Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Remarks by Julie Dickson, Acting Superintendent
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
2007 Financial Services Invitational Forum

Cambridge, Ontario
Thursday, May 10, 2007

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Opening

Thank you for inviting me to speak to you tonight.

In the 1960s a show called *Bewitched* was quite popular. It was about a witch named Samantha who married a mortal named Darrin, who was an advertising executive. They lived in the suburbs and tried to lead a normal life. I liked the way Samantha would twitch her nose and make anything happen – for example she could turn a sow's ear into a silk purse. I did not like her husband Darrin - he was always trying to prevent her from using her powers to do such things, and that annoyed me.

Many years later, I have new found respect and sympathy for Darrin. All he wanted was for them to live a happy, normal life, and he was not sure he understood the implications of Samantha's actions, because he knew that in the real world it was not possible to turn a sow's ear into a silk purse.

Today, markets seem to be producing triple-A instruments from instruments that are not rated triple-A. Some regulators and market commentators who focus on risk are saying that this is too good to be true and that somewhere, somehow, this is going to come back and bite us. Richard Fisher, President of the Federal Reserve Bank of Dallas, says that the recent surge in financial innovation, improperly understood, can intensify rather than mitigate the scope for error.

Darrin never really had a good explanation as to why he opposed Samantha using her powers. He just knew that he did not understand the full implications of this usage, so he wanted to stick with what he understood.

The neighbor, Mrs. Kravitz, knew that something strange was going on in the house. She was considered to be crazy. But today, many people, like Mrs. Kravitz, are asking questions about what they see in the financial markets.

Risk Transfer

One question is whether the transfer of risk from banks to other market participants is good or bad. Some say it is good because risk dispersion has made the system as a whole more sound. They say it is better to have risk dispersion and not know exactly where it is, than to have it concentrated in a single entity, know where it is and then potentially pay the price when an event occurs. This is what happened in the 1980s with the savings and loan crisis in the U.S. However, while many agree that risk dispersion is better than risk concentration, they are still not entirely comfortable. This is because they know they can only be comfortable if the risk has been 100 per cent transferred, and if the acquirers understand what they have bought.

Correlations

Other questions are about correlations. Every time markets face a test, observers look to see whether the prices of various asset classes moved as they have historically.

A recent article in *The Banker* noted that today, compared to earlier times, there are few places to hide if something goes wrong in the financial markets. It said that asset classes are linked together in a way unseen previously and in today's markets, a problem in one asset class will likely impact another. As proof, it looked back 10 years to the Asian crisis, a problem, characterized as a geographic contagion with problems in one part of the world – Asia and Russia -- spreading to other parts, such as Latin America. The authors noted that, in contrast, today investors seem to distinguish between geographies, but they may instead fall victim to spillover between different asset classes. Consequently, while investors used to be able to achieve diversification by putting their money into different investments such as emerging market economies, hedge funds, small cap stocks, etc. -- so that when one asset class went down, another went up -- the same correlations may not exist today. This is a big unknown.

Second Round Effects

Another question concerns the attitudes of financial institutions to a future event or crisis. Someone at one institution I talked to agreed that stress testing and capital cushions were very important. But he went on to note that the objective is to be stronger than the next institution, so as to take advantage of the many buying opportunities that will be available as the weak players flounder. According to this scenario, in times of stress, the weak get bought, and the strong buy, and get stronger.

There is an element of truth to this. But the International Monetary Fund (IMF) will tell you that, when they go into a country and focus on stress testing, sometimes the results they are presented with are quite positive because each institution individually assumes that, if a competitor were in trouble, it is an opportunity to gain market share. So stresses were seen as buying opportunities, not as difficult times. This tells regulators that not enough attention is being focused on second round effects of a stress. Indeed, we have to remember that if shocks could be anticipated, they would not be called shocks.

Complex Products

Innovation is a really good thing. But structured products are evolving rapidly and must be testing the limits of the arranging institutions, their lawyers and the rating agencies - - all of whom are mere mortals. 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.

At home I often ask my sons why they have done something, and the response I always get is, “Everyone does it Mom. Things are different today”. Then I go to work and I cannot help but wonder whether the same phenomenon is at play in the financial markets. Complex transactions are increasingly regarded as “business as usual” deals -- everyday transactions. But, volatility in the markets is extremely low and this could suggest a complacency about risk (versus greater economic stability, better dispersion of risk, etc).

While complex products present significant challenges, we should not forget the importance of basic controls and ensuring that they are effective. I talked to one industry person who told me that she is sometimes more concerned about the simple things than the complex things, because at least someone looks at the complex things. Sometimes the simple things -- even basic controls -- turn out to be the problem because they are taken for granted or people get careless. We need to keep that in mind.

Back to *Bewitched*, I think the neighbor, Gladys Kravitz, was on to something when she questioned the wizardry she was seeing. Meanwhile, her husband thought that everything was perfectly normal and continued to conduct daily activities as usual.

In the financial markets, the longer the good times continue, and the more frequent the markets successfully come through small tests, such as the events of February, the more resilient the markets are seen to be, and the more complacent players can become, which can create challenges for regulators.

Stress Testing

At OSFI, we identified readiness planning as a major priority this year. That includes a focus on stress testing at both large and small financial institutions. Better risk management and more risk-based capital, via the implementation of the Basel accord, is another priority.

When there are unanswered questions out there, and sows' ears are being turned into silk purses, there must be a focus on capital, as capital is the cushion for the unexpected. Stress testing has to advance and has to assume scenarios that are not entirely comforting. These are broad guiding principles. As a mostly principles-based regulator, we do not want to tell financial institutions what stress tests to run, we want them to look at their business and figure out what makes sense for them. We also want banks to come up with a robust view on what capital levels should be, in light of the uncertainty that exists.

None of us has the ability to twitch our noses and magically change balance sheets or market positions in a hurry when we face a challenge. Those who realize we are mere mortals will be the best prepared.

Thank you.