



Introduction to the Supervisory Framework Ratings Assessment Criteria

OSFI shared its Supervisory Framework (“Framework”) with institutions in August 1999.

As indicated in the Framework's Key Principles, we will be sharing our assessments with institutions through supervisory ratings. Each institution will be provided with a Composite Risk rating, which represents OSFI's assessment of the safety and soundness of the institution. We will also be preparing ratings for each of the institution's applicable Risk Management Control Functions (“Oversight Functions”), with the ratings reflecting an assessment of the effectiveness of these functions in overseeing the management of the institution's activities.

We will begin sharing the Composite Risk rating with institutions in 2002, with full implementation expected over the following two years. Relationship Managers will be prepared to discuss the rationale for their assessments with individual institutions, which may include discussing ratings of particular Oversight Functions.

Assessment Criteria for the supervisory ratings were developed over a two-year period through research of material available nationally and internationally, review of practices at some forty different types and sizes of regulated institutions in Canada, and with input from supervised industries through their associations. The Assessment Criteria are not required standards. They will be used to guide supervisory assessments. Ratings will be based on actual findings and observations during on-site reviews and monitoring activities.

OSFI expects that the nature and extent of oversight by an institution over its activities will be commensurate with its complexity and risk profile. Accordingly, the various factors considered in the assessment of the Oversight Functions may be weighted differently for different institutions.

It is not intended that institutions should restructure or reorganize their oversight processes as a result of this initiative. OSFI expects institutions to establish organizational structures and control practices that are appropriate to their unique circumstances.

It is important to recognise that the ratings were developed as an internal process for standardizing OSFI's approach to the assessment of institutions, thereby improving the consistency and comparability of our assessments. The Assessment Criteria may be revised from time to time, based on experience gained through implementation and as industry practices change over time.

Confidentiality of the rating information is protected by the *Supervisory Information Regulations*. The regulations provide that institutions may disclose “prescribed supervisory information”, which includes ratings, to affiliates, directors, officers, employees, external auditors, appointed actuaries, security underwriters, or legal advisors, provided the institution ensures the continued confidentiality of the information.

An Overview of the Supervisory Framework and Related Ratings

The objective of the supervisory process is to assess the safety and soundness of regulated financial institutions and intervene on a timely basis where OSFI considers an institution's practices to be imprudent or unsafe. The Supervisory Framework sets out a disciplined, risk-based approach to making these assessments, that uses the work of an institution's Oversight Functions, where appropriate, to understand how effectively an institution manages its risks.

The Composite Risk rating is the key rating under the Framework. It represents OSFI's assessment of the safety and soundness of an institution. The Assessment Criteria provide rating categories and criteria for assessing the Composite Risk rating and each of its components, i.e., Overall Net Risk, Earnings and Capital.

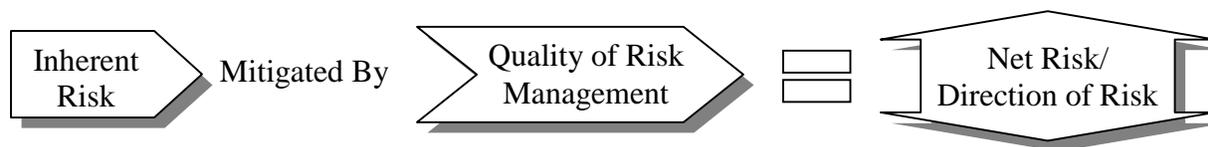
It is important to note that all assessments made throughout the supervisory process consider the nature, scope, complexity and risk profile of an institution, i.e., its unique circumstances.

Assessing an Institution's Safety and Soundness

The assessment of an institution's safety and soundness is built on an understanding of the institution, its industry, and its environment. Based on this understanding, an institution's significant activities are identified. Both qualitative and quantitative factors are used to assess the materiality or significance of an activity to the achievement of the institution's objectives and strategies.

A significant activity can be a line of business, business unit, or other institution-wide process such as treasury operations or information technology. Generally, OSFI groups an institution's activities in a manner that is consistent with the business model used by the institution, i.e., how the institution is structured and managed.

Significant activities are assessed using the following equation:



For each significant activity, the key risks inherent in the activity are identified and assessed, without considering the level of mitigation provided by the institution's risk management processes and controls. This assessment is mainly qualitative. Inherent risk assessments are identified under seven risk categories: credit, market, insurance, operational, liquidity, legal and regulatory, and strategic. These categories represent a broad classification of the risks that are generally applicable to financial institutions, and most risks can be considered within one of these categories.

The Quality of Risk Management is evaluated to assess the level of risk mitigation occurring within the significant activities to arrive at the Net Risk and Direction of Risk for each activity. This assessment is judgemental and is based on a sound understanding of the activity, the risks

inherent in the activity, and the effectiveness of the institution’s mitigation, taking into account the unique circumstances of the institution.

In assessing the Quality of Risk Management, both Operational Management and the Oversight Functions of an institution are reviewed.

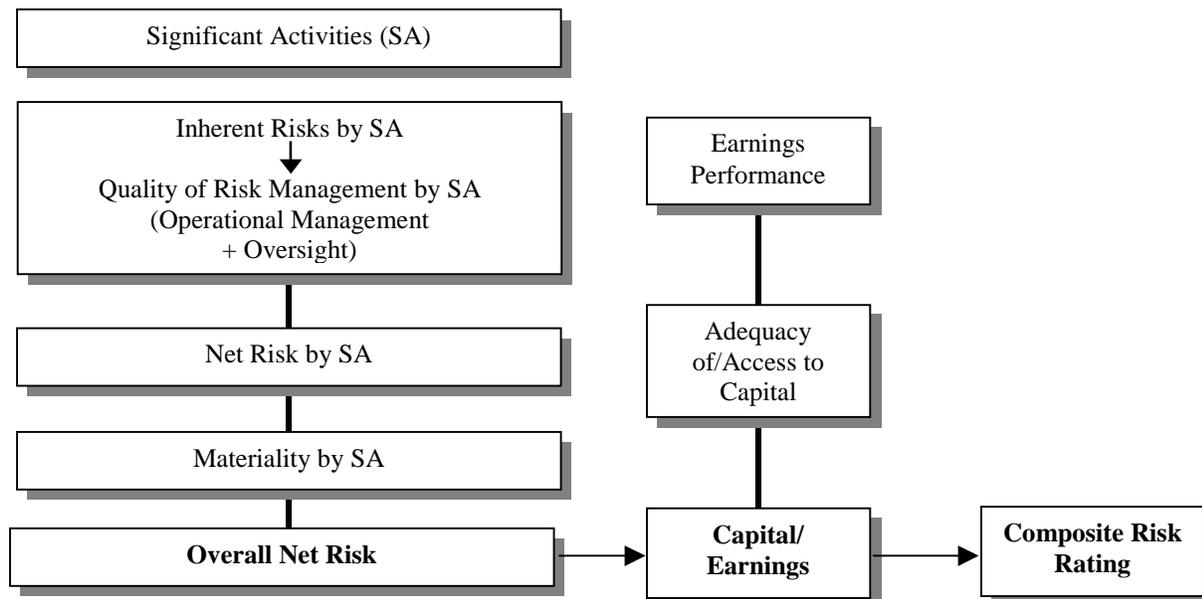
Operational Management for a given activity is primarily responsible for its day-to-day management. This function ensures that policies, processes, control systems, staff levels and experience are in place, and are sufficient and effective in managing and mitigating risks inherent in the activity.

Besides Operational Management, OSFI has identified six Oversight Functions that may exist in an institution. They are Board of Directors, Senior Management, Risk Management, Internal Audit, Compliance, and Financial Analysis. These functions provide an independent review of the management of business activities. The purpose of this oversight is to ensure that Operational Management is effective in managing and controlling the risks for a given significant activity on a day-to-day basis.

OSFI’s primary objective in assessing the Oversight Functions is to determine the extent to which it can use the work of these functions to ensure that appropriate controls are in place and are being followed at the operational level. This allows OSFI to focus its own resources on reviewing areas that are likely to affect the risk profile of the institution.

Composite Risk Rating

The Composite Risk rating is an assessment of the institution’s overall risk profile. It reflects OSFI’s assessment of the institution’s safety and soundness. The following chart illustrates the structure of the Composite Risk Rating:



Once the net risk in significant activities has been assessed, the materiality of each activity is taken into account to arrive at the level and direction of Overall Net Risk for the institution as a whole. The Overall Net Risk is a weighted aggregation of the Net Risks in the institution's significant activities.

The adequacy of Earnings and Capital, given an institution's Overall Net Risk, is assessed to arrive at the level and direction of the institution's Composite Risk.

The objective of assessing Earnings is to understand and assess the quality, quantity and volatility/sustainability of an institution's earnings and how they contribute to Capital.

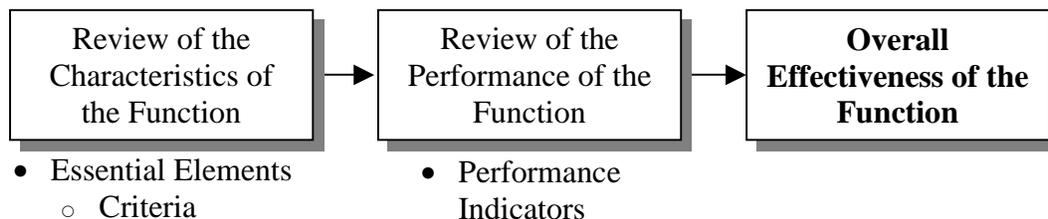
Capital is a source of financial support that contributes to an institution's safety and soundness. It is a cushion to absorb unexpected losses and to provide a safety net for the institution. In assessing Capital, the objective is to assess capital adequacy and the effectiveness of capital management policies and processes in the context of the risk profile of the institution.

Oversight Function Ratings

Institutions will also be provided with ratings for the Oversight Functions that exist within the institution. These ratings are developed during the review of significant activities and reflect an assessment of the function's overall effectiveness across all significant activities. They also reflect, in part, the extent to which an institution's Oversight Functions satisfy the Assessment Criteria that are considered appropriate and relevant to its operations.

OSFI's overall assessment of an Oversight Function involves assessing the characteristics and performance of the function in executing its mandate across all significant activities, in the context of the institution.

The structure of the rating is illustrated below:



The unique circumstances of an institution are key considerations in assessing the effectiveness of the institution's Oversight Functions. This requires the use of judgement in applying criteria and performance indicators included in the Assessment Criteria, in the context of the institution. The particular circumstances of each institution will determine the relative importance of the individual criteria and performance indicators in arriving at an overall rating for a function.

Smaller institutions are not likely to have all the Oversight Functions because oversight responsibilities, in these institutions, are generally carried out by Senior Management. Where an institution lacks some or all of the Oversight Functions, OSFI looks to other functions, within or external to the institution, that handle these oversight responsibilities, for example,

operations reviews by other branches, outsourcing arrangements, and Senior Management's activities. In the absence of effective oversight, OSFI will step up its supervision of the institution and recommend or require that the institution implement an appropriate level of oversight.