ADVISORRESEARCH

OSFI and the Third Pillar

BY JAMES HYMAS

Banks worldwide are regulated under the Basel II accord, an agreement reached after years of multilateral discussion under the aegis of the Bank for International Settlements. Canada is one of fourteen members of the "Basel Committee on Banking Supervision," represented by both the Bank of Canada (as the central bank) and the Office of the Superintendent of Financial Institutions (OSFI) as the prudential regulator.

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 there have been some failures, 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":

- The first pillar is formed by the required balance-sheet ratios. The accord specifies rules for capital that must be available to absorb losses before depositors are hurt and the general manner in which these are calculated. In Canada and the U.S., there is an additional "leverage requirement" that serves to check that banks aren't exploiting inconsistencies in the rules for capital calculation.
- The second pillar is prudential regulation. The supervisory review process is intended not only to ensure that banks have adequate capital, but to review and encourage the risk management process.
- The third pillar is market discipline. "The committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes and hence the capital adequacy of the institution."

As investors, we are extremely interested in the third pillar – our success in administering market discipline to the correct degree will have a direct relationship with investment performance. If we refuse to invest in a particular security due to overemphasized fear, we will miss opportunities. If we overemphasize greed and invest in superficially attractive but overly risky securities, we will simply lose money.

Many things are required of an investor in order to judge the balancing point between greed and fear. Clearly, we must understand what the capital adequacy ratios of the first pillar are telling us and we must have sufficient disclosures from the issuer's management for us to judge the degree of faith that may be placed in figures that are, necessarily, ultimately derived from estimates.

Most important of all, however: investors must understand the rules of the game. It does an investor no good to receive disclosures without being aware of what the disclosures reveal and conceal; an investor cannot assess the impact of regulatory changes without understanding both the positive and negative impacts of the change; and investors will be penalized for making long-term investment decisions if the entire framework of regulation can change at any time without notice.

It is on these points of market discipline that OSFI fails in its duty to the capital markets.

Visit the website of the Committee of European Banking Supervisors 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/basel2/USImplementation.htm for a review of various aspects of the implementation of the Basel II accords. 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 publication of each 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.

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These admirable examples of rational and transparent regulation are ignored in Canada. OSFI maintains a website that would not receive a passing grade in high school and that, until recently, was absurdly slow. Its practices in posting draft documents for discussion prior to issuance of a final rule are haphazard at best – only two papers, from the same date in 2004, are found upon examination of the "Banks/Drafts and Consultation Papers/OSFI Papers" section, for example. Comment is discouraged – the recent Draft Advisory on Innovative 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. This does not "encourage market discipline."

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 comparing measures 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 capital has, in North America, shielded many banks from the worst effects of the credit crunch. The Swiss regulator has indicated that it will introduce a similar measure, perhaps embarrassed by UBS, which was singled out by the IMF for having an extraordinarily high ratio of actual assets to risk-weighted assets.

Like any other rule, the leverage ratio has its advantages and disadvantages. To learn more about these attributes, I suggest that readers visit the Federal Reserve website, because there is nothing – absolutely nothing – about the Canadian experience on the OSFI website.

It gets worse. The limit for the ACM in Canada is 20:1, but OSFI emphasizes its ability to permit an increase to 23:1. Royal Bank obtained such permission several years ago; in the first quarter of 2008, for instance, its ACM was reported by OSFI to be 22:05, although RBC could not be bothered to include this figure in their quarterly report. A rational investor might well wonder how RBC justified the request for an increased limit and what terms and conditions were imposed by OSFI for granting this request.

A rational investor can just go on wondering. RBC will not answer the question and OSFI considers the information to be confidential and protected by Section 22 of the Act creating their office. So much for market discipline.

Let us turn to the recent example of the revision of the Minimum Continuing Capital and Surplus Requirements (MCCSR). The segregated fund segment of the market was growing rapidly in the late 1990s and in 1999, OSFI began studying the risks involved with a view to ensuring that these funds would be guaranteed only to a degree prudently constrained by the guarantor's capital. In August 2000, a task force of the Canadian Institute of Actuaries proposed a framework for the capital requirements of this business; in December 2000 new MCCSR guidelines were published.

Capital requirements for the guarantees were specified at the CTE(95) level – that is, scenarios of possible investment performance over time are prepared, the worst 5% of these scenarios isolated and the average cost of making good the guarantee under such conditions added to the MCCSR. It is important to note that the models include the reduction of sampling bias over lengthy periods (sometimes mistaken for reversion to mean) and that the benefits of hedging were recognized.

Recently, Manulife got into a little difficulty with respect to these rules. Equity markets had deteriorated significantly in the third quarter, taking the firm to the lower limit of their targeted range for MCCSR ratio (the actual capital of the firm divided by the MCCSR capital required – a minimum of 150% and generally in the 180%-200% range. Further weakness 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 commencing January 1, 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 issue equity to meet the margin call – it would appear that he just called folks at OSFI, said "Frog" and they jumped.

Yes, I'm speculating here and I'm only highlighting the worst possibility. But there is nothing in OSFI's release that gives the slightest degree of comfort 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 are standard but picayune; for catastrophe analysis, disclosures for 20%, 30% and 40% moves are required.

OFSI claims to be studying the question of increased transparency, but is naturally doing this secretively. If OSFI seeks to be trusted by the capital markets as a 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 "Third Pillar" of a prudent banking and insurance environment can operate effectively, then it must:

- Recognize that investors making long-term investments require a consistent approach to rule-making
- Release proposed rule changes well in advance
- Release their research and internal analysis to the public
- Encourage and publish comments from all capital market participants
- Defend or amend their judgments when these comments are critical
- Ensure that there is full disclosure of the rationale behind any emergency action or discretionary exemptions. AER

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