Bank Corporation (Canada)	754	5
Manufacturers Hanover Bank of Canada	729	5
The Bank of Tokyo Canada	666	3
Hong Kong Bank of Canada	608	*
Midland Bank Canada	595	2
Union Bank of Switzerland (Canada)	573	2

Appendix A – Continued

	Total Assets ⁽¹⁾ as at October 31, 1985	Net Income ⁽²⁾ for the year ended October 31, 1985
	(millions of dollars)	
Deutsche Bank (Canada)	506	2
Banca Commerciale Italiana of Canada	488	*
The Chase Manhattan Bank of Canada	484	1
Fuji Bank Canada	452	1
Lloyds Bank International Canada	449	1
Dai-Ichi Kangyo Bank (Canada)	433	1
Continental Illinois Bank (Canada)	416	*
The Industrial Bank of Japan (Canada)	411	1
Crédit Commercial de France (Canada)	400	1
Mitsubishi Bank of Canada	394	1
National Bank of Detroit, Canada	384	1
Bank of Credit and Commerce Canada	381	*
Sanwa Bank Canada	362	1
Paribas Bank of Canada	353	1
The Mitsui Bank of Canada	347	1
Dresdner Bank Canada	346	1
Irving Bank Canada	335	1
Republic National Bank of New York (Canada)	309	1
Banca Nazionale del Lavoro of Canada	290	*
The First National Bank of Chicago (Canada)	286	*
Standard Chartered Bank of Canada	280	2
BT Bank of Canada	264	1
ABN Bank Canada	254	1
Mellon Bank Canada	220	*
Security Pacific Bank Canada ⁽⁴⁾	217	1
First Interstate Bank of Canada	182	1
Bank Hapoalim (Canada)	163	*
Bank Leumi le-Israel (Canada)	150	*
Comerica Bank Canada	149	*
Korea Exchange Bank of Canada	145	1
Bank of Boston Canada	138	1
Israel Discount Bank of Canada	122	*
National Bank of Greece (Canada)	113	*
Grindlays Bank of Canada	86	*
State Bank of India (Canada)	81	*
Hanil Bank Canada	65	(2)
International Commercial Bank of Cathay (Canada)	55	*
Banco Central of Canada	55	*
Overseas Bank (Canada)	36	*

Appendix A – Concluded

	Total Assets ⁽¹⁾ as at October 31, 1985	Net Income ⁽²⁾ for the year ended October 31, 1985
	(millions of dollars)	
Overseas Union Bank of Singapore (Canada)	21	*
Wells Fargo Bank Canada ⁽⁵⁾	9	*
	29,397	107
Total	433,597	2,214

(1) Source – Supplement to the Canada Gazette, December 21, 1985.

(2) Source – Bank Annual Reports.

(3) Subsequently placed in liquidation.

(4) Subsequently amalgamated.

(5) Not operating.

* Earnings of less than \$500,000.

Appendix B

Coopers & Lybrand Staff Participating in the Study

Principal Members

Warren Chippindale, FCA	Chairman and Chief Executive Partner
Richard S. Buski, CA	Partner and Chairman of the Banking Practice
Henry C. Knight, CA	Partner and Director of the Financial Institutions Consulting Practice
E. Austin Fricker, CA	Senior Consultant, Financial Institutions Consulting Practice
Christopher B. Begy, CA	Senior General Practice Manager and Director – Toronto Office Banking Practice

Support Members

David H. Atkins, FCA	Partner, Toronto Office
Patrick D. Lafferty, CA	Partner, Ottawa Office
Peter A. Smith, CA	Partner, London, England Office
Thomas H. Asson, CPA	Partner, New York, U.S.A. Office

Appendix C

List of Participants Interviewed

Chief Executive Officers

Mr. Michel Bélanger
Chairman & Chief Executive Officer
National Bank of Canada

Mr. Geoffrey D. Farrar
President & Chief Executive Officer
Barclays Bank of Canada

Mr. Bernard Fleury
President & Chief Executive Officer
Banque Nationale de Paris (Canada)
(Mr. R. Liefoghe, Executive Vice-President,
was also in attendance.)

Mr. Rowland C. Frazee
Chairman & Chief Executive Officer
Royal Bank of Canada
(Mr. D. D'Alessandro, Senior Vice-President and Comptroller,
was also in attendance.)

Mr. R. Donald Fullerton
Chairman, President & Chief Executive Officer
Canadian Imperial Bank of Commerce
(Mr. J. Bickford, Executive Vice-President,
was also in attendance.)

Mr. David A. Lewis
President & Chief Executive Officer
Continental Bank of Canada
(Mr. D.A. Rattee, Executive Vice-President and
Chief General Manager, was also in attendance.)

Mr. William D. Mulholland
Chairman & Chief Executive Officer
Bank of Montreal

Mr. Cedric E. Ritchie
Chairman & Chief Executive Officer
Bank of Nova Scotia
(Messrs. R. R. Holmes, Senior Vice-President, Planning and
Legislation, R. L. Brooks, Executive Vice-President and General
Manager, Finance and Administration and P. Nicholson, Executive
Assistant to the Chairman, were also in attendance.)

Mr. Richard M. Thomson
Chairman & Chief Executive Officer
Toronto-Dominion Bank
(Messrs. R.W. Korthals, President and A.C. Baillie, Executive
Vice-President, Investments, were also in attendance.)

Mr. Charles B. Young
President
CitiBank Canada

Mr. Edgar F. Kaiser, Jr.
Chairman & Chief Executive Officer
Bank of British Columbia

Chief Inspectors

Mr. Donald G. Barkley
Chief Inspector
Continental Bank of Canada

Mr. A.D. Broomfield
Senior Vice-President & Chief Inspector
Canadian Imperial Bank of Commerce

Mr. Maurice M. Christens
Vice-President & Chief Inspector
The Mercantile Bank of Canada

Mr. Keith O. Dorricott, FCA
Senior Vice-President & Chief Auditor
Corporate Audit Department

Mr. Georges Fortin
Vice-President
Audit
National Bank of Canada

Audit Committee Chairmen

Mr. Donald G. Campbell, FCA
Chairman
Toronto-Dominion Bank Audit Committee

Mr. E. Kendall Cork
Chairman
Bank of Nova Scotia Audit Committee
(Mr. R.D. Wolfe, Audit Committee member, was also in attendance.)

Hon. W. Darcy McKeough
Chairman
Canadian Imperial Bank of Commerce Audit Committee

Mr. Neil F. Phillips, Q.C.
Chairman
Royal Bank Audit Committee

Shareholders' Auditors

Mr. William H. Broadhurst, FCA
Senior Partner and Chairman
Price Waterhouse

Mr. Michael A. Mackenzie, FCA
Partner
Clarkson Gordon
(Mr. M. O'Regan, Partner, was also in attendance.)

Mr. James A. McMyn, CA
Partner
Peat, Marwick, Mitchell and Co.

Mr. Robert M. Rennie, FCA
Chairman of the Board
Touche Ross & Co.
(Mr. G. Rutledge, Partner, was also in attendance.)

Other Parties

Mr. Robert M. MacIntosh
President
The Canadian Bankers' Association
(Ms. L. Buckle, Financial Institutions Advisor, Mr. R. Barnowski,
Senior Co-ordinator Financial Analysis and Mr. A. Cooper
were also in attendance.)

Mr. Ronald A. McKinlay
Chairman
Canada Deposit Insurance Corporation
(Mr. C. de Léry, President, was also in attendance.)

Mr. Gerald K. Bouey
Chairman and Governor
Bank of Canada
(Messrs. S. Vachon, Advisor and J. Crow, Senior Deputy Governor,
were also in attendance.)

Mr. Robert M. Hammond
Superintendent of Insurance
Department of Insurance
(Messrs. K.B.L. Kohli, Director of Research, G.W. Poznanski,
Assistant Superintendent, D.A. McIsaac, Director, Life Insurance
Division, R.H. Mabey, Director, Property and Casualty Insurance
Division, R.G. Page, Director, Trust, Loan and Investment
Companies Division, were also in attendance.)

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Appendix E

Comparison of Bank Regulatory Systems of Selected Countries

	Canada	United Kingdom
Supervisory Authority	Office of the Inspector General of Banks (OIGB) within the Department of Finance, reporting to the Minister of Finance.	Bank of England
Legislation	Bank Act, 1980	Banking Act, 1979
Entry Procedure	Criteria set out in Bank Act covering minimum capital, directors and powers. Approval of Governor in Council required.	Criteria covering minimum capital, quality of management and proposed activities. Bank of England is the sole authority for authorization.
Permitted Activities for Banks	Banking and financially related activities excluding trade, fiduciary, investment management and portfolio management activities, providing non-bank related data processing services or acting as agent for an insurance company.	A broad range of activities is permitted, although certain activities such as insurance and primary market government securities business must be undertaken within separately capitalised subsidiaries. The bank will expect to be consulted before new activities are commenced.
Capital Adequacy	Capital leverage ratios established for each bank in consultation with the OIGB.	Capital adequacy ratios appropriate to each institution are agreed and compliance monitored. The review is based on a risk asset ratio constructed by reference to risk-weighted asset measures.
Liquidity	Reserve regulations under Bank Act approved by Governor in Council.	Informal monitoring by Bank, particularly of primary, secondary ratio and of projected liquidity. Maturity information is submitted regularly to Bank.
Large Loans	Formal guidelines issued for the foreign bank subsidiaries to restrict loans to 100 per cent of capital. Informal guidelines have been communicated to the domestic banks to restrict such loans to 50 per cent of capital.	Prior to 1986, banks were not subject to regulatory limitations although they were reported to the Bank. New procedures will require reporting of connected exposure greater than 10 per cent of capital and will normally prohibit connected exposure greater than 25 per cent of capital.

	Canada	United Kingdom
Foreign Exchange Exposures	Not subject to regulatory limitations. Exposure is reported monthly to the OIGB.	Long, short and net position limits are set by Bank and reported.
Country Exposure	No specific limits. Monthly reporting to the OIGB.	No specific limits but regular reporting required.
Provisions	Non-performing loans are reported quarterly. Asset quality is reviewed during the annual inspection. Provisions are required to be maintained against country risk credits as directed.	No specific limits.
Inspection/Audit	The OIGB is required to inspect each bank annually. It does not conduct comprehensive on-site audits. It relies heavily on bank's internal and external auditors.	Companies legislation requires independent audit. Bank does not carry out regular on-site examinations but it has powers to appoint Inspectors.
	United States	Switzerland
Supervisory Authority	Supervision is divided between: <ol style="list-style-type: none"> 1. Federal Reserve System 2. Office of the Comptroller of the Currency 3. Federal Deposit Insurance Corporation 4. Various state agencies. Majority of banks come under both federal and state supervision. 	Federal Banking Commission (FBC) (separate from central bank which has no formal supervisory responsibilities) is chief supervisor and licensing authority.
Legislation	Federal Law and individual state laws.	Federal Law Relating to Banks and Savings Banks, implemented via the Banking Ordinance.
Entry Procedure	There are minimum requirements for capital. Procedures may vary according to whether the bank is applying for a national or state charter.	Specific regulations governing minimum capital, proposed activity and management quality. (FBC can require higher ratios from banks engaged in international lending.)
Permitted Activities for Banks	Generally confined to traditional banking activities. With limited exceptions, banks cannot undertake securities business or engage in insurance or commercial activity (Glass- Steagall Act).	Although not restricted by law, permitted activities are mostly financially related. Fiduciary business may be undertaken at customers' risk.
Capital Adequacy	Federal supervisors' regulations require separate ratios to be calculated for primary and total capital (on a gearing type basis); current minimum levels are 5.5 per cent and 6.0 per cent respectively.	Minimum ratios set down under the risk asset approach.

	United States	Switzerland
Liquidity	No specific requirements although close reviews are undertaken at the time of examinations.	Regulations require minimum liquidity based on two stage structure; a measure of liquid assets against short term liabilities (up to 1 month, plus 15 per cent of savings deposits), and a measure of liquid assets and marketable assets against short term liabilities.
Large Loans	15 per cent of capital for federally chartered banks. State limits vary between 10 and 25 per cent of capital, depending on State and security held.	Large loans limited in a range from 20 per cent of capital for unsecured advances, to 160 per cent of capital for Swiss public sector risk.
Foreign Exchange Exposures	Not subject to regulatory limitation, although they are reported monthly to the federal authorities and reviewed during examination.	Where total foreign exchange exposure exceeds 40 per cent of capital a bank must inform FBC.
Country Exposure	Quarterly reporting, and disclosure to the public of large exposures to individual countries. No specific supervisory limit.	No specific limits, but there is regular reporting and monitoring. Auditors required to comment on banks' efforts at evaluating country risk.
Provisions	Asset quality reviewed primarily during examination. Under the Allocated Transfer Risk Reserve requirement, "reserves" must be maintained against country risk credits which are classed as value impaired: minimum 10 per cent, or as directed.	Provisions of 20 per cent are required for specified developing and newly industrialized countries.
Inspection/Audit	Comprehensive on-site examination: for chartered banks this takes place at least once every three years. Also, limited interim examinations. Supervisory authorities tend to rely on their own examinations rather than on external auditors.	Independent bank auditors are approved by and act as agents for the FBC. They examine compliance with regulations on an annual basis with intermediate checks. The form of their reports follow a guidance note issued by FBC.

	France
Supervisory Authority	<ol style="list-style-type: none"> 1. Banking Commission*: responsible for monitoring compliance with regulations. It relies on the central bank to carry out much of the supervision. 2. Committee on Bank Regulation (COBR)—technical body to establish regulations, ratios, accounting standards, etc. 3. Committee on Credit Institutions (CCI)* — issues new licences and technical decisions.

* Chaired by Governor of central bank. Governor also sits on COBR.

	Germany
	Federal Banking Supervisory Office (FBSO) reporting to Ministry of Finance exercises its functions in close collaborations with central bank. FBSO consulted on appropriate ratios, etc., and collects supervisory data.

	France	Germany
Legislation	Banking Law 1984 set up single supervisory structure.	Banking Law (last amended 1985) defines the scope of the supervisory system.
Entry Procedure	Criteria set down in Banking Law, covering capital, proposed activity and quality of management. Authorizations are granted by CCI.	FBSO is the sole authority for authorization. There are criteria covering minimum capital, proposed activity and quality of management.
Permitted Activities for Banks	Banking and financially related activities, including securities, underwriting, etc.	Banking and financially related activities. Also non-financial activities, e.g. capital investment in corporate borrowers, etc.
Capital Adequacy	Minimum risk asset ratio levels set by COBR according to a differentiation based on categories of institution. Endowment capital required for branches.	FBSO, in conjunction with central bank, has established certain "Principles". Under one of these, a bank's loans and participation may not exceed eighteen times capital, calculated on a risk asset basis.
Liquidity	COBR empowered to set minimum levels. Short-term ratio requires liquid assets of 60 per cent of 3 month liabilities. Medium and long-term assets limited to three times a bank's savings deposits and capital.	FBSO's Principles also cover liquidity. There are complex formulae covering short, medium and long-term liquidity.
Large Loans	No more than 50 per cent of capital allowed in lending to one customer (does not apply to bank – if less than 1 year – or government guaranteed credits). In addition, total of loans exceeding 25 per cent of capital must not be more than eight times own funds.	Loans to any group of related customers not to exceed 50 per cent of capital. Also limit on the aggregate amount of large loans. Special reporting for loans to parties connected with lender which are deducted from own funds.
Foreign Exchange Exposures	Exchange controls exist. Specific authorization is required. Maximum levels of exposure are set by the central bank.	Difference between assets and liabilities in foreign currency not to exceed 30 per cent of capital.
Country Exposure	No specific limits; regular reporting to the commission.	No specific limits but regular reporting and monitoring.

	France	Germany
Provisions	No minimum requirements, but assessed in the light of overall asset quality.	No minimum requirement, but regular assessment. Increases sought where necessary.
Inspection/ Audit	On-site inspections by central bank (for a normal bank, every 4/5 years). Commission can refuse appointment of auditors.	FBSO entitled to inspect, with or without particular cause. The inspectors used will be auditors, Bundesbank officials or FBSO staff. Auditors appointed by the bank must submit their report to FBSO.

Sources:	Canada, United States, Switzerland France and Germany United Kingdom	– respective Bank Acts – U.K. White Paper (December, 1985).
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This matrix has been prepared on the basis of up-to-date information but in a highly simplified form.

Appendix F

Proposed Changes to Financial Institution Supervision

The accompanying synopsis summarizes changes to the supervision of financial institutions as proposed in:

- The Regulation of Canadian Financial Institutions: Proposals for Discussion (Green Paper) (Canada)
- House of Commons Standing Committee on Finance, Trade and Economic Affairs – Eleventh Report on the Regulation of Canadian Financial Institutions: Proposals for Discussion
- Chancellor of the Exchequer White Paper on Banking Supervision (U.K.)
- Blueprint for Reform: The Report of the Task Group on the Regulation of Financial Services (Bush Report)

Proposed Changes to Financial Institution Supervision

Subject	Canada Green Paper (Apr. '85)	Canada Commons Report (Dec. '85)	Canada Senate Report	United Kingdom White Paper (Dec. '85)	United States Bush Report (July '84)
Supervisory Authority	<ul style="list-style-type: none"> Combine federal supervisors (Inspector General of Banks and Superintendent of Insurance) 	<ul style="list-style-type: none"> Create independent agency "National Financial Administration Agency" to include both federal supervisors and Canada Deposit Insurance Corporation Separate board of directors Separate branches for banks, trust, life and property companies and pension funds Regional offices across Canada NFAA to maintain separate consumer protection plans (e.g. Deposit Insurance) for each type of financial institution Cost of NFAA be charged back to each supervised institution 		<ul style="list-style-type: none"> Create new Bank of England Board of Banking Supervision to assist Governor in his banking supervisory responsibilities Board is responsible for advising Governor on <ul style="list-style-type: none"> – broad supervision issues – development and evolution of supervisory practice – administration of new bank supervisory legislation – structure, staffing and training of Banking Supervision Division Board consists of 3 permanent ex-officio members including Governor and 5 outside board members Activities of Board reported to Chancellor of the Exchequer Greater control to be established over representative offices of overseas banks 	<ul style="list-style-type: none"> Maintain dual banking system (federal/state) and other elements of checks and balances Create "new" Federal Banking Agency within Treasury Dept. to regulate all national banks while Federal Reserve Board would be responsible for federal regulation of state chartered banks Agency regulating bank would also supervise its parent holding company Federal Reserve Board to continue to supervise largest banks, those with significant international activities and foreign banks FDIC would focus solely on bank deposit insurance system Banks, thrifts and credit unions would continue to be supervised and insured separately

Proposed Changes to Financial Institution Supervision – Continued

Subject	Canada Green Paper (Apr. '85)	Canada Commons Report (Dec. '85)	Canada Senate Report	United Kingdom White Paper (Dec. '85)	United States Bush Report (July '84)
Supervisory Methods	<ul style="list-style-type: none"> • Supervisor to have access to accounts and records of Financial Holding Company and its member firms • Specify criteria for granting new licences 	<ul style="list-style-type: none"> • Perform on-site inspections • One of two external auditors be appointed by and report to NFAA • NFAA to participate in annual meeting with shareholders' auditors and bank Audit Committee • On-site inspection to be condition of liquidity support • Increased disclosure of fee income on restructured loans; amount of non-accrual loans and interest accrued; related party transactions • Hold post-resignation reviews with auditors, directors and officers • Monitor brokered deposits • Pre-notification to NFAA of special or extraordinary dividend • NFAA to have remedial powers similar to those in U.S.A. bankruptcy law (Chapter 11) 		<ul style="list-style-type: none"> • Organization and personnel changes to be made to improve supervisory system • Executive Director position established • Standing Committees established • Responsibilities of managers clarified • Frequency and content of supervisory contracts enhanced • Planning to increase secondments of experienced accountants and commercial bankers • Planning to increase outward secondment of supervisory staff to commercial banks and accountancy firms • Plan to develop core staff of career individuals 	

Proposed Changes to Financial Institution Supervision – *Continued*

Subject	Canada Green Paper (Apr. '85)	Canada Commons Report (Dec. '85)	Canada Senate Report	United Kingdom White Paper (Dec. '85)	United States Bush Report (July '84)
Enforcement Powers	<ul style="list-style-type: none"> • Issue cease and desist orders • Prohibit changes in control • Increased grounds for taking immediate control of assets of banks • Authority to force divestiture of prohibited loans and investments • Power to require restoration of assets illegally paid out 	<ul style="list-style-type: none"> • Appoint curator • Issue cease and desist order • Suspend/remove directors and senior officers • Require declaration of interests of substantial shareholders • Deem transactions to be non-arm's length • Force divestiture of prohibited loans/investments • Require restoration of assets paid out • Specify asset values • Substantially increase penalties • Impose criminal penalty on directors and officers for gross negligence 		<ul style="list-style-type: none"> • Breach of information requirements will be seen as warning sign and will subject bank to closer inspection • Criminal sanctions to be made available for breach of information requirements • Institute statutory provisions to gain access to information from any person appearing in breach of the Act • Provisions for granting conditional licences to be improved • Prior approval required for changes in control 	

Proposed Changes to Financial Institution Supervision – Continued

Subject	Canada Green Paper (Apr. '85)	Canada Commons Report (Dec. '85)	Canada Senate Report	United Kingdom White Paper (Dec. '85)	United States Bush Report (July '84)
Auditors		<ul style="list-style-type: none"> • NFAA to maintain list of approved auditors and other professionals • NFAA in conjunction with CICA and others to develop standards for financial reporting • NFAA to require professional bodies to establish solvency standards • Establish severe disciplinary standards against professionals who fail to observe standards 		<ul style="list-style-type: none"> • Mandatory report from external auditors to supervisor required on adequacy of control systems and other specified matters • Prudential statistical returns to supervisors to be examined periodically by external auditors • Supervisor may require appointment of second auditing firm if he is dissatisfied with auditors • External auditor required to notify supervisor if he resigns, retires or qualifies his report • Bank must advise supervisor if it fires its auditor • Existing confidentiality constraints on auditors and supervisors to be removed • Qualified privilege should attach to communications between auditors and supervisors 	

Proposed Changes to Financial Institution Supervision – Concluded

Subject	Canada Green Paper (Apr. '85)	Canada Commons Report (Dec. '85)	Canada Senate Report	United Kingdom White Paper (Dec. '85)	United States Bush Report (July '84)
Directors		<ul style="list-style-type: none"> • Increase standard of care from prudent person to prudent director • Financial institution directors must be on register approved by NFAA • Greater use of specific board oversight committees re conflicts of interest, self-dealing • Impose minimum but no maximum size of board • Independent board members only to sit on oversight committees • No restrictions on interlocking directors 		<ul style="list-style-type: none"> • Board required to set out policy in writing on large exposures to banks, countries and economic sectors • Bank required to advise supervisor of individual exposures exceeding 10 per cent of capital base and obtain prior approval of individual exposures exceeding 25 per cent of capital base 	

Appendix G

Comparison of Selected Statistics

Canadian and United States

Financial Institution Regulators and Insurers

	Number of Institutions Insured ⁽¹⁾ /Supervised ⁽²⁾	Assets of Institutions Insured ⁽¹⁾ /Supervised ⁽²⁾	Size of Staff	Agency Expenses	Assistance to Depositors
United States					
Federal Deposit Insurance Corporation					
1983	14,500 ⁽¹⁾	\$1.69 trillion (deposits) ⁽¹⁾	3,846	\$970 million	\$1.2 billion
1984	14,785 ⁽¹⁾	\$1.81 trillion (deposits) ⁽¹⁾	5,076	\$1.3 billion	\$309 million
Federal Savings and Loan Insurance Corporation					
1983	3,183 ⁽¹⁾	\$818 billion ⁽¹⁾	103	\$26.1 million	\$1.8 billion
1984	3,167 ⁽¹⁾	\$979 billion ⁽¹⁾	116	\$32.3 million	\$2.66 billion
National Credit Union Corporation					
1983	15,881 ⁽²⁾	\$81.9 billion ⁽²⁾	850	\$101 million	\$9.9 million
1984	15,163 ⁽²⁾	\$94.4 billion ⁽²⁾	620	\$86.3 million	\$34.8 million

Comparison of Selected Statistics

Canadian and United States

Financial Institution Regulators and Insurers – *Concluded*

	Number of Institutions Insured ⁽¹⁾ /Supervised ⁽²⁾	Assets of Institutions Insured ⁽¹⁾ /Supervised ⁽²⁾	Size of Staff	Agency Expenses	Assistance to Depositors
Canada					
Inspector General of Banks					
1983	73 ⁽²⁾	\$383.6 billion ⁽²⁾	30	\$1.7 million	N.A.
1984	72 ⁽²⁾	\$428.4 billion ⁽²⁾	36	\$1.9 million	N.A.
Federal Superintendent of Insurance					
1983	270 ⁽²⁾	\$181.2 billion ⁽²⁾	208	\$13.1 million	N.A.
1984	270 ⁽²⁾	\$206.2 billion ⁽²⁾	214	\$13.3 million	N.A.
Canada Deposit Insurance Corporation					
1983		\$297.6 billion ⁽¹⁾ (Est)	11	\$2.8 million	\$23.5 million
1984	186 ⁽¹⁾	\$326.5 billion ⁽¹⁾	16	\$3.1 million	\$201 million

Source: Department of Finance

Note: Data for the other two substantial other U.S. regulators, namely, the Comptroller of the Currency and the Federal Reserve System are not available.

Appendix H

Risk and Control Assertions

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Appendix H

H.1 Risk and Control Assertions

- H.1.1 As stated in paragraph 4.6.2 the OIGB is reliant upon the effectiveness and continued operation of the policies and systems of internal control in place at each bank and the information produced by those systems. In order to establish a basis for that reliance, the OIGB needs to have a reasonable level of assurance that:
- the individual banks have properly identified the key areas of risk with which they are faced, and
 - adequate policies and systems of internal control exist and are in use to:
 - i) monitor and allow for the timely and effective management of those areas of risk; and
 - ii) ensure the adequacy of the related financial reports submitted to the OIGB.
- H.1.2 As described in paragraph 4.6.5, senior bank management should report annually to the OIGB on the extent to which the policies and related internal controls operate to manage the risks of the business and ensure accurate financial reports. These “assertions” would be subject to the review of the internal audit department and the shareholders’ auditors.
- H.1.3 The implementation of this system gives rise to a number of issues:
- the confidentiality of the management assertions;
 - the need to develop guidelines on risk identification and minimum requirements for systems of internal controls;
 - the procedures for disclosure of deficiencies in policies and internal controls;
 - the specific wording of the required reports; and
 - the standards underlying the review of the assertions by the internal audit department and by the shareholders’ auditors.
- H.1.4 Attached are sample letters which might be prepared in respect of these management assertions. These letters include:
- a sample letter to the Inspector from the Chief Executive Officer and Chief General Manager of a Schedule A bank describing the policies and systems of internal control relating to credit risk;
 - a sample letter to the Inspector from the Chief Inspector of the same Schedule A bank; and
 - a sample letter to the Inspector from the shareholders’ auditors of the same Schedule A bank.

ABC Bank of Canada

The Inspector General of Banks
Ottawa, Ontario

Dear Sir:

As requested in your letter of _____, we have identified the key areas of risk facing the bank and the key elements thereof.

In accordance with the guidelines on Risk Identification issued by your office, these key areas of risk facing the bank and their key elements are as follows:

e.g. Credit Risk

- concentration of exposure to industry segments, geographic segments and individual customers;
- enforceability of security documents and credit agreements;
- evaluation of security;
- identification of accounts of doubtful collectability;
- timely action on accounts of doubtful collectability;
- timely adjustments to loan valuation; and
- rates of return.

In our opinion, the bank's policies and systems of internal control as described in Attachment I are sufficient to:

- i) monitor and allow for the timely and effective management of these risks; and
- ii) ensure the accuracy of the related financial reports submitted to your office.

Yours very truly,

Chief Executive Officer

Chief General Manager

Example – Attachment I

ABC Bank of Canada Assessment of Risk for the Period Ended

Elements of risk	Significant policies in place to address the risk	Significant controls	Current status of the controls	Remedial action being taken by management
Concentration of exposure to industry segments, geographic segments and individual customers	<ul style="list-style-type: none"> Loans and advances to customers in any one industry, as defined, are not to exceed 20 per cent of capital. 	<ul style="list-style-type: none"> A monthly report of loans and advances outstanding by industry is prepared and approved by executive personnel. 	The aggregate credits outstanding to an individual industry are not in excess of 20 per cent of capital.	—
	<ul style="list-style-type: none"> Loans and advances to customers in any one geographic location, as defined, are not to exceed 20 per cent of capital. 	<ul style="list-style-type: none"> A monthly report of loans and advances outstanding by geographic location is prepared and approved by executive personnel. 	Loans and advances outstanding to borrowers in Alberta total 22 per cent of capital. Loans and advances to borrowers in all other individual geographic areas do not exceed 12 per cent.	New advances in Alberta are being reduced until the outstanding amounts are within policy limits.
Enforceability of security documents and credit agreements.	<ul style="list-style-type: none"> Loan agreements and security documents are to be adequately documented and legally enforceable. 	<ul style="list-style-type: none"> Written guidelines for completion of loan agreements and security documents have been distributed to all account management and credit personnel. 	Guidelines are updated monthly as appropriate.	—
		<ul style="list-style-type: none"> Legal opinions are obtained on significant agreements and security documents prior to advancement of funds. 	—	—
		<ul style="list-style-type: none"> A dual system of account management and credit approval is in place. Credit personnel review loan agreements and security documents and concur on their completeness prior to advancement of funds. 	—	—

Elements of risk	Significant policies in place to address the risk	Significant controls	Current status of the controls	Remedial action being taken by management
Evaluation of security	<ul style="list-style-type: none"> The adequacy of security pledged should be evaluated at periodic intervals. 	<ul style="list-style-type: none"> Written guidelines have been developed and distributed to account management and credit personnel detailing requirements for valuation of security. 	Guidelines are updated as circumstances warrant.	—
		<ul style="list-style-type: none"> The valuation of real estate assets pledged as security is performed prior to advancement of funds and at such other times as considered appropriate in the circumstances. 	—	—
Identification of accounts of doubtful collectability	<ul style="list-style-type: none"> Loans, other than personal plan and credit card loans, are reviewed on a quarterly basis for collectability. 	<ul style="list-style-type: none"> Written guidelines have been established and distributed to all credit personnel describing the procedures for the review of credits for collectability. 	Guidelines are updated as circumstances warrant.	—
		<ul style="list-style-type: none"> Loans and advances are subject to a review for collectability on a quarterly basis. A rating system is in place to identify accounts on the basis of the risk associated with the accounts. The system applies a rating ranging from 1 (low risk) to 5 (high risk — provision for loss recorded). 	<p>Loans and advances other than personal and credit card loans are reviewed quarterly.</p> <p>—</p>	—

Elements of risk	Significant policies in place to address the risk	Significant controls	Current status of the controls	Remedial action being taken by management
Timely action on accounts of doubtful collectability	<ul style="list-style-type: none"> Action should be taken on a timely basis in respect of accounts of a doubtful nature. 	<ul style="list-style-type: none"> Written guidelines have been established and distributed to all credit personnel. 	Guidelines are updated as circumstances warrant.	—
		<ul style="list-style-type: none"> Special units have been established with specialized personnel to monitor accounts where collectability of outstanding amounts is in doubt. 	There are currently eight such units, each administered by a senior vice-president monitoring 384 loans of various sizes.	—
Timely adjustments to loan valuations	<ul style="list-style-type: none"> Loans should be recorded at their net realizable value. 	<ul style="list-style-type: none"> Loans are reviewed on a quarterly basis. If there is doubt as to the ultimate collectability of the outstanding principal, a provision is established at a level sufficient to reduce the loan to its estimated net realizable value. 	Loans were reviewed on a quarterly basis. Provision for losses totalling \$896 million have been established to reduce the loans to their estimated net realizable value.	—
Rates of return	<ul style="list-style-type: none"> The rate of return charged to customers will reflect market conditions and the risk inherent in the credit. 	<ul style="list-style-type: none"> Written guidelines for rates applicable to credits have been developed and distributed to all credit personnel. 	Guidelines are updated as circumstances warrant.	—
		<ul style="list-style-type: none"> Rates of return are reviewed and approved by credit personnel during periodic reviews of the credits and approved by executives of the bank. 	—	—

ABC Bank of Canada

Inspector General of Banks
Ottawa, Ontario

Dear Sir:

As Chief Internal Auditor of ABC Bank of Canada, I have examined the operation of the policies and internal controls of the bank for the period ended _____ (date) _____ relating to the key areas of risk and their key elements as described in the letter to you of _____ (date) _____ signed by _____ of this bank.

My examination consisted of a review and such tests as I considered necessary in the circumstances of:

- (a) the method of identifying the key areas of risk and their elements;
- (b) the related policies and systems of internal control over those areas of risk and their elements; and
- (c) the financial reports on each of these areas or their elements that have been submitted to your office.

In my opinion:

- (a) the bank's management has identified the key areas of risk facing the bank and their key elements, in accordance with the guidelines on Risk Identification issued by your office; and
- (b) the bank's policies and systems of internal control as described are sufficient to:
 - i) monitor and allow for the timely and effective management of these risks; and
 - ii) ensure the accuracy of the related financial reports submitted to your office.

Yours very truly,

Chief Inspector

The Inspector General of Banks
Ottawa, Ontario

Dear Sir:

Re: ABC Bank of Canada

We have examined:

- (a) the letter from the bank to you dated _____ signed by _____ which identifies the key areas of risk facing the bank, their key elements and the bank's policies and related systems of internal control in respect of those areas of risk and their elements; and
- (b) the examination performed thereon by the Chief Inspector of ABC Bank of Canada as described to you in his letter of _____ (date).

Our examination consisted of:

- (a) a review of the guidelines on Risk Identification issued by your office;
- (b) a review and examination of the methodology employed in the identification of the key areas of risk and their key elements;
- (c) a review and examination of the policies and systems of internal control over those areas of risk and their elements; and
- (d) a review and such tests as we considered necessary in the circumstances of the above-mentioned internal audit examination.

In our opinion:

- (a) the bank's management has identified the key areas of risk facing the bank and the key elements of those risks, in accordance with the guidelines on Risk Identification issued by your office; and
- (b) the internal audit examination conducted should provide reasonable, but not absolute, assurance that the policies and systems described are sufficient to:
 - i) monitor and allow for the timely and effective management of these risks; and
 - ii) ensure the accuracy of the related financial reports submitted to your office.

Yours very truly,

A & Co., Chartered Accountants

B & Co., Chartered Accountants

Appendix I

How the OIGB Is Organized to Carry Out Its Responsibilities

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Appendix I

I.1 Introduction

- I.1.1 The purpose of this appendix is to describe how the OIGB is organized to carry out its mandate and to provide an overview of its operations.

I.2 Mandate of the OIGB

- I.2.1 As discussed in Chapter 4, the mandate of the OIGB can be summarized as follows:
- I.2.1.1 To be responsible to the Minister for the administration of the Act, as well as to:
- report annually to the Minister on the correctness of the banks' cash reserve returns; and
 - make or cause to be made the examinations and inquiries as referred to in the Canadian Payments Association Act;
- I.2.1.2 To make or cause to be made at least annually such examination and inquiry into the business and affairs of each bank as the Inspector may deem necessary or expedient for the purpose of reporting to the Minister whether the provisions of the Act having reference to the safety of depositors, creditors and shareholders have been duly observed and that the bank is in sound financial condition;
- I.2.1.3 To make such other examinations and inquiries as considered necessary by the Minister;
- I.2.1.4 To advise the Minister on policy matters respecting banks and banking; and
- I.2.1.5 To respond to complaints on banking matters received from the public.

I.3 Organization

- I.3.1 In order to fulfill his mandate, the Inspector has organized his office on a divisional basis, with the director of each division reporting to the Assistant Inspector. The divisions, which have been in place since July 1982, are:
- Compliance
 - Inspection
 - Research.

I.4 Specific Responsibilities

- I.4.1 The specific responsibilities of each of these divisions are set out in the position descriptions of each of the division directors. In summary, these responsibilities are as follows:

Compliance

- I.4.1.1 To direct the implementation of procedures for analyzing applications for incorporation and assessing the capabilities of the applicants and the soundness of their business plans;
- I.4.1.2 To ensure that banks and others are complying with banking legislation and related regulations by developing and enforcing appropriate standards, policies and procedures;
- I.4.1.3 To participate in the formulation of policies and the development of legislative provisions;
- I.4.1.4 To recommend and carry out the imposition of directives and to direct the taking of legal proceedings in cases of non-compliance;
- I.4.1.5 To plan, organize and direct the examination of representative offices of foreign banks;
- I.4.1.6 To maintain contact with senior officers of banks, legal counsel, shareholders' auditors, officials of federal and provincial government departments and private sector sources; and
- I.4.1.7 To conduct an ongoing review of current OIGB regulations to assess their relevance.

Inspection

- I.4.1.8 To develop standards, policies and practices for the conduct of inspections of banks;
- I.4.1.9 To plan, organize and direct the inspection program;
- I.4.1.10 To review the results of individual inspections with senior bank officials and senior officials of the OIGB, identifying areas of weakness and proposing remedial action;
- I.4.1.11 To recommend, as required, the imposition of constraints on the activities of individual banks;
- I.4.1.12 To examine the contingency reserves of banks which are deductible for income tax purposes; and
- I.4.1.13 To maintain contact with senior officials of banks, shareholders' auditors, officials of other federal government departments, the Bank of Canada, foreign supervisory authorities and private sector sources.

Research

- I.4.1.14 To manage the in-house research and analysis process to develop an integrated system of studies and reports on bank accounting, tax, regulatory and financial issues to make appropriate recommendations to the Inspector;

- I.4.1.15 To develop programs for the rehabilitation of problem banks by advising the Inspector as to the nature and causes of specific problems and monitoring remedial actions being taken as to their timely implementation and progress in achieving the intended results; and
- I.4.1.16 To develop consistent accounting rules for banks and issuing special instructions.

Compliance Division

I.5 Mandate of the Division

- I.5.1 The primary functions of the Compliance division are to:
- assess applications for incorporation;
 - ensure compliance with the Bank Act;
 - recommend and impose directives; and
 - perform the role of ombudsman between banks and their customers.

I.6 Personnel

- I.6.1 The division comprises five individuals below the director with varying backgrounds in law, government administration, government audit and public relations.
- I.6.2 The responsibilities of each employee in the division are set out in position descriptions developed for each job classification at varying dates from 1982 through 1985.
- I.6.3 The performance of personnel is rated annually using the standard Performance Review and Appraisal Report of the Department of Finance.

I.7 Training and Education

- I.7.1 The division does not have "in-house" training courses. We were informed by the division director that division personnel have not recently attended any training courses.

I.8 Internal Communications

- I.8.1 During the year, division directors normally met with the OIGB senior executives on a weekly basis to review projects in progress and current issues. We understand that the frequency of the meetings has been sporadic since September 1985.
- I.8.2 Personnel within the division have described the lines of communication within their division as "informal" in nature. Individuals maintain an awareness of other activities within the OIGB through the review of files of correspondence assembled weekly for each division which are circulated throughout the OIGB.

I.9 Procedures and Activities

- I.9.1 The functions of the division encompass a large number of discreet activities which include the following:

Ongoing compliance matters

- I.9.1.1 The assessment of applications for increases in the level of deemed capital and development of recommendations relating thereto;
- I.9.1.2 Responding to enquiries of banks and shareholders' auditors concerning compliance with the Bank Act or regulations;
- I.9.1.3 Review of the annual returns of reserves and insured deposits submitted by shareholders' auditors;
- I.9.1.4 The provision of information requested by the Inspection division prior to the conduct of inspections;
- I.9.1.5 The review of merger agreements and development of recommendations thereon;
- I.9.1.6 The preparation of orders in council;
- I.9.1.7 The review of various compliance returns received from banks;
- I.9.1.8 The review of preliminary and final prospectuses;
- I.9.1.9 The review, analysis and development of recommendations concerning applications to incorporate including preparation of orders in council and letters patent and the issuance of banking licences;
- I.9.1.10 The renewal of banking licences;
- I.9.1.11 The completion of special projects as necessary; and
- I.9.1.12 The investigation of breaches or possible breaches of the Bank Act and the issuance of letters to others concerning compliance.

Other

- I.9.1.13 Performance of an inspection of the Canadian Payments Association and the drafting of a report from the Inspector to the Minister;
- I.9.1.14 Performance of inspections of representative offices of foreign banks;
- I.9.1.15 Fulfillment of the role of ombudsman between the banks and their customers resulting from approximately 2,000 complaints per year directed to the OIGB; and
- I.9.1.16 Calculation of billings to banks to recover the costs of the OIGB.

Inspection Division

I.10 Mandate of the Division

- I.10.1 The primary function of the Inspection division is to fulfill the mandate of the Inspector under Section 246(2) of the Act which requires him to conduct an

inspection to satisfy himself that the provisions of the Act having reference to the safety of depositors, creditors and shareholders have been complied with and that the bank is in a sound financial condition.

I.11 Personnel

- I.11.1 In order to meet this requirement, the Inspection division employs eleven inspectors (including the division director and an inspector on executive interchange) of varying civil service classifications for the purpose of conducting what it terms a "management" inspection. Personnel employed in the division below the director have been hired from a variety of backgrounds. Based upon the experience of each of the individuals other than the director over the past five years, their backgrounds can be classified as follows:

		Number of employees
Government experience	-	5
Bank experience	-	4
No previous experience	-	$\frac{1}{10}$

- I.11.2 Our review indicated that two of the employees are Chartered Accountants, one is a Certified General Accountant, one is a Certified Management Accountant, one is a Chartered Financial Analyst, one is a Fellow of the Institute of Canadian Bankers, two have Masters degrees in Business Administration and one has a Bachelor of Commerce degree.
- I.11.3 Of the ten employees in the division below the director, six have joined in the past year. We understand through discussions with the division director that he has recently engaged the services of twelve retired individuals with credit experience to assist the division on a contract basis when required.
- I.11.4 The responsibilities of each employee in the division are set out in position descriptions which were developed in 1983 for each job classification.
- I.11.5 The performance of personnel is rated annually using the standard Performance Review and Appraisal Report of the Department of Finance.

I.12 Training and Education

- I.12.1 The division does not have "in-house" training courses. However, over the past two years, a number of personnel from the division have:
- attended Federal Financial Institutions Examination Council (U.S.) courses on bank analysis,
 - attended Federal Deposit Insurance Corporation (U.S.) courses on foreign exchange and international banking,
 - attended Office of the Comptroller of the Currency (U.S.) courses on interview techniques,
 - attended a number of credit courses provided by four of the major banks,
 - attended a course on asset and liability management,

- spent a day at the foreign exchange and money market trading operation of several major banks or,
- viewed 10-12 videotapes on various banking topics developed by a major U.S. bank.

I.13 Assignments

- I.13.1 The assigning of personnel to specific 1985 inspections was performed in December 1984, January 1985 and July 1985 for the ensuing months. These assignments were based upon availability of personnel and previous experience with the individual banks. In an attempt to provide experience to new personnel, a combination of experienced and new personnel were often assigned to inspections. The assignment forecasts identified inspections which were to be attended by the division director, Assistant Inspector and the Inspector. The Assistant Inspector or Inspector were scheduled to attend the inspection of each of the Schedule A banks.
- I.13.2 The division did not schedule inspections during the period of June 22, 1985 to August 26, 1985 (ostensibly at the request of the banks due to vacation commitments) and December 6, 1985 to January 13, 1986. Further, Schedule B bank inspections were generally not conducted on Mondays or Fridays.

I.14 Internal Communications

- I.14.1 During the year, division directors normally met with the OIGB senior executives on a weekly basis to review projects in progress and current issues. We understand that the frequency of the meetings has been sporadic since September 1985.
- I.14.2 Personnel within the division have described the divisional communications as being "informal" in nature. The Inspection division does, however, meet formally each Monday morning to review the prior week's activities as well as the activities which are planned for the current week. The division's personnel maintain an awareness of other activities within the OIGB through the review of files of correspondence assembled weekly for each division which are circulated throughout the OIGB.

I.15 Inspection Procedures and Activities

- I.15.1 The annual inspection conducted by the division has been categorized by the division director as essentially a "management" inspection, as it does not encompass an examination of the financial records of the bank.
- I.15.2 The inspection consists of a preliminary phase conducted in the division's office and a management interview phase conducted at the head office of each bank.
- I.15.3 The activities performed in each of these two phases are as follows:

Preliminary

- I.15.3.1 Approximately 2-3 months in advance of the proposed inspection dates, the necessary arrangements are made with the Chief Financial Officer by the assigned inspector. These include confirmation of appointments to meet senior bank personnel and arrangements for

the preparation of a pre-inspection questionnaire. The arrangements are subsequently confirmed in writing by the inspector with a copy of the pre-inspection questionnaire for completion.

I.15.3.2 The pre-inspection questionnaires for Schedule A banks are developed on the basis of the prior year's inspection and are intended to supplement the information received on a regular basis from the banks. Based upon our review of a number of these questionnaires, the information sought includes the following:

- staff complement and turnover statistics;
- most recent management letter from the shareholders' auditors;
- profitability by functional area;
- loans outstanding by product classification;
- yields on loans by classification;
- a listing of large loans with authorized or outstanding amounts greater than threshold amounts;
- non-current loans by industry classification;
- a listing of the largest twenty non-current loans;
- deposits outstanding by type;
- maturity schedules of assets and liabilities; and
- the annual report of the Chief Inspector to the Audit Committee.

I.15.3.3 For Schedule B banks, the pre-inspection questionnaire is a standard pre-printed document which is intended to supplement the information received on a regular basis from the banks and which requests the following types of information:

- an organization chart and details of staff complement;
- information concerning the 50 largest loans, including acceptances;
- a listing of the 25 largest authorized guarantees and letters of credit over \$1 million;
- a listing of all loans on which interest is past due 90 days or more;
- a listing of all loans outstanding against which provisions for loan losses have been made;
- transactions between the bank and its parent and affiliates;
- a brief definition of the bank's internal classification of its loan portfolio and the number of loans and dollar value of loans outstanding, by classification;
- the total amount of deposits, by funding source;
- the date of the most recent inspection of the bank by the parent bank internal auditors and a copy of the report; and

- a copy of the most recent management letter of the shareholders' auditors.
- I.15.3.4 The request for information relating to the listing of all loans outstanding against which provisions for loan losses have been made and information concerning the number and value of loans categorized in accordance with the bank's internal rating system were incorporated in the pre-inspection questionnaire issued on December 4, 1985. This information was therefore not obtained in the 1985 inspections.
- I.15.3.5 The inspectors obtain a report of financial results of the bank from the division's database which is maintained on a personal computer. The information includes:
- a monthly condensed balance sheet for the previous twelve months;
 - a monthly summary of domestic assets (Schedule Q) for the previous twelve months;
 - a quarterly summary of revenue and expenses (Schedule O);
 - a report detailing the calculation of all revenue and expense items as a percentage of average total assets;
 - a report detailing interest revenue and expense by category and certain calculated ratios; and
 - a condensed balance sheet which includes the capital leverage ratio.
- I.15.3.6 In addition to reviewing the completed pre-inspection questionnaire and financial information which is received approximately 2-4 weeks prior to the inspection, we have been informed that the pre-inspection process includes such activities as:
- inquiry of Compliance division for matters which should be followed up;
 - inquiry of database personnel of the Research division for matters of interest such as timeliness of required periodic returns; and
 - a review of the prior year's inspection files for "going-out" concerns (i.e. concerns discussed with the Chief Executive Officer) and prior year's financial data which is carried forward to the current year's pre-inspection report.
- I.15.3.7 Upon receipt of the above information, one of the assigned inspectors will review the information and compile a "pre-inspection" report supplemented by information supplied by the banks for the use of the inspectors. While there is some variation in the format of these pre-inspection reports, they generally include such information as:
- the names of the senior officers and number of employees of the bank;
 - a summary of capital and revenue and deemed authorized capital;

- the location of branches;
- a review of the balance sheet over recent quarters, including some comments as to changes in balances;
- a summary of major loans including guarantees/letter of credit; and
- a review of the statement of income over various periods (generally 3-5 quarters) including the return on assets, return on equity and percentage of net interest income and other income to assets, including some comments on changes.

I.15.3.8 The pre-inspection report is accompanied by a summary of topics for discussion with the executive of the bank; normally comprising 2-3 pages for a Schedule B bank and 10-15 pages for a Schedule A bank. These notes and questions are reviewed by each of the inspectors before the inspection commences.

I.15.3.9 The completion of the analysis and the development of the pre-inspection report and matters for discussion generally require approximately 2-5 days depending upon the complexity of the bank.

I.15.3.10 The division has recently completed a draft inspection manual. The manual, which is intended to be a reference document, includes:

- a summary of the purpose of the manual;
- history, functions and organization of the OIGB;
- comments on the prudential supervision of banks;
- pre-inspection planning process including:
 - pre-inspection checklist
 - pre-inspection questionnaire
 - objectives of pre-inspection analysis
 - a summary of ratios to be used in pre-inspection analysis
 - a listing of banks by peer group for comparison and analysis purposes
- a summary of the approach to the inspection and a list of questions which the inspectors may wish to address on various aspects of the bank's operations; and
- a summary of post inspection activities.

“On-site” Inspection

I.15.3.11 The inspection of a Schedule A bank is conducted over a 3-4 day period by two to three inspectors. The inspection of a Schedule B bank is conducted over a 1-2 day period by two inspectors. The inspection consists primarily of interviews with senior management and the shareholders' auditors and a review of the minutes of the meetings of the Board of Directors and committees thereof and including all submissions thereto.

I.15.3.12 Inspection interviews are conducted with the most senior person of each organizational area of the bank. Typically, the discussions with senior executives of a Schedule A bank, which are based upon the pre-inspection analysis, may include such topics as:

Executive representing	Topic of discussion
Internal Audit	<ul style="list-style-type: none"> • the length of the cycle • the organization of the department • overall ratings of units
Commercial, International and Domestic Banking	<ul style="list-style-type: none"> • monitoring of special loans • extent of loan losses • market share
Systems	<ul style="list-style-type: none"> • number of Automated Banking Machines
Chief Accountant/Controller	<ul style="list-style-type: none"> • past financial performance • expected results of the current fiscal year
Treasury	<ul style="list-style-type: none"> • monitoring of maturity gaps • liquidity
Personnel	<ul style="list-style-type: none"> • total complement.

I.15.3.13 In addition, the inspectors also interview the shareholders' auditors. These interviews are generally about one hour in length. The matters typically discussed with the shareholders' auditors include:

- the prior year's management letter and corrective action taken by management;
- the quality of the bank's loan portfolio;
- sovereign risk provisioning;
- significant frauds; and
- other significant events.

I.15.3.14 Each of the interviews is attended by all of the inspectors assigned to the inspection, one of which makes notes of each of the interviews. At the completion of the interview process, the inspectors collectively review the results of the interviews and summarize the concerns which have arisen. Prior to leaving the bank's premises, the inspectors generally meet with the Chief Executive Officer to convey the results of their inspection, including any concerns which they may have.

Post Inspection

I.15.3.15 Upon returning to the office, the inspectors prepare "post-inspection notes" documenting the results of the inspection. These notes generally include:

- names of inspection personnel attending the inspection;
- the dates of the inspection;
- a summary of "going-in" concerns;
- an OIGB evaluation of capital, assets, management, earnings and liquidity and a composite using a rating system of 1(poor) to 5(excellent);
- overall comments concerning the bank such as "loan quality very good", "bank is well run", "good asset portfolio";
- a summary of "going-out" concerns;
- a summary of any comments made to the Chief Executive Officer; and
- notes of the interviews with senior personnel of the bank as previously discussed.

I.15.3.16 In a number of cases we noted that the post inspection notes were not completed for a number of months. In the interim a two-page memorandum summarizing the bank's performance and activities during the year was prepared by the inspectors which did not include the above level of detail.

I.15.3.17 In summarizing the performance of the bank, the inspectors assign a numerical rating of 1(poor) to 5(excellent) based upon a largely subjective evaluation of the following types of factors:

Capital:	capital leverage ratio loan sizes industry diversification
Assets:	asset growth level of non-performing loans
Management:	competence, experience compliance with guidelines, regulations, etc.
Earnings:	historical trends quality
Liquidity:	volatility of deposits reliance on interest sensitive funds

I.15.3.18 In addition, Inspection division personnel advise the Compliance division of any matters of a compliance nature noted during the inspection.

I.15.3.19 The division director prepares a draft copy of a report, for the signature of the Inspector, to the Minister confirming that an examination and inquiry into the affairs of the bank was conducted and to confirm that the provisions of the Act having reference to the safety of the depositors, creditors and shareholders have been duly observed and that the bank is in sound financial condition. In those cases where the Inspector has concerns about the bank, the report to the Minister outlines the nature of the concerns and the action which he proposes to take (e.g. close supervision).

Research Division

I.16 Mandate of the Division

- I.16.1 The primary functions of the Research division are to:
- manage the research and analysis process of the OIGB;
 - develop accounting rules and guidelines for issuance to the banks;
 - develop loan loss provisioning rules and guidelines for tax purposes for issuance to the banks;
 - maintain a comprehensive database to support the research and analysis process;
 - maintain an effective Early Warning System of performance indicators of banks; and
 - maintain the records centre of the OIGB.

I.17 Personnel

- I.17.1 Personnel employed in the division have been hired from a variety of backgrounds. Based upon the previous experience of each of the individuals, other than the director and the clerical staff, their backgrounds can be classified as follows:

Research

	Number of Employees
Government experience	4
Bank experience	1
No previous experience	$\frac{1}{6}$

Database Management

Database management	4
Government	$\frac{1}{5}$
Total	11

- I.17.2 Our review indicated that one of the individuals is a Chartered Accountant and one is a Certified General Accountant.
- I.17.3 The responsibilities of each employee in the division are set out in position descriptions.
- I.17.4 The performance of personnel is rated annually using the standard Performance Review and Appraisal Report of the Department of Finance.

I.18 Training and Education

- I.18.1 The division does not have "in-house" training courses. Over the past two years, the division director and senior commercial officers have attended;
- a course on Bank Structure and Competition sponsored by the Federal Reserve Board (U.S.),
 - the Canadian Institute of Chartered Accountants Tax Conference,
 - a course on bank accounting sponsored by an accounting firm,
 - a course on bank analysis sponsored by the Federal Deposit Insurance Corporation (U.S.), or
 - the Financial Analysts Federation Annual Conference of Bank Financial Analysts (U.S.).

I.19 Assignments

- I.19.1 The division prepared work plans for 1985 in January 1985. The summary of completed projects for the six months ended December 31, 1984, being the last such review available, indicated that the division completed thirteen of the forty planned projects in addition to one hundred unplanned activities. Work plans for 1986 are currently in the process of being prepared.

I.20 Internal Communications

- I.20.1 During the year, division directors normally met with the OIGB senior executives on a weekly basis to review projects in progress and current issues. We understand that the frequency of the meetings has been sporadic since September 1985.
- I.20.2 During the year, the division held weekly staff meetings on Monday afternoons to review the status of various projects and current issues. We have been informed that the frequency of the meetings has been sporadic since September 1985.
- I.20.3 The division's personnel maintain an awareness of other activities within the OIGB through the review of files of correspondence assembled weekly for each division which are circulated throughout the OIGB.

I.21 Procedures and Activities

- I.21.1 The conduct of the functions of the division encompass a large number of activities which include the following:

Prudential Policy Development

- I.21.1.1 The preparation of briefs on behalf of the Inspector concerning bank policy in Canada and other countries;
- I.21.1.2 The review of regulatory reports of non-performing loans received from banks for consistency from period to period;

- I.21.1.3 The performance of the necessary research and development of rules and guidelines of a prudential policy nature;
- I.21.1.4 The development and issue of guidelines to banks;

Tax and Accounting

- I.21.1.5 Responding to questions of a tax or accounting nature from banks and shareholders' auditors;
- I.21.1.6 The determination of changes required to the prior year's Prescribed Aggregate Reserve (PAR) rules and development or issue of new rules for the current year;
- I.21.1.7 The review of PAR returns received annually from each bank;
- I.21.1.8 The review and comment on the tax and accounting issues relating to applications for mergers;

Database Management

- I.21.1.9 The processing of periodic reports received from banks;
- I.21.1.10 The provision of information to personnel within the OIGB as required;
- I.21.1.11 The maintenance of internal alpha and numeric databases;
- I.21.1.12 The development of new computer software applications as required;
- I.21.1.13 The issue of amendments to the Manual of Reporting Forms;
- I.21.1.14 The provision of consolidated reports to banks based upon the periodic reports received from the banks;

Other

- I.21.1.15 The maintenance of an Early Warning System of bank performance indicators; and
- I.21.1.16 The preparation of a "Quarterly Products Book" of quarterly financial information.

Appendix J

Recommendations Relating to the Inspection Division

Index

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Appendix J

J.1 Recommended Mandate for the Inspection Division

- J.1.1 As described in paragraph 4.8.1 of Chapter 4, in order to provide adequate direction to the division through the establishment of objectives and accountabilities, its mandate should incorporate at least the following matters:
- (a) the reporting lines within the OIGB;
 - (b) the lines of communication with the banks and other parties;*
 - (c) the requirement to conduct inspections* of banks of sufficient scope as to gain reasonable assurance that:
 - i) the provisions of the Bank Act have been complied with;
 - ii) the OIGB guidelines relating to accounting policies and procedures have been complied with;
 - iii) bank management has developed and maintained appropriate policies and systems of internal controls to:
 - (a) monitor and provide for the timely and effective management of the key risks facing the bank; and
 - (b) provide the OIGB with accurate reports on information it requires on such risk areas;
 - iv) matters on which corrective action is required are being identified and appropriately responded to by management on a timely basis;
 - (d) the nature of the working relationships to be maintained with foreign regulators in order to monitor regulatory issues and relevant inspection results;
 - (e) the responsibility for the review and concurrence on new guidelines or rules prior to their issuance;
 - (f) the responsibility to perform inspections of representative offices of foreign banks;
 - (g) the responsibility to maintain appropriate training programs and a system to ensure that all staff attend training and education courses on an annual basis in accordance with the division's policy; and
 - (h) the preparation of such reports to the Minister as may be required from time to time.

* matters currently included in the division's mandate

J.2 Suggested Contents for an Inspection Division Policies and Procedures Manual

- J.2.1 To provide a workable framework for the achievement of the division's mandate, suitable policies and procedures should be developed and documented in a logical and usable format. This could usefully be achieved through the establishment of a comprehensive manual setting out the policies and procedures of the division.
- J.2.2 As an indication of the nature and scope of such a manual it would include at least the following information:
- (a) Administrative policies and procedures, including those relating to:
 - interdivisional lines of communication;
 - personnel assignment;
 - training and education.
 - (b) Inspection policies and procedures, including those relating to:
 - i) standards of documentation;
 - ii) the determination of the frequency of inspections (as described on pages 140 and 141 of this appendix);
 - iii) the use of standardized inspection programs; compliance questionnaires and preferred practice checklists (as described on pages 141 to 151 of this appendix);
 - iv) pre-inspection planning (as described on pages 154 to 158 of this appendix);
 - v) the conduct of the inspection (as described on pages 158 to 164 of this appendix); and
 - vi) reporting the results of the inspection (as described on pages 164 to 166 of this appendix).

J.3 Frequency of Inspections

- J.3.1 As described in paragraph 4.7.5.5 of Chapter 4, the frequency of the conduct of inspections should be based upon the performance rating of the bank established by the Early Warning System and, in the case of banks with operating difficulties, the advice of the director of the proposed Inspector's Advisory Group based upon their monitoring program.
- J.3.2 For example:
- banks rated as 1-3 (low to average risk) may be inspected annually;
 - banks rated as 4 (high risk) may be inspected semi-annually;
 - banks rated as 5 (acute risk) may be inspected quarterly.
- J.3.3 The procedures employed in the semi-annual or quarterly inspections may encompass all operations of the bank or be directed to specific areas of the bank (e.g. loans), as the circumstances dictate.

J.3.4 It is anticipated that in 1986 a number of new banks will be incorporated. In order to ensure that the banks establish sufficient and appropriate policy and control standards, an inspection should be conducted within six months of commencement of operations to:

- ensure that sufficient appropriate policies and systems of internal control have been established;
- ensure that management possesses appropriate experience and qualifications;
- ensure that commitments made in the application to incorporate have been complied with;
- ensure that the Bank Act has been complied with; and
- recommend any corrective actions to be taken by management.

J.4 The Use of Standardized Inspection Programs, Compliance Questionnaires and Preferred Practice Checklists

J.4.1 The division has recently prepared a draft inspection manual. We understand that this manual is to be used as a reference source by inspectors and is to be retained in the office and not form a part of inspection files. The manual is primarily a lengthy list of potential questions which may be used in the management interview process. It is the stated view of the director of the Inspection division that it is not possible to adopt uniform procedures for each inspection. Based upon our review of a number of 1985 inspection files, there is no indication that the draft inspection manual has yet been used.

J.4.2 In our view, there are significant benefits to developing a compendium of standard inspection programs and checklists which can be modified as to the nature and extent of the tests to be performed in each inspection, based on the results of the pre-inspection analysis. The development and use of standard inspection programs and checklists would:

- provide consistency to the inspection process;
- formalize the relationship between the pre-inspection analytical review and the inspection procedures performed;
- integrate the work of the internal auditors and the shareholders' auditors into the inspection process;
- assist the inspectors to focus their efforts on "risk" areas;
- ensure that inspections are conducted on a sound basis; and
- provide documentation of the procedures performed.

J.4.3 Such a compendium of inspection programs and checklists should be segregated into three sections, as follows:

- pre-inspection;
- inspection; and
- post-inspection.

J.4.4 Each section should contain a program or series of programs for each aspect of the inspection, identifying:

- a description of the operation of the particular area of the bank;

- the risks associated with the particular area;
- the objectives of the inspection of the area; and
- the specific inspection procedures to be performed.

J.4.5 An example of such a program ("Reliance on the Work of Internal Auditors") is set out in Attachment I on page 143 of this appendix. A copy of the standard programs should be "tailored" during the pre-inspection planning process by noting the nature and extent of the procedures to be performed during the inspection. These should be identified by the "in-charge" inspector based upon the results of the pre-inspection planning process. The appropriateness of the nature and extent of the procedures should be continually reviewed during the inspection and modified as circumstances warrant. These "tailored" programs should then form part of the inspection file. Each inspector who performs the procedures should be required to sign the program for their completion.

J.4.6 In our view, the same master program could be used for all but the most special circumstances, as the inherent differences between banks can be taken into consideration in the tailoring of the programs and determination of the nature and extent of the procedures to be performed. The programs should, of course, be supplemented by specific procedures or matters arising from the pre-inspection analysis.

J.4.7 In addition to the standard inspection program, the division should develop and use standard questionnaires and checklists to ensure the completeness of its documentation. These questionnaires and checklists fall into the following four categories:

- (a) Compliance questionnaires, a sample of which is included as Attachment II on pages 144 to 151 of this appendix, which sets out a number of relevant Bank Act sections for use in evaluating the bank's compliance with the Act. Further, such questionnaires would be useful in evaluating compliance with OIGB guidelines.
- (b) Questionnaires for meetings with senior management and the shareholders' auditors, detailing topics for discussion.
- (c) Preferred practice checklists, which comprise a summary of preferred practices for use in evaluating the operations of banks. These would include matters along the following lines:
 - a description of basic internal controls;
 - the minimum content of internal audit programs;
 - the training standards for internal auditors;
 - a preferred internal audit cycle;
 - the minimum content of accounting, treasury and credit policies and procedures;
 - a sample EDP systems development methodology; and
 - the minimum documentation standards of the shareholders' auditors.
- (d) Completeness checklists. For example, a checklist detailing information which should be presented to the Board in order to evaluate the adequacy of the information provided.

Attachment I – Sample

Reliance on the Work of Internal Auditors

Programme preparation:

Inspector _____ (date)

Inspector in charge _____ (date)

Programme completion:

Inspector _____ (date)

Inspector in charge _____ (date)

Procedures	Date	Extent/Comments	Working paper reference	Done by/ date
1. Obtain a copy of the organization chart of the department.				
2. Review the organization chart and ascertain the divisions and staff complement of each.				
3. Determine the qualifications of the senior personnel of each division and consider their appropriateness for the responsibilities to which they are assigned.				

Attachment II – Sample

Bank Act Requirements Checklist

Bank _____

Completed by _____ (date)

Reviewed by _____ (date)

Section reference	Details	Complies page reference	Fails	N/A
	A. Corporate and Capital Structure			
36(2)	At least one-half of the directors of a foreign bank subsidiary shall be Canadian citizens ordinarily resident in Canada.			
36(2)	At least three-quarters of the directors of any other bank shall be Canadian citizens ordinarily resident in Canada.			
36(3)	No more than 15 per cent of the directors of a bank shall be persons who are officers or employees of the bank or of an affiliate of the bank except that up to four persons who are officers or employees of the bank or of an affiliate of the bank may be directors of the bank if those directors constitute not more than one-half of the directors of the bank.			
46(2)	Where a bank has more than ten directors it may appoint committees of no less than five directors providing that: i) the majority are Canadian citizens resident in Canada; and ii) they are not officers of the bank.			
46(3)	In the case of a foreign bank subsidiary one-half of the directors appointed to a committee may be other than Canadian citizens resident in Canada.			
47(2)	A director of the bank may be appointed to any office of the bank but, subject to subsection 36(3), not more than six directors may be full-time employees of the bank or of an affiliate of the bank.			

Section reference	Details	Complies page reference	Fails	N/A
	A. Corporate and Capital Structure (Cont'd)			
58(1)	The Chief General Manager shall make an annual report to the directors on non-current loans included in the latest return under Section 219 (Schedule J), if the aggregate amount exceeds 1/10 of 1 per cent of the aggregate of paid-in capital, contributed surplus and retained earnings. This report should be incorporated in the minutes and a copy forwarded immediately to the Minister.			
110(1)	The total number of shares held by non-residents cannot exceed 25 per cent of the total number of shares issued or outstanding (this restriction does not apply to foreign bank subsidiaries).			
110(2)	A foreign bank subsidiary cannot transfer the ownership of any of its shares unless the transfer has been approved by the Minister.			
110.1(1)	No one person or group of associated persons can hold in excess of 10 per cent of the total issued or outstanding shares of a bank (does not apply to shares held by a foreign bank in its Canadian subsidiary).			
111	Where a person or associated person holds in excess of 10 per cent of the voting shares, they are prohibited from voting any of those shares.			
116(1)	The authorized capital of a Schedule B bank shall not be less than \$5,000,000.			
116(2)	The shares of a bank shall have a nominal or par value of between \$1 and \$100 each except where: i) the Minister approves that any class shall be without nominal or par value; and ii) the Minister has issued letters patent pursuant to Part X amalgamating one or more banks and one or more financial institutions.			
124(1)	A bank shall not purchase, redeem or otherwise acquire shares issued by it except as provided in section 79 (over-issue of shares) or section 125 (special resolution approved by the Governor in Council).			
129(4)	A bank is prohibited from paying a dividend exceeding the rate of 8 per cent per annum on its paid-up capital unless after the payment, the general reserves and retained earnings of the bank are equal to at least 20 per cent of its paid-in capital and contributed surplus after making all necessary provisions for ascertained and estimated diminution in the value of assets.			

Section reference	Details	Complies page reference	Fails	N/A
	A. Corporate and Capital Structure (Concl'd)			
132(1)	A bank may issue bank debentures at any time after the completion of its first financial year of at least 12 months duration or in any other case after the completion of its second financial year.			
132(2)	Bank debentures must have a stated term of at least five years.			
132(3)	Bank debentures outstanding are limited to the amount of one-half of one per cent of the aggregate of the total paid-in capital, contributed surplus, retained earnings and general reserves.			
	B. Business and Powers of a Bank			
	Review the bank's licence to operate and note any restrictions contained therein. Note the compliance or failure to comply with such restrictions.			
173(1)	Banks may conduct certain activities only through a subsidiary of the bank. i) factoring of accounts receivable; and ii) financing leasing.			
173(2)	Schedule B banks are prohibited from opening any foreign branches and may only open a head office and one branch in Canada. Opening of additional branches requires the approval of the Minister.			
174(2)	A bank shall not: (a) deal in goods;			
	(b) engage in fiduciary activities;			
	(c) engage in portfolio management or investment counselling;			
	(d) contribute to any bank guarantee fund or pension fund if: i) any part of the fund is invested in shares of a corporation incorporated in Canada, in which the bank is authorized to invest in more than 10 per cent of the shares, or ii) if more than 10 per cent of the assets of the fund have been invested in shares of the bank;			

Section reference	Details	Complies page reference	Fails	N/A
	B. Business and Powers of a Bank (Cont'd)			
174(2) (Cont'd)	<p>(e) have average outstanding domestic assets in any three-month period more than 20 times its authorized capital, if more than 10 per cent of the voting shares of the bank are held by any one resident or non-resident shareholder and his associates.</p> <p>Average domestic assets are defined in section 174(8); (this restriction applies to all Schedule B banks).</p>			
	<p>(f) lend money to or on the guarantee of any officer or employee of the bank unless:</p> <p>i) the loan is secured by a mortgage; or</p> <p>ii) the loan is less than the greater of the employee's annual salary and \$25,000.</p> <p>In addition, board of director approval is required for all loans to employees and directors when the total of all loans to that individual reach \$25,000.</p>			
	(g) acquire, deal in or lend money on the security of shares of another bank;			
	(h) acquire or hold an interest in a partnership; and			
	(i) engage in providing data processing services other than bank-related data processing services.			
174(10)	A bank shall not, in its first two financial years, lend money to any director of the bank who is not a full-time officer of the bank.			
175(2)	<p>A Schedule B bank must maintain assets in Canada at least equal to the aggregate of:</p> <p>i) the liability of the foreign bank subsidiary to residents in Canada; and</p> <p>ii) the paid-in capital of the foreign bank subsidiary.</p> <p>(N.B. "in Canada" refers to the location of the legal documentation of the asset, not the location of the security underlying the asset.)</p>			

Section reference	Details	Complies page reference	Fails	N/A
	B. Business and Powers of a Bank (Cont'd)			
176(1)	The amount of any residential mortgage issued by the bank shall not exceed 75 per cent of the value of the property unless they are NHA guaranteed, guaranteed by a provincial agency or insured by a policy of mortgage insurance issued by a company registered under the Canadian and British Insurance Companies Act or Foreign Insurance Companies Act.			
176(2)	At the end of any financial year, the total residential mortgage principal outstanding shall not exceed an amount equal to 10 per cent of the total at that time of the Canadian currency deposit liabilities of the bank and its outstanding Canadian currency debentures. (N.B. This restriction does not include collateral mortgages or mortgages held in a mortgage subsidiary of a bank.)			
190(3)	Except as specifically permitted, a bank may not buy or sell equity securities.			
190(4)	A bank may: <ul style="list-style-type: none"> i) buy and sell equity securities, but where the transactions are other than for the bank's own investment account, the transaction must be done through a broker or dealer; ii) act as agent of a vendor or purchaser of equity securities if the transaction is effected by a broker; and iii) make a distribution to the public of its own equity shares. 			
190(5)	A bank is prohibited from acting as an underwriter of securities or as a member of a selling group except for: <ul style="list-style-type: none"> i) its own debentures; ii) government guaranteed indebtedness; or iii) as a member of a selling group for the underwriting of the securities of a non-bank corporation. 			
191(1)	Except in the case of a real estate investment trust, a mortgage investment company or a mortgage-based mutual fund, a bank shall not manage or participate in the management of a mutual fund.			

Section reference	Details	Complies page reference	Fails	N/A
	B. Business and Powers of a Bank (Concl'd)			
193(2-6)	<p>Bank ownership of capital stock in other Canadian corporations is limited to an amount not exceeding 10 per cent of the voting shares, except that there is:</p> <ul style="list-style-type: none"> i) no limit for a subsidiary that is a mortgage loan corporation that owns no shares in any other corporation; ii) no limit for a subsidiary that is a venture capital corporation and does not hold directly or indirectly more than 20 per cent of a corporation that accepts deposits from the public or of a trust or loan corporation; iii) no limit for a bank service corporation; iv) no limit for a real estate investment trust or a mortgage investment company as long as all of the shareholders are financial corporations and not more than one other shareholder is a bank; and v) no limit for a factoring or leasing corporation that is a subsidiary of the bank. 			
193(4)	A schedule B bank cannot own more than 10 per cent of the voting shares of a foreign corporation.			
199(2)	<p>A bank is permitted to hold real property or an interest in real property only if:</p> <ul style="list-style-type: none"> i) the property is for its own use; ii) the property is being held for resale and was acquired by way of loan realization. 			
199(3)	Except as provided in Section 184 or 185, a bank shall not acquire or hold real property at any time after six months after this Section comes into effect unless the interest acquired exceeds 50 per cent of interests of all owners, including the bank, or the Minister gives special permission.			
200	A Schedule B bank is prohibited from owning any interest in real property if the total of land, buildings and equipment as reported in Schedule J would exceed at any time, one-half of the aggregate of the paid-in capital, contributed surplus, retained earnings and general reserves of the bank.			

Section reference	Details	Complies page reference	Fails	N/A
	C. Financial Statement Disclosure Requirements			
215(3)	<p>The bank's annual financial statements shall contain a:</p> <ul style="list-style-type: none"> • Statement of assets and liabilities in the form of Schedule K; • Statement of income in the form of Schedule L; • Statement of appropriations for contingencies in the form of Schedule M; and a • Statement of changes in shareholders' equity in the form of Schedule N. 			
215(3)	The annual financial statements shall include a statement of assets and liabilities and a statement of income for each of the bank's factoring, leasing, mortgage and venture capital subsidiaries.			
216(1)	The financial statements of the bank shall be prepared using the consolidation method for controlled corporations and the equity method for corporations in which the bank holds 20 per cent or more of the shares.			
216(2)	<p>If the bank owns more than 10 per cent of the shares of a company where:</p> <ul style="list-style-type: none"> i) the holding is temporary and there is a formal arrangement for disposal of the interest; ii) the holding has been acquired through shares acquiring votes after their acquisition by the bank; or iii) shares were acquired through realization of security for a loan (as per sections 193(10) or (12)). 			
216(4)	<p>The bank shall include in its annual financial statements a list of corporations in which the bank holds more than 10 per cent of the voting shares, showing for each corporation:</p> <ul style="list-style-type: none"> i) the name and address of its head office; ii) the book value of the voting shares of the corporation owned by the bank; and iii) the percentage of the issued and outstanding voting shares of the corporation owned by the bank. 			

Section reference	Details	Complies page reference	Fails	N/A
	D. Shareholders' Auditors and Audit Committee			
237(1)	The bank's shareholders are required to appoint two firms of accountants to be the auditors.			
238(2)	If the same two firms have been appointed for two consecutive years, one such firm shall not be appointed for the next two years.			
242(3)	<p>Auditors are required to report to the president or general manager any transactions or conditions affecting the well-being of the bank that in their opinion are not satisfactory and require rectification.</p> <p>Specifically:</p> <ul style="list-style-type: none"> i) Transactions having come to their notice that are not within the powers of the bank. ii) Loans owing by any person, the aggregate of which exceeds 1/2 of 1 per cent of the paid-up capital, contributed surplus and retained earnings accounts, in respect of which, in their opinion, loss to the bank is likely to occur. (A report in future years of such loans is only required if the loss is likely to increase.) <p>A copy of the report above should be submitted to the Inspector General.</p>			
242(10)	The auditors of the bank are to be the auditors of all subsidiaries of the bank.			

J.5 Recommendations for the Conduct of Inspections

J.5.1 Our detailed recommendations relating to inspections comprise:

- pre-inspection planning;
- conduct of the inspection; and
- reporting on the results of the inspection.

J.5.2 In order to address the objectives which we have suggested be included in the division's mandate, the current approach to the conduct of inspections must be reconsidered.

J.5.3 In our view, the inspection should comprise the following significant stages:

- (a) the performance of detailed pre-inspection planning procedures;
- (b) the determination of the nature, extent and timing of procedures performed by the internal auditors and the shareholders' auditors;
- (c) the determination of the potential ability of the OIGB to rely upon the work of the internal auditors and shareholders' auditors through the examination of their files;
- (d) confirmation of the ability of the OIGB to rely on the work of the internal auditors and shareholders' auditors through re-performance of the work performed by them and examination of their files;
- (e) the performance of substantive tests of bank records, the extent of which would be determined by the conclusion formed on the ability of the OIGB to rely on the work of the internal auditors and shareholders' auditors; and
- (f) the formal reporting of the results of the inspection to the bank's Chief Executive Officer and Audit Committee and to the shareholders' auditors.

J.5.4 In the event that:

- (a) the bank does not have an internal audit department or the results of the procedures performed by the inspectors indicate that the work of the internal auditors cannot be relied upon; and/or
- (b) the results of the work performed by the shareholders' auditors is insufficient or cannot be relied upon or significant time has elapsed since the completion of their procedures; and/or
- (c) the bank has significant weaknesses in its system of internal control or policies;

the inspector must decide whether:

- i) additional procedures should be performed by the shareholders' auditors;
- ii) additional procedures should be performed by (or changes should be recommended to the organization of) the internal audit department, where the bank has such a department; and
- iii) additional substantive procedures should be performed by the inspectors.

J.5.5 The approach described above can be graphically illustrated as follows:

Conduct pre-inspection planning to become familiar with the bank's operations and past financial performance

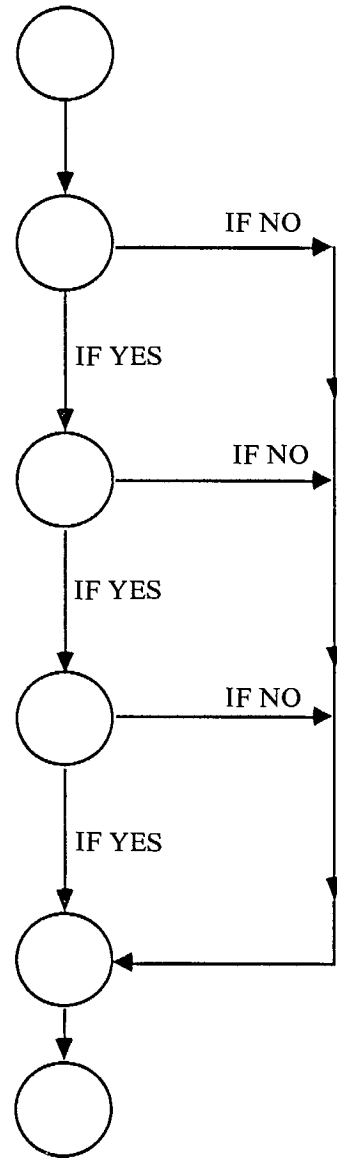
Identify the procedures of the internal and shareholders' auditors

Determine the potential ability of the OIGB to rely on the work of internal and shareholders' auditors

Confirm through testing of their files the OIGB's ability to rely on the work of internal and shareholders' auditors

Perform any required additional substantive test of the bank's records

Report on the results of the work performed



J.5.6 There are a number of issues involved in the adoption of this inspection framework which must be addressed. These include:

- (a) the necessity for a clear understanding of their roles in the inspection process by each participant;
- (b) the acceptance of responsibility by each participant;
- (c) the potential for additional procedures to be performed by the internal auditors or the shareholders' auditors; and
- (d) the additional time and personnel requirements of all participants which will be required to implement the approach.

J.6 Pre-Inspection Planning

J.6.1 The procedures, which should be completed by the “in-charge” inspector and noted on the inspection program, should encompass at least the following items:

- (a) an in-depth review of the pre-inspection report and analyses prepared by the Statistical Analysis group of the Statistical Analysis and Database Management division;
- (b) a review of organization charts and summary of matters for follow-up provided by the Statistical Analysis group of the Statistical Analysis and Database Management division;
- (c) a review of the prior year’s inspection files for significant matters, including the ability to rely upon the work of the internal auditors and the shareholders’ auditors;
- (d) a review of reports concerning the bank received from the Compliance and Research divisions;
- (e) the determination of whether the bank is on the quarterly “Watch List” of those banks requiring monitoring and the reasons therefore;
- (f) liaison with the Inspector’s Advisory Group concerning the performance of those banks under their supervision;
- (g) determination of any licence restrictions;
- (h) a review of the reports of other regulators relating to foreign units of the bank and consideration of the implications thereof;
- (i) the determination of the significant subsidiary corporations and foreign branches and the necessity of conducting an on-site inspection of each entity based upon whether the operation or significant portions thereof are self-sustaining entities. This requires an assessment of:
 - i) the extent to which the management of assets and liabilities of the unit are integrated with the bank or are self-sustaining;
 - ii) the extent to which the manual and computer systems of the unit are integrated with the bank or are self-sustaining; and
 - iii) the extent to which business transactions are dependent upon the parent bank.

(Significant subsidiaries and foreign branches which are self-sustaining or have substantial elements which are self-sustaining would be subject to “on-site” inspection. The specific procedures to be completed during the inspection would be determined during the pre-inspection planning process.)

- (j) the identification of risk including:
 - i) overall risk of the business such as credit risk, foreign exchange risk, maturity risk and interest rate risk;
 - ii) inherent risk, being the risk that problems or errors could occur in certain areas (e.g. lack of geographic dispersion creates exposure to an economic recession in that area); and
 - iii) control risk, being the risk that the systems of internal control will not prevent errors or misstatements.

- (k) a preliminary determination of the ability to rely upon the work of the internal and the shareholders' auditors;
- (l) a preliminary judgement as to the nature of the procedures to be performed as set out in the standard inspection programs;
- (m) a preliminary judgement as to the extent of the procedures to be performed as set out in the standard inspection programs;
- (n) the liaison with the bank concerning administrative matters such as working space and timing of interviews;
- (o) the determination of the responsibilities of each inspector assigned to the inspection; and
- (p) the conduct of a pre-inspection meeting with personnel assigned to the inspection in order to:
 - i) review the inspection timetable,
 - ii) review areas of risk,
 - iii) review the pre-inspection analysis,
 - iv) review work assigned,
 - v) review any concerns which the OIGB may have, and
 - vi) answer any questions;
- (q) the forwarding of an agenda to bank executives and shareholders' auditors personnel in advance of interviews.

J.6.2 The inspection programs developed by the "in-charge" inspector should be reviewed and approved by an assistant division director prior to the inspection.

J.6.3 The pre-inspection report should be prepared from information already submitted on a periodic basis by banks and through special requests made to the Chief Accountant prior to the inspection.

The pre-inspection report should be assembled and analysed by the Statistical Analysis group of the Statistical Analysis and Database Management division. It should consist of reports, analyses and comparisons to peer groups and prior periods, based upon:

	Available "in-house"	To be requested from the bank
Balance sheet		
• a Balance Sheet (Schedule J) for the latest four quarters and including the most recent fiscal year-end;	X	
• a summary of securities, by type, for the latest four quarters;	X	
• a summary of "other loans" by type, for the latest four quarters;	X	
• a summary of non-performing loans, by portfolio, for the latest four quarters;	X	

	Available "in-house"	To be requested from the bank
• a quarterly geographic distribution of assets for the latest four quarters;	X	
• a summary of deposits, by type, for the latest four quarters;	X	
• a summary of other loans, by industry, for the latest four quarters;	X	
• a summary of sovereign risk provisioning, by quarter, for the latest four quarters and the most recent fiscal year;	X	
• a continuity schedule of loan loss experience since the latest fiscal year-end for those loans with a value over a certain threshold;	X	
• a summary of loans outstanding, by operating division, for the latest four quarters;		X
• a summary of interest rate sensitivity for the previous four quarters;	X	
• a summary of transactions with the parent bank over the previous 12 months detailing the nature and amount of:		
• loan swaps, sales or purchases		X
• guarantees		X
• personnel and services provided or received		X
• deposits;		X
• a profile of the loan portfolio for the most recent four quarters based upon the number and value of credits by risk rating using the bank's internal rating system;		X
• a periodic maturity profile of assets and liabilities;		X
• a summary of the capital leverage ratios for the latest four quarters;	X	
Statement of income		
• a Statement of Income (Schedule O) for the latest four quarters and the most recent fiscal year;	X	

	Available "in-house"	To be requested from the bank
<ul style="list-style-type: none"> a summary of major income and expense items, by category, as a percentage of average assets for the latest four quarters and for the most recent fiscal year; 	X	
<ul style="list-style-type: none"> an income statement, by operating division, for the latest four quarters; 		X
<ul style="list-style-type: none"> a summary of operating ratios for each revenue and expense category for the latest four quarters; 		X
Off-balance sheet items		
<ul style="list-style-type: none"> a summary of off-balance sheet exposure for the latest four quarters summarizing the outstanding amounts of: <ul style="list-style-type: none"> letters of credit guarantees foreign exchange contracts other off-balance sheet transactions; 	X X	X X
Other		
<ul style="list-style-type: none"> an organization chart of the bank's: <ul style="list-style-type: none"> legal entities operating divisions executive personnel; the locations of the bank's primary loan files; a listing of property other than bank premises; information concerning shareholders and directors; the business plan/budgets for the past four quarters and for the succeeding 2-3 years; the most recent management letter or audit observations letter (draft or final) prepared by the shareholders' auditors; 		X X X X X X

	Available "in-house"	To be requested from the bank
• the most recent semi-annual or annual report of the Chief Inspector to the Audit Committee or to the Chief Executive Officer;		X
• a narrative or graphic outline of the accounting and operating systems which generate each of the amounts in the bank's financial statements;		X
• reports issued since the prior inspection by other regulators in jurisdictions where the bank has subsidiaries or foreign branches.		X

- J.6.4 The preceding information marked as "to be requested from the bank" should be available in all cases. In the event that a bank cannot provide the requested information, the inspection approach should be modified to investigate the reasons for the bank's inability to comply with the request. The request for the preceding information should be included in a standard pre-inspection questionnaire.

J.7 Conduct of the Inspection

- J.7.1 The specific procedures to be performed in the completion of an inspection, which should be documented in the inspection programs, would include, but not be limited to, the following:

(a) **A review of the procedures performed by the internal auditors**

This would include:

- obtaining and documenting an understanding of the organization of the department;
- obtaining and documenting the internal audit department's approach and methodology; and
- performing a review and evaluation of internal audit programs for completeness and appropriateness of procedures in relation to pre-established checklists of controls, (e.g. preferred practices) which should be in place relating to:
 - credit
 - domestic operations
 - international operations
 - policies and procedures
 - systems development
 - systems operations

- investigation of frauds
- statutory reporting systems.

(b) Determination of the potential ability of the OIGB to rely on the work of the internal auditors

This would include the performance of a detailed review and evaluation in relation to "preferred practices" of:

- the organization of the department;
- the lines of reporting within the bank;
- the qualifications and experience of the department's personnel;
- the standards of the department;
- the frequency of the inspection cycle;
- the method of documenting controls;
- the method of evaluating controls;
- the extent of development of computer interrogation software for use in the inspection process;
- the method of reporting results of its inspections;
- the method of reporting deficiencies noted during the inspections;
- the timeliness of follow-up by the operating departments for the correction of deficiencies;
- the method of rating the results of inspections;
- the monitoring of follow-up action of deficiencies by management;
- the method of reviewing new systems under development;
- the procedures for the review of new bank policies and procedures; and
- the nature and extent of training and education provided to internal audit personnel.

(c) Confirmation of the ability of the OIGB to rely on the work of the internal auditors

This would comprise the completion and documentation of a review of a sample of inspection files to ensure that:

- audits appear to have been adequately planned;
- procedures are completely performed by the internal inspectors;
- procedures are evidenced on the inspection files;
- deficiencies noted in the files are completely recorded in the inspection report; and
- audit ratings and deficiencies are supported by the inspection files.

The sample of files selected for review should encompass a representation from significant areas of risk to the bank.

(d) A review of the procedures performed by the shareholders' auditors

This would include:

- obtaining and documenting an understanding of the approach and methodology of the shareholders' auditors;
- performing a review of the Audit Plan of the shareholders' auditors, with emphasis upon:
 - commentary as to rationale for the approach to the audit;
 - comments concerning the objectives of each aspect of the audit;
 - identification of management letter comments;
 - identification of the nature and extent of the work performed; and
 - performing a review and evaluation of audit programs for completeness and appropriateness in relation to pre-established checklists of procedures which should be performed relating to:
 - statutory reporting systems
 - evaluation of accounting policies and practices
 - evaluation of credit policies and practices
 - evaluation of treasury policies and practices
 - evaluation of each area of risk identified in the Audit Plan.

(e) Determination of the potential ability of the OIGB to rely on the work of the shareholders' auditors

This would include the performance of a detailed review and evaluation in relation to "preferred practices" of:

- the organization of the audit team;
- the use of taxation, computer and other specialist personnel;
- the lines of reporting within the audit firm;
- the qualifications and experience of the audit personnel;
- the nature and extent of training and education programs provided to staff;
- the technical standards of the audit firms;
- the method of documenting controls;
- the nature and extent of computer interrogation software applications used in the completion of the audit;
- the method of documenting the nature and extent of the tests performed; and

- the method of transmitting audit observations to senior audit personnel and to the bank.

(f) Confirmation of the ability of the OIGB to rely on the work of the shareholders' auditors

This would comprise the performance of a review of the significant audit files, with particular emphasis on:

- summaries of significant matters resulting from the audit (the terms for such memoranda vary by accounting firm);
- matters relating to the internal audit department which may affect the ability of either the shareholders' auditors and/or the OIGB to rely upon its work;
- the nature and amount of unadjusted differences noted by the auditors;
- the evaluation of the work performed to determine the bank's compliance with prescribed accounting policies;
- the extent of involvement of computer audit specialists and the nature of their work and findings;
- the completeness and appropriateness of the work performed on adherence to credit policies and practices including:
 - granting of credit
 - levels of approval
 - delegation of limits
 - periodic review of limits
 - "house" limits
 - authorization by the Board of Directors
 - periodic review for collectability
 - reporting of non-performing loans
 - risk ratings
 - monitoring of poor loans;
- the completeness and appropriateness of the work performed on adherence to treasury policies and practices, including:
 - off-balance sheet exposure
 - foreign exchange exposure
 - interest rate exposure
 - maturity exposure;
- the adequacy of systems for the reporting of non-performing loans;
- the level of documentation on the audit files;

- the adequacy of the bank's systems of internal control;
- the completeness and appropriateness of audit work performed relating to the completeness and appropriateness of accounting, credit and treasury policies of the bank;
- the completeness and appropriateness of audit procedures performed in relation to the bank's taxation accounts;
- the audit evaluation of the provision for loan losses, including:
 - the auditors' assessment of loan losses compared to management's assessment
 - the nature and extent of the auditors' comments on loans
 - the depth of the auditors' review
 - the audit test selection methods and stratification of loans
 - the extent of examination of documents including financial statements and original security documents
 - the auditors' assessment of the bank's credit granting procedures
 - the extent of the auditors' reliance on management representations
 - summarization of results of the review
 - extent of the auditors' reliance on the internal audit department
 - the auditors' assessment of loan monitoring procedures of the bank;
- the extent of work performed to ensure compliance with the Bank Act and the results thereof; and
- the results of the auditors' substantive tests performed in the Treasury department of the bank including:
 - money market operations
 - off-balance sheet risk
 - foreign exchange exposures
 - interest rate exposure
 - maturity exposure.

(g) The conduct of substantive tests

The nature and extent of substantive tests to be performed by the OIGB inspectors would depend upon the results of the work described above. As a minimum, the tests would comprise at least the following:

- a review of the management letters/audit observation letters of the shareholders' auditors and determination of the extent of corrective action taken by management;
- a review of the procedures for the development of business plans including a review of the plans and the assumptions contained therein for the ensuing 2-3 years;

- a review and evaluation of the bank's procedures for the monitoring of actual results to planned results and related action taken by management where there are variances;
- an evaluation of the organization structure of the bank;
- a review of the bank's sovereign risk provision practices;
- an evaluation of the consistency of the bank's provision for loan losses on credits shared with other banks;
- a review and evaluation by a computer systems specialist of the bank's systems development and system testing methodology;
- a detailed review of the calculation of the provision for loan losses and the PAR transfer;
- a review of the minutes of the Board of Directors meetings and all committees thereof (including submissions to the Board) to ensure that matters requiring the approval of the Board are so noted (e.g. dividends, financial statements, large loans);
- an evaluation of the information provided to the Board as to its sufficiency and appropriateness;
- a review for corrective action concerning matters requiring attention noted in the prior year's inspection report;
- a review and discussion with management of non-arm's length transactions;
- a review of documents concerning significant legal claims and the system in use to record such claims;
- obtaining a letter of representation from the bank confirming the presentation of records and the adequacy of its policies and practices, its loan loss provisions and its internal controls, which letter should be signed by the Chief Executive Officer, Chief Financial Officer and Chief Inspector of the bank;
- completion of a review for compliance with commitments made, if any, in the bank's application for incorporation;
- completion of a checklist of compliance with the Act (a sample of which is included as Attachment II on pages 144 to 151 of this appendix);
- completion of a review for compliance with licence restrictions;
- a review of the significant personnel policies of the bank relating to:
 - organization structure
 - position descriptions
 - training and education
 - performance reviews
 - salary and remuneration; and
- an evaluation of the completeness and adequacy of the bank's policies in relation to preferred practices.

(h) The conduct of discussions with senior management

During the course of the inspection, the inspectors should meet with senior executives of the bank, as appropriate, in order to discuss such matters as:

- the inspectors questions arising from the pre-inspection analyses;
- the bank's policies and practices;
- reports of foreign regulators concerning foreign branches or subsidiaries of the bank;
- the future plans of the bank; and
- any disagreements in valuation of assets which may have arisen.

It is expected that such discussions would be conducted by the "in-charge" inspector.

(i) Control of the Inspection

In the course of the inspection the "in-charge" inspector should be expected to:

- supervise the staff in an appropriate fashion;
- provide guidance and on-the-job training to the staff as required;
- review the completed work of the staff for the sufficiency and appropriateness of the work performed and the documentation thereof;
- liaise with senior management of the bank;
- re-evaluate the nature and extent of procedures to be performed, as circumstances warrant; and
- summarize the time incurred on the inspection in order that a database can be developed of time requirements for each inspection.

(j) The preparation of post-inspection reports

The results of the inspection should be summarized for inclusion in separate reports for internal and external distribution, as follows:

i) For internal use

The report prepared for the internal use of the OIGB should include:

- name of the bank;
- names of the inspectors;
- timing of the inspection;
- a summary of significant matters and issues arising from the pre-inspection analysis; and

- a rating on a scale of 1-5 of each of the following:
 - internal audit department
 - accounting policies and procedures
 - credit policies and procedures
 - systems development methodology and systems operations
 - treasury policies and practices
 - personnel management
 - compliance with the Bank Act
 - overall (based upon the ratings of each area).

These ratings should be determined as follows in accordance with pre-defined guidelines:

1) Excellent

- the policies, practices and methods of the banks are well documented and fully exceed the preferred practice criteria.

2) Good

- the policies, practices and methods of the banks are generally well documented and generally exceed the preferred practice criteria.

3) Adequate

- the policies, practices and methods of the banks are adequately documented and meet the preferred practice criteria.

4) Poor

- a number of policies, practices and methods of the banks are not documented or do not always meet the preferred practice criteria.

5) Inadequate

- the policies, practices and methods of the bank are not documented or do not meet the preferred practice criteria.

- a summary of significant events and matters noted during the inspection including:
 - important positive findings,
 - significant matters requiring correction by management,
 - the future plans of the bank.

The Inspection division should also:

- (a) forward a report to the Compliance division of concerns of a compliance nature for subsequent follow-up action (or a confirmation that no such matters were noted);
- (b) report the overall rating of the results of the inspection to the Statistical Analysis group of the Statistical Analysis and Database Management division for its inclusion in the Early Warning System; and
- (c) report technical matters to the Research division where further investigation or development of a policy or guideline may be appropriate.

ii) For external use

In order to convey a summary of the matters which arose during the inspection to the bank's Audit Committee and management and to the shareholders' auditors, a formal report should be provided to them which should include, as a minimum:

- a summary of the procedures performed; and
- a summary of the areas where a concern was noted and corrective action is considered necessary by the OIGB.

The reports should be reviewed by the division director and forwarded to the Inspector or Assistant Inspector, as appropriate, for final approval and issued in draft to the bank's Chief Executive Officer for response as to the corrective action proposed as well as the time-frame for correction. (The Assistant Inspector and Inspector must, of course, be prepared to review the report in person with the CEO when the report contains significant recommendations for corrective action.)

The response should be incorporated in the final report which should then be sent to each of the parties noted above. The forwarding of the report to the shareholders' auditors may require a change to Section 251 of the Act. Should the Act not be changed, a copy of the report should be forwarded to the Chief Executive Officer of the bank with a request that it be forwarded to the shareholders' auditors.

To the Minister

Upon completion of the inspection, the Inspector should report to the Minister that he has conducted an examination in accordance with Section 246(2) of the Bank Act and whether, in his opinion, the provisions of the Act having reference to the safety of the interests of the depositors, creditors and shareholders of the bank have been duly observed and whether the bank is in a sound financial condition.

Appendix K

Recommendations Relating to OIGB Divisions Other than Inspection

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Appendix K

K.1 Suggested Review of the Early Warning System

K.1.1 The Early Warning System (EWS) currently administered by the Research division does not have sufficient scope to track the appropriate performance indicators of all banks. The system should be subject to in-depth review for the purpose of:

K.1.1.1 revising the system along the following lines:

- (a) the incorporation of all banks into the system rather than just the Schedule A banks as presently included;
- (b) the issuance of reports within 15 days of the receipt of quarter-end information from the banks;
- (c) the provision for relative rankings of all banks on the basis of:
 - i) large Schedule A banks
 - ii) small Schedule A banks and large Schedule B banks
 - iii) other Schedule B banks;
- (d) the computerization of the "Relative Ranking by Bank" report component of the system;
- (e) the incorporation in the system of additional performance indicators which might include:
 - the base capital ratio in addition to the base capital equivalent ratio,
 - a maturity profile of assets and liabilities,
 - the bank's liquidity as established in proposed guidelines and the changes in liquidity over various periods,
 - the off-balance sheet risks,
 - the bank's interest rate sensitivity and its potential financial impact,
 - the bank's core (retail) deposits as a percentage of its total deposits,
 - identification of major changes in key ratios;
- (f) a revision of the weighting attached to each factor. The share dividend coverage ratio should not necessarily have

the same weight as the percentage of non-performing loans to total loans, as is currently the case;

- (g) the transfer of performance indicators currently included under the management caption to other captions in order that the management of the bank may be rated by the Inspection division based upon the results of the inspection process. This would comprise a rating of the bank's:
 - internal audit department
 - accounting policies and practices
 - credit policies and practices
 - systems development methodology and systems operations
 - treasury policies and practices
 - personnel management practices
 - compliance with the Bank Act;
- (h) the establishment of the final EWS rating and a "watch list" of banks with operating difficulties at a meeting of senior personnel from each division;
- (i) the development of a clear definition of the range of ratios which fall into each rating category;
- (j) the assignment of an A, B, or C rating within each 1-5 rating to identify whether the results are:
 - improving (A);
 - steady (B); or
 - deteriorating (C);
- (k) the requirement for assignment of banks rated as 3C, 4 or 5 to the Inspector's Advisory Group for monitoring in accordance with its mandate;
- (l) the development of a qualitative overview analysis of the EWS ratings on a quarterly basis which would include:
 - quarterly trends;
 - a review of specific banks;
 - potential problems; and
 - banks for the Inspector's Advisory Group review and monitoring;
- (m) the development and distribution of a quarterly EWS book to all OIGB personnel comprising:
 - a list of overall ratings for each bank within its specific bank group;

- a report of the qualitative analysis, as performed on the ratings described above;
- a report from the Inspector's Advisory Group on all banks under their scrutiny, detailing action taken by management and the results to date;
- a "watch list" of accounts which are experiencing operating problems or are showing initial signs of potential problems; and

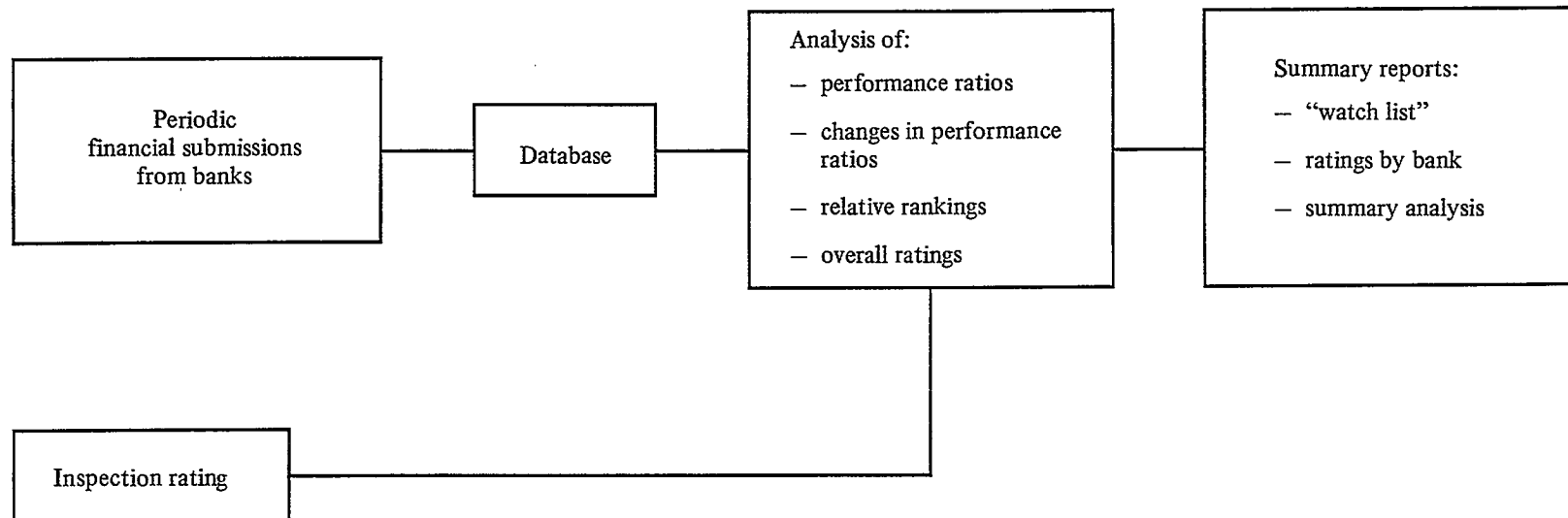
(n) the development of written procedures for the production of the EWS reports, quarterly reports, analysis, commentary and "watch list".

K.1.1.2 confirming the integrity of the data included in the system through the conduct of a detailed review of the calculations of each of the ratios and amounts included in the EWS.

K.1.2 Upon completion of the in-depth reviews and implementation of the necessary changes, written guidelines for the establishment of the final ratings assigned to each bank should be developed which would include as a minimum:

- a definition of superior, satisfactory and unsatisfactory ratings; and
- the establishment of the relationship of the key ratios to the specific ratings (e.g. if the capital ratio is not satisfactory then a rating of 3 or 4 is automatically assigned).

K.1.3 A graphic illustration of the EWS is included as Attachment I on page 172 of this appendix.

Attachment I**Conceptual View of the Early Warning System**

K.2 Suggestions for the Review of the Systems and Information Requirements of the OIGB

K.2.1 The OIGB processes information received on a periodic basis from banks using:

- (i) the computer facilities of the Bank of Canada which serves the function of a service bureau to the OIGB in the processing of periodic financial returns received from banks;
- (ii) an "in-house" personal computer with internally developed programs primarily to record data received from periodic information returns received from banks. This system also has the capacity to process certain financial information received from the Bank of Canada computer facility.

K.2.2 As suggested in paragraph 4.7.3.3 of Chapter 4, a comprehensive review of the computer systems and information requirements of the OIGB should be conducted for the purpose of:

- (a) enhancing information included in the Early Warning System and extending the system to encompass the performance indicators of all banks as described on page 169 of this appendix.
- (b) investigating the alternatives in producing reports on a more timely basis than at present. Time to process certain of the reports are as follows:

Report	Number of days from receipt of information to issue of report
• Quarterly Products Book	90–120 days
• Early Warning reports	90–115 days
• Schedule J	30 days
• Non-Mortgage Loans	45 days
• Loans to Business	45 days
• Schedule O	21–30 days
• Schedule Q	20 days
• Return of Assets and Liabilities by Region	60 days
• Geographic Distribution of Assets	30 days
• Return of Securities	45 days

- (c) identifying potential new applications for computerization which might include:
 - Inspection division scheduling of staff for each inspection throughout a year;
 - Database management group scheduling of work flow and report processing;
 - Research division scheduling of work projects;
 - Inspection division reports on time requirements for each inspection;
 - performance of quality control procedures on the reports received from banks;

- compilation of information from quarterly reports of non-performing loans;
 - production of pre-inspection reports with inter-bank comparisons;
 - compilation of information from the proposed liquidity reports; and
 - the ability to obtain and retrieve data for "ad hoc" reports.
- (d) assessing the efficiency of the current systems arrangements of the OIGB. The alternatives may include:
- i) continuation of the "split" processing of information between the Bank of Canada and the OIGB;
 - ii) the processing of all reports and information using internal processing facilities; and
 - iii) the processing of all returns and information at an outside service bureau.
- (e) ensuring the completeness and adequacy of the current security controls over the "in-house" personal computer system.
- (f) ensuring that a sufficient, appropriate systems development and testing methodology exists and is documented.
- (g) ensuring the existence of sufficient, appropriate documentation for systems developed "in-house".

K.3 Suggestions for the Assessment of the Contents of the Manual of Reporting Forms

K.3.1 As discussed in paragraph 4.7.3.4 of Chapter 4, a review of the Manual of Reporting Forms should be undertaken for the purpose of making revisions to the forms and instructions as appropriate. Our initial review indicated that:

- (a) there are a number of returns which appear to be superfluous, as follows:
- Return of Directors
 - Return of Shareholders
 - Return of Property
- The information included in these returns can be reviewed during the OIGB's annual inspection. As the Return of Property and Return of Directors are legislated in the Bank Act, their deletion may have legal implications;
- (b) the Monthly Geographic Distribution consolidation report is produced on a "request" basis, and is only requested on an infrequent basis;
- (c) the Return of Holdings in Subsidiaries is redundant, as the information is available from the annual financial statements of the bank;
- (d) a report of the Quarterly Returns of Chartered Bank Operations in Selected Countries is prepared only upon very infrequent requests;
- (e) a number of reports should be requested from the banks and included in the Manual. For example:

- Maturity profiles of all assets and liabilities rather than domestic amounts as presently submitted by banks;
 - A summary of specific loans over 90 days in arrears which have not been recorded as non-performing;
 - A report on interest rate sensitivity;
 - The components of "other income" and "other expense" items included in the Statement of Income; and
 - Capital leverage ratios;
- (f) the division receives a large number of enquiries from banks concerning the returns, which may indicate that the content of the forms may be confusing or that the instructions are not clear and concise; and
- (g) the database management group regularly obtains information from banks by telephone. The requirements for such information should be assessed and incorporated into the reporting systems, if appropriate.

K.4 Suggested Revisions to the "Quarterly Products Book"

K.4.1 The "Quarterly Products Book" is prepared within 90 – 115 days of the quarter-end. The "Book", which is distributed to the senior executive of the OIGB and division directors, includes such material as:

- the quarterly operating results of the domestic banks;
- a summary of the domestic and international assets of the "Big 5" banks;
- capital components and leverage ratios of each bank;
- an Early Warning System report; and
- common share market data for Schedule A banks.

K.4.2 As described in paragraph 4.7.3.3 of Chapter 4, the Quarterly Products Book should be subject to in-depth review with a view to making revisions along the following lines:

- (a) the establishment of peer groups for comparative analysis and reporting as follows:
- 1) Large A banks
 - 2) Small A banks
Large B banks
 - 3) Other B banks
- consideration may be given to establishing peer groups within the "other" Schedule B bank category along the lines of type of business or country of origin;
- (b) the development of reports comprising 8-10 pages consisting of numerical data and analysis by peer group;
- (c) the issuance of reports within 45 days of the quarter-end. This may have significant implications in terms of the ability of computer systems to

generate such information on a timely basis. However, manual preparation would be preferable to the considerable delay in distributing the information now experienced;

- (d) the inclusion of the following information for each bank and for each of the peer groups as a whole:

	Quarter/YTD	
• Net income before income taxes	”	”
• Income taxes	”	”
• Net income	”	”
• Extraordinary items (if any)	”	”
• Return on assets	”	”
• Return on equity	”	”
• Non-performing loans		”
• Average assets	”	”
• Asset/liability maturity		”
• Leverage ratio		”
• Interest rate sensitivity		”

the reports would include dollar and percentage changes from the comparative periods;

- (e) the performance of an overall analysis of the reports of each peer group compared to prior periods with comments concerning:

- changes
- impact of events
- trends
- banks varying significantly from the norm;

- (f) the distribution of the quarterly report to all personnel within the OIGB; and

- (g) the implementation of quality control procedures before the issuance of reports.

K.4.3 Upon completion of the in-depth review and implementation of the necessary changes, written procedures for the production of the reports should be developed.

K.5 Proposal for an Inspector's Advisory Group (IAG)

K.5.1 As described in paragraph 4.7.6.2 of Chapter 4, the objectives of the IAG are to:

- i) ensure that management of banks experiencing operating problems have developed an appropriate plan of corrective action;
- ii) monitor the performance of banks experiencing operating problems including the implementation by management of plans for corrective action; and
- iii) provide advice to the Inspector concerning the action to be taken in respect of such banks.

K.5.2 The director of the IAG would report directly to the Inspector in recognition of the potential implications of the work to be performed by the group.

K.5.3 The method of operation of the IAG would include the following, as a minimum:

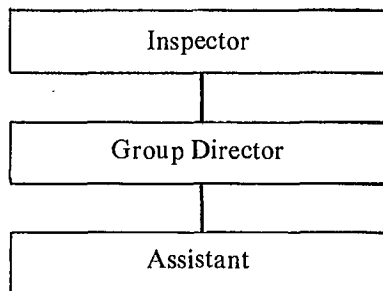
- (a) banks experiencing problems would be identified through the Early Warning System (EWS) which comprises a composite of each bank's performance and inspection ratings. Banks with a rating of 3C (average risk but deteriorating), 4 (high risk) or 5 (acute risk) would be drawn to the attention of the IAG director at quarterly meetings with division directors to review the EWS and establish final performance ratings;
- (b) the nature of the operating problems of banks would be identified at such meetings to the extent possible:
 - e.g.: loan losses
 - operating losses
 - fraud
 - loss of deposits;
- (c) the IAG director would meet with management of the bank to review and confirm the operating problems and ascertain management's plans for corrective action;
- (d) the IAG's personnel would review management's plan of action to ensure that the proposed action was:
 - workable
 - complete
 - timely;
- (e) the IAG's personnel would make written recommendations to management on the adequacy of the action plan;
- (f) the IAG's personnel would monitor on an ongoing basis management's implementation of the action plan;
- (g) the IAG's director would provide the Inspector with a monthly written report concerning the status of each bank under review;
- (h) the IAG director would make written recommendations to the Inspector concerning future courses of action to be taken by the OIGB in respect of banks experiencing operating difficulties:
 - e.g.: request capitalization
 - request asset sale
 - consider a merger
 - consider curatorship
 - consider liquidation;
- (i) the IAG's personnel would provide direction to the Statistical Analysis group of the Statistical Analysis and Database Management division concerning the nature, extent and timing of review of results necessary for monitoring problem banks and would review all such reports prepared;
- (j) the IAG would act as liaison between the OIGB and appointed curators or liquidators of banks;
- (k) the IAG would monitor the work of appointed curators or liquidators of banks;

- (l) the IAG would assume control of banks as directed by the Inspector;
- (m) the IAG would operate according to a pre-defined, documented methodology;
- (n) the IAG would have documented standards by which the methodology is conducted;
- (o) the IAG would maintain a database of external personnel who could be engaged to perform tasks in special circumstances; and
- (p) the IAG would liaise closely (i.e. quarterly) with the Federal Deposit Insurance Corporation (U.S.) and Office of the Comptroller of the Currency (U.S.) personnel on "support" techniques and training programs for personnel involved in such activities.

Organization

K.5.4 The IAG would be small in size on the basis that resources could be internally or externally obtained as circumstances dictate. Based upon the number of banks currently experiencing difficulties, the IAG complement would consist of two individuals.

K.5.5 As previously indicated, the Group director would report directly to the Inspector.



Liaison within the OIGB

K.5.6 The IAG would work in close consultation with other OIGB divisions along the following lines:

- Statistical Analysis and Database Management Division
 - the IAG would provide advice in establishing the Early Warning System ratings; and
 - the Statistical Analysis group of the Statistical Analysis and Database Management division would perform extensive analysis of weekly, monthly and quarterly information concerning banks as required by the IAG.
- Research Division
 - the IAG would consult the Research division on matters of concern relating to accounting policies, liquidity or other matters.
- Compliance Division
 - the IAG would report to the Compliance division all matters of a compliance nature noted during its work.

- Inspection Division
 - the IAG would utilize inspection personnel in the performance of specific procedures as circumstances warrant.

Qualifications of Personnel

- K.5.7 As the IAG would be small in nature and highly specialized, the individuals employed should have significant experience at a senior level in either of the following areas:
- “work-out” experience at the pre-receivership stage (e.g. management consultant); or
 - receivership experience in the financial services industry.
- K.5.8 As it is unlikely that the individuals who possess these qualifications would possess a detailed knowledge of banking, it would be necessary to impart such knowledge within a short time frame. This would necessitate identification and enrollment in suitable training courses.

K.6 Mandates of the Divisions

- K.6.1 As described in paragraph 4.8.1 of Chapter 4, the division mandates should provide an emphasis on expected results and objectives in order to provide direction to the divisions.
- K.6.2 The mandates of the divisions should be reviewed and amended to incorporate at least the following:
- K.6.2.1 **Compliance Division**
- (a) the reporting lines within the OIGB;
 - (b) the reporting lines to banks;
 - (c) the lines of communication with other parties;
 - (d) a statement of objectives which might include requirements to ensure that:
 - i) applications to incorporate new banks or amalgamate existing banks are evaluated in accordance with pre-defined standards;
 - ii) banking licence renewals are reviewed and revised, as appropriate, at periodic intervals;
 - iii) there is reasonable assurance as to compliance with the Bank Act*;
 - iv) complaints from the general public concerning banks and their activities are responded to in an appropriate fashion;
 - v) assistance is provided in the formulation of policy as required by the Inspector*;

* Denotes inclusion in the current mandate of the division.

- vi) an inspection of sufficient scope is conducted in order to report to the Minister on compliance of the Canadian Payments Association with its by-laws; and
 - vii) letters or directives for compliance* are issued when appropriate.
- (e) An outline of the specific methods of achieving the above compliance objectives. These might include:
- i) the establishment and maintenance of a procedures and standards manual;
 - ii) the establishment of working relationships with other regulators in jurisdictions where Canadian banks operate in order to monitor compliance issues;
 - iii) the maintenance of lines of communications with:
 - Chartered banks
 - Canadian Bankers Association
 - Other government departments*
 - Shareholders' auditors of banks;
 - iv) the procedures for the review and concurrence with new rules and guidelines to be issued by the Research division;
 - v) the maintenance of a summary of training and education courses and a system to ensure that staff attend training and education courses on an annual basis in accordance with the division's policy;
 - vi) the procedures for providing advice concerning the establishment of the capital leverage ratio of each bank;
 - vii) the preparation of reports to the Inspection division prior to each inspection on compliance matters concerning banks;
 - viii) the procedures for provision of assistance to the Inspector's Advisory Group as may be required;
 - ix) the procedures for the review of periodic returns for compliance with the Bank Act;
 - x) the procedures for the conduct of such examination as may be required when a breach in the Act is suspected or confirmed; and
 - xi) the procedures for the issuance of letters or directives for compliance when a breach of the Act has been confirmed.

* Denotes inclusion in the current mandate of the division.

K.6.2.2

Research Division

- (a) the reporting lines within the OIGB;
- (b) the reporting lines to banks;
- (c) the lines of communication with other parties;
- (d) a statement of objectives which might include requirements to ensure that:
 - i) a program of general research into matters of a taxation, accounting or prudential policy nature is conducted*; and
 - ii) rules and guidelines relating to taxation, accounting or prudential policy matters are issued in appropriate circumstances;
- (e) an outline of the specific methods to be used in achieving the above objectives. These might include:
 - i) the establishment of policies and standards for the operation of the division;
 - ii) the maintenance of working relationships with foreign regulators in jurisdictions where Canadian banks operate;
 - iii) the preparation of reports and position papers as may be required by the Inspector, Assistant Inspector or Minister;
 - iv) the maintenance of lines of communication with*:
 - Chartered banks
 - Canadian Bankers' Association
 - Shareholders' auditors of banks
 - Other government departments;
 - v) the maintenance of a summary of appropriate training and education courses and a system to ensure that all staff attend training and education courses on an annual basis in accordance with the division's policy;
 - vi) the development and circulation of "Exposure Drafts" of proposed rules or guidelines before their final issue; and
 - vii) the maintenance of a Manual of Reporting Forms.

K.6.2.3

Statistical Analysis and Database Management Division

- (a) the reporting lines within the OIGB;

* Denotes inclusion in the current mandate of the division.

- (b) the reporting lines to banks;
- (c) the lines of communication with other parties;
- (d) a statement of objectives which might include requirements to ensure that:
 - i) a database of information sufficient to monitor the operations of banks is maintained;
 - ii) reports of bank operations for internal and external use are prepared as required;
 - iii) detailed analyses of operations of banks are prepared on a periodic basis from the information received from banks;
 - iv) information required from banks is received, controlled, summarized and distributed as appropriate;
 - v) an Early Warning System of bank performance indicators is maintained;
 - vi) the results of the Early Warning System are analyzed and the Inspector's Advisory Group advised as appropriate;
 - vii) the financial components of applications for incorporation are subject to appropriate analysis;
 - viii) the information and systems needs of the OIGB are appropriately identified; and
 - ix) systems are developed to respond to the information needs of the OIGB which are identified;
- (e) an outline of the specific methods to be used in achieving the above objectives. These might include:
 - i) the establishment and maintenance of a procedures manual for the conduct of reviews, analyses, etc.;
 - ii) the establishment of working relationships with foreign regulators;
 - iii) the preparation of such reports and analyses as may be required from time to time by:
 - the Minister
 - the Inspector and Assistant Inspector
 - other OIGB divisions
 - OIGB personnel;

- iv) the establishment and maintenance of lines of communication with:
 - Chartered Banks
 - Canadian Bankers' Association
 - Shareholders' auditors of banks
 - Other government departments;
- v) the development of new systems to respond to the information needs of the OIGB;
- vi) the review of, and concurrence with, the issuance of changes to the Manual of Reporting Forms and rules, guidelines and regulations, and identification of the changes necessary to information systems resulting therefrom;
- vii) the provision of an appropriate level of training and education to division personnel;
- viii) the establishment and maintenance of an Early Warning System of bank performance indicators which would summarize key performance ratings of banks;
- ix) the establishment of performance ratings for each bank in conjunction with other OIGB divisions;
- x) the provision of assistance to the Inspector's Advisory Group as may be required;
- xi) the provision of a pre-inspection analytical package of information for use by the Inspection division in periodic inspections.

K.7 Standards and Procedures Manual

- K.7.1 As indicated in paragraph 4.8.2 of Chapter 4, a standards and procedures manual should be developed which would include at least the following matters:

Compliance Division

• General Standards

- the purpose of the manual;
- the interrelationship of the division with other OIGB divisions;
- the procedures for the review and concurrence with new rules and guidelines;
- the internal reporting lines of the division;
- the training and education requirement of personnel; and
- level and types of documentation required.

- **Administration**
 - the files to be retained; and
 - the procedures for the development of work plans and objectives.
- **Compliance matters**
 - the procedures for the review of applications to incorporate;
 - the procedures for increases in deemed capital;
 - the procedures for the renewal of licences;
 - the procedures for issuance of letters or directives for compliance;
 - the procedures for the review of returns of reserves;
 - the procedures for the review of returns of insured deposits;
 - the procedures for the review of propectuses;
 - the procedures for the determination of OIGB expenses to be billed to banks;
 - the procedures for reviews of mergers and acquisitions; and
 - the procedures for the review of periodic returns.

Research Division

- **General Standards**
 - the purpose of the manual;
 - the interrelationship of the division with the Inspection, Compliance and Statistical Analysis and Database Management divisions and Inspector's Advisory Group;
 - the training and education requirements of personnel;
 - the procedures for the issuance of changes to the Manual of Reporting Forms and the issue of rules, regulations and guidelines;
 - the internal lines of communication and organization of the division; and
 - the level and types of documentation to be retained.
- **Administration Standards**
 - the files to be retained;
 - the procedures for the development and monitoring of work plans and objectives;
 - the procedures for the identification of projects to be undertaken;
 - the standards of policy development;
 - the review of reports by senior personnel;

- the minimum content of a statement of objectives for rules and guidelines;
- the procedures for the issuance of Exposure Drafts; and
- the procedures for the compilation of the comments received regarding Exposure Drafts.
- **Tax and Accounting**
 - the procedures for the identification of projects to be undertaken;
 - the procedures for documentation of responses to inquiries;
 - the basic standards of development of rules and guidelines; and
 - the guidelines for discussions with CBA/CICA/AICPA/US regulators.
- **Research**
 - the basic standards for the conduct of research activities;
 - the guidelines for communications with other regulators; and
 - the quality control and review procedures.

Statistical Analysis and Database Management Division

Standards

- **General**
 - the purpose of the manual;
 - the interrelationship with the Inspection, Compliance and Research divisions and Inspector's Advisory Group;
 - the training and education policies of the division;
 - the procedures for the division's concurrence with changes to the Manual of Reporting Forms and issuance of rules, regulations and guidelines;
 - the internal lines of communication and the division's organization; and
 - the level and types of documentation to be retained.
- **Administration**
 - the files to be retained; and
 - procedures for developing and monitoring work plans and objectives.
- **Database Management**
 - the procedures for maintenance of the database;
 - the procedures for the identification of changes or additions to the database;
 - a systems development methodology;

- systems standards;
- quality control procedures; and
- the procedures for the review of reports.
- **Analysis**
 - the analytical review techniques to be used;
 - a summary of key ratios for comparison;
 - a procedure for establishment of capital adequacy ratios;
 - the operation of the Early Warning System;
 - minimum report contents;
 - the procedures for the review of reports by the director;
 - the provision of notification to the Inspector's Advisory Group of banks exhibiting problems;
 - procedures for the compilation of the pre-inspection analyses for the Inspection division and the format thereof;
 - a summary of standard reports for issuance;
 - the review of specific reports to OIGB executives; and
 - the distribution of reports.

Procedures

- **Database**
 - the procedures for the receipt of reports from banks;
 - the procedures for quality control;
 - the procedures for reprocessing of returns with errors;
 - reporting to the Compliance division;
 - the procedures for report processing;
 - the procedures for the issuance of reports;
 - the procedures for the processing of the Early Warning System; and
 - the procedures for the processing of the Quarterly Products Book.
- **Analysis**
 - the standard analysis programs for each type of analysis performed:
 - Early Warning System;
 - Quarterly Products Book;

- Pre-inspection package; and
- applications for incorporation.

The programs would describe the:

- objectives;
- particular techniques and ratios to be applied;
- comparative periods;
- comparisons with peer groups; and
- reports to be generated.

Appendix L

Staffing and Organization of the OIGB

Index

	Section	Page
Current and Proposed Organization of the OIGB.....	L.1	191
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Training and Education	L.5	205
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Appendix L

L.1 Current and Proposed Organization of the OIGB

- L.1.1 Recommendations concerning the organization of the OIGB are described in detail in Section 4.8 of Chapter 4.
- L.1.2 The accompanying charts graphically illustrate:
 - Chart I Current Organization of the OIGB
 - Chart II Suggested Organization of the OIGB
 - Chart III Suggested Organization of the Compliance Division
 - Chart IV Suggested Organization of the Statistical Analysis and Database Management Division
 - Chart V Suggested Organization of the Research Division
 - Chart VI Suggested Organization of the Inspection Division
 - Chart VII Suggested Organization of an Inspection Team
 - Chart VIII Suggested Organization of the Inspector's Advisory Group
 - Chart IX Suggested Organization of the Office Services and Records Group

Chart I

Current Organization of the OIGB

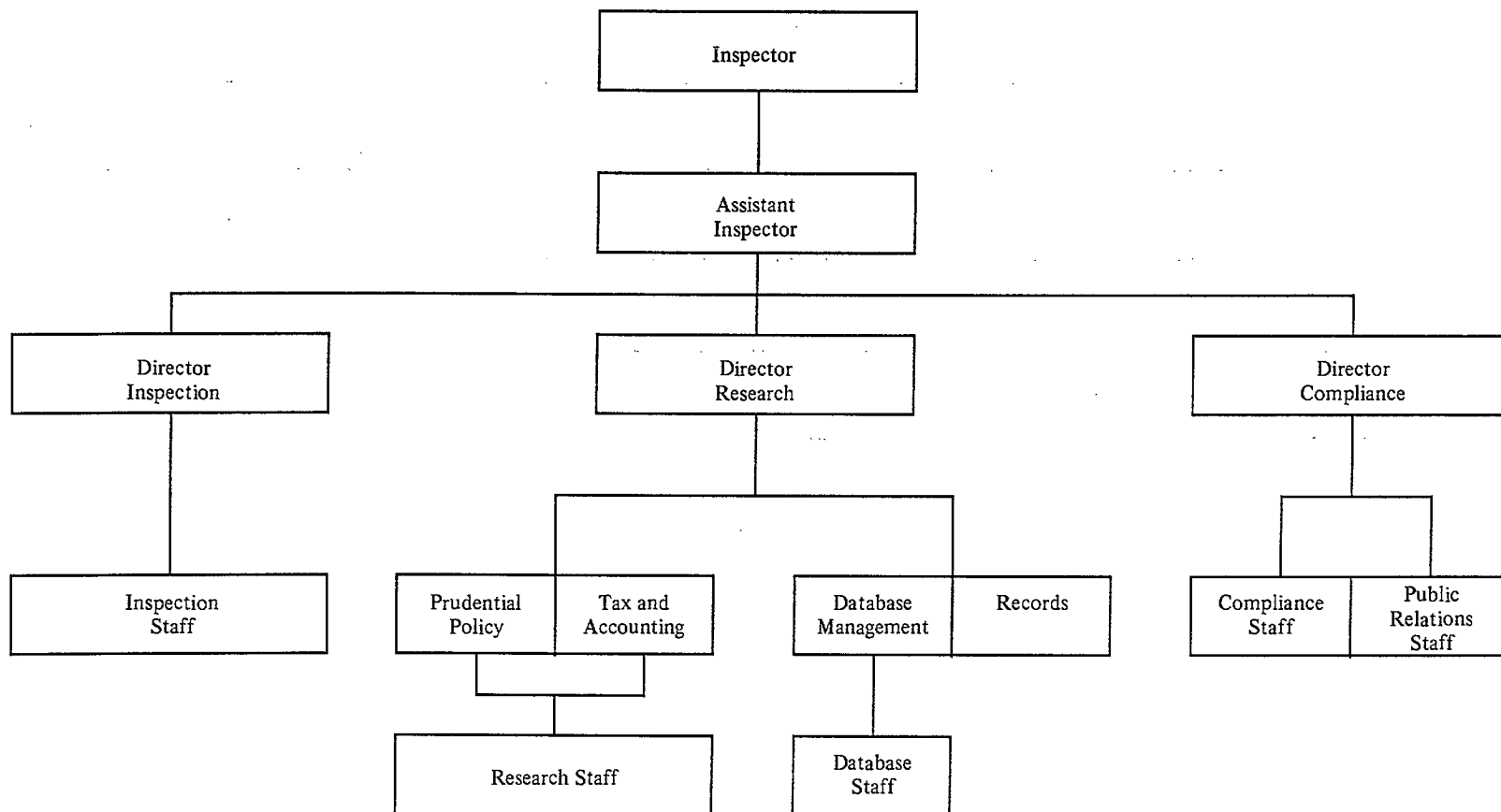


Chart II

Suggested Organization of the OIGB

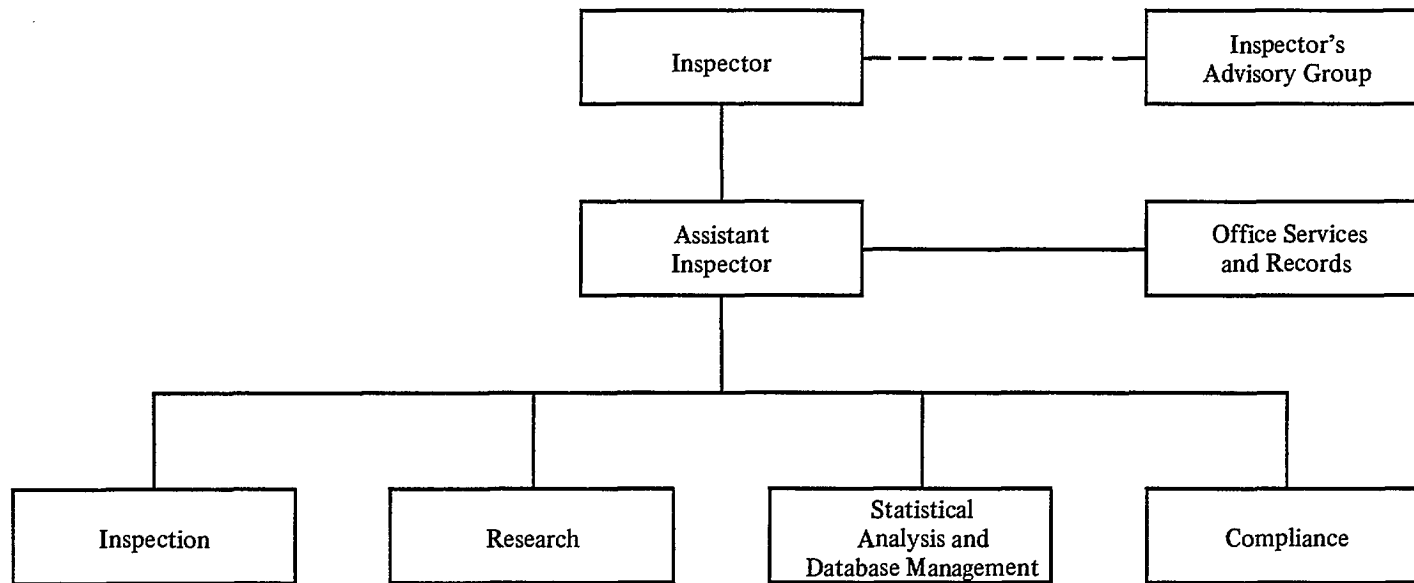


Chart III

Suggested Organization of the Compliance Division

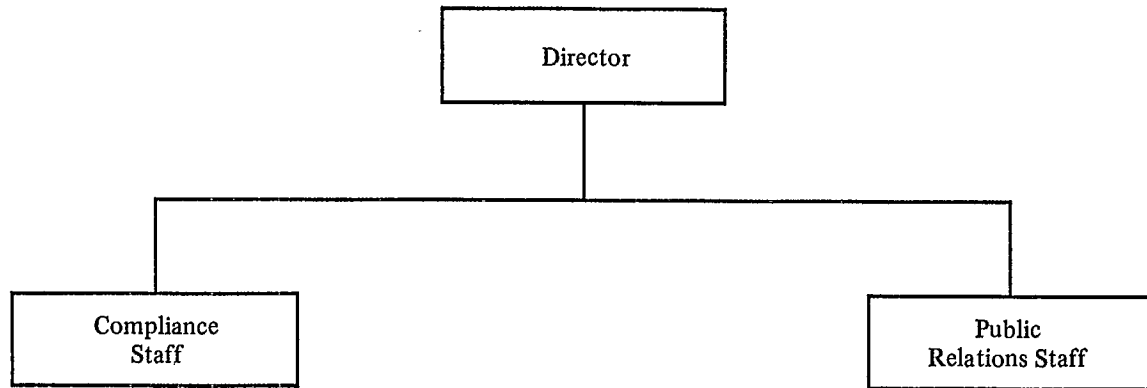


Chart IV

**Suggested Organization of the Statistical Analysis
and Database Management Division**

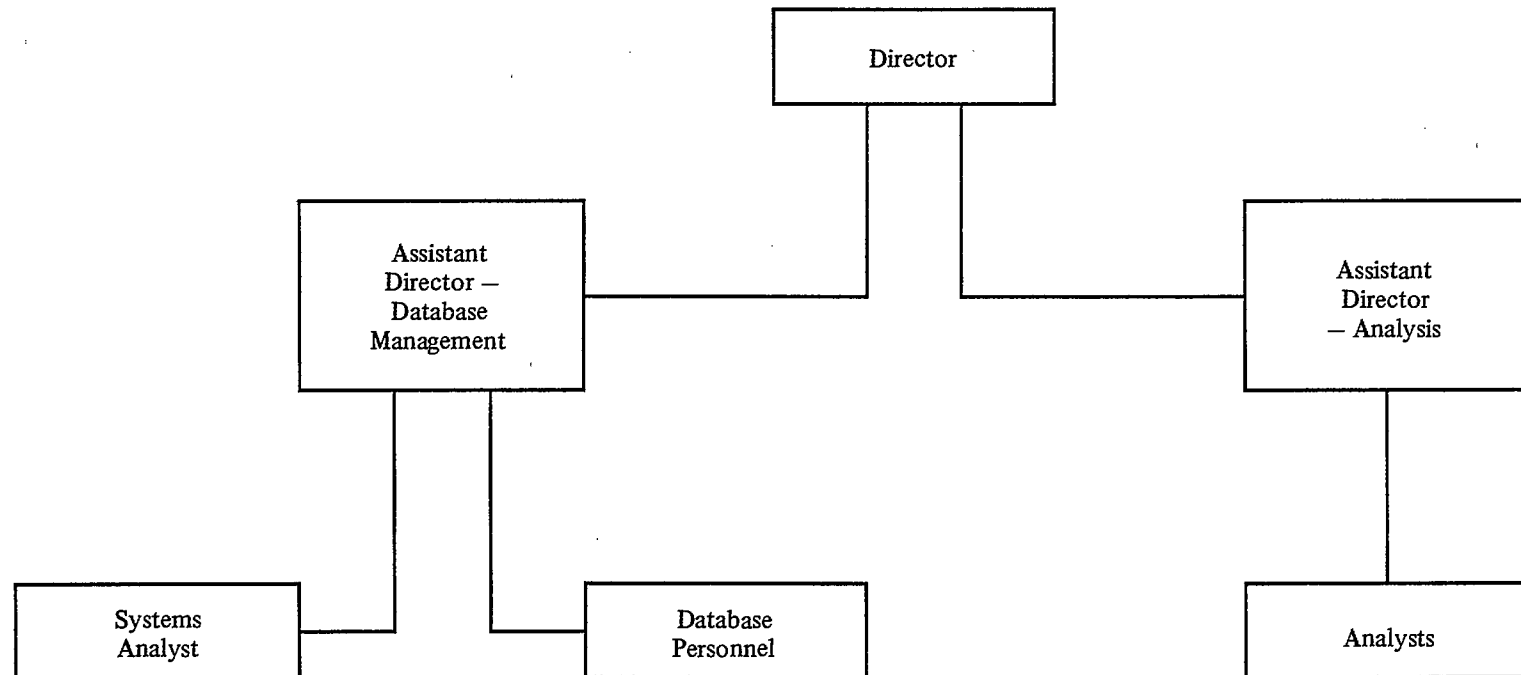


Chart V

Suggested Organization of the Research Division

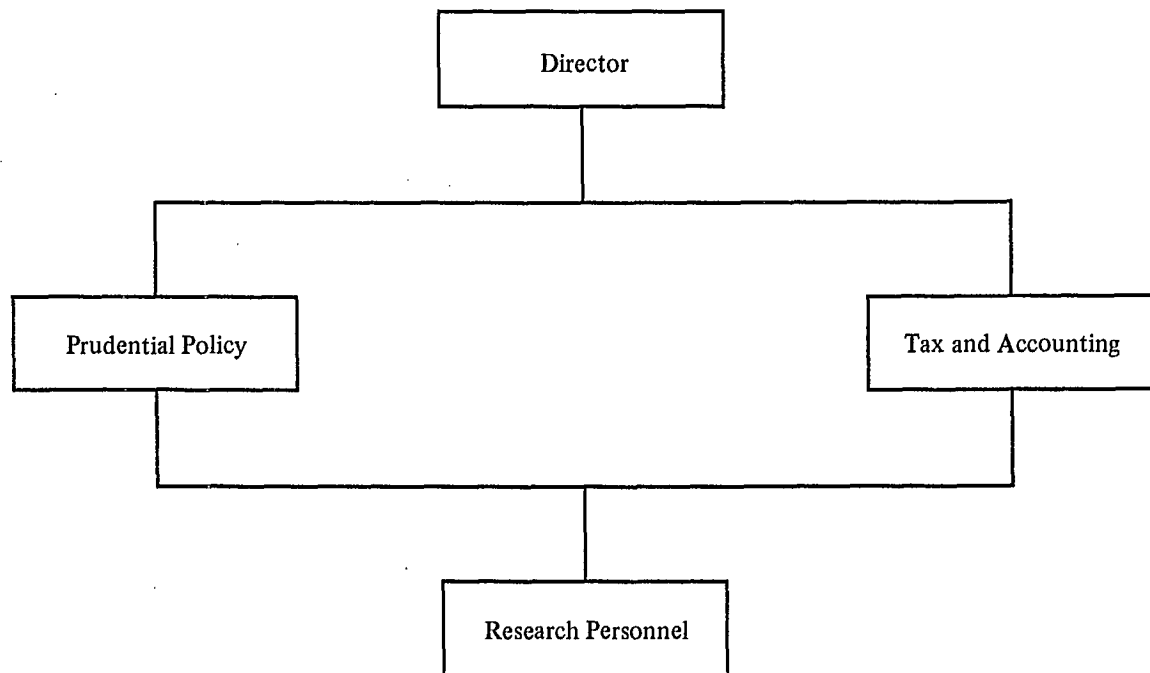


Chart VI

Suggested Organization of the Inspection Division

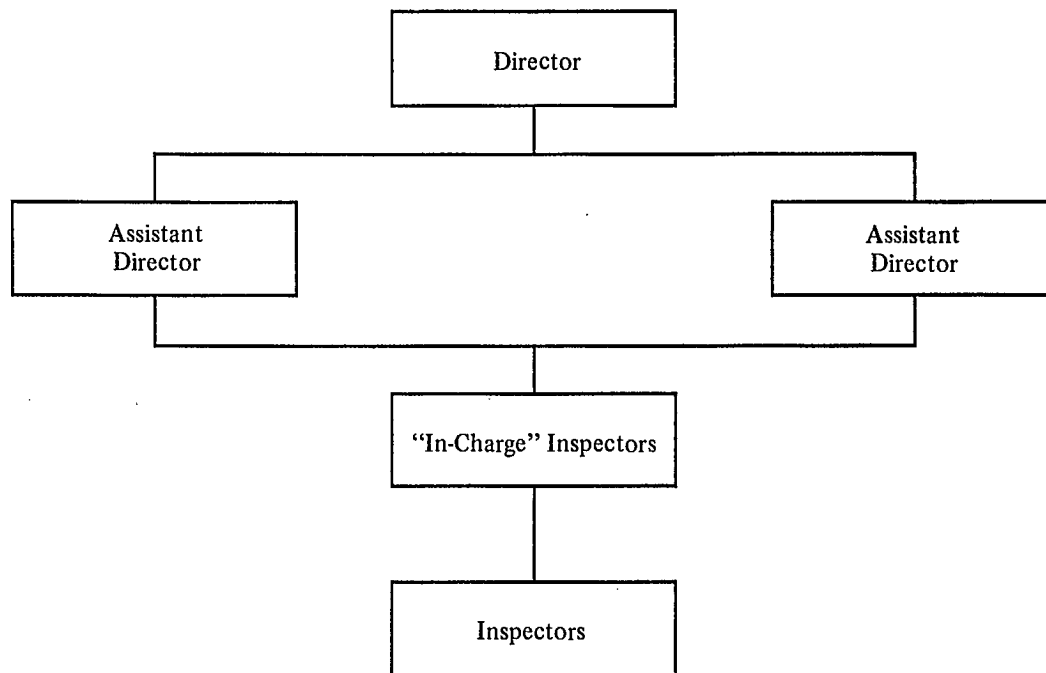


Chart VII

Suggested Organization of an Inspection Team

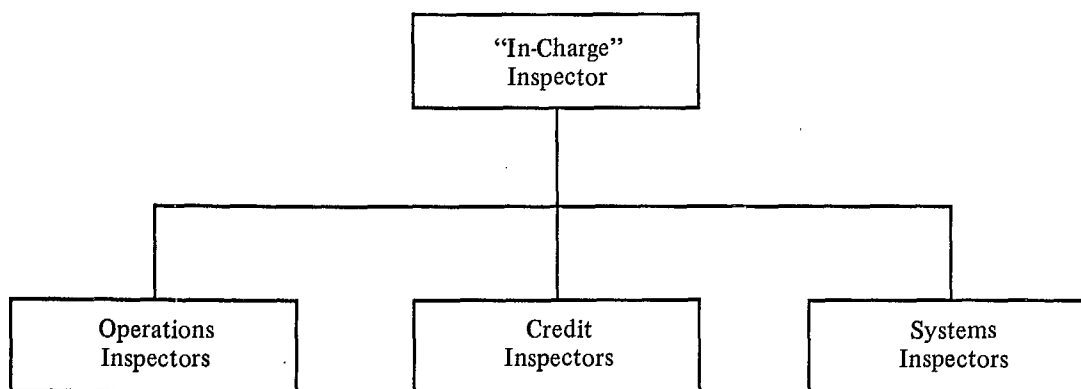


Chart VIII

Suggested Organization of the Inspector's Advisory Group

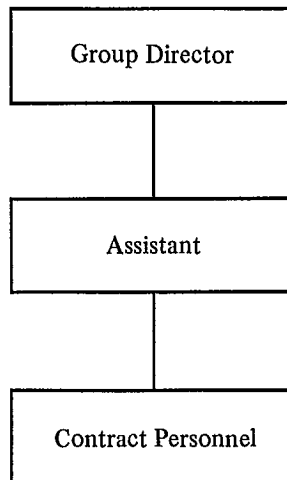
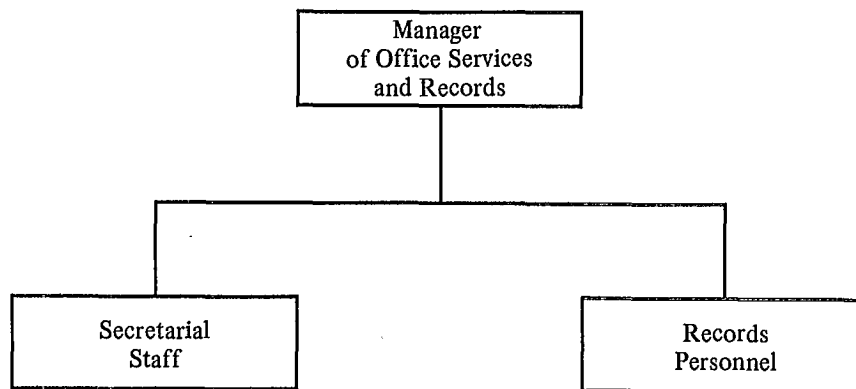


Chart IX

**Suggested Organization of the
Office Services and Records Group**



L.2 OIGB Staff Complement

- L.2.1 As described in Section 4.9 of Chapter 4, the number of OIGB personnel must be increased and their qualifications upgraded in order to carry out the program requirements which we have recommended and to deal with senior bank management in a credible fashion.
- L.2.2 The accompanying Chart X on page 202 of this appendix reflects the current and suggested personnel complement of the OIGB and the current and suggested qualifications of its personnel. While it is difficult to ascertain the actual staffing requirements of the OIGB without developing work programs and allocating duties to individuals, the suggested complement represents our best estimate in the circumstances.

Chart X

Comparison of OIGB Staff Complement and Previous Experience

Current Complement		Suggested Complement	
Inspection Division			
Chartered Accountants	2	Chartered Accountants	13
C.G.A./C.M.A.	2	Credit experience	12
Banking	3	Computer systems	
Other	3	experience	<u>5</u>
No previous experience	<u>1</u>		30
	11		
Research Division			
Chartered Accountants	1	Accounting and	
C.G.A.	1	prudential policy	
No previous experience	1	research	9
Other	<u>4</u>		
	7		
Database Management Group			
Database management	4	Chartered Financial	
Other	<u>1</u>	Analysts	4
	5	Database management	2
		Systems analysts	<u>1</u>
			7
Compliance Division			
Government	4	Government/compliance	5
Legal	1	Legal	1
Public relationship	<u>1</u>	Public relations	<u>2</u>
	6		8
Inspector's Advisory Group			
	—	Receivership or	
		"workout" experience	2
Clerical staff			
	11	Clerical staff	15
Total			
	40		71

- L.2.3 The most significant increase in staffing is suggested for the Inspection division. It is estimated that the staff complement would be increased from the present level of 11 individuals to a complement of 30 individuals. The suggested staff complement is based upon the following estimates of time requirements in normal circumstances:

Category	Time requirements per bank	Number of banks	Total person-weeks required
i) Large Schedule A banks	<ul style="list-style-type: none"> • Conduct of the inspection by 5 individuals for 4 weeks • Pre-inspection planning and post-inspection reporting totalling 4 person-weeks <p>Total requirement of 24 person-weeks</p>	6	144
ii) Small Schedule A and large Schedule B banks	<ul style="list-style-type: none"> • Conduct of the inspection by 5 individuals for 3 weeks • Pre-inspection planning and post-inspection reporting totalling 4 person-weeks <p>Total requirement of 19 person-weeks</p>	15	285
iii) Other Schedule B banks	<ul style="list-style-type: none"> • Conduct of the inspection by 3 individuals for 2 weeks • Pre-inspection planning and post-inspection reporting totalling 4 person-weeks <p>Total requirement of 10 person-weeks</p>	49	490
Total person-weeks			919

- L.2.4 The staff complement was determined as follows:

• basic staff requirement based upon:	22
• a 42 person-week work year in recognition of time for vacation, sickness, training and education, and "down-time" due to bank fiscal year-ends	
• 919 person-weeks of work to be completed	
• conduct of audits on a 5-day work week	
• additional personnel due to the probability of increasing the frequency of inspections in certain instances	3
• special projects of an inspection nature	4
• division director	<u>1</u>
Total Inspection division complement	30

L.3 Suggested Qualifications of Personnel

L.3.1 As previously described on page 201 of this appendix, the implementation of the suggested programs will require an upgrading of the qualifications of the staff of the OIGB.

L.3.2 Qualifications should be established along the following lines:

Inspection Division

The division director:

- should be a Chartered Accountant having had experience as an audit partner of an accounting firm with responsibility for major engagements.

"In-charge" inspectors:

- should be Chartered Accountants having attained the position of manager with an accounting firm and should have previous banking or bank audit experience.

Inspectors should comprise a combination of:

- Chartered Accountants, preferably at a supervisory or manager level with an accounting firm, with previous banking or bank audit experience or significant internal audit experience at a bank at a senior level;
- credit personnel with significant experience at a senior manager or vice-president level of a bank; and
- specialist personnel, including computer system specialists and valuation specialists with significant prior experience in their fields.

Statistical Analysis and Database Management Division

The division director:

- should be a Chartered Financial Analyst and have had significant management experience at a senior level, preferably in a banking environment.

Assistant directors:

Analysts:

- should have a background which include significant management experience in financial analysis in the banking sector, and possess a Chartered Financial Analyst designation.

Database management:

- should have backgrounds which include significant management experience in database management and information systems.

Personnel

Analysts:

- should have extensive backgrounds in financial analysis in the banking sector.

Database management:

- should have extensive backgrounds in data processing (one such individual should have significant experience in systems analysis).

Research Division

The division director:

- should be a Chartered Accountant having had experience as a research partner of an accounting firm.

Personnel:

- should have backgrounds which include significant experience in accounting or prudential policy research at a senior level, preferably in a banking environment. The individuals would preferably have earned a professional designation.

Compliance Division

The division director:

- should have a background which includes significant experience at a senior level in compliance with statutes.

Compliance personnel:

- should have backgrounds which include significant experience in compliance with statutes or a background in law.

Public relations personnel:

- should have backgrounds which include extensive experience in public relations matters.

L.4 Executive Interchange Program

- L.4.1 As discussed in paragraph 4.9.14 of Chapter 4, the current guidelines of the Public Service Employment Commission will render it difficult to recruit the qualified staff which we are recommending. Until this matter can be resolved, an executive interchange program should be developed to fill the key positions. As a basis for implementing such a program with the banks, we recommend that a joint committee of the Canadian Bankers' Association and the OIGB be established to identify the major issues and concerns of the banks and to develop an effective approach to implementing such a program. We also recommend that the OIGB commence discussions with the Advisory Committee of Bank Auditors to implement an interchange program with the shareholders' auditors of banks.

L.5 Training and Education

- L.5.1 The effective regulation of an industry requires a high level of knowledge of the underlying business and its risks by the personnel involved. In order to assist

personnel in the maintenance of a sufficient, appropriate base of knowledge concerning the banking industry, the OIGB should:

- (a) establish a formal policy of ensuring that all individuals within the division are provided with at least 10 days of formal training per year;
- (b) develop an indoctrination course for all personnel joining the OIGB which would include such topics as:
 - an overview of the system of bank supervision and regulation,
 - the mandate of each of the divisions,
 - the method of achieving the mandates,
 - the standards and procedures of the applicable division,
 - the content of reports, and
 - documentation of the work performed;
- (c) develop and maintain a comprehensive database of appropriate training courses available from:
 - Institute of Canadian Bankers,
 - training departments of banks,
 - public accounting firms,
 - computer hardware/software corporations,
 - American Bankers Association (U.S.),
 - Bank Administration Institute (U.S.),
 - Federal Reserve Board (U.S.),
 - Office of the Comptroller of the Currency (U.S.),
 - Federal Financial Institutions Examination Council (U.S.),
 - Federal Deposit Insurance Corporation (U.S.), and
 - independent training organizations;
- (d) annually develop a specific list of training programs to be attended by each employee;
- (e) assign an individual within each division to monitor staff attendance at the specified programs; and
- (f) include the time to attend training programs in each division's assignment forecasts or work programs.

L.6 Capital Leverage Ratios

- L.6.1 The legislated power to establish the appropriate leverage ratio of a bank is one of the more significant powers of the Inspector. The appropriate capital leverage ratio of each bank should be established by a Capital Leverage Committee chosen by

the Assistant Inspector and comprised of each of the division directors and the Inspector's Advisory Group director. The committee would meet at periodic intervals to evaluate requests for an increase in the leverage ratio as well as to evaluate the need to reduce the permissible ratio in particular circumstances. This would ensure that the views of each division are considered in establishing the appropriate capital leverage ratio.

L.7 Communication With Banks and Shareholders' Auditors

- L.7.1 In the course of our review we noted that some uncertainty and confusion exists on the part of bank management and the shareholders' auditors as to the appropriate individual within the OIGB with whom to discuss issues. There is some evidence that individuals within the OIGB respond to issues that may not fall within the mandate of their division. A program should be developed to familiarize representatives of the banks and the shareholders' auditors with the names of the specific individuals with whom to discuss issues of a compliance, general research, inspection or reporting nature.