Remarks by Nicholas Le Pan, Superintendent
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the Empire Club of Canada

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Welcome

OSFI is the prudential regulator for over 450 banks and insurers and over 1200 federally registered pension plans. Prudential -- that means we focus on safety and soundness. It also means we care about the success of the institutions and plans we regulate.

There are two topics I would like to share with you today: first, the state of the financial institutions and pension plans regulated by OSFI and second, my view of important factors for success in regulation going forward.

OSFI's Mandate

OSFI has a mandate from Parliament for early intervention to deal with potential safety and soundness problems and to promote policies and procedures designed to control and manage risk.

OSFI's legislation requires us to have due regard for banks and insurers to be able to compete effectively and take reasonable risks.

It also recognizes that management, boards of directors and pension plan administrators are ultimately responsible and that financial institutions and pension plans can fail. I know the word "fail" doesn't make most of us feel warm and fuzzy. Having said that, the Canadian financial services industry (like the industry worldwide) has been enormously successful over the past decade at weathering disruptions that would have produced a lot more serious consequences historically. It's easy to forget how to deal with problems.

Recognition of the Importance of the Financial Services Sector

I want to emphasize that policy-makers, regulators, decision-makers, and those in charge of financial institutions need to recognize the incredible importance of the financial services sector to the Canadian economy. A properly functioning, efficient financial services sector is behind so many parts of our economy and our day-to-day lives. Financial services represent 6% of Canada's Gross Domestic Product, employ over 600,000 Canadians and pay $13 billion in taxes. They are one of the few, large, internationally successful groups of Canadian companies. Toronto is headquarters for five major banks and two major insurers. That concentration in a single North American city may be unique outside of New York. The sector is also very important in other Canadian cities. So finding and keeping a regulatory regime that protects depositors and policyholders, but also supports industry success, matters.

State of the Industry

Financial Institutions

The credit quality of banks has been excellent and they are well capitalized. Core earnings remain near record highs.

We may have passed the peak in credit quality and there is that old truism that bad loans are made in good times.   The market and credit risk in complex, potentially illiquid products deserves ongoing and active management.

Capital ratios for the life insurance industry remain well above minimum regulatory requirements. **Overall,** we see **a stable outlook,** with improvements in profitability, asset quality and capital levels.

I think inherent operational risk for banks and insurers is still increasing, though so is the capability to manage it. Reputation risk issues, including Anti-money laundering and Counter-terrorist financing, deserve ongoing heightened attention. Our message is also that expense control should not undercut high-quality compliance and risk management.

Many smaller banks or life companies are less diversified, pursuing niche-oriented strategies to remain competitive. The challenge is to ensure that, in an effort to achieve growth and sales objectives, these institutions do not make compromises that ultimately add risk beyond their capability to manage.

Returns on Equity in the property and casualty insurance sector are approaching 20%, though there are some who are nowhere close to that.   I have been pleasantly surprised by the sustainability of these results.

The improvement in operating results since 2002 has led to a material decline in the number of property and casualty insurance companies subject to OSFI's heightened supervision.

I am impressed by the property and casualty insurance industry's commitment to strong discipline in pricing and underwriting. That reduces the risk of a repeat of the bad times of a few years ago.

Internationally, the loss experience of the past two years from catastrophes was the most severe in history. But the strong financial condition of the sector meant the global industry was able to sustain the impacts of these events. The spill-over effect on Canadian insurance markets has not been serious.

Lastly, parts of the banking and insurance industries have experienced material compliance lapses. But these have **not** been systemic in Canada in my judgement. The response by industry in tightening oversight and governance from OSFI's perspective has been impressive.

Major banks and insurers are following much more divergent strategies than they used to. They are operating in a more complex environment—more complex products, different geographies, tougher competition, less room for error. Overall, however, in part pushed by regulators like OSFI, management, governance and oversight of risks is markedly improved from five or ten years ago. Canadians need to understand better what a success story this has been.

Pension Plans

In contrast, the defined benefit pension plans that OSFI regulates continue to show significant challenges to their long-term health and viability. Our estimates show that some three-quarters of defined benefit pension plans have a solvency ratio of less than one and the number of plans on our watch list is rising and we expect it to rise further. Partly this is due to lower market interest rates and to the fact that people are living longer. It is fair to say the situation for defined benefit pension plans continues to be challenging, but I believe it is manageable.

OSFI has seen an increase in the use of defined-contribution-plan versus defined-benefit-plan arrangements.

Does this matter? I think so. Defined benefit and defined contribution arrangements are, of course, markedly different in how they share risk. I don't advocate one over the other, but I think that employers and employees ought to have a fair choice and know what the real risks are. Right now, I think the choices are stacked against defined benefit plans. Partly this is because of tax rules, partly because of ongoing fights regarding ways to resolve surplus disputes, and partly it results from costs of multiple rules and rigidity in funding.

Some Important Success Factors Going Forward

So, as a country, what does it take to maintain and sustain success going forward?

The Right Mindset in Approaching Regulatory, Legislative and Policy Issues

Financial institutions are not public utilities. Success is important, particularly from OSFI's perspective, as it is the number one line of defence against safety and soundness problems.

What do I mean? The economic and financial environment has been exceptionally good, and I have no sense of short-term deterioration. But we know that, from time to time, stresses inevitably arise. We **want** the financial services sector to be accepting risk and measuring and managing risk well. When you are dynamic and accept risk, there are going to be losses. And we want the financial sector to be a good absorber of economic and financial shocks, not a magnifier of shocks, as it has been in some countries. When industry players have major losses, it is one thing if those losses eat up only a quarter or two's earnings—it is quite another if they cut materially into capital and thus risk cutting into public confidence.

Of course the financial services sector is regulated, and there are important tradeoffs between various policy goals. But when I tell people what I do for a living, they don't enthuse about the safety and soundness and success of our financial services industry.

And in terms of mindset we have to understand that those who want to continually bash major industry players are not committing a victimless crime. Of course these organisations make mistakes from time to time. They need to be fully held to account for those. That's what OSFI does in the safety and soundness sphere. But making decisions about rules and policies based on a 'bashing' mindset is wrong.

I do not advocate failing to address legitimate public policy issues and concerns (whether it be who ought to market or distribute insurance or how par policyholders ought to be treated). But it does mean addressing these issues based on as much dispassionate analysis and judgement as possible, and with a full range of options under consideration, not just on interest group politics or the 'sky will fall' kind of analyses.

And it means facing the real financial and economic costs of suggestions before deciding whether they are a good thing—not, for example, promoting new guarantees for pensioners as inexpensive or neglecting to mention that a guarantee fund could make the regulatory job harder by reducing incentives for plan stakeholders to face and solve their problems themselves.

When public policy decisions affect major strategic direction of financial institutions, or of defined benefit plans, it is also key that whatever decision is taken by governments be clear and timely—otherwise we introduce unnecessary risk and inefficiency into the system.

Efficiency and Rules

This is also where efficiency in the legislative and regulatory structure comes in. If we don't give due regard to efficiency, we sap success.

I believe that the prudential regulatory system stacks up pretty well in this regard. OSFI runs a reliance-based, risk-focussed regulatory and supervisory system that is not very costly. Our average cost recovery from a large financial institution is $4-5 million. We are increasingly working with foreign regulators such as the U.S. and the U.K. to avoid unproductive duplication and overlap in our supervision program. In Canada, harmonisation of key prudential rules between the federal government and provinces is in place. Basic prudential rules are becoming less one-size-fits-all and more related to real risks.

On the market conduct side of financial institutions regulation, in contrast, we have a bewildering array of actors, both federally and provincially, risk-based approaches to regulation are just starting to be talked about, a range of products that are economically similar are treated differently, and my sense is that compliance costs are rising rapidly.

One key question is always whether we need more rules, and the balance between principles versus rules. This is not only a matter for those of us at OSFI, but also for other financial regulators and other standard setters who have a big impact on financial institutions, such as in the area of accounting and auditing.

Today, I think we've reached "new rule overload" -- new accounting rules, Sarbanes Oxley 404, new international rules in banking and insurance, new market conduct rules.

Over the past few years, OSFI has tried very hard to resist the temptation to put in place detailed new rules. The Basel Committee on Banking Supervision, whose membership is composed of the G-10 countries and of which I am proud to be serving as Vice Chair, has decided on a rule pause.

More and more rules, and more detailed rules, risk becoming a checklist, at which point their benefit is greatly reduced. The rules themselves become a risk. At worst, a financial institution or a regulator administering a plethora of rules may take their eye off the things that really matter.

In the pensions world, efficient regulation means dealing with the issues raised (in the recent Department of Finance discussion paper) to create a more level playing field in the choice between defined benefit and defined contribution plans. I support those initiatives. Longer term, it also means recognizing the costs to plans of dealing with rules from multiple jurisdictions

Whatever happens with these bigger-picture pension initiatives, they are unlikely to be much help with the immediate funding challenges faced by defined benefit plans. Nevertheless, they should still be pursued.

For efficiency in regulation, I strongly support key rules based on international norms. But then, we must be very disciplined to allow for local variants or add-ons, only where it is absolutely essential.

Focus on Contingency Preparedness

Even in good times OSFI, and the institutions we regulate, have to be prepared to deal with problems. Increasingly, we don't just focus on risks but also on the resiliency of our institutions and the financial system to deal with the unexpected. Currently, for example, OSFI is reviewing the contingency plans of major banks and insurers to deal with a flu pandemic. While there can be no guarantees of success, I am satisfied with financial institutions progress to date in this regard.

Pensions – The Short Term

Dealing with problems like those in the pension sphere means facing them, communicating frankly with those who need to be involved, and acting. Despite the continued decline in solvency ratios and the fact some plans are in difficulty, the majority of federal plans continue to fund their deficits. However, because of current challenges, plan administrators may need to review their plans' benefit structures and determine whether the plans, in their current structure, continue to be affordable. Don't wait for interest rates or markets to turn around. In the present environment, high-quality disclosure to members regarding the health of their plan is key.

OSFI has seen a marked increase in the number of plans seeking to reduce benefits. In some cases, this option may be better for plan members than the alternative of plan termination. But I want to be clear: This is <u>not</u> an easy road to pursue.

Recently, the Globe and Mail called OSFI the most active pension regulator in Canada. I like to think that is true. To that point, OSFI is prepared to continue working with plan sponsors and members to find reasonable solutions. This could involve plan restructurings to make them more affordable, and we are approving benefit reductions where this is better for plan members than the alternative of plan termination. We have been impressed by the number of plan administrators/sponsors who have given us a heads-up on looming problems. It is very important to engage OSFI early in the process so that we can consider viable options together.

Pension Funding Rules

OSFI would support flexibility in the regulations, perhaps temporarily, for plans to deal with increased deficits. However, we also want it more likely that plan members will not be any worse off under any new arrangements and that they are made aware of the risks. This decision is not OSFI's to make, and we will continue to work with the department of Finance on these issues.

Conclusion

Despite the issues I have mentioned here today, Canadians can have a high degree of confidence in the fundamental soundness of our financial institutions and private pension system. The prudential regulatory system is sound. Thank you.