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/ ANNUAL REPORT 2002.03 /

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

Canada

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PLEASE SEE PAGE 058 FOR
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LETTER OF CONVEYANCE

The Honourable John Manley, P.C., M.P.
Deputy Prime Minister and Minister of Finance
Ottawa, Canada K1A 0A6

Dear Minister:

Pursuant to section 40 of the *Office of the Superintendent of Financial Institutions Act*, I am pleased to submit to you and the Secretary of State (International Financial Institutions) the Annual Report of the Office of the Superintendent of Financial Institutions (OSFI) for the period April 1, 2002, to March 31, 2003.

Yours sincerely,

NICHOLAS LE PAN
Superintendent

Ottawa, October 1, 2003
c.c.: The Honourable Maurizio Bevilacqua

FISCAL YEAR 2002–2003 WAS A CHALLENGING ONE FOR THE FINANCIAL SERVICES INDUSTRY AND FOR OSFI, BUT CANADIANS HAD EVERY REASON TO REMAIN CONFIDENT IN THE SAFETY AND SOUNDNESS OF OUR FINANCIAL SYSTEM.

SUPERINTENDENT'S MESSAGE

Fiscal year 2002–2003 was a challenging one for the financial services industry and for OSFI, but Canadians had every reason to remain confident in the safety and soundness of our financial system.

As we started the year, OSFI's top priority was to continue to enhance our capacity to identify risks faced by federally regulated financial institutions and pension plans, promote better management of those risks and improve our readiness to deal with problems, consistent with our early intervention mandate. Taking action so our framework of guidance and rules continues to meet or exceed international minimums was important as well.

We expected that 2002–2003 would pose challenges, with possible increases in the number of problem financial institutions and pension plans. We therefore focussed our resources on supervision and reduced somewhat rule-making and guidance activities. While our focus was on the short term, we continued to make progress over the year on longer-term initiatives to enhance our effectiveness and efficiency.

Canadian financial institutions in the main performed better than many around the globe during the period under review. Although profitability for banks and insurers was challenged by unfavourable conditions in financial markets and by deterioration in corporate credit in several sectors, continued strength in Canadian employment and personal incomes was an important sustaining influence. The situation in the Property and Casualty (P&C) industry was more difficult and was complicated by factors such as rapidly rising claims costs, particularly in auto insurance, and lower returns on investments.

Pension plans also faced challenges, the most serious of which occurred in plans where the effects of the decline in investment returns were combined with weakness in the sponsor's business conditions.

Public confidence in financial reporting by the corporate sector generally was undercut in the wake of high-profile scandals, largely emanating from the United States. Legislation applying to federal financial institutions already contains a number of safeguards, but Canada has not been immune to similar events. I believed, therefore, that it was important to enhance the integrity of our marketplace. In addition, OSFI relies on strong and effective governance and audit processes in doing its work. Accordingly, during the year OSFI participated extensively with others — securities regulators, standard setters and policy makers — in developing concrete measures to promote improved transparency and governance in Canada's business sector.

Problems in the financial services industry often lag behind economic and financial cycles, and material economic and financial market uncertainties remain as we enter 2003–2004. OSFI will therefore continue to remain vigilant in the year ahead. We will maintain efforts to contribute to high levels of public confidence in our financial system that is a key element of our economic success.

NICHOLAS LE PAN
Superintendent

Nicholas Le Pan
Superintendent

Donna Pasteris
Assistant Superintendent,
Corporate Services

John Doran
Assistant Superintendent,
Supervision

Julie Dickson
Assistant Superintendent,
Regulation

ROLE AND RESPONSIBILITIES

OSFI was established in 1987 by an Act of Parliament — the *Office of the Superintendent of Financial Institutions Act*. The Office supervises and regulates all banks in Canada, and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and pension plans.

OSFI also provides actuarial advice to the Government of Canada and conducts reviews of certain provincially chartered financial institutions by virtue of federal-provincial arrangements or through agency agreements with the Canada Deposit Insurance Corporation (CDIC).

OSFI derives its powers from and is responsible for administering the following legislation:

- *Bank Act*
- *Trust and Loan Companies Act*
- *Cooperative Credit Associations Act*
- *Insurance Companies Act*
- *Pension Benefits Standards Act, 1985*

These Acts set out the rules for the structure and operation of federally regulated financial institutions and the standards for pension plans. The various Acts address the unique aspects of the sectors each governs, but are designed to be consistent with each other.

OSFI comprises the Supervision, Regulation and Corporate Services sectors, as well as the Office of the Chief Actuary, employing some 450 people in offices located in Ottawa, Montreal, Toronto and Vancouver.

OSFI is funded mainly through asset-based, premium-based or membership-based assessments on the financial services industry and a modified user-pay program for selected services. A small portion of OSFI's revenue is derived from the Government of Canada, primarily for actuarial services relating to the Canada Pension Plan, the Old Age Security program, the Canada Student Loans Program and various public sector pension and benefit plans.

MANDATE

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To accomplish its mission of protecting depositors, policyholders and pension plan members from undue loss, OSFI advances and administers a regulatory framework that provides for the early identification and resolution of issues that could threaten the safety and soundness of financial institutions and pension plans. At the same time, OSFI recognizes the regulatory system must not unduly impede institutions from competing effectively. OSFI's employees are committed to delivering professional, high-quality and cost-effective performance.

ORGANIZATION OF THE REPORT

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This report is organized according to the five main external outputs that support the achievement of OSFI's mandate.

-- *Risk assessment and intervention* includes our activities to monitor and supervise financial institutions and pension plans; monitor the financial and economic environment to identify emerging issues; and intervene in a timely way to protect depositors, policyholders and pension plan members, while recognizing that all failures cannot be prevented.

-- *Rule making* encompasses the issuance of guidance and regulations; our input into federal legislation affecting financial institutions; our contribution to accounting, auditing and actuarial standards; and our involvement in a number of international rule-making activities.

-- OSFI's *approvals* function covers approvals required under the legislation applying to financial institutions and pension plans, as well as supervisory approvals.

-- OSFI's *international assistance* operations help other countries that are building their supervisory and regulatory capacity.

-- The *Office of the Chief Actuary* provides a range of actuarial services under legislation to the Canada Pension Plan (CPP) and federal government departments.

These external functions are supported by the Corporate Services Sector, which contributes to our effectiveness and efficiency.

01

RISK ASSESSMENT AND INTERVENTION

RISK ASSESSMENT AND INTERVENTION

Overall business and financial market conditions in Canada and internationally have a significant impact on the performance of financial institutions and pension plans, and therefore on their safety and soundness.

Against a background of global economic weakness and heightened financial market uncertainty, the Canadian economy exhibited considerable strength in 2002. This constituted important support to the operations of a wide range of financial institutions during the year. Job creation was outstanding, household incomes and corporate profits experienced solid growth, and domestic demand conditions remained robust.

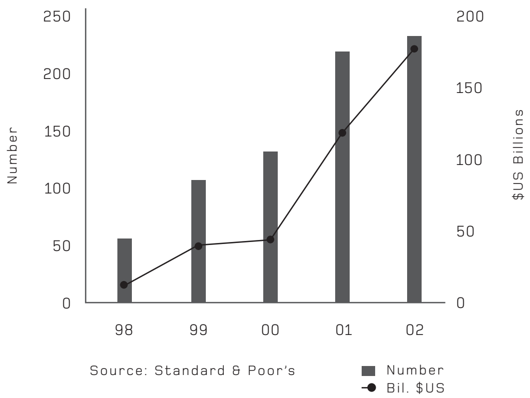
But these strengths at the macroeconomic level masked significant weaknesses in some areas, which contributed to the challenging environment for Canada's financial sector. A weak and unsettled global economic environment affected institutions with international exposures. The fallout from the bursting of the stock market bubble three years ago and widespread concerns about financial reporting continued to depress financial markets, both in Canada and abroad. Capital market activity remained weak, and returns to financial institutions from their wealth management businesses suffered.

In light of these conditions, credit risk was an important area of focus during the year. Overall credit quality among corporate bonds declined again in 2002, on the heels of significant deterioration in the previous year. Corporate defaults globally set new records, both in number and value. Risk premiums rose for much of the year as a result, though they began narrowing towards year-end and into 2003.

THE FALLOUT FROM THE BURSTING OF THE STOCK MARKET BUBBLE THREE YEARS AGO AND WIDESPREAD CONCERNS ABOUT FINANCIAL REPORTING CONTINUED TO DEPRESS FINANCIAL MARKETS, BOTH IN CANADA AND ABROAD.

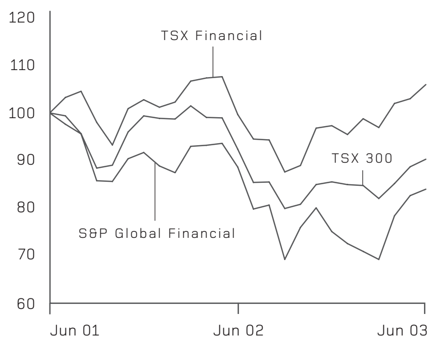
Given this difficult background, Canadian financial institutions performed well during the period under review. Improved diversification and risk management practices enabled them to weather successfully the recent downswing in the credit cycle. Though their profitability eroded — in some cases significantly — their balance sheets on the whole remain sound and their capital positions solid. Indeed, judging by their stock market performance for the two-year period to June 30, 2003, they have fared better than the rest of the business sector domestically and their counterparts abroad.

GLOBAL CORPORATE DEFAULTS



Source: Standard & Poor's

COMPARATIVE STOCK MARKET PERFORMANCE



/ MAJOR CANADIAN BANKS /

Sustainable profitability is key to the safety and soundness of financial institutions. The major domestic banks experienced a significant decline in profits in 2002. Returns for the first quarter of 2003, however, indicate a rebound.

Large losses in corporate lending, primarily in the U.S. syndicated loan market, and weak capital market activity were the major factors behind the erosion in earnings. Impaired loans rose during the year, as did provisions for loan losses. Some banks also wrote off investments in areas that did not perform as expected.

Continuation of the solid results in domestic retail and commercial operations was an important key to the banks' ongoing strength. However, there were material differences in the performance of institutions depending on the mix of their business and the quality of their loan portfolios.

Wider net-interest margins (in part due to the sharp drop in short-term interest rates of the previous year) helped to limit the erosion in bank profits.

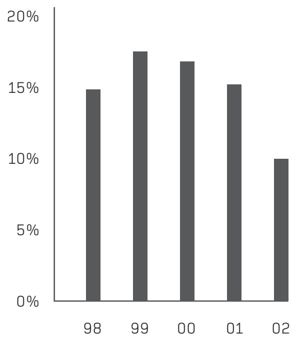
Canadian banks continue to be well capitalized. At over 12%, the average ratio of capital to risk-adjusted assets at the end of 2002 was considerably higher than the BIS (Bank for International Settlements) 8% minimum threshold or OSFI's 10% target.

Several banks announced or continued plans to refocus operations to their core retail market and reduce their exposure to the corporate sector. Some are expanding internationally (primarily into the U.S.) given the mature character of the Canadian market.

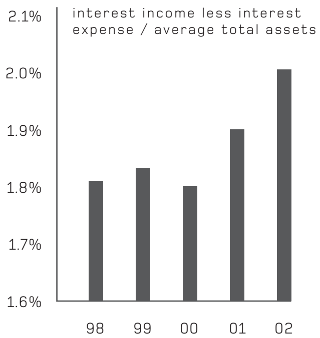
In addition to regular supervisory reviews tailored to individual institutions, OSFI completed a review of interest rate risk management at major banks.

Our overall assessment based on our 2002–2003 reviews is that the major Canadian banks generally have strong risk management processes and sound diversification policies and are adequately provisioned for losses for risk in their loan portfolios. We have been stressing the need for banks to remain vigilant in their underwriting and loan monitoring.

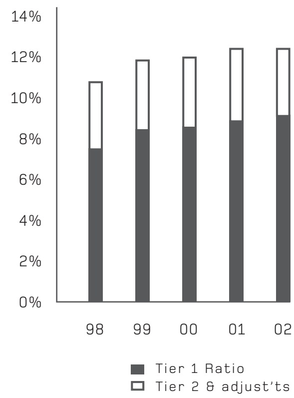
RETURN ON EQUITY



SPREAD



RISK-WEIGHTED CAPITAL RATIOS



/ OTHER DEPOSIT-TAKING INSTITUTIONS /

As at the end of March 2003, there were 44 smaller deposit-taking institutions supervised by OSFI, including 10 banks and 34 trust and loan companies (excluding bank-owned trust and loan companies). There were also 32 foreign bank subsidiaries and 21 branches of foreign banks, accounting for some 6.0% of all bank assets. Three foreign bank subsidiaries converted to branches in 2002, bringing the total of such conversions to 13 since foreign branching was permitted in 1999.

There is a wide range of business strategies amongst smaller domestic deposit-taking institutions and foreign banks. Accordingly, the factors affecting these institutions are varied and the risks are more specific to individual institutions.

Overall, these deposit-taking institutions showed stability by most financial measures. Capital positions remained at healthy levels and most institutions reported reasonable levels of profitability. Credit quality remained an issue, but was being actively managed overall. The good performance of the Canadian economy and retail and commercial banking has been particularly important to the health of a number of these institutions. OSFI took action under its supervisory framework in several cases in which risk management and control practices were inadequate relative to the risks being assumed.

OSFI continues to monitor closely pressures in certain troubled foreign markets, notably Japan and Germany, to detect any adverse impact on Canadian operations of institutions from those countries.

OSFI TOOK ACTION UNDER ITS SUPERVISORY FRAMEWORK IN SEVERAL CASES IN WHICH RISK MANAGEMENT AND CONTROL PRACTICES WERE INADEQUATE RELATIVE TO THE RISKS BEING ASSUMED.

/ LIFE INSURANCE COMPANIES /

Canadian life insurance companies generally weathered the recent financial and economic conditions better than their counterparts in most other countries. This was partially due to lower direct exposure to equity markets, particularly relative to their European counterparts. Nevertheless, with the downturn in equity markets, fees from a variety of equity-related products were compressed and reserves to support embedded guarantees in these products enhanced.

Despite these pressures, life companies managed to maintain healthy profit margins overall. Earnings have generally been stable, with a slightly deteriorating trend. On the whole, the life conglomerate groups did better than the smaller Canadian companies and foreign companies and branches.

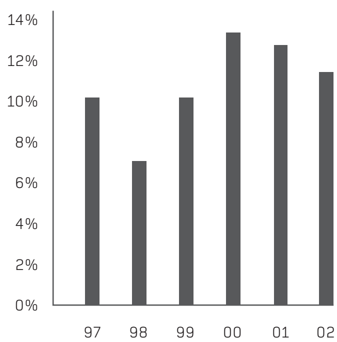
Good cost control contributed to the sector's performance. In 2002, the industry's expenses (commissions and other expenses) relative to premium revenues were the lowest in recent years. The industry also benefited from the relatively strong domestic economy. While net income from all jurisdictions combined fell slightly in 2002, net income from Canadian operations increased by over 10%. Roughly half of the sector's income originates from foreign operations.

OSFI establishes Minimum Continuing Capital and Surplus Requirements (MCCSR) for life insurance companies based on their business and investment risks. The ratio of a company's actual capital relative to the minimum requirement (the MCCSR ratio) is an indicator of how well that company is capitalized. The ratio, which was already strong, improved for most life companies in 2002. Changes in the MCCSR formula, discussed in the rule-making section below, contributed to this improvement.

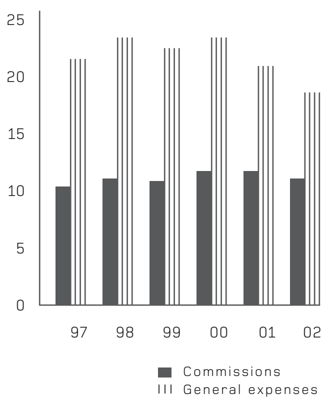
The consolidation trend in the industry gained momentum recently with the completion of two acquisitions involving some of Canada's largest insurance companies. Acquisitions have been a major source of earnings growth in the industry, based on expense synergies. In assessing acquisition proposals, OSFI considers the safety and soundness of the combined institutions. Additional focus is on the management of integration risks and, depending on how a transaction is financed, its impact on the acquiring company's capital and reserves.

OSFI has continued to support the development of enterprise-wide risk management in insurance companies. OSFI has also been monitoring the ongoing efforts of companies to adjust to the

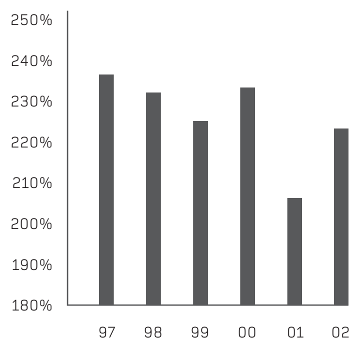
RETURN ON EQUITY



EXPENSES AS A %
OF PREMIUMS



MCCSR RATIOS



impact of low interest rates and depressed equity markets, particularly on products with guaranteed investment returns or death benefit and maturity guarantees. Indicators in these areas have generally been positive, but OSFI is prepared to intervene, if necessary, in individual cases.

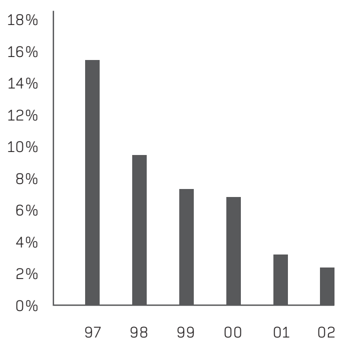
OSFI HAS CONTINUED TO SUPPORT THE DEVELOPMENT OF ENTERPRISE-WIDE RISK MANAGEMENT IN INSURANCE COMPANIES.

/ PROPERTY AND CASUALTY [P&C] INSURANCE SECTOR /

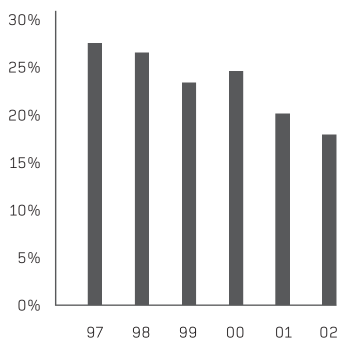
The past year was another difficult one for the P&C industry. Rapidly growing claims costs, especially for automobile insurance, have kept underwriting losses high despite premium increases. Low investment returns have made it difficult for insurers to generate the income necessary to offset underwriting losses. Increasing reinsurance costs in the wake of 9/11 have aggravated insurers' difficulties. In 2002, P&C profits fell for the fifth consecutive year.

As a result of these conditions, the capital position of the industry overall continued to erode. In some cases, weak insurance and capital markets worldwide reduced the availability of capital to the sector. Capital adequacy, as measured by the Minimum Asset Test (MAT), remained above

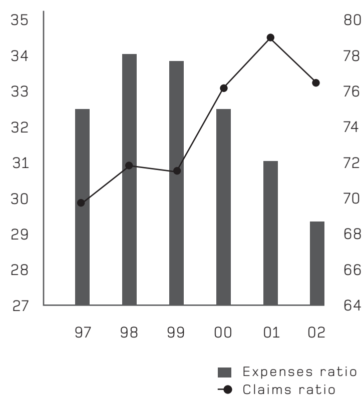
RETURN ON EQUITY



EXCESS ASSETS - MINIMUM ASSET TEST



EXPENSE AND CLAIMS RATIOS (%)



minimum requirements, but the downward trend that began five years ago continued into 2002 with more companies bumping against OSFI's capital target thresholds.

Underwriting results improved significantly last year, with declines in both expense and claims ratios, though not sufficiently to offset poor investment returns.

OSFI has worked with companies to ensure they maintain capital ratios above supervisory thresholds on a continual basis. Staff has been reallocated to make more resources available to the supervision of P&C companies, and more specialist resources are being applied to P&C issues. Companies with higher-risk profiles have been subject to more frequent financial reporting and increased intervention.

/ PENSION PLANS /

OSFI supervises 1,205 private pension plans covering employees in federally regulated areas of employment. These include inter-provincial and international transportation, telecommunications and banking, and enterprises in the Yukon, Northwest Territories, Nunavut and Aboriginal communities. OSFI-supervised plans account for about one-tenth of all registered pension plans in Canada, with the rest being supervised provincially.

Private pension plans are voluntary arrangements between employers and employees. OSFI must find the appropriate balance between prudential supervision and establishing an environment that does not discourage the creation of pension plans or cause employers to terminate plans. A balanced approach to supervision recognizes that plan administrators need to take reasonable risks in their investment and funding strategies and that plans or their sponsors can sometimes

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THROUGH ITS PARTICIPATION ON THE ACCOUNTING STANDARDS OVERSIGHT COUNCIL (AcSOC), OSFI IS ALSO WORKING FOR IMPROVED DISCLOSURE AND TRANSPARENCY OF PENSION PLAN OPERATIONS AND FINANCIAL CONDITIONS.

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experience difficulties that lead to loss of benefits. Legislation specifically permits defined-benefit pension plans to operate in a deficit position. In deciding whether and how to intervene, OSFI takes into account the size of the deficit and the sponsor's capacity to fund it.

Weak investment returns in the last two years have had a significant adverse impact on many pension plans. Stress testing conducted by OSFI using year-end 2002 data showed that approximately half of all defined-benefit plans supervised by OSFI were underfunded, meaning their estimated liabilities exceeded assets. Of these, some 55% were underfunded by more than 10%. A small number of these plans continued to take contribution holidays in 2003, which in OSFI's view was not prudent given the particular circumstances of some of these plans. A number of plan sponsors are taking steps to deal with deficits in their plans.

OSFI took action ranging from issuing direct orders to cease the contribution holidays to requiring enhanced notification to members. OSFI also announced that, going forward, it will increase the frequency of stress testing. For plans operating close to the solvency margin, OSFI is pursuing options that include more frequent valuations (which trigger requirements to fund deficits), required notification to OSFI and to members of intentions to take contribution holidays, and board approval of such intentions.

Through its participation on the Accounting Standards Oversight Council (AcSOC), OSFI is also working for improved disclosure and transparency of pension plan operations and financial conditions.

/ SUPERVISORY POLICIES /

OSFI uses a world-class supervisory framework designed to help identify risks early and channel resources effectively to assess the impact on regulated financial institutions and to intervene on a timely basis as necessary. We assess separately the level of risk and quality of risk management for each of an institution's significant activities. OSFI's supervision relies on effective risk management control and governance functions at the institutions, but tests that reliance through a cycle of monitoring and on-site reviews.

We continue to refine the supervisory framework and make it more transparent. Over the past years, OSFI has introduced detailed criteria to guide supervisors in applying the framework. In 2002, these criteria were made public. We also introduced Composite Risk (CR) ratings for financial institutions. These ratings are shared, on a confidential basis, with institutions.

The CR rating represents OSFI's overall evaluation of the safety and soundness of an institution. In addition to the business risks and quality of controls, the CR rating also takes into account the earnings and capital position of the institution. There are four CR ratings: low, moderate, above average and high. CR ratings covering 204 institutions were provided to those institutions during 2002–2003.

At the end of March 2003, over 75% of all institutions provided ratings were assigned a low or moderate risk rating. In the life insurance sector, where conditions were generally the healthiest, 94% of all companies fell into these two lower-risk categories. In the P&C sector, nearly 70% did. Overall, only 1.5% of institutions were assessed as high risk.

WE CONTINUE TO REFINE THE SUPERVISORY FRAMEWORK AND MAKE IT MORE TRANSPARENT. OVER THE PAST YEARS, OSFI HAS INTRODUCED DETAILED CRITERIA TO GUIDE SUPERVISORS IN APPLYING THE FRAMEWORK.

The risk rating also helps determine the degree of supervisory attention an institution receives. OSFI follows the published *Guide to Intervention*, which sets out the supervisory intervention steps associated with different levels of overall risk posed by an institution. Under the Guide, financial institutions are rated on a scale of 0-4. An institution with a zero rating is subject to routine supervisory and regulatory actions. Where concerns exist, institutions are assigned ratings from stage 1 (early warning) to stage 4 (problems so serious that the institution is not viable).

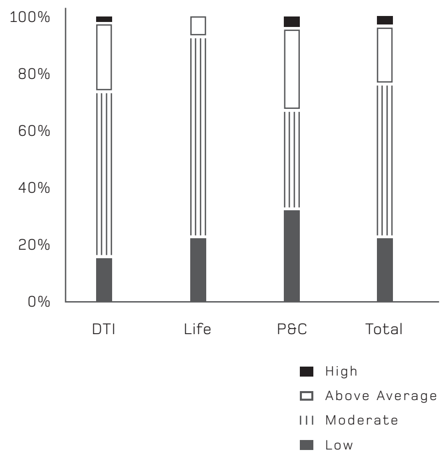
Given the challenging financial environment, the number of institutions at stage 1 or above increased substantially in 2002–2003. This was especially true for P&C companies. The vast majority of staged institutions were in the early warning (stage 1) category. In addition, in part through OSFI's interventions, nine staged institutions were upgraded during the year, indicating improvement in their condition.

During 2002–2003 there were no institutions that OSFI applied to have wound up. Shortly after the fiscal year-end, due to the issuance of the U.S. liquidation order against Home Insurance, the Canadian branch of the U.S.-based P&C company was wound up in order to protect policyholders and creditors in Canada. In 1997, OSFI had restricted the Canadian branch's activities and frozen the vested assets held in Canada because of the financial difficulties the U.S. company was experiencing at the time.

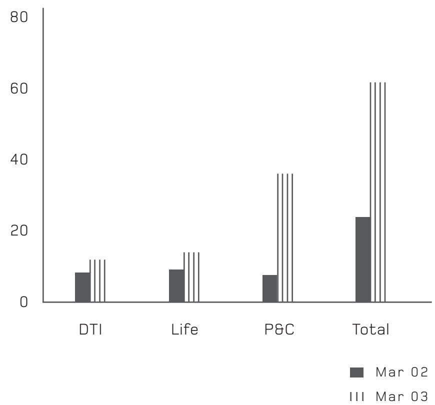
As discussed earlier in the report, the difficult market conditions also had a significant impact on pension plans. The number of pension plans on OSFI's watch list rose during the year from 50 to approximately 80. Of these, about 60 were defined-benefit plans and 20 were defined-contribution plans. There were some positive results as well, however. Several plans were upgraded over this period and the number of plans with late remittance of contributions declined.

In the aftermath of 9/11, Canada stepped up efforts to combat financial crime and prevent the use of financial institutions to launder money or finance illegal activities, including terrorism. As part of these efforts, in 2002–2003 OSFI initiated a program of more-focussed reviews of anti-money laundering and anti-terrorism policies and procedures of banks and life insurance companies.

COMPOSITE RISK RATING BY SECTOR



NUMBER OF STAGED INSTITUTIONS



02

APPROVALS

APPROVALS

Federally regulated financial institutions are required to seek consent from the Minister of Finance or the Superintendent of Financial Institutions for certain types of transactions, including incorporation, corporate restructuring and ownership change. Bill C-8, which came into effect in October 2001, introduced a streamlined approval process. It reduced the number of matters requiring approval, shifted some from ministerial to Superintendent approvals and established a "deemed approval" process. Under this new process, certain types of applications are automatically approved 30 days after receipt unless the Superintendent raises concerns or requires a delay.

The new process has now been fully implemented, with significantly positive results for institutions. Of the roughly 730 approvals granted in 2002, more than half were subject to the streamlined process. Ministerial approvals accounted for less than 20%.

Of the transactions subject to the streamlined approval process, 71% were completed within the 30-day period. The new streamlined approval process has reduced considerably the time it takes to deal with applications.

OSFI intends to build on this improvement. It has begun a review of the regulatory approval process for all types of applications, not just those subject to the deemed approval regime, with a view to tracking and improving the turnaround time for an application. To improve efficiencies, a comprehensive electronic case and document management system was introduced in 2002.

OSFI is also continuing efforts to make the approval process more transparent to the industry. To this end, the Office published an additional 21 instruction guides over the past year, setting out key information requirements for applications for regulatory consent. Failure by institutions to provide the required information remains the most common reason for delays in approvals. In

THE NEW STREAMLINED APPROVAL PROCESS HAS REDUCED CONSIDERABLY THE TIME IT TAKES TO DEAL WITH APPLICATIONS.

October 2002, OSFI hosted a seminar on the regulatory approval process for regulated institutions and their advisors. Additional seminars are being planned, as they allow timely communication on ways to reduce or eliminate impediments to an effective and efficient approval process.

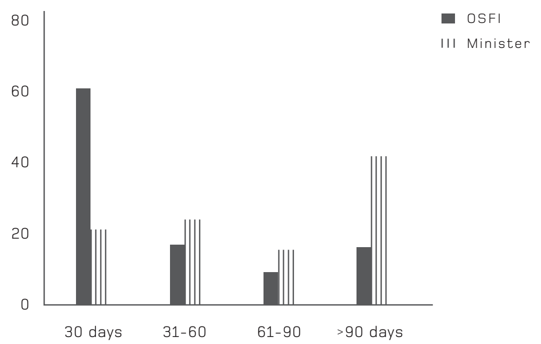
OSFI approved two applications during the year to establish new domestic banks in Canada. One of these, the Pacific and Western Bank, involved converting an existing provincially based trust company to a bank. The other, Bank West, is a start-up. By year-end, a third application was close to receiving approval and a handful of other parties were discussing with OSFI the possibility of establishing a bank.

The number of transactions requiring approval under the legislation declined slightly in 2002 from the previous year. This was due to the streamlining initiatives noted above and to industry conditions.

In addition to legislative approvals, OSFI provides advance opinions on various capital transactions where institutions want certainty about the regulatory treatment of the transaction. OSFI also validates the use of certain complex models for use by institutions in determining their compliance with regulatory capital rules. Twelve approvals and opinions of this nature were provided during the year.

While timeliness of approvals is key, applying judgment in a consistent and appropriate way is critical. To that end, the various internal practices to review precedent approvals, seek regular feedback from industry and provide more information publicly on precedent approvals are an important part of success.

PROCESSING TIME 2002
(% OF ALL APPROVALS)



03

RULE MAKING

RULE MAKING

OSFI is involved in the development and promotion of regulatory standards and practices consistent with its mandate. This includes contributing to legislative changes, drafting regulations and guidelines, and participating in joint efforts with other agencies engaged in standard-setting functions, both domestically and abroad.

/ DOMESTIC RULE MAKING /

OSFI's rule-making initiatives during the year focussed on strengthening the governance of financial institutions and enhancing public trust in the operation of Canada's financial markets. These initiatives acquired added importance in the wake of Enron and similar events.

In the summer of 2002, OSFI, along with the Canadian Institute of Chartered Accountants (CICA) and the Ontario, Quebec and British Columbia securities commissions, created the Canadian Public Accountability Board (CPAB). The Board's mission is to contribute to public confidence in the integrity of financial reporting of Canadian public companies by promoting high-quality, independent auditing. The Superintendent is a member of the Council of Governors, which is responsible for making appointments to the board of directors of CPAB and periodically reviewing the effectiveness of this new system of auditor oversight.

OSFI'S NEW GUIDANCE FOCUSSED ON GOVERNANCE ISSUES PARTICULARLY IMPORTANT TO FINANCIAL INSTITUTIONS, INCLUDING THE ROLE OF THE BOARD WITH RESPECT TO RISK MANAGEMENT, INTERNAL CONTROLS AND EXTERNAL OVERSIGHT, AND THE RELATIONSHIP BETWEEN THE BOARD AND REGULATORS.

OSFI is also a member of the Accounting Standards Oversight Council (AcSOC), an independent body overseeing the activities of the Accounting Standards Board. AcSOC focussed much of its activity during the past year on accounting issues that gained prominence in the wake of Enron. It also endorsed making mandatory the recognition of stock option costs in corporate financial statements. While many corporations, including most banks, were already moving to recognize stock option expenses on their own, a consistent accounting framework for all corporations that better recognizes their true costs is highly desirable.

In November 2002, OSFI issued a draft guideline setting out its expectations for an external review process for reports produced by appointed actuaries of federally regulated insurance companies. The draft guideline will be revised to consider comments received from the industry and the actuarial profession. Periodic review of the work of appointed actuaries will commence with actuarial reports as of the end of 2003. The purpose of these reviews is to increase the consistency of actuarial practice and reinforce the ability of OSFI and others to rely on the work of the appointed actuary.

Following extensive industry consultations, in January 2003 OSFI released the *Corporate Governance Guideline* for financial institutions. To avoid duplicating the considerable guidance on corporate governance already available from other sources, OSFI's new guidance focussed on governance issues particularly important to financial institutions, including the role of the board with respect to risk management, internal controls and external oversight, and the relationship between the board and regulators. OSFI is strengthening its focus on governance as part of its supervisory process, and the release of the guideline reflects OSFI's desire to emphasize the importance of effective governance to the safety and soundness of financial institutions. The guide was provided to all directors of the institutions OSFI regulates.

A considerable part of OSFI's rule-making function relates to capital. Having adequate capital is fundamental to the safety and soundness of any institution. But capital is costly, and excessive requirements, or requirements unrelated to risk can put a firm at a disadvantage relative to its competitors. During the year, OSFI issued revised capital guidelines for the life insurance and the property and casualty (P&C) insurance sectors.

Capital charges for life insurers were reduced for participating policies and index-linked products where investment risks are partially or fully passed on to policyholders. Mortality risk requirements for non-participating individual insurance policies were also lowered to take into account improvements in mortality rates over the years. OSFI continues to work with the industry to ensure that capital adequacy requirements reflect developments in the sector.

Beginning this year, the capital rules for the P&C industry were replaced by a new capital adequacy standard, the Minimum Capital Test (MCT). Developed in consultation with the industry and provincial supervisors, the new standard provides for the first time a harmonized, risk-based capital adequacy test for P&C companies across Canada. This new standard replaces four separate solvency tests applicable under federal and provincial legislation, reducing the burden of multiple jurisdictional requirements. The MCT has been designed to be, on average, neutral in its impact on capital relative to the MAT. The new test is considerably more risk-sensitive and, by implementing conservative risk management and investment practices, companies may take advantage of the risk-sensitive nature of the new test to lower their capital requirements. Companies have been maintaining results on both the old and new basis in order to monitor the transition to the new rules. These results show that the new test yielded an overall reduction in the industry capital requirements of some $700 million.

OSFI participated during the year in an international comparison of capital and related accounting and actuarial rules in the P&C industry. The study strongly supported OSFI's risk-based approach to measuring capital, but also queried how the thresholds for intervention above the minimum compared to certain other jurisdictions.

OSFI is also developing a number of regulatory changes to strengthen the current pension plan funding rules. These changes will require that plan sponsors fully fund promised benefits on termination of the plan. In addition, existing legislation authorizes the Superintendent to disallow any benefit improvements that would cause the solvency ratio of the plan to fall below a prescribed ratio. Work on regulations to implement this power is currently under way. We anticipate that these regulatory changes would come into effect in early 2004, following consultations.

/ INTERNATIONAL RULE MAKING /

In its international rule-making activities, OSFI participates most actively in areas of greatest importance to Canadian financial institutions and areas where we, or our institutions, have particular expertise or interest.

The Basel Committee on Banking Supervision (BCBS) is the prime body bringing together supervisors and regulators of international banks from G-10 countries. It has taken a leadership role over a number of years in rule setting. The BCBS has focussed recent efforts on developing a modernized capital adequacy accord that will better relate capital requirements for international banks to the risks they assume.

OSFI believes new risk-based capital rules for banks are highly desirable and supports the work of the BCBS as a member of the Committee and through active participation in a number of

OSFI BELIEVES NEW RISK-BASED CAPITAL RULES FOR BANKS ARE HIGHLY DESIRABLE

subcommittees responsible for different aspects of the New Accord. The Superintendent of Financial Institutions also chairs the BCBS Accord Implementation Group, whose purpose is to share information among supervisors in G-10 and other countries, thereby promoting consistency in their approaches to implementation.

OSFI's contribution and commitment to the work of the BCBS was recognized in March 2003, when the Superintendent of Financial Institutions was appointed to the newly created position of vice-chair of the Committee.

As part of its involvement in developing the New Basel Accord, OSFI has actively sought the input of Canadian banks and shared with the BCBS members Canada's expertise in retail lending and asset securitization. In October 2002, OSFI enlisted the participation of major Canadian banks in a quantitative impact study and a review of the draft rules allowing participating banks around the world to perform concrete and comprehensive assessments of the proposals. In addition, during the year OSFI made significant efforts to be ready in time for implementation of the New Accord. This allows OSFI to start to respond to industry requests for interpretation of the Accord, which is key to banks being able to implement the changes necessary to comply.

OSFI also plays an important role in the work of the International Association of Insurance Supervisors (IAIS), which has been increasingly active in its evolving role as a standard-setter for life and general insurance supervision. OSFI participates as a member of the Executive, Technical and Budget committees of the IAIS and the Accounting, Investment and Solvency subcommittees. It is also a member of the Task Force on Revision to the Insurance Core Principles and Methodology, and participated in the Working Group on the Future and Financing Structure of the IAIS, which produced a working plan for the IAIS last October.

As well, OSFI follows the progress of other industry and regulatory groups and comments regularly on their draft papers.

04

INTERNATIONAL ASSISTANCE

In 2002, OSFI achieved a significant measure of success with its technical-assistance program, which is aimed at helping emerging market economies improve their financial institutions' supervisory systems. OSFI's commitment in this area represents a practical and effective means of contributing to international stability and is consistent with Government of Canada priorities. The International Advisory Group (IAG), which administers and operates the program, provides hands-on technical advice, training, workshops and seminars, primarily to supervisors in the Caribbean, Asia and Latin America in the areas of bank and insurance company regulation and supervision. The Canadian International Development Agency (CIDA) provides the bulk of the funding for the Group.

During the year under review, IAG developed and began offering "in-house" programs that allow foreign bank and insurance company supervisors the opportunity to visit and learn at OSFI. IAG contributed to the IMF/World Bank Financial Sector Assessment Program as expert assessors and by providing technical assistance to rectify identified shortcomings in several jurisdictions. IAG was also active in delivering regional training seminars and in assisting various offshore finance centres.

In addition, OSFI continues to support the Toronto International Leadership Centre for Financial Sector Supervision through its role on the Board of Directors, the Executive Committee and the Banking Program Advisory Board, as well as through the secondment of an OSFI employee. Founded in 1998, the Centre is unique. Individuals with substantial experience in financial supervision from Canada and abroad help supervisors from around the world acquire the knowledge and leadership skills to build effective supervisory regimes in their countries. The programs, initially held solely in Toronto, are now delivered virtually worldwide, often in partnership with other international or local partners.

05

OFFICE OF THE CHIEF ACTUARY

The Office of the Chief Actuary (OCA) has responsibilities that are different in nature from those of the other sectors within OSFI. Rather than fulfilling a regulatory or supervisory function, OCA provides actuarial services for a variety of programs. These include the Canada Pension Plan (CPP), Old Age Security, Canada Student Loans Program, and pension and benefit plans covering the federal Public Service, the Canadian Forces, the Royal Canadian Mounted Police, federally appointed judges and members of Parliament.

In addition to preparing statutory actuarial reports on the financial status of the plans, OCA provides the relevant government departments with actuarial advice on the design, funding and administration of these plans. OCA clients include Human Resources Development Canada, Department of Finance, Treasury Board, Public Works and Government Services, National Defence, the RCMP and Justice Canada.

The 19th Actuarial Report on the Canada Pension Plan was tabled in Parliament in June 2002 and confirmed the long-term viability and financial sustainability of the CPP. The Report confirms that the 9.9% combined employer-employee contribution rate attained in 2003 is expected to be sufficient to sustain the Plan indefinitely as larger numbers of Canadians reach retirement age. This actuarial report was prepared to show the effect of Bill C-3 (originally Bill C-58), *An Act to amend the Canada Pension Plan and the Canada Pension Plan Investment Board Act,* on the long-term financial status of the CPP. Bill C-3 gives full responsibility for cash management of the CPP to the Canada Pension Plan Investment Board by transferring the three-month operating balance and the CPP bond portfolio to the Investment Board.

OCA completed a number of other reports during the year, including actuarial reports on the Old Age Security program, the Canada Student Loans Program and several public sector pension plans, as well as the actuarial studies "Canada Pension Plan Experience Study of Disability Beneficiaries" and "CPP Actuarial Adjustment Factors Study." OCA also carried out two international mandates, one involving a review of Mexico's long-term economic and investments risks and the other a peer review of actuarial reports prepared by the Government Actuary of the United Kingdom.

06

CORPORATE INITIATIVES

In 2002–2003, OSFI embarked on a multi-year plan to enhance its information systems and help improve overall efficiency and effectiveness. This initiative should produce savings for regulated institutions in direct costs and in their costs of complying with OSFI information requirements. OSFI created an information portal for employees, to facilitate on-line access to information materials and save search time; completed implementation of a case management system to handle approvals more effectively; and began work on a multi-year business systems integration initiative (BSII) to streamline core supervisory processes and enable them with workflow tools. In addition, OSFI began to implement an office-wide electronic document management capability, with a view to moving to a fully electronic corporate record system over the next five years.

During this period, OSFI initiated enterprise-wide risk management (ERM). ERM is a contemporary management tool that provides organizations with a comprehensive and integrated approach to identifying risks in their operations and assessing the quality of risk mitigants. It is a proactive approach that helps organizations anticipate changes to their operating environment and respond to them effectively.

OSFI also adopted a formal competency model in its human resource management. A competency model outlines the full range of skills, knowledge and behaviours required for success in a given position or in groups of comparable positions. Given the unique skill sets required in many OSFI positions, the competency model will strengthen our ability to improve organizational performance by identifying appropriate candidates when recruiting, surfacing training and development needs of current staff, and differentiating individual performance and rewards.

PRIORITIES GOING FORWARD

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OSFI does not anticipate a major change in priorities for the upcoming year. OSFI will remain vigilant as financial institutions and pension plans may continue to face a number of challenges depending on the environment. The Office will continue to:

- Effectively identify the risks faced by federal financial institutions and pension plans and intervene as appropriate;
- Improve OSFI's readiness to deal effectively with problem federally regulated financial institutions (FRFIs) and pension plans, including through finalizing and testing OSFI's own Business Resumption Plan (BRP);
- Ensure that the framework of OSFI guidance and rules applying to FRFIs and pension plans remains relevant and meets international minimums through focussed updates, such as with respect to outsourcing by FRFIs;
- Analyze the implementation of policy frameworks and adapt regulatory and supervisory approaches as required (examples include further refining OSFI's approach to assessing governance of FRFIs and fully implementing a compliance program for anti-money laundering);
- Maintain the resources and infrastructure necessary to support supervisory and regulatory activities, such as completing current projects to enhance information systems and workflow processes on time and on budget, and fully implementing major human resources policies such as the introduction of competencies; and
- Respond in a focussed and selective way to the increasing demands for OSFI's technical assistance, funded by CIDA, and further develop OSFI's program of hands-on training.

FINANCIAL STATEMENTS

FINANCIAL HIGHLIGHTS FOR 2002–2003

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/ BACKGROUND /

OSFI recovers its costs from several revenue sources. Costs for risk assessment and intervention (supervision), approvals and rule making are charged to the financial institutions and private pension plans that OSFI regulates and supervises.

The allocation of costs to individual institutions for OSFI's main activities of supervision, approvals and rule making is determined in several ways. In general, the system is designed to allocate costs to institutions based on the approximate amount of time spent supervising and regulating the institutions. As a result, well-managed, lower-risk institutions and those with fewer approvals bear a smaller share of OSFI's costs.

Specific user fees cover costs for certain approvals. Problem (staged) institutions are assessed a surcharge approximating the extra supervision resources required.

OSFI also receives revenues for cost-recovered services. These include revenues from CIDA for international assistance, revenues from provinces for whom OSFI does supervision of their institutions on contract, and revenues from other federal agencies for whom OSFI provides administrative support. Starting in 2002–2003, cost-recovery revenue also included amounts charged separately to major banks for implementation of the internal ratings-based approach of the New Basel Capital Accord over the three-year period ending 2004–2005.

The remainder of costs of risk assessment and intervention, approvals and rule making are recovered through base assessments against institutions and pension plans according to various formulae. Overall, OSFI fully recovered all its expenses for the fiscal year 2002–2003.

This year OSFI began collecting late and erroneous filing penalties from financial institutions that submit late and/or erroneous financial and non-financial returns. These penalties are billed quarterly, collected and deposited in the government's accounts. By regulation, OSFI cannot use these funds to offset expenses.

The Office of the Chief Actuary is funded by fees charged for actuarial services and by parliamentary appropriations.

/ FEDERALLY REGULATED FINANCIAL INSTITUTIONS /

Base assessments to industry rose $3.0 million, or 5.5%, for the year ended March 31, 2003. Total expenses were $64.0 million, a 12% increase from the previous year. Revenue from user fees and charges and cost-recovered services increased considerably faster. Surcharges to problem institutions rose by $1.4 million from the prior year. This was due to the combined effect of a greater number of staged institutions in the year, the full-year application of the surcharges (vs. 10 months in fiscal year 2001–2002), and the full phase-in of surcharges (vs. a 50% phase-in for fiscal year 2001–2002). User fees from approvals were lower than expected due to a decline in the number of approvals. The current level of user fees for approvals does not approximate costs incurred. As a result, OSFI is working to alter regulations to increase fees over a two-year period.

Cost recovery revenue related to implementing the internal ratings-based approach of the New Basel Capital Accord was $2.2 million. Other service charges rose by slightly more than $0.6M.

The increase in personnel costs that was the main driver of OSFI expenses arose from an increase in the number of employees at OSFI and continued adjustments to employee compensation to more closely reflect market levels. These cost factors are part of a strategy to ensure OSFI attracts and retains the people it needs, with the requisite range of experience and skills to meet its mandate. During the year OSFI also increased its performance-related pay.

OSFI staff increased during the year as vacant positions were filled in supervision and in specialist areas that largely support risk assessment and intervention. Additional resources also supported OSFI's international assistance activities and implementation of new international capital rules for banks (these do not affect general assessments to institutions). OSFI is currently close to its optimum size and during the year a limit was set on headcount.

/ PRIVATE PENSION PLANS /

A formula is used to set revenue from pension plans at a level that matches expenses. Expenses in this area declined 8% from the previous year, due mainly to staff vacancies.

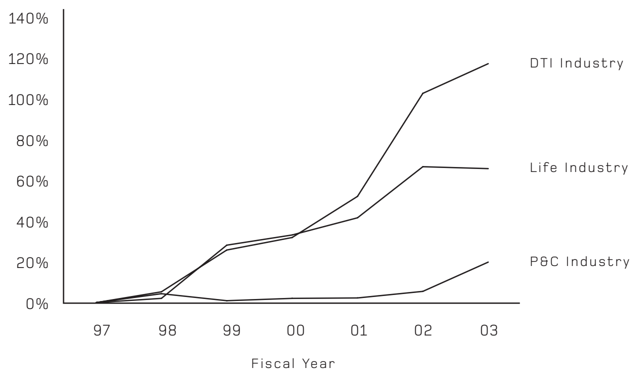
/ OFFICE OF THE CHIEF ACTUARY /

The decrease from the prior year in the expenses of the Office of the Chief Actuary is mainly attributed to non-recurring costs incurred in 2001–2002 for the independent review of the 18th Actuarial Report on the Canada Pension Plan.

/ FINANCIAL INSTITUTION ASSESSMENTS BY INDUSTRY /

OSFI assessments are differentiated to reflect the costs incurred by each industry group. The chart below shows the growth of general assessments by industry group over the past five years. General assessments are the costs allocated to an industry, less specific fees for approvals and surcharges for problem institutions. As the chart shows, assessments on the P&C sector over this five-year period rose considerably less than for other industry sectors. In 2002–2003, however, assessments on the P&C sector grew faster.

GENERAL ASSESSMENTS BY INDUSTRY
Cumulative Growth Rates from Fiscal Year 1997



MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

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Responsibility for the integrity and objectivity of the accompanying financial statements and the consistency with all other information contained in this annual report rests with OSFI management.

These financial statements, which include amounts based on management's best estimates as determined through experience and judgement, have been prepared in accordance with Canadian generally accepted accounting principles. Management has developed and maintained books of accounts, records, internal controls, management practices, and information systems designed to provide reasonable assurance that assets are safeguarded and controlled, resources are managed economically and efficiently in the attainment of corporate objectives, and transactions are in accordance with the *Financial Administration Act* and regulations and with OSFI policies and statutory requirements.

The Auditor General of Canada, the independent auditor for the Government of Canada, has audited the transactions and financial statements of OSFI and reports on her audit to the Minister of Finance.

NICHOLAS LE PAN
Superintendent

DONNA PASTERIS
Assistant Superintendent
Corporate Services

Ottawa, Canada
May 30, 2003

Auditor General of Canada
Vérificatrice générale du Canada

AUDITOR'S REPORT

To the Minister of Finance

I have audited the statement of financial position of the Office of the Superintendent of Financial Institutions as at March 31, 2003 and the statements of operations and equity of Canada and cash flows for the year then ended. These financial statements are the responsibility of the Office's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Office as at March 31, 2003 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

John Wiersema, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
May 30, 2003

STATEMENT OF FINANCIAL POSITION

AS AT MARCH 31

/ ASSETS /	2003	2002
Assets		
Cash Entitlement	$ 35,514,923	$ 34,722,099
Accounts Receivable	5,240,382	1,260,864
Accrued Base Assessments	1,039,822	4,777,922
Capital Assets (note 4)	5,389,282	5,349,082
TOTAL ASSETS	**$ 47,184,409**	**$ 46,109,967**

/ LIABILITIES AND EQUITY OF CANADA /	2003	2002
Liabilities		
Accounts Payable & Accrued Liabilities	$ 3,211,176	$ 2,456,561
Accrued Salaries and Benefits	8,887,754	8,306,154
Deferred Charges	561,083	1,534,604
Deferred Private Pension Plan Revenue	1,039,596	933,193
Employee Future Benefits other than pension (note 9)	5,947,187	5,341,842
	19,646,796	**18,572,354**
Equity of Canada	**27,537,613**	**27,537,613**
TOTAL LIABILITIES & EQUITY OF CANADA	**$ 47,184,409**	**$ 46,109,967**

Commitments and Contingencies (note 6)

NICHOLAS LE PAN
Superintendent of Financial Institutions

/ THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE FINANCIAL STATEMENTS /

STATEMENT OF OPERATIONS AND EQUITY OF CANADA

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FOR THE YEAR ENDED MARCH 31

/ SUPERVISION OF FEDERALLY REGULATED FINANCIAL INSTITUTIONS /	2003	2002
Revenue		
Base Assessments	$ 56,542,383	$ 53,577,359
User Fees and Charges	4,036,411	3,070,006
Cost Recovered Services	3,451,087	534,685
Total Revenues	64,029,881	57,182,050
Expenses (note 10)		
Supervision & Regulation	60,578,794	56,647,365
Cost Recovered Services	3,451,087	534,685
Total Expenses	64,029,881	57,182,050
Results before Non-Respendable Filing Penalties Revenue	--	--
Non-Respendable Filing Penalties Revenue (note 11)	709,900	--
Net Results	709,900	--

/ SUPERVISION OF PRIVATE PENSION PLANS /		
Revenue	3,163,398	3,438,563
Expenses (note 10)	3,163,398	3,438,563
Net Results	--	--

/ OFFICE OF THE CHIEF ACTUARY OF CANADA /		
Revenue	2,907,745	2,804,500
Expenses (note 10)	3,614,745	3,772,356
Net Results	(707,000)	(967,856)
Net Results of Operations before Government Funding	**2,900**	**(967,856)**
Government Funding (note 5)	707,000	916,500
NET RESULTS OF OPERATIONS FOR THE YEAR	**709,900**	**(51,356)**
EQUITY IN CANADA, BEGINNING OF YEAR	**27,537,613**	**27,588,969**
Non-Respendable Filing Penalties Earned on Behalf of the Government (note 11)	(709,900)	--
EQUITY OF CANADA, END OF YEAR	**$ 27,537,613**	**$ 27,537,613**

/ THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE FINANCIAL STATEMENTS /

STATEMENT OF CASH FLOWS

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FOR THE YEAR ENDED MARCH 31

/ OPERATING ACTIVITIES /	2003	2002
Net Results of Operations	$ 709,900	$ (51,356)
Non-Cash items included in Operations		
Amortization of Capital Assets	2,233,744	1,760,267
Employee Related Liabilities	1,186,945	4,533,038
Gain on Disposal of Capital Assets	--	(9,248)
Change in Assets / Liabilities		
(Increase) in Accounts Receivable	(3,979,518)	(956,540)
(Increase) / Decrease in Accrued Base Assessments	3,738,100	(4,169,767)
Increase / (Decrease) in Accounts Payable and Accrued Liabilities	754,615	(1,657,801)
Increase / (Decrease) in Deferred Charges	(867,118)	1,144,997
Non-Respendable Filing Penalties Revenue (note 11)	(709,900)	--
Cash Provided by Operating Activities	**3,066,768**	**593,590**

/ INVESTING ACTIVITIES /		
Acquisition of Capital Assets	(2,273,944)	(3,459,649)
Proceeds of Disposal of Capital Assets	--	9,248
Cash Applied to Investing Activities	**(2,273,944)**	**(3,450,401)**
INCREASE / (DECREASE) IN CASH ENTITLEMENT	**792,824**	**(2,856,811)**
CASH ENTITLEMENT, BEGINNING OF YEAR	**34,722,099**	**37,578,910**
CASH ENTITLEMENT, END OF YEAR	**$ 35,514,923**	**$ 34,722,099**

/ THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE FINANCIAL STATEMENTS /

NOTES TO THE FINANCIAL STATEMENTS

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FOR THE YEAR ENDED MARCH 31, 2003

1. / AUTHORITY AND OBJECTIVE /

i) The Office of the Superintendent of Financial Institutions ("OSFI") was established by the *Office of the Superintendent of Financial Institutions Act* ("OSFI Act") in 1987 to regulate and supervise all federally regulated financial institutions. For OSFI, a federally regulated financial institution is any entity that has been created or is allowed to offer financial services pursuant to one of the financial institution statutes promulgated by the federal government and includes banks, trust and loan companies, federally-registered insurance companies, cooperative credit associations, fraternal benefit societies and pension plans. Pursuant to the *Financial Administration Act* ("FAA"), OSFI is a department of the Government of Canada for the purposes of that Act and is listed in schedule I.1 of the Act.

ii) The Office of the Chief Actuary ("OCA"), a division of OSFI, provides actuarial advice to the Government of Canada. The OCA performs actuarial services for a variety of public insurance and pension programs as required under the *Canada Pension Plan Act* and the *Public Pensions Reporting Act.*

iii) In addition, OSFI has responsibilities under the following legislation:

-- *Bank Act*;
-- *Cooperative Credit Associations Act*;
-- *Green Shield Canada Act*;
-- *Insurance Companies Act*;
-- *Trust and Loan Companies Act*; and
-- *Pension Benefits Standards Act, 1985*.

iv) Under previous provisions of the *Insurance Companies Act* and the *Winding-Up Act,* OSFI acted as liquidator of failed insurance companies when appointed by Court Order. Under these circumstances, the Superintendent hired agents to carry out the liquidation work in each case. However, under the new provisions of the *Winding-Up and Restructuring Act* (Section 23.3), the Superintendent can no longer be appointed as liquidator of a failed institution.

2. / SPENDING AND BORROWING AUTHORITY /

Pursuant to section 17 of the OSFI Act, the Minister of Finance may spend any revenues collected under sections 23 and 23.1 of the OSFI Act to defray the expenses associated with the operation of OSFI. The Act also establishes a ceiling for the expenses and sets this ceiling at $40,000,000 above the amount of revenue collected.

OSFI revenues comprise assessments, fees, and service charges. The expenses against which assessments may be charged include those in connection with the administration of the *Bank Act,* the *Cooperative Credit Associations Act*, the *Green Shield Canada Act*, the *Insurance Companies Act,* and the *Trust and Loan Companies Act*. The formula for the calculation of assessments is included in regulations.

The *Pension Benefits Standards Act*, 1985 ("PBSA, 1985") provides that fees may be charged for the registration and supervision of pension plans and for the supervision, including inspection, of registered pension plans. The amount of the fees is set annually by regulation pursuant to section 25 of the PBSA, 1985.

Section 23.1 of the OSFI Act provides that the Superintendent may assess against a person a prescribed charge ("service charge") and applicable disbursements for any service provided by or on behalf of the Superintendent for the person's benefit or the benefit of a group of persons of which the person is a member. "Person" includes individuals, corporations, funds, unincorporated associations, Her Majesty in Right of Canada or of a province, and a foreign government. The service charges are detailed in the regulations.

Pursuant to section 16 of the OSFI Act, Parliament annually provides appropriations to support the operations of the Office of the Chief Actuary.

a) BASIS OF PRESENTATION

The financial statements of OSFI have been prepared in accordance with Canadian generally accepted accounting principles.

b) REVENUE RECOGNITION

Revenue is recorded in the accounting period in which it is earned whether or not it has been billed or collected.

OSFI charges interim base assessments calculated on its budgeted expenses and forecast industry results. Final base assessments are billed in the subsequent fiscal year, calculated on the actual results from the prior year.

On April 1, 2002, OSFI's filing penalty regulations came into force in accordance with the OSFI Act. Penalties are levied quarterly to financial institutions when they submit late and/or erroneous financial and non-financial returns due to OSFI during the preceding calendar quarter. Penalties levied by OSFI are non-respendable and are remitted to the Consolidated Revenue Fund.

Pension plan fee rates are set annually based on budgeted expenses, forecast pension plan membership and actual results from the previous year.

User fees and charges include revenues earned pursuant to *Service Charges Regulations* and surcharges assessed against federally regulated financial institutions assigned a "stage" rating pursuant to the *Guide to Intervention for Federal Financial Institutions*.

Cost-recovered services are provided based on terms outlined in Memoranda of Understanding and preliminary billings are based on settlement estimates.

c) CASH ENTITLEMENT

OSFI does not have its own bank account. The financial transactions of OSFI are processed through the Consolidated Revenue Fund ("CRF") of Canada. OSFI's cash entitlement represents the amount the Office is entitled to withdraw from the CRF without further authority. This amount does not earn interest.

d) CAPITAL ASSETS

Capital assets are recorded at historical cost less accumulated amortization. Amortization is recorded using the straight-line method over the estimated useful lives of the assets as follows:

Assets	Useful life
Leasehold Improvements	Remaining life of the lease
Furniture and Fixtures	7 years
Office Equipment	4 years
Informatics Hardware	3 years
Informatics Infrastructure (Networks)	3 years
Informatics Software	5 years
Motor Vehicles	5 years

e) EMPLOYEE FUTURE BENEFITS

(i) Pension Benefits

OSFI's eligible employees participate in the Public Service Superannuation Plan administered by the Government of Canada. Both the employees and OSFI contribute to the cost of the Plan. This amount is currently based on a multiple of the employee's required contributions, and may change over time depending on the experience of the Plan. These contributions represent the total pension obligations of OSFI and are charged to operations on a current basis. OSFI is not required under present legislation to make contributions with respect to any actuarial deficiencies of the Public Service Superannuation Plan.

(ii) Severance Benefits

On termination of employment, employees are entitled to certain benefits provided for under their conditions of employment through a severance benefits plan. The cost of these benefits is actuarially determined and is accrued as the employees render their services necessary to earn severance benefits.

The cost of the benefits is actuarially determined using the projected benefit method prorated on services. The valuation of the liability is based upon a current market discount rate and other actuarial assumptions which represent management's best long-term estimates of factors such as future wage increases and employee resignation rates.

f) SPECIFIED PURPOSE ACCOUNT

OSFI has an interest-bearing specified purpose account within the Consolidated Revenue Fund for insurance company liquidations. Previous to recent amendments to the *Insurance Companies Act,* the courts appointed the Superintendent as the liquidator of several failed insurance companies. In this capacity, OSFI pays, on behalf of the remaining active institutions, all expenses related to the liquidation, and then recovers these costs from active institutions. The revenues and expenses related to these accounts are not included in the OSFI Statement of Operations and Equity of Canada.

g) USE OF ESTIMATES

These financial statements are prepared in conformity with Canadian generally accepted accounting principles, which require that OSFI management make estimates and assumptions that affect the amounts reported in these financial statements. Human resources related liabilities and the useful lives of capital assets are the most significant items for which estimates are used. Actual results could differ from those estimates.

4. / CAPITAL ASSETS /

Cost	March 31, 2002	Additions	Disposals	March 31, 2003
Leasehold Improvements	$ 1,473,252	$ 152,426	$ --	$ 1,625,678
Furniture and Fixtures	1,529,984	59,278		1,589,262
Office Equipment	318,586	32,724		351,310
Informatics Hardware	1,432,527	270,930		1,703,457
Informatics Infrastructure	1,756,779	858,227		2,615,006
Informatics Software	4,912,315	900,359		5,812,674
	$ 11,423,443	$ 2,273,944	$ --	$ 13,697,387

Accumulated amortization	March 31, 2002	Amortization	Disposals	March 31, 2003
Leasehold Improvements	$ 495,829	$ 427,471	$ --	$ 923,300
Furniture and Fixtures	653,756	213,437		867,193
Office Equipment	131,662	74,034		205,696
Informatics Hardware	1,049,625	281,500		1,331,125
Informatics Infrastructure	897,395	557,713		1,455,108
Informatics Software	2,846,094	679,589		3,525,683
	$ 6,074,361	$ 2,233,744	$ --	$ 8,308,105
Net Book Value	$ 5,349,082			$ 5,389,282

5. / GOVERNMENT FUNDING /

OSFI receives an annual parliamentary appropriation pursuant to section 16 of the OSFI Act to support its mandate relating to the Office of the Chief Actuary. In this fiscal year, OSFI was granted $707,000 (2002: $916,500) in parliamentary appropriations to defray the expenses associated with the provision of services by the Office of the Chief Actuary.

6. / COMMITMENTS AND CONTINGENCIES /

a) COMMITMENTS

OSFI has entered into lease agreements for office space and office equipment in four locations across Canada. The minimum aggregate annual payments for future fiscal years are as follows:

2003-2004	$ 3,773,718
2004-2005	354,467
2005-2006	90,343
2006-2007	22,586
2007-2008	--
	$ 4,241,114

b) CONTINGENCIES

OSFI is involved in claims and litigation for which provisions have been made to the extent determinable.

7. / SPECIFIED PURPOSE ACCOUNT /

During the year, the following activity occurred in this account:

Specified Purpose Account: Insurance Company Liquidations	**2003**	**2002**
Opening Balance	$ (45,212)	$ 6,712,292
Recoveries deposited	20,458,870	53,475
Interest earned	35,040	161,223
Distribution of assets from liquidated estates	--	(6,633,788)
Net disbursements in respect of liquidation expenses	(870,704)	(338,414)
Closing Balance	$ 19,577,994	$ (45,212)

Remaining active insurance companies are liable for all expenses related to the liquidation of failed insurance companies.

8. / RELATED PARTY TRANSACTIONS /

OSFI is related in terms of common ownership to all Government of Canada departments, agencies and Crown corporations. OSFI enters into transactions with these entities in the normal course of business and on normal trade terms.

OSFI recorded expenses of $14,434,287 (2002: $14,781,443) and revenues of $3,050,027 (2002: $6,660,558) from transactions in the normal course of business with other Government departments during the year.

As at March 31, accounts receivable and payable with other Government entities and unrelated external parties were as follows:

		Related Parties	External Parties	Total
2003	Accounts Receivable	$ 47,058	$ 5,193,324	$ 5,240,382
	Accounts Payable	$ 837,236	$ 2,373,940	$ 3,211,176
2002	Accounts Receivable	$ 9,252	$ 1,251,612	$ 1,260,864
	Accounts Payable	$ 39,345	$ 2,417,216	$ 2,456,561

9. / EMPLOYEE FUTURE BENEFITS /

(i) Pension Benefits

The estimated contributions to the Public Service Superannuation Plan during the year were as follows:

	2003	2002
Employer	$ 5,365,591	$ 4,552,442
Employees	$ 2,018,946	$ 1,799,641

(ii) Severance Benefits

The net expense for OSFI's severance benefits for the year ended March 31, 2003, was $999,030 (2002: $389,851).

The cost of benefits is actuarially determined using the projected benefit method prorated on services. The accrued benefit liability recognized in the balance sheet at March 31, 2003, in respect of these benefits is $5,947,187 (2002: $5,341,842).

The significant actuarial assumptions adopted in measuring OSFI's accrued benefit liability were as follows:

	2003	2002
Liability discount rate	6.13%	5.95%
General economic increases	3.00%	3.00%

10. / EXPENSES BY MAJOR CLASSIFICATION /

	2003	2002
Human Resources	$ 52,215,147	$ 48,853,100
Professional Development	1,727,111	1,537,127
Travel	2,953,349	2,281,082
Professional Services	1,237,072	1,297,863
Facilities	5,098,288	4,878,084
Information Management/Technology	5,518,605	3,143,854
Administration	2,058,452	2,401,859
TOTAL EXPENSES	**$ 70,808,024**	**$ 64,392,969**

11. / LATE AND ERRONEOUS FILING PENALTIES /

On April 1, 2002, OSFI's filing penalty regulations came into force in accordance with the OSFI Act. Penalties are levied quarterly to financial institutions when they submit late and/or erroneous financial and non-financial returns due to OSFI during the preceding calendar quarter. Penalties levied by OSFI are non-respendable and are to be remitted to the Consolidated Revenue Fund. The funds are not available to OSFI and are not included in the balance of the Cash Entitlement. As a result, the penalties do not reduce the amount that OSFI assesses the industry in respect of its operating costs.

During 2002/03, OSFI levied $709,900 in late and erroneous filing penalties. OSFI remitted $353,500 to the Consolidated Revenue Fund and $356,400 are included in Accounts Receivable and Accounts Payable & Accrued Liabilities.

12. / COMPARATIVE FIGURES /

Certain 2002 comparative figures have been reclassified to conform to the presentation adopted in 2003.

APPENDIX 1

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DISCLOSURE OF INFORMATION

The *Office of the Superintendent of Financial Institutions Act* requires the Superintendent to report annually to Parliament on the disclosure of information by financial institutions and the state of progress in enhancing the disclosure of information in the financial services industry.

/ OSFI'S ROLE IN ENHANCING DISCLOSURE /

OSFI contributes to and promotes effective disclosure by publishing selected financial information on OSFI's Web site; providing guidance to institutions on their disclosure practices through *Beyond 20/20 Inc*.; and participating in international supervisory groups with similar objectives.

Over the past few years, OSFI has issued separate disclosure guidelines for deposit-taking institutions, life insurance companies and P&C insurance companies and set out minimum requirements for information disclosure on financial, risk management and control practices. These requirements supplement disclosures required under generally accepted accounting principles as set out in the *CICA Handbook* and other OSFI guidelines. In 2002–2003, OSFI reviewed a sample of financial institutions' annual reports to evaluate compliance with the guidelines. This review concluded that:

-- Virtually all deposit-taking institutions selected for review comply with quantitative disclosure requirements. In general, the level and quality of disclosures related to risk management and control practices, especially as they relate to the participation of the board of directors, have increased. Qualitative risk management and control disclosures among smaller banks and trust companies, however, require improvement;

-- Overall, life insurance companies are in compliance with OSFI's disclosure guideline and have shown some improvement in risk disclosures since our last in-depth review in 1999–2000. While disclosed information on risks associated with policy liabilities has improved, further improvements could be made to disclosures of risk management and control methods for other types of risk; and

-- P&C insurance companies met OSFI's minimum disclosure requirements for investments, policy liabilities and, with a few exceptions, interest rate sensitivity analysis. Risk management and control practices disclosures were not assessed, as they do not form part of the annual return submitted to OSFI. These qualitative disclosures will be subject to on-site review by OSFI in the future.

Demutualization of several large life insurers in 1999–2000 has increased the need for market understanding and the application of market discipline. Following a successful educational seminar for analysts in late 2000, OSFI and the Canadian Institute of Actuaries developed a model for disclosure of annual gains and losses by source. This model has recently been submitted to the Practice Standards Council of the Canadian Institute of Actuaries and the requirement for public disclosure of the source of earnings is being considered for the 2004 fiscal year. Embedded value disclosure is a reporting feature of several large Canadian life insurers.

Internationally, OSFI participates in the Transparency Group of the Basel Committee on Banking Supervision and maintains a watching brief on the work of the Task Force on Enhanced Disclosure of the International Association of Insurance Supervisors. Both of these groups focus on promoting market discipline through such means as developing best-practice disclosure guidance. In addition, the Basel Committee's Transparency Group has conducted regular surveys of the annual report disclosures of large, internationally active banks and is participating in an International Accounting Standards Board improvement project on financial activities disclosures. Results of their 2001 disclosure survey, which included those of large Canadian banks, revealed that internationally active banks have expanded disclosures in the areas of accounting and presentation policies, capital structure and inherent risk. However, disclosures related to credit risk modelling, credit derivatives and credit enhancements could be expanded further.

APPENDIX 2

FINANCIAL INSTITUTIONS AND PENSION PLANS REGULATED BY OSFI

	Number [1]	Assets [2, 3] (Millions)
Banks		
Domestic	16	$ 1,645,618
Foreign bank subsidiaries	32	$ 85,425
Foreign bank branches	21	$ 25,916
Trust and Loan Companies		
Bank-owned	30	$ 197,912
Other	34	$ 9,720
Cooperative Credit Associations	7	$ 11,983
Life Insurance Companies		
Canadian-incorporated	42	$ 325,091
Foreign branches	55	$ 27,986
Fraternal Benefit Societies		
Canadian-incorporated	13	$ 6,201
Foreign branches	10	$ 1,035
Property and Casualty Insurance Companies		
Canadian-incorporated	89	$ 48,068
Foreign branches	102	$ 21,163
Pension Plans	1,205	$ 90,656

1 Number of regulated companies as at 31 March 2003. Includes institutions in the process of liquidation or termination and institutions limited to servicing existing business. A list of institutions regulated by OSFI can be found on OSFI's Web site at www.osfi-bsif.gc.ca/eng/whoweregulate.asp. **2** As at 31 March 2003 where available, otherwise 31 December 2002. **3** Total assets of the industries regulated by OSFI are not the simple sum of the above-noted figures. The figures for entities that report on a consolidated basis include subsidiaries whose assets may also be included in a different category.

Office of the Superintendent of Financial Institutions

OSFI welcomes questions about its role and responsibilities as well as enquiries related to federally regulated pension plans. Several methods are available to communicate with us:

Toll-free Information Service
OSFI operates a toll-free information service from 8:30 a.m. to 5:00 p.m. Eastern Time, Monday through Friday. It can be reached by calling 1-800-385-8647 or (613) 990-6011 for local (Ottawa-Gatineau) calls.
E-mail: extcomm@osfi-bsif.gc.ca

Internet
OSFI's Web site address is www.osfi-bsif.gc.ca. The site provides timely access to a wide variety of OSFI information and documents, including speeches, news releases, guidelines, legislation, policy statements, bulletins, financial information and a listing of all financial institutions and pension plans regulated by OSFI.

Publications
OSFI publications are generally available on our Web site (www.osfi-bsif.gc.ca) or by contacting: Publications Distribution – Office of the Superintendent of Financial Institutions, 13th Floor, 255 Albert Street, Ottawa ON K1A 0H2, Telephone: (613) 990-7655, Facsimile: (613) 952-8219, E-mail: pub@osfi-bsif.gc.ca

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