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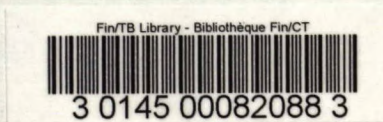
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# **Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC)**

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Submitted to  
The Honourable Barbara McDougall  
Minister of State (Finance)

April 24, 1985



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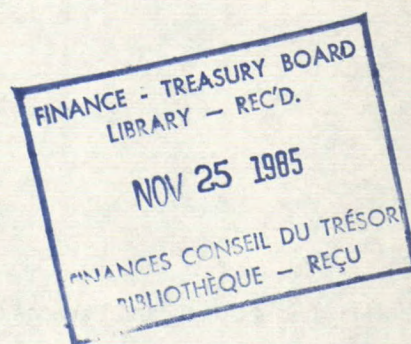
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Minister of State (Finance)

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Vancouver, B.C.  
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April 24, 1985

Hon. Barbara McDougall, P.C. M.P.  
Minister of State  
Department of Finance Canada  
Ottawa, Canada  
K1A 0G5

Dear Minister:

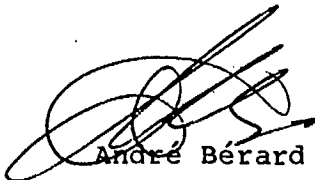
As Chairman of the Working Committee on the Canada Deposit Insurance Corporation, I am pleased to transmit our final Report on recommendations for reform to the operation and structure of the Corporation.

All of those associated with the report will be pleased to discuss it further with you at your convenience.

Sincerely,



W. Robert Wyman  
Committee Chairman



André Bérard



Hugh M. Brown



J.L.A. Colhoun



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## **Chapter I**

# **Executive Summary**

## **Mandate of Committee**

On January 10th, 1985, the Minister of State for Finance, the Honourable Barbara McDougall, P.C., M.P., announced the formation of a committee to study the operations and structure of the Canada Deposit Insurance Corporation. The Committee members included:

Mr. W. Robert Wyman; Committee Chairman and Chairman, Pemberton Houston Willoughby Inc.

Mr. A. Bérard; Senior Executive Vice President, The National Bank of Canada

Mr. H.M. Brown; Director, Burns Fry Limited

Mr. J.L.A. Colhoun; Vice-Chairman, The National Victoria and Grey Trustco Limited

Mr. E.A. Fricker acted as a consultant to the Committee and Mrs. K. Humber provided support services.

The Committee's terms of reference required it to examine and make recommendations on the following by April 30, 1985:

- objects of deposit insurance;
- possible reforms of deposit insurance;
- funding;
- supervision and monitoring of member institutions;
- lessons from recent member institutions failures;
- rehabilitation and liquidation of member institutions;
- organization and staffing;
- the public relations of the Corporation.

In fulfilling its mandate, the Committee requested and received a number of briefs from interested parties and held a number of meetings with senior officers of the Bank of Canada, Federal Department of Finance, Inspector General of Banks, Superintendent of Insurance, Canada Deposit Insurance Corporation and Ontario Department of Consumer and Corporate Affairs, Financial Institutions Division and others. As well, the Committee had discussions with senior United States

officials in the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, Comptroller of the Currency and Treasury Department. The Committee has reviewed a number of documents dealing with the reform of financial institutions and deposit insurance programs which are noted in the accompanying bibliography appearing as Appendix II.

## **Overview**

The Committee believes that the recent losses arising from insolvent financial institutions are unacceptable and are in part the direct result of outdated legislation and inadequate supervisory resources. It is beyond this Committee's mandate to delve into the framework of regulation of financial institutions in Canada. However, a brief comment is essential. At present the responsibility for supervision of financial institutions is split between political jurisdictions, departments of government and in the private sector, various self-regulatory bodies. As a result, monitoring and supervision are at best difficult and in many instances ineffective.

As stated, the Committee was not empowered to address this question; others are doing so. Nevertheless, it is faced with the problem. Therefore its recommendations, in order to be workable, had to be based on a framework that took into account this confused situation.

Preferably the Committee would hope, over time, for a monitoring and supervisory framework of financial institutions under control of one agency of government. However, until this happens, the Committee's proposals for CDIC should serve as a workable stop gap. When rationalization does occur, the Committee's proposals, with modest adjustment, should fit into this single structure or perhaps even become the nucleus into which other supervisory agencies are incorporated.

## **Key Recommendations**

### **Objects**

1. The primary object of CDIC should be to insure small unsophisticated depositors against loss and to administer the Deposit Insurance Fund. All other objects should be of a secondary nature.
2. CDIC should have the power of lender of last resort, but only to the extent that CDIC is providing liquidity for the purpose of reducing risk or averting a threatened loss to itself.
3. CDIC should continue to set and maintain proper financial standards and have adequate capacity to supervise member institutions.
4. CDIC should not get involved in considerations affecting the stability of the financial system that go beyond its primary object.

## **Powers – Insurance**

1. All companies be required to apply for insurance.
2. The granting of insurance be a matter of discretion for CDIC.
3. As a condition of a new charter being granted, the applicant be approved for insurance.
4. CDIC should establish standards for insurance.
5. CDIC should have the power to vary and amend the contract of insurance appearing as a schedule to its Act.
6. CDIC should have the power to set premium rates, establish appropriate reserve levels and approve rebates.
7. The contract of insurance should be subject to annual renewal. If in the opinion of CDIC a member's standards have fallen below an acceptable level, the renewal of insurance could be for a shorter period.
8. CDIC should have the right automatically to review and continue or discontinue as the case might be the contract of insurance upon any transfer of ownership control.
9. CDIC should have the power to terminate a federally incorporated member's insurance for cause as is the case with provincially incorporated members. Obviously, cancellation would not be retroactive and depositors in place at the time insurance was terminated would continue to be protected.

## **Powers – Regulation**

1. CDIC should maintain a more complete and current data bank of information concerning all its insured institutions.
2. CDIC should have a meaningful authority to step in and take action if it ever becomes concerned that necessary action is not being taken by the responsible regulator. It should, therefore, have the following powers:
  - (i) power to order a member to either cease doing any act or pursuing a course of conduct deemed by the regulators to be contrary to the Act under which he is operating or which may be prejudicial to the well-being of the member;
  - (ii) power to work out a voluntary compliance program with a member;
  - (iii) power to put conditions on a member's licence to carry on business subject to being removed when the reason for the conditions is corrected;

- (iv) power to hold hearings which would give rise to the program contemplated in (ii) above or the conditions contemplated in (iii) above;
- (v) power to require a member institution to cease conducting a particular type of business and, if this business is being conducted in a subsidiary, power to restrict the downstreaming of funds to the subsidiary;
- (vi) power to alter the leverage ratio of a member institution;
- (vii) power to require a change in the management of a member institution;
- (viii) power to take possession and control of the assets of a member institution carrying on unsound business practices and in these circumstances appoint managers and deal with its business;
- (ix) power to require the winding-up of a member institution and to become its liquidator if it so chooses.

#### **Powers – Supervision and Examination**

1. CDIC should take a leading role in working with the Canadian Institute of Chartered Accountants (CICA), appraisal institutes, member institutions and federal and provincial regulators to develop uniform accounting and real estate valuation standards for member institutions and, where agreement proves difficult or impossible to get, that CDIC have the power to set such standards as a condition of granting insurance.
2. CDIC should take a leadership role in determining uniform examination standards including examination programs, frequency of examinations and minimum qualifications for examiners.
3. CDIC should develop performance measurement standards for member institutions to serve as an early warning system to detect at an early stage indications that a member institution may be heading for trouble.
4. CDIC should develop a performance rating system for member institutions and determine appropriate breakpoints which would correspond to various levels of difficulty in order to standardize appropriate courses of remedial action or liquidation by CDIC.
5. CDIC should establish its own data base from which it can make its own determination about which member institutions are likely to cause it problems.
6. Member institutions should be required to furnish CDIC direct with the information it needs to maintain its data base. Such information would be

prescribed by CDIC and would be reported quarterly by member institutions in sound financial condition and more frequently as directed by CDIC by member institutions on its watch list.

7. CDIC should engage a small core of highly competent professionals to monitor the performance of member institutions using the performance measurement system referred to above and to carry out on behalf of CDIC inspections of member institutions that appear to be having problems.

8. CDIC should receive on a timely basis complete copies of all reports and correspondence on problem member institutions prepared for or by the respective regulators of these institutions.

9. CDIC should be given the power to levy significant penalties against member institutions, their managements, directors, and professional advisors to ensure compliance with its Act, regulations and guidelines.

#### **Powers – Liquidity**

1. CDIC's method of funding problem members and its borrowing capacity from the Consolidated Revenue Fund should be reviewed.

#### **Powers – Insolvency/Liquidation**

1. CDIC should be given substantial authority so that it can become directly involved in the affairs of problem institutions even to the point of becoming liquidator if it so chooses.

2. CDIC's Act should be amended to give it, as liquidator, the broadest possible powers including the power to carry out a sale of a member institution's business simultaneously with the granting of a liquidation order against it.

3. The Committee does not recommend that CDIC be denied the power to adopt agency procedures to wind down a troubled member institution.

#### **Powers – General**

1. CDIC's board should have complete discretionary authority to take action in pursuit of CDIC's objects.

#### **Market Discipline**

1. The Committee's recommendations are built around the belief that additional market discipline ought to be placed upon owners, management

and depositors. Some measure of market discipline must be restored so as to improve market efficiency and reduce risk to CDIC.

### **Market Discipline – Capital**

1. The Committee believes that maintenance of a strong capital base by member institutions is the best insurance against loss to depositors and therefore to CDIC.
2. Initial capital requirements for all new entrants into the deposit-taking industry should be raised significantly and CDIC in conjunction with the regulator should formulate appropriate levels.
3. A common definition of the components of capital and of the computation of leverage should be adopted for all types of member institutions.
4. CDIC in conjunction with regulators should develop standards for leverage. A well-defined leverage rating system should be formulated with the risk profile of assets (valued at market) being a key determinant.
5. A maximum leverage ratio related to its capital base should be determined for each member institution based upon the risk profile of that institution, using standards developed in (3) above, rather than by the type or size of the institution.
6. Members should be given somewhat more flexibility in the choice of instruments comprising their capital subject to certain safeguards.

### **Market Discipline – Risk-Related Premiums**

1. The Committee is of the opinion that it is not possible at the present time for CDIC to establish a system of risk-related premiums but the issue should be pursued.

### **Market Discipline – Co-Insurance**

1. Depositor market discipline is an essential ingredient of a sound financial system and that all depositors must use some judgment in deciding which depository they use.
2. The Committee firmly believes that without co-insurance starting at the first dollar, effective market discipline cannot be achieved.
3. A majority of the Committee recommends a depositor co-insurance system. Under this system 90% of an individual deposits between zero and \$100,000 would be insured.

4. The co-insurance program should be phased-in over a reasonable period, for example three years.

## **Funding**

1. Member institutions, not governments, should directly refinance CDIC.
2. The "target" size of the Deposit Insurance Fund should be 0.75% of insured deposits and this should be reached within 10 years.
3. CDIC should issue \$1 billion of floating rate preferred shares to member institutions on an obligatory pro rata basis on which the dividends would be tax free.
4. CDIC should increase its "basic" annual insurance premium rate from 1/30th of 1% to 1/10th of 1% in two stages over the next two years.
5. CDIC should be granted tax free status or failing this the power to create a tax deductible insurance reserve fund equal to 0.75% of insured deposits.

## **Organization and Staffing**

1. The Committee envisages a stronger, more independent role for CDIC.
2. The Board of Directors should be expanded to nine members comprising four senior government members and five private sector members including the Chairman and the President who would be Chief Executive Officer.
3. CDIC's expertise should be strengthened by the addition of four senior officers plus a small, highly qualified, experienced professional group not currently on staff.

## **Public Relations**

1. CDIC should expand its public relations role with member institutions, depositors and government.



## Chapter II

# The Environment

By way of introduction, the Committee would observe that volatile, uncertain international economic and political conditions have escalated the degree of risk for financial institutions to a degree unknown since the 1930s. Governments, regulators and management of financial institutions have all experienced pressure from these changes. As well, they have provided hitherto unavailable opportunities for the unscrupulous. As a consequence, the 1980s have seen an unprecedented number of financial institution failures and near failures not only in Canada but throughout the Western World. Some of the more important factors leading to the current conditions are set out below.

After roughly three decades of stable economic growth, the 1970s saw a dramatic change in economic conditions. Double-digit inflation, more frequent business cycles with increasingly deeper troughs and higher peaks, oscillating and more frequently changing interest rates, increasingly large government deficits, all contributed to significant volatility in financial markets, a substantial increase in domestic and international interest rates and greater credit risk thereby further contributing to financial instability. Governments responded by emphasizing a monetary, rather than an interest rate, policy. This resulted in further interest rate instability. For example, twenty or more changes in the bank rate in one year and daily fluctuations in exchange rates and Treasury bill rates in excess of ½% were commonplace. As partial solutions to the shrinking profitability that arose from all these factors, financial institutions sought rapid growth together with high levels of financial leverage.

Rapid changes have taken place in computer/communications technology. Some of these include electronic funds transfer systems, plastic credit/debit cards, automated teller machines and the development of satellite communications capabilities. These changed the dimension of the North American financial services industry. They permitted the integration of financial services and the entry of new participants and new combinations of participants (Sears, Prudential/Bache, American Express, Trilon, Power Financial). They fostered new products (daily interest chequing accounts, cash management accounts); lowered costs through the efficiencies of automation and reduced float, and provided much greater customer convenience (automated teller machines and 24-hour service). They also increased the risk of rapid transfers of short-term funds in large amounts often across international boundaries at the slightest hint of danger.

The dramatic improvement in education, a high level of female participation in the workplace, the coming of age of the "baby boom" generation, increased mobility

and other societal factors, have all led to a more sophisticated market. Consumers demanded higher quality service and constant innovation from the participants in the financial services industry. These trends have contributed to decreasing customer loyalty and to the gradual breakdown of the traditional separation of industry powers commonly referred to as the four pillars (banking, trust, insurance and investment).

The above factors have combined to produce an intensely competitive environment as financial institutions become more market oriented to better meet customer financial needs and to protect and improve profit margins. The impact of these changes has led to opportunities for higher returns but often at the cost of higher risk not only for financial institutions but also for their customers. There has been a growing trend towards larger firms for capital, cost efficiency and market share reasons. Mergers within certain industries and the growth of financial holding companies to better compete with major banks are examples of the trend. These have spawned their own concerns, particularly in the area of concentration of ownership.

In the political arena, deregulation and policies promoting "less government" have been two primary domestic thrusts of North American politicians. Canada has faced other dilemmas; one is the difficulty experienced by federal and provincial governments in finding a process to facilitate reaching consensus on common courses of action. Another is the slowness in planning and implementation of legislation to provide for orderly change. Trust and loan, insurance, bankruptcy and winding-up legislation has not been updated for decades. As a consequence, adequate powers respecting asset diversification have not been given to financial institutions to cope with the environment in which they are operating. Adequate controls have not been set up to prevent abuses which were not present in a more stable era. Of even greater concern, in an effort to keep governments lean in a time of high deficits, regulators have not been given the appropriate resources to deal with the high-risk environment. The combination of outdated legislation and inadequate supervisory resources has resulted in a large number of costly financial institution failures.

Some of the lessons to be learned from the problems of the 1980s are set out below and represent a summary, not only of the conclusions of James A. Morrison FCA, author of the 1983 report on the special examination of certain trust and loan companies but also of comments received from others during the course of the Committee's deliberations:

1. **Detection** – regulators and the insurer need to develop an early warning system, a series of red flags to identify problem institutions to facilitate early problem identification and resolution. Some of these include:

- decline or sudden fluctuations in profitability;
- interest rate sensitivity;
- premium interest rates;
- cash flow and liquidity problems arising from mismatching of maturities of assets and liabilities and too great a reliance on purchased deposits;

- non-recurring items;
- unusually large commercial transactions especially those occurring near year-end;
- unduly large front end fees on loans;
- related transactions – back-to-back deals;
- equity raised for a consideration other than cash;
- too rapid overall growth of a member institution.

2. **Expertise** – regulatory inspection staffs have not been sufficiently sophisticated to identify the implications of the more complex deals being made.

3. **Monitoring** – the capability of both the insurer and the regulator to monitor the external environment in which financial institutions operate and the results of their operations are critical to sound, anticipatory supervision. Some key areas requiring monitoring are:

- real estate price trends;
- interest paid on deposits;
- brokered deposits;
- non-accruing loans;
- quality of appraisals used to value real estate.

4. **Accounting** – the accounting principles relating to the determination of when assets are impaired seem to provide too great a degree of discretion so that it is difficult at times to form any sound opinion concerning tangible net worth from financial statements. This is a matter which the Committee believes should be examined by the Canadian Institute of Chartered Accounts.

5. **Prevention** – legislation and supporting regulations dealing with self interest and conflicts of interest are required to minimize abuse by unscrupulous management.

6. **Power to Act** – expanded powers for CDIC to act to protect depositors in situations where a member institution has problems but is solvent and where a member institution is insolvent are urgently required.

The need to minimize the degree of risk faced by financial institutions and their customers has never been greater. It is the Committee's view that the cost of recent insolvencies is unacceptably high. Immediate attention is required to strengthen the powers and increase the resources of CDIC and the regulators of financial institutions so they can do a more effective job in preventing problems and promoting rehabilitation. Stringent legislation is required to deal with self interest and conflict of interest situations along the lines suggested in Chapter V of the Interim Report of the Ontario Task Force on Financial Institutions (The Dupré Report).



## **Chapter III**

# **Objects and Powers of the Canada Deposit Insurance Corporation**

When, in early 1967, the then Minister of Finance introduced the Bill to establish CDIC he listed three important objects:

1. "The primary objective, of course, is to ensure the safety of the deposits of small investors who are usually not in a position to judge for themselves the financial soundness of the institutions to which they entrust their savings".
2. "The CDIC will also have power to function as a lender of last resort for deposit accepting institutions, providing needed liquidity at time of crisis when such institutions may not have access to the normal sources of liquidity".
3. "Member institutions will be subject to inspection. It will be an objective to bring about a gradual improvement in the minimum financial standards of deposit accepting institutions across the country. There will be a generally sympathetic and helpful attitude towards institutions who wish to co-operate in this objective".

In 1983, when the original statute was amended, the Minister of State for Finance at that time added a fourth objective which presumably had been implicit in the 1967 Bill. Specifically, the added objective of deposit insurance was to "assist in maintaining the confidence and stability in the financial system".

During the course of the Committee's deliberations on the submissions it received, it became apparent that many briefs put forward profoundly different views with regard to the primary purpose of deposit insurance. While some submissions strongly advocated insurance and the protection of the depositor as the sole purpose of CDIC, others appeared to take the position that the objects noted above were equally important and in addition, existed "to encourage competition by facilitating entry into the financial services sector". Interestingly, one brief contended "the single most important goal of CDIC is to play its part in maintaining and enhancing public confidence in Canadian financial institutions".

## **Recommendation 1**

The Committee discussed this issue in detail and at great length. **It concluded that the primary object of CDIC should be to insure small unsophisticated depositors against loss and to administer the Deposit Insurance Fund.** All other objects should be of a secondary nature.

## **Recommendation 2**

In its capacity as an insurer, CDIC has the responsibility to protect the assets of the Deposit Insurance Fund. In order to achieve this object it must have the power of lender of last resort, but only to the extent that CDIC is providing liquidity for the purpose of reducing a risk to the Corporation or reducing or averting a threatened loss to it. The Committee holds the view that CDIC has no responsibility to uninsured creditors or shareholders of member institutions which experience difficulty.

## **Recommendation 3**

The Committee holds strong views with regard to the object of establishing and maintaining adequate and uniform financial standards and supervision. Given the manner in which some member institutions appear to have ignored acceptable standards in the past, it is imperative that, in the future, all member institutions be required to conform to a set of standards that would be promulgated by CDIC. Further, member institutions would be required, as a condition of receiving and maintaining insurance, to file reports relative to these standards with CDIC as prescribed.

In the past, supervision of member institutions has been carried out by the regulators. Indeed CDIC's powers in this respect are very limited. If the Corporation is going to function effectively it must have the right either by statute or as a term of its insurance contract to involve itself directly in the affairs of problem members.

Concerning CDIC's implied area of responsibility to contribute to the stability of the financial system, the Committee holds the view that this should be the responsibility of others. It recognizes that, when a member institution is experiencing serious financial difficulties, consideration must be given to such factors as:

- the effect of failure on the international perception of Canadian financial institutions;
- the possibility that a failure could cause a loss of confidence in other financial institutions and perhaps the failure of one or more of them;
- the effect of failure on the businesses financed by the member and therefore on the economy of the country or of a region.

However, the Committee is of the opinion that consideration of these factors is outside of the purview of CDIC's mandate.

Returning to the question of the powers of CDIC, these will be discussed under a number of headings as follows:

- Insurance
- Regulation
- Supervision/Examination
- Liquidity
- Liquidation
- General Matters

## **Recommendation: Insurance**

The Committee has concluded that the present method whereby federally incorporated banks, trust and loan companies receive deposit insurance automatically and provincially incorporated institutions receive insurance on application should be changed. In particular, deposit insurance should be viewed as a privilege and should not be conferred automatically by statute. It recommends that:

1. All companies be required to apply for insurance.
2. The granting of insurance be a matter of discretion for CDIC.
3. As a condition of a new charter being granted, the applicant be approved for insurance.
4. CDIC should establish standards for insurance.
5. CDIC should have the power to vary and amend the contract of insurance appearing as a schedule to its Act.
6. CDIC should have the power to set premium rates, establish appropriate reserve levels and approve rebates.
7. The contract of insurance be subject to annual renewal. If in the opinion of CDIC a member's standards have fallen below an acceptable level, the renewal of insurance could be for a shorter period.
8. CDIC should have the right automatically to review and continue or discontinue as the case might be the contract of insurance upon any transfer of ownership control.
9. CDIC should have the power to terminate a federally incorporated member's insurance for cause as is the case with provincially incorporated members. Obviously, cancellation would not be retroactive and depositors in place at the time insurance was terminated would continue to be protected.

## **Recommendation: Regulation**

The relationship of CDIC with the regulatory agencies, both federal and provincial, has been of serious concern to the Committee. Every member institution of CDIC is subject to regulation, but the range and variety of regulatory regimes varies widely. Under current procedures, CDIC is almost entirely dependent on the relevant federal or provincial regulator both as to ongoing supervision of member institutions and as to the authority to rehabilitate although they frequently look to CDIC to provide the financing for rehabilitation procedures.

This contrasts, for example, with the relationship between the FDIC in the United States and the institutions it insures. FDIC is actively involved in the regulation, continuing supervision, rehabilitation and where necessary, the liquidation of these institutions whether state or federally incorporated. A case can be made that a similar relationship should exist in Canada, on the principle that he who pays the piper should call the tune. Clearly, if this were done, the potential for conflicts of interest in the decision-making process would be reduced.

The Committee accepts the present situation where the Inspector General of Banks, the federal Superintendent of Insurance, the Ontario Registrar and other provincial regulators have overall responsibility for institutions under their jurisdiction but hopes there can be a better rationalization of this position in the future.

In the meantime, two major changes should be made. First, CDIC should maintain a more complete and current data bank of information concerning all its insured institutions. Second, CDIC should have a meaningful authority to step in and take action if it ever becomes concerned that necessary action is not being taken by the responsible regulator.

Set out below are the authorities the Committee feels should be available to regulators with respect to all financial institutions:

- (i) power to order a member to either cease doing any act or pursuing a course of conduct deemed by the regulator to be contrary to the Act under which it is operating or which may be prejudicial to the well-being of the member;
- (ii) power to work out a voluntary compliance program with a member;
- (iii) power to put conditions on a member's licence to carry on business subject to being removed when the reason for the conditions is corrected;
- (iv) power to hold hearings which would give rise to the program contemplated in (ii) above or the conditions contemplated in (iii) above. The threat of a hearing can be a strong weapon in the hands of

the regulator as most corporations doing business are concerned about maintaining the goodwill of the regulator and again they generally wish to avoid the adverse publicity of a hearing;

- (v) power to require a member institution to cease conducting a particular type of business and, if this business is being conducted in a subsidiary, power to restrict the downstreaming of funds to the subsidiary;
- (vi) power to alter the leverage ratio of a member institution;
- (vii) power to require a change in the management of a member institution;
- (viii) power to take possession and control of the assets of a member institution carrying on unsound business practices and in these circumstances appoint managers and deal with its business;
- (ix) power to revoke a licence/registration and require the winding-up of the corporation.

One very critical problem about the exercise of each of these powers is the question of timeliness. The regulator cannot be placed in the position that it has to sit by, watching in transfixed terror, behaviour which it feels will irreparably damage an institution without being able to act expeditiously to deal with that behaviour. On the other hand, Canadians are concerned about the exercise of arbitrary powers. In the Committee's opinion it becomes a question of balance, and where a corporation is permitted to conduct a deposit-taking business, the interests of the depositors must take precedence over the interests of the holders of capital. Thus, in some instances, the powers of the regulator should be exercisable forthwith where, in its opinion, there is substantial risk to the interest of depositors, with a hearing to follow.

As noted above, the primary users of the authorities listed should be the regulators with direct responsibility for particular financial institutions. But if CDIC is to have meaningful authority to step in and take action if it ever becomes concerned that necessary action is not being taken by the responsible member or regulator, then CDIC must be able to exercise these authorities directly. This requires substantial revisions of existing law and of the contractual arrangements between CDIC and its member institutions. Constitutional problems as to allocation of responsibilities between Parliament and the provincial legislatures will have to be surmounted. The Committee has not had the time nor the resources to analyze the details of the provisions and techniques necessary to accomplish this objective. The Committee has, however, done sufficient work that it is as confident that the task can be done as it is that it must be accomplished.

The most appropriate and practical technique would be to effect co-ordinated amendments to: the contractual arrangements between CDIC and its member institutions; the CDIC Act; the Winding-Up Act; and the Bankruptcy Act. The

contractual arrangements would be supplemented by amendments to CDIC's Act so that it would have clear discretion to administer the new authorities. The amendments to CDIC's Act and the amendments to the two statutes dealing with insolvency would be linked, providing a more flexible and effective legislative pattern to deal with insolvency situations and to provide CDIC with a position that recognizes its responsibility and its financial exposure.

The Committee believes that this co-ordinated set of amendments, contractual and legislative, would have far-reaching beneficial effects. Co-ordination between CDIC and the primary regulators would be improved, and the latter would be influenced by an awareness of CDIC's reserve authority. Member institutions, similarly aware, would pay more attention to CDIC than has sometimes been the case in the past. CDIC would have authorities more commensurate with its responsibilities. And, in the ultimate insolvency situation, appropriate actions could be taken more quickly and effectively, with an involvement for CDIC more appropriate to its interest.

## **Recommendation: Supervision and Examination**

A corollary of regulation is supervision to ensure that the regulated comply and avoid business practices that might lead to problems in the future. The Committee is concerned that CDIC does not have, within itself, adequate powers, the information and the resources needed to supervise and monitor members but must rely on the appropriate regulatory authorities. It seems to the Committee that every effort should be made to overcome what is obviously an unsatisfactory state of affairs and one that must cause CDIC a great deal of frustration. Accordingly the Committee recommends:

1. CDIC should take a leading role in working with the Canadian Institute of Chartered Accountants (CICA), appraisal institutes, member institutions and federal and provincial regulators to develop uniform accounting and real estate valuation standards for member institutions and, where agreement proves difficult or impossible to get, that CDIC have the power to set such standards as a condition of granting insurance.
2. CDIC should take a leadership role in determining uniform examination standards including examination programs, frequency of examinations and minimum qualifications for examiners.
3. CDIC should develop performance measurement standards for member institutions to serve as an early warning system to detect at an early stage indications that a member institution may be heading for trouble. Points made earlier in this report on lessons to be learned from earlier problems should be included in such a system. The Committee commends the "Uniform Bank Reporting System" used by the FDIC to CDIC management.

4. CDIC should develop a performance rating system for member institutions and determine appropriate breakpoints which would correspond to various levels of difficulty in order to standardize appropriate courses of remedial action (or liquidation) by CDIC. In this connection, the Committee noted that FDIC has developed a rating system known as CAMEL under which a member institution receives a rating of 1 (good) to 5 (bad) for each of five areas – capital adequacy, asset quality, management ability, earnings quality and liquidity as well as an overall rating which includes the examiners' overall assessment.

5. CDIC establish its own data base from which it can make its own determination about which member institutions are likely to cause it problems. Regulators could have access to this data on a confidential basis since there should be no need to duplicate this facility.

6. Member institutions should be required to furnish CDIC direct with the information it needs to maintain its data base. Such information would be prescribed by CDIC and would be reported quarterly by member institutions in sound financial condition and more frequently as directed by CDIC by member institutions on its watch list.

7. As detailed in Chapter VI, CDIC should engage a small core of highly competent professionals to monitor the performance of member institutions using the performance measurement system referred to above and to carry out on behalf of CDIC inspections of member institutions that appear to be having problems. In short, CDIC should not rely, where problems exist, on agents which it does not control. A collateral advantage of having a small core of highly competent professionals is that these people will be the nucleus around which a larger staff of permanent or temporary personnel and consultants can be engaged to deal with special situations should this be necessary.

8. CDIC should receive on a timely basis complete copies of all reports and correspondence on problem member institutions prepared for or by the respective regulators of these institutions.

The Committee has formed the impression that CDIC is not being taken seriously by some member institutions and therefore CDIC does not receive the co-operation that the Committee feels it should. As a result, many reports are in arrears and generally the response time to CDIC inquiries is not satisfactory. This is really unacceptable. Therefore, CDIC should be given the power to levy significant penalties against member institutions, their managements, directors, and professional advisors to ensure compliance with its Act, regulations and guidelines.

Penalty premiums, fines and special charges if used properly, would have the following advantages:

1. The cost burden would be the same as in the case of a risk-related premium with the advantage that the implementation of these further items

would not provide the basis for costly appeals as may be the case with a risk assessment method.

2. They would go a long way in changing member institutions attitudes noted above.

3. The imposition of a charge for the additional costs incurred to monitor closely a problem institution is good business practice and does not require further comment.

On the general subject of regulation and supervision the Committee would like to make several points. Improved supervision is not inconsistent with the movement towards deregulation. Indeed the latter may well increase the need for the former. However, it must be noted that the object of regulation and supervision in a competitive economy is not to render impossible the failure of a financial institution, but rather to enable regulators and any insurer of deposits to identify incipient problems early and deal with them effectively in the interest of depositors.

For CDIC to play an effective role the changes the Committee recommends should be made expeditiously. If a distinction were drawn between supervision on the one hand and substantive matters on the other, the Committee feels that consensus is closer on the supervision side than on the substantive side and it would deplore any delay on legislation to deal with supervision until decisions are made on legislation dealing with substantive matters. In short, the Committee is expressing a strong sense of urgency to reduce the likelihood of serious difficulties arising in future and to enhance the ability of CDIC and the regulators to deal with any difficulties that may arise.

### **Recommendation: Liquidity**

At present, CDIC is obtaining its funding by guaranteeing (as it has the right to do) the loans of solvent member institutions to those being wound down or in liquidation. This appears to be an expensive way in which to acquire funds. If the guaranteed loans were replaced by advances from the Consolidated Revenue Fund their cost would likely be reduced. The Committee recommends greater use of this facility. If the existing line of credit available to CDIC, namely \$1.5 billion, should become insufficient, the Committee further recommends that consideration be given to increasing CDIC's borrowing limit from the Consolidated Revenue Fund.

### **Recommendation: Insolvency/Liquidation**

When a member institution in difficulties cannot be rehabilitated using the various powers mentioned earlier, winding-up or liquidation becomes inevitable. While the Committee is not in favor of drastic action at the first sign of difficulties, it takes

the position that a decision to delay is rarely, if ever, appropriate unless arrangements are in place that provide assurance against a further deterioration during the period of delay.

Insolvency is the trigger point that ultimately governs the extent of the claims against CDIC. Under the current law, it is not sufficiently clear that this can be established by a balance sheet test (excess of liabilities over assets valued at current market) as well as by a cash flow test (inability to meet liabilities as they fall due). Even when the condition of insolvency is clearly present, valuable time can be lost in demonstrating that condition to the satisfaction of a court (e.g., in the Cardinal Insurance case it took about eight months before the courts). Moreover, the lack of legal recognition for the fact that CDIC has, almost invariably, a special financial interest means that the insolvency is conducted in accordance with traditional court procedures without CDIC's interests being accorded the weight that its financial commitment might justify.

The protracted process that is necessary before action can be taken is unjustifiable. Much harm can be caused, and much goodwill lost, while this process is carried out. Such requirements as the rule in the Winding-Up Act that the appointment of a liquidator of a bank must be preceded by meetings of its shareholders and its creditors are not supportable in policy terms. What is needed is a provision allowing the determination of insolvency to be made by a non-appealable Cabinet order on the recommendation of CDIC. An alternative would be to allow a finding by CDIC that a state of affairs existed in a member institution that imperilled the position of its depositors, to constitute an immediate and non-contestable basis for a court to grant a liquidation order on the application of CDIC.

Adoption of a clear means of establishing the insolvency of an institution expeditiously would also enhance the potential use of one of CDIC's few powers, namely its power to cancel a member institution's insurance "forthwith" (excluding already-insured deposits) when, in the opinion of CDIC, "the member institution is insolvent". The lack of a definition in the CDIC's Act as to what is meant by insolvency detracts from the value of this power, particularly since certain provisions in the Bank Act and the Winding-Up Act lend credence to the view that insolvency means only the cash flow test. For this reason the authority to terminate insurance based on a finding of insolvency has been of little or no value to CDIC at present.

Going further, it is the Committee's position that CDIC should have the power to initiate liquidation proceedings. Consequently, it recommends that CDIC be given the right by statute or under its insurance contract or both to become, if it so elects, the receiver/liquidator of an insolvent member institution.

A power that has proved to be very useful to FDIC at the very point of time that a liquidation takes place is the power to arrange a "merger" of the insolvent bank with a solvent one. Since control of the capital of the insolvent institution is outside FDIC's control, the "merger" in question is really a purchase of the insolvent's assets and the assumption of its liabilities. To assist the transaction

FDIC will often purchase the "soft" assets at book value for cash and liquidate these subsequently. The loss it incurs in doing so will be reduced by whatever assumption price (often substantial) it can get from the acquirer of the insolvent's business.

In Canada such a procedure is impossible at the moment because even with co-operation from the shareholders, the procedures that have to be followed to bring about the sale of the business of a member institution would not permit a sale contemporaneously with the granting of a liquidation order – in short, a Friday night to a Monday morning transfer – so that there is no interruption whatever in the position of depositors. In the Crown Trust situation, because of the delay occasioned by the circumstances, depositors' accounts in excess of the insured limit were frozen and this caused enormous problems with lawyers' trust accounts which had funds in excess of the insured limit that had to be called upon to complete transactions on behalf of clients.

The Committee recommends that CDIC's Act be amended to give it, as liquidator, the broadest possible powers including the power to carry out a sale of a member institution's business simultaneously with the granting of a liquidation order against it.

## **General Matters**

### **Legislative Prohibition of the Agency Procedure for Winding Down a Troubled Member Institution**

From its discussions with the Board, individual directors and officers of CDIC, as to the bases of CDIC's decisions to adopt the agency and wind-down procedures in a number of situations it had to deal with, the Committee is satisfied that CDIC proceeded in a reasonable manner having regard to the information available to it when it had to make these decisions. However, it is evident that CDIC's decisions have created strong resentment on the part of some member institutions. This type of tension would not arise if CDIC were denied by legislation the right to follow this course of action. In addition, depositors would know very clearly the extent of the protection afforded them by CDIC which in itself should give rise to some market discipline.

The major problem with this approach is that if CDIC encountered the failure of one of its larger members it probably would not have the capacity to pay off its depositors even having regard to its line of credit with the Consolidated Revenue Fund which of course could always be increased to meet the problem. In addition, it might deny CDIC the power to make a decision which would be in the best interests of CDIC and its member institutions.

The Committee does not recommend that CDIC be denied the power to adopt agency procedures to wind down a troubled member institution.

## **Flexibility of Decision-Making for CDIC Board**

While the Committee believes the primary object of CDIC is comparatively narrow, namely protection of small depositors and administration of the Deposit Insurance Fund and program, it recognizes that a very substantial range of flexibility must be available to CDIC's Board so that it can carry out that object in the most cost-efficient way. Contributions to the rehabilitation of an institution in difficulty, designed to avoid a greater loss at a later date, are only one example of the types of actions that should be permissible, if CDIC's Board concludes they will contribute to its object. It is the view of the Committee that the Board of CDIC should not be subject to being second-guessed on these decisions. A considered determination by the directors of CDIC that an action is necessary should be final and provide the legal support for implementation of the action by CDIC. If this were not clear, unacceptable uncertainty would result and the directors of CDIC would be placed in an unreasonable position. Legislation that implements the Committee's recommendations should clearly spell out that CDIC's Board has complete discretionary authority to take action in pursuit of CDIC's objects.



## **Chapter IV**

# **Market Discipline**

## **Introduction**

The automatic availability of deposit insurance together with the widely held perception that depositors in general will not suffer loss regardless of the amount of their deposit has created a series of problems for the Committee. In its view, effective 100% insurance coverage has led to a number of undesirable practices:

- depositors, directly or through deposit brokers, are encouraged to place deposits with the deposit institution paying the highest interest rates, regardless of the financial health of that institution;
- excessive risk taking by financial institution management is encouraged to offset high deposit costs;
- the growth of poorly managed deposit institutions is subsidized at the expense of sound institutions;
- unscrupulous persons are encouraged to abuse their positions, resulting in situations which destabilize rather than stabilize the financial system.

In short, the apparent 100% insurance has caused a number of natural disciplines of the financial marketplace to disappear thereby reducing efficiency and increasing risk to CDIC. It is the Committee's view that this lack of discipline should be addressed. These disciplines are the first line of defence and should be put back into the system. To replace them by restrictive legislation or excessive regulation could lead to market rigidities and insufficient risk taking of the type required to support a growing economy.

The Committee's recommendations, which are discussed in some depth below, are built around the belief that additional market discipline ought to be placed upon owners, management and depositors.

## **Capital**

The Committee's strongest point is its belief that maintenance of a strong capital base by member institutions is the best insurance against loss to depositors and therefore to CDIC. While capital is not a substitute for healthy earnings and good management, it is an essential ingredient in maintaining the stability of and public confidence in the financial system. Maintenance of adequate capital also represents a significant form of market discipline since the rights of investors are

subordinate to those of depositors in the event of failure. The potential of a 100% loss of investment is the ultimate form of market discipline.

The subject of capital adequacy is extremely complex and it is doubtful that perfect solutions are available. Nevertheless, the Committee believes the following recommendations provide a useful framework in dealing with this issue.

1. Initial capital requirements for all new entrants into the deposit-taking industry should be raised significantly and CDIC in conjunction with the regulators should formulate appropriate levels.
2. A common definition of the components of capital and of the computation of leverage should be adopted for all types of member institutions. Currently, the Committee understands there are significant differences as between banks and trust companies.
3. CDIC in conjunction with the regulators should develop standards for leverage. In this connection, a well-defined leverage rating system should be formulated with the risk profile of assets (valued at market) being a key determinant.
4. A maximum leverage ratio should be determined for each member institution based upon the risk profile of that institution, using standards developed in (3) above, rather than by the type or size of the institution.
5. In the aggregate the Committee does not feel member institutions are undercapitalized. The Committee, however, notes with interest the recent trend toward lower levels of capital leverage and would like to encourage continuation of this trend. The Committee realizes the importance of allowing member institutions enough common equity capital leverage so that a reasonable and competitive return on common equity can be achieved. With this in mind and to facilitate the trend towards further reduction in total capital leverage ratios the Committee recommends that members be given somewhat more flexibility in the choice of instruments comprising their capital (e.g. common equity including retained earnings, non-specific loss reserves, preferred shares, subordinated debentures, etc.) subject to certain safeguards.
6. A member should be allowed to issue equity instruments for cash only, unless its regulatory authority approves otherwise.

The view is often put forward when a member institution is in trouble that its leverage should be cut back. This idea has little practical value since its implementation involves the member allowing its deposit liabilities to run off. If its assets are not maturing at the same rate, which is likely to be the case, the member may be forced to liquidate assets at prices below book value. This will compound its problems.

## **Risk-Related Premiums**

Under the current deposit system, a single insurance premium rate set out in CDIC's Act is charged to all member deposit taking institutions. There is no variation in premiums among insured institutions based upon the level of risk. Therefore, managements of member institutions have no incentive to reduce risk in order to lower premium costs. Indeed, the current system in effect forces prudently managed institutions to subsidize high risk institutions through the unrealistically low insurance premiums these latter institutions pay; in effect the exact reverse of market discipline.

The Working Group for the Cabinet Council on Economic Affairs (CCEA) in the United States concluded in its 1985 report:

"The Working Group found that the current flat rate premium structure for deposit insurance is inequitable because healthy institutions subsidized troubled ones; and there is little economic incentive to control risk taking. Therefore, the introduction of risk-related pricing although not necessarily perfect would clearly be better than the current flat rate system in stimulating the operation of the free market and hence reducing the inequity and risk-taking."

While it is obvious that risk-related premiums are a highly desirable tool to enforce market discipline, there are a number of practical problems with implementing such a plan. There is no consensus on how to measure risk objectively. From an actuarial point of view there is insufficient historical data. There is also the inability to forecast risk and measure it before it occurs. Because the premium must be sufficiently high to prevent a less-strong member institution from excessive risk taking, the application of a heavy premium may have the opposite effect by encouraging excessive risk taking to cover the higher cost. Finally, the implementation of a risk-related premium plan could give rise to the development of an extensive appeal program as member institutions would frequently disagree with their assessments.

The FDIC has proposed a method of establishing a risk-related premium structure by varying the rate of premium rebates based upon three broad levels of risk. However, no specific program has yet been instituted because of the problems noted above.

The Committee is of the opinion that it is not possible at the present time for CDIC to establish a system of risk-related premium but the issue should be pursued. As indicated on page 19, the Committee is making recommendations in regard to the use of penalty premiums, fines and other charges to compensate for the additional costs of monitoring problem members.

## Co-insurance (Risk Sharing)

At present, depositors are fully protected to the first \$60,000 of their deposits. Above this amount, there is no protection.

The main argument in favour of total co-insurance is that if all depositors are not exposed to some risk, they need not be concerned about the financial condition of the member institution with which they place their savings provided they keep under the insured limit. A corollary of this proposition is that before depositors are required to assume some proportion of the risk, it will be necessary to ensure that they receive or have available to them sufficient information about the member institution to enable them to form a reasonable judgment concerning the soundness of that institution.

Other reasons for favouring co-insurance are as follows:

- if depositors have no risk they will obviously favour those institutions that pay higher rates;
- co-insurance should reduce abuse by unscrupulous operators;
- without co-insurance, the weaker member institutions have an incentive for excessive risk taking.

Some of the reasons against adopting a co-insurance policy are:

- If an appropriate regulatory authority, with all its powers of inspection and information is prepared to allow a given member institution to continue in business, why should a small depositor not be prepared to rely on that fact?
- Some commentators argue that co-insurance might operate to increase the instability of the system as depositors become concerned about the solvency of a member institution.
- As long as there is any minimum total coverage, depositors concerned about getting full protection will achieve it simply by splitting their deposits among the required number of member institutions.

As an alternative to depositor co-insurance, the Committee considered the possibility of the private sector providing additional insurance beyond a given level. There were many problems, the most important being that the private sector insurance market does not have the capacity to provide any meaningful amount of additional insurance. However, a major insurance broker did suggest an alternative that would merit further examination, namely: have the private insurance sector insure against the possibility of member institutions having to pay an additional assessment or assessments resulting from the insurance fund being in a deficit position.

The Committee has concluded that depositor market discipline is an essential ingredient of a sound financial system and that all depositors must use some judgment in deciding which depository they use. **The Committee firmly believes that without co-insurance, starting at the first dollar, effective market discipline cannot be achieved.**

A majority of the Committee recommends a depositor co-insurance system. Under this system, 90% of an individual's deposits between zero and \$100,000 would be insured. The 10% potential loss is viewed as being roughly equivalent to one year's income on the deposit.

The advantages of this approach include:

- by exposing all depositors to some risk, discipline will return to the marketplace;
- market discipline problems associated with brokered deposits, multiple deposits, interest rate and commission controls, etc., are largely eliminated and the market is left to operate on its own without a host of new regulations;
- the insured protection offered the small unsophisticated depositor has been increased from \$60,000 to \$100,000. Although the depositor will bear a small risk on the entire amount, the stability of the financial system should not be adversely impacted. Meanwhile, increased market discipline should greatly improve market efficiency and lessen CDIC's exposure.

Those making this recommendation recognize that it represents a significant departure from existing practice, particularly in light of current unsettled conditions. Therefore, they believe it is appropriate to implement this recommendation over a period of time. They suggest three years. An example of such a phase-in program is as follows:

- Year 1    Insure 100% to \$60,000 of deposits (i.e., no change)
- Year 2    Insure 100% to the first \$40,000 of deposits and 90% of the amount between \$40,000 and \$75,000
- Year 3    Insure 100% to the first \$20,000 of deposits and 90% of the amount between \$20,000 and \$90,000
- Year 4 (and thereafter)
- Insure 90% to the first \$100,000 of deposits.

It is clearly understood that the introduction of co-insurance would not affect time or term deposits in place at the time the program is implemented.

## **Improved Disclosure**

For increased co-insurance or risk sharing with depositors to work, the amount and quality of financial disclosure by member institutions to the general public should be improved. Too much disclosure in a meaningful manner is better than

too little. The Committee's recommendation is that CDIC should establish uniform minimum levels of financial disclosure and encourage individual members to exceed this stipulated level. Disclosure standards should constantly be updated in order to highlight current material events rather than yesterday's events.

## **Implicit Full Guarantee of Bank Deposits**

From the manner in which insolvent member institutions have been dealt with in recent years and as a result of the public's interpretation of various statements made by government officials, there is a widespread perception, perhaps erroneously held, that no depositor will be allowed to lose any part of a deposit in a chartered bank. A few examples will illustrate the point.

1. In October 1982, Mr. Lalonde as Minister of Finance, made the statement in New York that "we're behind our banking system as a government".
2. The manner in which the difficulties encountered by Canadian Commercial Bank were resolved recently without any loss to depositors.

One of the results of this perception is that depositors regard the chartered banks as a more secure place in which to place their funds – a point borne out by a survey done on behalf of the Dupré Committee. Another is that in the summer of 1984 the Benchers of the Alberta Law Society enacted a rule to the effect that members of the Society could only deposit funds in mixed trust accounts with a chartered bank or an Alberta Treasury branch but not with a trust company.

Throughout this report the Committee has been stressing the importance of market discipline to increase market efficiency and reduce the risk of claims on the Deposit Insurance Fund. The recommendations with respect to co-insurance are based upon this approach.

If the perception to which the Committee has referred continues to be held, co-insurance would not exist as a market discipline with respect to deposits in chartered banks. This point having been made, the Committee was unable to formulate a recommendation to deal with the problem but it does feel very strongly that this perception has to be changed.

## **Brokered Deposits**

A quotation from the end of Chapter III of the 1983 FDIC Report on Deposit Insurance in a Changing Environment sets out the problem with respect to brokered deposits:

"The emergence of brokers who perform a deposit-parcelling function for the purpose of maximizing deposit insurance coverage undermines efforts to establish discipline in the banking system through risk-sharing by large

depositors. The FDIC believes the activities of such brokers must be controlled as an integral part of any risk-sharing proposal and is considering a number of alternatives for correcting this problem. The FDIC is particularly concerned about the practice of some brokers of placing fully-insured deposits in banks at random without credit analysis or worse yet, placing them in known problem banks (presumably at higher interest) and collecting a higher fee."

In the opinion of the Committee, while the problem does exist in Canada it has not reached the grievous proportions it has in the U.S.

The regulatory authorities have brought to the Committee's attention that the recently troubled financial institutions were relying very heavily on brokered deposits and that such was the case with Seaway Trust where 90% of the deposits were brokered deposits.

It is interesting to note that notwithstanding the fact that FDIC has been concerned about this problem for some time now it has yet to find an acceptable solution.

In Canada quite a number of the smaller financial institutions that are members of CDIC – for example, most of the Schedule B banks and many smaller trust companies have, as a matter of corporate policy, decided against developing a large branch structure in favour of paying a commission to a variety of agents who arrange to have deposits placed with them. These agents would be real estate brokers, lawyers and investment dealers to name but a few. This is clearly a legitimate procedure, the problem only arising where the agent wishing to get the best result for his customer/principal places the funds in question with the weakest institution because that institution is paying a higher rate of interest. The Committee was not able to ascertain whether, in these circumstances, the institution paid a higher than normal commission as a further inducement.

Initially, the Commission considered limiting broker deposits entitled to insurance to deposits received from an agent acting solely for one institution. Apart from creating an administrative nightmare in keeping track of which depositors were or were not insured, there were the questions of (a) would the person from whom the deposit was being made understand his position and (b) how would CDIC deal with this problem. Again such a limitation would restrict the normal business activities of legitimate agents. Under the current circumstances to require all agents placing deposits for others to be registered would be unacceptable to some regulatory bodies.

Another approach was to place some liability on the broker. To make a broker responsible for any loss occasioned by the failure of an institution into which he had placed customer/principals funds seemed unduly harsh because, if the obligation could be enforced, it would only be enforced against reputable agents who were in business for the longer term. A less harsh approach would be to require the broker to forfeit to CDIC all commissions earned on deposits in a failed institution where CDIC suffered any loss.

The Committee believes that brokered deposits have a major impact on market discipline and therefore, should be regulated without taking excessive measures that would endanger well-managed smaller institutions that depend on that source of funds for their survival. The recommendation with respect to 90% co-insurance on all deposits up to \$100,000 will provide sufficient discipline for brokers to ensure they place customer deposits in sound financial institutions – their customers will demand it. In addition, the Committee recommends that CDIC should have the power to impose on all member institutions that are not following sound financial practices and which extensively rely on brokers:

- (i) a freeze on brokered deposits; or
- (ii) a ceiling as to the percentage of brokered deposits to the total deposit base; or
- (iii) a modest annual growth rate on brokered deposits.

## **Multiple Accounts**

If an individual has a deposit account in his own name, for example, another jointly with another person, the two deposits are insured separately. Also, a deposit made by a trustee for a beneficiary is insured separately.

RRSP and RHOSP deposits are also insured separately.

The depositor can further multiply the amount of his insurance protection by using many companies or through the device of two companies, a trust company and a loan company, or a bank and a loan company, usually in a parent/subsidiary relationship.

Therefore, it has been possible to obtain insurance for considerably more than the minimum 100% insurance coverage by using one or more of the above-mentioned mechanisms.

The Committee is of the opinion that trying to limit the insurance protection by imposing a maximum that any depositors will receive by way of insurance for all deposit accounts in all insured institutions would be complex and the monitoring very expensive.

A 10% co-insurance plan will tend to minimize the use of multiple accounts because small depositors will always be at risk to the extent of 10% on each of their deposits in all institutions.

## **Interest Rate/Commission Cap**

The ability of weaker institutions and/or unscrupulous managements to gather in large amounts of deposits in a very short time simply by raising interest rates well above market is considered by the Committee to have been a major problem.

New and small companies often try to build up business by offering premium interest rates on their deposits. They must then search out investments that will give them a return to cover this premium rate and these are likely to be high-risk investments or loans.

The "Morrison Report" stated that some trust companies attracted enormous amounts of deposits by offering deposit rates up to 250 basis points above those offered by other institutions.

In nearly all cases of institutions that ultimately gave rise to substantial claim against CDIC, there was a dramatic increase in deposit levels at critical periods by the payment of rates of interest well above those offered by sound and well-managed competitors.

The argument against any form of control on interest paid by financial institutions is that interest rates paid by well-run institutions can vary significantly for a number of legitimate business reasons:

1. An institution may have arranged to lend funds at a rate that will permit it to make satisfactory spreads by paying a premium to attract the deposits required to fund the deal.
2. An institution may be in a temporary mismatched position with long-term assets funded by short-term deposits. If that institution were to perceive that short-term interest rates were likely to rise dramatically (e.g. 1981-82) it might well decide to cover its mismatch by paying a premium to attract deposits to match the term of its assets.
3. A smaller but less well-known institution not saddled with the burden of an expensive branch system might deem it appropriate or might even have to pay a higher rate for its deposits which it can afford because it does not have the cost of a branch system.

Thus the Committee recognizes that there is some legitimacy for financial institutions to pay a premium on interest rates as stated in the above examples. The Committee does not believe that a rigid cap on interest rates and commissions is practical but it does believe that CDIC should have the power at its discretion to restrict interest rates and commissions in dealing with problem institutions.

## **Timing of Payment of Deposits**

CDIC's Act obligates it to make payment of insured deposits "as soon as possible after the obligation arises". The Committee was told that, at least until the 1983 amendments to the Act, there was uncertainty as to exactly when CDIC's obligation arose. It might be said to arise immediately on an insolvency but it might also be said to arise only on completion of the liquidation and distribution of assets, for only then is the loss suffered by the depositor formally quantified. While adherence to the latter interpretation might reduce costs to CDIC and

impose greater market discipline on the depositor (who would not rely so heavily on insurance if there was the prospect of long delay in payment), the Committee concurs with CDIC's long-standing policy of endeavouring to make payment as expeditiously as possible. Delays can cause unnecessary and unjustified hardship.

The 1983 amendments to CDIC's Act dealt with this question in a manner that, the Committee is told, has proven unhelpful in practice. New subsection 13(4.1) says that CDIC "may" make payment if certain events have occurred. One of these is that a winding-up order has been made, or payment of the deposits precluded by court order. The intent may have been to ensure early payment, but the necessity to await a winding-up order or an order precluding payments sometimes has the effect of delaying payments by CDIC. The Committee recommends that the section be further amended to authorize CDIC to make earlier payments if satisfied that the institution is insolvent and the payments are necessary.

## **Publication of List of Problem Companies**

At any one time CDIC acting directly or through its agents, the various regulatory authorities, may be paying particular attention to a number of member institutions which are in a weak condition. In fact some of these institutions may be on a limited licence and CDIC may even have given notice of its intention to withdraw insurance coverage as a technique to induce the institution in question to improve its business practices and/or capital base.

The point has been made with the Committee that if CDIC were to publish the names of those member institutions which are being followed closely by it, the public would be less likely to place deposits with these institutions and thus some degree of market discipline would be achieved. In the first place, such action by CDIC would be a signal to those depositors with accounts above the insured level to withdraw them or at least to reduce them to the insured level. At the same time, no accounts above the insured level would be opened. Thus, CDIC's exposure in the event of the failure of any institution on its watch-list would be 100%. In the second place, the institutions whose names were published would encounter serious funding problems. At the very least, this would involve CDIC in providing short-term liquidity. Most probably the publication of a member institutions name because it was in a weak condition and therefore on CDIC's watch-list, would make rehabilitation of that institution impossible and would virtually ensure its going into liquidation.

The Committee is against the proposition that the names of member institutions which are in a weak condition and therefore on CDIC's watch-list should be published.

## **Status of CDIC Claim Against Assets of Liquidated Member Institutions**

One important issue where the Committee has encountered some confusion concerns the pari passu nature of deposit liabilities. CDIC for legal reasons has not attempted to gain a prior charge on assets for advances to pay out insured depositors thereby materially reducing the claim of uninsured depositors on assets when liquidated. CDIC's losses would be reduced if, by obtaining a senior charge against the assets of the insolvent companies, the liquidation proceeds were to go towards offsetting CDIC's outstanding liability claim before any payments to uninsured depositors. Apparently this is the practice in the United Kingdom. If the view is taken that CDIC's role is primarily that of an insurer, then a case can be made for putting CDIC in a similar position in like circumstances. The Committee does not approve of such a proposition. In the first place, it would involve a change to the Bankruptcy Act to give CDIC this position. If that change were made, all deposits in member institutions would no longer rank pari passu which traditionally has been the case. Further, it is hard to see why the public, once aware of the change, would place any deposits with a member institution above the insured limit.



## Chapter V

# The Funding of CDIC

## Introduction

The deposit insurance system is designed to operate much like a casualty insurance company. Premiums collected from insured member institutions and income from investments are used to cover operating expenses, losses (or claims) and additions to reserves (i.e., net worth). If the deposit insurance system is properly structured, then premium income and investment income will be sufficient to cover expenses and losses and to maintain net worth at a level deemed appropriate to absorb unanticipated losses.

There are three principal differences between a normal casualty insurance business and that of the deposit insurance system.

1. The beneficiary of deposit insurance, the small depositor, does not pay the insurance premium himself. Instead, member deposit-taking institutions pay premiums into a pool on a quasi self-insurance basis. In a sense, the Deposit Insurance Fund operates much like a bonding company for member institutions.
2. It is almost impossible to accurately quantify future risk and thereby charge precisely calculated risk-related premiums and maintain a "perfect" reserve level in the Fund. History is not a good guide and risk concentration is extreme. For example, the largest single member institution has insured deposits of \$28.7 billion representing almost 20% of all member institutions insured deposits.
3. Unlike a private insurer, CDIC does not currently have the ability to reject applications for coverage or cancel existing coverage with respect to federally incorporated companies.

Canada's deposit insurance plan began in 1967. Canadian dollar deposits with an original term to maturity of less than five years were insured up to \$20,000 (subsequently raised to \$60,000 in 1983) and member institutions were obligated to pay an annual insurance premium equal to 1/30th of 1% of insured deposits. All member institutions pay the same premium with no risk differentiation. However, when in "the opinion of the Corporation, the Deposit Insurance Fund at the end of a financial year of the Corporation is **adequate, having regard to all circumstances,**

Table 1

## Financial Statistics — Canada Deposit Insurance Corporation (year ending December 31)

	Number of Member Institutions <sup>(1)</sup>	Total Deposits (\$ bil) April 30	Insured Deposits (\$ bil) April 30	Ratio — Insured to Total Deposits	Income & Expenses (\$ millions)								Deposit Insurance Fund (\$ mil) <sup>(4)</sup>	As a % of insured deposits	Similar Ratio for FDIC in U.S.
					Premium Income <sup>(2)</sup> (net)	Net Investment Income	Total Income	Loss Provision	General Overhead	Income Taxes <sup>(3)</sup>	Total Expenses	Net Income			
1967	69	\$31.2	\$17.1	54.81%	\$5.7	\$0.5	\$6.2	\$0.0	\$0.1	\$0.0	\$0.1	\$6.1	\$16.1	0.09%	1.33%
1968	71	\$35.6	\$19.5	54.78%	\$6.5	\$1.0	\$7.5	\$0.0	\$0.2	\$0.0	\$0.2	\$7.3	\$23.4	0.12%	1.26%
1969	73	\$42.6	\$22.5	52.82%	\$7.5	\$1.7	\$9.2	\$0.0	\$0.2	\$0.0	\$0.2	\$9.0	\$32.4	0.14%	1.29%
1970	73	\$47.0	\$24.5	52.13%	\$8.2	\$2.2	\$10.4	\$1.5	\$0.2	\$0.0	\$1.7	\$8.7	\$41.0	0.17%	1.25%
1971	75	\$52.8	\$27.2	51.52%	\$9.1	\$2.6	\$11.7	\$0.5	\$0.2	\$0.0	\$0.7	\$11.0	\$52.0	0.19%	1.27%
1972	74	\$62.1	\$30.1	48.47%	\$10.0	\$2.7	\$12.7	\$0.0	\$0.2	\$0.0	\$0.2	\$12.5	\$64.5	0.21%	1.23%
1973	81	\$73.0	\$34.4	47.12%	\$9.2	\$3.5	\$12.7	\$0.0	\$0.2	\$0.0	\$0.2	\$12.5	\$77.0	0.22%	1.21%
1974	80	\$91.6	\$42.9	46.83%	\$13.4	\$4.6	\$18.0	(\$1.0)	\$0.2	\$0.0	(\$0.8)	\$18.8	\$95.7	0.22%	1.18%
1975	83	\$106.3	\$49.0	46.10%	\$10.3	\$6.1	\$16.4	\$0.0	\$0.3	\$2.9	\$3.2	\$13.2	\$108.9	0.22%	1.18%
1976	94	\$124.2	\$56.0	45.09%	\$11.8	\$7.3	\$19.1	(\$0.4)	\$0.3	\$3.6	\$3.5	\$15.6	\$124.3	0.22%	1.16%
1977	102	\$146.8	\$66.2	45.10%	\$15.0	\$8.0	\$23.0	\$0.0	\$0.4	\$4.1	\$4.5	\$18.5	\$132.8	0.20%	1.15%
1978	109	\$175.9	\$71.7	40.76%	\$7.7	\$10.6	\$18.3	\$0.0	\$0.5	\$4.7	\$5.2	\$13.1	\$145.9	0.20%	1.16%
1979	115	\$211.9	\$82.5	38.93%	\$11.4	\$14.6	\$26.0	(\$0.1)	\$0.5	\$6.5	\$6.9	\$19.1	\$165.0	0.20%	1.21%
1980	123	\$259.6	\$96.1	37.02%	\$21.9	\$18.4	\$40.3	(\$0.1)	\$0.8	\$8.6	\$9.3	\$31.0	\$195.9	0.20%	1.16%
1981	145	\$309.0 E	\$109.0	35.28%	\$19.8	\$26.3	\$46.1	\$3.2	\$0.7	\$12.4	\$16.3	\$29.8	\$225.7	0.21%	1.24%
1982	186	\$374.0 E	\$118.0	31.55%	\$14.6	\$25.9	\$40.5	\$0.0	\$1.0	\$12.0	\$13.0	\$27.5	\$253.1	0.21%	1.21%
1983	188	\$376.0 E	\$154.0	40.96%	\$51.1	\$27.7	\$78.8	\$649.6	\$2.8	\$11.7	\$664.1	(\$585.3)	(\$332.1)	-0.22%	1.22%
1984 <sup>(5)</sup>	193	\$397.2	\$161.5	40.66%	\$53.9	\$28.5	\$82.4	\$112.1	\$3.1	\$12.3	\$127.5	(\$45.1)	(\$377.2)	-0.23%	1.20%

<sup>(1)</sup> There is significant double counting in these totals in that a number of member institutions are represented in two or more forms — i.e., parent bank and mortgage loan subsidiary or sister trust & mortgage loan companies. On a consolidated basis, the net number of member institutions was 153 in 1984.

<sup>(2)</sup> Net of credits and rebates which totalled \$109.4 million during the years 1973 to 1982 inclusive.

<sup>(3)</sup> Although always subject to income tax, CDIC was granted remission under Section 22 of the Financial Administration Act until 1975.

<sup>(4)</sup> The Government of Canada originally invested \$10 million in equity capital in 1967 which was redeemed in June 1977. (The \$10 million is included in the above data prior to 1977.)

<sup>(5)</sup> Based on preliminary data.

the Corporation may reduce the amount of the premiums to be paid" [Section 19/8] subject to the condition that a member institution must have paid **cumulative** premiums at least equal to 1/6th of 1% of insured deposits as at April 30th in the then current premium year. There was no formal definition of the term "adequate having regard to all circumstances". In the United States, the FDIC is required to maintain its Deposit Insurance Fund between 1.25% and 1.40% of insured deposits. Other countries outside North America generally operate at much lower fund levels than the United States with 0.2% of insured deposits being close to an average.

The data in Table 1 summarize the first eighteen years of CDIC's existence using preliminary data for 1984. As indicated, there has been steady growth. The number of member institutions has increased almost three times while the amount of insured deposits has increased **9.4 times** to \$161.5 billion in 1984. The annual compound growth in insured deposits has been 14.1%. The growth in insured deposits was accentuated by an increase in the deposit insurance ceiling from \$20,000 to \$60,000 in 1983 which caused insured deposits to rise by approximately \$25 billion. Loss experience during the first sixteen years was minimal. The Deposit Insurance Fund grew to \$64.5 million or 0.21% of insured deposits by the end of 1972 at which point the Corporation felt the Fund was "adequate". During the subsequent 10-year period, premiums were reduced through credits and rebates totalling \$109.4 million. If allowance is made for additional investment income that would have been earned on these rebates, the total cumulative negative impact on the Fund from premium credits and rebates would be nearly \$133 million.

As indicated, there was a dramatic deterioration in loss experience in 1983 and 1984 with loss provisions totalling \$762 million during these two years. Despite much higher premium revenues (as all premium credits and rebates were terminated) the Fund's surplus of \$253 million shrank to a deficit of **\$377 million** by the end of 1984. Aggravating the situation was \$24 million in income taxes paid by CDIC during the two years despite its massive losses.

## **Target Level for Deposit Insurance Fund**

The Committee believes that a target reserve level in the Deposit Insurance Fund of 0.75% of insured deposits is appropriate. This reserve level is approximately three-and-one-half times the level previously deemed "adequate" and therefore recognizes the increased risks posed by the current volatile economic environment and the trend towards deregulation. On the other hand, the Committee believes that the recent extreme losses were of a one-time nature and reserves need not be built to fully cushion the Fund against a problem of such magnitude.

The recommended reserve level for the Deposit Insurance Fund at 0.75% is substantially less than the 1.25% plus level deemed adequate for FDIC in the

United States. The Committee believes the prefunding requirements in Canada for the Deposit Insurance Fund are proportionately less than in the U.S. for the following reasons:

1. **Concentration** – The ten largest member institutions (6 banks and 4 trust companies) represent 86.15% of all member insured deposits and the remaining 143 represent 13.85%. It would be impractical and in fact punitive to attempt to build a fund that would be able to fully cover losses from the failure of one or more of these large institutions. Expressing the 0.75% reserve as a percentage of the remaining 143 member institutions' (consolidated) insured deposits (i.e.,  $0.75\%/13.85\%$ ) produces a reserve level of 5.4% which is adequate in the conditions the Committee foresees in the future.

2. The concentration referred to in (1) does not add to risk because:

- a) there is much greater reliance in Canada on stable retail core deposits;
- b) there is much broader product and geographical diversification in Canada.

3. **Tighter Control** – In Chapter III of this report the Committee recommends substantial upgrading in CDIC's financial standards, CDIC's monitoring ability and CDIC's enforcement power. Implementation of these recommendations should serve to materially reduce future losses for CDIC.

4. **Higher Relative Borrowing Authority** – CDIC may borrow from the federal government's Consolidated Revenue Fund, subject to Governor-in-Council authorization, up to \$1.5 billion (raised from \$500 million in 1983). This borrowing limit currently equals 0.9% of all deposits insured by CDIC. In the United States, FDIC has similar authority to borrow up to \$3 billion from the U.S. Treasury which represents approximately 0.2% of deposits insured by FDIC. CDIC therefore currently has more than four times the borrowing authority of FDIC.

5. **Effective Risk Sharing with Depositors** – In the United States there is a widespread public perception that there is 100% de facto deposit insurance with only minor exceptions. If the Committee's majority report on co-insurance is put into practice, the Deposit Insurance Fund will be less exposed.

The Committee would define the Deposit Insurance Fund as "mixed assessment". In other words, it is pre-funded and adequate to absorb unanticipated losses in a "normal" economic environment. The Committee would not change this structure.

Some observers have suggested a post-assessment deposit insurance plan. Under this proposal the plan would be totally unfunded (i.e., no reserve) and would rely on levies on member institutions to cover losses after they occur. Supporters of this

proposal argue that CDIC's back-up borrowing authority from the Consolidated Revenue Fund (now \$1.5 billion) would be adequate to handle immediate liquidity problems. Loans from the government would be repaid by future premium revenues or assessments received from member institutions. This type of post-assessment plan is in use in France and the Netherlands and to a lesser degree in the United Kingdom. The National Contingency Fund (funded and run by Canadian securities dealers) operates partly on a post-assessment basis. From newspaper accounts, it appears that the Canadian insurance industry (both life and casualty) is considering the establishment of an industry run post-assessment insurance plan.

The Committee favours partial pre-funding of unanticipated losses through the establishment of a Deposit Insurance Fund because:

1. It creates more public confidence in the financial system and its ability to withstand adversity.
2. It is easier to gradually build up a reserve over 20 to 50 years than to have member institutions post-fund a large loss in a much shorter period of time. Often the period following large setbacks to the Deposit Insurance Fund would be a difficult period for financial institutions in general. Having to post-fund the Deposit Insurance Fund would probably make a difficult period more difficult still.
3. In a post-assessment fund only the solvent remaining members would pay. At least in a pre-assessment fund both the "good" and the "bad" pay insurance premiums. Further, risk-related insurance premiums are only possible with a pre-assessment fund.
4. The existence of a pre-funded Deposit Insurance Fund should foster more discipline on the part of regulators and member institutions as there should be a desire on their part to avoid impairment. Taxpayers should also be less concerned that tax funds would be used to bail out mismanaged financial institutions.
5. The existence of a pre-funded Deposit Insurance Fund will reduce the likelihood of a call being made on the Consolidated Revenue Fund.

The Committee recognizes that it is not possible to accurately predict economic conditions over the next ten to twenty years. Therefore, it believes that the CDIC should be given the power to alter the target level of 0.75% following thorough investigation.

## **Tax Status of CDIC**

The Committee strongly recommends that CDIC should be granted tax free status at least until the Deposit Insurance Fund is rebuilt to the proposed "adequate" level of 0.75% of insured deposits. Insurance premiums paid to CDIC should continue to be tax deductible to member institutions.

The reasons advanced for the above recommendation are:

1. The tax free status would substantially accelerate the rebuilding of the Deposit Insurance Fund towards the "target" or "adequate" level (especially when taken together with the proposal contained later in this Chapter to initially refinance the Fund with a \$1 billion preferred share issue).
2. A viable deposit insurance plan maintains financial stability and public confidence in the financial system. It also eases entry for new small competitors coming into the deposit taking business. These broad public benefits warrant tax free status for CDIC which FDIC enjoys in the U.S.A.
3. The current tax position of CDIC is contradictory. CDIC paid \$24 million in income taxes in 1983 and 1984 despite massive losses. Investment income net of interest paid and general overhead is taxed. Premium income is not included as part of taxable income. Loss provisions are **not** deductible. CDIC accrues as investment income, interest on loans outstanding to "troubled member institutions" in the process of being wound down. "Payment" of this loan interest greatly increases the "losses" of these troubled member institutions and therefore CDIC's non-deductible loss provisions.

The Committee strongly favours the granting of the tax free status to CDIC. The Committee realizes that granting CDIC tax free status will require significant amendments to the Income Tax Act, a subject that requires further analysis. Issues such as the tax status of other "quasi" deposit insurance schemes would have to be dealt with. On this subject the Committee believes that favourable tax treatment for CDIC is justified because of the importance of the Corporation's function in maintaining stability of the Canadian financial system.

If it is not possible to grant CDIC tax free status, then the Committee recommends that CDIC be given the power to create a tax free Deposit Insurance Fund equal to 0.75% of insured deposits with full allowance given to the initial deficit position of the Fund. There should be no limit on the amount that may be transferred to the Fund for tax reasons in any one year.

## **Accounting Presentation**

Reflecting the proposed new tax treatment and in order to enhance public understanding of CDIC's financial affairs, the Committee recommends the following changes to the format of CDIC's financial statements:

1. Insurance premiums less credits and rebates should be recognized as normal revenue on the statement of income.
2. Investment income less interest cost on borrowings should be presented as a revenue item.

3. Where CDIC has an existing loss provision with respect to a member institution, it should cease accruing interest on its loans to that institution as this procedure simply has the effect of inflating the loss provision.

4. CDIC's provision for loss should reflect anticipated losses in addition to "incurred" losses on known problem situations. At present, CDIC's method of making loss provisions does not appear to allow fully for this. Private sector financial institutions must establish loss reserves today for losses expected tomorrow. The business of projecting future losses is admittedly difficult and subjective; however, this is no reason to avoid the exercise.

In its balance sheet CDIC should net out its provision for loss against loans to and claims on member institutions. This is a generally accepted accounting principle. At present, by grossing up the "provision" as a liability, total assets are overstated.

6. CDIC's balance sheet should have a "net worth" section on the liability side which would include both the accumulated amount in the "Deposit Insurance Fund" and any equity capital the Corporation might issue pursuant to the proposal contained later in this Chapter.

## **Financing the Deficit – Financial Projections**

In devising a plan to refinance the Deposit Insurance Fund, the Committee established the following conditions or criteria:

1. The Government of Canada would not directly participate in the refinancing of the Fund. The Committee believes that member institutions, not the taxpayers of Canada should shoulder this burden. The Committee however believes that certain changes to the tax status of CDIC are justified (see previous section) which if legislated would aid CDIC in rebuilding the Fund.
2. The "target" size of the Fund (i.e., net worth equal to 0.75% of insured deposits) be achieved within a reasonable period of time. The Committee thinks that 10 years is a reasonable period of time.
3. The net worth of CDIC be immediately changed from a large deficit to a positive position through an equity issue to member institutions. This proposal would lead to public domestic and international financial market credibility in the Fund's ability to sustain itself in an adverse situation.
4. If at all possible, the burden or impact on member institutions' annual reported after tax earnings of proposed changes be minimized.

The Committee's financial projections for CDIC over the next 15 years (to 1999) are outlined in Table 2 and summarized below. The Committee believes that the

Table 2

**Financial Projections — Canada Deposit Insurance Corporation**  
(key assumptions below) (as prepared by the Committee)

	1983	1984 **	1985E	1986E	1987E	1988E	1989E	1990E	1991E	1992E	1993E	1994E	1995E	1996E	1997E	1998E	1999E
1) Insured Deposits — \$ billions	\$154.0	\$161.5	\$176.0	\$191.9	\$209.1	\$228.0	\$248.5	\$270.9	\$295.2	\$321.8	\$350.8	\$382.3	\$416.7	\$454.2	\$495.1	\$539.7	\$588.3
(S millions)																	
2) Premium Revenue	\$51.1	\$53.9	\$117.4	\$191.9	\$209.1	\$228.0	\$248.5	\$270.9	\$295.2	\$321.8	\$350.8	\$382.3	\$416.7	\$454.2	\$495.1	\$539.7	\$588.3
3) Net Investment Revenue	(9.9)*	(41.8)*	7.3	52.8	56.8	69.8	89.0	120.8	151.4	187.3	226.9	270.2	318.5	358.2	388.1	426.5	478.9
4) Total Revenue	\$41.2	\$12.1	\$124.7	\$244.7	\$265.9	\$297.8	\$337.5	\$391.7	\$446.6	\$509.1	\$577.7	\$652.5	\$735.3	\$812.4	\$883.3	\$966.2	\$1,067.2
5) Less: General Overhead	2.8	3.1	4.7	7.0	8.4	10.0	12.1	14.5	17.4	20.8	25.0	30.0	36.0	43.2	51.6	62.2	74.6
6) Loss Provisions	612.0*	41.7*	225.0	200.0	100.0	75.0	50.0	50.0	50.0	60.0	100.0	125.0	150.0	150.0	200.0	150.0	150.0
7) Total Expense	\$614.8	\$44.8	\$229.7	\$207.0	\$108.4	\$85.0	\$62.1	\$64.5	\$67.4	\$80.8	\$125.0	\$155.0	\$186.0	\$193.2	\$251.8	\$212.2	\$224.6
8) Net Income	(\$573.6)	(\$32.7)	(\$105.0)	\$37.7	\$157.5	\$212.7	\$339.5	\$327.2	\$379.3	\$428.2	\$452.7	\$497.5	\$549.3	\$619.2	\$631.4	\$754.0	\$842.6
9) Less: Income Tax	11.7	12.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10) Preferred Dividend	0.0	0.0	30.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	51.4	34.2	16.7	0.0
11) Net Income Available for Fund	(\$585.3)	(\$45.0)	(\$135.0)	(\$22.3)	\$97.5	\$152.7	\$279.5	\$267.2	\$319.3	\$368.2	\$392.7	\$437.5	\$489.3	\$567.9	\$597.3	\$737.3	\$842.6
12) Deposit Insurance Fund — Beg. year	\$253.1	(\$332.1)	(\$377.2)	(\$512.2)	\$534.4	(\$436.9)	(\$284.2)	(\$4.7)	\$262.6	\$581.9	\$950.1	\$1,342.8	\$1,780.3	\$2,269.6	\$2,837.5	\$3,434.7	\$4,172.0
13) Deposit Insurance Fund — End year	(\$332.1)	(\$377.2)	(\$512.2)	(\$534.4)	(\$436.9)	(\$284.2)	(\$4.7)	\$262.6	\$581.9	\$950.1	\$1,342.8	\$1,780.3	\$2,269.6	\$2,837.5	\$3,434.7	\$4,172.0	\$5,014.6
14) As a % of insured deposits	-0.22%	-0.23%	-0.29%	-0.28%	-0.21%	-0.12%	.00%	0.10%	0.20%	0.30%	0.38%	0.47%	0.54%	0.62%	0.69%	0.77%	0.85%
15) Equity Capital	\$0.0	\$0.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$1,000.0	\$855.9	\$569.4	\$278.7	\$0.0
16) Total Net Worth	(\$332.1)	(\$377.2)	\$487.8	\$465.6	\$563.1	\$715.8	\$995.3	\$1,262.6	\$1,581.9	\$1,950.1	\$2,342.8	\$2,780.3	\$3,269.6	\$3,693.4	\$4,004.1	\$4,450.7	\$5,014.6
17) As a % of insured deposits	-0.22%	-0.23%	0.28%	0.24%	0.27%	0.31%	0.40%	0.47%	0.54%	0.61%	0.67%	0.73%	0.78%	0.81%	0.81%	0.82%	0.85%

\* Restated

\*\* Based on preliminary data

## SUMMARY OF KEY ASSUMPTIONS

- 1) 9% growth in insured deposits
- 2) Premium Income 1985: 1/15th of 1% of insured deposits  
1986 and subsequent years: 1/10th of 1% of insured deposits
- 3) Loss provisions are estimated.
- 4) 50% growth in general O/H in 1985 and 1986 — 20% growth 1987 onward
- 5) Net Investment Revenue: prime rate at 12% — yield on investments 11%.
- 6) No tax refund in 1985.

four conditions mentioned previously are met if **all** parts of its refinancing proposal are implemented. Failure to implement any one recommendation would seriously impair the overall plan.

1. Governments make no direct financial contribution although the tax status of CDIC is changed.
2. The ratio of net worth to insured deposits rises to over 0.75% by 1995 or in ten years.
3. The \$377 million deficit of CDIC is turned into positive net worth of \$488 million in the first year.
4. Although not indicated in Table 2, the negative annual impact on almost all member institutions' after tax earnings is estimated to be very modest relative to their overall earning power. (See the second last section of this Chapter).

A discussion of the assumptions underlying the financial projections in Table 2 including the Committee's proposals for preferred share financing and premium rate changes follows.

## **Financing for CDIC**

The Committee recommends that CDIC be given the power to issue a **non-voting** equity instrument (which it will refer to as preferred shares) to member institutions as a means of immediately creating a positive net worth in CDIC. Terms and conditions of this preferred share equity instrument should include:

**Timing** – Immediately following passage of enabling legislation (assumed June 30/85).

**Size** – One billion dollars.

**Buyers** – Individual member institutions would be obligated to subscribe in cash for an amount equal to the member's percentage share of insured deposits as at April 30, 1985 multiplied by one billion dollars.

**Dividend** – Floating to equal one-half the Canadian prime rate on a non-cumulative basis. The dividend is to be calculated as a percentage of the member institution's carrying value (see comments on valuation below).

**Redemption** – There will be no purchase fund, sinking fund or right of retraction to benefit the owners of the preferred shares. Subject to CDIC Board approval and discretion, the preferred shares would only become redeemable when and if CDIC's net worth exceeds 0.75% of insured deposits. At that point, redemption would only take place in an amount that would not cause the net worth ratio to fall below 0.75% on a one-year lag basis. Redemption would occur on a pro rata basis.

**Tax Status** – Dividends would be tax free in the hands of member institutions.

**Valuation** – The preferred shares should be carried at par value as an asset by member institutions. A decline below \$250 million in CDIC's net worth would trigger a 25% writedown in carrying value by member institutions. The writedown would be fully tax deductible to member institutions. A further decline in CDIC's net worth below zero would trigger an additional 25% writedown by member institutions. Similar action would occur as CDIC's net worth reached minus \$250 million and minus \$500 million. The Committee believes that action would likely be taken by CDIC to prevent net worth declining in the manner described (i.e., higher premiums, an additional equity issue, etc.).

The proposed writedown schedule is provided in order to give formal direction with regard to "permanent impairment" and to eliminate debate and possible divergence in accounting treatment among member institutions. Allowing a full deduction for tax purposes with regard to the preferred share writedown is consistent with the tax status granted loss provisions against loans. The deductibility of the writedown as outlined would also give member institutions greater financial ability to participate in a further refinancing of CDIC if this ever became necessary.

**Marketability** – There will be no guarantee of principal repayment or regular dividend payment by the federal government or its agent corporations including CDIC. It is not intended to list these privately placed shares on any stock exchange and CDIC will not file a prospectus. However, member institutions are free to sell their shares to knowledgeable and sophisticated arm's length buyers in blocks of over \$97,000 in the "over the counter" market. Member institutions may themselves guarantee timely payment of dividend and may incorporate conditions such as a "put" in order to make these shares saleable to knowledgeable buyers. It is important however that the tax treatment available to the initial purchaser of these shares be available to subsequent buyers.

## **The Premium Rate Increase**

The Committee recommends that CDIC increase its "basic" premium rate from 1/30th of 1% to 1/10th of 1% of insured deposits in two steps. In the first year (1985), the premium will increase to 1/15th of 1% and then in the second year (1986), the premium will increase to 1/10th of 1%.

Once the net worth of the Fund (after redemption of the preferred shares) reaches 0.75% of insured deposits, CDIC should be given the power to lower the net premium rate charged to individual institutions as long as the net worth of the Fund (after redemption of the preferred shares) remains at or above 0.75% of insured deposits. At that point (1999 based on the financial projections in Table 2), it is envisaged that CDIC would design a premium rebate or credit system to maintain the Fund at that level.

If a risk-related premium structure is ever adopted by CDIC, the incremental revenues to it from risk-related premiums above the basic rate are not likely to be material because most large institutions would probably qualify for the lower "basic" premium rate. Therefore, for illustrative purposes, the financial projections in Table 2 do not incorporate incremental premium revenues above the basic rate.

## **Other Variables**

In addition to the \$1 billion equity financing, the increase in premium rates and change in CDIC's tax status, other assumptions incorporated into the financial projections (Table 2) include:

### **Nine-per-cent annual growth in insured deposits (see line 1 – Table 2)**

Over the last eighteen years, insured deposits at member institutions have grown at a 14.1% annual compound rate (12.8% netting out the 1983 increase in deposit insurance ceiling) which compares to an 11.5% annual growth rate in Canada's GNP. Nominal Gross National Product for Canada is projected to grow at an 8% annual rate which incorporates a 5% to 6% inflation rate and 2% to 3% real growth. Annual growth in insured deposits is expected to continue to exceed that of nominal GNP by roughly 1% as savings in Canada continue to be increasingly institutionalized and the population ages.

As indicated in Chapter IV of this report, a majority of the Committee recommends increasing the deposit insurance ceiling to \$100,000 (from \$60,000) and making all deposits subject to a 10% co-insurance factor. The Committee is unable to quantify the impact, if any, of these proposed changes on the assessment base but it does not believe the results would be material as they should be largely offsetting. Therefore they are not incorporated into the Committee's projections.

The current base for calculating insurance premiums is insured deposits as defined in CDIC's Act. It has been suggested that the assessment base for calculating premiums be broadened to include all deposits including those denominated in foreign currencies, deposits with terms exceeding five years and off-balance-sheet liabilities. In the United States a broader assessment base along these lines is either in place or is proposed largely on the basis that there is de facto 100% deposit insurance. The Committee has **rejected** the idea of broadening the assessment base because the Committee does not believe that 100% de facto coverage exists in Canada. Given the accuracy of this belief, broadening the assessment base would represent an unfair burden to Canada's large and wholesale-oriented financial institutions.

## **Net Investment Revenue and Interest Rate Assumptions**

Net investment revenue (gross interest earned on investments less interest paid on borrowings) is a very important source of revenue to CDIC (see line 3 in Table 2).

Key determinants of net investment revenue are the level of interest rates and the amount of "free" funds available to CDIC for investment (i.e., largely invested in short-term Government of Canada securities and loans to member institutions).

Throughout the forecast period the Committee has assumed a stable prime rate of 12%. The assumed yield on CDIC's investments is 11% or 1% less than the prime rate. Obviously different assumptions with regard to interest rates could materially impact the projections of net investment revenue; however, it is important to note that variables are interrelated and changes often tend to cancel each other out. For example, a higher level of interest rates would be positive for net investment income, but the logical implications of higher interest rates are higher growth in insured deposits and a higher level of loan losses. The cost of servicing the preferred shares would also rise.

An 11% return of invested funds and a 6% inflation rate implies a real cost of borrowing (or return) of 5% which is high by long-term historical standards. However, it is the Committee's opinion that these rate spreads are sustainable in the projected environment.

Net investment revenue has been restated to eliminate the accrual of interest on loans to member institutions where a loss provision has been established. In 1984 this accrued interest amounted to \$70.3 million. Therefore reported net investment revenue of \$28.5 million is restated to a negative \$41.8 million. A similar offsetting adjustment is made to the provision for loss which drops \$70.3 million from \$112.1 million to \$41.7 million.

The restated negative net investment revenue of \$41.8 million in 1984 reflects the cost of financing CDIC's negative net worth. CDIC's deficit averaged \$355 million in 1984. Expressing \$41.8 million as a percentage of \$355 million equals 11.8% which was the approximate average prime rate in 1984.

In 1985, net investment revenue will rise to a modest \$7 million reflecting six months of investment income on both the proceeds of the \$1 billion preferred share issue and the increased premium revenue offset in part by the cost of financing the increased deficit in the deposit fund. In 1986, the full positive impact of the preferred share issue and increased premium level will be felt. Despite a continuing heavy burden from loan losses, CDIC's net income (after preferred dividends) should recover from a projected loss in 1985 of \$135 million to a projected loss of \$22 million in 1986. Beyond 1986, net investment income should continue to rise as increasing internal profit generation rapidly reduces the deficit in the Deposit Insurance Fund.

## **Future Provision for Loss**

It is extremely difficult to predict future loss provisions. The loan loss projections outlined in Table 2 are based on the following assumptions made by the Committee:

- a) Eight problem institutions identified in 1983 (Crown Trust, Seaway Trust, Seaway Mortgage, Greymac Trust, Greymac Mortgage, Fidelity Trust, District Trust, AMIC Mortgage) are projected to generate additional losses to CDIC of \$50 million annually over the next four years as they are wound down or liquidated. It is important to note that these loss provisions exclude any interest accrual as mentioned previously. Use of current CDIC accounting would double these future loss provisions.
- b) Additional loss provisions of \$175 million in 1985 and \$150 million in 1986 have been estimated.
- c) Starting in 1987 loan loss experience is projected to decline due to ongoing actions by CDIC to achieve higher financial and examination standards.
- d) Largely for illustrative purposes the Committee has assumed a cyclical rise in loss experience in the 1990s.
- e) Loss projections are based on the assumption that CDIC's claim in liquidation of member institutions ranks *pari passu* with other creditors.

## **Future Growth in General Overhead**

Significant growth in CDIC's general overhead is expected as it gears up to handle its increased responsibilities as outlined by the Committee. On this basis the Committee has assumed that CDIC's general overhead grows at a 50% annual rate in 1985 and 1986 and then at a 20% annual rate during the remainder of the forecast period. Notwithstanding these increases, the future projected level of overhead is modest relative to CDIC's responsibilities.

## **Income Tax Alternatives**

The impact on the Committee's projections if CDIC were to remain taxable and were allowed to create a 0.75 of 1% tax free reserve does not appear material in the first ten years. It will take that long before CDIC fully utilizes the tax deductions available to it and becomes partially taxable. This situation is illustrated in Table 3.

## **Impact on Member Institutions' Earnings**

Member institutions are being asked to contribute in two ways to the refinancing of CDIC:

1. Purchase of CDIC floating rate preferred shares with the amount purchased determined by the member institution's share of total insured

Table 3

**Impact on Projected Income Taxes by Making CDIC Taxable  
But with the Ability to Create 0.75% Tax Free Reserve**

	1985E	1986E	1987E	1988E	1989E	1990E	1991E	1992E	1993E	1994E	1995E	1996E	1997E	1998E	1999E
Insured Deposits — \$ billions	\$176.0	\$191.9	\$209.1	\$228.0	\$248.5	\$270.9	\$295.2	\$321.8	\$350.8	\$382.3	\$416.7	\$454.2	\$495.1	\$539.7	\$588.3
\$ millions															
Unutilized Tax Loss — beg. year	\$1,588*	\$1,802	\$1,884	\$1,855	\$1,784	\$1,598	\$1,439	\$1,242	\$1,013	\$778	\$517	\$226	(\$112)	(\$437)	(\$856)
Plus: increase in allowed tax deduction during year	109	119	129	142	154	168	182	200	218	236	258	281	307	335	364
Less: taxable income (L8, table 2)	(\$105)	\$38	\$158	\$213	\$340	\$327	\$379	\$428	\$453	\$498	\$549	\$619	\$631	\$754	\$843
Unutilized Tax Loss — end year	\$1,802	\$1,884	\$1,855	\$1,784	\$1,598	\$1,439	\$1,242	\$1,013	\$778	\$517	\$226	(\$112)	(\$437)	(\$856)	(\$1,335)
Taxes Payable	0	0	0	0	0	0	0	0	0	0	0	\$56	\$162	\$210	\$240

\* Calculated: 1984 insured deposits (\$161.5 billion) x 0.75% plus 1984 year-end deficit (\$377 billion).

deposits (see Table 4). The dividend rate on the preferred shares is one-half of the bank prime rate and is meant to generate an after-tax return on assets of approximately 0.50% assuming the member institution is taxable and funds the investment in the wholesale money market at prime less 1%. The Committee believes that most financial institutions are marginally taxable currently and that their taxable income will increase significantly over the next several years as increasing amounts of "loan substitutes" booked in the late 1970s mature. Many financial institutions will be able to fund in the retail marketplace at a lower rate than prime less 1% thus achieving a profit margin above 0.50%. In almost all cases their share investment will represent less than 1/2% of total assets and the impact on earnings ought to be negligible.

2. Payment of increased insurance premiums to CDIC. The insurance premium rate is being tripled in two steps over two years. Outlined in Table 4 is the earnings impact resulting from the premium rate increase. As indicated in this table the negative impact on earnings available to common shareholders is less than 2% in 1985 for most member institutions. In the opinion of the Committee this does not represent an undue burden for member institutions.

When examining the issue of member institutions' profitability, the Committee notes that one class of institution, the chartered banks, must carry non-earning cash reserves. This burden reduced bank industry earnings by approximately 17% in 1984.

Table 4

## Financial Statistics — CDIC Member Institutions - Earnings Impact of Increase in Insurance Premium Rate (\$ million)

	Total Assets December 31/84	Insured Deposits April 30/84	Pro Forma Preferred Share <sup>(1)</sup> Investment	As a % of Total Assets	After Tax Earnings <sup>(2)</sup> 1984	After Tax Return on Average Assets 1984	Dollar Increase in Insurance Premium 1/30 to 1/10th of 1%	Negative Earnings Impact	
								On Full Amount	In 1985
<b>BANKS</b>									
Royal	\$90,477	\$28,663	\$177.4	0.20%	\$385.8	0.45%	\$19.1	2.5%	1.2%
Commerce	\$71,789	\$27,103	\$167.8	0.23%	\$200.3	0.29%	\$18.1	4.5%	2.3%
Bank of Montreal	\$77,206	\$21,994	\$136.1	0.18%	\$230.8	0.34%	\$14.7	3.2%	1.6%
Bank of Nova Scotia	\$57,592	\$13,327	\$82.5	0.14%	\$261.3	0.46%	\$8.9	1.7%	0.8%
Toronto-Dominion	\$47,086	\$14,664	\$90.8	0.19%	\$338.7	0.76%	\$9.8	1.4%	0.7%
National	\$19,718	\$7,947	\$49.2	0.25%	\$101.1	0.55%	\$5.3	2.6%	1.3%
Other Banks (66)	\$42,045	\$5,289	\$32.7	0.08%	\$88.4	0.22%	\$3.5	2.0%	1.0%
Total Banks (72)	\$405,913	\$118,987	\$736.5	0.18%	\$1,606.4	0.42%	\$79.3	2.5%	1.2%
<b>TRUST &amp; LOAN</b>									
Canada Trustco	\$11,750	\$8,501	\$52.6	0.45%	\$66.4	0.61%	\$5.7	4.3%	2.1%
Royal Trustco	\$11,157	\$4,954	\$30.7	0.27%	\$64.0	0.62%	\$3.3	2.6%	1.3%
National V&G	\$8,224	\$6,320	\$39.1	0.48%	\$45.4	0.67%	\$4.2	4.6%	2.3%
Canada Permanent	\$7,639	\$5,817	\$36.0	0.47%	\$28.2 <sup>(3)</sup>	0.38%	\$3.9	6.7%	3.4%
Montreal Trustco	\$2,529	\$1,128	\$7.0	0.28%	\$14.8	0.65%	\$0.8	5.1%	2.5%
Central Trustco	\$2,627	\$2,054	\$12.7	0.48%	\$6.9 <sup>(6)</sup>	0.28%	\$1.4	10.1%	5.1%
Trust General	\$2,500	\$682	\$4.2	0.17%	\$14.1	0.60%	\$0.5	1.6%	0.8%
Guaranty Trust	\$3,074	\$2,297	\$14.2	0.46%	\$9.6	0.33%	\$1.5	8.0%	4.0%
First City Trust	\$2,809 <sup>(4)</sup>	\$1,644	\$10.2	0.36%	\$34.7 E	1.30% E	\$1.1	1.6%	0.8%
Standard Trust	\$1,036	\$623	\$3.9	0.37%	\$3.0	0.32%	\$0.4	6.8%	3.4%
Others	\$13,824	\$8,540	\$52.9	0.38%					
Total Trust (80)	\$67,169 E	\$42,560	\$263.5	0.39%					
Overall Total (152)	\$473,082	\$161,547	\$1,000.0	0.21%					

<sup>(1)</sup> Assuming \$1 billion issue and allocation based on share of insured deposits.<sup>(2)</sup> After preferred dividends.<sup>(3)</sup> Assuming marginal tax rate of 50%.<sup>(4)</sup> At September 30, 1984.<sup>(5)</sup> Before extraordinary items.<sup>(6)</sup> Before writedown MICC.

## **Chapter VI**

# **Organization and Staffing**

While private sector deposit institutions are responsible for the funding and the losses of CDIC, the federal government, under the Financial Administration Act, is responsible for the appointment of the Board of Directors and the Chief Executive Officer. It must also approve CDIC's annual corporate plan including operating and capital budgets. As well, the government can give any directive to CDIC, which, assuming it is within its powers, must be implemented by its Board of Directors although they are not liable for so doing.

It is the Committee's view that CDIC should have a greater degree of independence than it currently enjoys and that perhaps the model of the Bank of Canada is a more appropriate one.

In Chapter III of this report, the Committee outlined the responsible role CDIC would play in future in monitoring member institutions in order to protect depositors and the Deposit Insurance Fund. In addition, it has been recommended that under certain circumstances and when necessary to fulfill its revised mandate, CDIC should be able to involve itself directly in the affairs of a problem member institution. To accomplish these very important objectives, the Corporation should have an expanded staff of highly competent, experienced people reporting through the Chief Executive Officer to an enlarged Board of Directors.

While the Committee believes that the existing government representation on the Board is both desirable and necessary from a policy and co-ordination viewpoint, it believes there must be greater representation from the private sector to provide insight and skills not currently present.

In the high risk, volatile economic conditions of the 1980s, and in an environment of deregulation, it is critical that CDIC be given the resources it needs to fulfill its important mandate. It should be noted, however, that the Committee is not recommending the creation of another large bureaucracy. Current losses have their basis in difficult economic conditions, inadequate management in some member institutions and insufficient resources on the part of the regulatory authorities. CDIC's organization structure and staffing should reflect these realities.

The Committee recommends that CDIC's Board of Directors should be strengthened by the addition of four private sector members in addition to the chairman so that it will be constituted as follows:

- Chairman of the Board;
- Chief Executive Officer;
- three additional private sector members;
- the Governor (or a Deputy Governor) of the Bank of Canada;
- the Deputy Minister (or Associate Deputy Minister) of Finance;
- the Inspector General of Banks;
- the Superintendent of Insurance.

The Committee strongly recommends that alternates should not be allowed for Board Members.

While the government would appoint the Board of Directors, it is the strong view of the Committee that the Board of Directors must have full responsibility to select and appoint the Chief Executive Officer.

The Committee discussed the rationale of having persons actively employed by member institutions on the Board of CDIC and noted such representation is not unusual in similar corporation in other countries. However, several briefs took strong exception to such representation citing the problem of conflict of interest that would inevitably arise if such participation existed. As a result, the Committee recommends excluding such direct involvement and would opt instead for participation by individuals with extensive background in the financial services industry. In addition, it is hoped the private sector members would bring professional expertise in the areas of real estate, liquidations, corporate/commercial law and accounting. Finally, the private sector Board members should be compensated by way of annual and meeting fees at comparable private sector rates and should be reimbursed for out-of-pocket expenses.

The Chairman of the Board should be a highly creditable individual with a financial background from the private sector. Moreover, he should be a part-time, salaried, but fixed-term appointment. His term could well be shortened from the existing five years to permit more frequent rotation from deposit institution sectors. The Committee has in mind three years with a two-year option. While his chief functions would include chairing Board meetings and providing counsel to the Chief Executive Officer, his role would also include a significant public relations function to promote interest in, and understanding of CDIC.

The Committee recommends the creation of the position of President and Chief Executive Officer who would be on the Board. As previously noted, it is the Committee's preference that the Board have the authority to hire, terminate and remunerate the President and CEO. In view of the number of problems presently facing the Corporation, this would be a full-time, permanent position. The incumbent should have significant senior executive experience and be capable of holding the CEO position with a major financial institution. As a result, the

President's remuneration would be comparable with that of a senior executive in the private sector.

The Officers of CDIC, in addition to the Chairman and President, would include:

1. **Vice President, Supervision:** This person would be responsible for developing accounting and examination standards in conjunction with regulatory authorities and others and monitoring and examining member institutions. Included in his area of responsibility would be maintenance of the financial institutions' data base referred to elsewhere in this report. The position would require a professional accounting background.
2. **Vice President, Liquidation:** This person would be responsible for dealing with problem members and handling insolvencies. He should work closely with the Vice President, Supervision. The position would require a basic knowledge of real estate and would require a professional background (legal/accounting) in receiverships and liquidations.
3. **Vice President, Legal:** This person would be responsible for legal advice, taking and defending legal actions, and providing legal support. Corporate secretarial functions would be performed by this position. A strong legal background is required, particularly in corporate/commercial law and real estate.
4. **Vice President, Administration:** This person would be responsible for developing premium recommendations, administration of the Deposit Insurance Fund, accounting, personnel and administration functions. The incumbent would direct the development and operation of all automated systems as required by his colleagues and approved by the Board of Directors.

Each of the above officers would be a highly qualified, experienced professional. In keeping with the Committee's view that CDIC should be a lean corporation, each of the officers should have the senior experience required to identify, guide and direct key individuals to carry out examinations, receiverships, liquidations or other specific assignments. As well, these individuals should have superior communications skills as they will be working closely with both federal and provincial regulators and member institutions.

In view of the increasingly complex situation arising from the resolution of the problems of member institutions, the Committee recommends that CDIC carry Directors' and Officers' liability insurance. It would be a Board decision as to whether this would be self-insured (as in the case with the FDIC) or purchased from an outside carrier.

The Committee recommends that CDIC establish standing or, in special circumstances, ad hoc Committees often comprising personnel from member corporations to act in an advisory capacity to the President. The precise functions of such committees would be determined by the strengthened Board and the CEO.

The Committee has in mind a format somewhat along the following lines:

- a committee representing member institutions;
- a committee of senior chartered accountants to provide guidance on accounting and examination standards;
- a regional advisory group to provide intelligence to the Corporation. Time and again in the course of its deliberations the Committee came across situations where intelligence of a regional nature or specific to a particular problem would have been useful to CDIC in deciding on a course of action. Unfortunately, this intelligence was not always readily available. By having this advice on hand, this problem should be, at least in part, alleviated.

## **Chapter VII**

### **Public Relations**

Until the 1980s, CDIC operated in a relatively quiet environment and had few insurance losses. Apart from the membership insignia found on the doors of each branch of each member institutions, it kept a very low profile. However, a continuing string of large and small insolvencies of federally and provincially incorporated member institutions in the 1980s and the resulting deficit in the Deposit Insurance Fund have put CDIC front and centre in the public limelight. This has created a need for CDIC to expand its public relations role with its various publics: depositors, member institutions and government.

Accordingly, the Committee makes the following recommendations:

1. CDIC, in conjunction with financial industry trade associations, should embark on a public education program to explain changes to CDIC arising from the implementation of the Committee's recommendations. A secondary role of this program would be to inform unsophisticated depositors in the use of and limitations of deposit insurance.
2. CDIC could consider the use of a Zenith telephone system to respond to direct deposit insurance queries from all Canadians.
3. The ad hoc committees referred to in Chapter VI will also be useful channels of communication and should improve CDIC's public relations.



## **Appendix I**

# **Terms of Reference for Review of CDIC Law and Operations**

### **Powers and Objects**

What should be the objectives of deposit insurance and the Corporation?

### **Possible Reforms of Deposit Insurance**

Should insurance be provided by a private company or companies?

Should the present level of deposit insurance coverage be changed?

Should there be a provision for co-insurance by the depositor within the insured deposit limit?

Should risk-related premiums be introduced?

Should the liabilities of any other types of deposit-accepting institutions be covered?

### **Funding**

Are the funding provisions adequate to recoup anticipated losses?

Should premiums be large enough to build up a fund adequate to meet any likely future calls on it?

Are the Corporation's borrowing powers adequate and should they be restricted to borrowing from the Consolidated Revenue Fund?

Should any borrowing involving a provincially chartered institution be done pro rata between that now in existence and the Consolidated Revenue Fund?

Are there other ways of placing a financial responsibility on provinces, which in practice provide the first line of supervisory protection of a shared backstop (using CDIC as the vehicle) for any bailant?

## **Supervision and Monitoring of Member Institutions**

What should CDIC's role be in determining the adequacy of supervision of member institutions?

What should CIDC's role be in relation to the monitoring of troubled member institutions? (This item is narrower than the question of the adequacy of regulation and supervision for solvency in Canada).

Should all provinces agree now that, at any time in the future, when a provincially chartered institution is put on a short licence, CDIC must be involved as a full partner in supervision and monitoring.

Are there any means of exercising tougher discipline on institutions on short licence of no deposit insurance if assets exceed a certain level?

## **Lessons from Recent Member Institution Failures**

What are the lessons in relation to a) monitoring and supervision, b) arrangements for dealing with insolvent companies?

## **Rehabilitation and Liquidation of Member Institutions**

Should the Corporation have broader powers and funding to enable it to play a more active role in the rehabilitation of member institutions in difficulty?

In the case of insolvent institutions, does the Corporation need broader powers to enable it to meet its insurance responsibilities at the least cost to itself and consequently to member institutions?

What should the Corporation's policy be in relation to shareholders and uninsured creditors of insolvent companies?

Is it appropriate under the existing Act for CDIC to provide liquidity funding to troubled groups? Should this power be more explicitly provided in new legislation? Has this power been prudently used in the past?

## **Organization and Staffing**

Is the present composition of the Board of Directors satisfactory?

Should members have some form of representation on the Board or an advisory role to the Board?

Is the Corporation's permanent staff and administrative structure adequate to enable it to meet its responsibilities?

Should the Corporation be depending to a lesser or greater degree on consultants and agents?

Should the Chairman's position be full time?

**Public Relations of the Corporation**

Should the Corporation improve its communications with its member institutions, provincial regulatory and related bodies and the public?



## Appendix II

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