

# FROM TRIAL TO TRIUMPH: HOW CANADA'S PAST FINANCIAL CRISES HELPED SHAPE A SUPERIOR REGULATORY SYSTEM

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## Abstract

As anyone paying attention during the 2008–2009 financial crisis is aware, the Canadian financial system weathered the storm uniquely well. Exactly why Canada's system remained so comparatively stable, while so many other foreign systems broke down, is a question that remains largely unsettled. One explanation may be that the regulatory system that emerged from a very specific history of prior crises had both prepared Canada well for such a crisis, and responded effectively as the crisis unfolded. But the very regulatory system that provided stability in recent years may also be at risk of becoming warped by its own success, with regulators so emboldened by the acclaim for their recent achievements that they overreach to ensure their track record remains unblemished in the future. The stunning collapse of a pair of western Canadian banks, a number of major Canadian trust companies and several insurance companies, as well as some other precarious near misses in the 1980s and 1990s, were a shock to the financial regulatory system, highlighting deficiencies that would be addressed with new regulations and, most notably, the creation of the Office of the Superintendent of Financial Institutions (OSFI). Canada's centralized regulatory approach, through the OSFI and just four other major regulatory bodies, has proved both more elegant and effective than, for instance, the more complicated, more convoluted and more decentralized American financial-oversight system. But some regulated companies, insurers in particular, have long maintained that the concentration of power in Canada's large banks has resulted in a one-size-fits-all regulatory approach that does not offer a relatively lighter burden for smaller institutions, potentially stifling growth. In other words, an over-emphasis on stability may be hampering market efficiency. Nor is there any economic evidence to shed light on whether those and other costs of regulating stability are justified by the costs spared by avoiding instability. Received wisdom would naturally assume that avoiding certain institutional collapses are worth any cost, but of course there must be some limits to that logic. To be clear, Canada's regulatory model almost certainly appears to be a better-functioning one than that of many in its peer group, and the OSFI approach is gaining acceptance by many countries, particularly in emerging markets that are implementing cohesive regulatory systems for the first time, using the Canadian framework as a template. This does not, however, mean that Canada's regulatory system cannot still be refined and improved. Suggestions for improvement include: the possibility of creating an industry-based collaboration committee — similar to the regulators' Financial Institutions Supervisory Committee — that would monitor industry risk over time; the modernization of the Winding-up and Restructuring Act, conceived more than a century ago, to address the modern reality of immense and complex institutions of today, providing regulators the flexibility to resolve such entities when they become troubled; and the strengthening of board structures for large institutions, which remain much as they were in the 1980s, including the possibility of appointing permanent, full-time, independent directors and requirements for boards to better train directors and utilize outside expertise when warranted. Canada's regulatory system is arguably one of the most effective in existence, but its success through the recent financial crisis is no guarantee that it will be sufficiently prepared for the next.\*\*

**Key Words:** Financial Crises, Canada, Regulatory System

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## Introduction

The primary objective of this paper is to describe the evolution of the Canadian government's regulation of

the financial services industry, with particular regard to the businesses of banking and insurance. A secondary objective is to consider whether there are aspects of the Canadian financial regulatory

framework that explain, or partially explain, why Canada is now generally perceived to be a “high achiever” in this field. By most measures, the Canadian economy and Canada’s financial institutions have had a more stable and predictable performance than most other jurisdictions since the onset of the financial crisis in 2008. If there are particular features of the Canadian financial regulatory system that have contributed to stable and predictable performance, it will obviously be beneficial to discern what they are, if only to enable other interested parties to consider how such features might be successfully incorporated into the financial regulatory frameworks of their own jurisdictions. It is also hoped that this paper will provide a useful backdrop for additional papers and research that will be prepared under the sponsorship of the Financial Markets Regulation Program at the University of Calgary’s School of Public Policy.

At the outset, we need to be clear on the objective of financial services industry regulation. In our view, it is to ensure system stability and to protect depositors and policyholders within a global financial marketplace. Members of the public — who provide the bulk of the required funding for banks and insurers through their deposits and premiums, respectively — must be able to have a high degree of confidence in the obligations and promises undertaken by their financial institutions. Lacking this confidence, the financial system would quickly fall into disorder, with dramatic impact on the economy as a whole. At the same time, a balance must be maintained between the need to maintain citizens’ confidence in the system, and the need to provide shareholders with an opportunity to earn a satisfactory risk-adjusted return on capital. If this latter circumstance does not also prevail, shareholders will not invest, which again would result in the inability of the financial system to function. In endeavouring to maintain the appropriate balance between these competing objectives, the cost of regulation (including not just the monetary cost but also the potential cost in terms of burdening the efficiency and effectiveness of financial markets) must also be part of the equation. The over-arching purpose of the financial regulatory system is to achieve a satisfactory balance between these competing objectives.

The need for well-designed systems of financial regulation has never been greater given the devastating impact of the recent financial crisis and the increasingly global nature of the financial services industries.

## **Survey of Historical Developments**

Since Confederation in 1867, the Canadian financial system has been the subject of six major reviews: the MacTavish Royal Commission on Life Insurance in 1906; the McKeown Royal Commission to Inquire

into and Report upon the Affairs of the Home Bank of Canada in 1924; the MacMillan Royal Commission on Banking and Currency in Canada in 1933; the Porter Royal Commission on Banking and Finance in 1964; the Estey Inquiry into the Collapse of the

CCB and Northland Bank in 1986; and the McKay Task Force — dubbed “Reforming Canada’s Financial Services Sector” — in 1996. In addition to these in-depth government reviews, in 1985, the Department of Finance — responding to a series of financial-institution failures — released a major green paper, *The Regulation of Canadian Financial Institutions: Proposals for Discussion*. Also in 1985, there was the *Final Report of the Working Committee on the Canada Deposit Insurance Corporation*, known as “The Wyman Report.” Each of these latter two papers commented extensively on perceived inadequacies in the regulatory system and put forward recommendations for action.

Some of these inquiries and papers have had financial regulation as a major focus of their investigations; others have not. But at the very least, each has provided an invaluable overview of the financial system, viewed from the perspective of the times in which they were written. These extensive reviews and papers, all commissioned by the government of Canada, have provided much of the historical input for this paper, supported by various scholarly papers and other sources as referenced.

## ***The Early Days of Canadian Banking***

The origins for banking in Canada were in the United States, where a bank charter was granted by Alexander Hamilton, the first secretary of the Treasury, to the First Bank of the United States in 1791. The Canadian banking system is a direct descendant of the First Bank, which itself was in part modelled after the Bank of England.<sup>1</sup>

The first modern bank incorporated in Canada, by an act of the then-province of Lower Canada, was the Bank of Montreal, which opened for business in 1817. A number of banks had been incorporated prior to 1817, but each of these disappeared through merger or failure.<sup>2</sup> The Bank of Montreal Act of Incorporation served as a model for the incorporation of other banks in later years.

The Canada Life Assurance Company was Canada’s first incorporated life insurer, established in 1849 by an act of the province of Upper Canada.<sup>3</sup> As was the case with the Bank of Montreal, the company’s special act contained investment powers and other features that were later used as the model for special act incorporations of other life insurers.

## ***The First Bank Act and Revisions***

In 1871, the first Bank Act was adopted by the newly formed Canadian Parliament, authorizing Canadian

banks to “open branches and agencies or offices of discount and deposit and transact business at any place or places in the Dominion.”<sup>4</sup> This was the genesis of the branch banking system that has been a hallmark of Canadian banking practice. (See page 11 for a discussion of the growth of a national, branch banking system in Canada, versus the system in the United States, where small regional banks tended to be the norm.) A particularly far-sighted provision of the original Bank Act was that it was to expire in 1881, laying the foundation for the system of mandatory decennial revision.<sup>5</sup> Mandatory revision of financial services industry statutes (today, every five years) is undoubtedly a worthwhile regulatory practice — one that few jurisdictions have adopted, and which, in our view, has been to their disadvantage.

The new act limited bank dividend payments to eight per cent per annum until such time as a surplus account had been built up to a level of 20 per cent of paid capital.<sup>6</sup> The act required initial capital of \$500,000, of which \$100,000 had to be paid in before commencing business, with a further \$100,000 within two years. The remainder could be called on as required by the bank. (The estimated current value of \$100,000 in 1871 is about \$7.6 million.)<sup>7</sup>

An interesting feature of the 1871 Bank Act, modeled on then existing banking laws in the United States,<sup>8</sup> was the so-called “double liability” requirement. The terminology refers to the fact that, in the event of insolvency, bank shareholders stood to lose not only their investment, but additionally, they would be assessed for an amount up to the par value of the shares they owned. At that time, bank shares were almost always \$100 par value, with treasury shares offered at par. Thus, in the event of liquidation, every shareholder would be assessed for an additional contribution up to the par value of shares owned. Some U.S. state legislatures actually provided that state bank shareholders would be assessed for multiples of the par value of their shares (Colorado, for example, adopted triple liability) and in California, the principle of limited liability for corporate shareholders was entirely suspended, with bank shareholders being subject to unlimited liability to depositors. Although such provisions would have had a substantial negative impact on the ability of banks to raise capital, Benjamin Beckhart, in his seminal 1929 publication, *The Banking System of Canada*, states that the double-liability feature “has been of real protection to the depositors.”<sup>9</sup> Nevertheless, in the U.S. and Canada over the course of the Depression years, all variations of the double-liability provision were abandoned as policymakers became convinced that the benefits for depositors were not sufficient to offset the economic repercussions of making it so difficult for banks to raise capital.<sup>10</sup>

Commenting on that first Bank Act in 1871, Beckhart indicates: “Through the adoption of this

legislation, Canada had perhaps the most elaborate and detailed banking code of the British Empire.”<sup>11</sup> But notwithstanding that accolade, we find that in the 22 years after Confederation — i.e., between 1867 and 1889 — 10 banks failed and nine others ceased transacting business, involving heavy losses to depositors and shareholders.<sup>12</sup> Canada endured a period of recession during the 1880s, making life particularly difficult for the country’s evolving banking industry. According to Beckhart, “the banking failures occurring in the eighties convinced some of the necessity of a more stringent supervision of banks, and of independent audits.”<sup>13</sup>

In the 1891 Bank Act review, the government tightened the financial requirements for banks, adopting legislation that compelled banks to deposit with the minister of finance five per cent of their notes in circulation. As well, the paid-in capital requirement was raised to \$250,000 (this figure equates to about \$10.7 million in current dollars<sup>14</sup>). The five per cent requirement can be considered to be a proxy for a modern-day leverage requirement and, interestingly, it is in line with the current Office of the Superintendent of Financial Institutions’ (OSFI) leverage cap of about 20 times. Another change required directors to hold a certain amount of paid-up stock, rather than subscribed stock, as a qualification for holding office. The revisions also enabled banks to make loans on the security of warehouse goods, which greatly increased the amount that could be loaned to a single debtor, as the previous limit had been related to the capital base of the borrowing firm. (A problem that had to be rectified in later years was that, by this means, a bank could have a first lien on the goods of a producer, but this fact would not be known to other lenders, who could discover later on that the apparent security of their loan was preempted by a bank lien.)

In 1891, the Canadian Bankers Association (CBA) was established after it had become clear to bankers and the government that a formal banking organization was required along the lines of what already existed in the United States and Britain.<sup>15</sup> The organization was formally incorporated by an act of Parliament in 1900. The CBA was granted specific powers, including, in Section 7, the power “... to establish and regulate clearing houses ...” This authority was retained until the 1980 Bank Act repealed Section 7 of the CBA Act and responsibility for the operation of the clearing system was transferred to the Canadian Payments Association. In 1900, the president of the CBA was also given the power to appoint a curator, which arose from the establishment under the 1890 Bank Act of the “Bank Circulation Redemption Fund.” Under the fund, all circulating notes from a failed bank (at that time banks issued their own notes — the Bank of Canada took over the function in 1935, although technically banks retained the right to issue their own notes until 1967) would be redeemed from the fund, the money

in which was provided by the banks. So, as the other banks were providing the funds to redeem any outstanding notes of a failed bank, and would obviously want to ensure that it was done effectively and properly, it was understandable why the CBA Act initially granted the president of the association the power to appoint a curator.<sup>16</sup>

According to the MacMillan commission, “the period from 1900 to 1913 was one of unprecedented economic development in Canada, in which the banks played a very important part.”<sup>17</sup> To reflect the changing circumstances, the Bank Act was subject to a number of amendments during this period, but only one of these, in 1913, was of a nature that we would today consider to be central to the regulatory process: provision was made for a shareholders’ audit of each bank, by auditors chosen by the shareholders, from a panel selected by the Canadian Bankers Association and approved by the minister of finance.

Economic conditions in Canada in the early 1920s were difficult, especially for the farming community, which at that time represented a significant proportion of the Canadian populace. Many farm operators were members of the Progressive party, which held the balance of power in Parliament between the ruling Liberals and the Conservatives. Beckhart indicates that the Progressive party promoted a view that “the banking system was diabolically responsible for the economic maladjustments in which the farmers had become enmeshed.”<sup>18</sup> This view was no doubt helped along by the fact that Merchants Bank of Canada had become insolvent in 1922. This failure, combined with the economic recession, gave rise to a strong sense among many voters that the government needed to make changes to the laws on banking.

Some of the key amendments in the 1923 Bank Act revisions were:<sup>19</sup>

- Pension funds of bank employees must be invested in securities that would be eligible investments for trustees under the Trust Companies Act. (The employee pension fund of Merchants Bank had been fully invested in shares of the bank.)

- The attendance record of directors was to be sent to shareholders along with the notice of the annual meeting. (There was evidence that some directors of Merchants Bank had rarely attended meetings and paid little attention to the bank’s affairs.)

- There were to be clearer and more detailed bank financial filings with the Ministry of Finance.

- The provisions for the shareholders’ audits were rewritten and greatly strengthened.

The subject of possible government inspection of the banks was a hot topic in 1923, sparking a number of animated debates in the House of Commons. According to Beckhart,<sup>20</sup> “bankers were unalterably opposed” to the idea of government inspection and in 1923 the CBA produced a pamphlet

entitled *Banks and Banking*, in which “several pages were devoted in an effort to convince the public of the impossibility of government inspection.” Accordingly, the government decided not to proceed.

Shortly thereafter, however, the Home Bank failed and “the opposition to government bank inspection vanished in thin air.”<sup>21</sup> Accordingly, there were additional amendments to the act in 1924, the most significant being the establishment of the Office of the Inspector General of Banks (OIGB). More comments on the amendments of 1923 and 1924, including with regard to the OIGB, follow later in this paper.

### ***The Armstrong Inquiry in the U.S. and the MacTavish Royal Commission on Life Insurance***

In 1905, in New York State, directors and senior executives of several of the largest life insurers in the U.S. became the focus of international attention as a result of their extravagant lifestyles. (This would be akin to situations that have arisen in the past few years where there has been significant media coverage regarding the levels of compensation and bonuses paid to CEOs and other executives whose organizations received vast amounts of taxpayer support in order to avoid liquidation.) The displays of wealth in 1905 were considered especially improper because the life insurers concerned had large numbers of participating policyholders who clearly were not earning high returns on their life insurance investments. Ultimately, the New York State Legislature appointed Senator William W. Armstrong to hold a formal inquiry into the life insurance business in the state.

The importance of this inquiry cannot be exaggerated insofar as life insurance is concerned, but its influence extended far beyond the life insurance industry.<sup>22</sup> The investigation was confined to the “Big Three” U.S. life insurance companies of the time: Equitable of the U.S., Mutual of New York and New York Life. The inquiry found that the funds of these U.S. life insurers were being ruthlessly exploited “for the personal advantage of the officers and directors and that nepotism was rampant.”<sup>23</sup> The inquiry ended up generating some 10 volumes of testimony and uncovered a whole series of abuses, including the fact that policies frequently contained provisions that made it difficult to claim some of the important benefits that were purportedly available under the contracts, especially accumulated cash values. Another practice exposed by the inquiry involved the propensity for large life insurers to actually incorporate and operate public utility companies, railroads and other significant businesses. The inquiry concluded that it was inappropriate for life insurers to be running other corporations rather than focusing their endeavours on the areas for which they were originally incorporated: the underwriting of life insurance policies. It was also evident from the

inquiry hearings that the use of policyholder funds in these other businesses led to many additional business and “insider”-type investment opportunities for directors and senior officers of the life insurer. In terms of financial dealings, the inquiry brought to light the fact that some of the insurers were engaged in misleading investment transactions, designed to hide investment losses and involving illegal activities such as forgery of documents and the fictitious sale of various securities. The inquiry led to the indictment of senior officers of a number of the life insurers involved.

According to the Canadian Life and Health Insurance Association, “The inquiry must be viewed as part of the social and economic history of the U.S. at the turn of the century. It was the culmination of the doctrine of laissez-faire in economic matters: that in business and manufacturing the law of the jungle should prevail and by the survival of the fittest, true progress would be achieved.”<sup>24</sup>

Responding to the inquiry’s findings, the New York State Legislature enacted a series of new regulations, including the introduction of certain standard provisions to be included in life insurance policies. While the actual wording for inclusion in policies was not dictated by the new law, contracts were required to provide certain minimum benefits (such as non-forfeiture provisions that would ensure that values built up in life insurance policies were not completely lost solely on account of premiums being briefly overdue), expressed in language that was acceptable to the regulator. Investment powers were also constrained significantly.

Interestingly, one of the reforms prohibited any one company from writing more than \$150 million in new insurance if it had \$1 billion or more of insurance in force. This can be seen as an early effort to rein in the growth of what we would today refer to as “too big to fail” financial institutions. (The provision was revoked in a subsequent sitting of the legislature. If that had not been the case, and if parallel provisions had been applied to banks and investment companies, the financial landscape might be very different than it is today.) Life insurers were also restricted in the amounts they could invest in the shares of other corporations.

The Armstrong committee revelations also had an important impact in Canada. Largely as a result of the revelations south of the border, in 1906, the MacTavish Royal Commission on Life Insurance was established to look into the situation in Canada. The commission investigated the operations of every one of the then-active domestic life insurers. The commission found that although the scale of problems was far less than what had been found south of the border, and no instances of actual fraud or other criminal activities were unearthed, there were numerous instances of conflicts of interest whereby directors and officers were placed in favoured positions by means of the investment operations of

the insurance companies they represented. It is clear from the testimony of directors and officers at the time that their view was that these benefits were entitlements of their positions.

For reasons that are now unclear, no one seems to have wondered what was happening in Canada’s chartered banks at this time. If directors and senior officers of life insurance companies took the view that they were entitled to benefit personally from the investment and other business activities of their companies, one might expect that not entirely different views may well have been held by at least some directors and shareholders of Canadian banks.

However, no investigation along these lines took place. In light of that, it is interesting to note that the failure of the Home Bank, reported on in the next section, was found by investigators to be significantly attributable to self-dealing by its directors and officers.

In any case, the main recommendations of the MacTavish report, corresponding to those of the Armstrong inquiry, were adopted by the government of Canada by means of a new Insurance Act in 1910. To ensure greater transparency in insurance, the superintendent of insurance was required to publish annual reports setting out the income statements and financial positions of insurers in great detail. Providing greater emphasis to the concept of moral suasion, the superintendent was also empowered to publish any correspondence with insurance companies which might be instrumental in revealing improper operational policies, and from time to time that was actually done. (This is an approach known today as “name and shame,” but it is no longer a significant part of the Canadian financial regulatory framework.) The new provisions served to lay the foundation for insurance legislation in Canada, and remained its cornerstone until the introduction of a much-revised Insurance Companies Act in 1992.

Although there were no specific implications for banking legislation as a result of the MacTavish commission, in a move towards increased transparency, the Bank Act was amended in 1923 to require registration and publicity with regard to loans made under certain provisions of the Bank Act. This would enable members of the public to know when banks had a prior lien on certain assets of borrowers. Also, banks were required to provide the regulator with financial statements for any corporations in which bank or bank-related operations were being carried out. (It is regrettable that in modern times, AIG Financial Products Corporation was not subject to such a requirement under either U.S. or U.K. laws. In that event, insurance regulators would not have been so unaware of its operations, which were the primary cause of AIG’s perilous exposure to risk. See page 44 for more on AIG.) According to the Estey inquiry report, “By 1923, the bank audit provisions required two auditors for each bank selected from different firms and subject to replacement every two

years. The auditors were required by the Act to report to the general manager and directors of the bank on any loan exceeding one per cent of paid-up capital which appeared to be inadequately secured.”<sup>25</sup> The 1923 revisions also prohibited loans or advances to bank officers in an amount of more than \$10,000 (or \$156,000 in 2013 dollars <sup>26</sup>), a relatively small amount by today’s standards. Under the current Bank Act, subsection 496(2), a bank may make a loan to an officer that does not exceed the larger of twice the officer’s annual salary or \$100,000.

### ***Failure of the Home Bank and the McKeown Royal Commission of 1924***

In 1923, the Home Bank failed, giving rise to significant public controversy and political pressure on the government of the day. The bank had been incorporated in 1903 and had focused on building its business in Western Canada through a regional office in Winnipeg. With significant numbers of loans to the agricultural sector, it found itself exposed when that sector ran into hard times with declining grain prices in the early 1920s. In an effort to continue to operate, the bank took to capitalizing interest on overdue loans and rewriting them as new loans in order to avoid booking losses. Other practices generally regarded as unacceptable were also adopted to make the bank’s position look better than was actually the case. Related-party transactions were substantial relative to the bank’s financial resources. The independent auditor never qualified the bank’s financial statements, on the grounds that the auditor’s job was “not to second-guess management practices.” Several members of the board of directors, lacking any semblance of proper corporate governance, aided and abetted the deception. The minister of finance had been alerted to bad practices by several other Home Bank directors as early as 1915 and again in 1918, but for whatever reason no action was ever taken by the government.<sup>27</sup>

The McKeown royal commission was appointed to look into the Home Bank failure. According to Lew and Richardson, “The Commission determined that the bank was probably insolvent at the time of the complaints to the Minister of Finance and that statements issued by management and attested to by the auditor did not fairly reflect the financial position of the bank. The president, vice-president, five directors and the bank accountant were all convicted of fraud.”<sup>28</sup>

The liquidator of the bank, G.T. Clarkson, is quoted in the *Globe* newspaper of Dec. 7, 1923, as saying “the bank’s insolvency is due to the fact that there was no proper fulfilment of the functions for which it was chartered, and because of the lack of experienced management, disregard of the safeguards by which the business of all efficiently managed banks are protected, and lastly because of serious losses incurred from loans in which executive officers

were interested or loans which were made to companies in which certain of the directors or officers were shareholders.”

In another edition of the *Globe* (Nov. 10, 1923, page 4) a member of Parliament who had carried out a survey of the officers of U.S. banks, reported that one of his experts from south of the border indicated: “Nearly all bank failures can be attributed to crookedness, wildcatting or mismanagement; there have been very few failures due to conditions over which the bank had no control.”

The failure of the Home Bank was front-page news across the country for many months. In many cases, meetings of depositors almost came to blows with the government and legal experts who were attempting to deal with the failure in an orderly manner. The general feeling, expressed with considerable passion, was that the government should make all the depositors whole. As one depositor indicated to the *Globe* (Dec. 8, 1923): “When the Government gives a certain group of men a charter to carry on a banking business and take the people’s money in trust, it should make sure that those men are capable and competent.”

As a result of its investigation, the McKeown commission concluded that the government had a moral, if not a legal responsibility to depositors, this arising as a result of not having acted on the complaints of improper practices which were lodged with the minister of finance in earlier years. After the bank failed, the government partially compensated depositors for their losses (35 per cent of deposits for amounts of less than \$500 and 25 per cent of other deposits),<sup>29</sup> mainly because of the commission’s findings of moral responsibility. The commission determined, based on financial information available at the time, that had action been taken in 1918 when some directors of the bank were filing complaints with the minister of finance, it would have been possible to merge the bank with a stronger institution, or even to wind down its affairs, and depositors would not have suffered losses.

In Parliament, there was much debate as to what steps should be taken to strengthen the bank regulatory system, with broad and varied provisions given consideration, including the possibility of deposit insurance and the establishment of a central bank. In the end, the main result was to amend the Bank Act in 1924 to provide for the creation of the Office of the Inspector General of Banks. But according to Lew and Richardson, not much really changed: “The inspector’s responsibilities did not differ greatly from those held previously by the Minister and he would have few staff, further limiting an expansion of authority through the office.”<sup>30</sup>

There had previously been reluctance by government to introduce a requirement for bank inspections because there was a fear that that would make the government liable for any failures. The new law contained a specific provision that the

government would not become liable as a result of the power of inspection contained in the 1924 amendments to the Bank Act.

Beckhart indicates, with regard to the 1924 version of the act, “the statute is a lengthy document of some 90 pages, which makes it a close rival in size to the National Bank Act of the United States, and as a matter of passing interest, it is the most complete and detailed general banking law existing in any part of the British Empire.”<sup>31</sup>

Lew and Richardson recap the development of banking regulation in Canada: “In 1867 note insurance was provided to all banks, then in 1871 with the Bank Act, formal barriers to entry were erected. However, to deflect the growing potential financial liability or fiscal crisis facing the state in the event of bank failures, operational responsibility was gradually moved to ‘independent’ agencies. First, an independent bank audit was instituted in 1910, upgraded to require a state-sanctioned professionally incorporated auditor in 1923, and finally in 1924 a state inspector was introduced.”

The dual-audit system introduced in 1923 and the creation of the OIGB with inspection powers in 1924 comprised the basic system of bank regulation in Canada until the mid-1980s.

### ***The MacMillan Royal Commission on Banking and Currency***

In the preceding sections of this report, we have made reference to the 1933 MacMillan commission. One of the important terms of reference for that commission was to consider whether Canada should have a central bank. It is worth reminding ourselves that this commission was acting in the depths of the Great Depression. Nevertheless, as the commission expresses in its report, “The Canadian banks give admirable evidence of security, efficiency and convenience. In a time of universal economic difficulty, the Canadian banks have stood firm and have continued to render to the people of the Dominion the same high quality and the same wide variety of services as in the past.”<sup>32</sup>

Based on the text of the commission report, it is clear that with the severe economic trials posed by the Depression, international consensus was converging on the view that modern financial systems, and especially the derivation and application of monetary policy by governments, required independent advice from professionals, such as would be provided through a central bank. As well, these were the early days of economic policy making — the report indicates that at the time of writing in 1933: “new methods and new terms are, as a result of manifold and prudent experiment, steadily but effectively gaining acceptance.”<sup>33</sup>

The MacMillan commission report states: “By a majority, (The Chairman, Sir Charles Addis and Mr. Brownlee; Sir Thomas White and Mr. Beaudry

Leman dissenting) we recommend that a central bank for Canada be forthwith established.”<sup>34</sup> So, despite the strong statements of support for a central bank that were included in the body of the report, the favourable recommendation was made with a majority of only one commissioner.<sup>35</sup> The government accepted the commission’s recommendation and the Bank of Canada was founded in 1934 and became a Crown corporation in 1938. Its basic objective has not changed since its creation: “to regulate credit and currency in the best interests of the economic life of the nation.” The bank functions as an independent agency accountable to the government of Canada.

While Canada was developing a banking system comprised of a small number of large banks, each having local branches, in the United States, small, local banks were the norm. The Bank of Canada website provides the following insights into the reasons for this completely different pattern of development:

“The banking system that developed in Canada was quite different from that in the neighbouring United States. South of the border, a different philosophy encouraged the development of independent local banks and a larger population, clustered in established communities, made it workable.

“In Canada, the continuing British influence was reflected in the preference for a limited number of banks with multiple branches. In the years leading up to Confederation, small rural settlements spread over an extended area made branch banking a practical approach. In a relatively undeveloped economy, branch banks could be established with less capital and fewer skilled officers than would have been required for independent banks at each location.

“The branch bank network was sufficient to the nation’s needs for almost a century. The chartered banks provided the bulk of notes in circulation and could meet seasonal or unexpected demands. The larger banks were able to deal with government business without strain, and the branch network gradually developed a system for clearing cheques between banks.”

From shortly after the time of Confederation to the mid-1900s, one cannot help but take note of the tremendous degree of consolidation that took place in the banking industry. At the time of Confederation there were 35 active banks, and the number increased to 51 by 1874, a number that would not be attained again until the revision of the Bank Act to permit Schedule B banks in 1980.<sup>36</sup> By 1900, the number of chartered banks had reduced by 24; seven had been merged with other banks and 17 had failed or had their charters repealed.<sup>37</sup> By 1918, the number had

declined to 19, and by the time the MacMillan commission reported in 1933, the number was down to 10.<sup>38</sup> By 1961, there were only eight chartered banks in Canada.<sup>39</sup> The reduction in numbers over time was, not surprisingly, accompanied by a concentration of assets in the largest banks. "By the 1920's over 50 per cent of banking assets were held by the three largest banks, three quarters by the largest nine."<sup>40</sup> By the time of the Porter commission in 1964, the three largest banks owned a striking 70 per cent of total banking assets.<sup>41, 42</sup>

However, quoting from the Estey inquiry report, "In the late 1960's, interest in the formation of new banks revived." The Bank of British Columbia was established in 1967 along with the Bank of Western Canada which never came into operation. The Unity Bank of Canada was established in 1972.<sup>43</sup> There was particular pressure from Western Canada for additional banks to be headquartered in that part of the country. At a Western Economic Opportunities conference in 1973, the premiers of the four western provinces released a joint statement: "The branch banking system, characterized by the five major Canadian chartered banks with branches coast to coast, and head offices in central Canada, has not been adequately responsive to western needs."

Investors stepped in to fill this apparent market niche and, in 1975, Canadian Commercial Bank and Northland Bank were incorporated and headquartered in Calgary and Edmonton, respectively. But as most readers of this paper will be aware, neither case had a happy ending. Their stories will be briefly recounted later in this paper.

### ***The Porter Royal Commission on Banking and Finance***

In 1964, the Porter commission was charged with responsibility "(a) to enquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital-market; and (b) to make recommendations for the improvement of the structure and operations of the financial system".

By the date of the commencement of the Porter commission, it noted that the Canadian economy had grown significantly in size compared to 1933 when Lord MacMillan oversaw the preparation of his royal-commission report. Total financial institution assets at the earlier date were just \$5.5 billion, compared to \$47 billion when Porter's commission was at work. In 1964, Canadian banks continued to be small in number but large in assets, with eight chartered banks as compared to 10 at the time of the MacMillan commission in 1933. However, the largest three banks continued to represent 70 per cent of total assets, as was the case in 1933.

The Bank Act had been amended in 1954 to give banks the power to make National Housing

Association (i.e., government-guaranteed) mortgage loans, and to make personal loans secured by chattel mortgages on personal property (e.g., car loans). At the same time, the Canadian Mortgage and Housing Corp. introduced mortgage loan insurance, taking on the mortgage risk for cases where there was at least a 25 per cent down payment, thereby making home ownership significantly more accessible to Canadians. These amendments permitted banks to enter the business of household lending in a serious way.

Following the recommendations of the Porter commission, in 1967, bank powers were further broadened to remove the previously established interest rate ceiling of six per cent on bank loans, which, as interest rates rose above this level during the 1960s, had effectively forced banks out of the mortgage-lending market. The Porter commission also recommended that banks should have freedom to make conventional (i.e., uninsured) mortgage loans, and that the maximum loan-to-value ratio be increased from 66.67 per cent to 75 per cent. Both of these recommendations were accepted and the Bank Act was amended accordingly in 1967. Banks were now in a position to help fuel the rapidly increasing demand for residential housing and their mortgage-loan books grew substantially as a result. Mainly because of the restrictions on mortgage lending, which did not apply to trust companies and credit unions, banks' assets as a per cent of total financial system assets had declined over the 30 years since the MacMillan commission and, according to the Porter commission report, this was from 44.4 per cent of the total in 1935 to 34.9 per cent by 1962.<sup>44</sup>

The Porter commission report also points out that between 1933 and 1964, the credit union and *caisse populaire* movement expanded substantially, having had total assets of less than \$10 million in 1933 but by 1964 having become a more significant factor in the Canadian financial system with total assets of \$1.5 billion. At the time of the Porter commission, mutual funds were proliferating and by then accounting for 1.7 per cent of financial-institution assets,<sup>45</sup> while they were unknown in 1933. Strong demand for consumer goods between 1933 and 1964 had caused the total assets of sales-finance companies to grow from \$75 million to \$2 billion over the period. With the growth in population and family formation, especially after the Second World War, we see that pension funds also show a strong surge in growth, from a minuscule percentage of system assets in 1935 to fully 10.8 per cent of total financial system assets by 1962.<sup>46</sup> Given that these were the early years when baby boomers were entering the workforce, it is perhaps not surprising that the Porter commission report refers to "the relatively new" pension business.

The Porter commission was not specifically charged with considering the regulatory landscape, but it did recommend that all significant transactions



involving bank share ownership should be subject to prior governmental approval. The commission report mentions<sup>47</sup> that, while not ruling out bank mergers or acquisitions, such approval requirements would “ensure that an excessive concentration of power does not develop.” In fact, rather than adopting the “transaction approval” approach recommended by Porter, the government of the day chose, in the 1967 amendments to the Bank Act, to introduce specific share-ownership restrictions for Canadian banks: no individual shareholder, or group of related shareholders, would be permitted to control more than 10 per cent of the shares of a chartered bank. In addition to meeting the Porter commission objective of ensuring that no one entity would have inordinate influence over the Canadian economy, the rule also served to prevent foreign takeovers of Canadian chartered banks. The so-called “10 per cent rule” also served to somewhat mitigate the risk of self-dealing in the banking field because, with the ownership constraint, it would be difficult for any individual shareholder to engineer transactions that would be primarily for its own benefit.

One other noteworthy aspect of the Porter commission recommendations is that the commission seemed to have an almost prescient approach to a philosophy that is today being adopted by more progressive regulatory authorities, with Canada at the forefront. For example, the report indicates “we have tried to make recommendations which meet the need without at the same time bequeathing a legacy of unnecessary rigidities and obsolete rules which leave the financial system no discretion at all to develop those traits of vigorous innovation and creative competition we deem essential to its success.”<sup>48</sup> This is a good description of the benefits of a principle-based approach as compared to a rule-based approach to regulation.

Turning more specifically to bank regulation, we obtain a sense of the bank regulatory environment of the times when, on page 114 of the Porter commission report, the commissioners comment on the requirements for the establishment of a new bank: “The Inspector General told us that apart from expecting the bank to have somewhat more capital than the law requires and having an interest in the character and standing of the group making application, the government does not set out other requirements.” The report goes on to mention that the board of directors is responsible for the bank’s affairs and that “The only restriction on their powers appears in Section 75 [of the Bank Act] which specifies that loans in excess of 5 per cent of paid-up capital ‘to a director of the bank or to any firm or corporation of which a director or the general manager of the bank is a member or shareholder’ must be approved by two-thirds of the directors present, and the director may not be present at the discussion of any loan in which he has an interest. About 30 per cent of the banks’ authorized lines of credit of \$100,000 or more at the

end of 1962 were to directors, their firms, or corporations of which they were officers or directors, or were guaranteed by them.” Today, transactions with related parties are much more restricted than was the case at the time of the Porter commission.

### ***A Time of Change – 1965 to 1985***

The Porter commission brings us up to the mid-1960s in our look back over milestone events in the evolution of Canada’s financial regulatory system. Between 1965 and 1985, there were no royal commissions or other major investigations of the financial system so let us continue this story by briefly adopting a more personal perspective — that of the author of this paper, who in 1966 was a new recruit at the Department of Insurance (DOI), one of the two predecessor organizations to today’s OSFI.<sup>49</sup>

At that time, the largest life insurance companies were the Canadian mutuals: Canada Life, Confederation Life, Great-West Life, London Life, Manufacturers Life and Sun Life. The property/casualty insurance business was highly fragmented, but most of the larger insurers were members of international groups with professional management. Canadian-owned property/casualty insurers tended to be smaller and were mostly controlled by members of the Canadian establishment. In fact, at that time, the financial system as a whole tended to be relationship-driven with, for example, significant lending decisions being based more on the identity of the principals than on the underlying terms of the proposed deal. No insurance companies were publicly listed. All of the insurers of the day followed conservative operating policies and had low levels of leverage. Minimum solvency requirements for property/casualty insurers, albeit unsophisticated, were included in the law. (For example, section 103 of the Canadian and British Insurance Companies Act (the C&B Act) required general insurers to maintain a minimum margin of assets over liabilities equal to 15 per cent of total unearned premiums and outstanding claim provisions.) Life insurance companies were not subject to any specified minimum solvency requirement, mainly because at that time, the actuarial reserves tended to be so conservatively determined that even if a life insurer had liabilities equal to its assets (i.e., no equity at all), it was thought that it would still be able to meet all policyholder obligations.

Insurance companies were required to submit detailed annual financial filings to the department for review, supplemented by interim financial and investment filings during the year. The annual filings were extensive, running to more than 80 pages, and were in addition to a requirement for annual audited financial statements. Insurers’ investments were highly constrained, having to be judged “eligible” under the conservative investment provisions of the

C&B Act. For example, common shares were only eligible if they had paid a dividend of at least four per cent of their value in the capital-stock account of the company in at least four of the previous five years. This effectively limited common share investments to so-called blue chip stocks. Notwithstanding this high standard for common share investments, the total common share investment of each insurer was limited to a maximum of 20 per cent of assets. Few insurers were anywhere near the 20 per cent limit. Debt securities were subject to a strict interest-coverage test, but if a corporation's common stock qualified for investment, then all of its debt securities also qualified. The C&B Act included a "basket clause," which provided relief from the strict investment rules, for up to seven per cent of total assets. Even so, few insurers had any basket-clause holdings. These conservative investment rules were a legacy of the MacTavish commission recommendations of some 50 years earlier.

While the regulatory framework of the Canadian and British Insurance Companies Act restricted straightforward related-party transactions, such as the loaning of insurance company funds to other corporations controlled by the controlling shareholder of the insurance company, there remained plenty of scope for self-dealing. For example, it was possible for shareholders to purchase an insurance company on a 100 per cent leveraged basis, but then for the new owners to strip surplus funds from the insurer by way of management fees and other transactions, which in turn would be used to liquidate the borrowings that had been used to fund the original purchase. In other words, the insurer's own funds could be used to pay for its purchase, but leave the insurer in a weaker financial position and its policyholders insured but with a much less secure institution.

However, during the latter part of the 1970s, it began to become clear that the winds of change were blowing through the relatively tranquil insurance world described above. This was evidenced by changes taking place in the underlying ownership and management structure of the industry, along with the appearance of new market entrants, which had previously been few and far between. Entrepreneurial players began to be attracted to the business, probably for two reasons. First, there was a view, which had some basis in fact, that the insurance business was somewhat sleepy but had the potential to generate a high return on investment. And second, the then-simplistic regulatory environment with its lack of effective controls on self-dealing, offered considerable potential for accessing what some perceived to be "excess" capital, which in their view could be better employed in other businesses.

This change in the outlook and approach of financial system players during these years was commented on by Ron Suskind in his recent book, *Confidence Men*.<sup>50</sup> He refers to Paul Volcker, the

former U.S. Treasury secretary, as "part of the mid-century's community of prudent men, referees on the field of play, making sure conduct was fair, and cheap shots led to real penalties — and to social sanction. Nothing was worth risking that." Suskind then quotes Volcker, speaking about the obvious abuses that were revealed as a result of the sub-prime mortgage crisis: "There are those like me who say the heart of this system ought to be the banking system, like it was historically, and it ought to be a service organization to take care of the basic needs for its clients ... Its big job is providing someplace for their money, transferring funds around the country, making loans, helping them with investments and the rest. They shouldn't get off doing hedge funds and equity and trying to make all their money by trading. That's my view."

By the end of the 1970s, it was also becoming clear that the rule-based investment regime set out in the insurance law was being subjected to considerable "reinterpretation." In a classic illustration of the weaknesses of rule-based systems, legal firms began to purchase tiny corporate entities, such as companies that had been owned by retiring dentists, strictly to take advantage of the entity's established dividend record. Then, the tiny corporation with the five-year dividend record could be restructured, merged with an existing corporation and its dividend record utilized to facilitate a huge IPO, which would be deemed to be an eligible investment for insurance companies registered under the C&B Act and the Foreign Insurance Companies Act. Many investment trusts and other investment schemes required the "legal for life" designation as a standard for investment purposes, so a positive opinion with regard to being an eligible investment for insurers also opened the door to many other potential buyers of the security concerned.

As a result of these and other similar machinations, the apparently conservative investment rules began to have less and less significance in terms of their implications for market risk of insurance companies. Clearly, the world that currently surrounds us is very different from the world that Paul Volcker was most familiar with — and with the world we have described in the insurance field in the mid-1960s.

We have been speaking in general terms about rising risk profiles and entrepreneurialism, but to actually provide the flavour of the times, let us briefly describe a few of the actual scenarios that played out on the regulatory front for non-life insurance companies:

- There was the case of the insurance company that was reinsuring with a bogus reinsurance broker in the London market, and was accepting the risks in the name of another Canadian insurer, but without any notification to the latter insurer, with reinsurance monies disappearing

- somewhere in the chain of transactions. The ceding insurer was rendered insolvent.
- There was the case of the insurance company CEO who was defrauding his insurer. The regulator gathered evidence and wrote to the board members, pointing out the evidence without naming who might be responsible for the losses. The board members refused to take any action. The CEO was subsequently found guilty of fraud, but the company was insolvent by the time he could be arrested and charged.
  - There was the insurer that was ceding business to a reinsurer in a tax-haven jurisdiction, while hiding the fact that that reinsurer was actually owned by the shareholders of the insurance company — that is, it was a non-arm's-length situation and the reinsurance arrangements were rigged so as to deplete the capital base of the insurer while transferring funds tax-free from the Canadian insurance company to its shareholders in the tax-haven jurisdiction. This type of situation actually arose with a number of insurers.
  - There was the case of the Canadian insurer with an inadequate capital level that undertook a huge volume of high-risk motorcycle business in the U.S., this after having signed an undertaking with the DOI that it would not write any significant volume of such business unless it first bolstered its capital base by a substantial amount. The undertaking notwithstanding, and with no additional capital, the company went ahead with a grand expansion of the U.S. business, which it did not report in its monthly returns to the DOI. When the real financial figures became available, the company had been rendered insolvent. As to the undertaking with regard to the U.S. business, the company merely stated that the undertaking had been inadvertently overlooked.
  - There was the case of the entrepreneur who purchased an ailing insurer, subject to the condition that, in order to maintain the company's licence, additional capital would be injected. The capital was increased by about half of the agreed-upon amount, with the other half to be paid within a few months. On the strength of that, the company's licence was renewed and the transfer of ownership took place. Shortly thereafter, when DOI inspectors visited the company, they found that the newly injected capital had been transferred back to the personal bank account of the entrepreneur. The Department of Justice, representing the DOI, sued the entrepreneur for the missing funds, plus the funds that had been promised. But while the legal wrangling carried on, the insurer had to be closed due to insolvency.

The non-arm's-length practices and other gyrations mentioned above were not generally precluded by the insurance law of the time, although the risks to policyholders could be significant. In fact, we can say that most of the situations described above would have simply been unimaginable in the 1960s. However, as the 1970s progressed, the implications of the changing environment were becoming clear to the insurance regulators of the day.

Nevertheless, they were powerless to do anything other than harangue the concerned companies and shareholders in an effort to get them to change their practices. Unfortunately, by that point in time (the late 1970s and early 1980s), the concept of moral suasion had become pretty much meaningless to those for whom the message really mattered.

To be clear, these types of situations were certainly not occurring with main-line insurers, which continued to go about their business in a professional manner. Nevertheless, insurers like the ones mentioned above, and others that we could mention, tended to take up huge amounts of regulatory resources. As well, the Property and Casualty Insurance Compensation Corporation (the "deposit insurance" parallel for general insurance companies) was only established in 1987, so for cases between 1980 and 1985, some policyholders were badly hurt. When a property/casualty insurer fails, most policyholders (i.e., those with no claim outstanding) lose a relatively small amount — the amount of their unearned premium. But if you happen to be one of the unfortunate ones with an outstanding claim — say your house has burned down and you now find that your insurance is worthless — it is a life-changing event. The pain of the insolvency falls disproportionately on those who have experienced claims.

The run of insurer insolvencies actually extended into the 1990s, with Canada's first-ever life insurance company failures: Les Coopérants in 1992, followed by Sovereign Life in 1993 and then, in 1994, one of Canada's largest and oldest life insurance companies, Confederation Life. And as we will discuss in more detail below, both the Canadian Commercial Bank and the Northland Bank failed in 1986, more than 60 years since the time of the Home Bank collapse in 1923. Finally, as we will also comment on in more detail below, the 1980s saw the collapse of some 23 trust companies in Canada.

We suggest that, substantially due to the increasingly entrepreneurial approach to insurance and other financial businesses, a long period of quite stable financial-institution operation was drawing to an end. For example, after almost 50 years without a significant failure, in the six-year period between 1979 and 1985, seven Canadian property/casualty insurers became insolvent.<sup>51</sup> For most of those seven insurers (Mennonite Mutual was an exception), the CEO was also a controlling or substantial

shareholder, and in a number of those cases, the CEO was also the chair of the board of directors. Also, in a number of the cases, the CEO/shareholder had other business interests, and in the recessionary climate of the early 1980s, the insurance companies were sometimes regarded as a ready source of funding. For insurers involved in self-dealing, as well as other improper and high-risk practices, efforts to apply moral suasion were typically greeted by the phrase “where does it say in the law that we cannot do that?” Corporate governance was virtually non-existent for these insurers, although that did not mean that they were contravening the requirements of the C&B Act.

Officers of the Department of Insurance lacked the relatively sophisticated methods of risk assessment and risk classification that are in use by the OSFI today, but it was nevertheless clear at the time that these were high-risk situations. Fortunately, there was ample documentation of the extensive correspondence and minutes of meetings involving the troubled companies, with clear regulatory diagnoses of the problems and urgent requests for action by management and shareholders (often the same people). The House standing committee on finance, chaired by MP Don Blenkarn, held hearings into these insurance company failures. The initial reaction of committee members was that “the regulators must have been asleep at the switch to allow this to happen.” However, when all the evidence was in, there was, to our knowledge, no criticism of the DOI. And shortly thereafter, in 1985, an important point in the federal government’s green paper on regulatory reform was the need to provide regulators with power to intervene directly in companies’ affairs when circumstances clearly dictate that action is required.

With hindsight, we can see that the changing conditions in the financial markets were part of a more fundamental shift in the entire socio-economic environment that was emerging at that time. Technological change was occurring at an exponential rate, facilitating a more rapid pace of business activity generally, and leading to new products such as daily-interest chequing accounts and to the introduction of ATM machines, greatly increasing consumer convenience. (But as pointed out in the Wyman Report discussed below, the new technology also facilitated “rapid transfers of short term funds in large amounts across international boundaries at the slightest hint of danger.”) This period also saw the coming of age of the baby boom generation, with higher levels of education and increased mobility of citizens, all leading to decreasing customer loyalty and growing expectations for improved service and more innovative products.

All in all, these developments were giving rise to an increasingly competitive marketplace for all types of products, including financial services. And the competitive environment was not limited to

consumer products and services: competition exists for shareholder funds as well as for primary-level products, and many financial institutions were finding it necessary to accept higher levels of risk in order to generate returns that would be judged acceptable by their shareholders.

### ***The Estey Inquiry into the Collapse of the CCB and Northland Bank***

The small western banks that failed in 1986, Canadian Commercial Bank (CCB) and Northland Bank, were part of this new spirit of financial entrepreneurialism that was emerging in North American financial markets. The main problem for both CCB and Northland was that these banks lacked the gravitas to attract large clients, and thus, found that most of their business consisted of loans to small, western-based businesses, and often to entities whose loan applications had already been declined by the large chartered banks. Their loan portfolios, therefore, typically consisted of transactions with a less credit-worthy sector of the economy, often including members of cyclical real-estate and energy businesses. It was precisely these types of businesses that were the hardest hit by the early-1980s recession, which was particularly severe in western Canada.

According to the Estey inquiry report, “The evidence is open to the interpretation that the improvident lending practices of these banks created a demand from those lacking in the capacity to repay their borrowings and to whom credit should not have been extended.”<sup>52</sup>

Unlike the situation with the insurance companies, the bank regulator of the day, the Office of the Inspector General of Banks, did not seem to be aware of the significant risk levels that were building up in the two small banks. With regard to the failure of Northland Bank, the Estey commission commented: “It is necessary in the face of the record compiled by this Commission to conclude that although the OIGB was in possession of all the information essential to a true comprehension of the state of affairs in Northland, awareness did not come. Even if it had, the will to respond was missing.”<sup>53</sup>

Regulatory ineffectiveness was also cited by Estey as a significant factor in the ultimate failure of CCB: “The OIGB, by reason of its position in the statutory pattern for the regulation of banks, must bear much, but not all of the blame for this condition and for what transpired. As mentioned earlier, the Inspector General was aware of the state of the bank and failed to act.”<sup>54</sup>

One must recall that while the Office of the Inspector General of Banks had been established in the 1920s, even some 60 years later in the 1980s there was no established tradition of hands-on bank regulation in Canada. The mandate of the OIGB was essentially to rely on the auditor and the audited financial statements as being sufficient to reveal the

true financial position of every bank. The OIGB carried out no on-site inspections and had no tradition of probing to understand the operational details behind the reported figures. In the U.K., which as in many areas of activity had great influence on the pattern for Canada, there was no bank regulatory statute at all until 1979, and in fact it was only in 1987 when the impact of European Union rules began to be felt that the Bank of England was given the power to request information from banks and to carry out inspections.<sup>55</sup> From today's perspective this historical information about U.K. bank regulation seems almost incredible.

The marked differences between the regulatory regimes for banking and insurance during the 1980s and prior were reflected in the staffing requirements of the respective insurance and banking regulatory bodies. In the early 1980s, the Department of Insurance had a total of approximately 75 employees operating out of offices in Ottawa, Toronto, Halifax, Montreal, Winnipeg and Vancouver.<sup>56</sup> By contrast, in 1984 the Office of the Inspector General of Banks had only 14 employees classified as inspectors, analysts or the equivalent, working from a single office in Ottawa.<sup>57</sup> A sense of the somewhat hands-off approach of the bank regulators is also conveyed by the comments mentioned earlier (see page 12) from the Porter commission, indicating that the OIGB did not have particularly stringent requirements for new bank incorporations. Banks were, in a sense, expected to self-regulate, as the provisions in the Bank Act and regulations were much more substantial than were the resources allocated for their oversight.

One might reasonably wonder about how two federal financial regulatory agencies, the OIGB and DOI, could be following such different operational policies. We suspect that the DOI's more hands-on approach to regulation was grounded in the MacTavish commission's findings early in the century, which recommended quite detailed oversight for insurance companies.

Comparable recommendations were never made in the banking area, even after the failure of Home Bank in 1923. As to why the differences persisted, apparently without any attention being given to the policy dichotomy between the two agencies, we can only suspect that as often seems to happen, organizations do not have a natural tendency to work together: during some periods, their head offices were actually located in the same office building in Ottawa.

### ***The Trust Companies***

A trust company is similar to a bank except for three important differences. First, while banking is an exclusively federal concern, the federal government as well as provincial governments is able to incorporate and regulate trust companies. Thus, in each province of Canada that has incorporated trust companies, there is a department or ministry that is

responsible for their regulation. (Federal trust companies are regulated by the OSFI, and before the OSFI was created, they were regulated by the Department of Insurance.) So, for example, Ontario-incorporated trust companies are overseen by the Financial Services Commission of Ontario. Second, banks are the only financial institutions to have unfettered commercial lending powers. Trust company powers in this area differ by jurisdiction of incorporation but generally speaking, commercial lending limits are based on capital levels. The third and perhaps most important distinguishing feature is that trust companies are empowered to administer trusts and to hold assets in trust for their clients. Banks do not have this power.

While developments in bank regulation have been outlined above, the actual business powers of banks were somewhat limited until the latter half of the 20th century. As mentioned under the heading for the Porter commission, until 1967, banks were not empowered to engage in conventional mortgage lending. This left a significant market niche for non-bank financial institutions, especially after the Second World War, when the Canadian economy was growing rapidly and the emergence of the baby boomers into their years of family formation meant that new home purchases and concomitant mortgage lending was also subject to a vast expansion.

The market niche was mainly filled by trust companies and credit unions, which were able to grow quickly because of the demand for their services, which included the power to issue residential mortgages. According to Lew and Richardson (quoting Neufeld), "in 1950 the chartered banking sector held over half of all financial assets, but by 1965 it had declined to only one third, due to growth in these competing sectors."<sup>58</sup>

Trust companies reached their zenith during the 1970s and early 1980s, but relaxation of the rules constraining banks' ability to participate in the mortgage market enabled the banks to gradually but inexorably increase their share of that business, at the expense of the trust companies. Banks were also keen to be able to provide the broadest possible range of financial services to their clients. Although trust powers were not available to them, they were able to overcome this difficulty by acquiring trust companies and holding them as subsidiaries. An additional factor prompting the acquisition of major trusts by chartered banks was the federal government's decision in 1998 not to allow mergers between Canada's chartered banks. With that decision, Canada's chartered banks began to look elsewhere for growth by acquisition, and the more substantial trust companies were logical targets. By 2000, with the acquisition of Canada Trust by TD Bank, almost all of Canada's major trust companies had become affiliated with chartered banks.

The website of the Canada Deposit Insurance Corporation (CDIC) indicates that since 1970, 43

deposit-taking institutions have failed, including CCB and Northland. Although this period of CDIC payouts covers more than four decades, fully 53 per cent of the total number of failures occurred during the 1980s, and except for the two banks, virtually all of the failed institutions were trust companies. (Insurance companies are, of course, not members of CDIC.)

In 1983, there was considerable public concern when the government of Ontario felt that it had no choice but to take control of Seaway Trust, Greymac Trust and Crown Trust, as well as several associated companies. The collapse of these institutions, widely known as “the trust companies affair,” involved significant fraud, and the key principals, Leonard Rosenberg, William Player and several cronies, were found guilty and served time in jail (Player was sentenced to 15 years; Rosenberg to five years). Essentially the fraud involved the pyramiding of property flips based on dodgy appraisals, with the “profits” from one flip being used to finance larger flips, aided by financing provided by the trust companies that were controlled by the principals. The final “deal” involved the resale of 10,931 apartment units in Toronto, which had ostensibly been purchased for \$271 million, with the entire package being flipped and then flipped again, all within a few days. The final “sale,” supposedly to a group of Saudi investors, was to be for a payment of \$500 million. The sustained losses represented a substantial claim on the CDIC depositor protection fund, to say nothing of uninsured losses of individual depositors.

The failure of a significant number of trust companies over a 40-year period, with a particular concentration in the 1980s, was relevant to the evolution of financial regulation because, in combination with the bank and insurance company failures, it emphasized that there was a newly emerged volatility in the financial system, which was having substantial impact on financial institutions. In turn, this galvanized governments with regard to the need for a significant restructuring of Canada’s financial regulatory system as a whole. At the same time it has to be said that the failures of both the insurance companies and the trust companies were not very significant to the financial system per se, because the failed institutions were small relative to most other institutions in the financial sector. In the case of the trust companies it was also the case that most were regulated by provincial governments and therefore subject to regulatory regimes that were not necessarily representative of those applicable to the much larger, federally supervised banks and insurance companies.

### ***The 1980s: Lessons Learned***

The previous pages have described how an evolving business environment for banks and insurance companies during the 1970s was accompanied by a

rising tide of incipient financial risk. Altogether, between 1981 and 1985, the time of the federal green paper on financial regulation, there were seven insurance company failures, 11 trust and mortgage loan company failures, and a support package had to be extended to a small chartered bank (that being CCB, which would ultimately fail along with Northland Bank in the following year).<sup>59</sup> According to the CDIC web site, 10 of the trust company failures occurred in just two years: 1985 and 1986.

In 1985, the federal government undertook a comprehensive policy review of the whole area of financial regulation. This was accomplished through two main initiatives: (1) The Working Committee on the Canada Deposit Insurance System (the Wyman committee) and (2) the green paper issued by the Department of Finance: “The Regulation of Canadian Financial Institutions: Proposals for Discussion.”

Although the remit of the Wyman committee was focused on the role and operations of CDIC, the committee felt that it should consider policy options for CDIC in the broadest possible context, and accordingly looked at the then-existing framework for financial-institution regulation. The committee identified many shortcomings and made valuable suggestions for improvement. Some of the key recommendations made by the Wyman committee, which were subsequently adapted by the government to be part of the new framework, are outlined below:<sup>60</sup>

- The regulator should take a leadership role in determining uniform examination standards and develop an early warning system to detect problems at an early stage.
- The regulator should develop a “performance rating system” for institutions, including determination of appropriate “break points,” which would correspond to “various levels of difficulty in order to standardize appropriate courses of remedial action.” (This corresponds to the OSFI’s Guide to Intervention, which is an important component of the current risk-based operational framework.)
- The regulator should be able to levy significant penalties against regulated institutions, including their management, directors and professional advisers, to ensure compliance with the statutes, regulations and guidelines.
- The regulator should have the power to become “directly involved in the affairs of problem institutions.”
- The regulator should develop detailed standards for leverage.

It should be noted that most of the above references to “the regulator,” were actually envisaged by the Wyman committee as being CDIC — i.e., in order to protect its position as an insurer, CDIC would itself have a number of direct regulatory powers. The government ultimately opted for a more

neutral role for CDIC, with the main regulatory powers to be exercised through the OSFI, but the thrust of the recommendations were considered to be worthwhile.

The federal green paper acknowledged that the existing financial regulatory system was outmoded, with increasing numbers of deposit-taking institutions and insurance companies getting into financial difficulty, and the grave consequences this had had for affected consumers, along with the potentially disruptive impact that this trend could have on the greater economy. (The year was 1985, with the failure of Canadian Commercial Bank and Northland Bank still to come in 1986, to be followed by other failures, including the insolvency of the massive Confederation Life in 1994.) Accordingly, the paper emphasized, inter alia, the following key areas for attention:

- Strictly controlling self-dealing by essentially “banning” such transactions for all federally regulated financial institutions.
- Guarding against conflicts of interest by enhancing and clarifying the regime applicable to conflicts of interest and also by establishing a

new public body to investigate consumer and other complaints where conflict-of-interest abuses are suspected.

Enhancing the powers of regulators to enable them to properly carry out their responsibilities.

- Clarifying and simplifying the regulatory structure, possibly by consolidating the Office of the Inspector General of Banks and the Department of Insurance.
- Ensuring the soundness of financial institutions and the stability of the financial system.

In addition to the two most prominent investigations of the time — the federal green paper and the Wyman report — there were numerous other bodies that carried out investigations and made recommendations for change. These various analyses were all prompted by the spate of financial institution insolvencies in the 1980s, and in their totality they gave rise to a powerful consensus that major change was needed. Table 1 below outlines key issues that were identified after the financial failures in the 1980s, along with the important measures that were introduced by the federal government to address them:

**Table 1.** Financial failures in the 1980s and corrective measures of the regulators in Canada

Identified Weakness	Corrective Measure (1987 OSFI Act and 1992 New Legislation)
Lack of co-ordination between Office of the Inspector General of Banks and Department of Insurance, even though there was increasing convergence between banking and insurance (banks owning insurance company subsidiaries and life insurance companies increasingly promoting wealth-management and savings products).	Formation of the OSFI to take over regulation of all federal financial institutions. Also, formation of the Financial Institutions Supervisory Committee (FISC), which meets quarterly to discuss systemic risk issues and developments with regard to federally regulated financial institutions. Members of FISC are: The OSFI, the Department of Finance, the Bank of Canada, the Canada Deposit Insurance Corporation and the Financial Consumer Agency of Canada.
Lack of effective controls with regard to related-party transactions.	Related-party transactions effectively prohibited, except for those of nominal value. New requirement for conduct review committee of board (majority of independent directors) to approve “nominal” transactions based on being at market value and in interests of institution.
Obvious ability of players to “get around” rule- based regulatory regimes.	Much greater emphasis on principle-based approach, with guidance as to interpretation.
Lack of a comprehensive regulatory regime for banking, including minimum capital requirements and on-site inspections.	Harmonization of regulatory framework for banking and insurance, which means banks are subject to minimum capital requirements and regular on-site inspections. Increasing adoption by the OSFI of international regulatory standards in banking and insurance. (In fact, as an active member on international committees, the The OSFI has a significant influence on the development of these standards.).

Identified Weakness	Corrective Measure (1987 OSFI Act and 1992 New Legislation)
Lack of meaningful standards with regard to corporate governance, risk management and internal controls.	New legislation sets out detailed responsibilities of boards of directors, including in respect of governance, risk management, internal controls and other key areas of financial-institution management. Also imposes clear conflict of interest disclosure requirements and stringent “duty of care” for directors and officers. High standards of corporate governance are front and centre in the new financial regulatory framework.
Lack of a risk-based perspective by both the Office of the Inspector General of Banks and the Department of Insurance.	The OSFI develops a comprehensive risk-based approach to its regulation of financial institutions. This requires a formalized, consistent and as-objective-as-possible methodology for assessing risks across the range of financial institutions. The OSFI develops a “Guide to Intervention” for the benefit of its own personnel and for industry members, setting out the types of OSFI responses that can be expected at different levels of risk in
Although the Department of Insurance carried out on-site inspections and received a considerable amount of financial data from insurers, its regulatory processes were mainly based on long-ago developed routines and procedures, many of which were outmoded and inefficient. Information obtained from on-site inspections was not interpreted in a consistent, risk-oriented manner.	All processes are reviewed to incorporate a risk-based perspective and a principle-based approach to regulatory operations. Many “old” procedures are considered to provide insufficient value-added for resources expended, and are dropped. Replaced by risk-based procedures that are designed to focus resources where there are the greatest risks to individual institutions and to the financial system as a whole.
Insufficient recognition by government of importance of financial regulation, as attested to by negligible resources dedicated to bank oversight and (by today’s standards) to insurance regulation. Salary levels were linked to public service, which made it difficult (although not impossible) to attract staff members who had qualifications and expertise comparable to industry counterparts, making it hard to oversee the financial industry in an effective manner.	The OSFI currently has in the neighbourhood of 600 employees and is authorized to follow industry norms when establishing salary levels. This means that the OSFI can employ professional actuaries, risk-management experts, financial engineers and other personnel that are critical to staying on top of developments in the financial industry.
Financial institutions are diversifying into new types of businesses, directly and through acquisitions, and this is blurring the lines of the traditional financial pillars.	In order to ensure transparency and regulatory coherence within policy boundaries for new business development, a formal system of financial holding companies is adopted. This will enable institutions to accommodate new types of business within a single corporate grouping, primarily by requiring each type of regulated business to be carried out within a regulated entity that sits downstream from the regulated holding company.

These were far-reaching revisions: after many years of gradual, evolutionary change in the regulatory laws and practices governing financial institutions, there was suddenly a tremendous burst of creative activity. Our view is that the regulatory innovations that mostly had their genesis in the mid-1980s and early 1990s, were an important contributing factor with regard to Canada’s excellent performance through the recent financial crisis.

### *An Apparent Paradox?*

At first glance it might seem as though arguments developed in the foregoing pages give rise to something of a paradox. On the one hand, we suggest that, to a material extent, the excellent performance of the Canadian financial system through the recent financial crisis is largely attributable to developments that commenced with the creation of the OSFI and the new legislation of 1992. But on the other hand, as can



be seen from the historical sections of this paper, no Canadian banks or insurance companies had to be closed during the Great Depression, which was an even steeper decline than that experienced during the recent crisis.

We have asserted that until the creation of the OSFI in 1987, and certainly during the 1930s, bank regulation was relatively minimal. And, as was demonstrated by the failure of a number of insurance companies in the 1980s and 1990s, insurance regulation was also far from optimal, including during the time of the Great Depression. Taken together, these points might suggest that the factors leading to the resilience of Canadian financial institutions must have been in place long before the events of the 1980s and early 1990s. How do we reconcile an argument that recent improvements in the regulatory framework have given rise to a world-class system when, even 50 or 60 years before the development of that system, Canadian institutions seemed to be able to satisfactorily ride out the greatest economic decline the developed world has experienced?

A situation that is not typically referenced among the historical milestones of Canadian financial-institution development is that during the 1930s, a number of Canada's life insurers, most notably Sun Life, which was the largest Canadian life insurer at that time, were in fact technically insolvent. This was common knowledge among staff members at the Department of Insurance during the author's tenure with the DOI. To confirm that this was not some kind of organizational legend having no basis in fact, one may access various scholarly references on the subject. For example, Kryzanowski and Roberts state that their research "provides extensive evidence of the insolvency of Canada's largest life insurance company of the day, Sun Life. It also shows that six of nine of Sun Life's Canadian competitors were also probably insolvent."<sup>61</sup> In an earlier paper<sup>62</sup> the authors presented evidence to show that one of Canada's largest banks, the Bank of Montreal, was insolvent on a market-value basis during most of the 1930s. The fact is that the government essentially colluded with the management and boards of these institutions to mask the fact that they were technically insolvent. For example, in responding to questions in the House of Commons about Sun Life's solvency, then prime minister R.B. Bennett made the following (convoluted) statement in Parliament: "My duty was to see to it that without further instructions than those which I have indicated to the House as values — that apart from that our officials should make a report which would enable me to say to the people of Canada and elsewhere, who were depending on the solvency of this great enterprise, that it was solvent."

Prior to its amalgamation with the OIGB in 1987 to create the OSFI, the Department of Insurance was responsible for an annual publication known as the *List of Securities*, which included all of the

investments of federally licensed insurance companies, along with the DOI-approved year-end market value for each security, to be utilized by insurers for financial-reporting purposes. For a number of the Depression-era year-ends, the Department used what it referred to as "authorized values," which were not market values at all but were in fact considerably higher. With the use of authorized values, every Canadian insurance company was able to produce a balance sheet that showed it to be solvent. Thus the prime minister could indicate that he had a report from his officials which would enable him to say that Sun Life was solvent.<sup>63</sup>

These Depression-era situations might be considered as representing early application of the "too big to fail" doctrine, which in turn, would imply that there was careful analysis of the pros and cons of the various options as part of a formalized decision-making process. On the other hand, during a time when transparency was not a pervasive preoccupation the way it is today, it is also possible that no government felt that it could be seen as a messenger carrying such bad news, especially during an era of high unemployment and other dismal financial statistics, and that the politically expedient course of action (or inaction) was to hope that the problems would gradually be cured over time. In thinking about this latter possibility, one must reflect on the fact that in the several years preceding the Home Bank failure, a number of the bank's directors wrote to the minister of finance expressing their view that the bank was likely to become insolvent, if that situation did not already exist, but no action was taken by the government of the day.

There is a fine line between regulatory forbearance as part of a well-considered "too big to fail" policy, and pure inaction because of the lack of a political will. The author of this paper has carried out many regulatory development projects in emerging market countries. It is not uncommon to find that there are insolvent institutions, sometimes among the most sizable in the marketplace, that are still actively transacting business. In most of these cases, there is no policy of "too big to fail"; there is only a fear by ministers of the government that by being the messenger bearing the bad news, they may be the ones to suffer, if not literally, then certainly at the ballot box. One of the most difficult changes to make in these jurisdictions is to get the local government and the regulator to begin meaningful measures of intervention designed to either take an institution out of the market, or on the basis of rational policy analysis, to conclude that the institution is too big to fail and to take whatever steps might best be appropriate to contain the problems rather than doing nothing and having them worsen.

### ***The McKay Task Force — Reforming Canada's Financial Services Sector***

The McKay task force, convened in 1996, was not a royal commission and it did not particularly focus on issues related to prudential regulation, nor did it feature a review of Canada's financial services history, as was the case for most of the previously cited commissions. To the extent that a regulatory perspective was adopted, it was mostly with regard to competition and consumer service. A number of recommendations were brought forward that were intended to increase competition among deposit takers, including reduced capital requirements to promote the incorporation of new banks, freeing up the ability for credit unions and *caisses populaires* to expand their services, and broadening the membership of the Canadian Payments Association. There were also a number of important consumer-related recommendations, including enhanced transparency of financial contracts, protection of privacy, and increased emphasis on avoidance of coercive tied selling. Consumer-protection recommendations led to the establishment of the Financial Consumer Agency of Canada and a system of financial ombudservices to look into public complaints across the financial services sector.

### **Overview of the Canadian System Today**

In this section, we outline the main characteristics of the Canadian financial regulatory system as it exists today, with particular emphasis on the areas that we believe to be most responsible for its effectiveness.

- Integrated supervision: The job of assessing risk in the financial system can be compared to putting together a jigsaw puzzle. A person looks at all the pieces and begins to move them around looking for a pattern to emerge, which can then be further built upon. But if there are a number of players holding different pieces of the puzzle, it will take much longer for anyone to recognize the image. Similarly, when there are different regulators looking at different parts of the financial system, it is all too easy to see only a part of the picture and therefore not recognize what is really happening. Unfortunately, this difficulty is compounded by a characteristic of human nature whereby executives in different institutions usually seem reluctant to share information with their counterparts in other institutions, often because of competitive rivalries, individual egos, turf wars and so on. A single regulatory agency (or minimal number of agencies) minimizes the potential for this type of difficulty.

Another advantage of an integrated approach is that it substantially diminishes the danger that responsibility for different parts of a complex financial system, or newly developing parts of that

system, will fall between the cracks, with no regulatory agency assessing the risks that may be emerging in that particular area. If something new is happening, each agency may be able to quite correctly say “that is not our responsibility.” It is no one's responsibility because the new activity was not previously contemplated, and therefore, is not included in the remit of any of the individual agencies. By contrast, when any new financial institution product or activity now comes over the horizon in Canada, the OSFI, as the sole financial regulator, is expected to begin thinking about its risk implications for the system and for individual entities.

- Principle-based/outcome-based approach as opposed to rule-based/compliance-based approach: The experience of the old Department of Insurance, with its detailed investment rules, provides a good example of the way in which rules can be subverted. As well, in the course of our regulatory career, we have often come across situations where rules that were promulgated long ago have clearly become obstacles to good public policy, merely because the present landscape is entirely different from what existed when the rule was brought into play. It is far better to lay out more fundamental principles which need to be respected, with clear guidance as to what is to be achieved.

Risk-based approach: The OSFI has developed a sophisticated framework for assessing risk across different types of institutions, using formalized, consistent methodologies that are as objective as possible, to assign risk ratings to all institutions. Regulatory resources are allocated based on risk ratings, as well as the overall impact on the public in case of failure. This approach ensures that time is not wasted on activities where risk is low, as was often the case in the days of the Office of the Inspector General of Banks and the Department of Insurance.

- Sound capital requirements: The extent to which assets exceed liabilities is the fundamental measure of the quantum of loss that can be absorbed without becoming insolvent. In good times, capital relative to assets or liabilities can be quite small — say, only a few percentage points — because losses are not expected. Of course, the caveat is that losses tend never to be expected, but we know that they do occur from time to time. The OSFI has been successful in holding firm to higher capital levels in good times and bad, and there seems to be little doubt that these requirements helped Canadian financial institutions to weather the storm of the recent financial crisis. In fact, the OSFI makes it clear to regulated institutions that they are expected to maintain working-level capital positions that are at least 150 per cent of the minimum permissible level.
- Escalating intervention based on risk versus compliance-based approach: The OSFI has, and

international standards require, the power to apply preventive and corrective measures on an escalating basis as risk increases. For example, suppose the regulator notes that in an otherwise well-run institution there has been an increasingly significant series of difficulties in the IT area, leading to control and other related issues. The first step would be for the regulator to bring the situation to the attention of management and to require a well-thought-out plan to address the issue. If the plan is not effective or is not followed, the regulator would follow up, perhaps by meeting directly with the board, and insisting that steps be taken to get the problem under control. If there continues to be no effective action, the regulator might consider other possible interventions, such as requiring the institution to increase its capital base to offset the higher level of risk, or requiring that the institution bring in new management with respect to the area of concern. The point is that the regulatory agency is adopting the same approach that would be followed by any competent management team in addressing a business issue: first there will be a plan to be implemented and tracked and, if it is not doing the job, more serious measures will be identified and implemented by management as required. The regulatory agency is merely requiring management and the board to follow the same path as should be adopted by them in dealing with any business weakness.

This is to be compared with a compliance-based approach, where the regulator imposes fines and other penalties for “breaking the rules.” When institutions pay fines, the payments only reduce the financial resources of the institution. More importantly, fines are paid by the institution, not by the managers who are making the decisions, so they tend to have a minimal effect on the decision-making process, which is where the changes need to take place. And we would say, most important of all, fines and other compliance-based actions are, by definition, only imposed when the rules have been broken, by which time the damage may already have been done. Effective regulatory oversight is based on risk assessment and working with management, backed up with the ability to enforce change when it is clearly required. Fines and other penalties don’t do the trick.

- High standards of corporate governance: The quality of governance within an institution is the foundation for effective management of that institution. The board must establish a clear framework for the organization’s strategic direction, control framework and risk appetite across the risk areas that are relevant to the institution’s operations. In this regard, one of the clear messages from the failures in the early 1980s was that boards of directors had not focused on the importance of effective systems

of corporate governance. Many critical decisions were made by managers in different functional areas, without board oversight, resulting in highly inconsistent risk decisions and internal standards for different parts of the business. Rather than making sure that they were satisfied that the business was being operated in an effective fashion, including risk management, internal controls, internal audit, etc., boards tended to be comprised of friends of the CEO and controlling shareholders, without much consideration of their responsibilities and the expertise these directors might bring to the boardroom table. Today, one of the OSFI’s main areas of focus, including assessing the overall risk level of the institution, is the quality and effectiveness of the institution’s corporate governance framework. The statutes set out in considerable detail the responsibilities of board members, including the particular duties of members serving on the obligatory audit committee and conduct-review committee, both of which require a majority of independent-director members.

- Strong “duty of care” provisions: Although part of the corporate governance requirements, the duty-of-care provisions in Canada’s financial institution laws (which are the same as are applicable to other corporations under the Canada Business Corporations Act), make the significance of directors’ and officers’ responsibilities very clear. For example, there is a duty to act in the best interests of the *institution*, which includes key stakeholders such as depositors and policyholders. Thus, if a proposition were to come before a bank board which was clearly favourable to the bank’s shareholders but very unfavourable to the bank’s depositors, the board members would have to strike a balance that is beneficial to the institution as a whole. Our view is also that clear, strongly worded duty-of-care provisions have a highly beneficial impact on the operation of the system as a whole, in terms of fostering an overall risk-tolerance level that is appropriate for a financial institution. However, this is a subject for future investigation, as we are presently not aware of any quantitative studies or other research that would substantiate this “hunch.”
- Control of related-party transactions: Another important cause of institutional failure was the ability of financial institutions to enter into transactions with related parties. Financial institutions have, by their nature, access to large amounts of cash and liquid assets. When institutions have controlling shareholders that own other businesses, those shareholders can be tempted to reach into the controlled institution to obtain funding. For example: by making loans

to themselves on extremely favourable terms, by “buying” real estate and other assets at below market value, by selling assets to the institution for cash and at values that are higher than market value, and so on. The 1992 legislation introduced a general prohibition on related-party transactions in both banking and insurance, except for those of nominal value. Even those, however, are required to be pre-approved by the conduct-review committee, which must have a majority of independent directors, and also subject to the criteria that the transaction be on terms that are at least as favourable as market value. (Note that related-party transactions were more of a regulatory issue for insurance than for banking because, as previously mentioned, the Bank Act revisions of 1967 prevented any individual shareholder, or group of related shareholders, from controlling more than 10 per cent of the shares of a chartered bank.)

- Disclosure of conflicts of interest: The laws now require directors and officers to fully disclose to the board any conflict of interest that may arise in connection with their responsibilities to the financial institution. The director or officer concerned cannot be a party to any discussions related to the transaction in question. Failure to disclose a conflict of interest results in the disqualification of the individual from his or her position and renders him or her ineligible to act as a director of a federal financial institution for five years from the date of the contravention.
- “Fit and Proper” requirements for all directors, officers, shareholders and key professional advisers required to be appointed by law: International standards, to which Canada ascribes, require all key personnel to be fit and proper. This means that there must be nothing in their backgrounds that would provide reason to believe that they may be inclined not to act in the best interests of the public. Obviously a prior history of illegal activity or inappropriate role in an institutional insolvency would be grounds for the regulator to block an individual’s appointment. Another area that could give rise to a regulatory veto would be a lack of qualifications in terms of education or experience. The point is that if there are reasons to believe that, from a public policy perspective, it would be inappropriate for an individual to be appointed to a key position in a financial institution, then the appointment should be blocked by the regulator.
- Existence of Consumer Compensation Plans: Although Canada is certainly not alone in this regard, the entire regulatory system is underpinned by a series of consumer compensation schemes that provide assurance to members of the public that, even if their financial institution becomes insolvent, they will

be protected within the limits of the relevant plan. The Canada Deposit Insurance Corporation, for deposit-taking institutions, established in 1967, is of course the most significant of these plans. But there is also, for life insurance, Assuris, established in 1990, and the Property and Casualty Insurance Compensation Corporation (PACICC) for general insurance, established in 1987. Each of these plans provides limited coverage so as to minimize the potential impact of moral hazard — i.e., the possibility that the existence of the plans will take away the incentive of consumers to deal with the most reputable and well-managed enterprises, rather than merely those that pay the highest rates of interest or have the lowest insurance premiums. As someone with regulatory experience, the author can also attest to the fact that the presence of these plans is conducive to early and objective intervention by the regulator. Without such plans, regulators cannot help but be mindful of the fact that the act of closing an institution’s doors will plunge large numbers of innocent consumers into a nightmare of financial disruption — and this knowledge seems inevitable to cause some delay in “pulling the trigger” on closure, as there is hope (or rather, wishful thinking) that something may materialize to make this unnecessary.

The OSFI supervisory framework is described in considerable detail on its website at: <http://www.osfi-bsif.gc.ca/eng/fi-if/rai-eri/sp-ps/pages/sff.aspx>. (Note that, in international parlance, which is used by the OSFI, “supervision” generally refers to the practices, policies and procedures utilized by the agency to meet its objectives. On the other hand, “regulation” generally refers to the legal and statutory requirements applicable to licensees.)

The International Monetary Fund (IMF) and the World Bank conduct the Financial Sector Assessment Program (FSAP), where teams of investigators are sent to specific countries (with the agreement and co-operation of the country concerned) to painstakingly compare the local regulatory framework with the applicable international standards. The most recently available IMF FSAP for the Canadian financial system (January 2014) indicated that “Canada has a very high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs). In response to the challenges and structure of its market, the Canadian banking supervisor (OSFI) has developed, and is a strong proponent of, risk based, proportionate, supervisory practices and applies a ‘close touch’ approach to its supervised entities. The supervisory approach is well structured, forward looking and maintained on as dynamic a basis as possible. Entry to the Canadian market is subject to demanding prudential entry standards.”

As a generalization, one can say that institutions are required, first at a primary level by the basic terms

of the statutes, but secondly and more profoundly at an operational level by the OSFI's policies and guidelines, to adhere to sound business and financial practices in the transaction of their businesses. In other words, the Canadian requirements for financial institutions are consistent with what one might include in an MBA textbook intended to guide management in the operation of a sound institution. We say: "How can any regulatory system do better than that?" In contrast, we find it impossible to believe that any prescriptive framework, acting over a diverse group of financial institutions, could ever hope to approach a situation of optimality in terms of meeting desired regulatory objectives.

We also suspect that Canadian corporate governance requirements for financial institutions are more stringent than those applicable to most other jurisdictions and particularly to U.S. financial institutions. However, to reasonably compare the Canadian and U.S. systems across this dimension requires knowledge not only of what the laws in each country state, but also how the courts have interpreted those laws. That is outside the scope of this paper, but we flag it as a possible area for future research.

Of course, no system is perfect or incapable of improvement. While systems can be designed in theory, in the real world, there are usually issues with implementation and administration that conspire to produce results that are sub-optimal compared to theory. According to the OSFI's mission statement and other documents, its role is not to prevent the *failure* of financial institutions, which is the responsibility of institution managers and boards of directors, but rather "to protect depositors and policyholders from undue loss." In this regard, a possible emerging issue, based only on speculative comments by some industry members, is that after receiving international accolades for good performance of the Canadian financial system during the crisis, the OSFI may now be overly conservative in its application of the supervisory framework, feeling that it cannot allow its good record to be tarnished by a failure.

If the foregoing point has any credibility, it would be adding to one concern that we have heard expressed for as long as the OSFI has been applying its guidelines and policies. In the documents laying out those guidelines and policies, the OSFI always indicates that the agency "recognizes that regulated institutions may have different practices depending on their size, ownership structure, nature, scope and complexity of operations, corporate strategy, and risk profile." In other words, we have written our policy or guidance to apply to a large chartered bank, but don't worry, if you are a small operation we will take account of that when we interpret the policy for your particular institution. Many of our industry contacts are in the property/casualty insurance field, where company sizes tend to be a minuscule fraction of the size of a chartered bank. Many of them suggest that

while the OSFI *says* size and complexity will be taken into account, the regulatory troops on the ground will want to ensure that they are not criticized by their superiors who will be reviewing their reports. We suspect that from the perspective of frontline workers who are inspecting the companies, they believe they will be more likely to be criticized for missing something in the application of a guideline than to be complimented for their thoughtful interpretation that fully takes account of the size and complexity of the regulated entity. Thus, the feedback we get from insurers is that there is a tendency, despite the caveat about size and complexity, to apply the full weight, or at least *much* of the weight of big-institution requirements to small institutions.

Most of this paper is about the regulatory framework and how it works to ensure system stability. At the outset of the paper though, we recognized that a good system must also balance that particular goal with the overall efficiency of the markets. Too much regulation is definitely not a good thing. While the system may be very stable it may also have high overhead, leading to low return on investment, dissuading shareholders; and it may be so constrained as to lack innovation and product development, penalizing members of the public.

In this regard, we have to say that, in our view, the current regulatory system seems to strike a reasonable balance with regard to market efficiency. The use of principle-based and outcome-based approaches leave boards and senior managers free to design operational policies that are a good fit with their overall core competencies and strategic plans. However, the proof of the pudding is in the eating, and over the past 12 years — which includes the period of the financial crisis — Canadian banks have generated pre-tax return on equity (ROE) ranging from a low of 19 per cent in 2008 to a high of 37 per cent in 2006, with an average of 31 per cent over the period.<sup>64</sup> We think it would be hard to argue that, with these metrics, Canadian banks are finding themselves saddled with a regulatory regime that is stifling their ability to generate sufficient profit to be attractive to investors. (But we also acknowledge that a simple statistic like annual ROE doesn't necessarily "measure" market efficiency.)

However, that takes us back to the points made just above. If the system is market efficient for Canada's big banks, it does not necessarily mean that the same is true for small institutions such as property/casualty insurers. Indeed, the property/casualty business has certainly not enjoyed industry-wide ROEs that are comparable to those of the chartered banks, although there may be many other reasons why this would be the case. As well, if there is truth to the "street talk" with regard to an increase in the OSFI's conservatism since the time of the financial crisis, for whatever reason, then market efficiency may be declining at the expense of an over-emphasis on stability. At the end of this paper, we

take note of the market-efficiency question as one for possible future research.

### **Other Regulatory Factors That May Have Helped Canada to Perform Well During the Crisis**

In the sections above, we have outlined the main characteristics of the Canadian financial regulatory framework and have expressed the view that the system's design and operation have been significant, if not primary, reasons for Canada's ability to weather the financial storm of the sub-prime crisis.

However, it is clear that there have been other factors that have also been to Canada's benefit in terms of its recent financial system performance.

One distinguishing feature of the Canadian system is the degree to which governments of the day have been prepared to work on a collaborative basis, as opposed to an adversarial basis, with Canadian businesses. For example, when we discussed the establishment of the Canadian Bankers Association earlier in this paper, we noted that more than 100 years ago, in 1900, the Canadian government provided the CBA with powers to act as a curator in resolving failed banks, an activity that in many countries would be reserved for the ministry of finance or a regulatory agency. This willingness to work with the regulated industries has been a feature of the Canadian financial system since its earliest days and is a characteristic that is seldom found in other countries.<sup>65</sup> As one study reported, "It is curious and paradoxical that Canada is a country which has been largely developed around a special blend of private initiative and public policy. From the earliest days, large projects critical to the economic survival and growth of the country have tended to be joint ventures between the state and private entrepreneurs: for example, the Hudson's Bay Company and the Canadian Pacific Railway.

Nor was the close cooperation of business and government only a phenomenon of the first stages of development. Since that time, it has continued in the form of providing funding, supportive legislation and actual ownership in such industries as canals and seaways, air transportation, pipelines, broadcasting, banking and insurance, agriculture, petroleum and potash to name but a few."<sup>66</sup>

We believe that in the financial sector especially, the degree to which industry and governments in Canada have worked together in the public interest is relatively unique and is an important contributing factor to Canada's record of financial stability. The regulation of insurance intermediation and of investor-protection aspects of the securities industry have, to a considerable extent, been outsourced to industry-run self-regulatory organizations. The consumer ombudservices mandated by the federal government for insurance, banking and securities are run by independent boards

(with some industry participation) and are funded by the respective industries. The insurance policyholder compensation plans for both the life insurance industry (Assuris) and the property and casualty insurance industry (PACICC) are additional examples of ways in which governments can outsource activities that, in many countries, are carried out directly by regulatory agencies or governments. Over the years, Canadian regulatory agencies have outsourced many important initiatives across the financial sector to the respective industry trade associations, for example, the Canadian Bankers Association, the Canadian Life and Health Insurance Association, the Insurance Bureau of Canada (the property/casualty insurance trade association) and the Canadian Securities Association. In the mid-1990s, when it was decided that there should be Standards of Sound Business Practice for insurance companies, the OSFI suggested an industry working group, including OSFI observers, to develop the basic standards. The end result was an excellent document that both industry and regulators could adopt. This same pattern has been successfully followed by Canadian financial regulators in different sectors of the financial services industry over the years.

Although we were obviously not privy to communications between senior government officials and the management of Canada's large chartered banks during the financial crisis, we are confident that there were frank and ongoing discussions that could only be helpful to the overall goal of minimizing the impact of the financial turbulence. In many countries, there is a strong adversarial relationship between governments and regulated entities, and in those cases, it would be very difficult to arrange collaborative, constructive conversations in a time of danger to the system.

Outlined below are some additional regulatory aspects that may have helped Canada's economy and its financial institutions weather the recent financial storm:

- A legal difference between Canada and the U.S. in the field of home financing is that, in most provinces of Canada, if foreclosure on a mortgage is not sufficient to repay the outstanding amount to the lender, the homeowner is not let off the hook but rather remains liable for any part of the debt that remains outstanding. By contrast, when their mortgages are "underwater" — i.e., the amount they owe the lender exceeds the market value of the property — U.S. borrowers in most states are able to walk away from their mortgages. If they do not do so, they will end up paying off a loan that is greater than the market value of their home — a losing proposition from their perspective. This exposes lending institutions to a risk that does not arise to an appreciable extent in Canada. In retrospect, it seems clear that the myth that home prices would always rise, and

the existence in the U.S. of government-sponsored incentives for consumers to borrow funds for home purchases, gave rise to market distortions and the mispricing of risk by banks and other lending institutions. Similar distortions have not existed, at least to the same extent, in the Canadian marketplace.

- A significant difference in the financial-institution landscape also arises from the fact that, as previously mentioned, the Canadian banking system has been a branch-based system, as opposed to the system of local banks that emerged in the U.S. Having just a few banks, which, through their thousands of local branches, represent the major lending institutions in every corner of Canada, provides a broadly diversified base of business that can provide each bank with stability in uncertain times. When the fishing business is poor in the Atlantic provinces and loans there are going into default, the lumber business in British Columbia may be booming and loan default rates will be very low. There are also significant economies of scale to be achieved by having a few very large institutions versus a large number of small to middling institutions.

A study carried out for the U.S. Congress (CRS Report for Congress, “Financial Market Supervision: Canada’s Perspective” — discussed in more detail in discussed in more detail in the Comparison of the Canadian System with that of the United States section of this paper found on page 39), emphasizes that the U.S. financial system is much more complex than the Canadian system. One area where that is likely to have a particular impact is with regard to the number of institutions that must be regulated. Other things being equal, it should be less difficult to successfully oversee the operations of five very large banks than to keep on top of developments with respect to thousands of smaller banks: according to the Federal Deposit Insurance Corporation’s 2012 annual report, FDIC was at that time insuring the deposits of 7,181 institutions! So having a relatively small number of institutions to oversee probably does facilitate the delivery of regulatory activities.

- Another factor that may be relevant to Canada’s “success” in terms of financial-institution stability is the way in which ownership rules developed over time. To maintain domestic control and to prevent commercial ownership of banks, the 1967 Bank Act placed a 10 per cent ownership limit on bank shares, and this also helped to avoid problems of self-dealing. (Insurance companies were not subject to this restriction, which is why self-dealing was a much more common problem in that industry, at least for stock companies. Self-dealing was not a concern for the large mutuals because, being owned by their policyholders, they have no shareholders in the traditional sense.)

Downstream control situations had, for many years, also been limited for both banks and insurance companies, so they were not able to control other businesses as subsidiaries. However, in recognition of competitive and other business-related considerations, the 1987 Bank Act amendments, along with changes in Ontario law, lifted the restrictions having to do with banks owning securities dealers, with the result that all of Canada’s major securities dealers were soon acquired by the chartered banks. The comprehensive 1992 legislation, described in Table 1, introduced the financial holding-company concept, which provided a formal regulatory framework for cross-sector enterprises. In any event, the result has been that in Canada, since 1987, there have been no major securities dealers that are not owned by chartered banks.<sup>67</sup>

This may be relevant because being aligned with owners who have a “banking mentality” may have served to lower the risk profiles of what the investment firms may have become if they had different ownership. In the United States, where the big brokerage firms and investment banks were not owned by traditional banks, some grew to be gigantic enterprises, but of these some were thinly capitalized relative to their liabilities and were more directly involved in the risk-taking business.

- Each of the five federal agencies with shared responsibility for ensuring the efficiency and stability of the Canadian financial system — the OSFI, the CDIC, the Bank of Canada, the Department of Finance and the Financial Consumer Agency of Canada — has a clear mandate which doesn’t overlap with the mandates of other agencies. As in most areas, clearly defined, non-overlapping responsibility is an important attribute of successful operation.

Although the OSFI is an integrated regulator, the concept of integration is extended to the maximum degree by the existence of a number of formalized arrangements within the government. For example, representatives of the OSFI, the CDIC, the Bank of Canada, the Department of Finance and the Financial Consumer Agency of Canada, comprise the Financial Institution Supervisory Committee (FISC). The FISC’s mandate is “to address the issues and challenges facing the financial sector, and to refine regulatory requirements that promote sound practices and procedures to manage risk.”<sup>68</sup> The Auditor General of Canada, in his 2010 review of the OSFI’s operations, found evidence that these committees meet as required and that their discussions are substantive. He also noted that during the financial crisis, meetings were held much more frequently than in normal times.<sup>69</sup>

In the course of researching this paper, we have not found any quantitative analyses that shed light on the potential validity or importance of the above

factors, although several articles in the popular press have commented on the possibilities.<sup>70</sup>

The media and others have also suggested additional factors, unrelated to the regulatory environment, that may have affected the extent to which the Canadian economy was impacted by the financial crisis, such as: actions by the Bank of Canada, the degree of Canadian banking linkages with foreign jurisdictions, the general quality of mortgage loan portfolios in Canada compared to the United States, and so on. Some have even speculated that much of the “good performance” of Canadian financial institutions can be attributed to a basic inclination of Canadians to be risk-averse compared to their U.S. counterparts. However, all such hypotheses are outside the scope of this paper and we leave it to other researchers to quantify their significance, if any.

### **Corresponding Regulatory Developments in the United Kingdom**

As mentioned earlier, the U.K. did not adopt its first bank regulatory regime until 1979. The basic reason for this state of affairs was that, in the U.K., the historical approach to financial regulation has been somewhat along the same lines as the approach in most countries to securities regulation, which is to say that as long as users of the system are well informed and there is full disclosure with regard to the details of the financial transactions they are entering into, the state need not interfere. This shifts the focus of regulation away from the realm of prudential regulation and more to conduct of business regulation. The typical regulatory approach for securities is exemplified by the website for the Ontario Securities Commission, which indicates: “it is the general requirement in securities legislation to provide ‘full, true and plain disclosure’ of all material facts relating to the securities issued or proposed to be distributed.”

Thus, in the case of securities it is the expectation of regulators that prospective investors are sophisticated and capable of assessing the risks for any particular investment opportunity they may want to consider, so they will be able to make an informed decision as long as all material facts have been disclosed. However, the situation with respect to banking, insurance and dealings with other types of financial institutions, is quite different. The average individual who is seeking a mortgage to buy a house, or who wishes to obtain an automobile insurance policy, is not an expert in the workings of the financial markets and will generally not be in a position to evaluate the risks that the transaction may entail. With these types of common financial transactions, the power of knowledge all rests with the institution that has prepared the contract. This fact is formally recognized in the law through the

treatment of insurance and many other financial contracts as “contracts of adhesion”— i.e., a contract is 100 per cent prepared by one party and the other party can decide to adhere to the contract as presented, or refuse it. The view from North America has been that merely requiring the institution to provide the consumer with a bundle of explanatory brochures will not serve to level the playing field to any appreciable extent. But in any case, in many situations where consumers are dealing with financial institutions, one of the most significant risk areas relates to the financial health of the institution rather than to the details of the transaction, and almost no individual will have sufficient technical expertise to meaningfully assess the financial health of a bank or insurance company. Also, most consumers of financial services are generally less mindful of the consumer-law principle of *caveat emptor*, or “let the buyer beware,” than is the case with the purchase of more tangible consumer goods such as automobiles (where the tires can actually be kicked).

Another difference between the traditional U.K. model and the North American approach is that, in the U.K., there are very few restrictions on the business powers of financial institutions. They can engage in almost any business they wish, but through separate subsidiaries. For example, a number of grocery stores have incorporated their own banks to provide services to their customers. “In effect, firms have virtually no regulatory limits imposed on them with respect to what business they can conduct, but regulation and monitoring with respect to how business is conducted with consumers is strong, detailed, prescriptive, and extensive.”<sup>71</sup>

As the U.K. has moved to adopt the rules of the European Union, as expectations regarding compliance with international standards have become more important, and as the financial services business has become increasingly complex, the U.K. has gradually adopted an institutional safety-and-soundness-focused model, closer to what we are used to in North America. However, there continues to be a strong tradition of marketplace supervision and consumer protection at the transactional level.

### **Comparison of the Canadian System with That of the United States**

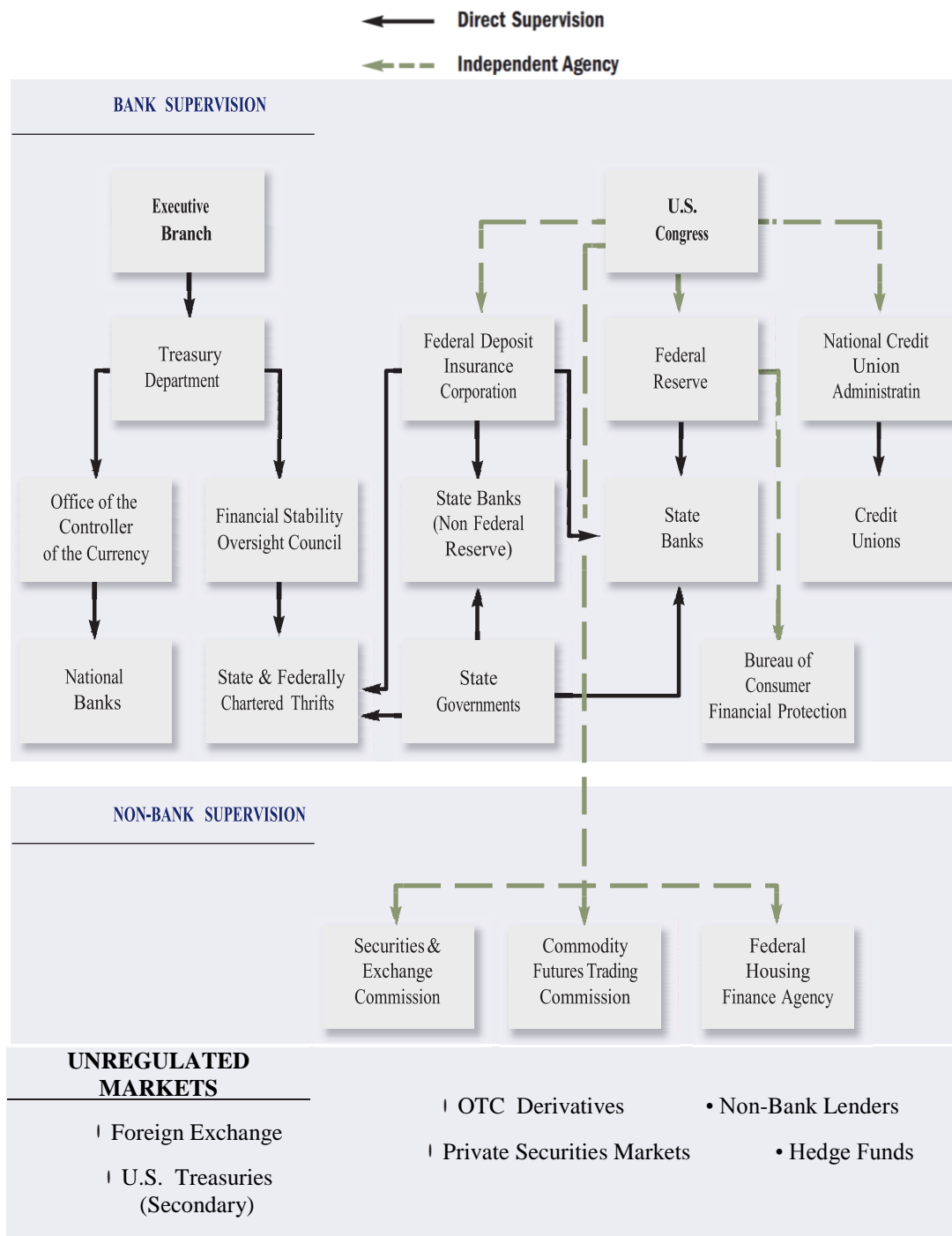
The key features of the Canadian financial regulatory system have been described above.

After the financial crisis, the United States Congress was aware of the apparently good performance of Canadian financial institutions and asked its research group to produce a report describing the Canadian system and determining whether it could have application for the

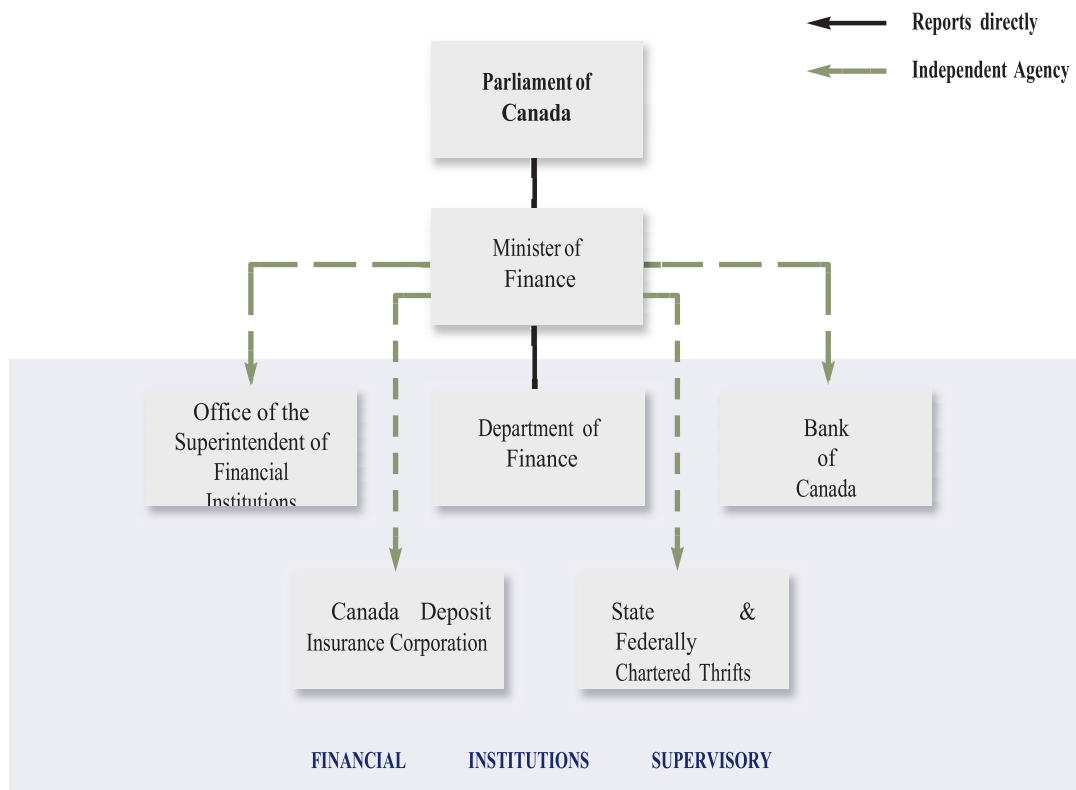
U.S.<sup>72</sup> Included in the report, dated April 4, 2013, are the following two diagrams illustrating the structures of the respective systems.



**Figure 1.** The U. S. Regulation system



**Figure 2. Canadian Regulative System<sup>73</sup>**



The author of the report concludes: “There likely are aspects of Canada’s financial supervisory framework that may offer an approach to supervising financial markets that may be useful for the United States to consider. However, the smaller scope of Canada’s financial system and its economy likely lessen the transferability of systems or procedures used in Canada to the vastly more complex U.S. financial system.”<sup>74</sup>

It is clear from the diagrams that the U.S. framework, even in summary form, is far more complicated than the Canadian framework. As well, the diagram for the U.S. only applies to banking. Other types of institutions would have different diagrams, possibly even more complicated than for banking. For example, the insurance business in the U.S. is separately regulated by each of the 50 states. However, the Canadian diagram covers the entire financial system except for the securities industry, which is provincially regulated, and except for other provincially regulated financial companies, which account for only a small part of the overall financial system. Thus, we can see that, in addition to its relative simplicity, the diagram for Canada pertains to a much greater percentage of the entire financial system than is the case for the U.S. diagram.

However, we do not agree that because the U.S. financial system is undoubtedly vast and complex it necessarily requires a complex system for its oversight. In fact, the OSFI, which is responsible for by far the bulk of regulatory responsibilities within the Canadian framework, is not a monolithic entity

but is comprised of a number of specialist groups, functionally focused divisions, and so on. When viewed at a level of detail, even the insurance system is somewhat complex. At a primary level, there are different entities transacting life insurance, property/casualty insurance and other specialty lines of insurance. However, overlaid on that primary level of business is the reinsurance business, which sees reinsurance companies providing specialized reinsurance coverage to insurance companies but not to members of the public. The different types of insurance businesses, especially life versus property/casualty, must be staffed by, and regulated by, people having different technical knowledge and professional training. In fact, the old Department of Insurance was organized by type of entity supervised, with a life insurance division, a property/casualty division, a trust and loan division, and so on. But no one would seriously argue that because all of these types of businesses have different characteristics, they need to be regulated by stand-alone regulatory agencies.

Another issue, related to integration of supervision, is that in Canada, consumer affairs, including matters directly related to the making of contracts (such as insurance), are entirely within the jurisdiction of the provincial governments. Thus, all of our discussions about the OSFI are in respect of safety-and-soundness considerations, not direct consumer-related issues. In the U.S. on the other hand, each state government is responsible for both insurer solvency and direct consumer protection

arising from insurance contract disputes, licensing of agents and brokers, etc. State governments also have some responsibilities for bank supervision within their jurisdictions. Some observers have suggested that the U.S. system would be improved if the states were left to concentrate on consumer protection (as is the case for the provinces in Canada), with the federal government taking on a much more integrated role in overseeing insurer solvency.<sup>75</sup>

We do not suggest that the complexities of the U.S. financial system would somehow become less complex within an integrated regulatory environment, but instead, that by combining many of the regulatory responsibilities within one or two agencies, there would be the potential for substantial improvement in efficiency and effectiveness. This would arise, not from in any way simplifying the underlying system, but rather from providing the regulatory agency (or agencies) with a far more comprehensive and cohesive overview of the system at large, with the potential for achieving more efficient and effective internal communication and analysis of risk areas.

Real-life implications of the lack of integration are revealed in the Levin-Coburn report, which was instigated by the U.S. Senate to investigate the causes of the sub-prime crisis and to make recommendations for the future. One section of the report describes, as an example, the situation at Washington Mutual Bank, which was among the eight-largest financial institutions insured by the Federal Deposit Insurance Corporation (FDIC). Because “WaMu,” as it was generally known, was technically a savings-and-loan company rather than a bank, it was subject to direct supervision by the Office of Thrift Supervision (OTS). After an extensive description of WaMu’s high-risk business philosophy and operations, which in some cases included fraudulent practices — none of which were ever effectively challenged by the regulator — as well as documenting OTS’s refusal to co-operate with FDIC reviewers, the report indicates “OTS officials allowed the bank’s short term profits to excuse its risky practices and failed to evaluate the bank’s actions in the context of the U.S. financial system as a whole. *Its narrow regulatory focus prevented OTS from analyzing or acknowledging until it was too late that WaMu’s practices could harm the broader economy*”<sup>76</sup> (emphasis added). So, OTS is a perfect example of a non-integrated regulator failing to perceive the big picture, with disastrous results.

We should add that, in outlining the benefits Canada has enjoyed as a result of its integrated, principle-based approach, we do not mean to suggest that simply combining different agencies under one roof will necessarily give rise to some sort of magical gain in efficiency or effectiveness. However, over time, with good leadership, cross training of staff, and other tactics designed to lead to a harmonized organization, the benefits of integrated regulation will almost certainly become apparent.

There are several other important differences between the two systems, not reflected on the charts above. One is that, in Canada, every OSFI-supervised institution is subject to a consistent risk-assessment system. This is not the situation in the United States — a point that also came up in numerous instances in the Levin-Coburn report. As well, most U.S.-based regulators have a much more rule-based approach than is the case in Canada, where principle-based and outcome-based approaches, supplemented with detailed guidance, are the norm. We are also of the view that Canada’s standards of corporate governance tend to be higher, with a more stringent duty-of-care provision than exists in most U.S. jurisdictions. However, as we have already noted, quantifying the relevance of any differences in corporate governance and duty of care will require more in-depth research.

Another difference between the two systems is the simple matter of Canada’s mandatory review of banking and insurance legislation every five years. As far back as 1929, Benjamin Beckhart, in *The Banking System of Canada*, commented on page 302 regarding the then-required system of decennial revision: “These frequent revisions have been of real advantage in preventing the Act from becoming obsolete, in contrast to the policy followed in the United States, where reform comes not through periodic revisions but through the addition here and there of patch-like provisions which serve more to confuse and complicate the measure.”

We have described how, in Canada during the 1980s, there was a series of financial institution insolvencies and high-risk situations, which led to a complete reshaping of the financial regulatory framework. We associate that reshaping and improvements since that time with the current good performance of the Canadian system. However, in the U.S., there was no such regulatory epiphany, with the possible exception of the adoption of the Sarbanes-Oxley Act (SOX) of 2002. However, the SOX requirements apply to all publicly listed companies and are not particularly geared to financial institutions. As well, in keeping with U.S. approaches generally, they are heavily compliance-based, rather than principle-based, so that an already complex system became significantly more complex under the SOX rules.

### ***The AIG Situation***

The near-failure of AIG was a critical development in the sub-prime meltdown. It is worth taking a closer look at how this occurred, in the context of the above discussion about the risks inherent when there is fragmented regulation of institutions.

During the most difficult days of the financial crisis, when AIG was known to be on the brink of failure, there was considerable confusion evident in the media about the regulatory agency responsible for this insurer, one of the world’s largest. It was well-

known within the insurance industry that AIG's insurance operations had historically been subject to regulation by the New York State Insurance Department. However, the identity of the regulator of AIG's parent holding company, if said regulator existed at all, was a question mark for knowledgeable people in both the industry and the financial media. To the surprise of many, it transpired that the holding company was regulated by the Office of Thrift Supervision (OTS). A system is extremely fragmented when seasoned industry executives<sup>77</sup> do not know the identity of the regulatory agency responsible for overseeing one of its largest members.

Why would what was purportedly the world's largest insurance business be subject to regulation by the OTS? The answer is that, after the savings and loan (S&L) crisis of the 1980s, U.S. law was amended to put the OTS in charge of any holding company having an S&L association as one of its members. Somewhere within the vast corporate domain of AIG, there was a small S&L — which, under the law, brought the entire AIG domain within the remit of the OTS. It is pretty clear, especially in hindsight, that the OTS had little or no familiarity with insurance and insurance-like risks and therefore was not in a position to understand the significance of the sophisticated financial instruments being issued by a non-insuring member of the AIG organization. (The OTS had many other issues as well and, largely on the recommendation of the U.S. Senate following the Levin-Coburn report — which recommended “complete OTS dismantling” — the agency has been disbanded and its responsibilities have been absorbed into other regulatory agencies.)

As for the credit default swaps being issued by AIG Financial Products (and other issuers) that were at the root of most of the difficulty, they were like insurance policies but without the traditional insurance requirement that the purchaser must have an insurable interest in the cover being offered. In other words, credit default swaps (CDS) were akin to naked bets on whether particular securities would default or not.

The insurable-interest requirement means that the insured will bear an economic loss should the insured event occur. If individuals could insure against events having no direct bearing on their own economic situations, they could enter into speculative contracts that would encourage them to wish for losses to befall others; not considered to be a socially desirable situation.

Even more relevant, however, is the fact that unlimited numbers of individuals might decide to insure (i.e., “bet”) on a particular outcome in which they have no financial or other interest, resulting in an aggregation of risks and possible catastrophic loss to the insurer. And that is exactly what happened to AIG.

One can never know with any certainty “what might have happened if ...”, but with regard to AIG,

it seems probable to us that if there were an integrated approach to financial regulation, or at least to insurance regulation, the insurance specialists within the regulatory agency would have been looking into the activities of the U.K. subsidiary that was issuing the credit default swaps, would have been aware of the tremendous leverage and associated risk that was involved, would have recognized the dangers in issuing insurance-like products with no insurable-interest requirement, and would have moved to curb AIG's activities in this area.

We feel that as long as there is such a fragmented system of prudential regulation in the U.S., it will be very challenging for the government to establish an effective mechanism for macro-prudential oversight, without which it will be difficult to avoid future risk bubbles.

### **The System-Wide Perspective**

To this point, we have said virtually nothing about system-wide considerations. This is because the evolution of financial regulation in Canada, and other jurisdictions as well, has mostly been about doing whatever can be done to assure the viability of individual institutions. Prior to 1987 and the creation of the OSFI, the idea was generally that if institutions follow the laws and regulations that are applicable to them, that is the best we can do. In the late 1990s and early 2000s, there was much talk at the international level of the need to “ring fence” vulnerable institutions. It now seems naïve to believe that somehow huge financial institutions could simply be shuttled into a kind of financial isolation ward where they would be nursed back to good health without implications for the system as a whole. In historical terms, the realm of system-wide risk and its implications for individual institutions has tended to be more the concern of the professional economist than of the financial regulator or regulatory policymaker.

The sub-prime crisis has illustrated, more dramatically than any previous financial crisis, that simply complying with a series of basic rules and regulations will be no guarantee of survival. When the crisis was at its worst, many international financial markets froze up due to a collapse of confidence within the system as a whole. In such circumstances, institutions could not afford to take the risk of entering into transactions with other institutions because of concerns that their counterparties would be unable to honour their side of the transactions. A number of very large, but thinly capitalized institutions had upcoming transactions that they had every reason to believe would be low risk. But at the height of the crisis, all bets were off, and what would be considered to be uneventful transactions in normal times turned out to be impossible to complete during the crisis. Without the benefit of government bailouts and support of the

system overall, the failure of those thinly capitalized institutions would have further damaged confidence, leading to greater paralysis of markets and more widespread failures, and so the cycle would go on to who-knows-what end. These developments highlight the fallacy in merely considering the positions of individual financial institutions when thinking about problems of system stability.

However, Canadian markets performed much better than described above. We have already discussed characteristics of the Canadian financial regulatory system that might have contributed to this result. Since the creation of the OSFI as an integrated regulator, we have had somewhat of a system-wide perspective here in Canada, because *one* regulator is now thinking about risks in different types of institutions. As well, the interactions of the FISC members no doubt help to bring a more systemic perspective to oversight of the financial system. The recent inclusion of Canada Mortgage and Housing Corporation under the OSFI's remit will also help to broaden the OSFI's breadth of perspective in the housing and mortgage arena.

Nevertheless, the fact that there is much to be done on the system-wide front is well illustrated by the sub-prime crisis. It is incredible to think that even with the OSFI as an integrated regulator, and the discussions taking place at the FISC group level, the huge risk bubble that gave rise to the crisis did not get onto the radar screen of the OSFI — or of any other regulatory agency, anywhere in the world.

This points out that every jurisdiction will have to do more, both within its own borders and working with international counterparts, to assess system-wide risks. (It goes without saying that in this globalized financial world, system risk cannot be thought of as falling only within specific geographical borders. It will have to be monitored on an international basis.) In the United States, which was clearly the birthplace of the crisis, the cumulative impact of the wide-ranging incentives designed to encourage home ownership, and the many unforeseen consequences of those incentives, turned out to be hugely greater than was anticipated by the authorities or was recognized by the authorities until after the crisis. If the enormous system-wide distortion that was building up had been more accurately monitored and identified, it might have been possible to defuse the sub-prime crisis before it began. Recent steps by Canada's minister of finance clearly demonstrate how risk levels in the housing and mortgage-lending fields can be tempered by judicious adjustment of mortgage-lending rules and other fine-tuning of system parameters.

Thinking of Canada's successful tradition of working closely with the regulated institutions, we wonder if system-risk awareness could not be significantly improved by having something like a financial-industry-based parallel to the FISC group, which would include senior-level representatives of

the banking, securities, insurance and pension businesses in Canada and which would be charged with monitoring system risk in their industries over time. It may be possible to derive industry-specific ratios and other indicators that could provide a quantitative dimension to the committee's discussions. This would be important because the evidence of the financial crisis is clearly that people in the industry, like the regulators, did not recognize the extent to which risk was accumulating in the system. (Our impression is that, from an industry perspective, and particularly in the U.S. market, as long as everyone seemed to be making money, no one had any incentive to look too closely at what might be happening beneath the surface.) The industry committee would meet with the government's FISC on a regular periodic basis to provide input to the latter group's policymaking deliberations. Such a collaborative effort could prove to be beneficial to both government and industry, and of course ultimately it would be hoped, to the public. Ideally, such an industry group in Canada could be paralleled by similar groups in other countries, which could then establish a macro-prudential risk forum at the international level. (At the present time, our observation — which may be incorrect — is that within the international standard-setting bodies we mainly have regulators talking to other regulators, with relatively little input from industry members.)

### **Too Big To Fail**

The "too big to fail" issue is a difficult one. The regulatory framework we have described is designed to avoid institutional failure, and fortunately has mostly been quite successful.

However, each of our five major banks is systemically important in the Canadian context; given the extraordinarily important role that each plays in the Canadian financial system, and the overall economy, each must be regarded as too big to fail. There have been advantages in allowing five huge banks to deliver almost all of our banking services — in terms of regulatory efficacy for example — but at the same time, we have placed ourselves behind the 8-ball in case there were to be a failure. Not only is there the obviously enormous problem of direct damage to the financial system in the event of a failure, there is also an underlying problem of moral hazard — i.e., assuming that each of the major banks is too big to fail, they will be able to operate in a manner that need not fully take account of risk, aware that if trouble arises they will be "saved" by the taxpayers.

Regulatory forbearance, rather than bailout, served the purpose during the Great Depression (see the An Apparent Paradox section of this report on page 26), but it is questionable whether similar tactics could work in today's environment. During the '30s, it was feasible to keep the potential import of the

situation somewhat wrapped in a hazy world of imprecise statements and fuzzy documentation. But such would certainly not be possible in the modern, transparent world. Would Canadians be prepared to accept government assurances that “all will be well in time”? Or would there be rioting in the streets with demands that the government take immediate action to “make things right”? Canadians do generally seem to have confidence in their governments, and don’t seem prone to rioting in the streets. If the minister of finance and/or the prime minister of whatever party might be in power were to say “we will ride through these problems,” it is possible that a majority of Canadians might just be inclined to continue to provide them with political support, partly in recognition of the fact that there may be no viable alternatives.

However, this presupposes that one or more banks are *technically* insolvent but still able to continue to operate, as was the case in the 1930s. In today’s world, that would not likely be the situation; during the financial crisis, there was evidence that the entire system was freezing up, which is a different circumstance entirely. So what would the alternatives be in that event?

One alternative is the one that we saw widely applied in the United States during the crisis, through the Troubled Asset Relief Program (TARP), where huge amounts of taxpayer funds were used to recapitalize institutions so that they could continue to operate. However, this type of financing from the public purse always carries the risk that taxpayers will not be paid back for the amounts they have contributed.

Another alternative being discussed at the international level is the “bail-in.” This approach would require large institutions to sell special debt securities that, in the event of financial difficulty, would be converted to equity, diluting existing shareholders. The “haircut” would be to the debt holders and to the existing shareholders rather than potentially to the taxpayers. At first glance, this option seems to have considerable merit, but it is not without problems. As pointed out by widely respected finance professor, Avinash Persaud,<sup>78</sup> as financial difficulty increases, bail-in securities would become increasingly high risk and could quickly become a barometer forecasting the onset of serious financial problems. This, in turn, could merely aggravate an emerging financial crisis, spreading the contagion more quickly than would be the case without the bail-in option. As Persaud also points out, there is no free lunch. In good times bail-in bonds would be considered appropriate for long-term investors, such as pension plans, but if times suddenly turn bad, pensioners would, in effect, “be thrown under the bus” in order to bail out other bank stakeholders. Although not meeting the bail-in concept in terms of being *legally required* for large institutions, some Canadian banks and insurance companies make use

of “Tier 2” capital in the form of subordinated debt, which is provided for in international standards and which is accepted by the OSFI subject to terms and conditions — one of the most important being that, in liquidation, such debentures are subordinate to the interests of depositors and policyholders, as the case may be. Thus, in liquidation, the holders of the Tier 2 subordinated debt would have the same status as common shareholders, somewhat in keeping with the bail-in concept.

International standard-setting organizations are calling for higher capital levels for systemically important financial institutions, with this additional capital serving in a sense as insurance against failure. Canadian banks are already meeting higher capital standards than their counterparts in other countries. Basically then, we must hope that the financial regulatory framework, including higher capital levels, will serve to prevent the failure of any one of our major institutions. In the meantime, as suggested in the Final Thoughts section of this report found on page 50, we should at least modernize the Winding-up and Restructuring Act so as to provide increased flexibility in the resolution of large financial entities.

## The Role of International Financial Regulatory Policies

In different jurisdictions, at different times, there has been an emerging realization that the modern financial network has become sufficiently complex, while its significance to citizens, businesses and whole economies has become so critically important and globally connected, that greater international co-ordination and integration of regulatory practices is a necessity. These emerging concepts found their first supporters in multi-lateral organizations such as the Bank for International Settlements (BIS). Although the BIS was founded in 1930 and played a role in a number of important economic and banking developments in Europe during its early years, it was only after a number of significant financial institution failures in Europe and in the United States (in particular, Franklin National Bank, which at one point in time was the 12th largest bank in the U.S.)<sup>79</sup> that the BIS began to focus on the implications of international banking operations and bank solvency in general.

The Basel Committee on Banking Supervision was established in 1974 and, according to the BIS website, its objective is “to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international

standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.”

Other international organizations have established core regulatory principles for insurance (the International Association of Insurance Supervisors, or IAIS) and securities regulation (the International Organization of Security Commissions, or IOSCO), while corresponding standards are now being developed for pensions by the International Organization of Pension Supervisors (IOPS).

Another international organization that is having a very substantial impact on financial institutions, in Canada and other countries, is the International Accounting Standards Board, which is the authority for prescribing International Financial Reporting Standards (IFRS).

There are many good reasons for wanting to standardize financial-reporting requirements across the globe, but at the same time, finding apparent solutions to some problems seems often to lead to new ones in other areas, and always with the possibility of unintended consequences. For example, the “mark to market” rules, among other requirements of IFRS, give rise to difficult issues for institutions such as life insurers and pension funds, which have long-term liabilities.

Some observers have expressed concern about the fact that these international organizations are asserting a form of extra-jurisdictional power by implying that all member countries must fully adopt the standards dictated by the international organizations.

In the financial regulatory area, for example, it is true that the IMF and the World Bank exert pressure on individual jurisdictions to adopt international standards of regulation: as mentioned earlier, these two organizations conduct the Financial Sector Assessment Program to determine the extent to which local regulatory frameworks comply with international standards.

Relatively minor variations from international standards can sometimes result in downgrading of the “report card” for the particular part of the financial sector concerned. The IMF and World Bank strongly encourage governments to improve their FSAP report cards, generally by modifying the laws and regulations so as incorporate the principles of the international standards and then making sure that the new laws are properly and fully implemented.

One can quarrel with the implicit assumption in the FSAP process that international standards are “correct” and that even small deviations therefrom may be considered “incorrect.” Conditions are different in different countries and it is almost certainly true that one size does not fit all in the realm of international financial regulation.

At the same time, we believe it is also true to say that international standards in financial regulation have played a tremendously beneficial role in

assisting jurisdictions in improving their overall regulatory frameworks. We have personally witnessed the situation in many jurisdictions where there is no formal legal framework for regulation of financial institutions, and no conception of the policies that should be adopted to provide greater financial security to citizens and public confidence in financial systems as a whole. International standards provide a concrete framework towards which countries can aspire or that they can build upon. So while one can question the exercise of quasi-legal powers by these international organizations, and argue about some details in the international standards, we would say that on balance, their existence is very beneficial. If anyone has a better way to proceed in terms of raising the effectiveness of financial regulation in countries around the world, we have not yet seen evidence of it.

The international standards for banking and insurance are detailed and pervasive, covering the baseline conditions for effective regulation, the principles that need to be enshrined in the laws, and the methodologies that should be adopted by agencies in their supervision of the financial institutions. As well, they are now being augmented with additional material on capital standards, too-big-to-fail/systemically important institutions and macro-prudential regulation.

We should specifically comment on the role Canada has played in the development of international regulatory standards. This country’s directions in modern financial regulation long pre-date the development of international standards by the various international agencies just referred to. For example, we can say with certainty that, in the late 1970s and early 1980s the Department of Insurance was beginning to implement processes that would now be identified as precursors to “risk-based supervision,” i.e., developing different risk indicators and focusing regulatory attention on entities where research indicated there was a higher probability of failure. By the early 1990s, the OSFI was well into its process of developing a regulatory framework based on risk assessment, guiding principles and high standards of corporate governance, the latter recognizing that boards of directors and senior managers are ultimately responsible and accountable for overseeing their institutions’ operations and properly mitigating the risks they take on. Of course, these measures were less sophisticated than is currently the case, but the adoption of the new approaches marked the critically important first steps.

As a designer and early adopter of these new regulatory approaches, the OSFI has played a lead role in the development of international standards. Senior OSFI officials have frequently held high-level positions in the international standard-setting organizations for banking and insurance, and the secretariats of these organizations almost always

include OSFI officers who have been seconded to the international entities.

### **Final Thoughts**

Thinking about what might be done to improve the Canadian system, and having in mind the tremendous emphasis on the role of the board of directors, one has to admit that boards of directors and senior managers are not superhuman. They already have many responsibilities and more are being added all the time. Perhaps it is time to consider strengthening the board structure for our largest institutions. Looked at through the lens of history, it seems that board structures have not changed much over the past 30 or 40 years. However, since 1992, the responsibilities of boards at financial institutions have exploded. In the Canadian and British Insurance Companies Act of the 1970s, “corporate governance” essentially dealt with the procedures for the calling of shareholder meetings, appointment of the auditor and other prosaic responsibilities. The whole gamut of important board responsibilities we have described, were absent.

One possible change would be for boards to have some permanent, independent directors working full time on behalf of the entire board. This would not be the same as having a group of institutional employees assigned to do research on issues raised by the board. Full-time, independent directors would be bound by the duty-of-care and other directorial responsibilities and would have to maintain an impartial perspective in addressing the issues of interest. As with the rest of the board members, their objective would not be to oppose management, but rather to provide directors with additional assurance with regard to management recommendations. For example, in modern-day banks it is not unusual for directors on credit committees to be faced with lengthy submissions from management with regard to proposed loans and other transactions. At present, although directors will almost always conscientiously review all the material they are asked to review, in most cases they do not have unlimited time available. As a double check, we think it would be beneficial to have a more focused review by full-time directors who would then be able to provide increased confidence that any contentious issues or other matters for debate, are fully aired with all members of the committee or the board.

It might also be helpful for the law to place a specific responsibility on institutional boards (for institutions over a certain size) to engage independent, external professional advisers when they are required to consider complex or particularly technical issues. Of course, any institution is currently free to retain whatever advisers it wishes to employ, and no doubt some institutions do that. However, our impression, gained over the years, is that boards are sometimes hesitant to consult with outside advisers,

other than with respect to particular transactions, such as mergers and acquisitions. Generally speaking, we think directors may feel that they are on the board because of their extensive experience and that therefore they should be able to provide required input, without running up the additional cost of outside advisers. We think this bias would be countered if there were a specific legal requirement along the lines that “the board has a responsibility to seek input from independent professional advisers when there is an issue for which the majority of the board members believe that such outside advice could be beneficial to the institution and its clients.” Most board members would probably prefer to err on the side of caution, and therefore if the situation were such that outside professional advice *might* be beneficial, it would be sought. We think this would encourage boards to assess issues in the most effective and unbiased manner possible.

Another area that we believe could represent a public-policy improvement, would be to require not only that every board have a significant proportion of independent directors, but to also require that those directors have at least a certain minimum level of knowledge about the business in question, including the fundamental principles and key risk variables with respect to the financial business concerned, as well an understanding of the legal/regulatory framework within which the institution must operate. At the present time, although independent directors will almost always have achieved considerable success in their main field of interest — otherwise they would not be invited to join the board — their prominence is sometimes in areas that are not related to the operations of financial institutions. This diverse experience likely serves the institutions well by bringing new perspectives to the consideration of important issues facing the institution. However, the other side of the coin is that without knowledge or experience regarding financial institution operations, there may be occasions when they are not in a position to fully participate in board discussions. This could dilute the benefits that were anticipated by policymakers when mandating the need for boards to include independent directors.

Some “director training courses” currently exist of course, but there is no consistent requirement that independent directors partake of such courses, nor are they — to the best of our knowledge — focused on providing core information about particular industries such as banking or insurance. (There would probably have to be separate programs for banking and insurance because the details of the business are different. On the other hand, it wouldn’t hurt for bank directors to know something about insurance and vice versa.) Based on our experience in providing these types of training courses to independent directors of insurance companies (in foreign jurisdictions), we would say that, at most, one week should be sufficient to provide a rudimentary but practical understanding



of the fundamentals of the particular financial business and its regulation. We might add that the feedback from directors about these programs was uniformly positive.

Many independent directors do have extensive, directly relevant experience, in which case institution-specific training would not be required. It might be satisfactory for the law to make boards themselves responsible for determining in particular cases, whether they think newly appointed independent board members should participate in a training program, or not. Except in cases where the background of the individual obviously makes such training unnecessary, we expect that, in most cases, the board, and the directors concerned, would decide in favour of the training.

In terms of the regulatory regime more generally, we hope that Canada will not become overly reliant on the use of models for determination of such basic operational parameters as minimum acceptable capital levels. This is a trend that seems to be gaining favour in a number of international jurisdictions. Models are undoubtedly useful tools but the data used for input can never be entirely representative of the real universe of possibilities. We also wonder how many regulatory agencies, including in Canada, will be able to accurately assess the models to understand any potential shortcomings. As well, the models say nothing about the potential surprises that may lurk in the tail-values of distributions. As the financial crisis demonstrated, those uncharted scenarios can be so extraordinary as to completely dwarf what were considered to be the more likely possibilities. Many of the razor-thin capital margins that were accepted by regulators in other countries were accepted on the strength of model predictions that purported to show capital levels would be sufficient at a 99.5 per cent level of confidence. Models are a one-way street: no institution will submit a model for regulatory approval that demonstrates that it requires a *higher* level of capital, only the opposite.

One area where we think the Canadian system could be improved is in the area of resolution. The relevant statute for winding up a bank or insurance company is the Winding-up and Restructuring Act (WURA). Fortunately, the need for its application has been infrequent, but the statute is more than 100 years old. Although it has been subject to minor amendments over the years, it does not contemplate the liquidation of a huge, modern institution such as one of Canada's major chartered banks, with their myriad types of financial instruments, off-balance-sheet items, global interconnectedness and so on. Nor does it provide flexibility with regard to possible restructuring of debt or other innovative means by which a modern-day liquidator, with the approval of the Superintendent of Financial Institutions and the court, might find to be desirable in terms of reducing the burden of loss that would otherwise fall too

heavily on depositors or taxpayers. Legislation (with the exception of Canada's requirement for five-year reviews of financial legislation) is often only amended after some sort of disaster shows that amendment is required. But if one of Canada's large banks ever got into financial difficulty, it would be too late to consider amending the WURA to facilitate what would need to be done.

The time to act is before there is an urgent need to apply the provisions of the act.

In thinking about possible future financial crises, we should mention a field of scholarly research having to do with so-called "normal accidents."<sup>80</sup> The theory of normal accidents holds that there are some situations where, over time, a catastrophic accident is inevitable. This is because some processes are so incredibly complex that if they become out of control, which they inevitably will, then there are an almost infinite number of directions the process can take, with the possibility of completely unpredictable feedback loops and other random developments, so that no effective form of intervention will be possible in the short term. The most frequently cited examples involve out-of-control nuclear reactors, such as we recently saw with the Fukushima Daiichi nuclear disaster in Japan after the 2011 earthquake and tsunami.

There is plenty of evidence that the international financial system is incredibly complex, and given the fact that there are no "on/off" buttons or other direct controls on the system, some have argued that the system constitutes one that is vulnerable to normal accidents. However, unlike the case with nuclear reactors, the financial system is ultimately controlled by individuals who, with an appropriate level of international co-ordination, are in a position to quickly change their operational practices. The great difficulty is that, in the heat of the moment, there is usually no consensus as to what should be done. Nevertheless, there is the *potential* for effective action, which in our view, distinguishes the financial system from the normal-accident-type situation. This reinforces the view that international agreements and co-ordinating practices need to be given much greater attention than has been the case in the past, so that when a global crisis threatens international financial stability, pre-determined game plans can quickly be put into practice.

## Conclusion

The Canadian financial regulatory system has indeed undergone dramatic changes over the years. During the early period, there was an implicit assumption that the calibre of individuals involved with the operation of financial institutions was such that detailed requirements and standards were not really necessary. As well, there was a certain amount of naivete with respect to what might occur, for example, in the area of related-party transactions. As the world evolved, it

became clear that a much more comprehensive framework was required. That was ultimately accomplished primarily by two main initiatives: the creation of the OSFI in 1987 and the adoption of the new federal financial institution statutes in 1992.

The financial crisis has evoked a storm of discussion regarding the potential need for more regulation, for less regulation, for different types of regulation or a different regulatory focus. It is no doubt the case that every financial crisis sparks a somewhat similar debate, but the fact remains that financial crises continue to occur. However, with globalization and the vast increase in magnitude of the financial sector relative to world GDP,<sup>81</sup> financial crises are no longer of primary interest to bankers, regulators and wealthy members of society. The current crisis has wreaked havoc on property owners in many countries around the world, on middle-aged individuals whose life savings have been slashed, on retiring members of defined-contribution pension plans, and on businesses and many of their former employees.

Given the present state of the art, it seems to us that if it were to be applied in many jurisdictions, the OSFI approach would represent the current best bet for avoiding international financial disasters.

And in fact, this point of view is gaining acceptance with many countries — especially emerging market countries, which have not previously implemented a cohesive system of financial regulation — using the Canadian framework as a template, modified as necessary to take account of local circumstances. The OSFI frequently hosts delegations from regulatory agencies in other countries who are seeking to observe the Canadian system first hand. The government of Canada and a number of international sponsors, including the Swedish International Development Cooperation Agency, the World Bank and IMF, also support such development through the Toronto Centre, a non-profit organization established in 1998 in the aftermath of the Asian Financial Crisis. The Toronto Centre has an objective “to promote financial stability and access to financial services globally by building the capacity of financial sector regulators and supervisors, particularly in emerging markets and low income countries to help improve their agencies’ crisis preparedness and to promote change that will lead to more sound and inclusive financial systems.” The centre uses the best supervisory methodologies from Canada and other jurisdictions, but adapted to local capacities, cultures and circumstances. Because of its evident success, the Canadian approach is also receiving more attention from international organizations and regulatory agencies in general. Some developed countries, such as Australia — which also demonstrated good experience during the financial crisis — already have a system in place that is quite similar to Canada’s, and in fact Canada and

Australia have conferred on the development of a number of regulatory policies.

The Canadian framework is comprehensive, is principle-based, is consistent across the financial institution playing field, is focused on risk, and is administered on an integrated basis. It minimizes prescriptive rule-making; benefits from, but does not rely on, internal models that will never reliably predict what will happen in the tail of the distribution; and does not, by implication, suggest that regulatory agencies know better what is good for institutions than do the institutions themselves. The result of all this is to provide Canada with a regulatory framework that, arguably, is one of the most effective in existence. However, in the aftermath of the financial crisis there are still many new approaches being debated, some of which may ultimately further improve the world’s ability to understand and effectively oversee its financial system.

While, as discussed earlier, other factors have likely also played a role, our view is that the regulatory system has been substantially responsible for Canada’s better-than-average performance over the course of the recent financial crisis and that it currently provides a reasonable balance between stability and market efficiency.

#### Notes:

1. Report from the Commission of Inquiry into the Collapse of the Canadian Commercial Bank (CCB) and the Northland Bank (Estey Inquiry), 1986, Appendix A, 349.
2. Bank of Montreal website, <http://www.bmo.com/home/about/banking/corporate-information/history>.
3. 12 Vic, chap 168.
4. Estey Inquiry Report, Appendix A, 351.
5. Benjamin Beckhart, *The Banking System of Canada* (New York: Henry Holt and Company, 1929), 301.
6. *Ibid.*
7. Estimated, based on the Bank of Canada’s inflation calculator, which covers the 99 years between 1914 and today, and assuming that the 3.1 per cent average rate of inflation over that period can be extended back an additional 43 years to 1871.
8. Double liability was adopted by the U.S. Congress as part of the National Bank Act of 1863.
9. Beckhart, *The Banking System*, 482.
10. For more information on the subject of double liability, see: Benjamin C. Esty, “The Impact of Contingent Liability on Commercial Bank Risk Taking,” Graduate School of Business Administration, Harvard University, *Journal of Financial Economics* 47 (1998). Using U.S. data from 1900 to 1915, Esty demonstrates that “banks subject to stricter liability rules have lower equity and asset volatility, hold a lower proportion of risky assets, and are less likely to increase their investment in risky assets when their net worth declines, consistent with the hypothesis that stricter liability discourages commercial bank risk taking.”
11. Beckhart, *The Banking System*, 301.

12. Report from the Royal Commission on Banking and Currency in Canada (The MacMillan Commission), 1933, paragraphs 30 to 32.
13. Beckhart, *The Banking System*, 303.
14. Estimated, based on the Bank of Canada's inflation calculator, which covers the 99 years between 1914 and today, and assuming that the 3.1 per cent average rate of inflation over that period can be extended back an additional 24 years to 1890.
15. The information in this paragraph was graciously supplied by the Canadian Bankers Association.
16. For further details, see: Crawford and Falconbridge on *Banking and Bills of Exchange*, Eighth Edition (1986).
17. The MacMillan Commission, paragraph 38.
18. Beckhart, *The Banking System*, 308.
19. *Ibid.*
20. *Ibid.*, 442.
21. *Ibid.*
22. Canadian Life and Health Insurance Association, "Canada's Life and Health Insurance Industry: The Regulatory Environment," submission to the Task Force on the Future of the Canadian Financial Services Sector (1997), 2-9.
23. *Ibid.*, 2-10.
24. *Ibid.*, page 2-11.
25. Estey Inquiry Report, Appendix A, page 352.
26. Bank of Canada Inflation Calculator.
27. Byron Lew and Alan J. Richardson, "Institutional Responses to Bank Failure: A Comparative Case Study of the Home Bank (1923) and Canadian Commercial Bank (1985) Failures," *Critical Perspectives on Accounting* 3 (1992): 163-183.
28. *Ibid.*, 171.
29. Beckhart, *The Banking System*, 481.
30. Lew and Richardson, "Institutional Responses," 172.
31. Beckhart, *The Banking System*, 321.
32. Report of the MacMillan Royal Commission on Banking and Currency, Volume II, 61.
33. *Ibid.*, 62.
34. *Ibid.*, Chapter VIII, paragraph 293.
35. Perhaps we receive a hint of the Canadian irritation — which may have been widespread at the time — in being regarded as a colonial possession, when the dissenting Beaudry Leman of Montreal commenced his minority report with the somewhat sarcastic remarks: "It will undoubtedly be considered presumptuous that I should express opinions at variance with those of my colleagues, and particularly of the eminent and experienced gentlemen from Great Britain, who have been requested to study our Canadian financial problems and to advise the Dominion government in regard to their solution."
36. Estey Inquiry, Appendix A, 364.
37. *Ibid.*
38. Report from the Royal Commission on Banking and Currency in Canada (1933), paragraph 42.
39. Estey inquiry, Appendix A, 364.
40. Lew and Richardson, "Institutional Responses," 94, 99.
41. Report of the Royal Commission on Banking and Finance (Porter Commission).
42. Commenting on the decline in the number of banks up until 1929, the publication date of *The Banking System of Canada*, Beckhart reports (page 325): "The tendency toward fewer and larger banks has been perhaps the outstanding characteristic of the banking structure of Canada within recent years. Not that the disappearance of banking institutions is a condition peculiar to the Dominion, for the same condition has manifested itself also in other countries." And in a footnote on page 328, in relation to the trend of consolidation, he points out: "It might be noted that such a condition leads inevitably into a kind of government guarantee of banking. The Canadian government could not allow any of the larger banks to fail for such would be most disastrous to the entire economic structure of the country."
43. Estey Inquiry, Appendix A, 364.
44. Porter Commission, Volume 1, Table 6-3, 107.
45. *Ibid.*
46. *Ibid.*
47. *Ibid.*, Volume 4, 564.
48. Porter Commission, Volume 1, 8.
49. The Department of Insurance and the Office of the Inspector General of Banks were merged in 1987 to form the Office of the Superintendent of Financial Institutions (OSFI).
50. Ron Suskind, *Confidence Men: Wall Street, Washington and the Education of a President* (New York: Harper Collins, 2011): 288.
51. Property and Casualty Insurance Compensation Corporation website at [www.pacicc.com](http://www.pacicc.com). The companies were: Strathcona General Insurance, Pitts Insurance, Cardinal Insurance, Northern Union Insurance, Canadian Great Lakes Surety, Mennonite Mutual Hail Insurance and Northumberland Insurance.
52. Estey Inquiry Report, Volume 1, 2.
53. *Ibid.*, 10.
54. *Ibid.*, 17.
55. Charles Proctor, *The Law and Practice of International Banking* (Oxford: Oxford University Press, 2010), paragraph 1.04.
56. Personal recollection by author.
57. Estey Inquiry Report, 45.
58. Lew and Richardson, "Institutional Responses," 173.
59. Green Paper: "The Regulation of Canadian Financial Institutions: Proposals for Discussion," 11.
60. Points are taken from the Executive Summary of The Final Report of the Working Committee on the Canada Deposit Insurance Corporation (the Wyman Report).
61. Lawrence Kryzanowski and Gordon S. Roberts, "Capital Forbearance: Depression-era Experience of Life Insurance Companies," *Canadian Journal of Administrative Sciences* (March 1998).
62. Lawrence Kryzanowski and Gordon S. Roberts, "Canadian Banking Solvency, 1922-1940," *Journal of Money, Credit and Banking* 25, 3 (August 1993): Part 1, 361-376.
63. *Ibid.*
64. Standard & Poor's, *A Tale Of Two Countries: U.S. And Canadian Banks' Contrasting Profitability Dynamics*, Report, November 13, 2012.
65. Personal observation by the author, who has carried out regulatory projects in many countries around the world.
66. V. V. Murray and C. J. McMillan, "Business Government Relations in Canada — a Conceptual Map," *Canadian Public Administration* (1983): 592.
67. Information in this paragraph largely extracted from: Charles Freedman, "The Canadian Banking System." Conference on Developments in the Financial System: National and International Perspectives, The Jerome Levy Economics Institute of Bard College, April 1997.

68. OSFI web site at <http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/Pages/default.aspx>.
69. Office of the Auditor General of Canada, 2010 Fall Report to the Parliament of Canada, "Chapter 5: Office of the Superintendent of Financial Institutions."
70. See, for example: Andrew Coyne, "Our So-called Genius Banks," *Maclean's* (April 2009).
71. David T. Llewellyn, "Financial Regulation: A Perspective from the United Kingdom," *Journal of Financial Services Research* (2000): 311.
72. James K. Jackson, *Financial Market Supervision: Canada's Perspective*, Congressional Research Service, Report for Congress 7-5700, April 2013.
73. This diagram, published as part of the U.S. Congress report, shows the minister of finance reporting directly to the Parliament of Canada. To be more precise, the minister reports to the cabinet, chaired by the prime minister and consisting of the ministers of the Crown. Government policy decisions are made at the cabinet level and the minister of finance would be in frequent consultation with the prime minister and, from time to time, the cabinet as a whole. According to the government of Canada's website, the Doctrine of Ministerial Responsibility can be stated briefly as follows: "ministers are broadly accountable to the Prime Minister and the House of Commons [i.e. Parliament], on behalf of the people, for their exercise of the responsibilities assigned to them when they are appointed, including the powers and duties provided by Parliament through legislation."
74. Jackson, *Financial Market*.
75. See, for example: David Zaring, "It's Time to Rethink Insurance Regulation" *The New York Times "Dealbook"* blog, January 22, 2014, [http://dealbook.nytimes.com/2014/01/22/it-is-time-to-rethink-insurance-regulation/?\\_php=true&\\_type=blogs&goback=%2Egde\\_890207\\_member\\_5832476394906484736&r=0#%21](http://dealbook.nytimes.com/2014/01/22/it-is-time-to-rethink-insurance-regulation/?_php=true&_type=blogs&goback=%2Egde_890207_member_5832476394906484736&r=0#%21).
76. United States Senate, Permanent Committee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, 5.
77. Even some state insurance regulators were unaware that the OTS was the legal supervisor of AIG. This came up at an international conference in the fall of 2008, attended by the author, when panelists, including some U.S. state insurance commissioners, were not aware of the OTS role in overseeing AIG.
78. Avinash Persaud, "Bail-ins are no better than fool's gold," *The Financial Times*, December 10, 2013.
79. Joan E. Spero, *The Failure of Franklin National Bank: Challenge to the International Banking System* (New York: Beardbooks, 1999), 11.
80. There are two classic references on this subject. One is *Normal Accidents: Living with High-Risk Technologies*, by Yale University professor Charles Perrow, published in 1984. The other is *The Limits of Safety: Organizations, Accidents, and Nuclear Weapons*, by Stanford University professor Scott D. Sagan, published in 1993.
81. By 2006, total market capitalization of world stock markets, plus the total value of domestic and international bonds, equalled 2.4 times the world's total GDP. Niall Ferguson, *The Ascent of Money* (New York: Penguin, 2008), 5.