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The OSFI Pillar

FROM THE OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS CANADA


# Acting Superintendent Julie Dickson warns against risk complacency

*The following text is drawn from Ms. Dickson's May 10, 2007 address at the 2007 Financial Services Invitational Forum.*

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.

There are certainly some questions out there. 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.

There are other questions 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 spill-over between different asset classes.


(cont'd page 2)


## Study finds current funding approach for CPP to be optimal

On April 19, 2007, the Office of the Chief Actuary of Canada published an actuarial study which concluded that the current partial-funding model of the Canada Pension Plan (CPP) is robust and appropriate for the purpose of contributing to the long-term financial sustainability of the Plan.

"The current financing methodology helps to ensure that the CPP is affordable and sustainable for current and future generations of Canadians," said Canada's Chief Actuary Jean-Claude Ménard.

To view the complete press release, visit the OSFI Web site at: www.osfi-bsif.gc.ca

## Risk awareness — (continued from page 1)

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.

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.

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.

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.

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.

At OSFI, we identified readiness planning as a major priority this year. That includes a focus on stress testing at all 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 magically change balance sheets or market positions when we face a challenge. Those that take the time, and plan with an eye to the future, will be the best prepared.

To view the complete text of the remarks, visit the OSFI Web site at: www.osfi-bsif.gc.ca

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# Draft Guideline E-17

Draft Guideline E-17 sets out principles to assist federally regulated entities (FREs) in the establishment of policies and procedures to conduct assessments of the suitability and integrity of their directors and senior officers, such as security background checks. While FREs already have varying policies and procedures to assess the suitability and integrity of their Responsible Persons, this Guideline seeks to ensure that such practices are sufficiently robust across FREs.

You are invited to provide comments regarding the draft guideline by July 6, 2007. Questions concerning the guideline can be addressed to Laural Ross by email at laural.ross@osfi-bsif.gc.ca.

To view the complete text of the draft guideline, visit the OSFI Web site at: www.osfi-bsif.gc.ca

# Chief Actuary of Canada seeks external peer review panel for Actuarial Report on the Canada Pension Plan

On May 14, 2007, the Office of the Chief Actuary of Canada announced it was again commissioning an external peer review of its next Actuarial Report on the Canada Pension Plan (CPP), expected to be released in December 2007.

Jean-Claude Ménard
Chief Actuary of Canada

Actuarial reports on the CPP are conducted every three years and are used by the federal and provincial ministers of Finance when reviewing and making recommendations on the CPP.

First introduced in 1999, the peer review is intended to ensure that the actuarial reports meet high professional standards and are based on reasonable assumptions in order to provide sound actuarial advice to Canadians. As in previous years, the review will be conducted by Fellows of the Canadian Institute of Actuaries.

“Given the success of the last peer review, which generated a number of valuable recommendations, it was very clear that establishing this voluntary measure had undeniable benefits for future reports,” says Jean-Claude Ménard, Canada’s Chief Actuary. “We’ve responded to many of the recommendations the previous panel provided and look forward to the next review to further build on this successful process.”

The United Kingdom Government Actuary’s Department (GAD), recognized for its expertise in the field of social security, will select the members of the peer review panel through an open process and provide an independent opinion of the review.

Members will be selected between July and September. Once the 23rd Actuarial Report is tabled in Parliament, the panel will have three months to perform the review. When the review is completed, the GAD will have one month to provide an opinion on the work. The review will then be made public, as was done for previous CPP Actuarial Reports.

Application forms for anyone wishing to work on the review panel, as well as terms of reference, are available on OSFI’s Web site, and must be submitted by July 13, 2007.

Previous CPP Actuarial Reports and independent reviews are also available on the OSFI Web site.

The Office of the Chief Actuary operates independently within the Office of the Superintendent of Financial Institutions (OSFI) and provides actuarial services for various key government plans and programs such as the Canada Pension Plan, Old Age Security, Canada Student Loans Program and pension and benefit plans that cover public servants, Members of Parliament, and the RCMP among other groups.

## The OSFI Speaking Roster

To view the complete text of these remarks, visit the OSFI Web site at: www.osfi-bsif.gc.ca

Remarks by Julie Dickson, Acting Superintendent, to the 2007 Property and Casualty Insurance Industry Forum, Cambridge, Ontario

"*Knowing that good times cannot go on and on, prudent companies take time during the good times, to plan for the tough times.*"

May 25, 2007

Remarks by Jean-Claude Ménard, Chief Actuary of Canada, to the 15th International Conference of Social Security Actuaries and Statisticians of the International Social Security Association (ISSA), Helsinki, Finland

"*Mortality improvements are expected to emerge more slowly and mainly at older ages… In the context of the Canada Pension Plan, more and more contributors are expected to reach the retirement age of 65 and CPP retirement beneficiaries are expected to receive their benefit for a longer period.*"

May 24, 2007

Remarks by Julie Dickson, Acting Superintendent, to the 2007 Financial Services Invitational Forum, Cambridge, Ontario

"*While complex products present significant challenges, we should not forget the importance of basic controls and ensuring that they are effective.*"

May 10, 2007

Remarks by Julie Dickson, Acting Superintendent, to the Institute of Corporate Directors, Toronto, Ontario

"[*These*] *improved results do not justify complacency. Rather, we think they provide an opportunity for plan administrators and sponsors to take a fresh look at techniques to manage risk.*"

April 24, 2007

Remarks by Julie Dickson, Acting Superintendent, to the House of Commons Standing Committee on Finance, Ottawa, Ontario

"*Maintaining our status as a world-class prudential regulator is an OSFI priority.*"

March 27, 2007

# Part XIII of the *Insurance Companies Act*

**In the context of the Government of Canada's regular five-year review of the federal financial institutions legislation, many provisions of an *Act to amend the law governing financial institutions and to provide for related and consequential amendments*, (formerly Bill C-37) were proclaimed in force on April 20, 2007.**

The Act clarifies, among other things, that Part XIII of the *Insurance Companies Act* only applies to foreign entities that insure in Canada a risk. In particular, the regulatory focus with respect to foreign companies will be on the location of insurance, rather than the location of risk. As this represents a material change for the Canadian operations of certain foreign companies, both these foreign companies and the Office of the Superintendent of Financial Institutions (OSFI) require time to adjust to these changes. Therefore, many amendments to Part XIII will be brought into force at a later date.

OSFI has initiated work on amending its regime for regulating foreign companies' Canadian insurance operations based on the fact that:
a) risks located in Canada but insured outside Canada will no longer be subject to Part XIII requirements; and
b) risks located outside Canada but insured in Canada will become subject to Part XIII requirements.

As a first step, to provide guidance on what constitutes the insurance in Canada of a risk, OSFI will, in the coming weeks, issue in final form the draft advisory circulated for industry comment in December of last year. This document should assist foreign companies in their assessment of the implications of the Part XIII amendments on their Canadian insurance operations.

As a second step, OSFI will consult with insurance industry associations and other stakeholders who express an interest regarding proposed amendments to the regulatory regime for foreign companies. This will include, among other things, amendments to the reporting instructions for regulatory returns, to the vested assets requirements (e.g., TAAM and BAAT) and to the requirements for the taking of reinsurance credits when risks are ceded to a foreign company. OSFI expects to meet with industry associations in the near future to discuss the timetable for, and the transition to, the amended regulatory regime. OSFI also plans to issue amended documents in draft form for comment before year-end 2007.

For additional information or if you have questions regarding the Part XIII amendments, transition matters or the Advisory, please contact Louis Bourgeois, Director, Legislation and Approvals Division at 613-990-2957.

## What's New Online (www.osfi-bsif.gc.ca)

### Issuance of "Covered Bonds" by Canadian Institutions

OSFI has been approached by various banks regarding the potential for the issuance of bonds collateralized by banks' assets, also referred to as covered bonds.

### OSFI releases updated Pension Members' Guide

The Guide explains some of the minimum standards that apply to all federally regulated pension plans.

### Institutional Trade Matching in Straight-Through Environment

OSFI would like to bring to your attention National instrument 24-101, of the Canadian Securities Administration (CSA), which came into force on April 1, 2007.

To view the complete text of these documents, visit the OSFI Web site at: www.osfi-bsif.gc.ca

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## The OSFI *Pillar*

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