



**Remarks by Julie Dickson, Acting Superintendent
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
Joint Meeting of the Credit Union Stabilization Funds of Canada**

**Ottawa, Ontario
Friday, June 15, 2007**

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Opening

Thank you for the opportunity to come here today to talk about OSFI, and to discuss some of our priorities.

OSFI's mandate requires us to have due regard for the need to allow institutions to compete effectively and to take reasonable risks. It recognizes that financial institutions and pension plans can fail, and that management, boards of directors and pension plan administrators are ultimately responsible.

We can and do provide guidance, best practices, and direction -- but we are not in the business of telling institutions how to run their operations. There is a critical balance we must maintain between being a prudential regulator - focussing on safety and soundness - and the need to allow for a marketplace that benefits consumers through competitive offerings.

Our mandate also requires us to intervene early to avoid or minimize prudential problems. Our role is to help safeguard people's life savings through contributing to a healthy and sound financial sector. We do this by promoting sound business and financial practices, and by evaluating the risks to financial institutions, and assessing their capability to measure and manage those risks, and intervening promptly.

Let me provide you with an overview of some of the trends OSFI is seeing, as well as some of the areas where OSFI is currently directing its time and energy.

New Entrants

We have had several new entrants in the past year, where two foreign bank branches (one lending branch and one full-service branch) were authorised, and three new federal trust companies were established.

The proposed activities and services of the new trust company entrants are varied. One is a non deposit-taking transfer agent and trustee, one is a mortgage lender and back-office processor and another provides a wider array of

retail financial services. The two new foreign bank branches are major financial institutions originating from the U.S. and Ireland.

Generally, we are seeing increasing interest in the incorporation or acquisition of banks or trust and loan companies, and there is significant interest on the part of foreign banks looking to establish or expand their operations in Canada in other ways. Some of this interest originates from foreign banks that are in jurisdictions unfamiliar to OSFI.

Under current legislation, foreign financial institutions are able to access the Canadian market in a variety of regulated and unregulated ways which can involve innovative and/or complex business proposals and corporate structures. This contributes to OSFI's workload in the approvals area as we need to spend increasing amounts of time and expertise to:

- Understand complex business arrangements – some of which do not lead to the establishment of a regulated entity
- Research and understand the regulatory regimes, and the stability of the home country, of foreign applicants from jurisdictions with which we may not be familiar

We have seen indications that our domestic applicants are looking to target niche markets, both corporate market segments, and retail segments. There has been a lot of interest recently around the issue of Islamic or Shari'a-compliant financial services, and OSFI has been studying these new ways of providing financial services to see if they fit into our current policy framework and regulatory system. The challenge in this regard is two-fold.

First, we need to understand whether such services fit within our policy framework by assessing the extent to which Islamic finance and banking accomplish economic functions that are equivalent to existing products, together with an assessment of whether these functions fit under existing legal, accounting and fiscal regimes.

Second, we need to understand the supervisory implications so as to be able to formulate an appropriate supervisory framework, especially for institutions that intend to offer these types of services exclusively.

OSFI is certainly open to innovation in financial services, in fact we see it happening all the time, but whenever we see new offerings being proposed we have to ask:

1. Do these products fit within the broad policy framework?
2. Do these products fit within the financial institutions statutes?
3. How are these products accounted for?
4. How is the risk weighting performed?

5. What about customer disclosure requirements?
6. Are there liquidity management issues?
7. How will corporate governance requirements be met?
8. Is the potential market of sufficient size to be able to support these products?

In all cases where a regulated presence is established in Canada, OSFI must assess the viability of the business plan. We want to see a direct connection from the market survey to the business plan, and realistic numbers and assumptions for the best case/worst case scenarios. We want qualified and experienced people running the institution, and on its board of directors. In this light we perform security checks on the owners and on proposed senior management, and on each member of the proposed board.

Know-your-customer is an important aspect of our anti-money laundering regime, and we have taken that to heart in our own rule of know-your-applicant when assessing potential market entrants.

AML / ATF

The recently passed Bill C-25 -- amending the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* -- raises the bar significantly on Anti-Money Laundering / Anti-terrorist Financing (AML/ATF) standards in Canada, and it will require increased effort and resources by the financial sector to comply with its requirements.

Some of the new measures in the amendments include: a requirement to identify suspicious attempted transactions; requirements to identify and monitor politically exposed foreign persons; and a prohibition on opening account if client cannot be satisfactorily identified.

Most of the financial institutions we have assessed have already assigned a very high level of importance to getting AML/ATF implementation right, although some institutions have needed more specific guidance in certain areas.

OSFI has been proactive in providing guidance, both by undertaking an extensive program of outreach to the financial sector on AML/ATF issues, and by intervention at individual institutions on the quality of their AML/ATF controls and programs.

We have seen that Canada's banks and other federally regulated financial institutions are allocating significant dollar and people resources to the fight against money laundering and terrorist financing. Although the higher standards set in Bill C-25 do come at a cost, we believe the failure to implement these standards would cost Canadians much more in the long run.

The new regulations represent a significant milestone in the development of Canada's AML/ATF regime. The changes are designed to bring Canada closer to the Financial Action Task Force's (FATF) 40+9 Recommendations, and result from a need to ensure that our financial system is considered safe and sound.

The revised AML rules will be published at the end of this month. Most of the new requirements will take effect in June 2008, which OSFI believes gives the industry adequate time to prepare for implementation.

Some of the legislative and regulatory changes are designed to enhance the ability of financial institutions to apply a risk-based approach to the implementation of risk management and compliance controls. This approach permits financial institutions to exercise reasonable business judgment when implementing AML measures, and enables them to apply higher levels of resources to higher risks.

While this self-analysis approach is consistent with OSFI's Supervisory Framework, as well as the FATF Standards, this is a very important area to which the financial sector needs to pay close attention. We will be watchful for institutions that appear to focus on managing regulatory risk, rather than performing a robust self assessment to identify potential weaknesses in their AML/ATF procedures.

Pandemic Planning

Pandemic planning has also been a source of increased focus for OSFI. While there are mixed opinions about a potential pandemic, I think we are all aware that a pandemic could have economic consequences, in particular on the financial sector.

The potential for a pandemic outbreak raises significant issues in terms of business continuity and resilience practices.

Some of the more commonly cited impacts are increased insurance exposure, increased credit risk, and an increase in risk aversion that would lead to a higher demand for liquidity. The possible impact on the delivery of financial services to Canadians also needs to be considered.

This is why we asked financial institutions to review their Business Continuity Plans (BCP), and the adequacy of those plans for dealing with a potential pandemic. OSFI believes the financial sector should be aware of the potential for an outbreak and how such an event would impact their operations.

A BCP does not provide for business as usual, but business as necessary. It is a tool that allows institutions to implement recovery strategies so as to mitigate risk, and continuously deliver critical services despite disruption. We want to see a BCP process that includes identifying what is critical to the organization, and determining what is needed to continue those critical activities in the areas of personnel, technology, and information.

When building a pandemic plan, it is important to note that every organization has to review their unique situation. However, as this is not a threat restricted to only the financial services industry, all types of organizations are now considering and planning for the threat. As a result more and more information on the topic is becoming available.

OSFI itself takes this threat seriously and we have been working to get our own plans and contingencies in order.

Commercial Real Estate / Sub-Prime

Institutions have to be proactive and think about what might happen down the road, and how they might be affected. They should use past experiences as a guide, and they should look at developments occurring in other countries. Also, institutions should think about whether there are risks that might be new and try to think about worst case scenarios. OSFI also does this.

Recent US experience tells us that institutions should have their antennae up regarding commercial real estate exposure, and sub-prime lending.

I should say that Canada is different in many respects. For example sub-prime mortgages are not as popular here as they are in the U.S. But in terms of commercial real estate, Canadian financial institutions have similar exposures, and companies need to recognize that the market can change.

It is good practice to stress test commercial real estate portfolios and we have encouraged institutions to do so. The stress tests should also reflect the parts of the country in which those exposures are located. For example, the situation in Western Canada, where there is a boom (seen in high levels of construction activity, and strong appreciation in real estate markets), is very different than the situation in Ontario and Quebec, where weaknesses in manufacturing are evident. Both markets can pose challenges, and institutions need to be on top of those challenges.

As a principles based regulator, we do not tell trust companies and banks what tests to run. We expect management and boards to design stress tests that fit their circumstances. We expect the results to be given to the board, and to be thoroughly discussed. We also expect management and boards to stay on top

of these exposures, and their management of them. We ourselves want a copy of the stress testing work, and information on how institutions are managing their risks, so we can better assess how management and boards are exercising their responsibilities.

Another area of increasing interest to financial institutions in recent years has been the so-called sub-prime lending market. I say “so-called” because at this time, we are unaware of a widely accepted definition for what constitutes sub-prime mortgage lending. For our purposes today, I will consider anything below a “prime” mortgage, to be sub-prime.

With financial institutions competing to fund the mortgage needs of consumers, many institutions, especially in the U.S. but in Canada as well, see a potential niche market developing in the provision of sub-prime loans. Now obviously when a product is being offered to consumers where there is a materially higher risk of default, OSFI as a safety and soundness regulator, is going to want to know more.

The current differences between the Canadian and U.S. sub-prime mortgage market are significant. Sub-prime is just over 2 per cent of the Canadian market, but close to 15 per cent in the U.S. The type of products you see in the U.S. are very aggressive, and the loan conditions are more exotic. In Canada, we still see mostly 25 to 30 year amortizations, and we have not seen the kind of features that the U.S. market has been offering.

That said, the sub-prime market, while still very small in aggregate, is growing in Canada. In that context, we recently launched an exercise to determine what, if any, supervisory response is required of OSFI to help ensure that sub-prime lending is conducted in a prudent manner among Canadian financial institutions.

Using a questionnaire, we will be asking the institutions whether they consider themselves to be involved in sub-prime lending, what definition they themselves would use to define a sub-prime mortgage, and the size of their sub-prime portfolio.

While we do know the general characteristics of the various grades of residential mortgages, within the first phase of this review is the objective of developing a definitive definition of “sub-prime” as it relates to mortgage lending. This will allow us to more effectively identify the nature and size of the market, and will help guide further assessment. It will also give us an idea as to which institutions are more involved in sub-prime lending.

This, then, is the first step in a process aimed at developing OSFI’s expectations regarding risk management practices in an effectively managed sub-prime portfolio.

Basel II

The implementation date of Basel II (November 1, 2007) is fast approaching.

Many of you are well versed in Basel II, an international accord aimed at producing uniformity in the way banks and banking regulators approach risk management and capital assessment across national borders.

Small institutions are generally adopting the simpler approaches to credit risk and operational risk. OSFI has focused on three streams of work here.

Phase one was to have institutions do readiness assessments. This was to determine whether institutions understood the changes brought by Basel II and their impact, and identified any gaps that needed to be addressed. It also focused on the role of the Board, Internal Audit, and Senior Management. We used the results to guide our discussions with the institutions on areas that required more focus.

One area that we will issue guidance on shortly is Pillar 2. Pillar 2 is all about thinking about what capital levels you should operate with, and substantiating it, considering your own circumstances. It is not as easy to do that as it is to say, "We are above regulatory minimums". Pillar 2 involves doing a better job at things like stress testing.

Phase 2, involves banks taking a test drive – and reporting to us two sets of numbers – the first using Basel 1 and the second using Basel 2. Check the numbers and see whether they are reasonable before the system goes live.

Phase 3 involves OSFI, as well as the institutions, paying close attention to the results, and disclosure.

Complex Products

Basel has been criticized as being complex, particularly the advanced approaches. But institutions are not shying away from complexity in some of their investments. Innovation is a good thing, and is critical in ensuring a competitive financial services industry. But structured products are evolving rapidly and are the arranging institutions, their lawyers and the rating agencies able to keep up?

When OSFI issued its views on reputation risk management a few years ago, part of our thinking was that if financial institutions that were engaged in complex transactions needed thick binders for each transaction explaining tax issues, legal issues, and other expert views, red flags are present and it is incumbent on them to be sure they understand what they are doing. Similarly, if the

documentation behind a complex product is slim, you have to ask yourself whether you have all the facts.

Complex transactions are increasingly regarded as “business as usual” deals -- everyday transactions. We are also seeing small institutions getting involved. If you are contemplating this, ensure that you have strong risk management and controls. Do not be complacent about the risk and assume that, because everyone is doing it, it is fine.

In the financial markets, the longer the good times continue -- and the more frequent the markets successfully come through small tests -- the more resilient the markets are seen to be, and the more complacent players can become.

This can create certain challenges for regulators, and can also lead to potential surprises for boards and management of institutions who think that they are taking acceptable levels of risk, when in fact they do not have the processes in place to know that for sure.

Principles Based Regulation

Earlier, I referred to OSFI being a principles-based regulator. You may also have heard about the UK initiative to move towards principles based regulation.

This is a noble goal, and it is the direction that some regulators have been moving in for some years. The recent announcement by the UK’s Financial Services Authority (FSA) of their intent to move to principles based regulation, has heightened awareness that a more than rudimentary move towards principles based regulation is on the horizon.

The FSA states its aim is to focus more clearly on the outcomes it wants to achieve, leaving the means on how those outcomes are achieved in the hands of senior management of the firms. This does not mean the rule book will be wholly thrown out the window. The FSA is also very clear that in certain areas they will continue to rely on detailed rules and prescriptive processes.

Principles Based Regulation, does OSFI embrace it? Yes we do. Let us look at the supervisory side of OSFI’s work. In the late 1990s OSFI introduced the Supervisory Framework, a framework which outlines how we assess risk, how we quantify it, and how we measure risk management processes. The framework does not contain steadfast rules on how we want to see these outcomes achieved, but instead it provides guidance. We believe that this is the spirit and practice of principles based regulation.

The OSFI Act states that...*regulation and supervision must be carried out having regard to the fact that boards of directors are responsible for the management of financial institutions.*

This is a principle that we adhere to very earnestly, and it is something we stress to our supervisors at every opportunity – that Boards of Directors are responsible for the management of the companies we regulate. We are not in the business of running your business, and because of this, a regime of detailed rules governing an institution’s responsibilities would be incompatible.

Other principles are stated in the legislation, such as the requirement to maintain adequate capital and liquidity, and the requirement to have a prudent portfolio. While OSFI currently considers itself principles based, we need to constantly move forward on this front.

Conclusion

Canada is fortunate to possess one of the strongest financial systems in the world. Our strong financial system contributes to the strength and innovation of our economy, and protects the savings of individual Canadians. However, the environment in which we operate – both domestically and internationally – is fluid and at times, unpredictable. There is no doubt that maintaining high confidence in the safety of money entrusted to Canadian financial institutions is at the top of all our agendas.

I appreciate being invited to speak to you today on some of the topics that are important to OSFI. I would be pleased to answer any questions you might have.

Thank you.