Commonly Asked Questions and Answers

This document provides answers to the questions most commonly asked about OSFI's Assessment Criteria during industry consultation. The responses should be read in conjunction with the Supervisory Framework and Assessment Criteria.

The industry groups consulted also raised a number of questions related to the meaning of certain terms and phrases used in the Assessment Criteria. The use of these terms and phrases is explained in the attached Explanation of Terms.

1. Why has OSFI developed these Assessment Criteria?

The Criteria were developed as an internal tool to guide supervisors in assessing the safety and soundness of federally regulated institutions. A standardized approach will enhance the consistency and comparability of OSFI's assessments.

2. Does OSFI expect the Risk Management Control Functions ("Oversight Functions") identified in the Assessment Criteria to exist in every institution? Where a function does not exist, what will OSFI's approach be?

OSFI's Supervisory Framework and Assessment Criteria do not require a particular organizational structure. It is not intended that institutions should restructure or reorganize their processes as a result of this initiative. Institutions would consider the cost-benefit implications of a particular oversight structure before selecting the one that best meets their needs.

OSFI's overall assessment of an Oversight Function is based primarily on its effectiveness in overseeing the mitigation of risk in the context of its mandate, taking into account the nature, scope, complexity, and risk profile of the institution. Accordingly, in assessing the adequacy and effectiveness of a particular structure, OSFI will consider what is necessary, given the context of the institution.

Where an institution lacks some or all of the Oversight Functions, OSFI looks to other functions, within or external to the institution, that handle these oversight responsibilities – for example, operations reviews by other branches, outsourcing arrangements and Senior Management activities. In the absence of effective oversight, OSFI will step up its supervision and recommend or require that the institution implement an appropriate level of oversight.

3. Wouldn't the Assessment Criteria for the Oversight Functions quickly become a checklist of best practices for assessing institutions, without considering their applicability to individual institutions?

We are taking steps to guard against that. The criteria are not required standards, but considerations supervisors will use, where appropriate, to guide their assessments of the effectiveness of the institution's Oversight Functions.

Because the Supervisory Framework was designed to apply to all types and sizes of institutions regulated by OSFI, words like "appropriateness of", "adequacy of", and "extent to which" have been chosen deliberately to require supervisors to exercise sound and informed judgement in applying the criteria to the unique circumstances of each institution. The application and weighting of individual criteria will depend on the nature, scope, complexity and risk profile of the institution, and will be assessed collectively, together with performance, in rating the overall effectiveness of the function.

OSFI is committed to overseeing the implementation of supervisory ratings through an appropriate level of training and a quality review process to ensure that the criteria are applied in the context of each institution, and consistently across institutions. OSFI's relationship managers will be prepared to discuss the rationale for their assessments as part of the supervisory process.

4. Which key indicators identified in the Composite Risk rating definitions will OSFI use to assess an institution?

A number of key indicators are commonly used by both industry and OSFI. Those considered in the assessment of a particular institution would depend on the industry, the type and size of the institution, and on the indicators used by the institution itself.

5. Why can't OSFI define more precisely the expectations for each criterion? Won't the current wording result in inconsistent application of the criteria by supervisors?

OSFI's Supervisory Framework is a conceptual framework designed for universal application. What is appropriate for an institution depends on what is needed to mitigate the risks inherent in its particular activities. Therefore, it is not possible to provide detailed expectations for the various criteria. The criteria need to be sufficiently flexible to allow supervisors to apply them to the unique nature, scope, complexity and risk profile of each institution.

6. How do the ratings for the Oversight Functions affect the Composite Risk Rating of an institution?

OSFI's focus is on assessing the safety and soundness of an institution. This assessment is reflected in the Composite Risk rating, which is the primary rating under OSFI's Supervisory Framework. The Composite Risk rating is an integrated assessment of an institution's

Overall Net Risk, Capital and Earnings. The Overall Net Risk is a weighted aggregation of the Net Risk in each of the institution's significant activities and incorporates an assessment of the Quality of Risk Management for those activities. Hence, the Quality of Risk Management (Operational Management and Oversight Functions) contributes to the Composite Risk rating through the assessment of Overall Net Risk.

7. With regard to confidentiality, do the regulations allow for supervisory ratings to be shared within an institution and by an institution with its external auditors?

Yes. The *Supervisory Information Regulations* protecting the confidentiality of "prescribed supervisory information", which includes ratings, provide that institutions may disclose such information to affiliates, or to directors, officers, employees, auditors, actuaries, securities underwriters or legal advisors, provided the institution ensures the continued confidentiality of the information.

8. Does OSFI plan to share a comparison of an institution's ratings with those of its peers?

In the past, we have indicated where we believe an institution's practices and processes are not comparable to those used by other institutions in similar circumstances. We will continue to share this type of information for both Operational Management and the Oversight Functions.

In time, OSFI expects to share information on peer-group comparisons. However, this is unlikely to occur within the first couple of years of implementation. OSFI will need to ensure that peer-group comparisons are structured so that ratings of individual institutions cannot be identified and proprietary information is not disclosed. It is essential to maintain a balance between sharing peer-group information and ensuring confidentiality.

9. Why hasn't OSFI developed criteria for the assessment of inherent risks?

Since inherent risks are specific to the nature of an institution's significant activities, including its products and services, distribution channels and target markets, it is not feasible to develop criteria that are common to all institutions.

10. How are inherent risk categories that are not identified specifically in the Supervisory Framework dealt with by OSFI?

Appendix A of OSFI's Supervisory Framework defines seven inherent risk categories. These categories represent a broad classification of the risks that are generally applicable to financial institutions. Most risks can be considered within one of these seven categories. For example, settlement risk may be considered a subset of credit risk.

11. Why are no assessment criteria being proposed for Operational Management, the group that has front-line responsibility for managing risk?

It would not be practical to develop a set of criteria for Operational Management because of the large number of operational activities across all institutions and the differences in how these activities are managed.

Our primary objective in assessing Oversight Functions is to determine the extent to which OSFI can use the work of these functions to ensure that appropriate controls are in place and are being followed at the operational level. As well, from time to time and as necessary, OSFI will perform in-depth reviews of certain operational activities to confirm its assessment with respect to the effectiveness of the Oversight Functions.

12. Do the responsibilities listed under the "Role of the Board of Directors" need to be carried out by the full Board or could they be undertaken through a committee of the Board?

The "Role of the Board of Directors" section identifies some of the Board's key responsibilities and does not differentiate between those that are best undertaken by the full Board versus those that are better handled by a Board committee. This determination would be made by the Board.

13. Some of the performance indicators seem to require the Board to perform tasks that are not appropriate to its level.

The Board of Directors is responsible for providing stewardship and oversight of management and operations of the institution. The performance indicators included at the end of the Oversight Function criteria documents are not a list of requirements but rather examples to guide supervisory judgements made in the context of an institution. The emphasis is on the importance of independent thinking, the degree to which the Board is aware of, and actively addresses, critical issues affecting the institution, and the commitment by the Board to fulfill its responsibilities.

14. How will the appropriateness of independent representation on the Board be assessed?

The appropriateness of independent representation on the Board will be evaluated in the context of the nature, scope, complexity, and risk profile of each institution. Legislation provides a minimum level of independence, but, in practice, OSFI has seen a much higher level of independent representation, depending on the type and size of an institution. In reviewing industry practices as part of the ratings project, OSFI noted that the level of independent representation is generally similar at comparable institutions.

15. Do the Assessment Criteria apply to Canadian branches of foreign institutions?

The Assessment Criteria were designed to apply to all types and sizes of institutions, including Canadian branches of foreign institutions. In the case of branches, the Board criteria are not applicable. Instead, OSFI looks to the Principal Officer or Chief Agent of the branch to oversee the management of the branch, including matters of corporate governance. These individuals are recognized as having overall responsibility for their respective branches. Senior Management criteria would be used to assess the effectiveness of oversight by Principal Officers and Chief Agents.

16. Will the strength of a foreign parent or head office affect the rating of a Canadian subsidiary or branch operation?

Yes, the extent to which the foreign parent or head office is considered a source of strength for the Canadian subsidiary or branch operation will be taken into account in the assessment of the Canadian entity.

17. Why has OSFI moved from the three-level ratings, indicated in the Supervisory Framework document, to the four-level ratings included in the Assessment Criteria?

An additional rating category was added to the Assessment Criteria to provide for greater granularity in ratings. For example, an "Above Average" risk category was added to the risk rating categories for Overall Net Risk and Composite Risk. Similarly, a "Needs Improvement" category was added to the rating categories for Earnings, Capital, and each of the Oversight Functions.

18. What are the main drivers distinguishing a "Strong" from an "Acceptable" capital rating?

For both "Strong" and "Acceptable" ratings, an institution's capital must meet OSFI's target levels and have positive trend expectations over the following 12 months.

For an institution's capital to be rated "Strong", it needs to be more than sufficient for its risk profile, with capital management policies and practices that are superior to generally accepted industry practices.

For an institution's capital to be rated "Acceptable", it needs to be sufficient for its risk profile, with capital management policies and practices that are comparable to generally accepted industry practices.