Comments on Canadian Developments in the Supervisory Realm

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CMFE Conference

Economic and Financial Crisis: Lessons from the Past and Reforms for the Future

Carleton University; 13–14 May

Comments on Bank Supervision

Economists have had little to say about bank supervision.

Unfortunately economists have ignored an important part of the framework that governs the financial sector

1. What is supervision?

Supervision is a process that combines inspection , audit (or assessment), and remedy (or correction) with the objective of maintaining the soundness of financial institutions

2. Who supervises?

Public authorities are not the only bank supervisors.

Others include depositors, other creditors, external auditors, shareholders, boards of directors and rating agencies.

Comments on Bank Supervision

3. Bank Supervision in Canada

Earliest banks were organized as proprietorships and partnerships which gave their owners unlimited liability.. Depositors supervised banks by judging the wealth of the bank owners. This may have provided the origins of the tradition of banks having grand premises.

History of Canadian banking shows considerable shifts in the roles of different supervisors from Confederation to the present

Expansion of supervisors: (1867 -1935)

Double shareholder liability: By Confederation banks were organized as limited liability corporations with a twist

- Shareholders had double-liability
  - Not only lost value of their shares but had to pay an additional amount equal to par value of shares if bank failed
  - Strengthened the role of shareholders as supervisors
  - Shareholders and depositors were the only supervisors in the beginning

Comments on Bank Supervision

3. Bank Supervision in Canada (continued)\

External auditor:

Private accountant not government

Proposed several times but delayed because

"Impractical for independent auditor to ascertain the value and character of bank assets.

Implemented in 1923: two auditors with overlapping terms

Government Supervisor

Established 1924 after bank failure

Contraction of supervisors

Double-liability of share holders phased out beginning 1935 and eliminated 1954

Deposit insurance (1967) eliminates small depositors

Shareholder scrutiny reduced by limits to concentrated ownership (1967)

Financial crisis (2007): large depositors, bond holders, and other creditors all protected by government actions including enhanced liquidity facilities, asset purchases and offer of guarantees for borrowing.

These actions strengthened belief that governments will not allow major banks to fail

Comments on Bank Supervision

3. Bank Supervision in Canada (continued)

Current state: Burden of supervision rests on auditors and government supervisors

Tremendous burden for government supervisors given the size and complexity of Canadian banks

4. OSFI/ Finance Proposal of Imbedded Contingent Capital

Price's paper outlined a proposal that would require banks to raise contingent subordinated debt that would be converted to replenish equity when the bank gets into trouble.

Good as far as it goes but devil in the details:

Threat to convert subordinate debt into equity must be credible to market participants to apply pressure on banks

Forbearance – allowing unviable banks to continue in business - is the enemy of credibility

Unfortunately past performance of bank regulators around the world has created expectation of forbearance

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Comments on Bank Supervision

5. Other needed measures:

1. Limit to discretion: Limits to the bank regulators' discretion in triggering the conversion of subordinated debt are needed to build credibility that the promised action will be taken

2. Ability to wind-up large, complicated, interconnected institution:

The authorities' ability to wind-up a large bank must be unquestioned in order to give credibility to the imbedded contingent capital scheme.

- Canadian authorities can use existing Financial Institution Resolution Process and CDIC's bridge bank arrangements to wind up troubled institutions.

- Key question: Can these processes deal with institutions whose assets are 25 to 45% of Canada's GDP?

Issues may appear academic given performance of Canada's banks during the crisis BUT

Should remember that Bank of America, Citibank, Credit Suisse, UBS, HBOS were among the "strongest" banks in the world just 4 years ago