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Let There Be More Light: Enhancing Public Accountability for Prudential Supervision

Greater public accountability for those engaged in the supervision of deposit-taking institutions and insurance companies could have the salutary benefit of reducing some of the uncertainty that currently exists in the financial community about how prudential supervisors exercise their judgment.

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The Study In Brief

Little is known about how Canadian prudential supervision is conducted in practice because it has traditionally operated behind a veil of secrecy. While the federal Office of the Superintendent of Financial Institutions (OSFI) and its provincial counterparts have published the frameworks within which they conduct prudential supervision, in practice there is scope for supervisors to exercise judgment as to how prudential requirements are applied to the specific circumstances of individual financial institutions. Specifically, risks to those institutions and how they are managed can vary significantly from one institution to another.

The need for such a veil has traditionally been defended on the grounds of the social costs that might arise if supervisory ratings were publicly disclosed as well as the commercial sensitivity of the information and the discussions supervisors have with the financial institutions they oversee. As such, it is not unique to Canada but is also prevalent in other jurisdictions.

Canada has been blessed with few failures of financial institutions in recent decades. This suggests that prudential supervision at both the federal and provincial levels has largely operated well behind this opaque veil. While this track record indicates that there is no burning need to change current arrangements, it nevertheless makes sense to ensure that Canadian supervisory practices keep pace with those of other jurisdictions. As a result, this *Commentary* looks at current Canadian prudential supervision practices and considers how we can strengthen further the public accountability for those engaged in the supervision of deposit-taking institutions and insurance companies. Improvements in this area could have the salutary benefit of reducing some of the uncertainty that currently exists in the financial community as to how prudential supervisors exercise their judgment. In turn, that would set the stage for more disciplined discussions between financial institutions and their supervisors that might help foster quicker remediation of any supervisory concerns.

This *Commentary* begins by explaining the prudential supervisory frameworks used by OSFI and its provincial counterparts. Then, using OSFI as a case study, it delves into the current accountability arrangements surrounding prudential supervision and the accompanying economic rationales for secrecy. That sets the stage for surfacing some gaps in those arrangements and offering some recommendations for reform. The recommendations can be summarized as follows:

- While there is merit in maintaining the confidentiality of supervisory ratings and their supporting information, more details should be publicly disclosed about the supervisory process.
- Financial institutions would benefit from more detailed information on the factors underpinning their supervisory risk ratings. That could help facilitate more disciplined conversations between financial institutions and their supervisors and encourage quicker remediation of any risk-management concerns.
- The results of comparative or benchmarking supervisory reviews should be shared with all relevant financial institutions to help them improve their risk-management practices and help motivate the need for any new or updated guidelines.
- Independent reviews should be commissioned whenever there has been a failure or near failure of a financial institution. The purpose of these reviews would be to ascertain whether there has been a regulatory failure that contributed to the situation and, if so, to draw lessons on how to enhance the supervisory process.
- OSFI's public accountability could be strengthened by having the Superintendent of Financial Institutions regularly participate with the Governor of the Bank of Canada in the discussion of financial stability issues with parliamentarians.

Policy Area: Financial Services and Regulation.
Related Topics: Consumers' Interests and Protection; Financial Stability; International Competitiveness; Prudential Regulation.
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Prudential oversight of licensed deposit-taking institutions and insurance companies is among the many services that federal and provincial governments deliver to Canadians.

At the federal level, banks and federally incorporated or licensed deposit-taking institutions and insurance companies are overseen by the Office of the Superintendent of Financial Institutions (OSFI), while provincially incorporated or licensed financial institutions are overseen by a myriad of provincial agencies (see Box 1).

Regulation and Supervision are the Siamese Twins of Prudential Regulation

Prudential oversight encompasses both regulatory and supervisory activities. To put it simply, *prudential regulation* involves the formulation and setting of public policies and standards that define the minimum prudential expectations for all regulated institutions or a clearly defined subset of institutions. These expectations encompass a wide range of activities, including minimum standards for how much capital and liquidity regulated financial institutions are expected to carry as well expectations for governance and risk-management practices and the design of internal controls. With the exception of capital and liquidity requirements, where minimum quantitative standards are articulated mainly through public guidelines, most prudential guidance has been articulated in the form of principles.

By contrast, *prudential supervision* mainly involves the application of the above public regulatory expectations to individual financial institutions. This activity is largely conducted in private between the supervisors and the financial institutions they oversee. It is an activity that requires a healthy dose of judgment, as supervisors need to tailor regulatory guidance to specific risk exposures, governance and internal control frameworks, as well as to the risk-management practices of individual financial institutions. That tailoring helps promote a close alignment of a financial institution's risk appetites with its capacity to measure and manage those risks.

Prudential regulation and supervision are, therefore, two activities that are closely joined at the hip. Most of the reforms that have been introduced over the past dozen years or so have been focused on enhancing the public regulatory framework governing financial institutions in Canada and abroad to reduce the risk of a financial institution failure that would trigger an economic and financial meltdown like the one we saw in the wake of the global financial crisis. Much less attention has been paid to how these expectations are applied in practice to individual institutions; i.e., the conduct of prudential supervision. The latter is the focus of this *Commentary*.

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Key Concept Explainer

The Opacity Problem: While OSFI's supervisory framework and its guidelines for intervention provide a good general overview of how supervision is conducted, the details are somewhat lacking. For example, there is no discussion about how supervisors actually measure and assess the risks to which financial institutions are exposed, nor any details about how supervisors actually evaluate the quality of an institution's risk-management practices. Furthermore, one learns little about how supervisors determine the amount of capital and liquidity they believe an institution should carry over and beyond the minimum requirements contained in regulatory guidelines, given the institution's risk exposures and risk-management capacity. As a result, there is a fair amount of opacity in how supervision is conducted in practice because the regulatory requirements that supervisors apply are themselves generally articulated in the form of principles rather than specific requirements.

Box 1: Prudential Supervision at the Provincial Level

There are a wide range of deposit-taking institutions and insurance companies operating in Canada that are provincially incorporated or licensed and hence supervised by provincial authorities for solvency purposes. They range from large financial institutions like the Desjardins Group and the iA Financial Group headquartered in Quebec but have operations across Canada to numerous small credit unions and insurance companies operating locally in every province and territory.

The agencies responsible for the prudential supervision of these entities vary across the country. Quebec is unique in having one agency, the Autorité des Marchés Financiers, which is responsible for a myriad of oversight activities including prudential supervision of financial institutions, the regulation of financial markets, operating the deposit insurance system and a wide range of business conduct oversight activities. By contrast, BC and Ontario have recently established new independent regulatory agencies that are primarily responsible for supervising deposit-taking institutions, insurance companies, pension plans and mortgage brokers. They also operate the deposit-insurance system for credit unions in their respective provinces and jointly oversee BC-based Central 1. Meanwhile, other provinces rely mainly on government departments and local deposit insurance corporations to oversee the solvency of deposit-taking institutions like credit union networks and locally licensed insurance companies.

While the institutional arrangements for financial services regulation vary across the provinces, they all rely on prudential supervision frameworks that closely resemble that of OSFI at the federal level.[a]

a Unfortunately, there are few details available publicly about how prudential supervision is conducted in practice at the provincial level within those frameworks. That said, the most recent financial sector stability assessment of Canada by the International Monetary Fund in 2018 examined the supervisory practices of the AMF in Quebec and the BC Financial Institutions Commission (the predecessor agency to the recently created BC Financial Services Authority). It concluded that while the AMF is resourced for its role and maintains high regulatory and supervisory standards, BC FICOM was struggling to perform its role effectively. See: International Monetary Fund. 2020. Canada Financial Sector Assessment Program – Technical Note: Deposit-Taking Sector: Regulation and Supervision". (January). Available at https://www.imf.org/en/Publications/CR/Issues/2020/01/23/Canada-Financial-Sector-Assessment-Program-Technical-Note-Deposit-taking-Sector-Regulation-48974

Given that provincial supervision frameworks and practices closely resemble those of OSFI, the analysis and lessons presented in this *Commentary* mainly focus on OSFI's activities for the sake of brevity and simplicity. However, they are also relevant for supervisors at the provincial level.

Prudential Supervision Is Built on Trust but that Trust Is Hard to Verify

When Confucius was asked about stable government requirements by his disciple Zigong more than 2,000 years ago, he said three things were needed: weapons, food and trust. If a ruler cannot hold on to all three, he should give up weapons first, then food. However, trust should be guarded to the end because "without trust we cannot stand" (Yu, Tao and Ivanhoe 2010, p.99).

Prudential supervision gives Canadians confidence that regulated financial institutions are financially sound. But that confidence requires that Canadians trust the agencies assigned that task. They need to trust that those agencies are truly serving the public interest, not their own nor those of the institutions that they have been tasked to oversee.

To paraphrase the old Russian proverb "Trust, but verify," trust requires the ability to verify performance. Russell (2015) notes that verification is warranted when the outcome is essential, which is a criterion clearly met for prudential supervision given the importance of sound financial institutions for Canadians' standard of living. If nothing else, the 2008 global financial crisis demonstrated the wisdom of applying this doctrine to contain the risk of a financial institution's disorderly failure. But applying that doctrine is not easy.

An important complicating factor is that a financial institution's failure does not mean that there has been a failure of prudential supervision. This point is explicitly recognized in the federal legislation that governs OSFI. Section 5(4) of *OSFI Act* acknowledges that while regulation and supervision of financial institutions can reduce their risk of failure, their boards of directors are ultimately responsible for the institutions' management. It goes on to note that failure can arise because financial institutions operate in a competitive environment that necessitates the prudent management of risk. As a result, such institutions can experience financial difficulties that can lead to their failure even in the presence of good prudential supervision.

Bearing that in mind, the key questions then become more nuanced. They become: (a) ascertaining whether a prudential supervision failure has been a contributing factor to a financial institution encountering stress; (b) whether inadequate prudential supervision has contributed to depositors, policyholders and other creditors losing money when a financial institution fails; and (c) whether the financial institution's failure triggered a broader financial and economic meltdown such as we saw in many parts of the world with the global financial crisis.

It is much harder, however, to know when prudential supervision is working well, or more disturbingly when it is not working well, setting the stage for questions (a) through (c) above. That is because much of prudential supervision's core work revolves around the assessment of an institution's financial condition and the adequacy of its risk-management practices – an activity that has traditionally been conducted privately between the supervisor and the regulated institution away from the glare of the public spotlight.

One can argue that prudential supervision has been working well in Canada, so why reform it? Canada has, indeed, been blessed with few failures of financial institutions in recent decades, none of which were disorderly in terms of causing depositors, policyholders or creditors to lose money or, even worse, undermining the stability of the broader financial system and the economy.[1] That suggests that in contrast to many of its foreign counterparts, Canadian prudential supervision at both the federal and provincial levels has largely operated well behind its veil of secrecy. But demands for more public accountability by government agencies are generally on the rise. That begs the question: how much secrecy is truly required to conduct effective prudential supervision?

While there does not appear to be any burning need to reform current practices, it makes sense to be proactive and ensure Canadian practices keep pace with those in other jurisdictions. Moreover, there is currently some uncertainty in the financial community as to how prudential supervisors exercise their judgment in practice. As such, it makes sense to consider if there are ways we can strengthen the public accountability for those engaged in the prudential supervision of deposit-taking institutions and insurance companies and reduce some of that uncertainty. In turn, this could set the stage for more disciplined discussions between financial institutions and their supervisors going forward, something that might help foster quicker remediation of any supervisory concerns.

Few Details on How Supervision is Conducted in Practice

Let us now turn to how prudential supervision is conducted in practice, using OSFI as a case study. Canadians are fortunate that OSFI already has a solid base of public accountability arrangements. It was established as a separate office in 1987 under *OSFI Act* and is accountable to Parliament through the minister of finance. In carrying out its responsibilities, OSFI interacts with the Department of Finance, the Bank of Canada, the Canada Deposit Insurance Corporation (CDIC) and the Financial Consumer Agency of Canada (FCAC) through the Financial Institution Supervision Committee (FISC) chaired by the Superintendent of Financial Institutions, the Department's Senior Advisory Committee and the CDIC Board of Directors.[2] This web of interagency groups exposes OSFI to information and insights into the broader developments in the financial system and economy to help inform its own supervisory activities. More importantly for our purposes, the FISC also provides a mechanism for the heads of those agencies to monitor and comment on OSFI supervisory activities. That gives Canadians comfort that there are some knowledgeable senior experts keeping a watchful eye on OSFI's performance.

Canadians can also take comfort from the fact that OSFI's practices (and, indeed, those of its major provincial counterparts) are periodically reviewed by its peers from other jurisdictions through the International Monetary Fund's Financial Sector Assessment Program. OSFI practices are also periodically subject to peer reviews conducted by the Financial Stability Board, the Basel Committee on Banking Supervision and the International Association of Insurance

1 That said, there have been some close calls in recent years, notably the near failure of Home Trust in 2017 and the current travails surrounding the Pace Credit Union in Ontario.

2 This stands in contrast to many jurisdictions where prudential oversight of banks, at least, is often carried out by central banks rather than by a separate agency. That has never been the case in Canada. The Canadian practice of allocating monetary policy and prudential oversight to separate agencies has worked very well in practice and has enabled each agency (central bank and prudential supervisor) to focus on its respective mandates while benefiting from the information and perspectives of the other agencies. In addition, while central banks internationally tend to operate in a very transparent fashion in their conduct of monetary policy, this transparency has not resulted in their prudential activities being significantly more transparent than those of OSFI and its provincial counterparts.

Supervisors. These reviews assess Canadian prudential requirements and supervisory practices against expectations set by international minimum standards. However, it should be borne in mind that those reviews are not designed to opine on the quality and effectiveness of the supervision of individual institutions.

OSFI also has an audit committee in accordance with a Treasury Board directive to help the Superintendent of Financial Institutions oversee the agency's internal management. That committee, which consists mainly of external appointees, is charged with providing objective advice and recommendations to the superintendent regarding the sufficiency, quality and results of assurance on the adequacy and functioning of OSFI's internal risk management, control and governance frameworks and processes, including accountability and auditing systems. That committee does not, however, exercise any oversight over OSFI's core regulatory and supervisory work.

At one level, OSFI is arguably very transparent. Its website contains a wealth of governance information, including its strategic plans outlining, at a high level, regulatory, supervisory and corporate priorities over a three-year horizon. It also makes public annual reports on its accomplishments relative to those plans, the results of regular surveys to gather feedback from regulated financial institutions on their interactions with OSFI, quarterly financial reports on its own expenditures and the results of all OSFI internal audits on its internal processes. The website also serves as a library where one can find basic data on the institutions supervised by OSFI,[3] copies of regulatory guidelines, advisories and interpretations as well as public documents explaining OSFI's supervisory framework and its guides to intervention. OSFI also meets annually with representatives from the industries it supervises to explain its plans and account for how it is spending the money levied against regulated financial institutions and pension plans to operate the agency.

Where things become more opaque is with respect to OSFI's supervisory engagements with individual financial institutions. The Appendix summarizes OSFI's supervisory framework and its guidelines for intervention, which closely resemble those used by provincial prudential supervisors. While those documents provide a good general overview of how supervision is conducted, in practice the details are somewhat lacking. For example, there is no discussion about how supervisors actually measure and assess the risks to which financial institutions are exposed, nor any details about how supervisors actually evaluate the quality of an institution's risk-management practices. Furthermore, one learns little about how supervisors determine the amount of capital and liquidity they believe an institution should carry over and beyond the minimum requirements contained in regulatory guidelines, given the institution's risk exposures and risk-management capacity. As a result, there is a fair amount of opacity in how supervision is conducted in practice because the regulatory requirements that supervisors apply are themselves generally articulated in the form of principles rather than specific requirements. Ultimately, supervisors are allowed some scope to tailor the requirements to the business models and specific risks of individual financial institutions.

In short, it would be very difficult for someone outside of OSFI to know what kind of information is being used in the supervisory process, what analytical techniques are used to assess that

3 More detailed data are also published by the financial institutions themselves on their websites in accordance with public disclosure requirements mandated by OSFI and provincial securities laws.

information and how the results of that analysis is overlaid with judgment in determining the composite risk ratings for individual financial institutions that drive supervisory interventions with those institutions. This makes it challenging for any external observer to monitor and assess the quality and effectiveness of prudential supervision on an ongoing basis.

Section 22 of *OSFI Act* and the associated Supervisory Information Regulations prohibit financial institutions and OSFI from publicly disclosing supervisory ratings and supporting records for individual financial institutions.[4,5] But that prohibition does not extend to information about the underlying supervisory practices. Therefore, it begs the question of how much secrecy is actually required to conduct effective supervision.

The Need for Secrecy Reflects Desires to Avoid Triggering a Failure and to Gain Access to Commercially Sensitive Information

There is a long-standing tradition throughout the world of prudential supervision being conducted in secret. As noted by Tucker (2018, p.277):

> Within the community of prudential supervisors, sensitivity to the social costs of firm failure long ago gave rise to a culture, a doctrine even, among prudential supervisors globally that their work must be kept confidential: that the world would not be safe if they revealed what they knew about firms' weaknesses or what remedial actions they were requiring or urging.

The rationale for this way of thinking is readily apparent in the case of banks and other deposit-taking institutions. Such institutions are inherently complex, making it hard for external observers to discern their true financial condition. They are also inherently fragile in a funding sense, given that most of their balance sheet assets consist of loans that cannot be easily recalled or sold to third parties. That makes them susceptible to rumours. And as we saw with Home Trust in 2017, a loss of confidence can quickly give rise to a deposit run, even with deposit insurance, that could cripple a solvent deposit-taking institution's ability to honour its obligations. Hence, there is the risk that if depositors become aware that a supervisor has concerns about how a deposit-taking institution is being managed, it could perversely hinder the ability of the supervisor and the institution to remedy the situation at an early stage before solvency is cast in doubt. To put it simply, in the case of complex financial institutions like banks and other deposit-taking institutions, there is a significant risk that if it becomes known that a prudential supervisor has concerns, it could actually bring forward a failure that might otherwise have been avoided.

The same argument can also be extended to insurance companies but for slightly different reasons. Insurance companies are also complex, and this is compounded in their case by the opaque valuation of their liabilities that is largely based on

4 See Supervisory Information (Banks) Regulations and their analogues for federally incorporated trust and mortgage loan companies and insurance companies. Available at https://laws-lois.justice.gc.ca/eng/regulations/SOR-2001-59/index.html.

5 There is a limited exception in Section 4 of the Supervisory Information Regulations that permits regulated financial institutions to disclose prudential agreements made with OSFI and directions or enforcement orders formally issued by OSFI if the financial institution believes that they constitute a material fact or material change that requires disclosure by the securities laws of the relevant jurisdictions. In practice, OSFI and its counterparts around the world generally try in the first instance to informally encourage financial institutions to voluntarily adopt remedial actions proposed by the supervisor before resorting to more formal actions so that the supervisor's involvement need not be disclosed.

highly technical actuarial calculations. Here, too, it can be hard for external observers to discern their true financial condition. While insurance companies are not as fragile as deposit-taking institutions in a funding sense, they are nevertheless dependent on the confidence of the marketplace. For if they lose the confidence of their sales distribution networks, their ability to continue operating as a going concern and grow could be seriously impaired, given their reliance on those networks to obtain funding via the sale of insurance policies and annuities. Therefore, if it became known that a prudential supervisor has concerns about an insurance company, it could actually cause what was an otherwise solvent company to move from being a viable enterprise to one that has essentially ceased to function. And, like the infamous Cheshire Cat, fade away as it winds down its operations in tandem with the maturity of its policyholder obligations.

The need for secrecy extends beyond supervisory ratings to the information prudential supervisors use in their assessments. OSFI's supervisory framework summarized in the Appendix, along with its provincial analogues, make it clear that effective prudential supervision requires a detailed understanding of the risks to which financial institutions are exposed and their risk-management practices and business plans. That can be obtained only by gaining access to commercially sensitive information from, and frank discussions with, the senior management and boards of financial institutions. As Nouy (2017) notes in a European Union context, knowing that they can count on supervisors to treat their information confidentially gives financial institutions the confidence they need to engage in an open dialogue with their supervisors.

Publishing Stress Test Results May Not be an Accountability Panacea

The foregoing suggests that it is wise to maintain some secrecy in the conduct of prudential supervision. The issue is how much secrecy is really needed. Tucker (2018) suggests that the introduction of enhanced regimes for resolving distressed financial institutions in an orderly way can reduce the negative externalities of an institution's weaknesses becoming apparent, enabling supervisors to be braver about transparency. He also claims that the introduction of credible public stress tests of banks' capital adequacy in the US, the EU and the UK gives prudential supervisors something important to say publicly about the solvency of the banks they oversee when the stress test results are published. Year-by-year, everyone will be able to see the severity of the chosen stress test scenarios as well as the results for individual institutions.[6] Parliamentarians can then examine supervisors on both the scenarios used for the stress test exercise and the ensuing findings, drawing on commentary and research from different parts of the financial system and wider society.

In turn, this could help parliamentarians think about how much resilience they expect from the financial system, the cost and effectiveness of current prudential arrangements, and where these arrangements might benefit from reforms. More generally, public stress tests can help mitigate the risk of industry capture of regulators and supervisors and help build public awareness of prudential supervision.

6 In practice, the exercises conducted in those jurisdictions usually consist of two stages: a first step where the individual firm results are privately shared with the participating institutions and then a second stage, the results of which are made public after the institutions have had an opportunity to remedy any deficient results.

That of course presupposes that it is useful to publicize the results of stress tests for individual financial institutions. Here the answer is not so clear. Business models vary across banks and insurers. Some have significant international operations; others do not. Even among the largest banks and life insurers operating in Canada, there are important differences that may not be well captured by the single system-wide scenarios that form the cornerstone of current public stress test exercises in other jurisdictions. Therefore, relying on public stress tests based on single scenarios as a cornerstone for setting capital requirements for individual financial institutions may not be wise at this time, at least in Canada.[7] The stress-testing framework and technology are not there yet.

There is also a risk more generally that making stress test results public might hinder prudential supervisors in their ability to oversee financial institutions. At the federal level, OSFI is currently able to exercise significant moral suasion over the institutions it supervises due to the powers that it has been given by Parliament, most notably those to set capital and liquidity requirements. That has enabled it to exercise a significant amount of influence over those institutions' broader governance and risk-management practices. For example, OSFI has been known to impose additional capital requirements on financial institutions through higher supervisor-imposed value-at-risk multipliers or floors on risk-weight calculations that are used to compute capital requirements when shortcomings have been uncovered in risk-management practices (Zelmer 2013). The more that capital and liquidity requirements for individual financial institutions are driven by public stress-test results, the less scope there might be for prudential supervisors to be able to use those requirements to influence the evolution of governance and risk-management practices more generally.

The experiences in the UK and US, however, suggest there could be ways to manage this risk if public stress tests are adopted in Canada. The US Federal Reserve addressed this issue by subjecting banks to a separate but parallel qualitative review process that succeeded in pushing banks to enhance their governance and risk-management practices in the wake of the global financial crisis. The 2020 International Monetary Fund (IMF) financial sector assessment of the US financial system notes that this process has now been largely folded back into its ongoing confidential supervisory programs. Meanwhile, the Bank of England (2020) has introduced a scalar in its confidential Prudential Regulatory Authority (Pillar 2B) capital buffer for the institutions it supervises that can be used to encourage them to correct any governance and risk-management deficiencies.

Some Proposals for Reform

While publishing stress test results may not be a panacea for injecting more public accountability into the supervision process, there are some other steps that merit consideration.

An obvious place to begin would be to publicly disclose more detailed information about the supervisory process. Public scrutiny of prudential supervision would be enhanced by providing more fulsome details on the information that OSFI and its provincial counterparts use to measure and monitor the risks to which financial institutions are exposed. Specifically, how do they assess the governance and risk-management practices of those institutions

7 One should not forget that the main reason public stress tests were introduced in the US, UK and EU for major banks was a lack of confidence in those banks' financial conditions in the wake of the global financial crisis. Public stress tests were needed to restore confidence in those institutions and the agencies that supervised them. Fortunately, Canadian financial institutions and their supervisors have not yet had to resort to such measures to maintain confidence in the financial system.

and how do they assess their earnings, capital and liquidity positions. This could be accompanied by publicly disclosing details on the analytical techniques used to assess that information so that external observers can gain some insight into how that analysis is conducted and how the results are overlaid with judgment. One could even go a step further and subject those analytical processes to periodic external reviews that delve into how those processes line up with best practices (in effect, going beyond the current IMF and Basel peer reviews that focus more on adherence to international minimum standards). The results should then be made public to assure Parliament, provincial legislatures and the public that Canadian prudential supervisory analytical methods are keeping pace with leading practices elsewhere.

While there might be good reasons for keeping confidential supervisory ratings of individual financial institutions as well as the information provided by those firms, those arguments do not extend to prudential supervisors' own internal processes. More public disclosure of the details of how the business of supervision works in practice with an ongoing program of external validation of those business practices could help boost understanding and trust in prudential supervision. After all, US federal bank regulators – the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation – routinely publish their supervisory manuals and other guidance issued to supervisors on their websites.[8] While such documents may not be of interest to the general public, publishing similar ones here might be useful for regulated financial institutions in Canada and supervisors in other jurisdictions that interact with Canadian financial institutions to help them obtain a better understanding of how Canadian supervisors conduct their work and apply judgment.

Second, financial institutions would benefit from more detailed information on the factors that led to their composite risk ratings (CRRs). While federally regulated financial institutions are given their CRRs as part of the supervisory process, they are not given many details on how the ratings were determined, such as a completed risk matrix to help them understand the factors that led to the CRR decision. It is possible that financial institutions might get mired in the details. But, given the importance of the CRRs in driving supervisory interventions, it is important that they understand how their CRRs were determined and how judgment was applied in their cases. Giving financial institutions more information about their CRRs, such as supplying them with completed detailed risk matrices like the one illustrated in Table A1 in the Appendix, might help financial institutions gain a better understanding of their supervisor's thinking. In turn, this could help facilitate more disciplined discussions between prudential supervisors and the institutions they regulate and, possibly, quicker actions by the latter to remediate any supervisory concerns. However, in doing so it will be important that the senior management of prudential supervisors make sure that supplying more information about how judgment has been exercised does not result in the emergence of more mechanistic application of judgment by frontline supervisors, as that could seriously corrode the effectiveness of supervision over time.

8 The supervisory manuals for the three US federal bank regulatory agencies can be found on their websites at: Board of Governors of the Federal Reserve System: https://www.federalreserve.gov/publications/supmanual.htm; Office of the Comptroller of the Currency: https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/index-comptrollers-handbook.html; and Federal Deposit Insurance Corporation: https://www..gov/regulations/examinations.

Third, prudential supervisors should consider sharing the results of their comparative or benchmarking supervisory reviews with other relevant regulated firms. As noted in the Appendix, OSFI periodically conducts thematic supervisory reviews with groups of regulated financial institutions to gain insight into common and best practices on emerging issues of interest. The results of these reviews are then communicated to the participating financial institutions and help inform subsequent supervisory work and the development of new or updated guidelines. They are not, however, shared with other financial institutions nor made public. This stands in contrast to similar exercises conducted by the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors where anonymized results from their international surveys are routinely published. Sharing the results with other regulated firms could help more financial institutions benefit from the lessons learned from those reviews and help motivate the need for new or updated public guidelines.

A fourth improvement would be to follow the UK's standard practice of commissioning independent reviews whenever there has been a failure or near failure of a financial institution. Indeed, Part 5 of the *UK Financial Services Act* 2012 requires financial services regulators to conduct reviews when events have occurred that may have had a significant adverse effect on a regulated financial institution.[9] The purpose of these reviews is to ascertain whether there has been a regulatory failure that contributed to the situation.[10]

Reviews of prudential supervisory activities are also conducted in the US for the federal regulatory agencies by the staff of the Office of the Inspector General whenever a regulated financial institution fails and the Federal Deposit Insurance Corporation experiences a material loss in excess of US$50 million or when there is reason to believe there have been unusual circumstances surrounding a failure.[11] The Inspector General has even gone so far as to review bank supervisory practices when a bank has announced large losses even though the losses in question did not pose a risk to the bank's solvency, the London Whale incident at JP Morgan in 2012 being the most significant recent example.[12] However, that strikes me as excessive, given that prudential supervisors are not responsible for the behaviour of financial institutions unless there is reason to believe that their own lapses may have contributed to the losses. In contrast to the UK, the US Inspector General's reviews are mainly conducted by its own staff rather than by engaging senior external experts.

Canada has commissioned inquiries in the past when there have been multiple failures of financial institutions, notably the Estey Commission in 1986 and the McKay Task Force in 1997. However, independent reviews with public reports have not been routinely commissioned after individual

9 See https://www.legislation.gov.uk/ukpga/2012/21/contents/enacted for further informaton.

10 For the record, I should disclose that I had the privilege of conducting the most recent such review on a prudential matter for the UK government and Bank of England. I led the independent review into the prudential supervision of The Co-Operative Bank Plc, which nearly failed in 2013. My report can be found at https://www.gov.uk/government/publications/independent-review-of-the-prudential-supervision-of-the-co-operative-bank-plc.

11 An example of such a review would be the Office of the Inspector General's 2018 "Review of the Failure of Fayette County Bank." Available at https://www.oversight.gov/sites/default/files/oig-reports/board-fayette-county-bank-sep2018.pdf.

12 See Office of the Inspector General. 2014. "The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office" Evaluation Report 2014-SR-B-017 (October 17). Available at https://oig.federalreserve.gov/reports/2015-0030_-_Document_To_Release.pdf.

financial institutions have failed, nor after an institution has experienced a near-death experience like Home Trust in 2017 and Pace Credit Union in 2020.

One should never let a good crisis go to waste. Commissioning such inquiries, even for near failures, can serve as case studies that can be used to highlight for parliamentarians and the public more generally how the supervisors performed, surfacing issues that need to be addressed. Any risk of those reviews becoming overly politicized could be managed by allowing some time to pass before commencing a review, formulating a clear mandate for the review and exercising some care in deciding the appropriate qualifications for a prospective reviewer. Canada is fortunate in that it does not have many such events to draw from. But, it would be well served to not rest on its laurels and instead make full use of the events that will inevitably happen from time to time.

Finally, OSFI's public accountability could be strengthened by having the Superintendent of Financial Institutions participate in semi-annual parliamentary financial stability briefings. A review of the records for the House of Commons Standing Committee on Finance and the Senate's Banking, Trade and Commerce Committee shows the infrequent attention paid to OSFI and its prudential activities. Mid-level OSFI staff regularly attend the House Committee's annual reviews of the government's main estimates. But over the past 14 years (the tenures of Superintendents Julie Dickson and Jeremy Rudin), the House Committee met with the superintendent or other senior OSFI executives on only six occasions and with the Senate Committee only four times. On all of those occasions, the topics for discussion were broader financial stability issues. By contrast, the US congressional committees of both houses routinely meet with senior prudential regulators semi-annually to discuss prudential matters, and the same is true in Australia for meetings between senior officials from its Prudential Regulatory Authority and its House and Senate Committees. By the same token, in the UK and the EU there are regular interactions each year between officials responsible for prudential matters and various parliamentary committees.

This suggests that Canadians' trust in OSFI could be enhanced by having Parliament take a more active interest in prudential issues. However, some care would be required to ensure that increased parliamentary oversight does not go so far as to undermine OSFI's current operational independence in setting and enforcing prudential requirements. One way to begin that should not compromise OSFI's operational independence could be to invite the superintendent to participate in the regular semi-annual briefings that the Bank of Canada governor and senior deputy governor provide to the House of Commons and Senate committees on financial stability matters. If nothing else, it could help to encourage OSFI to be more nimble in its regulatory work in responding to emerging public interest issues such as climate change and infrastructure finance.

Conclusion

Prudential supervision in Canada and around the world has grown up in a world of limited public scrutiny. There have been good reasons for this, given the negative externalities that could emerge if supervisory ratings were made public and the need to protect commercially sensitive information. But demands for public accountability of government officials are on the rise. As a result, now is an opportune time to consider which aspects of prudential supervision truly require secrecy to be effective.

This *Commentary* argues that more light can be shone on the supervisory process to enhance Canadians' confidence that prudential supervision is being carried out in a competent fashion and operating as intended. Canadians would also be well served by having independent reviews routinely conducted after a financial institution encounters stress to determine the extent to which the stress may or may not have reflected regulatory failures and draw lessons on how to further enhance the supervisory process.

Finally, when things are working well there is a strong temptation to focus on other matters. But given the importance of sound financial institutions to the functioning of the economy, Canadians would be well served by having Parliament take a more active interest in prudential matters.

Appendix:

A Brief Summary of the OSFI Supervision Framework

The Office of the Superintendent of Financial Institutions (OSFI) is an independent federal government agency that has a Parliamentary mandate under the *Office of the Superintendent of Financial Institutions Act* (*OSFI Act*) to regulate and supervise more than 400 financial institutions and 1,200 pension plans to determine whether they are in sound financial condition and meeting their legal and regulatory requirements. The financial institutions in question include all banks and federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and private pension plans.

OSFI is mandated to contribute to public confidence in the Canadian financial system by protecting the interests of depositors, policyholders, pension-plan beneficiaries and other creditors of the financial institutions it oversees. In protecting their interests, OSFI is required to bear in mind that those entities must be allowed to take reasonable risks to compete effectively at home and abroad.[13]

For the purposes of our discussion, the *regulatory* work conducted by OSFI can be broadly defined as setting public expectations for capital, liquidity, governance and risk-management practices for the financial institutions it regulates. These expectations are mainly issued in the form of public guidelines that set minimum standards for each type of institution; i.e., deposit takers, life and health insurers, mortgage insurers, and property and casualty insurers. The guidelines are formulated in consultation with the relevant regulated entities and other stakeholders with opportunities for public input before the guidelines are issued in final form. Most OSFI guidance is articulated in the form of principles that can then be applied by supervisors in a way that takes account of each institution's specificities.[14]

The *supervisory* work conducted by OSFI can be characterized as applying the above guidance to assess the risks and vulnerabilities inherent in the financial condition, governance and risk-management practices of individual financial institutions. It also includes working with those institutions' executive management and boards of directors to correct any deficiencies. OSFI also regularly conducts comparative or benchmarking reviews across various sets of multiple financial institutions to identify standard or industry best practices.

OSFI's approach to supervision and its frameworks for taking corrective action when deficiencies are uncovered are set out in detail in its *Supervisory Framework* and *Guides to Intervention*, all of which are available on its website.[15] The key details can be summarized as follows.

Basically, supervisors are charged with using information obtained from each financial institution plus their own judgment to grade the institution in terms of *inherent risks* (credit risk, market risk, insurance risk, operational risk, regulatory compliance risk and strategic risk). Inherent risk

13 See Sections 3.1 and 4 of *OSFI Act*, available at https://laws-lois.justice.gc.ca/eng/acts/o-2.7/index.html.

14 Some exceptions would be more quantitative guidance, such as capital, leverage and liquidity requirements, which can be viewed more as minimum requirements applicable to a broad set of financial institutions.

15 See *OSFI Supervisory Framework*, available at https://www.osfi-bsif.gc.ca/Eng/Docs/sframew.pdf for more information. The Guides to Intervention for each sector can be found at https://www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/gid.aspx (for deposit-taking institutions), https://www.osfi-bsif.gc.ca/eng/docs/sup_guide_life.pdf (for life insurance companies) and https://www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/gip.aspx (for other insurers).

Table A1: Typical Net Risk Ratings for Combinations of Inherent Risk and QRM Ratings

Aggregate Quality of Risk Management (QRM) for a Significant Activity	Level of Inherent Risk for a Significant Activity			
	Low	Moderate	Above Average	High
	Net Risk Assessment			
Strong	Low	Low	Moderate	Above Average
Acceptable	Low	Moderate	Above Average	High
Needs Improvement	Moderate	Above Average	High	High
Weak	Above Average	High	High	High

Source: OSFI Supervisory Framework, Appendix C.

levels for each category are graded using a scale that ranges from *low* to *moderate*, *above average* and *high*.

Based on the key inherent risks identified for a significant activity and their levels, supervisors then set expectations for the *quality of risk* management they expect from the financial institution. The higher the level of inherent risk, the more rigorous the controls need to be.

In doing so for each significant activity, OSFI assesses operational management and each of the relevant oversight functions within the institution (financial, compliance, actuarial, risk management, internal audit, senior management and the board of directors) using a rating scale that ranges from *strong* to *acceptable*, *needs improvement* and *weak*. The appropriate rating is determined using assessment criteria that compare the nature and levels of the institution's controls or oversight to OSFI expectations developed when assessing the levels of the key inherent risks. These ratings also include a determination of the direction of the quality of oversight (improving, stable or deteriorating).

The *inherent risk ratings and quality of risk management* assessments for each significant activity are then combined, using judgment, to determine a *net risk* rating that can range from *low* to *moderate*, *above average* and *high*. Table A1 summarizes typical combinations in this regard. The *net risk* rating also includes a determination of whether the direction of *net risk* is decreasing, stable or increasing.

The *net risk* ratings of the significant activities are then combined, by considering their relative importance to arrive at the *overall net risk* rating for the financial institution as a whole. The *overall net risk rating* is an assessment of the potential adverse impact that the significant activities of the financial institution collectively could have on the earnings performance and adequacy of the institution's capital and, therefore, on the depositors or policyholders. *Overall net risk* is rated as *low*, *moderate*, *above average* or *high*, and the *direction* is assessed as *decreasing*, *stable* or *increasing*.

With the *overall net risk* rating in hand, supervisors then turn their attention to assessing: (i) the quantity, quality and consistency of the financial institution's earnings; (ii) the level and quality of capital under both normal and stressed conditions; and (iii) the level of liquidity and quality of the financial institution's liquidity-management practices. Each of these factors is graded on a scale ranging from *strong*, *acceptable*, *needs improvement* to *weak*, and the *direction* is assessed as *improving*, *stable* or *deteriorating*.

All of this is combined into a *composite risk rating* for the financial institution as a whole (*low*, *moderate*, *above average* or *high*) with a sense of direction (*decreasing*, *stable* or *increasing*) that drives the OSFI's intervention rating, which is described in the OSFI's *Guides to Intervention* for federal financial institutions.

OSFI has four *intervention ratings* that range from 0 to 4. The key point here is that a financial institution that has an *intervention rating* of 2 is considered to be at risk to its financial viability or solvency. The Superintendent of Financial Institutions would likely recommend the closure of a financial institution if it continues to deteriorate and is staged at the 4 level and, therefore, considered to be no longer viable with insolvency imminent.

Table A2: Alignment Between Composite Risk Ratings and Intervention Ratings

Composite Risk Rating	Intervention Rating	
Low	**0**	Normal
Moderate	**0**	Normal
	1	Early warning
Above Average	**1**	Early warning
	2	Risk to financial viability or solvency
High	**2**	Risk to financial viability or solvency
	3	Future financial viability in serious doubt
	4	Non-viable / insolvency imminent

Source: OSFI Supervisory Framework, Appendix E.

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OSFI Supervisory Framework. Available at https://www.osfi-bsif.gc.ca/Eng/Docs/sframew.pdf. (The guides to intervention for each sector can be found at https://www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/gid.aspx (for deposit-taking institutions), https://www.osfi-bsif.gc.ca/eng/docs/sup_guide_life.pdf (for life insurance companies) and https://www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/gip.aspx (for other insurers).)

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