# On the Evolution of the Financial Safety Net

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In the past 15 years, the financial-services industry has evolved substantially, driven by technological innovations and changing demographics, as well as by significant changes in the macroeconomic environment. There has also been significant development of the policy framework that influences financial sector behaviour in Canada.[1]

An important part of this policy framework is the so-called "financial safety net," which consists of prudential supervision, deposit insurance, and the central bank's lender-of-last-resort function. This paper reviews some of the key measures that have affected the financial safety net during the past 15 years, with a focus on deposit insurance and the prudential supervision of deposit-taking institutions.[2] This history can be interpreted as a long evolution towards a regime with clearer goals and improved incentives to act with regard to troubled institutions, along with greater authority to act.

## Improved Incentives

Prior to a series of reforms beginning in the late 1980s, the supervision of deposit-taking institutions had been compromised by ambiguity about the role and mandate of supervision and by weak incentives to respond effectively to troubled institutions.[3] This, in turn, increased deposit insurance liability and losses of the Canada Deposit Insurance Corporation (CDIC).

Accordingly, in the late 1980s, the federal government began a series of reforms that have improved supervisory incentives, which are presented here selectively in rough chronological order.

### A role for other agencies

A repeated theme in reviews of supervision (in Canada and elsewhere) has been the need to strengthen the incentives and ability of the supervisor to deal effectively with failing financial institutions. For example, strengthening the supervisor's will to act was a central concern following the failures of the Canadian Commercial Bank and the Northland Bank in the mid-1980s.

As a result, the Estey Commission (1986) recommended merging deposit insurance and banking supervision to strengthen the incentives of the supervisor to deal promptly with troubled institutions. In the mid-1980s, the House of Commons Finance Committee also recommended that deposit insurance and banking supervision be consolidated. The Committee argued that consolidation would improve the supervisory system because the body responsible for deposit insurance has a strong incentive to minimize its loss.

In 1992, following the collapse of another deposit-taking institution, Central Guaranty Trust, the House Committee argued that the supervisor should be explicitly directed, as a corporate objective, to minimize the costs of the deposit insurance fund. As before, the motivation was to improve the supervisor's incentives to act in a timely and effective manner when confronted with a troubled financial institution, by aligning the incentives of the supervisor with the need of the deposit insurer to control losses.

1. On these various points, see Daniel (2002–2003), Engert et al. (1999), Freedman and Goodlet (1998), and Freedman and Engert (2003).
2. For a discussion of the Bank of Canada's lender-of-last-resort function, see Bank of Canada (2004) and Daniel, Engert, and Maclean (2004–2005).
3. Changes in market structure (such as increased entry) also contributed to the challenges facing the supervisory regime. At that time, the banking supervisor was the Office of the Inspector General of Banks, which was subsequently replaced by a new organization.

Although the specific recommendations to consolidate deposit insurance and supervision were not accepted, a principal insight was applied.[4] That is, the government established ways to allow the views of safety-net agencies with potential exposures to troubled financial institutions to influence supervisory decision making. Accordingly, a supervisory structure was established that assigned interdependent roles and responsibilities to the supervisor, the deposit insurer, and the lender of last resort.[5]

More specifically, in 1987, the multi-agency Financial Institutions Supervisory Committee (FISC) was created, with the head of the newly formed Office of the Superintendent of Financial Institutions (OSFI) as the chair. The Superintendent was joined by the Chair of CDIC, the Governor of the Bank of Canada, and the Deputy Minister of Finance.[6] The role of the FISC is to regularly discuss matters related to the supervision of financial institutions, bank-holding companies, and insurance-holding companies, including the development of strategies to deal with troubled financial institutions.

The members of the FISC have a strong interest in the sound conduct of supervision (from various perspectives). And the creation of the FISC increased the scope for these interested agents to influence supervisory decision making. The Bank of Canada and CDIC were also given the authority to require OSFI to conduct an inspection of a financial institution, or to hire a third party to conduct an inspection, if either judged it necessary, in view of their potential exposures to troubled financial institutions.

As a result of these developments, incentives for the supervisor to act were sharpened, as were incentives to improve supervisory policy and practice. In addition, these arrangements provide the supervisor with the support of the FISC agencies when dealing with problem institutions.

4. According to the federal government's "Blue Paper" (1986), CDIC was retained as a separate body to facilitate the retention of private sector expertise on CDIC's board of directors and to preserve CDIC's relationship with provincial authorities responsible for the supervision of CDIC-insured provincially chartered institutions.
5. For more on this, see the federal government's "Blue Paper" (1986).
6. The Commissioner of the Financial Consumer Agency of Canada became a member of the FISC in 2001.

## Changing roles for the deposit insurer

As suggested above, the deposit insurance function aligns well with incentives for sound supervision. Put differently, offering a deposit guarantee requires effective prudential supervision to mitigate moral hazard and insurance loss.[7] In the absence of a well-functioning bank supervisor to control deposit insurance liability, one would expect that a deposit insurer would itself develop (independently) that capacity, provided that it had the authority and means to do so. And over the past 15 years, CDIC has developed a range of supervisory powers to mitigate the liability associated with deposit insurance, following the earlier failures of the supervisory framework to adequately manage that liability.

In 1987, Parliament expanded CDIC's mandate from that of a simple paybox institution (confined to paying the claims of creditors after a member is closed) to one aimed at reducing or averting a threatened loss to CDIC. Accordingly, CDIC was given the power to act as an inspector, receiver, or liquidator of a member institution, either directly or through an agent.[8] In the 1990s, CDIC also developed the *Standards of Sound Business and Financial Practices*, with associated reporting requirements for member institutions. (These standards were recently repealed; see footnote 10.) As well, CDIC instituted a system of differential premiums (whereby insured institutions pay premiums related to the assessed risk posed to CDIC).

In the mid-1990s, CDIC and OSFI jointly established a policy of early intervention when dealing with troubled institutions. This policy sets out a series of graduated supervisory interventions that CDIC and OSFI can take with regard to a troubled institution, according to increasing

7. For more on managing the liability associated with deposit insurance, see Merton and Bodie (1992) and Demirgüç-Kunt and Kane (2002). On the motivation and practice of deposit insurance (a large literature), see Garcia (1999, 2000) and Financial Stability Forum (2001), for example.
8. In practice, OSFI currently conducts annual examinations of CDIC-member institutions chartered by the federal government (the vast majority of members), and CDIC or its agent (typically OSFI) may conduct annual inspections of member institutions that are chartered by provincial governments. CDIC may also conduct (directly or through an agent) special examinations of its members, at its discretion.

seriousness. (This is discussed further below.) Additional amendments to the CDIC Act, made in 2001, encourage CDIC to make its own determination of the risk posed by member institutions (CDIC 2002). Finally, CDIC has had the authority to assess the acceptability of new entrants to the deposit-taking industry.

These various measures have provided CDIC with the means to act on its incentives to minimize deposit insurance liability. Importantly, in practice, this has also led to increased collaboration with OSFI, and so has influenced the conduct of supervision.[9]

However, particularly in view of the range of reforms made to the safety net over the past 15 years (see also below), these developments have also led to questions about overlap in supervisory arrangements and associated costs. Accordingly, in the budget of 23 February 2005, the federal government announced that it will clarify the roles and responsibilities of CDIC and OSFI and eliminate unnecessary overlap between the two agencies.[10]

## The supervisor's mandate

Incentives have also been improved through a legislative change that sharpened the role of the supervisor, which in the past had often been misinterpreted as preventing all institution failures. Notably, in 1996, OSFI's governing legislation was amended to improve the incentive structure of prudential supervision by making OSFI's mandate more clearly focused. Prior to this change, the role of the supervisor was essentially to enforce the provisions of the various financial-institution acts (such as the Bank Act), which set out the permitted and prohibited activities of regulated institutions.

More specifically, the OSFI Act was amended to indicate that the objectives of OSFI with respect to financial institutions are

- to supervise financial institutions in order to determine whether they are in sound financial condition and are complying with their governing statute law and supervisory requirements under that law;
- to promptly advise the management and board of directors of a financial institution in the event that it is not in a sound financial condition or is not complying with its governing statute law or with supervisory requirements under that law, and in such a case, to take, or require the management or board to take, the necessary corrective measures or series of measures to deal with the situation expeditiously;
- to promote the adoption by management and boards of directors of financial institutions of policies and procedures designed to control and manage risk; and
- to monitor and evaluate system-wide or sectoral events that may have a negative impact on the financial condition of financial institutions.

In pursuing its objectives, OSFI is directed to protect the rights and interests of depositors, policyholders, and creditors of financial institutions, having due regard for the need to allow financial institutions to compete effectively and take reasonable risks. And the OSFI Act recognizes that boards of directors and managements of financial institutions are responsible for the management of risk, and that financial institutions can fail.

As a result of these changes, OSFI emphasizes in its publications that its mandate is to safeguard depositors and other creditors from undue loss. (See, for example, the OSFI *Annual Report 2001–2002*.) As well, OSFI stresses that financial institutions operate in a competitive environment that necessitates the management of risk, and

9. The working relationship and information-sharing arrangements between CDIC and OSFI have been conditioned by agreements developed between the two agencies.
10. According to the budget documents (Government of Canada 2005), the government will maintain the key roles and responsibilities of CDIC, while consolidating several supervisory functions within OSFI. OSFI will be primarily responsible for interacting with federal financial institutions. It will assess institutions against OSFI guidelines, replacing the assessment of institutions against CDIC's *Standards of Sound Business and Financial Practices*, which have been repealed. Furthermore, OSFI will become solely responsible for reviewing new entrants to the financial sector and for developing prudential rules and guidelines. As part of these reforms, CDIC and OSFI are also expected to work together to streamline their administrative and corporate service functions.

that financial institutions can experience financial difficulties that can lead to their failure.[11]

## Authority to Take Control

Critical to the development of clearer goals and sharper incentives in the safety net has been the establishment of greater powers to respond to troubled institutions. In 1996, the Superintendent of Financial Institutions was given the power (through amendments of the various financial-institution acts) to take control of an institution's assets, or of the institution itself, and to restructure or close the institution for a variety of reasons that suggest threats to its viability (David and Pelly 1997; Bank Act; Office of the Superintendent of Financial Institutions Act).[12]

This change was of fundamental importance. It was a significant innovation in the supervisory framework, increasing the authority of the supervisor and underpinning the supervisor's ability to intervene in the affairs of a troubled financial institution. This power can be seen as the lynchpin of the supervisor's improved operating framework (based on structured, early intervention, which is discussed below). This authority and its derived measures also establish reinforcing incentives for financial institutions to avoid risks that could cause them to become subject to supervisory intervention.

Under certain conditions, the Superintendent can take control of the assets of an institution for 16 days. As well, the Superintendent can extend this 16-day period, take initial control of the assets for longer than 16 days, or take control of the institution itself, unless the Minister of Finance considers that these actions are not in the public interest.

11. Former Superintendent Palmer (2000) noted that the new mandate made clear that OSFI was expected to detect problems earlier and move faster to resolve them, either by requiring the institution to fix the problems or by closing the institution before the savings of depositors and policyholders were eroded. Palmer added that this mandate led to a fundamental transformation of OSFI.
12. In 1992, provisions had also been established to allow Governor-in-Council orders to vest in CDIC the shares or subordinated debt of a federally chartered CDIC member, to facilitate the institution's restructuring.

There are seven circumstances in which the Superintendent may take control of assets or of an institution itself:

- the institution has failed to pay its liabilities or, in the opinion of the Superintendent, will not be able to pay its liabilities as they become due and payable;
- in the opinion of the Superintendent, a practice or state of affairs exists that is materially prejudicial to the interests of the institution's depositors or creditors;
- the assets of the institution, in the opinion of the Superintendent, are not sufficient to adequately protect depositors or creditors;
- any asset appearing on the books or records of the institution is not, in the opinion of the Superintendent, satisfactorily accounted for;
- the regulatory capital of the institution has, in the opinion of the Superintendent, reached a level or is eroding in a manner that may detrimentally affect depositors or creditors;
- the institution has failed to comply with an order of the Superintendent to increase its capital; or
- the institution's deposit insurance has been cancelled by CDIC.

Once in control of an institution's assets, the Superintendent may take all necessary measures to protect the interests of the institution's depositors and creditors, pursuant to the mandate of OSFI, and OSFI can control access to the institution's assets, including cash and securities.

## An Improved Operating Framework

### Structured, early intervention

Consistent with the changes discussed above, the operating framework of prudential supervision has also evolved. The clearer goals and sharper incentives governing the safety net and the greater powers of safety-net agents (both CDIC and OSFI) have led to an improved operating framework based in part on "prompt, corrective action." Indeed, according to OSFI, safeguarding depositors from undue loss is best

achieved by intervening in a failing deposit-taking institution in a timely manner.

In the mid-1990s, OSFI and CDIC jointly introduced a program of early intervention, which is formalized in the *Guide to Intervention for Federal Financial Institutions* (OSFI 2002a). The guide describes the potential interventions of OSFI and CDIC in response to a troubled institution, depending on the institution's situation. The latter is characterized by four stages of increasing seriousness, each exemplified by specific problems set out in the guide.

This framework is broadly consistent with the analysis in past reviews of banking supervision, such as Estey (1986), which stressed the problems of supervisory forbearance, and with academic research emphasizing the importance of mandatory, prompt, corrective action by supervisors.[13] The OSFI/CDIC program differs from the academic literature, however, by giving judgment a relatively larger role (instead of mandatory action). This underscores the importance of the incentives conditioning these supervisory judgments.

The stages of the *Guide to Intervention for Federal Financial Institutions* can be summarized broadly as follows.

Stage 1. Early warning: Deficiency in policies or procedures or the existence of practices or conditions that could lead to the development of problems described at Stage 2.

Stage 2. Risk to viability or solvency: Problems that, although not serious enough to present an immediate threat to financial viability or solvency, could deteriorate into serious problems if not addressed promptly.[14]

Stage 3. Viability or solvency is in serious doubt: Problems are at a level where they pose a material risk to viability or solvency in the absence of mitigating factors, such as unfettered access to financial support from a strong financial-institution parent, or unless effective corrective measures are applied promptly.

13. On the academic literature concerning prompt, corrective action, see, for example, Benston et al. (1986) and Benston and Kaufman (1997).

14. Viability (an ambiguous term) appears to refer to a dynamic interpretation or view of solvency. That is, viability refers to the likelihood or expectation of an institution remaining solvent. Therefore, at any time, an institution can be solvent, but not viable.

Stage 4. Non-viability or insolvency is imminent: Severe financial difficulties exist, resulting in failure or imminent failure to meet regulatory capital requirements in conjunction with an inability to rectify the situation within a short time. Alternatively, the conditions for the Superintendent to take control of the institution are met (described above).

As noted, each stage is associated with a range of increasingly severe interventions that could be taken by OSFI and CDIC, at their discretion, to address the situation. An institution, including its board of directors, is notified if it is "staged" according to this scheme; however, such information is not made public.

## A procedural, risk-based approach for supervision

In 1999, OSFI introduced an approach that focuses on evaluating an institution's material risks and the quality of its risk-management practices (OSFI 2003). Application of this framework begins with the identification of an institution's significant activities and a judgment of the risk inherent in each activity; that is, the likelihood and significance of an adverse impact from that activity on an institution's capital or earnings. Such so-called inherent risk is assessed as being "low," "moderate," or "high."

OSFI then evaluates the quality of the risk-management process that the institution has in place for each significant activity by examining various control functions, including financial analysis, compliance, internal audit, risk management, and executive and board oversight. The overall quality of risk management for each significant activity is then judged as being "strong," "acceptable," or "weak," by qualitatively aggregating across the control functions.

The net risk for each significant activity is then determined as a function of the assessed level of inherent risk (low, moderate, or high), as mitigated by the assessed quality of risk management (strong, acceptable, or weak).

Finally, OSFI provides a judgment with regard to the direction of net risk ("decreasing," "stable," or "increasing") and prepares an overall composite risk rating that reflects net risk, direction of risk, and other salient factors, such as capital and earnings. The composite ratings broadly correspond to the stages set out in the *Guide to Intervention for Federal Financial Institutions*, so

that an institution judged to have a high composite risk rating, for example, is likely to be at an advanced stage, with associated supervisory interventions.

OSFI provides each supervised institution with the assessments and ratings that emerge from this process. As with information regarding staging under the *Guide to Intervention*, these reports are confidential.

## Concluding Remarks

The evolution of the safety net over the past 15 years can be interpreted as a series of fundamental changes to the incentive structure and powers of the regime which, in turn, have motivated improvements in the operating framework of the safety net. The key measures have been the following.

- Establishing a clear mandate for the supervisor, focused on protecting the interests of depositors and other creditors. This mandate also recognizes that financial institutions can fail.
- Creating the authority and obligation for the supervisor to act promptly with regard to troubled institutions so as to achieve its mandate. This includes providing OSFI with the power to take control of a financial institution before it is insolvent and establishing an appropriate range of instruments with which to act.
- Providing the authority and means for other agencies in the safety net to influence the supervisory process. Notably, there has been an increased reliance on the incentives to mitigate deposit insurance liability.
- These measures have motivated an improved operating framework based on a program of structured, early intervention.
- In turn, these changes have sharpened financial institutions' incentives to manage risk appropriately, in part to avoid becoming subject to supervisory intervention.

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