Remarks by Superintendent Julie Dickson
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
National Insurance Conference of Canada

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Recent turmoil in global credit markets and ABCP: OSFI's view

Introduction

When I was initially planning this speech – my first since I was named Superintendent of Financial Institutions – I was planning to talk about the property and casualty (P&C) business. But recent events in the global financial system have made headlines here and around the world, and I want to provide some insight into OSFI's view of what has been happening, and where we believe things are going. Also, while the P&C industry has not been directly affected by the issues in the asset-backed commercial paper (ABCP) market, you may think it's irrelevant to you. But there are in fact several lessons coming out of recent events that are applicable to P&C companies and all financial institutions.

Recent ABCP events

What was the cause of the global financial market turmoil? The trigger was rising default rates on sub-prime mortgages in the United States. This was amplified when globally, investors focussed on uncertainty about the types of loans underlying structured finance assets that they had purchased, such as asset-backed commercial paper. That led investors to reject certain products, and markets for ABCP become every illiquid, with many ABCP vehicles having difficulty selling paper to investors. Many investors around the world, including many Canadian corporations, were exposed. And everyone is looking for answers.

In interpreting recent events, there are three schools of thought. One school of thought is that the disruption in the ABCP market was unprecedented and not within the realm of a rational person's expectations. The second school of thought is that some sort of major disruption was predictable – various warnings were widely reported on in the financial press worldwide. The third is that bodies that have responsibility for regulation and global financial stability were asleep at the switch and are to blame for everything that has happened.

I obviously do not attend school number three. As for schools one and two, they are both interesting.

School one acknowledges that shocks can occur but focuses on the fact that they are extremely rare events – perhaps they're referred to as black swan events. A black swan event is a large-impact, hard-to-predict, and rare event beyond the realm of normal expectations. Some players pay little attention to the possibility of a black swan because such events are so remote. But regulators do worry about whether black swans can occur, as financial institutions have to be prepared should they happen.

School two teaches students that, where there is smoke, there is usually fire, or maybe incense, but there is something and it should be investigated. There was a lot of discussion by commentators about the red flags that were popping up and being reported on widely around the world. What was not known was whether the warning signs would lead to an orderly adjustment, such as an orderly increase in pricing of risk, which would be welcome, or whether they would lead to something far more serious. Commentators have noted how difficult it was to foresee that all of the factors that were publicly known would feed off one another in the ways they did, resulting in a disorderly adjustment.

That is the thing with shocks – and that's why they are called shocks – they cannot be predicted in advance with certainty.

Regulators, including OSFI, focussed on capital and liquidity at financial institutions as that is the best protection against unexpected events. We also called for extra attention to be paid to other buffers for the unexpected, including robust stress testing, and continual enhancement of monitoring systems and risk management. This was and continues to be key.

Due to the strong capital and liquidity position of the Canadian banking system, our system is well placed to deal with events such as we are experiencing now.

What warnings were sounded before the current problems in the global financial markets? And how did people respond to these warnings? Any why didn't everyone in the world figure out that a black swan was in the offing?

There were a number of warning signs. Let me highlight four of them:

1. <u>Complex products</u> – This warning was everywhere. The issue discussed by many commentators was whether people really understood the complex products they were selling, and buying. As well, there were questions around whether people were reading the material rating agencies produce, to understand the methodologies used. This was talked about because structured finance transactions were among the most complex financial instruments offered to investors, requiring a high degree

of analysis before and after investment. But investors were searching for yield in a low interest rate environment and the lure of the triple-A rating was hard to pass up given its track record. As for low-risk premia, some experts were arguing that the low-risk premia reflected sound economic fundamentals and the benefits of modern financial technology. Some very intelligent people assessed the risks and made the wrong decision.

2. US sub-prime market problems – In mid-2005 this began to be raised as a looming issue. But most commentators saw this as a containable problem, in part because it was a small part of the market and a lot of the problematic lending was outside of the regulated banking system. But as the months went by there was a realization that, through securitization, exposures were popping up in many places and had found their way into highly rated tranches of some vehicles – many of which were arranged by non-regulated players but which touched the banking industry, both in Canada and globally, via liquidity lines.

3. Lack of transparency of asset-based and highly structured securities – Most investors had information on the "characteristics" of the asset pool, as well as information on credit enhancements, and this satisfied them globally for many years. It did not satisfy them when the sub prime problem hit and they realized that sub-prime exposures might be lurking underneath. Investor sentiment can change and did change. Going forward I think that investors will demand more information. OSFI agrees that more transparency of the underlying assets in ABCP conduits is a good idea and we will be discussing this with banks involved in the market and with our colleagues internationally.

4. Uniqueness of the Canadian ABCP market – The fact that Canadian investors were buying ABCP with one rating and with limited liquidity lines was also known. S&P had put out reports explaining why they would not rate a product that had liquidity lines that could only be drawn in the event of a general market disruption (GMD or so-called Canadian style due to their popularity in Canada). S&P suggested that liquidity lines that were more readily available in time of need (so-called global style lines) were better for the investor. Others such as DBRS believed that GMD lines were sufficient given the higher level of credit enhancement in Canadian structures compared to international structures. Sophisticated investors and advisors supported the DBRS view.

I have read a lot of articles in the press on the Canadian ABCP market lately. A sample last week included comments like: "Credit crisis made in Canada: lax rules to blame;" "Canada was not as tough as other nations"; and "the Canadian regulator did not ask liquidity providers to set aside capital, so they could use it to grow other lines of business." The previous week I read, "The situation is different in Canada because it had looser rules. It was essentially up to the banks to decide how they would support that non-bank asset-backed commercial paper. OSFI sanctioned these looser rules."

I think it's time to separate fact from fiction. There are two ABCP markets in Canada - ABCP conduits sponsored by Canadian banks (banks that OSFI oversees), and ABCP markets sponsored by unregulated players.

ABCP vehicles sponsored by Canadian banks had either global style liquidity lines, or market disruption lines in place – it depended on the bank. OSFI applied internationally agreed capital rules. The more risk of a liquidity line being drawn, the more capital a bank had to hold (the charge was 10% for global style lines). Where the risk of a line being drawn was extremely remote, the capital charge was zero. These are international capital rules. Despite headlines suggesting lax rules, loose rules, or different rules, Canadian rules are robust and aligned with international standards. Like all international banks, Canadian banks have stepped in to support their conduits, and this has helped to bring back investor confidence. The banks have also announced a move to global style lines, again to reassure investors.

For ABCP sponsored by non-banks – entities OSFI does not oversee – the situation is different. Such vehicles chose to negotiate general market disruption liquidity lines exclusively. When market confidence waned, these conduits could not negotiate global style lines and were unsuccessful in availing themselves of liquidity under general market disruption lines, given disagreements over the terms they had agreed to with their liquidity providers. Close to 90 per cent of the banks that these entities were dealing with were offshore foreign banks and the rules under which they operate are not set by OSFI. In fact, Canadian banks that OSFI oversee were very small players in providing liquidity – very few Canadian banks provided liquidity, and when they did it was for very small amounts – a total of $1.8 billion in liquidity lines, according to OSFI estimates.

In assessing the comments that have been made, I have to note that it is not OSFI's role to use our powers over banks (which are designed to help protect bank solvency) to regulate capital markets.

As a prudential regulator we do not tell Canadian investors what to invest in or not invest in. We do not tell unregulated players how to go about their business. We do not tell banks to provide liquidity to certain players and on what conditions.

In summary, OSFI focuses on the strength of the financial institutions because that is our job – safety and soundness of institutions that make promises to pay depositors and policyholders. OSFI focuses on capital, or buffers for the unexpected, as well as stress testing, liquidity and continual enhancement of monitoring systems and risk management, as that plays a key role in maintaining a safe and sound financial system.

Now let's turn to the P&C industry where capital, stress testing and risk management remains a critical aspect of what we do. And lessons learned from the recent turmoil will also apply to the P&C industry even though you were far away from the esoteric world of ABCP.

Stress Testing

We have a lot of good debates at OSFI, and with the companies we regulate, about stress testing. No one in the banking industry would have run a stress test with a scenario involving events of this past summer – but they have been running stress tests for a long time. Liquidity is one area of stress testing focus, and banks test how many months they can operate without difficulty assuming severe liquidity issues. This helps smart bankers sleep at night, or at the very least ensures that they make changes so they can be well prepared for the unexpected.

The P&C industry ran some very useful tests in the early to mid-nineties in terms of catastrophe modeling. While the results are no longer surprising, the initial results caused a large increase in catastrophic reinsurance limits. That is the hallmark of a good stress test – something realistic, yet also somewhat surprising. Something larger than management's current expectations, and something that leads management to take appropriate action to mitigate risk.

Another good test we have seen is an appointed actuary (AA) who modeled the frequency and severity of events, split by line, with large losses modeled separately. The analysis was based on historical loss experience but included the impact of the current reinsurance program. The volatility was higher than expected and as a result the company is reviewing its reinsurance structure.

Then there are some less stellar stress tests.

We have seen companies using a certain percentage decline in the equity markets as a scenario in the current year, where the market had already declined by that amount by the time we get the document – so it wasn't much of a stress.

We have seen an AA who modeled the volatility in the unpaid claims and set the scenario at the 95^{th} percentile. When asked why the AA had not used the 99^{th} percentile – when most AAs use the 99^{th} percentile – we were told that the 99^{th} percentile would have shown near insolvency. This company's financial condition was not satisfactory and an inadequate stress test misleads the Board. Boards of Directors need full disclosure of information by management.

We have seen a company who has not had a loss ratio above 40 per cent in the recent past, assume a 200 per cent loss ratio for the purpose of a stress test. The result was insolvency, which the AA offset with a large deferred tax asset – but in circumstances where an FI is facing insolvency it is very unlikely that the auditor would approve a deferred tax asset. Management felt that the 200 per cent loss ratio was ludicrous, due to their business and their reinsurance structure. Based on our recommendation the AA withdrew the report and issued a new report with a scenario that considered reinsurance. The loss ratio was around 100 per cent and while this was significantly higher than any actual loss ratios, management accepted this as plausible and formulated appropriate action plans.

While regulators tend to focus on worse case scenarios, stress testing can get a bad name within the industry when the scenarios are seen to be so far-fetched that they are not taken seriously. I am speaking about scenarios that are not based on a good understanding of the company's business and where management is not really part of the process i.e. identifying risks, understanding new initiatives, interpreting coverage (esp. reinsurance.) In short the AA's scenario analysis should be convincing i.e. the risk should be clear to management, as well as being a stretch scenario.

At OSFI we often talk about what regulators can do to try to ensure that financial institutions think about realistic but unpleasant events and take into account the full range of consequences. I admit that it is sometimes hard to convince managers of some institutions to think about such events. Why is that? Why is it that some companies complain about pandemic planning when health experts say it’s not a question of *if* but *when*? Why is it that a supervisor can get a stress test from an institution that refers to a 20 per cent decline in the stock market and by the time we get the stress test the market has already fallen by more than 20 per cent? Why is it that warnings about risks can be everywhere but when the risks come to pass, people are really surprised? I do not have the answers to these questions, but it is OSFI’s job to consistently remind the institutions we regulate to prepare for the bad times.

I recently read in the *Financial Times* an article by Madeleine Albright (former US Secretary of State) who referred to Dale Carnegie's book – "How to Win Friends and Influence People" – which describes the power of positive thinking. According to her, the problem we face today is that many people think too positively. They believe that truly bad things could not happen to us, or to their company – that's why they try to ignore a possible pandemic, or build houses on flood plains, or buy complex instruments when they truly do not understand them. But as we have learned, truly bad things do happen. So OSFI’s message has always been that the best course of action is to plan, get the best information possible, and see how you might fare under various adverse scenarios.

Risk management in the P&C industry

Part XIII

Recent events clearly underscore the need to know what your risks are. Some people do not like changes to Part XIII of the *Insurance Companies Act* (ICA) because it will affect their business. I appreciate that concern and I understand that Part XIII will have an impact. But our motivation here was to establish, with certainty, what the obligations of a P&C company are, and tie the vesting of assets to these obligations. You cannot have a company in difficulty, think you know what the liabilities are, and then find claims coming out of the woodwork for which you have no assets vested.

OSFI's plan to mitigate the consequences of this change has been to remain transparent throughout the process for implementing the new provisions and during the drafting of the Advisory. Through consultation and the consideration of industry concerns, OSFI is confident that it will implement a fair regime designed to preserve the integrity of the ICA and the *Winding-Up and Restructuring Act*

Fair Value and D-10

Recent ABCP events underscore the huge challenge in fair valuing instruments when the market is thin or has few observable prices and when models are used to develop values. While ABCP is not an issue for P&C companies because they held little to no ABCP, it does support OSFI's view that increased use of fair value without the appropriate risk management procedures in place, especially where there are no observable markets, is a bad idea. That is why we introduced D-10 for the P&C industry. If you are going to put instruments in your trading book or in the AFS category, you may come across periods of time when the securities are hard to value and you will need expertise to react.

Reinsurance

Recent events clearly tell us that you need to know what risk you have transferred and whether it can come back to bite you. The analogy in the P&C world is reinsurance.

Are there lessons to be learned from recent turmoil that could apply to reinsurance? I think there are. Among the lessons are that you should not depend solely on the rating of a reinsurer. That is not due diligence. Think about what could go wrong. Make sure you understand the fine print and get rid of any ambiguous wording. Do not tolerate uncertainties related to coverage and intent.

The Outlook

There will be considerable follow-up to the causes of the global turmoil in financial markets, to determine whether corrective action is needed. Some have suggested that no regulatory action is needed – the "market" has learned a lesson and the lesson will not be forgotten. Others have suggested a list of areas that need to be reviewed, including liquidity risk management, degree of transparency surrounding complex products, capital rules, accounting impacts, and the whole area of how risk is transferred off balance sheets. History has shown that each bout of turmoil teaches new lessons, and that is what we are focusing on, both in Canada and internationally – whether there are lessons that we can learn so that global financial systems, of which Canada is a part, benefit for the well-being of all.