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Five Year Review Committee
c/o Purdy Crawford, Chair,
Osler, Hoskin & Harcourt LLP
Box 50, 1 First Canadian Place,
Toronto, Ontario M5X 1B8

Dear Mr Crawford,

I am writing to comment on the Draft Report of your Committee on Reviewing the Securities Act (Ontario), which I read with great interest.

On the whole, I think you have written an excellent document and it is well organized and addresses many of the more important issues facing regulators of securities markets. You may wish to review some of your findings in light of the very serious collapse in confidence in the reliability of financial information provided to equity markets post-Enron.

I am writing to you in my capacity as the former Superintendent of Financial Institutions for Canada in the period 1987 – 1994. I want to comment on your recommendation to remove the GAAP exemptions for banks and insurance companies.

First, it would be useful to consider the factors that led us to insist on writing into legislation the ability of the Superintendent to have some power over the accounting principles and practices of banks, trust and loan companies and insurance companies in the federal financial legislation passed in 1992.

1. There was the desire to use the reported capital shown in the audited financial statements of these institutions as the basis for computing the amounts of regulatory capital required as prudent. This reliance gives the regulator a vital interest in ensuring that the accounting and valuation practices followed by supervised institutions are adequately conservative. The OSFI made the judgement that the accounting basis for public reporting should be compatible with any financial reports filed with the regulator, and that it would be dangerous not to do so. This is unlike some other jurisdictions, such as the United States, where the published financial statements were not generally relied on by regulators in this context.
2. The history of banking failures in the US and Canada suggested that the use of GAAP by institutions under severe financial pressure did not produce reliable financial statements. That is, they indicated solvency conditions

when subsequent events indicated that their capital had been eliminated at the time of the financial statements. Because of the extremely high leverage employed by banks, trust and loan companies and life insurance companies, the margins for accounting error are very small. Materiality considerations designed for commercial and industrial companies are reflected in GAAP but are not suitable for financial institutions. The history of banking failures in the US did not lead us to the conclusion that the American approach under which financial statements of banks were prepared following GAAP was better than ours.

3. In 1987, the regulator had to impose special valuation rules to ensure that the Canadian banks made adequate provision against their non-performing loans to Less Developed Countries. American and other foreign banks facing this same situation took much longer to deal with this very serious problem than we did and there was wide variation among many of the banks, including those in the same country. It was our view that Canadian banks should be reasonable uniform in dealing with this issue. In my judgement, management of this problem would have been much more difficult without the regulatory power we had to write accounting rules.
4. Until recently, Canadian GAAP did not cover the accounting for interest on non-performing and restructured loans. In particular, it was said by our accounting advisors that the reversal of previously accrued interest on such loans was not in accordance with GAAP. This argument was used by many trust and loan companies whose financial statements were in accordance with GAAP. There were also GAAP based objections to defining as non performing any loans where payments were overdue by 90 days or more; this was said to be too arbitrary.
5. The growth in the securitization of credit assets starting in the early 1990s required the OSFI to issue accounting guidelines to identify transactions that were sales as opposed to those that were refinancings. GAAP rules on this were too loose. Similarly, the OSFI felt obliged to issue accounting and disclosure guidelines with respect to derivatives transactions and exposures. In both these cases, it was feared that the process of developing GAAP rules applicable to these new financial instruments and transactions would be too slow and too open to industry pressures.
6. The OSFI had serious concerns about the GAAP prescription of the use of the policy premium method in computing insurance policy liabilities, and that without OSFI intervention, the controls over the use of this method would be too weak. We were able to delay its implementation in order to test the method in practice and design controls to prevent inappropriate front ending of profits and mitigate large swings in income resulting from small changes in actuarial assumptions. This was testing that the CICA did not do.

At the time, we believed that the power to prescribe accounting for financial institutions was very important, even if we hoped we would have to use it very sparingly. Our view was that without the power, it would be difficult to ensure adequate conservatism and supervise institutions' capital effectively. I recognize that this reflects a focus on balance sheets more than the income statements. My interpretation of GAAP rules is that they are income-focused, not balance sheet focused.

At no time did we believe that the issue had anything to do with conflicting priorities of prudential and securities regulators, and that disclosure timing or the non-disclosure of certain events were issues. I believe the Commission report (page 95) is in error on this point. I cannot recall this having ever been an issue.

We also did not believe that the power to issue accounting guidelines or rules should be focused on particular institutions, and I cannot explain the change in thinking that has led to the bank loan loss accounting matter that you describe. Our core concern was that OSFI accounting interventions would be general in their application and be restricted to matters that were only prudential in nature and purpose. Any specific interventions would only occur where there were significant solvency concerns and would be covered by issuing directions of compliance to the institution involved. We also felt that any guidelines and instructions issued by the OSFI would essentially be aimed at narrowing the range of options under GAAP or covering emerging areas where GAAP was silent. They would only be contrary to GAAP in very exceptional circumstances.

I fully share your concern about the importance of good public financial disclosure. But, I see no reason why this is compromised by continuing with the GAAP exclusion you wish to get rid of. In this context, it seems clear that financial disclosures of the big Canadian banks and life insurance companies have improved enormously. I also do not think that financial holding companies can follow accounting practices at variance with those of their financial institution subsidiaries.

I am not sure what changes are required that could meet your concerns without weakening the safety and soundness of supervised institutions. I think it important not to erode the regulator's power to ensure that the standards of accounting and disclosures for Canadian banks and life insurance companies should, if anything, be more rigorous than those in other countries including the US. I would be pleased to discuss this problem with you if you thought it useful.

Yours sincerely,

Michael Mackenzie