CANADA DEPOSIT INSURANCE CORPORATION

SPECIAL EXAMINATION REPORT

PRESENTED TO THE BOARD OF DIRECTORS

on 1 December 2004

Office of the Auditor General of Canada
Bureau du vérificateur général du Canada

23 November 2004

To the Board of Directors of
Canada Deposit Insurance Corporation

We have completed the special examination of Canada Deposit Insurance Corporation, in accordance with the plan presented to the Audit Committee of the Board of Directors on 26 May 2004. As required by section 139 of the *Financial Administration Act* (FAA), we are pleased to provide our report on the special examination (attached).

We will be pleased to respond to any comments or questions you may have on our report at your meeting on 1 December 2004.

I would like to express my appreciation to the Board members, Management, and the Corporation's staff for the excellent cooperation and assistance offered to us during the examination.

Yours sincerely,

Richard Flageole
Assistant Auditor General

Attach.

240 rue Sparks Street, Ottawa, Ontario K1A 0G6

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To: The Board of Directors of Canada Deposit Insurance Corporation

SPECIAL EXAMINATION OPINION

1. Under Part X of the *Financial Administration Act* (FAA), the Canada Deposit Insurance Corporation is required to maintain financial and management control and information systems and management practices that provide reasonable assurance that its assets are safeguarded and controlled; its financial, human, and physical resources are managed economically and efficiently; and its operations are carried out effectively.

2. The FAA also requires the Corporation to have a special examination of these systems and practices carried out at least once every five years.

3. Our responsibility is to express an opinion on whether there is reasonable assurance that during the period covered by the examination, from February 2004 to September 2004, there were no significant deficiencies in the systems and practices we examined.

4. We based our examination plan on a survey of the Corporation's systems and practices, which included a risk analysis. We submitted the plan to the Audit Committee of the Board of Directors on 26 May 2004. The plan identified the systems and practices that we considered essential to providing the Corporation with reasonable assurance that its assets are safeguarded and controlled, its resources managed economically and efficiently, and its operations carried out effectively. Those are the systems and practices that we selected for examination.

5. The plan included the criteria that we selected specifically for this special examination, in consultation with the Corporation. The criteria were based on our experience with performance auditing. Our choice of criteria was also influenced

by legislative and regulatory requirements, professional literature and standards, and practices followed by the Corporation and other organizations. The systems and practices we examined and the criteria we used are listed in Appendix A.

6. We conducted our examination in accordance with our plan and with the standards for assurance engagements established by The Canadian Institute of Chartered Accountants. Accordingly, it included the tests and other procedures we considered necessary in the circumstances. In carrying out the special examination, we relied on an internal audit of the Insurance and Risk Assessment Division.

7. In our opinion, based on the criteria established for the examination, there is reasonable assurance that there were no significant deficiencies in the systems and practices we examined.

8. The rest of this report provides an overview of the Corporation and more detailed information on our examination findings.

Richard Flageole, FCA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
28 September 2004

THE FEDERAL SYSTEM FOR OVERSIGHT AND SAFETY NET FOR DEPOSIT-TAKING INSTITUTIONS—AN OVERVIEW

9. In Canada, the federal system for oversight and safety net for deposit-taking institutions is divided into specific functions carried out by separate federal bodies.

Public policy and legislation

10. The **Minister of Finance** is responsible for federal public policies that pertain to federal financial institutions as well as fiscal policies for the country as a whole. This includes responsibility for the legislation that affects deposit-taking institutions, including the *Canada Deposit Insurance Corporation Act*, the *Bank Act*, the *Trust and Loan Company Act*, the *Office of the Superintendent of Financial Institutions Act*, the *Canadian Payments Association Act,* and the *Bank of Canada Act*.

Financial institution supervision and regulation

11. The **Office of the Superintendent of Financial Institutions**, or OSFI, is the regulator and supervisor of federally incorporated financial institutions, which include banks, federal trust companies, federal loan companies, federal insurance companies, and pension plans.

12. The **Financial Consumer Agency of Canada**, or FCAC, regulates the activities of financial institutions under federal jurisdiction. Its focus is to ensure compliance with consumer protection laws, regulations and codes.

Monetary policy

13. The **Bank of Canada** is responsible for setting monetary policy and generally promoting the economic and financial well-being of Canada. It oversees the system of major payments and other clearing and settlement systems in Canada and provides liquidity to the financial system through its power to act as a lender of last resort.

Deposit insurance

14. The **Canada Deposit Insurance Corporation,** or CDIC, is responsible for providing deposit insurance and promoting standards of sound business and financial practices and contributing to the financial stability of the Canadian financial system.

OVERVIEW OF CANADA DEPOSIT INSURANCE CORPORATION

Background

15. Parliament established the CDIC in 1967 under the *Canada Deposit Insurance Corporation Act*; the Act has been amended several times since then, most recently in 2001. The Corporation is accountable to Parliament through the Minister of Finance. CDIC's head office is located in Ottawa, and there is one office in Toronto. For the year ending March 31, 2004 CDIC earned $160 million in revenue and $142 million in net income. As at March 31, 2004, the Corporation had 86 employees.

Mission and objectives

16. The following is the Corporation's mission statement:

> To provide deposit insurance and to contribute to the stability of the financial system in Canada in a professional and innovative manner, meeting the highest standards of excellence, integrity and achievement, for the benefit of depositors of member institutions while minimizing the Corporation's exposure to loss. CDIC will provide an environment where employees are treated fairly and given opportunities and encouragement to develop their full potential.

17. The mission statement is based on the Corporation's statutory objects, which are outlined in section 7 of the CDIC Act:

> (a) to provide insurance against the loss of part or all deposits;
>
> (b) to be instrumental in the promotion of standards of sound business and financial practices for member institutions and to promote and otherwise contribute to the stability of the financial system in Canada; and
>
> (c) to pursue the objects set out in paragraphs (a) and (b) for the benefit of persons having deposits with member institutions and in such a manner as will minimize the exposure of the Corporation to loss.

Business strategies

18. The *Summary of the Corporate Plan, 2004/05 to 2008/09* outlines the Corporation's business strategies:

- **Readiness**—being prepared to fulfill CDIC's role of deposit insurer by being ready, and alert to events affecting the Corporation and its members and having the ability to anticipate, react to and manage risk.

- **Sound Governance**—ensuring that policies, procedures and reporting are in place such that the Corporation can demonstrate it is well managed and can fulfill its mandate in an effective and efficient manner.

- **Strong Partnerships**—enhancing relationships with CDIC's partners (members, regulators, supervisors and suppliers) to better achieve the Corporation's mandate. This will include working with our members to identify opportunities to reduce costs and to maximize the benefits of deposit insurance for member institutions.

- **Deposit Insurance Awareness**—increasing depositor awareness and explaining the benefits and limitations of deposit insurance.

Operating environment

19. The Corporate Plan Summary outlines the Corporation's perspective on its external environment as follows:

> Although elements of uncertainty persist within the international economic environment in particular, CDIC anticipates Canada's economy will remain resilient to shocks and will experience healthy economic growth during the next five years.
>
> Canada's economic growth and job creation are now strong within an environment of low inflation and relatively low and stable interest rates. On the whole, these conditions should continue to provide for a favourable economic and financial environment for CDIC and its member institutions. Insured deposits are forecast to continue to grow at a moderate pace.
>
> Uncertainties remain that could alter this outlook. Among these are: slow GDP growth in the world's largest economies, including the Euro area and Japan; large fiscal deficits in the United States; the possible continuing effect on investor confidence of recent corporate and securities scandals; and currency fluctuations affecting the value of the Canadian dollar. Moreover, turbulence in other economies, international instability related to the war on terrorism, and the ever-present risk of unforeseen socio-political developments could affect the outlook.
>
> Given this environment, CDIC will remain focused on contributing to the stability of Canada's financial system by providing deposit insurance in accordance with its mandate, while continuing to enhance its preparedness in the event of unforeseen developments.

Interventions

20. Since its creation in 1967, CDIC has dealt with the failures of 43 financial institutions, almost all between 1980 and 1995. Some 24 of these failures resulted in payouts by CDIC of about $5.4 billion for insured deposits. In the other cases, CDIC intervened to facilitate the purchase of assets and assumption of $20.4 billion in insured deposits by other financial institutions through loans, payments, and guarantees. For financial planning purposes, the current Corporate Plan Summary assumes no failures during the period it covers.

Membership

21. At 30 April 2004, CDIC had 83 member institutions, down from 113 in 1999 when we conducted our previous special examination; the decline was largely a result of consolidations and exits from the industry.

22. Schedule I and II banks (as defined by the *Bank Act*) and federally incorporated trust and loan companies must be members of CDIC if they accept deposits at the retail level. Provincially incorporated trust and loan companies that accept deposits are required by provincial legislation to be members of a deposit insurance scheme. In Quebec, the Autorité des marchés financiers insures deposits held in Quebec by any provincially chartered trust and loan company; CDIC insures deposits held by these companies outside Quebec.

Insured deposits

23. Since 1983, the limit on the coverage provided by CDIC deposit insurance has been $60,000 per depositor in any one deposit-taking institution. Insured deposits must be payable in Canada, in Canadian currency. They can include savings and chequing accounts, term deposits with maturities up to five years, money orders and drafts, certified drafts and cheques, and travellers' cheques

issued by CDIC member institutions. Separate protection is provided for joint deposits, deposits held in trust, and deposits in registered retirement savings plans and income funds. CDIC does not insure deposits in foreign currency; term deposits with a maturity date more than five years from the date of deposit; debentures issued by chartered banks; bonds and debentures issued by governments and corporations; treasury bills; or investments in mortgages, stocks, and mutual funds.

CDIC Members and Insured Deposits

Member institution type (at 30 April 2004)	Number of Members	Deposits at 30 April 2004 ($billions)		
		Total	Insured	%
Domestic banks and subsidiaries	37	$ 1,023.2	$ 348.8	34.1
Subsidiaries of foreign institutions	24	60.5	18.4	30.4
Domestic trust and loan companies	22	11.3	8.4	74.3
Total	83	$ 1,095.0	$ 375.6	

Source: CDIC

24. CDIC identifies member institutions for inclusion on the “watchlist”—which means they are subject to close monitoring by CDIC. At the end of March 2004, insured deposits with these members represented less than three percent of all deposits insured by CDIC.

Special examination context

25. **Previous Special examination.** Management took action on the recommendations of the 1999 Special Examination Report and reported its progress to the Audit Committee.

26. **CDIC's reorganization.** Effective 1 April 2003, CDIC modified its organizational structure primarily to reduce staff levels and costs.

27. **Finance Minister's request.** In its March 2004 Budget, the federal government stated its commitment to maintain the present level of deposit insurance protection but noted there may be opportunities to improve the efficiency and effectiveness of the delivery of federal financial services regulation. To that end, the government stated it would seek views on how best to address any overlap in prudential, administrative, and corporate service functions between the Office of the Superintendent of Financial Institutions and the Canada Deposit Insurance Corporation, with a view to introducing any changes before the end of that year. As a result, the Minister of Finance subsequently asked both OSFI and CDIC to review and report to him on their respective roles.

28. This special examination focused on the systems and practices CDIC had in place between February and September 2004; it neither addresses the Minister's request nor comments on the reports submitted by CDIC and OSFI in response to that request.

FINDINGS

Board effectiveness

29. The effectiveness of a board of directors depends on the processes, practices, systems, and structures for overseeing the direction and management of an organization so it can carry out its mandate effectively and achieve its objectives. We expected that CDIC would have such a framework for corporate governance.

30. We interviewed directors and senior managers of the Corporation and reviewed corporate documents including the Board Governance Policy, the Directors' profile, Board self-assessments, corporate plans, financial and performance

information, and Board and its committee meeting minutes and information packages.

31. CDIC's Board of Directors is responsible for overseeing the management of the businesses, activities, and other affairs of the Corporation. It comprises the Chair, the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Financial Institutions, the Assistant Superintendent of Financial Institutions, the Commissioner of the Financial Consumer Agency of Canada, and five private sector members.

32. The officers of the Corporation are responsible for the stewardship and management of CDIC; they include the President and Chief Executive Officer and officers appointed by the Board of Directors.

33. Currently the Board has six committees: Executive Committee, Audit Committee, Human Resources and Compensation Committee (HRCC), Governance Committee, Nominating Committee, and Committee of Independent Directors. In 2003/04, the full Board met eight times and its committees met individually up to four times.

34. **A good governance framework.** We found that the Corporation has in place the key elements of a good governance framework. The Board assumes the stewardship of the Corporation and works closely with Management. It plays a key role in establishing the strategic direction of the Corporation and recommends the corporate plan to the shareholder.

35. The Board has an effective succession plan and maintains an internal audit regime. It communicates with the Crown and other stakeholders, and it allocates responsibilities, builds relationships, and holds Management to account.

36. The Board holds effective full-participation meetings and also makes good use of its committees. The Audit Committee's mandate includes responsibility for

overseeing the management of risks and actively soliciting information about the significant risks to which CDIC is exposed.

37. We found that the Board assesses its performance, conducts orientation and training sessions for members, and has a Board Governance Policy and a Code of Conduct for Directors.

Risk assessment

38. Risk assessment systems and practices are intended to identify problems in member institutions early enough that corrective action can be taken to minimize CDIC's exposure to loss.

39. We reviewed the report on an internal audit of the Insurance and Risk Assessment Division conducted in 2002 and related follow-up documents; we interviewed officials and reviewed additional documentation such as the Risk Assessment Methodology Manual (RAMM).

40. We expected that the Corporation would have systems and practices in place to identify risks in member institutions as early and as accurately as possible, maintain high-quality information and analysis so it can minimize its exposure to loss, and discharge its responsibilities appropriately. We also expected that the Corporation would establish and communicate to its member institutions comprehensive and up-to-date standards of sound business and financial practices they are to follow; monitor their adherence to these standards; and take appropriate, timely action when they do not.

41. In our previous special examination, we noted that CDIC needed to do better at documenting the role in risk assessment played by each department of the Insurance and Risk Assessment Division and at improving communication among these departments. It subsequently developed a risk assessment framework for assessing and reporting on the risks that each member institution

represents for CDIC. It also restructured the risk assessment function, most recently in 2003.

42. The previous special examination also noted that the Corporation's risk assessment systems and practices were not systematic or proactive enough. It was important that CDIC improve its understanding and knowledge of how economic and technological change impacts its members. The Corporation created the position of Emerging Issues Analyst in 2000 to support the risk managers and the risk assessment framework. The Corporation developed a risk assessment methodology and now completes a risk assessment profile (RAP) of each member institution. The RAP considers whether the member institution may be vulnerable to future trends and conditions.

43. In response to the 2002 internal audit recommendations, the Corporation made a number of improvements in its risk assessment process. Many of the recommendations were addressed in the Risk Assessment Methodology Manual (RAMM) finalized in June 2004. The RAMM outlines the methodology for monitoring member risk.

44. CDIC outlines and regularly updates the information criteria it uses to assess new applicants for deposit insurance, and it lists the information requirements in its application guide and forms. The application process is co-ordinated with OSFI's process for incorporating financial institutions. The Board considers Management's recommendations before deciding whether to approve or reject an application.

45. As well as monitoring member risk through the risk assessment process, CDIC reviews market information and monitors key environmental factors to keep track of developments affecting its members and the financial services sector in general. It meets as needed with OSFI's examiner to discuss member institutions. The annual membership review—a comprehensive analysis of CDIC standards and financial, market, regulatory, economic, and emerging issues in Canadian banking—uses the results of this monitoring.

46. We also noted that the Corporation takes timely and appropriate action to address identified risks. The Risk Assessment Department maintains a "watchlist" of member institutions that cause it significant concern or that pose a high risk. It discusses the status of watchlist members regularly with OSFI and provincial regulators and informs the members about their status; the Board regularly reviews the watchlist and possible actions suggested by Management.

47. **Standards of sound business and financial practices**. The Standards of Sound Business and Financial Practices set out CDIC's expectations for the business and financial practices of member institutions. They stress that while an institution's senior management has the day-to-day responsibility for the quality of processes, policies, procedures, controls, and internal reports, the ultimate responsibility rests with the board.

48. The risk that CDIC incurs in providing deposit insurance reflects in large part its member institutions' exposure to risk. It seeks to manage its own potential exposure as insurer by promoting standards of sound business and financial practices in its member institutions.

49. In the last special examination, we recommended that CDIC update the standards and the related reporting process. The Board approved an updated Standards of Sound Business and Financial Practices By-law in July 2001, after extensive consultation by CDIC with member institutions, their associations, regulators, and others.

50. The updated reporting requirements for member institutions started in July 2002; by July 2003 all members were to submit annually a board resolution and a letter of representation by senior management that the member institution was adhering to the standards. Additional, more extensive reports at least once every five years on adherence to standards are required from member institutions based on their risk classification under CDIC's Differential Premiums By-Law.

51. We found that CDIC keeps up-to-date on all significant developments in the financial sector that could have a material impact on the standards. It created a Standards Working Group of member institutions to consider areas of the standards for updating.

52. The standards are communicated to member institutions and other stakeholders through information bulletins and meetings with the board and senior management of each new member. On request, CDIC meets with the senior management and board of member institutions to discuss the standards and their application; it also promotes the standards through speaking engagements at various conferences.

53. CDIC monitors adherence to the standards by member institutions through their annual attestations; higher-risk institutions must accompany their attestation with a more detailed report. CDIC may ask for more information on areas of concern, and the member may be subjected to a special examination by CDIC. CDIC notifies the member when a deficiency is identified. In the risk assessment process, the Corporation considers the institutions' adherence to the standards and any related deficiencies and takes further action as appropriate.

Contingency planning

54. Readiness for failures of financial institutions is core to CDIC's mandate. We expected it would be prepared for intervention or timely, accurate payouts, with systems and practices in place that reflect the size and complexity of member institutions and current business conditions and practices. We expected it would have the appropriate human and financial resources to intervene with the least costly methods and minimize its losses. We also expected it would establish and maintain the capacity to maximize net claims and recoveries or minimize the cost of meeting guarantees and other commitments.

55. During the period under examination, there were no new interventions or payouts. Therefore, we focussed on CDIC's capacity for possible future interventions and payouts. We updated the knowledge and understanding gathered during the previous special examination by meeting with senior officials and reviewing changes in both the financial sector and CDIC. We reviewed a number of documents such as the Risk Assessment and Intervention Departmental Business Plan, Board minutes, minutes of Operational Readiness Group meetings, and Payout Overview guidelines.

56. **Increased focus on readiness.** Payout and intervention readiness relies on the support of information systems, human and financial resources, and adequate documentation of processes and practices.

57. Following the 2003 reorganization, the Insurance and Risk Assessment Division and the Field Operations Division were merged and continued as the Insurance and Risk Assessment Division (IRA) to focus on CDIC's core responsibilities, including payouts. CDIC modified its staffing approach to intervention in order to use its own staff more and rely less on outside suppliers. Strategies included creating in-house capacity for development and support of more information technology systems, introducing payout methodology to more CDIC employees, and training them to act as team leaders in the event of a payout. The IRA business plans reflect these strategies.

58. The previous special examination noted that the Corporation should establish a contingency plan to address future interventions involving potentially large, complex, multiple, and simultaneous failures. CDIC established an internal committee in 2000 to develop options for dealing with the failure of a large, complex member institution (LCMI) and assessing the legal implications. The conclusions were reported to the Board in December 2002.

59. CDIC considers the likelihood of a LCMI failure to be low in the current economic environment. We noted that Management is conscious of the risks that an LCMI failure would present; it believes that such a failure would most likely be caused

by extraordinary events. After discussion with the Board, it has chosen to focus on the intervention and payout systems and practices appropriate to the pool of smaller member institutions that represent a greater risk to the Corporation.

60. The IRA Division developed concrete measures of its readiness, by member institution peer group—large banks, member institutions specializing in real estate lending, trusts, etc.—indicating its level of readiness to deal with future interventions. This step has not yet been extended across CDIC as a whole and does not indicate the readiness of other divisions. We encourage the Corporation to assess the readiness of all key parts of the organization for each member institution peer group and report to Management and the Board, clearly identifying risks and outlining strategies to mitigate them.

61. As a result of the 2003 reorganization, the merged IRA Division was reduced, through transfers and elimination of certain positions, from 39 to 24 people. Management's strategy continues to be to retain and maintain corporate knowledge of systems and practices, using a knowledge management approach and expanding the in-house base of skills.

62. CDIC still plans to use consultants and temporary staff in areas where it lacks knowledge or human resources. It reviews its supplier network regularly and has concluded that the skills or human resources it lacks would likely be available if needed. In the previous special examination, we recommended that the Corporation ensure the availability of required resources by setting up standby arrangements and these were put in place until 2003; however, they were discontinued as Management now considers standby arrangements too expensive in times of low risk. CDIC has instead augmented its in-house expertise through formal training in intervention and payout, shadowing of key intervention experts, and use of computer simulations. It mitigates the risk of losing corporate knowledge by documenting experiences and identifying specific responsibilities.

63. In the last special examination, we noted that CDIC would be prudent to consolidate written procedures for the payout process. In the current special examination, we reviewed a number of draft documents on processes and systems, and we encourage CDIC to finalize these documents to support timely, appropriate intervention or payouts in the future.

64. **Information technology (IT).** In the previous special examination, we noted that an in-house computer system should be implemented fully to support contingency planning; CDIC finished implementing the system in 2001. The supporting technology was updated and the software upgraded in 2003 to meet the anticipated need for a payout. Maintenance of the systems is now the responsibility of CDIC's IT department.

65. CDIC uses risk-based simulations to assess the performance of its intervention and payout systems. The latest simulation in 2004 helped identify needed improvements to the systems and served as a training tool for staff to understand the payout process and the software. The Corporation intends to conduct more simulations with a view to making further improvements.

66. The IRA Division also identified two risks that CDIC could mitigate to increase its level of readiness.

67. The first risk is lack of knowledge or information about the data on insured deposits that reside in member institutions. CDIC has explored options for addressing and mitigating this risk, which Management acknowledges increases with the risk of member institution failure. Management believes it can gather this information on a timely basis by conducting special and preparatory examinations of a member institution where warranted by risk assessment and supported by the Board.

68. The second risk is in the valuation model CDIC uses in assessing various intervention methods in a given situation. The valuation model takes data drawn

directly from a failing member institution and uses a series of assumptions to produce detailed financial forecasts. The purpose of the model is to estimate CDIC's losses under various failure resolution scenarios. The valuation model is considered an important tool for CDIC in choosing the proper means of timely intervention; it must be reliable and flexible.

69. The current forecasting model was designed when CDIC's highest risk exposures were to institutions involved primarily in real estate lending. The model does not reflect the growing complexity of both financial institutions and the financial instruments they use.

70. The Corporation has not made updating the model a priority, first because it does not anticipate the need to apply the model to failed institutions in the near future, and second because if necessary, it could adapt and apply the model in an acceptable, if less than optimal manner. Management plans to upgrade the model using both internal resources and external development support.

71. We encourage Management to update and document the valuation model and thereby enhance its readiness for intervention.

72. **Maximizing recoveries and minimizing claims.** Overall, we are satisfied that CDIC has systems and practices that allow it to minimize claims it must pay and to maximize recoveries.

73. To maximize recoveries, CDIC works with reputable and experienced liquidators in the liquidation process. Liquidation strategies are set out in a business plan that is reviewed by CDIC Management and updated regularly. CDIC may negotiate incentive plans as motivation for liquidators to obtain the highest possible recoveries. The performance of liquidators is monitored regularly against the business plan.

74. To minimize claims, CDIC requires documentation to support any claim made against its guarantee. Before approving payment of the claim, it assesses the supporting documentation to determine whether the creditor has exhausted all avenues of collection. An independent auditor audits the claims annually. CDIC retains all documentation to be used for future reference on similar issues.

Relations with stakeholders

75. We looked at CDIC's systems and practices used to assess, monitor, and manage relations with stakeholders.

76. CDIC is a small organization with an experienced management team. We expected that to minimize unproductive overlap and duplication, it would have formal and informal systems and practices in place for good communication and co-operation, both with other organizations that help maintain the stability of the Canadian financial system and with its member institutions. We also expected that the Corporation would provide timely, accurate information to the depositing public to support its awareness of deposit insurance.

77. We met with many stakeholders: representatives of the Bank of Canada, the Office of the Superintendent of Financial Institutions, the Department of Finance Canada, the FCAC, and the Canadian Bankers' Association (CBA). We reviewed documents such as correspondence with key stakeholders, the CDIC/OSFI Strategic Alliance Agreement, Board information packages, and a map of CDIC's key relationships.

78. We concluded that CDIC's experienced management team has identified the parties with whom communication, co-ordination, and co-operation are necessary. It clearly understands the desired relationship with each stakeholder and it manages those relationships effectively.

79. CDIC formally manages its relationships with federal bodies in the system for oversight and safety net for deposit-taking institutions through the Financial Institutions Supervisory Committee (FISC), the Senior Advisory Committee (SAC), and its Strategic Alliance Agreement with OSFI. Certain officials from FISC and SAC are also members of CDIC's Board of Directors.

80. In the previous special examination we noted that CDIC needed to exchange information with OSFI more effectively. In the current examination we found that its exchange of information with OSFI has improved significantly; it is well documented and supported by the CDIC/OSFI Strategic Alliance Agreement, most recently revised in 2003.

81. **The issue of regulatory burden.** Member institutions are another important stakeholder for CDIC. In recent years the CBA has expressed concern about the increasing level of regulation in Canada and abroad. In the past year, the CBA specifically identified CDIC as one of the contributors to regulatory burden.

82. CDIC has taken steps to reduce the regulatory burden on its members. It has implemented a system that allows member institutions to file their reports for the Differential Premiums By-law electronically. It also updated and modernized the Standards of Sound Business and Financial Practices.

83. In the first quarter of 2004, the Corporation began meeting with the CEOs and chief compliance officers of financial institutions to obtain their comments on CDIC's performance and on the issue of regulatory burden.

84. The Board of Directors asked its Committee of Independent Directors to prepare a response to the Minister of Finance's March 2004 request that CDIC review its role in the federal regulatory and supervisory framework in relation to OSFI's activities. CDIC responded in July 2004 by sending a report to the Minister which included recommendations to address regulatory burden.

85. **An informed depositing public.** Managing the expectations of the depositing public depends in part on the level of public interest in deposit insurance, which varies with how the public perceives the level of financial institutions' stability and the risk of their failure.

86. In the previous special examination we noted that CDIC needed to improve its communication with the public. In the current examination, we found that the Corporation maintains systems and practices for providing timely, accurate information to the depositing public based on the needs it has identified for information, its current intervention activities, and its mandate. It provides this information in various ways - for example, television commercials, pamphlets, and decals in windows of financial institutions. The information includes limitations of deposit insurance coverage, coverage ceilings, and changes to the list of member institutions.

87. CDIC monitors the effectiveness of its information programs through toll-free telephone lines, e-mail, letters, and surveys that measure public awareness about deposit insurance. Management believes that the 64% awareness level measured in 2004 is high in sound economic times and at the present level of funding allocated to its Public Awareness Program. The Corporation is considering alternatives to the current five-year Program, which wraps up in March 2005.

Succession planning

88. Succession planning refers to the systems and practices in place to identify, retain or hire, and train as appropriate those persons who will replace certain key staff when they leave the organization.

89. Typically, many small organizations plan for succession informally, often without a policy or process, because the limited number of senior executives and their potential replacements are well known to senior management. An effective

succession plan is normally guided by a clear policy statement, supported by human resources management and other management processes, to ensure the transfer of knowledge, the effective development of employees, timely recruitment, appropriate compensation and retention strategies, and robust performance evaluation and performance management.

90. We reviewed policy manuals, performance appraisal files of all employees listed in the CDIC succession plan, an analysis of training gaps for those in the succession plan, a report on proposed revisions to the system of performance pay, minutes of the Board's Human Resources and Compensation Committee (HRCC), and staffing files on recent recruits. We interviewed senior officials at CDIC, the current Chair of the HRCC, and the Chair of the Board (who is a past chair of the HRCC).

91. CDIC has taken succession planning seriously and has developed both a policy and a process to govern it. Though a small organization, it has institutionalized its practices in order to ensure that it has the human resources in place (or plans for recruiting them) in all its key positions, given its concern that resources skilled in its business lines are in short supply and high demand in the banking industry.

92. CDIC's succession planning policy, developed in 1997, clearly articulates the purpose of succession planning in the organization, outlines the process it will follow, details the objectives, and assigns roles and responsibilities to the various levels and bodies in the organization. The Corporation has clearly delineated the roles that Management and the Board are to play.

93. The succession plan itself identifies both potential replacements for key jobs, in the event of unexpected vacancy, and others who could be considered and developed to take on a more senior position. CDIC addressed the government's recent announcement on the process to be followed in nominating and appointing heads of Crown corporations, including conducting a formal search and recommending candidates for the CEO position.

94. From the perspective of human resources management in general and succession planning in particular, CDIC strives to keep up-to-date on trends, be responsive to staff concerns, and apply policies and practices with consistency and transparency. In our view CDIC is well served by human resources management.

95. The succession planning policy and processes are well integrated and consistent with related policies and are reviewed regularly by the Board. The separate roles of the Board and its HRCC are clear and well understood, as is the division of responsibility between the Board and Management.

Financial risk management

96. CDIC's financial risk refers to any actual or potential exposures to risk incurred in the course of its activities, including credit, market, liquidity, operations, and legal risks. The Corporation has prepared financial risk management policies consistent with the Minister of Finance's *Financial Risk Management Guidelines for Crown Corporations*, which serve as a basis for its financial risk management framework and recommend that Crown corporations prudently manage financial risk in their treasury operations. As described in CDIC's 2003 Annual Report, and consistent with the Guidelines, the primary objectives of the Corporation's investment portfolio are liquidity and the preservation of funds.

97. We expected CDIC to have documented and approved policies and procedures to ensure that all financial risks are identified, measured, monitored, controlled, and regularly reported to the Board of Directors. We also expected that the Board would set risk limits at appropriate levels for all significant actual or potential exposures to ensure that the Corporation's net income and capital, if any, would not be materially at risk. We expected that CDIC would not engage in trading financial instruments as a separate corporate activity beyond what would meet its normal funding requirements.

98. We reviewed the investment policies approved by the Board of Directors, tested CDIC's compliance with the policies, reviewed the meeting minutes of the Board of Directors for regular compliance reporting, and reviewed Board documents relating to contingency planning for liquidity and the establishment of an ex ante fund.

99. CDIC has comprehensive investment policies to manage market, credit, and liquidity risk. The policies are conservative and are intended to protect CDIC from loss. The policies are reviewed and approved annually by the Board of Directors on the recommendation of the Audit Committee.

100. We noted no instances where Management did not comply with the approved policies in managing the investment portfolio. ALCO (Asset-Liability Committee) reports to the Board of Directors regularly on compliance.

101. The Corporation also examined the level of ex ante funding that would be prudent to maintain to deal with possible deposit insurance losses. In January 2004 the Board of Directors established a range for such ex ante funding for the purposes of the 2004/2005—2008/2009 Corporate Plan, and directed that CDIC manage the amount of the ex ante funding toward the mid-point of the range. The Board of Directors did not decide when the ex ante funding level is to be reached; however, it required that a review of how funding will be managed within the range is to take place no later than when the bottom of the range is reached. Premium rates are fixed annually considering the Corporation's financial condition, the economic environment, the risk profile of its membership and the actual and projected level of ex ante funding relative to the target range.

102. An effective reporting, governance and compliance framework supports the investment process. Management has a well-documented liquidity contingency plan. It also has begun to consider the impact that future premium levels will have on its ex ante funding.

Strategic planning

103. Strategic planning is a management tool that guides what an organization is, what it does, and why it does it, all with a focus on the future. It includes assessing and adjusting the organization's direction in response to a changing environment, an area where the board of directors plays an important and active role. A corporate plan outlines the organization's priority objectives and the allocation of resources to achieve them.

104. We expected that CDIC would establish specific, measurable objectives that were consistent with its legislated mandate. We expected that it would monitor and report on its performance against those objectives to support decision making by Management, the Board, and other stakeholders.

105. We assessed the information-gathering process that goes into developing CDIC's Corporate Plan. We looked at senior Management's role in that process, the involvement of the shareholder and other external stakeholders, and the Board's role in setting strategic direction. We examined the adequacy of the approach used to communicate the Corporate Plan to external stakeholders. Finally, we examined how CDIC established and reported its measures of performance.

106. **Strategic planning and performance measures**. The Corporation's current strategic plan is documented in its Summary of the Corporate Plan, 2004/05 to 2008/09.

107. CDIC has a position dedicated to monitoring emerging issues and it analyzes their impact on current and planned operations. Through means such as monthly newsletters, its strategic alliance with OSFI, and management and staff participation on various committees and working groups, it consults with key stakeholders and, where appropriate, its analyses are forwarded to the Board and its Committees.

108. In the previous special examination we noted that notwithstanding improvements, CDIC had not set out its corporate objectives and action plans in enough concrete detail that it would be able to fully measure their achievement. In the current examination, we noted that CDIC now takes a team approach to developing and reviewing all information destined for the Board. Board agendas are planned well in advance and are well developed. Reports to the Board typically have an executive summary supported by detail; the information package it receives includes detailed reporting on performance monitoring. CDIC has improved the measurement and reporting of achievements against objectives in its “scorecard” on performance. In July 2003, the Board evaluated and concluded it was satisfied with information it receives from Management.

109. The Corporation’s strong accountability reporting was recognized in 2003 and in each of the eight previous years, when it was named a finalist in its category for the Auditor General’s Award for Excellence in Annual Reporting by Crown Corporations.

110. **Enterprise risk management (ERM)**. The Board’s Audit Committee has responsibility for the oversight of CDIC’s risk management, including an obligation to actively solicit information about the significant risks to which the Corporation is exposed. In 2000, CDIC began a corporate risk project that became the ERM initiative in the fall of 2002.

111. The ERM initiative is intended to provide a comprehensive, systematic, disciplined process to coordinate, communicate and enhance existing systems and practices for identifying, assessing, managing, monitoring, documenting, and at any point in time reporting, the significant risks to the achievement of its objectives, strategies, and plans in the conduct of its affairs.

112. To date, CDIC has identified the significant risks to which it is exposed; it has presented to the Audit Committee an in-depth assessment of underwriting risk. Key next steps are to develop by the end of December 2004 the reporting package it has planned on the major risk areas. Over the next three years,

Management intends to present the Audit Committee with in-depth assessments of other risks and the related risk management policies.

113. Some Board and Audit Committee members have expressed concern about the timing, content, and clarity of ERM reports to the Audit Committee. Management is working with the Committee to address these concerns; we support that initiative.

CONCLUSION

114. As stated in our special examination opinion, we concluded that during the period under examination, the systems and practices of CDIC were designed and operated in a way that provided reasonable assurance that assets were safeguarded and controlled, resources managed economically and efficiently, and operations carried out effectively.

115. We have identified opportunities for CDIC to enhance the quality of these systems and practices. In our view, the Corporation should pay particular attention to

- assessing the readiness to deal with future interventions of all key parts of the organization, by member institution peer group;

- finalizing key documents on the processes and systems for intervention and payout.

- updating and documenting the valuation model used in assessing various intervention methods; and

- addressing the concerns about the timing, content, and clarity of enterprise risk management reports.

MANAGEMENT'S RESPONSE

116. CDIC Management has already made progress in these areas and has developed specific action plans and timelines to resolve these matters on a timely basis.

Appendix A

Systems and practices examined and related criteria

Risk Assessment

1. CDIC should identify as accurately as possible in a timely manner, member institution risks in order to take appropriate action to minimize the Corporation's exposure to loss. The Corporation should be expert in deciding when to intervene and how; have the relevant and requisite authority, capability and will to intervene at the right time; and have management strategies and procedures in place in order to meet the statutory objects.

2. CDIC should establish comprehensive and up-to-date standards for sound business and financial practices to be followed by member institutions, communicate and monitor adherence with these standards, and take appropriate and timely action when situations of non-adherence are encountered.

3. CDIC should maintain high quality information and analysis on member risk and CDIC exposure to loss, enabling it to discharge its responsibilities.

Contingency Planning

4. CDIC should have the capacity to make least cost interventions in member institutions as appropriate.

5. CDIC should establish and maintain the capacity to maximize net claims and recoveries, or minimize obligations associated with guarantees and other commitments taking into account sector stability objectives and its creditor status.

Succession Planning

6. CDIC should establish and effectively implement succession plans that are relevant to the size and nature of the Corporation and existing staff and planned changes thereto.

Relations with Stakeholders

7. CDIC should maintain good communications and co-operation with other organizations that are important to maintaining the stability of the Canadian financial system, including the Office or the Superintendent of Financial Institutions, the Department of Finance, the Bank of Canada, Financial Consumer Agency of Canada and Provincial regulators and deposit insurers as well as member institutions in order to minimize unproductive overlap and duplication and make the best use of available knowledge. We will also consider CDIC's relations with the Canadian Bankers Association (CBA).

8. CDIC should provide timely and accurate information to the depositing public to support a public awareness of and an understanding of deposit insurance.

Strategic Planning

9. CDIC should maintain a current knowledge of developments and emerging issues affecting the financial services sector and, within its mandate, should appropriately adjust its operations.

10. The CDIC Board should receive high quality information and analysis to facilitate decision-making and to monitor and assess CDIC's performance.

Board Effectiveness

11. In the context of the FAA control and accountability framework, CDIC should have a well-performing corporate governance framework that meets best-practice expectations for Board stewardship, shareholder relations and communications with

the public to maximize the effectiveness of the Corporation and its ability to balance public policy and corporate objectives.

Financial Risk Management

12. The Corporation should ensure that funds are obtained and managed to meet requirements at least cost within defined tolerance for market risks faced by the Corporation.