OSFI and the Third Pillar

Banks worldwide are regulated under the Basel II accord, an agreement reached after years of multilateral discussion under the aegis of the Group of Thirty – a private sector initiative. While events of the past year have shown weaknesses in the prudential regulation of banks worldwide, it is also apparent that things could have been much worse. Banks have been severely battered and yet have survived, but there have been more instances of a bank being recognized as no longer viable while there was value left in the concern – a primary objective of the process.

The core of the Basel II accord is formed by the “Three Pillars”, or:
• The first pillar is formed by the required capital and the supervisory review process. This must be robust and is independent of the capital
• The second pillar is prudential regulation and encourages the risk management process.
• The third pillar is market discipline. OSFI claims to be studying the market discipline that OSFI fails in its duty to the capital markets.

Visiting the website of the Committee of European Banking Supervisors (CEBS) at http://www.c-ebs.org/Recent consultations with the industry are highlighted on the index page, and it only takes a few clicks to view thirty responses to a consultation regarding the definition of “Tier 1 Hybrids” from market participants ranging from Morgan Stanley to the British Bankers’ Association. CEBS has made a public commitment to target the full range of interested parties, including market participants (e.g., credit institutions, investment firms, etc.), consumers and other end users, as well as their representative associations, for consultation and to make consultation proposals, related documents and key dates for the consultation widely known and available through appropriate means, in particular the Internet.

Another regulator notable for its transparency is the Federal Reserve. For example, visit the Fed site at http://www.federalreserve.gov/ GeneralInfo/baa12/ba12implement.htm for a review of various aspects of the implementation and review of these provisions. A plethora of information is available for the review of any investor desiring to obtain a fuller understanding of the issues and gain a deeper understanding of the reasoning behind the Fed’s actions. Comments on proposals are published in the public record, and the final rule points of disagreement are noted and discussed. Even if an investor should disagree with a Fed decision, there can be little complaint about lack of understanding of the rationale.

It does an investor no good to receive disclosures without being aware of what the disclosures reveal and conceal.

These admirable examples of rational and transparent regulations are ignored in Canada. OSFI maintains a website that would not receive a passing grade in high school and, until recently, was absurdly slow. Its practices in posting draft documents and responses to public inquiries have been lampooned at best – only two papers, from the same date in 2004, are found upon examination of the “Bank/Drafts and Consultation Papers/OSFI Papers” section. For example, Comment is discouraged – the recent Draft OSFI instrument “Systematic Tier 1 Instruments” made it quite clear that only questions were expected – and, in the case that commentary is received, neither published nor addressed. This is not acceptable behaviour for a prudential regulator.

Let us consider the “Asset-to-Capital Multiple” (ACM), the Canadian analogue of the American “Leverage Ratio.” This ratio seeks to add a sanity check to the more standard capital ratios of the first pillar by the ratio of total assets and total capital in a simple – some say simplistic – fashion. Prudential regulators have historically blindly accepted the opinion of credit rating agencies as infallible, but the limitation on the ratio of assets and total capital, together, has shielded many banks from the worst effects of the credit crunch. The Swiss regulator has indicated that it will introduce a similar measure, perhaps based on UIRS, which was singled out by the IMF for having an extraordinary tight “cyclically-adjusted” measure. The actual ratio to risk-weighted assets is even tighter in October led to a certain amount of speculation that – like CIBC earlier this year – MFC would be forced to raise equity capital in a hostile climate. OSFI has released a framework for a revision to the MCCSR rules, due for complete implementation, starting January 2013 – it will be a four-year process and has, in fact, been in the planning stages for some time already. But when MFC lost a lot of value due to its stock market guarantees, CEO Dominic D’Alessandro decided he did not wish to stake equity to meet the margin call – it would appear that he just called folks at OSFI, said “Frog” and they jumped. Yes, I am speculating here and I am only highlighting the worst possibility. But there is nothing in OSFI’s revised requirements that mitigate the impression that this was not the case or that any analysis or prudence was exercised when changing the MCCSR requirements. OSFI will not even release a list of companies alleged to have been consulted during the process – although confirming that no consideration was given to investor input regarding investors’ concerns – and do not pretend to have considered the question of disclosure requirements when modifying the rule. Disclosures regarding 10% moves in the equity markets that are overdue for complete implementation are hardly likely to encourage market discipline. OSFI makes it plain that no disclosure is required. OSFI claims to be studying the question of increased transparency, but is naturally doing this secretly. If OSFI seeks to be an independent, disinterested, conservative prudential regulator, if OSFI wants to ensure that its decisions will be respected as being a good faith effort at a mandate that necessarily includes estimation, approximation and judgment, if OSFI wants to ensure that the “Frog” model of a prudent bank and insurance environment can operate effectively, then it must:
• Recognize that investors making long-term investments require a consistent approach to risk-making
• Release proposed rule changes
• Release their research and internal analysis to the public
• Encourage and publish comments from all capital market participants
• Defend or amend their methodology. If any of these comments are critical
• Ensure that there is full disclosure of the rationale behind any emergency action or discretionary amendments.

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