Appendix A

Evolution of the Canadian Banking System Since Confederation

The first Canadian banks commenced business long before Confederation, and early nineteenth-century bank charters embodied features of banking which are still current. These charters were based on, and influenced by, early grants of power to banks in the United States. The early practice of banking in Canada reflected, as well, a British heritage. The British valued bank stability over experimentation, and the Colonial Office maintained close control on early practices in British North America.

In the United States, a bank charter was granted by Alexander Hamilton, first Secretary of the Treasury, to the First Bank of the United States in 1791. It has been noted that the Canadian banking system is a direct descendant of the First Bank, which was in part modelled after the Bank of England. The First Bank had centralized financial power over currency and credit and, to some extent, over fiscal policy. It also performed functions as a lender of last resort to state banks. Another of the First Bank's distinctive features was its branch system which enabled it to extend its control and influence throughout the country. It was therefore in a position to encourage conservative banking policies and practices. The First Bank's success as a stabilizing central element of the industry as a whole significantly influenced early Canadian bankers and the eventual course of Canadian banking.

The banking principles of strength and stability evident in the First Bank's structure and practices were to wane in the United States with that bank's failure to secure renewal of its charter. The Second Bank of the United States, established in 1816, and organized along the same lines as the First Bank, also failed to survive beyond its initial 20-year charter. The principles behind these early American experiments thrived in the different Canadian environment, however. In the United States, distrust of centralization of power, and dislike by western agrarians of conservative, eastern banking practices, were sufficiently strong to close the First and Second Banks and to dictate the creation of

a decentralized, unit banking system in the 1860s. National branch banking has until recently been impossible in the United States as a result of the combined existence of the commerce clause of the American Constitution which confers jurisdiction over interstate commerce to Congress, and political expediency which has prevented federal legislators from giving national banks more extensive branching privileges in their home states than state banks.

In Upper Canada, on the other hand, unit banking similar to that adopted in the United States had a short life under the *Act to Establish Freedom of Banking* of 1850. Under this Act, small banks were favoured, and each bank was to conduct business in one location. This development was opposed both by the now powerful chartered banks and by the British authorities, and it was ultimately unsuccessful in transforming the Canadian banking system into something along the lines of its American counterpart. In 1854, banking legislation moved further in the direction of a general Bank Act and the establishment of the chartered banking system. The number of chartered banks in Upper Canada rose dramatically in the prosperous 1850s.

Conservative elements in finance in Canada were generally much stronger than those in the United States, and distrust of concentration of power was weaker. The centralization of power appealed to Canada's nation-builders as well for both political and geographic reasons. Western Canadian interests did not possess sufficient strength to challenge the centralized structure of Canadian banking until after it was well entrenched. Finally, the Canadian banking system grew under English tutelage, undisturbed by major disruptions such as those caused to the American system by the Civil War and the controversy over paper money. All these factors combined to ensure that by the time of Confederation, the groundwork for a strong, conservative, national branch banking structure was well established.

The *Constitution Act, 1867*, conferred on the federal government the exclusive right to legislate with respect to "Banking, Incorporation of Banks, and the Issue of Paper Money", "Currency and Coinage", "Savings Banks", "Bills of Exchange and Promissory Notes" and "Legal Tender". Temporary legislation passed in the session of 1867-68 and supplemented by further enactments in 1869 and 1870 provided the initial post-confederation framework for the continued operation of the banking system which had previously developed in the confederated colonies. *An Act relating to Banks and Banking* was passed in 1871. This general banking legislation, since re-enacted with amendments approximately every ten years, has provided the continuing framework for banking in Canada.

Banks from the earliest statutes were required to keep a minimum of one-third of their cash reserves in the form of Dominion notes, and were subject to certain other restrictions on bank-note issue in the interests of stability and currency acceptability. In keeping with a long-established preference for short-term lending, these banks were precluded from mortgage lending, and were authorized to establish a system of branch banking "at any place or places in the Dominion". Regulation in the 1871 Act was confined to monthly returns to the government and to the issuance of certified shareholder lists.

A number of subsequent changes in banking legislation were intended to increase the security of members of the public in their dealings with Canadian banks. In 1890, for example, a Bank Note Circulation Redemption Fund was established. Banks, at this time responsible for issuing their own notes, were required to deposit 5 per cent of their average yearly note circulation with the Minister of Finance. This fund was used to redeem the notes of a failed institution if the liquidators failed to do so. In this manner, it was hoped that noteholders would be protected from losses caused by any discounting of their holdings.

The Canadian Bankers' Association (CBA) came into existence as a voluntary organization in 1891. In 1900, the CBA, with an initial membership of 34 banks, was incorporated with the objects of generally promoting the interests and efficiency of banks and bank officers, and of furthering the education and training of bank personnel. Through the 1900 *Bank Act* revision, the CBA was assigned certain functions including control by a curator over suspended banks pending the appointment of a liquidator. The CBA also received powers to establish and operate a clearing system for the Canadian banking community. This function was transferred to the Canadian Payments Association in 1980.

Proposals for some form of external supervision of Canadian banks were put forward as early as 1880. The first form of supervision involved the use of external auditors selected in a prescribed manner. In 1913, the *Bank Act* revision introduced the requirement for external auditors to be chosen from a panel selected by the Canadian Bankers' Association and approved by the Minister of Finance. Section 56 of the 1913 statute set out procedures for the appointment of the shareholders' auditor and described the responsibilities to be carried out. Section 56A authorized the Minister of Finance to require the shareholders' auditor or any other auditor selected by the Minister "to examine and inquire specially into any of the affairs or business of the bank, and the auditor so appointed or selected, as the case may be, shall, at the conclusion of

his examination and inquiry, report fully to the Minister the results thereof." By 1923, the bank audit provisions required two auditors for each bank selected from different firms and subject to replacement every two years. The auditors were required by the Act to report to the general manager and directors of the bank on any loan exceeding one per cent of paid-up capital which appeared to be inadequately secured.

Legislative changes of this nature corresponded to concern about the causes of early bank failures. The author of a major scholarly study of the growth and development of the Canadian financial system concluded that:

> ... loss of confidence in banks almost always resulted from their having made imprudent loans and investments or from suffering defalcations and almost never from external forces over which the banks had no control. It was hardly ever a case of having made good long term loans which could not be realized when depositors and noteholders for extraneous reasons demanded legal tender; but rather it was usually a case of having made imprudent loans (sometimes of a short term other times of a long term nature) which subsequently led to loss of confidence.

Shortly after the 1923 *Bank Act* revisions, the Home Bank of Canada, which had some 70 branches, failed. An inquiry under Mr. Justice H.A. McKeown was established, in February 1924, to investigate the collapse of the bank, and in particular, to consider what prior knowledge the Department of Finance may have had of the condition of the Home Bank, the effect of an audit under Section 56A of the *Bank Act, 1913* for the years preceding the failure of the bank, and "what steps, if any, could have been taken by the Government to save the situation."

The Commission reported in June 1924. In commenting on representations concerning the condition of the Home Bank made to the Department of Finance, Justice McKeown stated:

> It was therefore abundantly clear that the management of the bank had resulted in an amount over twice its paid up capital and reserve being locked up in accounts not realizable, and for the most part not bearing interest, from which it followed that whatever funds were available from day to day were those of depositors, and notwithstanding the declaration of dividends, a proper accounting would have shown that no profit at all had been made for years.

Commissioner McKeown reviewed the conduct of the Minister of Finance who was at the time directly responsible for supervisory proceedings. The Minister, in the view of Commissioner McKeown, exhibited "a lively apprehension ... concerning the position of the bank, and the desire to keep it upon its feet." The Minister had requested the bank's own auditors, rather than an outside auditor or one named by the Bankers' Association, to examine certain accounts, but no full report

was ever received. Commissioner McKeown concluded: "[I]t is inconceivable, I think, that the permission of the Department of Finance, or of the shareholders of the bank, could have been procured to countenance the continuation of the then conduct of the bank's affairs, as must have been disclosed by a thorough and effective audit." He expressed the view that apart from cooperation from the Bankers' Association or from other banks, the Government, after determining the true condition of the Home Bank, "could have closed the bank and forced liquidation at a time when, in my opinion, no loss would have fallen upon the depositors." The Commissioner concluded that had the government taken any action to cause an investigation of the affairs of the bank, it would have resulted inevitably in liquidation or amalgamation of the bank.

To increase the safety of deposits, a system of government inspection was introduced in 1924. The new legislation provided for the appointment of a person who had training and experience in the business of banking to be designated as Inspector General of Banks and to be responsible for annual inspections of each bank. He made his reports on each bank to the Minister of Finance. The first Inspector General had worked in the internal inspection division of the Royal Bank of Canada. The dual auditor system described above and the Inspector General's office have together provided the basic structure of banking supervision in Canada since that time.

In the period leading up to the next decennial revision of the *Bank Act*, a five-member inquiry chaired by the Rt. Hon. Lord Macmillan of the United Kingdom judiciary was established in 1933. The inquiry was instructed to prepare "a complete and detailed examination" of the *Bank Act* and of the functions and operations of the Canadian banking system. The terms of reference further stated that the examination:

> ... should include a study of the facilities now afforded by the Finance Act and a careful consideration of the advisability of establishing in Canada a Central Banking Institution, and, if so established, of the relation of such Central Banking Institution to existing banks and its proper authority and function in the operation of the banking system of Canada.

Following a survey of the evolution of the Canadian financial system and an analysis of its operational characteristics, the Macmillan inquiry directed its attention principally to "the absence in Canada of any single banking authority which, while linked by its activities with national finance and commerce, is nevertheless detached by its constitution and the temper of its administration from the ordinary pursuits of commercial banking". The functions of a central bank were described as follows:

> In the first place, from a national point of view, the central bank, within the limits imposed by law and by its capacities, should endeavour to regulate credit and currency in the best interests of the economic life of the nation and should so far as possible control and defend the external value of the national monetary unit. In the second place, from the international point of view, the central bank by wise and timely co-operation with similar institutions in other countries, should seek, so far as may lie within the scope of monetary action, to mitigate by its influence fluctuations in the general level of economic activity. These functions do not, of course, exhaust the tasks of a central bank. Within a state the central bank should, in addition, be a ready source of skilled and impartial financial advice at the disposal of the administration of the day.

Two members of the inquiry dissented from the Macmillan report's principal recommendation that a central bank for Canada be immediately created.

No mention was made of the relationship between the proposed central bank and the already existing Office of the Inspector General. Indeed the only reference in this extensive report is to a "provision made for government inspection" in the 1924 *Bank Act* as a result of the Home Bank failure. Two provisions of the original *Bank of Canada Act* deal with the relationship between the new Bank of Canada and existing inspection arrangements. To ascertain or confirm the reserve obligations of chartered banks with the Bank of Canada, the Bank could assign its own officers to conduct an inspection of the records of any chartered bank or it could authorize the Inspector General to conduct the necessary examination. In addition, the Minister was authorized "at his discretion" to call upon the Inspector General to examine the Bank "as the public interest may seem to require". The statute incorporating the Bank of Canada did not otherwise address the exchange of information between the OIGB and the Bank.

Several provisions of the 1934 *Bank Act*, including the requirement that each bank maintain a non-interest bearing cash reserve with the Bank of Canada of not less than 5 per cent of its deposit liabilities, were introduced in anticipation of the creation of the Bank of Canada. The Bank of Canada began operation in 1935. One of its functions was as a lender of last resort to banks with liquidity problems. In this role the Bank of Canada replaced earlier measures which had been adopted as emergency measures at the outbreak of World War I when several "runs" on the banks had occurred. The *Finance Act* of 1914 had authorized advances in the form of Dominion Notes from the Government of Canada to banks and to savings banks that were subject to the *Quebec Savings Bank Act*, where liquidity difficulties arose.

The longstanding prohibition against mortgage lending by banks was removed in the 1954 *Bank Act* revision. The existing restriction

reflected the traditional view that to ensure the safety of its note and deposit liabilities a bank's assets should be kept liquid. Loans therefore should generally be on demand or for short terms. The new legislation permitted chartered banks for the first time to participate in *National Housing Act* mortgages which were insured by the Government of Canada. In 1967 conventional mortgage lending (up to a 75 per cent limit on the value of the property) was authorized. This change was one of several introduced in 1967 following recommendations from the 1964 report of the Royal Commission on Banking and Finance under Chief Justice Porter.

This inquiry had been directed to report on the banking and monetary system and the institutions and operations of the capital market and to recommend legislative change as required. A central theme of its report in 1964 was the importance of sustaining and effectively regulating increased competition within the Canadian financial system which, as the inquiry clearly demonstrated, involved "overlapping of activity among institutions". The report recommended that the *Bank Act* be extended to cover a wider range of institutions which were engaged in banking.

The Commission on Banking and Finance also presented a comprehensive review of the supervision and regulation of banking institutions. The Commission concluded that "the main job of the government authority must be to stimulate the financial institutions to create their own internal regulation", and it recommended the extension of reporting, internal inspection, and outside audit requirements to all financial institutions under federal jurisdiction. In the view of the Commission certain additional powers were required in the *Bank Act* to require institutions to take such measures as were deemed necessary by regulatory authorities. A requirement for express ministerial consent and the availability of an appeal procedure would help to ensure the inquiry's objective that the proposed new regulatory power "should be used only sparingly and when attempts to persuade the institution concerned to modify unsound practices have failed." Other safeguards were elaborated:

> It is of course vital to phrase this recommended authority in such a way as to leave no doubt whatever that it relates only to the solvency and soundness of financial institutions. Its use should be accompanied by a formal statement from the supervising authority that it was being invoked for no other purpose, in order to ensure that it does not become a means for the government to direct financial institutions as to the types or amounts of assets that they must hold for reasons unrelated to the soundness of the institutions.

The proposed expansion of the *Bank Act* to cover institutions not previously within its provisions would require additions to the staff of

the OIGB. The Porter Commission rejected a proposal to replace the position of Inspector General with an inspection board. The Commission also addressed staff training requirements. In so doing, the Commission rejected consolidation of the OIGB within the Bank of Canada:

> The present difficulty mentioned to us by the Inspector General of training successors to the office could be met readily in an enlarged staff by careful selection of personnel. This would overcome a problem which has led to suggestions that the Inspector should be an official of the Bank of Canada where arrangements for training and succession could easily be made. In any case, the Inspector General can do his job best as an independent official not having other interests or responsibilities which may conflict with his work. For instance, it is easy to imagine circumstances in which the central bank and the Inspector General might have different views about the need for regulation of bank liquidity. Moreover, this change in the location of the office would deprive the Minister of a valued advisor thoroughly familiar with banking matters.

Following an extended process of legislative discussion involving several draft bills in 1965 and 1966, the revised *Bank Act* came into effect in May 1967. The Porter Commission's recommendation to adopt a clear definition of the essential characteristics of banking and to bring all institutions engaged in banking under federal supervision and control was not implemented. Of the inquiry's other proposals, many were adopted in the new banking legislation. It has already been noted that the 1967 revisions permitted banks to undertake conventional mortgage lending. In addition, and again following the advice of the Porter inquiry, the interest rate ceiling on loans by a bank (6 per cent since 1944) was removed.

Reporting or disclosure requirements were also modified in 1967 with the result that hidden reserves were eliminated. The Porter Inquiry devoted considerable attention to the complex and controversial question of these reserves:

> The present chartered banks, like other financial institutions and nonfinancial companies, may set up specific reserves out of pre-tax earnings to write down the value of particular assets to their estimated realizable value; as with other taxpayers, subsequent recoveries in excess of the written-down value of the accounts concerned must be taken into taxable income. The banks, however, may also set up contingency reserves out of pre-tax income to meet unforeseen future losses, the total of these two types of reserve being subject to a limit set by the Minister of Finance.

The existence of such reserves was widely regarded as a factor contributing to the stability of the Canadian banking system, yet the importance of disclosure to provide shareholders and the public with a reliable indication of earnings trends was also recognized. As a result of

the 1967 changes to the reporting schedules, information would become available to the Inspector General concerning accumulated inner reserves at the beginning of the year, additions during the year, withdrawals during the year, balance at year end, five year average of actual losses, and actual provision for losses during the year in excess of the five year average.

By means of the *Canada Deposit Insurance Corporation Act*, a federal scheme of deposit insurance was introduced in 1967. The legislation required federally regulated financial institutions, including the chartered banks and federally-incorporated trust companies who take deposits, to insure their deposits (initially $20,000 for each depositor) through premium payments to the CDIC. The CDIC was designed to operate on its insurance premiums and not on the basis of support from public funds. Provincially-regulated deposit-taking institutions were permitted to participate in the insurance arrangements subject to provincial government approval.

The most recent revision of Canadian banking legislation (the *Banks and Banking Law Revision Act, 1980*) was initiated in 1976 following the release of the *White Paper on the Revision of Canadian Banking Legislation.* The White Paper repeated the federal government's commitment to competition in the financial system:

> [T]he soundness of the basic approach to the strengthening and development of the financial system through effective and equitable competition was reaffirmed by the Porter Commission, was central to its recommendations, and remains the basic underlying objective of the government in its approach to banking legislation. ... An adequate level of competition will help to ensure that banking services are provided throughout the nation at the lowest cost to borrowers and the highest return to savers that are consistent with the survival and healthy growth of the country's financial system. Reliance on competition to achieve this objective avoids the use of restrictions which tend to dislocate markets and lead to inefficiency.

The 1980 *Bank Act* introduced a new type of bank called a Schedule "B" bank. The existing banks were classified by the Act as Schedule "A" banks. Schedule A banks, of which there are now 10, are widely held. No shareholder, whether a resident shareholder or a nonresident shareholder and his associates as set out in the Act, may own more than 10 per cent of the voting shares of a Schedule A bank. Schedule B banks in contrast are closely held in that individual shareholders and associates are permitted to hold in excess of 10 per cent of the voting securities. Schedule B banks may not open any branches, other than representative offices, outside Canada; nor, without the Minister's approval, may they open within Canada more

than a head office and one branch. The size of Schedule B banks has also been restricted, initially by a provision limiting their domestic assets to 8 per cent of total bank assets. The limit has recently been extended to 16 per cent of total bank assets. All Schedule B banks are now foreign-owned.

The background to the decision to incorporate the regulation of foreign banks within the general legislative framework of Canadian banking is again set out in the 1976 White Paper. After noting the existence in Canada of foreign bank affiliates primarily incorporated under provincial company laws, the White Paper provided this rationale for the conclusion that a legislative basis for regulating the operation of foreign banks in Canada was required:

> Foreign banks are to be encouraged because the additional competitive and innovative forces that they can bring to bear in the relatively highly concentrated Canadian banking system. They are to be encouraged too because of the additional financial support which they with their world-wide connections can bring to the development of our resource industries and trade. There is also the further consideration that if we provide a basis in law for the operation of foreign banks in Canada we can expect our own banks to obtain the reciprocal recognition in other countries which is necessary if they are to extend their participation in international markets as we would like.

When finally enacted in 1980, the latest revisions to Canadian banking legislation included the previously announced power to create a bank by a special act of incorporation or by letters patent, subject to capital requirements specified by the Inspector General. The minimum capital requirements are $5M and $10M for foreign and domestic Schedule B banks respectively. The approval of the Governor in Council and, in the case of a foreign bank subsidiary, a licence issued by the Minister, are required before a bank may commence or engage in the business of banking. The licence issued to a foreign bank subsidiary is valid for a specified time period not in excess of one year.

The 1980 amendments did not alter the OIGB although, prior to 1980, several new banks had been incorporated and, by virtue of the amendments, it was sure that others would follow. In fact, approximately 60 Schedule B banks came into existence between 1980 and 1984, frequently through the transformation of foreign-owned subsidiaries which had previously been operated in Canada on the basis of provincial incorporation. Despite the considerable increase in the OIGB's inspection responsibilities this enlargement of the banking community represented, no mention was made in the new *Bank Act* of 1980 of any expansion of the staff or other resources of the Inspector General.

For discussion of the duties and responsibilities of directors, officers, auditors and regulators of Canadian banks as set out in the *Bank Act*, see Chapter 3 of this Report.

Table A.1

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Commercial Bank of Canada (1831)	Merged with Merchants Bank of Canada (1868)
Commercial Bank of New Brunswick (1834)	Failed (1868)
Gore Bank (1835)	Merged with The Canadian Bank of Commerce (1870)
Bank of Acadia (1872)	Failed (1873)
Niagara District Bank (1855)	Merged with Imperial Bank of Canada (1875)
City Bank (1833)	Merged (1876)
Royal Canadian Bank (1864)	Merged (1876)
Metropolitan Bank of Montreal (1871)	Failed (1877)
Bank of Liverpool (1871)	Failed (1879)
Consolidated Bank of Canada (1876)	Failed (1879)
Mechanics Bank (1865)	Failed (1879)
Stadacona Bank (1873)	Failed (1879)
Bank of Prince Edward Island (1865)	Failed (1881)
Exchange Bank of Canada (1872)	Failed (1883)
Union Bank of Prince Edward Island (1860)	Merged with The Bank of Nova Scotia (1883)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Bank of London in Canada (1883)	Failed (1887)
Central Bank of Canada (1883)	Failed (1887)
Federal Bank of Canada (1872)	Failed (1887)
Maritime Bank of Dominion of Canada (1872)	Failed (1887)
Pictou Bank (1873)	Failed (1887)
Commercial Bank of Manitoba (1884)	Failed (1893)
Banque du Peuple (1843)	Failed (1895)
Banque Ville Marie (1872)	Failed (1899)
Bank of British Columbia (1862)	Merged with The Canadian Bank of Commerce (1900)
Summerside Bank (1866)	Merged with Bank of New Brunswick (1901)
Commercial Bank of Windsor (1865)	Merged with Union Bank of Halifax (1902)
Exchange Bank of Yarmouth (1867)	Merged with Bank of Montreal (1903)
Halifax Banking Company (1872)	Merged with The Canadian Bank of Commerce (1903)
Bank of Yarmouth (1859)	Failed (1905)
Peoples Bank of Halifax (1864)	Merged with Bank of Montreal (1905)
Merchants Bank of Prince Edward Island (1871)	Merged with The Canadian Bank of Commerce (1906)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Ontario Bank (1857)	Merged with Bank of Montreal (1906)
Peoples Bank of New Brunswick (1864)	Merged with Bank of Montreal (1907)
Banque de St. Hyacinthe (1873)	Failed (1908)
Banque de St. Jean (1873)	Failed (1908)
Crown Bank of Canada (1902)	Merged with The Northern Bank to become the Northern Crown Bank (1908)
Sovereign Bank of Canada (1901)	Failed (1908)
Western Bank of Canada (1882)	Merged with Standard Bank of Canada (1909)
Union Bank of Halifax (1856)	Merged with The Royal Bank of Canada (1910)
Farmers Bank of Canada (1904)	Failed (1910)
St. Stephens Bank (1836)	Failed (1910)
United Empire Bank (formerly Pacific Bank of Canada) (1903)	Merged with Union Bank of Canada (1911)
Eastern Townships Bank (1855)	Merged with The Canadian Bank of Commerce (1912)
Traders Bank of Canada (1884)	Merged with The Royal Bank of Canada (1912)
Bank of New Brunswick (1820)	Merged with The Bank of Nova Scotia (1913)
La Banque Internationale du Canada (1911)	Merged with Home Bank (1913)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Bank of Vancouver (1908)	Failed (1914)
Metropolitan Bank (1902)	Merged with The Bank of Nova Scotia (1914)
Quebec Bank (1822)	Merged with The Royal Bank of Canada (1917)
Bank of British North America (1836)	Merged with Bank of Montreal (1918)
Northern Crown Bank (1903)	Merged with The Royal Bank of Canada (1918)
Bank of Ottawa (1874)	Merged with The Bank of Nova Scotia (1919)
Merchants Bank of Canada (formerly Merchants Bank) (1861)	Merged with Bank of Montreal (1922)
Bank of Hamilton (1872)	Merged with The Canadian Bank of Commerce (1923)
Home Bank of Canada (1903)	Failed (1923)
La Banque Nationale (1859)	Merged with La Banque d'Hochelaga (later Banque Canadienne Nationale) (1924)
Sterling Bank of Canada (1905)	Merged with Standard Bank of Canada (1924)
The Molsons Bank (1855)	Merged with Bank of Montreal (1925)
Union Bank of Canada (formerly Union Bank of Lower Canada) (1865)	Merged with The Royal Bank of Canada (1925)

Table A.1 (cont'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
Standard Bank of Canada (1872)	Merged with The Canadian Bank of Commerce (1928)
Weyburn Security Bank (1910)	Merged with Imperial Bank of Canada (1931)
The Dominion Bank (1869)	Merged with The Bank of Toronto to become The Toronto-Dominion Bank (1955)
Barclays Bank (Canada) (1929)	Merged with Imperial Bank of Canada (1956)
Imperial Bank of Canada (1873)	Merged with The Canadian Bank of Commerce to become the Canadian Imperial Bank of Commerce (1961)
Unity Bank (1972)	Merged with Banque Provinciale du Canada (1977)
Banque Provinciale du Canada (formerly Banque Jacques Cartier) (1861)	Merged with Banque Canadienne Nationale (1979)
Canadian Commercial Bank (formerly Canadian Commercial and Industrial Bank) (1975)	Failed (1985)
Northland Bank (1975)	Failed (1985)
Mercantile Bank of Canada (1953)	Merged with Banque Canadienne Nationale (1986)
Bank of Montreal (1822)	Still active
Bank of Nova Scotia (1832)	Still active
Toronto-Dominion Bank (formerly The Bank of Toronto) (1855)	Still active

Table A.1 (conc'd)

Growth and Change in the Canadian Banking Community
(excluding banks whose charters were never used,
and Schedule B banks created since 1980)

Name of Bank and Date of Founding	*History*
The Canadian Imperial Bank of Commerce (formerly Canadian Bank of Commerce) (1867)	Still active
The Royal Bank of Canada (1869)	Still active
Banque Canadienne Nationale (formerly La Banque d'Hochelaga) (1873)	Still active
Bank of British Columbia (1967)	Still active
Continental Bank of Canada (1977)	Still active
Western & Pacific Bank of Canada (1983)	Still active
Bank of Alberta (1984)	Still active

From 35 active banks at the end of Confederation year, the Canadian banking system expanded to include 51 active banks in 1874, a nineteenth-century peak not exceeded until the introduction of Schedule B banks following the 1980 revisions.

From Confederation to 1900, 24 banks disappeared. Seven of these were merged out of existence, while 17 failed or had their charters repealed. An amendment introduced by the *Bank Act* of 1900 eliminated the requirement that mergers take place only by special act of Parliament. Thereafter, mergers required only the approval of the Governor in Council pursuant to a recommendation of Treasury Board. The significance of this change is evident in the statistics on disappearing banks from 1900 to 1926 when mergers accounted for the disappearance of 27 out of 35 banks. Eleven banks remained active in 1926.

The failure of the Home Bank and a series of mergers in the early 1920s had reduced the number of banks active in Canada from 18 at the outset of the decade to 11 by the end of 1925. In the succeeding four decades, only the formation of the Mercantile Bank of Canada in 1953 altered the measured decline in the number of Canadian banks to a 1961 low of eight institutions. In the late 1960s however, interest in the formation of new banks revived. The Bank of British Columbia was established in 1967 along with the Bank of Western Canada which never came into operation. The Unity Bank of Canada was established in 1972.

At the Western Economic Opportunities Conference in July 1973, further pressure for the creation of new banks came from the western provinces. In a joint submission, the governments of the four western provinces stated:

> The branch banking system, characterized by the five major Canadian chartered banks with branches coast to coast, and head offices in central Canada, has not been adequately responsive to western needs.

To alleviate what they regarded as a bias towards the interests of central Canada on the part of the major chartered banks, the western provinces urged the formation of independent regional banks in Western Canada:

> Western-based banks in which there was a degree of public participation would be more sympathetic to the needs of residents of the West and the major chartered banks. In particular, they could provide a substantially greater amount of financial capital than in the past to rural and urban communities and would facilitate an expansion of the productive capacities of the western provinces' economies. They would infuse effective competition into the banking industry in the securing of deposits and the making of loans and by extending considerably greater assistance to small-scale and risky ventures. Increased competition for business would induce the established chartered banks to improve the quality of services provided to residents of Western Canada.

Citing the experience of the Bank of British Columbia, then Minister of Finance John Turner expressed his sympathy for the creation of more western banks, and indeed more banks generally, to enhance competition. He announced the willingness of the federal government to recommend that the incorporation of new banks be permitted through letters patent to eliminate the cumbersome and expensive special act requirements of existing legislation.

The Canadian Commercial Bank (initially the Canadian Commercial and Industrial Bank) and the Northland Bank were created in 1975. Parliament granted the CCB charter on 30 July 1975. The Northland Bank obtained its charter on 20 December 1975. The

Continental Bank of Canada came into existence in 1977. All of these banks were established by act of Parliament. Two more small western banks were granted letters patent in 1983 and 1984.

Although the last Canadian chartered bank to fail before the events leading to the appointment of this Commission was the Home Bank in 1923, it would be wrong to equate this 60-year lull in bank failures with a completely untroubled banking scene. Nine further banks had ceased operating between 1924 and 1977. After a few years of operation the loan portfolio of the Unity Bank of Canada deteriorated significantly. When Unity's problems persisted despite a change in management, and in the light of unfavourable media commentary, the OIGB participated in discussions aimed at obtaining liquidity funding from the Bank of Canada and the CDIC. This liquidity support provided temporary stability and permitted the eventual merger of the Unity Bank in 1977 with the Provincial Bank (which in 1979 merged with the National Bank of Canada). The restructuring of the Canadian banking system through merger has continued, most recently involving the merger of the Mercantile Bank of Canada with the National Bank of Canada in 1986.

It is further relevant to note that since the late 1960s, the CDIC has been actively involved in working out, by one means or another, difficulties in a number of trust and loan companies which raise many of the same problems as bank failures.

Appendix B

Bank Supervision in the United Kingdom and the United States

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Appendix B

Bank Supervision in the United Kingdom and the United States

A. THE UNITED KINGDOM

1. The Financial System

The financial system of the United Kingdom is made up of a central bank, that is The Bank of England, (hereafter the Bank) commercial banks, merchant banks, and savings banks. In addition, there is a host of lesser, specialized financial institutions such as credit unions, building societies, and discount houses. Under the *Banking Act, 1979*, two categories of institutions are authorized to take deposits; "recognized banks" and "licensed deposit-taking institutions" (LDTs).

Of the 290 recognized banks and 315 LDTs operating in the United Kingdom at 28 February 1985, 250 were overseas institutions with U.K. branches, 65 were subsidiaries of overseas institutions and 24 were joint venture operations between overseas and, in some cases, U.K. institutions.

Under s. 3 of the *Banking Act, 1979*, the Bank of England is responsible for the recognition and licensing of banks and LDTs. It is not clear from materials available to the Commission to what extent the political processes play a role in the decision whether to allow new institutions to be licensed. However, certain objective minimum criteria are set out in Schedule 2 to the Act, and the Bank is directed to refer to these in making its decision. These criteria include, in the case of recognized banks, "a high reputation and standing in the financial community", provision of either a wide range of banking services including deposit-taking, overdraft or loan financing, foreign exchange services, commercial financing and financial advice, or provision of a highly specialized banking service. In addition, a bank is required to be carried on with integrity, prudence and the necessary professional skills, to be effectively directed by at least two individuals, to have net assets of at least £5M, if it will provide a wide range of services, or £250,000, if it will provide highly specialized services, and to maintain what the

Bank determines are appropriate levels of paid-up capital and reserves. Because of the requirement relating to reputation and standing, recognition as a bank is granted only to those institutions with proven track records. No matter how fully capitalized a new institution may be, it cannot enter the market as a bank without having spent a period of time under the LDT designation.

The licensing criteria for LDTs are less onerous. An LDT must be controlled by at least two persons who are "fit and proper" to hold their positions, must possess net assets of at least £250,000 and must carry on business in a prudent manner, maintaining a level of assets determined to be appropriate by the Bank and adequate liquidity, and making adequate provision for doubtful debts and contingent obligations.

The English system prior to the mid-1960s was composed of institutions informally recognized by the banking community as banks, and other deposit-taking institutions, which were not banks properly so called. Whether an institution was a "bank" was determined mainly by the banking community and the Bank, which would grant a series of "recognitions" to the institution, and only secondarily according to legislative criteria. Only banks were subject to the ongoing, but quite informal supervision of the Bank of England.

This arrangement had become confused by the mid-1970s, due to a conjunction of economic and legislative factors. These conditions culminated in a series of events known as the "secondary banking crisis". Liquidity problems affecting a nonbank deposit-taking institution which was not formally regulated or supervised by the Bank led to a lack of confidence in all such institutions, and threatened to infect the banking system proper as well. A support strategy, called "the lifeboat" (described in greater detail below) was put in place to avert this threat to the system, and in 1979, the *Banking Act* was amended to institute the formal, two-tiered system now in place. It was intended that the divisions would serve to put the public on notice that certain institutions are not as mature as others and, in addition, would allow a two-tiered system of supervision; that is, recognized banks would be subject to a less formal supervisory regimen than LDTs. In recognition of their often greater riskiness, LDTs would be subject to more detailed supervision by supervisors operating with a heightened state of awareness.

The two-tiered system has recently been criticized by the Committee Set-Up to Consider the System of Banking Supervision. The Committee wrote, with the benefit of the Johnson Matthey experience (described in greater detail below) that the system had not been

successful in achieving its objectives. This conclusion was accepted by the Government in its White Paper on Banking Supervision.

The current U.K. system of bank supervision reflects an apparent preference for voluntary self-regulation. The legislators in the United Kingdom recognize that the reduction (but perhaps not the elimination) of risk of loss to depositors is necessary in the interests of the requirement of financial stability. However, the legislators do not accept that the answer to risk reduction is a complex set of regulations. Rather, financial institutions in the United Kingdom are expected to maintain sound practices independent of regulation. Unhappily, reliance upon a purely self-regulatory system has proven increasingly hazardous and the government has expanded, and plans further use of, imposed prudential controls. However, the heavy costs associated with a more paternalistic regulatory scheme have caused Parliament to move reluctantly from self-regulation until a clear need is established.

2. Supervision of Banking in the United Kingdom

The Bank was established in 1694 by a charter granted under letters patent pursuant to an Act of Parliament, and in 1946, was brought into public ownership. The formal head of the Bank is the Chancellor of the Exchequer although, within the staff of the Bank, the Governor is the chief official. The Governor is appointed by the Queen on the advice of the Prime Minister for a renewable five-year term. By tradition, the Governor has usually been a senior banker drawn from the merchant banks. The Governor sits at the head of the "Court of Directors". Apart from the Governor, the directorate is comprised of the Deputy Governor, four executive directors and twelve individuals from outside the Bank, each appointed for a renewable four-year term. At the present time these directors control all functions of the Bank.

The Bank's principal functions are those common to many central banks. These responsibilities include the management of currency issuance, foreign exchange reserves and the national debt, the provision of advice to government on monetary and economic policy, the responsibility to act as banker to the government, the responsibility as lender of last resort and the duty to regulate the banking system. The Bank also has a large role in the deposit protection scheme, which secures up to 75 per cent of the first £10,000 of a depositor's deposits with any one institution. Pursuant to Schedule 5 of the *Banking Act, 1979*, the "Deposit Protection Board" comprises the Governor, Deputy Governor and Chief Cashier of the Bank, plus three persons appointed from the contributory institutions. The insurance fund is financed by a charge on all authorized institutions in proportion to their deposit base.

The Banking Supervision Division of the Bank is responsible for supervising both LDTs and recognized banks. In 1985, this Division employed 94 people directly in an analytical or supervisory role and a further 36 in a supporting capacity. The Bank's method of supervision of all recognized banks involves both quantitative and qualitative analysis. Supervision is based upon the systematic analysis of regular (usually quarterly) statistical returns and, also, regular prudential discussions with management.

The statistical returns are, generally, intended to elicit pertinent information respecting three main aspects of a bank's performance; capital adequacy, liquidity, and portfolio distribution. The Bank obtains a variety of quarterly returns dealing with (a) the capital base, the profit and loss development over the latest quarter, the operating expenses, loans and advances, income from fees and commissions, large exposures, and any form of connected lending; (b) the liquidity position and maturity analysis of liabilities and assets; and (c) a maturity analysis of liabilities and assets in currencies other than sterling. A balance sheet return is provided monthly by major banks and quarterly by smaller institutions. Other returns require breakdowns of provisioning for losses, sovereign debt exposure, and so forth. These various returns are not required to be audited but they must be certified to be true by a director or senior officer of the reporting institution.

The Banking Supervision Division has set out for the banking industry its approach to the assessment of capital adequacy, liquidity and portfolio distribution in three papers published by the Bank in or about September 1980, July 1982, and April 1981. The Bank's assessment of capital adequacy of banks incorporated in the United Kingdom is based upon two ratios, the "gearing ratio" and the "risk asset ratio". The former relates current, noncapital liabilities to the bank's adjusted capital base. The latter, which is regarded by the Bank as the more important for supervision purposes, measures the adequacy of capital in relation to the bank's exposure to risk of losses.

In the calculation of the "risk asset ratio", weightings are ascribed to various classes of assets according to their susceptibility to the risk of loss. The adjusted capital base is measured against the total of weighted assets, and a ratio is set for each bank having regard to its particular character and its exposure to various categories of risk, including risk arising from concentration.

The Bank does not set uniform liquidity guidelines for banks. It has been accepted that liquidity needs must be determined by individual circumstances. Liquidity assessments by the Bank take into account, for

example, an institution's cash flow provided by maturing assets, its holdings of marketable assets, the structure of its deposit base, and any standby facilities which can be counted on as a reliable source of funds in times of difficulty. Portfolio distribution is carefully watched. For instance, the Bank requires a bank to justify exposures to a single borrower or a group of closely related borrowers in excess of 10 per cent of the lending bank's capital base. The Bank has also proposed an absolute limit of 25 per cent on such exposures. These limits do not apply to inter-bank, country or sectoral exposures, which are watched separately.

Systematic analysis of statistical returns is supplemented by a less systematic interview and discussion procedure. At these "prudential interviews" senior management of the supervised institutions are evaluated and asked for further information concerning such matters as quality of capital, profitability, and business prospects. "Prudential interviews" do not necessarily occur after each quarterly return. For LDTs, the interview process may occur between two and four times a year. For branches of overseas banks, there may be only a single interview annually. Interviews for larger banks vary in frequency, but usually occur several times a year. In light of obligations imposed on the United Kingdom in 1983 under the European Communities Consolidated Supervision Directive, the Bank of England has reviewed its approach to the consolidated supervision of groups containing a bank. "Where a bank is part of a group, supervision of the bank must encompass the activities of the other group companies since their strengths and weaknesses will have implications for the soundness of the bank."

Charles F. Green of the National Westminster Bank stated that at his bank such interviews take place at three levels. One of the senior executive directors of the central Bank has a bi-annual meeting with the chief executive of the National Westminster group to discuss general strategies, performance, and prospects. At the second level, the heads of the major operating divisions of the National Westminster group attend at the Bank twice a year to report on operations. The third level of interviewing is conducted with the subsidiary banks belonging to the National Westminster group. The questioning at the third level is more detailed and specific and the chief executives of the subsidiaries are expected to disclose the performance of their banks as frequently as twice a year. Section 17 of the *Banking Act, 1979* provides a broadly worded authority for on-site inspection where it appears desirable in the interests of depositors. The Banking Supervision Division does not, however, carry out on-site examinations on a routine basis, and the power has in fact rarely been exercised.

The *Banking Act, 1979* imposes no special auditing requirements on recognized banks. All such institutions are subject to the same auditing requirements as are imposed on U.K. companies in general. Every corporation has a duty to appoint a properly qualified, professional accountant to conduct an annual audit. Most recognized banks in the United Kingdom employ one firm of external auditors, although because of past mergers some of the largest banks may employ two or more external auditors to review their financial statements. The most startling aspect of the role of the external auditor in the United Kingdom is that, at writing, the auditor has no duty to report or provide any information whatsoever to the supervisory staff at the Bank. This is so because of the traditional observance of strict laws against disclosure of information about bank customers, auditors' information, and banking information generally. The banking supervisors have no control over the appointment or removal of the external auditors and cannot seek disclosure from the auditors of information respecting any aspect of the condition of the supervised institution. This prohibition on dialogue between the auditors and supervisors has been recognized as a significant weakness in the existing system of supervision. Legislation is anticipated shortly which will enable and encourage communication between auditors and regulators.

The supervision method of the Bank cannot be characterized as being immediate or direct. There are no first hand examinations of asset quality. Country and sectoral exposures of supervised institutions, their profitability, managements, control systems, loss provisioning practices, and so forth are all evaluated at some distance by means of information returns or discussions which are only as detailed as management might feel compelled to make them. Furthermore, the present system of supervision in the United Kingdom provides no specific tools to enforce compliance by banks with directions of the Bank except the threat of revocation of authorization. To date, moral suasion has been the Bank's principal tool of enforcement.

3. "The Lifeboat" and the Johnson Matthey Bankers Failure

By the early 1970's, the British banking system's traditionally informal structure had permitted a large number of nonbank deposit-taking institutions to be established. These were not subject to Bank of England supervision and control, but were certified as banks for limited statutory purposes under the *Companies Act, 1967* on the basis of functional tests which did not assess the quality of their operations. In an era of speculative activity in property development, these companies became increasingly dependent upon money market funds.

Liquidity problems developed when at least one of these nonbank institutions was unable to renew essential money market deposits. This led to a crisis of confidence which rapidly infected other nonbank deposit taking institutions, and would, it was feared, have extended into the banking system proper. To counter this threat, the Bank, in conjunction with English and Scottish clearing banks, mounted a rescue operation. The Bank responded immediately to the crisis with a variety of *ad hoc* arrangements to deal with the initial casualties. It later moved to create a more formal structure, consisting of a Control Committee composed of senior representatives of the Bank and the clearing banks under the chairmanship of the Deputy Governor of the Bank. This Committee was colloquially referred to as "the lifeboat".

Investigation of a problem institution was carried out by the bank identified as having the closest business connection with the troubled institution. That bank would report back to the Committee, which would then decide whether to provide support. According to a Bank of England Quarterly Bulletin, the criteria upon which this decision was based were straightforward. The Committee had to be satisfied, on the basis of the best available evidence, that the institution was trading solvently and would remain in that state with the provision of liquidity support. Second, a judgment was made as to whether the institution had "sufficient banking characteristics" and had attracted "a significant level of deposits from the public". Finally, the Committee would make advances only if the institution had no institutional shareholders which might themselves provide liquidity support. It was recognized in this process that some problem institutions would be allowed to fail. Varying degrees of support were eventually given to 26 companies, of which a small number were authorized banks. The total advanced amounted to approximately £1.2B. Eight of the companies receiving support were ultimately placed in receivership or liquidation, and only four, by June 1978, were still relying on lifeboat funds.

Where liquidity support was given, measures such as the recycling of withdrawn deposits through the clearing banks and back to the original bank, and liquidity loans from the Bank and the participating clearing banks were used. The risk was in most cases shared by all members of the Committee based on a formula which took account of the relative size of their eligible liabilities. The Bank coordinated the provision of support. Interest was charged on the advanced funds at a commercial rate. This was intended as an incentive to the institution to regenerate its own funding capability. Where necessary, this strategy was modified to recognize the risk of prejudice to the supported institution's ability to survive. Security was taken for the support lending where appropriate and available.

In 1975 and 1976, Bank programs were extended without participation by the other members of the lifeboat. In two cases of particular significance, banks which were part of large groups with diverse interests were acquired in reconstruction schemes, and are still owned by the Bank. The Bank has retired the claims of depositors over a period of time and realized upon the loan portfolio to the extent possible. The extent of the exposure of the Bank in these two bank failures is not disclosed but the impact upon the banking community and the banking regulatory community was unquestionably extensive and fundamental.

The second crisis to affect the British banking system occurred in the autumn of 1984 when the Bank was faced with the sudden insolvency of Johnson Matthey Bankers Limited (JMB). JMB was a recognized bank established in 1965 to conduct the banking and bullion business of Johnson Matthey p.l.c., a member of the London Bullion Market. JMB's business was concentrated in bullion, foreign exchange, and trade finance. No attempt was made to diversify its business, although it did become involved in other financial services through the purchase of subsidiaries.

Mainly as a result of disastrous downturns in the performance of a few large loans, JMB's loan portfolio was, by mid-1984, in such a state that provisions for losses required against bad debts would wipe out its capital and reserves. The inadequacy of management and internal controls at JMB had contributed to this situation. The Bank of England, subsequently reported that insufficient attention had been paid to the concentration of risks (the two largest loans contributing to the failure were together, by 1984, equivalent to more than 100 per cent of the bank's capital base), that normal banking practices relating to the taking of security were not followed, and that where security was taken, appropriate steps to ensure the Bank's claim were not always taken. Additionally, the Bank found that JMB's management had failed to exercise proper caution in deciding on the need for provisions against bad or doubtful debts (JMB had adopted the unusual policy of not taking provisions on a loan-by-loan basis, but of writing off losses as they actually occurred), and had shown poor judgment in approving so many loans which ultimately turned out to require substantial provisions.

At the Bank's regular prudential interviews with JMB management in 1983 and 1984, inadequate liquidity and the scale of JMB's exposures were raised as concerns, but these matters seemed to have been dealt with to the Bank's satisfaction. The Bank's appreciation of the true state of affairs at JMB, however, was substantially diminished

by the fact that reporting from the bank was both late and seriously inaccurate. Thus by the time the Bank was informed by JMB of its impaired state, only limited courses of action remained open to the supervisors.

The first step taken was to have JMB's external auditors, and then a team from the clearing banks, review a wide cross-section of the loan portfolio of the bank. These two investigations revealed that the necessary provisioning would more than exhaust JMB's capital. This finding was confirmed independently by auditors hired by the Bank. It being clear that more than provision of liquidity support would be required to revitalize the bank, the Bank attempted to find a buyer to recapitalize it, but with no success. All these steps were taken in secrecy, between the 25th and the 30th of September 1984. The Court of Directors of the Bank then decided to purchase (in effect to nationalize) JMB and its subsidiaries for a nominal sum and, thereafter, to write off the enormous loan losses. Johnson Matthey p.l.c. agreed to provide £50M, and undertakings to contribute support were also secured from the other banks and members of the gold market. The Bank provided JMB with an indemnity of up to £150M to meet losses, and made a temporary deposit of £100M. The other banks and gold market members agreed to counter-indemnify the Bank for a total of half of any such losses, to be shared among the various categories of contributors according to a prearranged formula. Once the Bank had acquired JMB, the board of directors was reorganized. The new Chairman was an executive director of the Bank, and other new board members had varied banking experience. New executive, credit, audit, and staff committees were formed. The new board became involved in reviewing in detail the loan portfolio and in establishing the necessary level of provisioning against bad debts. Comprehensive review and restructuring of lending operations was commenced with the assistance of some 35 secondees from other banks and outside consultants. With disposition of JMB in mind, the Bank announced, prior to its year end in February 1985, a reorganization of JMB's capital base, involving the cancellation of 75 million issued and unissued ordinary shares and subscription by the Bank of £75M in fresh equity.

The decision to rescue JMB, a relatively small and specialized bank, was apparently made by the Bank, the commercial banks and the other members of the gold market in the belief that the failure of JMB would have had an injurious effect on the London gold market, and that the crisis of confidence which might have occurred could have spread to other British banks and possibly also to banks elsewhere. Underlying all of this was a desire not to damage London's standing as the world's most important international gold market, a consciousness of the

precariousness of confidence in financial markets generally following the Continental Illinois crisis in the United States, and a fear that a run on British banks would damage the pound.

4. Proposed Changes to United Kingdom Bank Supervision

It was widely agreed that the circumstances surrounding the lifeboat and the JMB rescue exposed the adequacy of the Bank's supervision system to question. Consequent upon the collapse of JMB, a Committee, led by the Governor of the Bank and including other members drawn from the Bank and a crown corporation not engaged in banking, was set up to consider the supervisory system and whether any changes in supervisory procedures were required. In particular the Committee was asked to examine the relationship between external auditors and supervisors, the handling of concentrations of risk and the assessment of the quality of assets, the notification process and collection of statistics, the adequacy of Banking Supervision Division of the Bank of England, and whether the *Banking Act, 1979* required changes. The Committee made various recommendations in June 1985.

The Committee did not examine in any detail the merit of changing to a basically different supervisory system. It was concluded that there were no fundamental flaws in the system of supervision in the United Kingdom but that certain improvements could be devised to correct some existing weaknesses.

The Committee founded its work upon certain fundamental assumptions which have value in a discussion of the Canadian system of bank supervision. Concerning the principles of U.K. bank supervision, the Committee stated:

> Continued reliance on a flexible system has three major implications. First, if the Bank is not itself to carry out detailed inspections of banks' books, it must be able to rely on the assistance and cooperation of the professional firms who do carry out this task: the bank's auditors. We believe it is important that coordination and contact between supervisors and auditors be improved in a number of ways. Secondly, it requires the continued cooperation of the banks which are supervised. We believe that the existing high level of cooperation between the banks and the supervisors can be maintained and that banks will remain responsive to the concerns of the supervisors. The system cannot, however, rely totally on this responsiveness in all circumstances; the supervisors must have adequate powers to deal with cases where this cooperation is not forthcoming. Thirdly, we believe that for the proper working of the present system, it is essential to improve the capacity of the supervisors to exercise the crucial qualitative judgments on the management, the loan book, the adequacy of capital and other elements of the business of the banks which they are supervising.

The Committee recommended that the present two-tiered system of authorization be replaced by a single authorization to take deposits and that new, stricter criteria for authorization be imposed; that communications between management, supervisors and auditors of banks be improved through the introduction of a mechanism to enable a regular dialogue between supervisors and auditors free from confidentiality restraints, in exceptional circumstances without the presence of representatives of the particular bank; that the Bank should be granted the power to require that, when necessary, statistical returns used for supervisory purposes be examined by the auditors; and that the Bank be empowered to demand a second audit of a bank's accounts where that bank's auditors are considered incompetent or negligent.

In relation to the supervision of asset quality, the Committee recommended that the Bank improve its methods for evaluating banks' control systems, increase the visits to banks and undertake, more readily than before, detailed investigations of problem banks. The Committee also recommended that the Bank tighten procedures to ensure that statistical information is returned in a timely fashion, and to improve the performance of the Banking Supervision Division by increasing numbers of staff and upgrading staff qualifications.

Many of the Committee's recommendations were adopted in the White Paper on Banking Supervision recently tabled in Parliament by the Chancellor of the Exchequer. The White Paper concentrated on improving the existing supervisory regime by strengthening those features which have a direct bearing on the flow of accurate and worthwhile prudential information to competent supervisors.

Certain of the White Paper recommendations merit comment. Consideration was given by its authors to separating the function of banking supervision from the the Bank. Advantages, such as the avoidance of conflicts of interest and the desirability of focusing talent and discussion in a specialized bank supervision body, were discussed. However, radical restructuring of the basic British supervisory system was rejected. Instead, it was recommended that in order to achieve some independence from the Bank for the supervisors, banking legislation provide for a body within the Bank, the Board of Banking Supervision, to assist the Governor of the Bank in banking supervisory activities. The Board is to consist of the Governor and Deputy Governor of the Bank and the Executive Director responsible for Banking Supervision as permanent *ex officio* members, together with five other members selected by the Governor of the Bank with the agreement of the Chancellor of the Exchequer from outside the Bank. In the main, these members would be retired senior bankers and members of the legal and

accounting professions. The aim is to integrate regulatory, banking, legal and accounting perspectives. The Board's responsibility is to report on banking supervision matters directly to the Governor. Its mandate is proposed to cover review of principles of banking supervision relating to such matters as capital adequacy and liquidity, review of developments in supervisory practice, administration of new supervisory legislation, and staffing and training of the Banking Supervision Division of the Bank. Its functions would include review of the regular reports from the Supervision Division and reporting to the Governor on these, including, where required, reference to individual cases. Should the Governor choose not to follow the advice of the Board, the Governor would be required to so report to the Chancellor of the Exchequer.

In addition to grafting this new forum onto the Bank of England structure, the White Paper recommends upgrading and increasing the staff of the Banking Supervision Division. In particular, it is recommended that there be appointed to the staff persons with accounting and legal training, and that by secondment, experienced banking personnel should join the staff of the Supervision Division. Conversely, members of that staff should be seconded to the banks for banking experience.

In short, the White Paper recommendations propose to increase the level of mandatory reporting to the Bank's supervisors, and to increase the effectiveness of that reporting through greater supervisory expertise and increased liaison between the supervised banks and the supervisors. Reliance on confidential supervision is maintained, and an on-site investigative model used in the United States was specifically rejected. If the White Paper proposals are implemented, the British banking system will continue to rely heavily on bank self-regulation, but in a strengthened system with prudential limitations imposed through an increased scope of regular mandatory reporting, backed up by criminal sanctions.

Some criticism of the U.K. proposals for change has come from financial commentators. Their attack is largely on the basis that the proposed changes deal only with the mechanical aspect of the system and not with the fundamentals. They have criticized the supervision system for being a closed circuit with little or no information getting out to investors, depositors, customers and the public generally concerning the state of the banks. Comparisons are drawn between the amount of disclosure required of U.K. banks and the Bank of England and disclosure requirements in the United States. The comment was made in the Financial Times of London on 18 December 1985: "None of this information concerning nonperforming loans, reserves and so on is required of British banks except ironically, three or four clearers, who

have chosen to issue securities in New York and thus to meet the New York Stock Exchange standard." The article concludes: "Secrecy is a moral hazard to central banking itself." Thus tension persists between the essential security of the bank in the community and the concomitant need of the community for information concerning bank security so that appropriate and timely curative action may be taken by the community to preserve that very security.

B. THE UNITED STATES OF AMERICA

1. Introduction to Bank Supervision in the United States

The banking system of the United States is staggeringly large and complex. So too is the banking regulatory system. At the end of 1983 there were 4,772 commercial banks established under federal laws and 9,691 commercial banks established under state laws. According to the 1984 Report of the Task Group on Regulation of Financial Services (the "Bush Task Group"), 80 per cent of U.S. commercial banks were minor entities, having assets of $100M (U.S.) or less; and 40 per cent had assets of $25M (U.S.) or less. The U.S. banking regulatory system has grown to the point that the seven federal agencies which operate the federal system have more than 38,000 full time employees. The three main federal banking agencies, the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (COC), and the Federal Deposit Insurance Corporation (FDIC), have more than 7,000 full time employees engaged in purely regulatory activity, including the supervision and other aspects of the regulation of banks. These three principal federal banking agencies spent approximately $173M (U.S.) on examinations alone during 1982, and in 1985, this figure is estimated to have reached $204M (U.S.). There is no readily available information as to the amount spent annually on examinations by the state regulatory authorities, however, statistics provided by the Conference of State Bank Supervisors reveal that the projected 1986 consolidated budget for 50 state banking agencies is approximately $250.5M (U.S.)

A variety of deposit-taking institutions operate in the United States. In the order of their respective market shares these deposit-taking institutions include commercial banks, savings and loan associations, savings banks (referred to generically as "thrift institutions"), and credit unions. These deposit-taking institutions are regulated by an assortment of federal and state agencies. Generally speaking, federal regulatory authority over commercial banks is shared by the COC, the FRB, and the FDIC. The savings and loan associations and the savings banks are primarily regulated by the Federal Home

Loan Bank Board and to some extent by the Federal Savings and Loan Insurance Corporations. Credit unions are regulated by the National Credit Union Administration.

2. U.S. Federal Regulation of Commercial Banks

The regulation of commercial banks is divided among the COC, FRB, FDIC, various state agencies, the Securities and Exchange Commission, and the Anti-Trust Division of the Department of Justice.

In the United States, banks may be chartered by either the COC or individual state chartering authorities. The COC has statutory authority to regulate all "national", that is federally chartered, banks. The FRB has statutory authority to regulate all national-charter or state-charter members of the Federal Reserve System, bank holding companies of both national and state nonmember banks and their nonbank subsidiaries, the international activities of banks and bank holding companies, and the U.S. banking and nonbanking operations of foreign banks. The FRB exercises a primary supervisory responsibility only for those member banks that are state-chartered, recognizing that the COC has primary responsibility for the supervision and examination of nationally chartered member banks. The FDIC has statutory authority to regulate all national-charter or state-charter banks insured by it, although its principal supervisory responsibility is over those insured state banks which are not members of the FRB. Because a single bank may fall under the authority of more than one federal agency, the agencies have attempted to coordinate their efforts to reduce duplication of regulatory effort.

In 1978, coordination efforts reached a high level of formality with the formation of the Federal Financial Institutions Examination Council which is empowered to work towards the elimination of regulatory overlap. As a matter of practice in the area of bank examination, the COC now examines all national banks. The FRB examines only state-chartered banks that are members of the Federal Reserve System ("state member banks"), bank holding companies and their nonbank subsidiaries, the international activities of banks and bank holding companies, and the U.S. banking and nonbanking operations of foreign banks. The FDIC examines only insured state-chartered banks that are not members of the Federal Reserve System ("state nonmember banks"). The FDIC or FRB, as the case may be, share the regulatory role with the particular state regulatory authority where a state bank opts for Federal Reserve System membership or federal deposit insurance protection.

a. The Office of Comptroller of the Currency

The powers of the COC were originally established under the *National Currency Act* of 1863 and the *National Bank Act* of 1864. The chief administrator of the agency is the Comptroller of the Currency who is appointed by the President and confirmed by the Senate for a term of five years. This official operates from the main bureau in Washington under the general direction of the Secretary of the Treasury. The principal functions of the COC are to charter national banks, to issue rules and regulations governing the corporate structure of national banks and their lending and investment practices, to determine when national banks become insolvent and to appoint the FDIC as receiver of such banks, and to monitor and examine national banks so as to ensure that they operate legally and soundly. To carry out its examination responsibilities for approximately 5,000 banks, the COC has approximately 2,200 examiners based in six regional offices, including full-time examiners at each of the largest national banks in the United States. The COC is entirely financed by assessments on the banks.

Under 12 U.S.C. s.24, a national bank comes into existence on incorporation, but cannot commence banking activities until the Comptroller issues a certificate of authority to commence banking pursuant to 12 U.S.C., ss. 26 and 27. Minimum capitalization requirements of $100,000 (U.S.) are established under 12 U.S.C. s. 51. In March 1985, the COC promulgated final rules raising capital requirements as a percentage of total assets for all nationally chartered banks to 6 per cent, of which 5 per cent is primary capital. Primary capital is defined as the sum of common stock, perpetual preferred stock, capital surplus, undivided profits, capital reserves, mandatory convertible debt, minority interests in consolidated subsidiaries, net worth certificates issued pursuant to 12 U.S.C. s.1823(1), and the allowance for loan and lease losses. The FDIC simultaneously issued final rules raising capital requirements for state nonmember banks to the same levels.

There does not appear to be any direct involvement by the executive branch in the issuance of the certificate of authority to operate by the Comptroller. The statutory factors which the COC must consider in deciding to approve or disapprove new banks are the bank's future earnings prospects, the general character of its management, the adequacy of its capital structure, the convenience and needs of the community to be served by the bank, the financial history and condition of the bank, and whether the bank has complied with the provisions of the *National Bank Act* and the *Federal Deposit Insurance Act*.

The determination of insolvency of nationally chartered banks is made by the Comptroller pursuant to 12 U.S.C. s.191 where the Comptroller is satisfied of the insolvency of the bank, or pursuant to 12 U.S.C. s. 192, when an association has failed to pay its circulating rates as they become due. Under 12 U.S.C. s. 1821(c), the FDIC must be appointed as a receiver in the case of any insured national bank. The determination of insolvency is independent of the executive branch. Notwithstanding the broad language in 12 U.S.C. s. 191, the courts have refused to interfere with the determination by the COC that a nationally chartered institution is insolvent, and thus there is no accepted judicially declared definition of insolvency. The courts, to the extent that they have commented on the issue, are divided. Some apply the balance sheet test in which the bank's assets are compared to its liabilities, while others apply a liquidity test in which the ability of the bank to meet its obligations as they become due is the determining factor. Even where a balance sheet test is applied, considerable debate rages in the United States as to the appropriate valuation procedure for individual loans, and whether loans should be valued on the basis of their book value or market value in light of current interest rates. In the Franklin National Bank failure, the COC depreciated securities and municipal bonds to their market value based on the current depressed stock and bond markets in 1974.

b. The Federal Reserve System

The Federal Reserve Board was created by the *Federal Reserve Act* in 1913 to carry out monetary policy, central banking functions generally, and to improve the supervision of banking. It is said to be an agency "independent within government" in the sense that decisions of the FRB do not have to be ratified by the President or the Executive Branch of government. The FRB reports to Congress.

The FRB consists of the Secretary of the Treasury, the Comptroller of the Currency, and five members appointed by the President and confirmed by the Senate for a term of fourteen years. Two FRB members are designated by the President, with Senate consent, to serve four-year terms as Chairman and Vice-Chairman. The appointments to the Board of Governors are made "having due regard to the fair representation of financial, commercial, industrial and agricultural interests as well as to geographical divisions of the country". The Board is assisted in its deliberations by the Federal Advisory Council consisting of representatives of each Federal Reserve District, and by the Federal Open Market Committee through which the Federal Reserve buys and sells securities, and thus influences the supply of money in the market.

The country is divided into twelve districts, and a Federal Reserve Bank is established by the Board of Governors in each district. The twelve Federal Reserve Banks operate with their own boards of nine outside directors, staffs, and budgets as relatively autonomous entities subject to policies set by the FRB. Every nationally chartered bank is required to be a member of the Federal Reserve Bank in the geographical district within which the member bank engages in banking activities (12 U.S.C. s.222), and under 12 U.S.C. s.321, any state chartered bank may apply for membership as well. The Federal Reserve Bank carries out direct supervisory functions only over state-member banks. Under 12 U.S.C. 24, all state-member banks are required to comply with the reserve and capital requirements of the *Federal Reserve Act*, and must make reports of condition and of payments of dividends to the Federal Reserve Bank of which they are a member. The reports of condition must contain the information required by the Board of Governors.

To carry out their supervisory and regulatory responsibilities, the Federal Reserve Banks employ approximately 1,300 examiners and 600 regulatory officers. The FRB does not receive appropriations from Congress. Nor does it impose examination fees. Rather, the FRB receives its income from assessments on the twelve Federal Reserve Banks. The main source of income of the Federal Reserve Banks is the interest earned on their proportionate share of the Federal Reserve System's holding of securities acquired through open market operations. To a lesser extent, the Federal Reserve Banks receive their income from interest on the Federal Reserve System's holdings of foreign currencies, from interest on loans to depository institutions and from fees for services to various depository institutions. At the end of 1984, 5,983 banks were members of the Federal Reserve System, including approximately 1,000 state-member banks which the FRB examines. The 1986 budget of the FRB provides for $194M (U.S.) for supervision and regulation of financial institutions, compared with $175.1M (U.S.) in 1985. In 1985, the Board and Banks conducted an estimated 750 examinations of state-member banks, 1,600 inspections of bank holding companies, and 2,300 reviews of bank holding company examinations. Under 12 U.S.C. s. 326, the Federal Reserve Bank may rely upon examinations and reports of state authorities in lieu of examinations made by examiners approved or selected by the Board of Governors. In all cases, the FRB can demand that special examinations be conducted.

Liquidity support is provided to both FRB member banks, and since 1980, to "non-member" banks as well, by the Federal Reserve Bank having jurisdiction, under 12 U.S.C. ss. 347, 347 (a) and 347 (b), and under rules and regulations prescribed by the Board of Governors of the Federal Reserve System. Liquidity support is extended either

through direct advances secured by "acceptable" collateral, or through the discount of paper meeting the requirements specified in the *Federal Reserve Act*. Short-term adjustment credit is provided directly by each Federal Reserve Bank to member and nonmember banks in each FRB jurisdiction. Extended credit is provided through the Federal Reserve System as "seasonal", "other extended", or "emergency" credit. "Seasonal" credit is provided by the Federal Reserve Bank to institutions experiencing temporary seasonal demands for credit which the Federal Reserve Bank considers will persist for at least four weeks. "Other extended credit" is available where assistance is not available from special industry lenders, and in exceptional circumstances, including sustained deposit drains, impaired access to money market funds, and sudden deterioration in loan repayment performance. Finally, "emergency credit" is available from Federal Reserve Banks, after consultation with the Board, to nondepository institutions where credit is not available from other sources, and failure to obtain credit would adversely affect the economy.

c. The Federal Deposit Insurance Corporation

The FDIC was established in 1933 by amendments to the *Federal Reserve Act*, and in 1950, the *Federal Deposit Insurance Act* conferred entirely separate status on the FDIC. The FDIC was created to insure small depositors against losses resulting from bank failures and was given supervisory responsibility to assess the financial risks to which it is exposed. Single depositors are presently protected up to $100,000 (U.S.). The FDIC is an independent agency of the federal government. Management of the agency is vested in a three-member Board of Directors, one of whom, by law, is the COC. The remaining two members are appointed for six-year terms by the President, subject to Senate confirmation.

The FDIC's regulatory powers are set out in 12 U.S.C. ss.1811 *et seq.* Under 12 U.S.C. ss.222 and 1814(b), all nationally chartered members and state banks which are members of the Federal Reserve System must be members of the FDIC. State nonmember banks can apply for FDIC membership. Nationally chartered member banks are automatically accepted into the FDIC upon certification by the COC, and state member banks are admitted upon certification by the Board of Governors of the Federal Reserve System. State nonmember banks are admitted into the FDIC by the FDIC Board only after consideration by the Board of their financial history and conditions, the adequacy of their capital structure, their future earnings prospects, the general character of management, and the convenience and needs of the community to be served by the bank. Certification by the COC in the

case of national member banks, and by the Board of Governors of the FRB is based on the same criteria.

The FDIC is based in Washington but conducts its supervisory activities through ten regional bank supervision offices (which are to be consolidated into six by February 1988) and a greater number of sub-offices. The FDIC directly supervises and regulates only insured state nonmember banks such as the Westlands Bank. Under 12 U.S.C. s. 1817(a) only these banks must make reports of condition to the FDIC. However, the FDIC has access to reports of examinations and reports of condition made to the COC and to any Federal Reserve Bank, and the COC and FRB must, under 12 U.S.C. s. 1817 (a)(2)(A), advise the FDIC of any revisions or changes in respect of deposit liabilities made in any report of condition.

To carry out its examination activities the FDIC had approximately 1,500 examiners who examined approximately 8,850 state nonmember banks in 1984. The Division of Bank Supervision (DBS) of the FDIC has shifted its resources from examining all banks and focuses its attention on problem institutions. In 1984, the DBS conducted 9,751 examinations, compared to 17,886 in 1982. The FDIC is self-sustaining, being financed by annual assessments on the banks it insures, at a basic assessment rate of 1/12 of one per cent of total assessable deposits. This assessment usually provides a surplus over operating expenses and insurance losses. A percentage of any surplus is credited to the assessed banks. The losses and expenses sustained by the FDIC in 1984 resulted in an assessment credit of $67.5M (U.S.), compared to $164M (U.S.) in 1983. The 1984 credit represented an effective assessment rate to banks of 1/12.5 of one per cent of assessable deposits, compared to 1/14 of one per cent in 1983.

The FDIC's enforcement powers, enumerated in 12 U.S.C. ss. 1818 *et seq.*, include:

a) termination of insurance where the Board finds that an insured bank is engaged in unsafe or unsound practices, or is in an unsafe or unsound condition, or has violated any applicable law, rule, regulation or order;

b) issuance of cease and desist orders;

c) suspension or removal of directors or officers; and

d) imposition of monetary penalties on the bank or bank officials.

Termination of insurance is employed only rarely. It effectively results in termination of a state bank's membership in the Federal

Reserve System, and in the case of a national member bank, in the appointment of the FDIC as receiver by the COC under 12 U.S.C. s. 1818 (o). The liquidation functions of the FDIC are carried out pursuant to its mandate as a receiver of insured national banks. The FDIC may choose to act as a receiver in the case of insured state banks.

A considerable percentage of the FDIC regulatory function consists of liquidation activities. Examiners detailed to perform liquidation activities gave a total of 352,000 hours to this effort in 1984 compared to 70,000 hours in 1982. At the end of 1984, the Liquidation Division held assets with a book value of $10.33B (U.S.). The Liquidation Division is currently expanding its staff, and has developed a centralized liquidation asset management information system which will support collection activity, loan servicing, loan delinquency analysis, and loan market analysis.

The FDIC is also empowered to purchase assets from, make deposits in, or extend loans to any insured banks which have closed or are approaching failure, and may make loans, purchase assets, or issue guarantees to help an insured bank assume a failed or failing insured bank. Finally, the FDIC may create "deposit insurance national banks" to provide limited banking services to ease difficulties for depositors in communities where banks have failed. The FDIC established such a bank in the case of the Penn Square Bank failure, and in 1983, sold the remaining deposits in that bank to Charter National Bank. The power to create a deposit insurance national bank is rarely exercised, as in most communities, existing alternate banks are available to provide depositors with replacement banking services.

The FDIC exercises a range of powers once it determines that a banking institution will not survive without active intervention. These include deposit payout procedures in which the FDIC simply closes the bank and pays off insured depositors under 12 U.S.C. s. 1821(f), purchase and assumption arrangements under 12 U.S.C. s. 1823(c)(2) in which the FDIC effectively insures all deposits by arranging for a merger or a consolidation with another bank (thereby recovering the "going concern" value of the bank), and deposit transfers in which insured deposits are transferred to a healthy insured bank and in which the FDIC will sometimes make an advance payment of funds to uninsured depositors and creditors of the failed bank. Neither the Federal Reserve nor the COC has the explicit statutory authority to supervise and manage a failing bank in the manners available to the FDIC.

Finally, the FDIC can exercise authority to take an assignment of the bank's assets, including the bank's right of action against its

directors and officers. Under 12 U.S.C. s. 1821(d), the FDIC has a statutory duty to enforce the individual liability of stock holders and directors. As one U.S. commentator stated, "in almost every bank failure case, suits are brought by the FDIC against various officers and directors". In addition, under 12 U.S.C. s. 1821(g), the FDIC upon payment to any depositor is subrogated to the depositors' rights against the bank.

d. Other Regulatory Authorities

As noted earlier, there are two other federal agencies which exercise regulatory responsibilities over commercial banks: the Securities and Exchange Commission (SEC) and the Anti-Trust Division of the Department of Justice. Neither the SEC nor the Anti-Trust Division has an examination role akin to that of the three other federal bank regulatory bodies. The Anti-Trust Division enforces anti-trust laws which may be offended by mergers and acquisitions in the banking community.

The banks are "regulated" in a sense by the SEC. Under 15 U.S.C. s.78l(h), regulatory authority over the issuance of securities by a FDIC insured bank or by a Federal Savings and Loan Corporation Act bank is vested in the COC for nationally chartered banks, in the Board of Governors of the Federal Reserve System for Federal Reserve member banks, and in the FDIC and Federal Home Loan Bank Board for FDIC and FSLIC insured banks, respectively. The COC, Board of Governors, FDIC, and FHLB are directed to issue substantially similar regulations to those issued by the SEC under the *Securities Exchange Act, 1934*, but under 12 U.S.C. s.78(l)(h) and s.78(l)(i), the bank regulators may use disclosure standards different from those used by the SEC.

The SEC does, however, directly supervise the issuance and trading of securities by bank holding companies. Under 12 U.S.C. s. 78(g)(i), "every issuer" must register securities with the SEC. The Bank holding companies are included in the definition of issuer.

Finally, the SEC can enforce the anti-manipulative provisions of the *Securities Exchange Act*, can suspend trading in bank securities, and is authorized to investigate the activities of banks and banking officials who may have disseminated false and misleading information about the bank's financial condition.

3. The System of Supervision in the United States

The three U.S. federal agencies rely on intensive systems administered by their own staffs whereas the systems of the United Kingdom

and Canada may be characterized, by comparison with the U.S. approach, as flexible and passive.

The COC, FRB, and FDIC have very similar systems of supervision. The tools used in each system are essentially of four kinds: prudential returns ("reports"), examinations and other visits to banks, computer-based surveillance systems that process and analyze data as received, and regulatory enforcement tools.

The "Reports of Conditions" from the banks are an essential tool. All commercial banks provide the regulators with a wide variety of prescribed regular reports, usually on a quarterly basis. The information obtained in most of the reports has a direct bearing on matters of safety and soundness, but some reports are designed to provide information to assist in evaluating the general economic condition of the nation.

The principal reports, known as "call reports", indicate financial condition and income on a quarterly basis. The form of the call reports is uniform among the three federal agencies. The report of condition consists of the balance sheet of the bank, with further details touching upon matters such as past due, nonaccrual, and renegotiated loans. The report of income includes detailed information about income, expenses, changes in equity capital, changes in allowances for loan losses, and tax liability. The data in the call reports are analyzed systematically by regulators, used to monitor the condition of the bank between on-site examinations, and stored on computer for future surveillance purposes. The contents of the reports are not audited but are certified as accurate by officers of the bank submitting them. The reports of condition and income are public records.

The second tool is the on-site examination, carried out by anywhere from four to twenty or more members of the specially trained staffs of examiners of the relevant agency. None of the federal bank agencies relies on work that may be conducted by a bank's external auditors. Where audits are conducted, the examiners may obtain the results for additional information purposes only. This lack of significant interplay between the supervisors and the external auditors is by design. Examiners consider that the work of auditors is of limited value as it focuses on audit controls, the financial reporting system of a bank, and whether the accounts adhere to accepted accounting principles rather than on a detailed assessment of the quality of the bank's assets and management. A qualitative assessment is essential to a measurement of safety and soundness.

Commercial banks may be subject to different kinds of examinations. The principal examination is for purposes of determining safety

and soundness. Generally speaking, the safety and soundness examination covers asset quality, the nature of liabilities, liquidity, earnings, capital adequacy, bank management and controls, policies, procedures, accounting practices, and insurance. Separate examinations are often conducted to determine compliance with consumer or civil rights legislation and laws of general applicability, or to confirm the soundness of trust departments, the quality of data processing facilities, and so forth. Examiners have designed a grading system for loan quality. Inferior assets may be classified as "other assets especially mentioned", "substandard", "doubtful" and, for the worst loans, "loss". This classification system assists the regulators in formulating directives to the examined bank to change practices, increase loss provisions, or to take other action as required.

A safety and soundness examination may be a "full scope" or "modified" examination. The full scope examination involves a more complete diagnosis of a bank's loan portfolio, including items such as past due loans, loans previously classified, and the quality of the underlying security. The modified examination is abbreviated and tailored to the bank's size and complexity. Examiners conducting a modified examination generally direct their attention to the adequacy of a bank's internal control measures rather than to a detailed sampling of assets. The modified examination is used only for banks which are regarded as having a good record of financial condition.

The frequency of safety and soundness examinations varies across the different agencies according to resources and the anticipated financial condition of a bank. For example, the FRB seems to examine state member banks every 18 months, except where weaknesses require more frequent visitations. In the case of a well-regarded bank, the Division of Bank Supervision of the FDIC may go four or five years between examinations, although state regulators may examine the same bank more frequently. Problem banks may be examined by the FDIC several times a year.

A safety and soundness examination results in a comprehensive bank report that is analyzed by regulatory authorities beyond the examiner level and forms the basis of discussion between the examiners and the bank management and board of directors. Since 1978, a safety and soundness examination also results in ratings under the Uniform Interagency Bank Rating System which has been adopted by both federal and state agencies. These ratings provide a succinct assessment of the examined bank's level of safety and soundness as part of the comprehensive bank report. Examiners initially rate banks in the five different categories which make up the CAMEL system (for capital, assets, management, earnings, and liquidity). On the basis of ratings in

these categories, the examiners then give to the bank an overall rating, on a scale of 1 to 5. In this overall rating, a 1 or 2 indicates that the bank is favourably regarded by the examiners. A 3 indicates that the bank is in a state which is marginally unsatisfactory. A rating of 4 or 5 indicates that the bank is fundamentally unsound, with 5 warranting immediate corrective measures to avert probable failure. As a bank's ratings deteriorate it is more closely watched by the supervisors, and appropriate steps are taken to restore its strength. These ratings are not publicly disclosed. In 1984, about 800 banks were identified by the FDIC as "problem" banks, with CAMEL ratings of 4 or 5. The numbers have grown steadily since 1981.

The third tool is the surveillance programs operated by the three main federal bank regulatory agencies. These are computer-assisted monitoring systems that permit the regulators to follow changes and trends in the financial condition of supervised banks and their holding companies. Data collected through the reporting and examination processes are gathered and entered into the agencies' computers, and used to produce a variety of statistics and financial analyses which in turn will give early notice of deteriorating conditions in a bank. Where problems are perceived to be developing, examinations of the troubled institution are increased accordingly. Where no problems are perceived or where trends do not show the signs of developing troubles and the bank has a good financial history, examinations may be deferred and the resources of the agency reallocated to institutions requiring closer scrutiny. As the cost of electronic data processing systems has declined, and the world of banking has become more complex, U.S. federal agencies have found their surveillance program to be an increasingly cost-effective supervisory practice.

The last tool of the supervisor consists of a series of enforcement procedures. As might well be expected in a banking system with 14,463 commercial banks, bank examinations in the United States frequently turn up troubled institutions. The troubles may have arisen for a number of reasons but generally reflect unsafe or illegal practices. Illegal practices will usually give rise to criminal prosecutions, and are dealt with by law enforcement authorities. Where practices are unsafe, the COC, FRB, and FDIC possess a variety of enforcement powers to rectify weaknesses or, in extreme cases, to close a bank. These include informal discussions, memoranda of understanding, cease and desist orders, civil money penalties, suspension and removal powers, termination of insurance by the FDIC, and revocation of a banking charter by the COC or state chartering agency, or revocation of membership in the Federal Reserve by the Board of Governors of the Federal Reserve System.

Informal discussions provide the obvious treatment for minor difficulties. Where examinations reveal that a bank's problems leave it in a marginally unsatisfactory condition, the regulatory agencies may wish to obtain a written assurance from the bank that unsafe practices will be stopped and specific corrective measures will be taken. Obtaining written assurances in a memorandum of understanding is a final step before formal procedures are used. Where a bank refuses to provide such a memorandum, or where the regulator determines that more prescriptive measures are warranted to correct specific situations, cease and desist orders may be issued. The regulatory agencies have the power, in extreme cases, to issue temporary orders which have immediate effect, but which only become permanent after subsequent administrative procedures.

Generally speaking, the practice is that the regulator issues and serves a notice of charges or violations of laws, rules, regulations, or any conditions imposed in writing by the regulator. The notice contains a statement of the facts constituting the alleged violation or unsound practice and fixes a time (not sooner than 30 days or later than 60 days) and place for a hearing (usually, but not necessarily, private) to determine whether an order to cease and desist should issue against the bank, or any individual participating in the affairs of a bank. Parties failing to appear are deemed to consent to the issuance of the cease and desist order. Where there is consent or where, at the hearing, the agency finds that the charge is established, the agency may issue and serve a cease and desist order. Such orders typically require the termination of violations or unsound practices or to take corrective action, and are effective 30 days after the order is served.

Any party subject to an order may obtain judicial review of the order. The start of proceedings for judicial review does not, unless specifically ordered by the court, operate to stay the cease and desist order. The review proceedings are public and subject to further appeal.

In the case of the FDIC, cease and desist orders are an integral tool of enforcement with important advantages over the more extreme power to terminate insurance and the more lenient power to require memoranda of understanding. These orders create a legal requirement for positive action, may be confined to particular problems, can be used promptly, and are less cumbersome to enforce than the extreme power of termination.

Agencies may remove or suspend bank executives or directors where their action or inaction can be shown to have jeopardized the safety or soundness of the bank. They may also impose money penalties on banks or bankers for failure to abide by various rules, regulations or

cease and desist orders. Civil money penalties are open to judicial review.

The remaining powers of the agencies are the most severe. Termination of insurance benefits, revocation of a charter by the COC or revocation of membership in the Federal Reserve System effectively end the operations of a bank. Loss of deposit insurance automatically follows loss of Federal Reserve System membership and effectively closes a bank. In view of the severity of these powers, and the accompanying procedural safeguards, regulators use them only in extreme cases. Nevertheless, their existence lends considerable strength to the instructions of the regulatory agency.

In 1985, the FDIC issued 186 cease and desist orders, down from 223 in 1983 but up from 138 in 1984. Forty-six civil money penalties were levied in 1985, representing a dramatic increase from the 14 and 12 levied in 1983 and 1984 respectively. During 1985, 37 removal or suspension proceedings were carried out compared with 13 such proceedings in 1984 and 9 in 1983. In 1985, the FDIC initiated 75 termination of insurance proceedings, which brought to 414 the number of times the power has been used since 1933. In the majority of these cases, the banks involved corrected their problems, were absorbed by other banks or closed before insurance was actually terminated.

The COC issued 154 cease and desist orders in 1985, compared with 99 in 1984. In 1985, 11 temporary cease and desist orders were issued compared with 9 in 1984. Two hundred and two civil money penalties were issued in 1985, a substantial increase over the 109 and 127 issued in 1984 and 1983 respectively. The COC used its suspension or removal powers on 19 occasions in 1985, 20 in 1984, and 4 in 1983. There have been no revocations of charters.

The Board of Governors and the Federal Reserve Banks completed 144 formal enforcement actions in 1985. In connection with these formal enforcement actions, the Board of Governors issued 79 cease and desist orders and 13 temporary cease and desist orders. The figures for 1984 show 80 completed actions with 22 cease and desist orders and 4 temporary cease and desist orders having been issued. The FRB entered into 98 written agreements in 1985, up from 60 in 1984. In 1985, there were 3 orders of suspension against individuals and 11 permanent removal or prohibition orders against individuals compared with 2 orders of suspension and 8 permanent removal or prohibition orders in 1984. Lastly, these statistics of the FRB show that in 1985, $46,000 (U.S.) in civil money penalties was collected from 14 individuals, and $1,000 (U.S.) from one company. Apparently, a further $50,000 (U.S.)

penalty against one individual was assessed in 1985 but is not yet collected. In 1984, $37,002 (U.S.) in penalties were collected from one bank, two bank holding companies, and 20 individuals.

4. The Continental Illinois Assistance Program

In the late winter of 1984, the FDIC, acting pursuant to 12 U.S.C. s.1832(c)(2), determined "in its sole discretion" that the Continental Illinois should receive assistance as it was either in danger of closing, or required assistance because of "severe financial conditions which threatened the stability of a significant number of insured banks possessing significant financial resources". The interim financial aid package announced on 17 May 1984, and authorized by 12 U.S.C. s.1823(c)(2), consisted of a $5.3B (U.S.) unsecured line of credit from 24 banks, a $2B (U.S.) subordinated demand loan from the FDIC, a promise by the FRB to meet "extraordinary liquidity requirements", and an FDIC guarantee that all depositors and general creditors would be fully protected. Over the course of the following months, the FDIC, FRB, and COC attempted, unsuccessfully, to arrange a merger of the Continental Illinois, and, in July 1984, announced a permanent assistance program.

The creation of a permanent assistance program is dependant upon a preliminary determination that a bank is "essential". Under 12 U.S.C. s.1823(c)(4)(A), the FDIC has virtually unconstrained discretion to determine that a failing bank's continued existence is "essential to provide adequate banking services in its community", and thus should receive financial assistance from the FDIC. There is nothing in the section which indicates which factors should be considered by the FDIC in its determination of essentiality. Apparently, the FDIC in the Continental Illinois case relied upon a range of factors including the size of the bank, the impact of the bank's failure would have on other banks with uninsured deposits and on correspondent banks, and the impact that the effects of the failure on international and domestic money markets.

Upon a determination of essentiality, the FDIC may render any assistance under s. 1823(c)(1) and (2), and is not restricted to an amount necessary to save the cost of liquidating. In the case of the Continental Illinois, the FDIC, together with the FRB and COC, announced a permanent assistance program consisting of:

(a) The purchase for $2B (U.S.) of Continental Illinois problem loans by the FDIC with a book value of $3B (U.S.). Payment for the loans was made by assumption by the FDIC of $2B

(U.S.) of Federal Reserve loans to Continental Illinois. The FDIC will repay the Federal Reserve loans with the proceeds of the purchased loans (which will be managed by Continental Illinois under a servicing contract with the FDIC), and will make up the deficiency, if any, from its own funds on maturity of the borrowings.

(b) An additional $1.5B (U.S.) of Federal Reserve borrowings was assumed by the FDIC in consideration of a promissory note in the amount of $1.5B from the bank. The bank has the option to repay the note by selling up to $1.5B (U.S.) of Continental Illinois loans outstanding on 31 May 1984 to the FDIC for book value. The option expires in three years. The FDIC is obliged to pay the Federal Reserve borrowings.

(c) The purchase of $1B (U.S.) of newly authorized nonvoting preferred shares of the Continental Illinois Corporation (CIC), the Bank's holding company. This amount would be down-streamed to Continental Illinois. The newly authorized shares consisted of:

(i) $720M (U.S.) of convertible preferred shares, convertible upon sale or transfer by the FDIC into 160 million common shares of the CIC representing 80 per cent of the capital of the holding company; and

(ii) $280M (U.S.) in adjustable rate, cumulative, preferred shares, callable at the option of CIC.

(d) The creation of a new holding company by the original shareholders of the CIC, the transfer of the $40M (U.S.) CIC shares owned entirely by the original CIC shareholders, who approved the plan at a special meeting on September 26 1984, to the new holding company.

(e) The granting of an option to FDIC to acquire up to 40.3 million shares of CIC held by the new holding company. It may be exercised at the price of $0.00001 per share in the event of a net loss to FDIC after 5 years on the loan purchase arrangements, at a rate of 1 share per $20 (U.S.) of loss.

(f) An agreement to return all remaining assets to the bank if the FDIC does not suffer any losses on the loan purchase arrangement.

(g) A restriction on the payment of dividends by the new corporation until final settlement with the FDIC. Any dividends received by the new corporation on its $40M (U.S.) share investment in CIC will be available to cover potential FDIC losses.

(h) The creation of a rights offering, to current CIC shareholders, consisting of 40 million shares of CIC at $4.50 (U.S.) per share within 60 days, or $6.00 (U.S.) per share within a subsequent 22 month period, the proceeds of which will be downstreamed to the bank.

(i) The continuation of the assurance given by the FDIC that all depositors and other creditors will be fully protected.

(j) The continuation of the FRB assurance that it will meet any extraordinary liquidity requirements of the bank.

(k) The continuation of the $5.3B (U.S.) line of credit provided by a group of major banks.

(l) The assignment to the FDIC by the bank of all claims against officers, directors, employees, accounting firms, and the like, arising out of any act or omission occurring prior to the permanent assistance package.

(m) The Boards of the CIC and the bank named two new executive officers.

It should be noted that the Federal Reserve and the FDIC have been severely criticized for the actions taken in connection with the Continental Illinois Assistance Program. The justification for the determination of "essentiality" under 12 U.S.C. s.1823(c)(4)(A), the absence of a written record to justify the FDIC decision to establish the temporary assistance program, the accuracy of FDIC assessments of the impact on other banks of the bank's failure, the decision, through the FDIC purchase of stock in the holding company, to take a subordinated position to $1.1B (U.S.) in long term debt, instead of purchasing debentures from the bank directly, and the failure of the FDIC to consult the Treasury prior to its involvement in the program, have all been cited as raising substantial questions regarding the authority and propriety of FDIC actions.

5. Public Disclosure of Cease and Desist Orders in the United States

Students of bank regulation in the United States have recently turned their attention to market discipline and its prerequisite, public disclosure, as a supplement to confidential bank supervision. Their experience and proposals are helpful in considering the complex issue of whether the cease and refrain order, recommended in Chapter 6, should be disclosed to the public.

The SEC does not directly regulate bank securities because banks are exempt from SEC jurisdiction under s.12(1) of the *Securities Exchange Act*. The SEC does, however, regulate bank holding companies which fall under the general definition of "issuer" in the Act. D.L. Goelzer, General Counsel of the Securities and Exchange Commission, in a presentation made in late 1985, described the position of the SEC regarding disclosure of bank regulatory action. According to him, an examination report, which remains the property of the bank regulatory authority, generally may not be disclosed to third parties, or to the public, by the financial institution. Disclosure is prohibited by regulations of the COC, the Federal Reserve, and the FDIC. As a result of its examination, the bank regulator may take further action, including an informal agreement, a formal agreement, a cease and desist order, or an undertaking. The existence of such items may be material to investors in the financial institution or its parent holding company, depending on the nature of the item. The conditions or practices cited in the examination report, or giving rise to the action by the regulatory authority, may also be material to investors. The underlying conditions and practices, the regulatory action, and any consequent undertakings may have to be disclosed in filings with the SEC under a rule which requires that registrants include in their filings "such further material as is necessary to make the required statements, in light of the circumstances under which they were made, not misleading." In the past, some holding companies have not made disclosure of such facts or events with respect to themselves or their subsidiary bank, on the ground that confidential examination reports must not be disclosed. The SEC, on the other hand, takes the view that information originating at the financial institution about such conditions in the bank exists independently of the confidential examination report. If such information is material, it must be disclosed. The case law in the U.S. courts tends to support that view.

Thus, in summary, it can be stated that the SEC expects disclosure of the existence of cease and desist orders, conditions and practices cited in examination reports, and undertakings given to the regulators

relating to the condition of a bank where they are material to investors in bank holding companies. While examination reports may be confidential, the information contained in them, of which the bank must know independently, therefore, must be disclosed.

The federal bank regulators themselves have adopted a similar attitude in their disclosure policies. An example is the FDIC. According to a 1985 FDIC Statement of Policy published in the U.S. Federal Register, insured state nonmember banks that are subject to orders resulting from statutory enforcement actions are presently required by FDIC regulations or policies to disclose this fact to the public in certain circumstances. Banks with securities registered with the FDIC in accordance with the *Securities Exchange Act of 1934* are required to inform investors of the issuance of the final orders in documents such as annual reports, quarterly reports, current reports, and proxy statements. Banks seeking to raise capital (debt or equity) through a public offering, whether or not their securities are registered, are expected to disclose the existence of enforcement actions in offering circulars prepared for distribution to potential purchasers. In addition, beginning in late 1984, all cease and desist orders issued by the FDIC have contained a provision requiring the bank to provide a description of the order to its shareholders in conjunction with the bank's next shareholder communication and with its notice or proxy statement preceding the next shareholders' meeting. In circumstances other than these, information concerning a statutory enforcement action against a particular insured state nonmember bank has generally not been made available. However, this is subject to two exceptions. The FDIC will release a copy of a final order issued against a specific bank or individual when such a document is requested under the *Freedom of Information Act*. As well, should the final administrative order be subject to judicial review, its existence will be disclosed through the ordinary hearing in open court.

In mid-1985, the FDIC proposed to issue new guidelines. Considering that its existing disclosure procedure was an inefficient method for insuring that all market participants are equally aware of statutory enforcement actions taken against a bank, and desiring greater public scrutiny of activities of the banks and individual bank officers, the FDIC proposed that it would publish and make available to the public, by way of FDIC press release, the names of all banks and persons participating in their affairs to whom the FDIC has issued orders in conjunction with formal enforcement actions. The policy would apply to insurance termination orders, cease and desist orders, removal orders, suspension orders, civil money penalty orders, and capital directives. The policy was not proposed to extend to notices issued by the FDIC to banks and persons participating in their affairs to

initiate administrative proceedings, and other lower forms of administrative law life such as memoranda of understanding with the FDIC. The proposals were withdrawn in June 1985. The FDIC received vigourous and varying comments on its proposal, which perhaps had led them to the conclusion that further study was necessary. Hence, while the FDIC is still considering the role of market disclosure in bank regulation generally, it has decided that the existence of final orders must be disclosed in shareholder communications.

In late 1985, the COC published a series of proposed rules for comment regarding disclosure of financial and other information by national banks. Included within the proposal was a requirement for banks to disclose any administrative action taken by the COC which during the fiscal year resulted in a cease and desist order, formal agreement, memorandum of understanding, civil money penalty, removal order, capital directive or other form of administrative action against the bank, any of its officers, directors, employees, agents or any person participating in the affairs of the bank. The bank would be required to summarize and disclose the facts and circumstances resulting in the administrative action taken by the COC, the result of that action, and any remedial steps taken by the bank. In addition, the bank would be required to state whether, during the year, the COC had issued any notice of administrative action not included in the foregoing. This would, therefore, include any notice of charges against the bank, notice of assessment of civil money penalty, or notice of suspension or removal of a director or officer. Similar disclosure requirements would apply to quarterly reports. In addition to the specific disclosure items, there would be a general requirement that periodic reports contain any material information required to make the reports not misleading in light of the circumstances under which they are made. The term "material" would reflect the broad class of persons intended to benefit from the disclosure requirements of the proposal, and the test of materiality would cover information about matters of which an average prudent depositor or investor should reasonably be informed. It is interesting to note that the COC is considering, but has not made proposals about, further new disclosure methods. Among other things, the COC is considering whether disclosure of composite or individual CAMEL ratings assigned to national banks would provide useful supervisory information to bank management. The COC noted in its proposal that, should it determine to disclose such information to banks, it would be necessary to consider collateral public disclosure issues raised by these actions, including whether CAMEL ratings should be publicly disclosed, or must be disclosed, under the federal securities laws.

Thus it must be concluded that the regulatory authorities both in banking and securities have recently turned their attention to the usefulness of the discipline of public disclosure as an aid to bank surveillance. The system has for years been a compromise between prudential confidential supervision to ensure the integrity of banks as institutions, and investor and depositor protection through awareness of matters material to the risk assessment process. The watershed has shifted over the years and this process of balancing will continue. All this should be instructive for those concerned with these same issues in Canada.

6. Proposed Changes to U.S. Bank Supervision

The current position in the United States and proposed changes to that position in relation to public disclosure of administrative orders has been briefly discussed in the last section. It is axiomatic that public disclosure of a bank's financial condition is not the cause of that condition. It has been argued that increased disclosure may result in a rapid deterioration of its financial condition, and liquidation. It would appear to have been demonstrated in the last decade in the United States by the experiments in public disclosure, that the market discipline model represents no "panacea for the ills of the banking system". Disclosure as practised in the United States is at most a reasonably satisfactory balance between the need to protect investors by disclosure on the part of banks, and the need to protect depositors and the general public through confidential supervision. Nor has the aggressive system of banking supervision used in the United States eliminated bank failures. In fact, in the last several years, the U.S. banking system has experienced some of the largest failures and near failures in its history. This year alone, to 26 March 1986, there were 13 state commercial bank failures and 8 national bank failures. In 1985, there were 88 state commercial bank failures and 30 national bank failures; a substantial increase over the failures which occurred in 1984.

These failures have led to various recommendations for improvements to the supervisory system. The General Accounting Office in the United States has made numerous studies of the federal supervision system, and has acted as a catalyst for change. So too have the federal regulatory agencies themselves. The report of the Bush Task Group recommended changes at the systemic level rather than alteration of existing supervisory practices. The Task Group suggested measures to reduce excessive regulation, to eliminate overlap in agency responsibility, and to control escalating costs. Apparently, the particular measures proposed by the Task Group have been received with limited enthusiasm

although there is agreement with its general conclusion that any modification of the regulatory system should have as its aims increasing competition among providers of financial services and reducing regulatory burdens that hinder the efficient provision of those services.

C. CONCLUSION

This brief review has focused upon the national system of bank supervision in the United States and the United Kingdom.

In the United States, unlike the United Kingdom, there is no concerted movement to make fundamental changes to existing supervisory practices which are regarded, generally, as satisfactory. One witness summed up this general satisfaction when he stated: "We obviously do not like bank failures. We try to prevent them if we can, but we do not regard a certain number of failures as being necessarily an indictment of the supervisory system".

The financial system in the United States is much larger and much more complex than that found in Canada. The detailed regulation that has built up around this financial system has become enormously expensive and, according to the Task Group, inefficient in many ways. The regulatory web in the United States also appears to have had a more insidious consequence: it has created financial institutions which often respond only to the precise demands of the letter rather than the spirit of the law, and has reduced the element of "self-regulation" to virtual extinction. What in other jurisdictions is seen as a working team of operator and regulator, has become, at least in the case of less substantial banks, an adversarial competition between the two.

Appendix C

Formation and Evolution of Canadian Commercial Bank

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Appendix C

Formation and Evolution of Canadian Commercial Bank

A. BACKGROUND AND INTRODUCTION

For many years prior to the creation of the Bank of British Columbia in 1967, the Canadian banking system was dominated by a small number of national banks with head offices in Eastern Canada. Generally, these banks were prosperous and stable. They developed diversified loan portfolios and enjoyed favourable economic conditions following the Second World War.

There was a concern in the 1960s that these large banks were not responsive to the economic needs of the western provinces. In July 1973, the Federal Government hosted the Western Economic Opportunities Conference in Calgary. The proceedings indicated a general perception that the banking industry had not served the economic needs of Western Canada effectively, and that western-based banks would be more responsive to the needs of residents of the region. The experience of the Bank of British Columbia was used to demonstrate that a western-based bank could be financially successful.

B. THE ORIGINAL CONCEPT FOR THE CCB

In the summer of 1973, the senior executives of Morguard Trust Company, through Boyd, Stott & McDonald Ltd., a merchant banking affiliate of Morguard, developed the concept on which the CCB was based. On 30 July 1975, Parliament granted a charter to incorporate the Canadian Commercial and Industrial Bank. In 1981, the name was changed to the Canadian Commercial Bank under which it carried on business until liquidation.

On the asset side, it was not contemplated that the bank would compete with the large chartered banks; rather, the target clients were members of the commercial middle market. These clients were junior industrial companies, privately owned and owner-managed. Such a client generally would not have access to equity markets or other

sources of capital. Typically, such businesses would require an operating line of credit, and also a term loan to finance the acquisition of fixed assets, with total borrowing requirements of $500,000 to $10M. The bank saw opportunities in pursuing such clients in the real estate, wholesale, and energy industries.

The original concept for the CCB indicated that the bank had no interest in consumer or retail banking. On the liability side, the bank was to be funded by the wholesale money markets. While this strategy entailed higher funding costs, savings were expected to result from the elimination of a large system of retail deposit-taking branches. The concept of wholesale funding was used by some banks in the United States, and in Canada, the Mercantile Bank was already operating on such a system. The loans to the middle market segment would necessarily involve a higher rate of interest above prime than would major and larger loans to big corporations. In many cases, lending would involve charging fees in addition to the interest rate, in compensation for the time required of the lending officers in tailoring and structuring the loan to the needs of the borrower.

CCB expected to provide merchant banking services. This term refers to bank activities that generated fee income in addition to interest income. Income would arise from acting as a financial intermediary, creating investment vehicles and raising capital for or facilitating the flow of capital into those vehicles. This was to involve the bank in providing financial counselling to its customers on a much greater scale than in the existing banks. It was understood that the CCB concept involved finding an entrepreneurially-minded lending staff; lending officers would be bankers who had an interest in the market segment CCB intended to serve. They would understand business, understand and relate to the entrepreneurs with whom they would be dealing, and be able to give fast responses to lending requests that were necessary in providing the special kind of service to that market segment. It was also part of the CCB concept that the bank was to be capitalized by a small number of shareholders. The shares would be placed privately, and the shareholders were to be for the most part large investors, such as financial institutions, pension funds and locally prominent and wealthy individuals. The bank was to identify with those shareholders, and would utilize them in the marketing of the business.

The fact that CCB would be a business-oriented, specialized bank that would not engage in consumer banking and would be funded by the wholesale money market, and that management of the bank would be aggressive and responsive to the needs of business in each of the areas where CCB would locate, was disclosed in the course of Commons and

Senate hearings relating to the private bill. The sponsors in 1973 retained economists and bankers or former bankers and William Scott, the former Inspector General of Banks who had retired in 1972, to advise in respect of the development of the proposal and its presentation to the various authorities who were responsible for its approval.

The representations made by the original incorporators of CCB in the House of Commons include a statement by the Provisional Chairman of the bank that it is "quite clear that we are wanting to establish a national bank with offices in all the provinces and we want to have an international outlet". These plans, it was stated, were in response to encouragement from the Department of Finance, the Bank of Canada and the Inspector General for the creation of new banks in Canada. The desire for national and international exposure reflected the originators' recognition that regional concentration of operations involved danger both in terms of loan quality and economic downturns. The proposed bank was intended to be an aggressive, low-overhead bank responding to the needs of smaller businesses and not one which would engage in direct competition with the major banks. The type of lending was described in detail by the first Chairman: "I think to the extent that we are going into certain classes of loans in greater volume, there will be a slightly greater risk but there will also be an anticipated greater return, so our risk return ratio will remain in balance." He went on to describe the primary interest of the existing large banks in lending on the strength of credit or covenant of the individual borrower whereas CCB intended to go into the higher risk loans to borrowers without the covenant strength necessary to attract the larger banks. In doing so, he stated, CCB would rely on the security taken. For all this, the CCB would, in their plan, recover a higher return than that received by existing banks. To the Senate Banking and Trade and Commerce Committee, Mr. W.H. McDonald, the first Chairman of the bank, revealed the bank's intention to "buy deposits" on the money markets.

The Inspector General of the day appeared in the Committees of both Houses of Parliament and recorded that he had no objections to the CCB proposals. The applicants were undeterred by the Committee Chairman's observation that there had been approximately 160 chartered banks in Canada most of which had failed or were amalgamated or otherwise rescued by other banks so that "what we have today are the survivors". In the Senate debates, the activities proposed by this new bank were described as unique in that "it will avowedly engage in what it calls 'risk' financing". Indeed, the sponsors of the bill were complimented on their courage in proposing to operate such a bank. In summary, the sponsor, speaking in the Commons, stated that

the CCB was to be a business-oriented bank "as distinct from a full service bank". The private bill went through in a short period of time: ten weeks passed from the date of introduction of the private bill until Royal Assent in 1975.

C. ORGANIZATION OF THE CCB

Originally, and as provided in the incorporating statute, the head office was to be located in Vancouver. Before licensing the bank for business, it was realized that the Alberta economy was more buoyant than that of British Columbia, and that there were advantages in Alberta's somewhat more central location. The CCB's Special Act was amended to provide that the head office of the bank would be located in Edmonton. The provisional directors of the bank were J.T. DesBrisay, Q.C., G.H. Eaton, A.V. Hudon, W.H.T. McDonald, W.E. Scott, and G.H. Walker. Eaton became the first Chief Executive Officer of the bank.

Howard Eaton had been with the Bank of America as an officer in the international banking division, with service overseas for 2 years. He then joined an investment firm in Vancouver, and was manager of the money market operations for two years. From August 1969 to January 1974, he was the Executive Vice-President of the Bank of British Columbia, and held similar posts in subsidiaries of that bank. His most recent experience, prior to joining CCB, was as President and Chief Executive Officer of a Vancouver financial company. Eaton was a very significant factor in marketing the concept for the CCB. He was found by DesBrisay, one of the original directors, to be an impressive organizer:

> There is no doubt, just absolutely no doubt that Howard Eaton was an extremely impressive person. He was articulate and he was very confident. He was experienced and, in the days at the very beginning of the bank, his management abilities were apparent. He was a great implementer; he was in total command and we thought we had, and probably did have, a winner.

The authorized capital base of the bank was $40M (par value of shares $10). Subscribed capital amounted to $22M, which was paid in between 17 June 1976 and 1 June 1978, at $11.00 per share. On 17 June 1976 the bank was granted a licence to commence business. By the end of the first fiscal period, the CCB had in place a chief operating officer, a general manager, vice-presidents for regional offices in each of Alberta, British Columbia, Ontario, and Eastern Canada, as well as for international and merchant banking operations. The bank had appointed assistant vice-presidents for asset-liability management, credit and foreign exchange. Other senior officers had been appointed to accounting and control functions.

D. WESTERN CANADIAN DEVELOPMENT AND THE EARLY GROWTH OF CCB

The bank grew quickly in its early years as Table C.1 containing financial highlights demonstrates.

Table C.1

CCB Financial Highlights 1977-82

	1976-77[a]	*1978*	*1979*	*1980*	*1981*	*1982*
			(millions of dollars)			
Total assets	113.3	249.2	504.7	863.6	1,475.3	1,995.5
Total loans	91.59	202	430.8	746.8	1,309.7	1,711.3
Deposits	91.8	218.3	458.7	763.9	1,348.4	1,817.4
Total capital & reserves (*includes surplus*)	16.44	23.3	26.0	55.7	75.5	83.6
Net income	0.279	0.9	2.9	5.6	9.9	8.5

a. First fiscal year end was 31 October 1977.

The early growth of the CCB and of the Northland Bank (described in Appendix E) was fuelled by the western economic boom which was largely led by the Alberta energy sector. Expectations of massive investment in Western Canada grew in the mid-1970s.

By February 1975, the Governments of Alberta and Canada had signed an agreement providing the basis for the successful financing of the first energy mega-project in Alberta, Syncrude. Analysts anticipated this project would generate an income effect of $2.5B in the construction phase, and an income effect of $34B during a 25-year operational phase. By year end 1974, the province had expended $41.5M on Syncrude, while the private sector in the same period expended some $9M in capital, and expected to add $19M to that by the end of 1976.

Syncrude marked a turning point in the energy history of Alberta. Four more such plants were expected by 1991, fuelled by demand projections such as the National Energy Board's 1978 report on Canadian Oil Supply and Requirements, and the Alberta Energy Resources Conservation Board's 1975 report on the application of Alberta Gas Ethylene Company Ltd.

These planned projects spawned considerable activity among smaller oil, construction, and trade companies. Lacking access to equity funding, these companies used short-term demand loans to finance their operations. This pattern was, by 1980, proceeding at a very rapid rate consistent with both private and public projections of requirements, and perceptions of opportunity. This Inquiry heard expert testimony to the effect that, as late as 1981, a prudent member of the Alberta business community would not have foreseen the magnitude of the economic downturn which occurred in 1982. All this must be borne in mind when assessing both the actions taken in the Alberta community, including the banking community, and the economic devastation which befell the region commencing in 1982. During the same period, real property values soared in Alberta. For example, in Cold Lake a 240-fold increase in real property values was experienced in some cases between 1977 and 1980. In downtown Calgary some commercial property values escalated at rates as high as 6 per cent per month.

The dramatic growth in the Alberta economy was matched by rapid growth at CCB, both on the balance sheet and the income and expense statement. The loan portfolio expanded quickly as lending activities which commenced in July 1976 in Edmonton spread to Vancouver. By October 1977, the bank had launched its Merchant Banking Division. This division in turn promoted the formation of CCIB Mortgage Investment Corporation, a company formed under the *Loan Companies Act*, and regulated by the Department of Insurance of Canada. The CCIB MIC loaned money primarily on residential real estate. It was managed by CCB by contract, although the bank held a minority share interest of slightly over 5 per cent out of a total paid-in capital of $21M.

In 1977, CCB opened branch offices in Calgary and Toronto, and in 1978, in Halifax. In 1979, offices were opened in Saskatoon and in Los Angeles, California (the L.A. Agency). The latter operated under a licence entitling the bank to establish an agency which could not take deposits but was authorized to make loans. Bank spokesmen regarded the CCB's entry into the field of United States domestic loans as a part of a "careful course" for it marked a shift in the bank's international activities away from sovereign risk loans.

In 1980, offices were opened in Montreal and Regina, and by 1981, the bank had established offices in Dallas, Texas and Willowdale, Ontario. In the following year, offices were opened in San Francisco, Denver and St. John's, Newfoundland. Despite the geographic spread of operations, loans authorized by the bank remained heavily concentrated in the provinces of Alberta and British Columbia. But at 53 per cent of

the loan portfolio at the end of 1981, the concentration in these two provinces had been significantly reduced from 91 per cent at the end of fiscal 1977.

The CCB continued to launch related ventures. In 1980, again through the Merchant Banking Division, the bank sponsored the Cancom Equity Fund, a limited partnership established under the laws of Alberta, with capitalization of $22.5M. CCB had only 6.7 per cent interest in Cancom, the balance being held mostly by shareholders of the bank. Cancom developed its own management and proceeded with its object of raising and providing to others venture capital. In 1981, the Merchant Banking Division launched a trust under the name of CCB REIT with a capital of $30M. The bank held a 5.6 per cent interest in the trust. As in the case of CCIB MIC, the REIT was managed by CCB under contract.

The capital of the bank was increased, in 1980, in the amount of $25.6M as the result of the exercise of options held by the initial subscribers ($3.6M) and by a rights offering ($22M). After expenses, this brought the bank's subscribed and paid-in capital to $46.3M.

By 1981, several concerns about the economy had clearly emerged: double digit inflation, high interest rates, and uncertainty surrounding federal-provincial agreements on energy. These concerns, and some emerging reservations about Eaton, were assessed by directors in the context of a successful half decade at the bank. Branch locations now numbered eleven, assets had risen from $113M in 1977 to $1.5B in 1981, and the 1981 pre-tax profit of $17.4M was highly satisfactory. CCB shares, issued at $11.00, reached $28.50 in May 1981, and a year later, the bank was pleased by the assessment it received from Canada's two leading rating agencies.

E. CCB MANAGEMENT AND INTERNAL PROCEDURES

1. Internal Credit Procedures and Controls

During the period of early growth, the CCB modified and developed its internal audit system. Initially, as might be expected in a newly formed small banking organization, the bank possessed inadequate internal control systems. There were two main problems: the bank possessed no internal inspection staff of its own, and the bank lacked procedures manuals for staff guidance and training.

The first problem was resolved by retaining the audit firm of Coopers & Lybrand as the bank's internal inspection team. These

inspectors reviewed adherence to bank procedures, but did not review or audit any credit decisions. This function was assigned to the head office Credit Department in 1980. Pursuant to a decision taken the previous year, the bank established its own internal inspection department which gradually assumed responsibility for this function.

By fiscal year end 1980, the external auditors, although continuing to be concerned with the bank's inadequate manuals and procedures, expressed the view that internal inspections had improved very considerably, and that credit supervision was good. By the end of fiscal year 1982, the external auditors found that the bank's internal inspection department had progressed to the stage that the auditors were able to rely on the work of that department in conducting the year end audit.

As it ultimately evolved, the internal control system of the bank consisted of two departments, the internal Inspection Department and the head office Credit Department. The functions of the former were to ensure compliance with the bank's established policies and procedures. It was not the Inspection Department's responsibility to assess the reasonableness of the bank's capitalized interest and accruals or to "second guess" the credits made by the branches. Indeed, only two major Schedule A banks have inspection departments which come close to looking at credit judgments.

The head office Credit Department conducted a semi-annual random review of credit underwriting decisions made in the regional credit committees. The head office Credit Department also received a copy of all new loans granted at the regional lending offices. These loans were reviewed to ensure compliance with the policies and standards of the bank.

Senior management in CCB developed in the following way. An Executive Vice-President, Canadian Credit, was charged with responsibility for the granting of credit in Canada. Under this officer, loan applications were approved, special credits were managed and the Canadian loan portfolio in general was monitored. A Special Credits Department was established under a Senior Vice-President whose principal responsibility was the close supervision of the larger unsatisfactory loans. Each region also had a vice-president; these senior regional officers across Canada reported directly to the Senior Vice-President, Canadian Banking. The Executive Vice-President and Chief Operating Officer of the bank was responsible for deposits with the bank, and for the corporate operations of the bank. Other officers included Senior Vice-President Treasury and Money Markets, and Vice-President Corporate Services.

In the United States, CCB had an Executive Vice-President and agent of the U.S. Division of the bank (Robert Heisz). This official reported directly to the President and Chief Executive Officer. Reporting to the Executive Vice-President (U.S.) was the Chairman and Chief Executive Officer of Westlands Bank (Linwood Boynton). This officer had responsibility for approving credit applications in the United States in a fashion similar to the function of the Executive Vice-President of Canadian Credit. The U.S. Credit Department reported to him, along with the U.S. Special Credits Division. The L.A. Agency operational regions (Northern California, Southern California, Rocky Mountain Region) also reported to the Executive Vice-President (U.S.).

The bank had seven lending offices in Canada, three of which were small offices whose credits were all submitted to Head Office for approval. In the four larger offices, there were on-site head office credit representatives who reported to the Canadian Credit Department. Each head office credit representative was a member of a regional credit committee. This officer had a right of veto on any deal. The regional lending limits ranged between $3M and $3.5M. Transactions to any one "connection" or borrower exceeding that amount were forwarded, with the recommendation of the committee, to Head Office. The proposal then received further assessment by head office credit staff, prior to approval at that level. Head office credit staff were also subject to a lending limit. David Smith, the Executive Vice-President, had a lending limit of $10M. Beyond that, loans went to the Loan Committee of the Board. It was the Loan Committee's function to review applications for loans of $10M and over, and to make recommendations for approval to the Board. The decision to approve such applications was made by the Board.

The ongoing management and monitoring of accounts was carried on at a number of levels. Responsibility for the day-to-day management of the account rested with the lending team. This team would follow the financial trends of the company by way of monthly or quarterly interim financial statements, and security margin positions, receivables and inventory on a monthly basis. This team was responsible for making periodic on-site inspections of the borrower. A credit services department in each lending office carried out the administrative function. This group ensured the receipt of all required ongoing information from each borrower. If a deficiency was noted, an "out-of-order" report would issue, which would bring the problem to the attention of the Regional Vice-President, and onward, for some loans, to Head Office. In addition, there was a "watch list", which included all accounts downgraded on the bank's loan classification system from a 3 risk rating to a 4 risk rating. Where an account fell to a 5 or 6 risk rating, a

marginal/unsatisfactory loan report (MARGUN report) was issued for the account. Each account was reviewed by the authority level on at least an annual basis. If the amount of the account exceeded the regional credit committee limit, a head office review would take place.

The marginal/unsatisfactory loan reports provided a basic overview of the account as of each month end. These reports were forwarded to the regional credit committee, who reviewed the report and forwarded a noted copy to the Vice-President, Credit, Head Office. Where no regional credit committee existed, lending platforms forwarded the reports directly to the Vice-President, Credit, Head Office. The information contained in the reports was consolidated in Head Office for presentation to the Board of Directors and other senior management of the bank.

Management meetings for the senior executives of the bank were held weekly. In addition, the President and Chief Executive Officer frequently visited the Canadian senior credit executives to understand developments in various accounts that had been reported on the previous marginal and unsatisfactory loan reports.

2. Directors

Howard Eaton, who had been the President and Chief Executive Officer of the bank since its earliest days in 1976, became Chairman of the Board in 1981. Gerald McLaughlan, President and CEO at the time of liquidation, joined the bank in 1976 and progressed through senior offices to the level of Executive Vice-President and Chief Operating Officer in 1981, and President in 1982, which office he held at the time Howard Eaton left the bank in 1983. Paul Britton Paine joined the Board in September 1983, and was elected Chairman in November 1983. He continued to hold that position until 1 September 1985.

Throughout most of its history, the CCB Board of Directors consisted of approximately twenty members. The directors represented every region of Canada, California, Great Britain, and France, and over the years included directors of varied and distinguished business and professional expertise such as the former Inspector General, a former Attorney General of British Columbia, a former premier of Manitoba, a former assistant minister in charge of Alberta utilities and telephone, senior officers of a major life insurance company, a former CEO and Chairman of a major financial institution, senior merchant bankers from the United States and Europe, directors or officers of large pension funds and credit unions, the owners of significant private companies, and the controlling shareholders of public companies.

As it evolved, the Board of Directors of the CCB had two distinguishing features. First, the majority of the directors represented directly the major shareholders of the bank of which there were about 12 by 1985. Those shareholders holding 3 per cent or more of the issued capital stock at 1 November, 1984 were:

Air Canada Pension Trust Fund
Alberta Government Telephone Employees' Pension Fund
M. Belkin
Alberta Teachers' Retirement Fund
Caisse de Dépôt et Placement du Québec
CNR Pension Trust Fund
The Great West Life Assurance Co.
North West Trust Company
Paribas International
Teachers Retirement Allowance Fund Board (Manitoba)
S.G. Warburg and Co. Ltd.

Second, following the resignation of Howard Eaton in January 1983, the Chairman of the Board was not the Chief Executive Officer. This was thought to add to the objectivity of the Board of Directors.

The directors played a role in the review and approval of loans made by the bank. The Loan Committee had the following major responsibilities: to approve loans outside management's limits on behalf of the Board; to review and recommend bank lending policies; to review the bank's loan mix (by industry and region); to review out-of-order reports (accounts not in compliance with approved terms and conditions); to review details of loans in arrears, nonearning or partially-earning loans, reservations for losses, and actual loan losses; to review annually the credit system of the bank; and to ensure that where decision-making was delegated, appropriate controls existed and were policed. All director or director-related loans had to be approved by the Board of Directors. Any loan exceeding $10M, which was the management lending limit, had to receive the approval of the Loan Committee of the Board. All loans of $5M and over were presented for review to the Board by way of a Board Sheet, which summarized the details of the loan.

Prior to each meeting the Loan Committee received marginal and unsatisfactory loan reports, nonearning loan reports and a three-month forecast of anticipated NELs, a list of partially-earning loans, a list of uncollected interest on those loans, a report on the mix of loans in the loan portfolio, a report of all new loans approved during the preceding month, periodic reports on particular large accounts in difficulty, and

reports on any particular program that management was considering to develop in terms of workout strategy or a new area to pursue.

The Board of Directors itself did not receive the same extensive materials but only an abbreviated summation of the foregoing information. The Chief Executive Officer of the bank received the same materials which the Loan Committee received, and in addition, the summary of the marginal and unsatisfactory loan reports.

On 26 May 1977, the Audit Committee of the Board of Directors was established and its terms of reference approved. The duties and responsibilities of CCB's Audit Committee were as follows:

(a) Review in detail the bank's financial statements and control structures and procedures and report the results to the Board.

(b) Review with management the results of the Inspector General's periodic visits to the bank. Meet, at least semi-annually, with the outside auditors to review matters concerning this aspect of bank control.

(c) Ensure that the bank's internal inspection program is effective.

(d) Meet with the CEO regarding all findings.

The purpose of the Committee was to ensure that the bank's accounting and financial control policies, codes of conduct, financial reports and practices were in accordance with the *Bank Act*, were within acceptable limits prescribed by regulation, and were in compliance with applicable accounting and taxation requirements. In order to perform its duties, the CCB Audit Committee met regularly with, and reviewed quarterly reports on inspections from, the Chief Inspector who compared any changes in ratings and discussed trends. Unsatisfactory reports were followed up with management. Audit Committee members met at least twice a year with the outside auditors who were given notice of all meetings and provided with copies of all Audit Committee minutes. The Committee reviewed supplementary materials from management concerning the financial statements and reviewed with management the results of OIGB visits to the bank.

F. EMERGENCE OF CANADIAN DIFFICULTIES AT CCB

1982 was the first difficult year for CCB. Profits had been uninterrupted and rising since its first year, but now the Western Canadian economy, where CCB's portfolio was concentrated (Table C.2), was collapsing. The trouble started when oil development

expenditures and exploration activity began to fall off in Alberta. Land values experienced a dramatic decline. Unemployment rose, and emigration from the province accelerated markedly. The Alberta market for goods and services collapsed. Many Alberta middle market companies, unable to weather the storm, collapsed with it. Heavy debt had become a way of life for Alberta and British Columbia business. A rising economy in both volume and price had easily sustained debt levels in the past. The recession, initially expected to last for six to eight months, lasted thirty months; many enterprises were crushed under the weight of debt and overhead. The customers of CCB were not immune. In all probability, given their predominant concentration in oil and gas and real estate, CCB's borrowers were hit harder than a cross-section of businesses in the Alberta economy.

The impact of the decline of the Alberta and British Columbia economies on banking was not confined to the CCB. Representatives of major Canadian banks active in Western Canada testified that they too suffered significant losses in the region during the early 1980s. Other witnesses confirmed that the economic decline had damaging consequences throughout the financial system. Most of CCB's loan losses and nonearning loans were in British Columbia and Alberta as Tables C.3 and C.4 illustrate.

Moreover, there was excessive concentration in real estate and energy. The problem of concentration had been recognized before 1980, and on 1 February 1981, new loan guidelines were established which restricted real estate-related loans to 40 per cent of the total portfolio, and energy loans to 25 per cent. New lending limits were imposed upon project lending in real estate. In May 1982, when the guidelines were revised, the real estate mix was reduced to 37 per cent. Term loans relating to real estate were reduced from 35 per cent to 28 per cent of the total portfolio. Construction and project loans were mostly restricted. Real estate and energy concentrations were reduced, as were British Columbia and Alberta loan authorizations. These reductions were made while the bank was under the command of Eaton. Effective 27 April 1982, Eaton announced that the bank was to operate under a management philosophy of "emergency conditions". Eaton advised the Board that "These conditions are imposed by a dramatic alteration in Canada's economy, serious change in Canadian banking, and by underplan performances in almost all facets of CCB's financial results."

Management appeared somewhat puzzled, at this time, by the rapid downturn in CCB performance. McLaughlan wrote to Eaton in July 1982 to outline his views about why CCB's nonperforming loans

Table C.2

Canadian Commercial Bank
Geographic Distribution of Outstanding Loans

	1980[a]	*1981*[a]	*1982*[a]	*1983*[a]	*1984*[a]	*1985*[b]
				(per cent)		
Lending in Canada						
British Columbia	14.8	16.2	15.5	14.1	13.7	13.2
Alberta	51.0	41.8	37.7	36.5	31.0	30.9
Saskatchewan/Manitoba	2.9	5.4	4.7	4.4	1.5	1.3
Ontario	12.2	13.1	12.5	11.3	10.3	12.7
Quebec	0.9	4.1	3.8	3.8	3.3	3.0
Atlantic Provinces	3.4	1.6	1.7	2.2	2.3	2.6
Total Canada	85.2	82.2	75.9	72.3	62.1	63.7
Lending Outside Canada						
United States	10.1	15.4	22.9	26.7	37.2	35.6
Other international	4.7	2.4	1.2	1.0	0.7	0.7
Total Foreign	14.8	17.8	24.1	27.7	37.9	36.3
	100.0	100.0	100.0	100.0	100.0	100.0

a. As at 30 September.
b. As at 30 June.

Table C.3

Geographic Distribution of Loan Loss Experience

	1977	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*
				($ 000s)				
Canada								
British Columbia	250	72	977	600	(1,129)	2,222	1,412	5,303
Alberta	—	314	23	127	170	1,314	8,621	10,213
Saskatchewan/Manitoba	—	—	—	—	—	630	120	—
Ontario	—	—	200	800	753	1,173	2,029	1,995
Quebec	—	—	—	—	800	2,444	55	401
Atlantic Provinces	—	—	—	650	710	(187)	(90)	125
Total Canada	250	386	1,200	2,177	1,304	7,596	12,147	18,037
United States								
California	—	—	—	—	600	1,090	1,731	2,003
Texas	—	—	—	—	—	—	—	—
Colorado	—	—	—	—	—	2,176	629	5,143
Total United States	—	—	—	—	600	3,266	2,360	7,146
International	—	—	—	—	—	—	—	—
Total Bank	250	386	1,200	2,177	1,904	10,862	14,507	25,183

Table C.4

Canadian Commercial Bank
Geographic Distribution of Nonearning Loans[a]

	1981[b]	*%*	*1982[b]*	*%*	*1983[b]*	*%*	*1984[b]*	*%*	*1985[b]*	*%*	*1985[b]*	*%*
British Columbia	1.3	10.3	14.2	18.1	14.5	12.1	27.5	14.1	25.4	10.5	42.6	11.9
Alberta	2.5	19.9	37.8	48.1	40.7	34.1	71.6	36.9	98.5	40.9	143.4	40.1
Other Canadian Provinces	4.5	35.7	5.3	6.7	27.3	22.8	8.5	4.4	15.8	6.6	32.8	9.2
Total Canada	8.3	65.9	57.3	72.9	82.5	69.0	107.6	55.4	139.7	58.0	218.8	61.2
Total United States	4.3	34.1	21.3	27.1	37.0	31.0	86.6	44.6	101.2	42.0	139.0	38.8
Total	12.6	100.0	78.6	100.0	119.5	100.0	194.2	100.0	240.9	100.0	357.8	100.0
As a percentage of eligible assets		0.89		4.19		5.91		7.93		9.55		13.64

a. Nonearning loans are net of specific provision for losses.
b. As at 31 October.
c. As at 31 January.
d. As at 1 May, post-assistance.

had reached "devastating proportions". McLaughlan's conclusions were:

1. Senior management's failure to monitor the external environment systematically. Consumers were found to be saving rather than spending. Management failed to recognize fundamental changes made by the recession and deflation. Above all, management underestimated competitive disadvantages of Canadian high technology industries and ignored the devastating impact of the NEP and the November budget of 1981.

2. Loan size concentrations. CCB had an inordinate concentration of loans in the $10M and over category. Accordingly, while NELs were few in number, they currently represented 10 per cent of total assets.

3. Loan administration. The bank suffered collection problems in a region that did not have high loan administration standards.

4. Conventional collection procedures. The bank had been pursuing the historical approach to solve problem loans; that is, continuing to leave management in the borrower's hands while the borrower's business continues to erode.

5. Credit granting mistakes. CCB had unquestionably made some bad credit decisions. The bank moved aggressively into financing drilling rig contractors, which was probably one of the most cyclical industries in North America. This deficiency was a credit policy error. Credit problems also emanated from certain weak regional vice-presidents.

6. Real estate concentrations. Real estate loans in 1982 represented 67 per cent of the nonearning portfolio.

7. The mid-market high growth clients of CCB were found to be inherently weak in a difficult economic climate.

On 31 January 1982, CCB's marginal and unsatisfactory loans (MULs) represented 4.1 per cent of the bank's portfolio. In the ensuing eight months, MULs quadrupled to 16 per cent. In the British Columbia and Rocky Mountain divisions of the bank, MULs stood at 26 per cent. Specific provisions for loan losses climbed from 0.26 per cent of the portfolio in 1981 to 1.0 per cent in 1982. Profit, which had increased by 77 per cent in 1981, declined by 14 per cent in 1982, and, in terms of pretax profit, by 28 per cent.

Signals that all was not well at CCB entered the regulatory system late in 1982 when Bank of Canada officials learned, during a visit to the CCB in September, that the bank had lost a dozen Canadian and several U.S. deposit accounts, and that a number of loans were in difficulty, including oil industry loans. President McLaughlan expressed concern about a loss of confidence which might culminate in a run on the bank. Then in October, the Bank of Canada received informal reports about the health of the CCB. The Governor and senior Bank of Canada officials were advised that "These comments are never very specific, but tend to infer that the Bank has a large number of real estate and oil industry loans that are in difficulty and that its financial position is worse than is commonly believed". These comments were made in a Bank of Canada internal memo produced to the Inquiry from the files of the OIGB. At the end of 1982, at least one director was also concerned that CCB might have become "overextended" as a result of "adventuresome growth" and that the "rapid growth and expansion may have been partly at the expense of fundamentals". DesBrisay wrote:

> During the past year we have been told of substandard lending practices in our Vancouver platform and of similar problems in Quebec and at least one of our U.S. offices. We have heard of waste and inefficiencies in Bancorp. We know that Cancom Equity Fund has been mismanaged. CCB Leasing, I understand, may have been misconceived.

G. HOWARD EATON, THE TRUST COMPANIES AFFAIR, AND THREATS TO CONFIDENCE IN THE CCB

Starting in 1980, several concerns about Eaton gradually emerged and were expressed by the Board of Directors. One was an apparent growing isolation from the Board. Another was Eaton's personal move to the United States. One bank director, DesBrisay, heard rumours in 1979 that the long-term plan for the bank involved Eaton's moving personally to California to oversee a substantial bank presence in that state. In the summer of 1980, Eaton caused the bank to purchase a residence in the vicinity of Los Angeles in order that he could split his executive time between Canada and the United States. This residence was subsequently sold, and Eaton purchased a second with financial assistance from CCB which received an assignment of legal title to this property by way of a deed of trust. To the directors, the CEO's isolation from the Board and the bank's California expansion appeared to be linked. The directors called Eaton to account for these moves but, in mid-1981, did not consider that radical action was appropriate in light of the bank's growing presence in the United States and the successful performance of Canadian operations. A third concern arose when Eaton

began to make personal business investments in the financial sector. These would occupy his time and had the potential of placing him in conflict with the bank.

In August 1982, Eaton advised the Board that he and Leonard Rosenberg, a Toronto financier, and others were forming an organization that had a very elaborate concept and plan. It was almost a bank. Eaton proposed that this organization buy from CCB its United States operation and that in turn CCB would invest in the new organization. The organization would have a number of other major business interests, including an oil company, and was contemplated to have capital of approximately $100M. Most of the Board members were indignant about this proposal. It indicated to them that Eaton was no longer interested in the bank but was going forward with a major business development proposal of his own.

Rosenberg's association with Eaton apparently commenced in 1982. In that year Greymac Mortgage held a 10 per cent share interest in CCB. Rosenberg represented this interest on the Board of the bank after April 1982. In accordance with policies established by the OIGB, he resigned as an officer of Greymac Trust on joining the CCB Board. By October 1982, Greymac Trust, Crown Trust, and other companies associated with Rosenberg had acquired about 30 per cent of the shares of CCB. In October of 1982, Rosenberg resigned from the Board of CCB. CCB refused to transfer the shares acquired by this group of companies as they exceeded the 10 per cent ceiling provided by the *Bank Act*.

These developments also concerned the Inspector General. He felt that Eaton's investment activities were contrary to the proper conduct of a Chief Executive Officer of a bank. In the Inspector General's words, Eaton was "getting greedy" and "losing sight of bankers' principles". He was also concerned that Eaton was not devoting his full efforts to the bank, and had become partially resident in California. All of the directors received a letter of 5 November 1982 from the Inspector General in which he outlined his concerns regarding Eaton. In response to pressure from the Inspector General, the directors followed up their own earlier concerns and took steps to replace Eaton as Chief Executive Officer of the bank.

At the 30 November 1982 Board meeting, it was decided that the directors should seek advice from the shareholders whom they represented, and the matter was put over to the January 1983 board meeting. Consideration of the problem was interrupted by the "seizure" by the Government of Ontario on 7 January 1983 of Crown, Seaway and Greymac. This produced an immediate effect upon CCB. While the

bank was not particularly heavily involved with Rosenberg, and Eaton was in the stages of early association with Rosenberg, there were rumours that CCB had financed Rosenberg's acquisition of the trust companies. This was untrue. It was agreed that Eaton would resign from the Board, and that McLaughlan, who had been the President and Chief Operating Officer, would succeed him as Chief Executive Officer. All of these developments were announced on 25 January 1983.

The Trust Companies Affair accelerated the resolution of the Eaton problem, although this appears to have been untimely from the bank's perspective. In a meeting with the OIGB on 18 November 1982, Eaton stated that he saw no immediate successor should he resign. While both Eaton and Bill McDonald, a director who eventually succeeded Eaton as Chairman, felt that Eaton's immediate resignation would not be in the best interests of the bank, his resignation was brought about in January 1983, and McLaughlan was appointed CEO. He was, at the time, 37 years of age but had 15 years experience in banking, mostly at lower levels of responsibility. After joining CCB in 1976, McLaughlan had advanced from Vice-President, Alberta and Saskatchewan to Executive Vice-President, Canadian Division.

The immediate effect of the seizure of the trust companies, and Eaton's resignation from the bank, was money market turbulence. Concerns were expressed to the Governor of the Bank of Canada by CCB and the Inspector General about declining market confidence in the CCB and the possibility of "contagion" effects on the Canadian financial system. On the evening of 25 January 1983, the Governor consulted the Inspector General and the banking community directly concerning the problems facing the CCB and concerning the possibility that turmoil in the financial markets could escalate rapidly as a result. In view of its perceived responsibility to preserve confidence in the financial system, the Bank of Canada contacted the press that evening. A press release was issued by the Bank of Canada on the morning of 26 January 1983, indicating that the Canadian Commercial Bank was solvent, and that the Bank of Canada would provide liquidity support, if reqired. The Bank of Canada dispatched its Comptroller to the CCB offices in Edmonton to ensure that the Bank of Canada was in a position to provide liquidity advances, if needed, and to monitor the bank's day-to-day funding activity. On 28 January, an agreement was executed whereby the Bank of Canada took security for any advances made to the CCB.

In view of the potential impact of CCB's liquidity difficulties on the financial system, certain chartered banks explored alternative methods of providing liquidity support at the request of the CCB. After

receiving positive responses from the large chartered banks regarding the possibility of establishing a special liquidity support package for the CCB, the Bank of Canada convened a meeting of representatives from the Royal Bank of Canada, the Toronto-Dominion Bank, the Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, and the Bank of Montreal ("the five chartered banks") on 7 February 1983. At that meeting, the Inspector General reiterated his conviction that the Canadian Commercial Bank was solvent. The five chartered banks agreed to provide a special liquidity facility to the CCB. During the meeting, the five chartered banks sought a formal undertaking from the Bank of Canada in support of the special facility. The Bank of Canada took the position that its public commitment as lender of last resort should provide sufficient assurance to the five chartered banks and, furthermore, that they should not be provided with more assurance than that afforded to any other depositor in the CCB.

The CCB did not, in fact, borrow from the Bank of Canada under the terms of the 1983 security agreement, but did make use of the special credit facility provided by the five chartered banks. All amounts borrowed by the Canadian Commercial Bank pursuant to that facility were repaid by 22 June 1983, and the facility was allowed to lapse. On 17 October 1983, pursuant to a request from the CCB, the security agreement in favour of the Bank of Canada was terminated.

The bank had, just before the Rosenberg/Eaton publicity, brought a preferred share issue in the amount of $25M to the preliminary prospectus stage. This initiative was abandoned as a result of the Trust Companies Affair. The shares which the trust companies had acquired, amounting to nearly 30 per cent of the CCB stock, were overhanging the market so that raising new capital presented an immense problem. Overall, confidence in the CCB had been eroded. Senior officers of the bank visited large depositors in an attempt to convince them to continue their business with the bank. Larger wholesale depositors, such as the Government of Ontario and Ontario Hydro, were lost and never returned. In March 1983, McLaughlan reported that the episode cost CCB between 15 and 25 basis points (100 basis points being 1 per cent) on the interest costs of its deposits, which added cost was never fully eliminated. There was a perception widely held, without any factual base so far as the evidence in this Inquiry is concerned, that the bank was part of the trust company scandal. This taint never left it.

H. CONTINUING TROUBLES IN CCB'S CANADIAN OPERATIONS

CCB had committed itself to an expansion program in 1980-81 in an effort to reduce the regional concentration. Yet because of the

recession, the bank found limited opportunity for new business in the regions into which it had expanded. Moreover, the funding problems caused by the trust company affair necessitated a curtailment of new business. The expansion expenses resulted in a very heavy operating cost burden. During 1983, programs were implemented to reduce expenses. Staff reductions were made. A salary freeze was put in place. In January 1983, zero-base budgeting was introduced and less profitable offices were closed. Noninterest expenses, as a ratio to average assets, climbed in 1983 reflecting the expansion program, but declined in 1984.

It was also recognized that the concept of wholesale funding on which the CCB had been founded was no longer acceptable. The bank established reserves sufficient to carry it for ten days without accessing the money market. In addition, commencing in April 1983, CCB attempted to build a retail deposit base. Retail deposits were increased to 4 per cent of total deposits by the end of 1983, and 25 per cent of total deposits by 1985. In 1983, the bank had 2000 depositors, and this was increased to 15,000 depositors in 1985. This program of course increased the bank's expenses.

In March 1983, the CCB updated the OIGB on its financial condition. CCB was then paying a premium of 15 to 25 basis points for its deposits, by virtue of the Rosenberg affair. Development of new business had been terminated in order to relieve funding pressures, and the substantial growth in noninterest expenses was expected to impact very negatively on the profitability of the bank when coupled with narrowing interest spreads. CCB continued to experience problems with its Western Canadian loan concentration. The NELs could not be reduced instantly because CCB clients, middle market businesses, did not have ready access to equity financing, and their only capital source (profitability) was eroding due to the recession. By this time, the market was so depressed in Alberta that assets held by the bank as security could not be disposed of for acceptable prices. Even at drastic price levels, buyers were hard to find. The DBRS, a rating service, reconfirmed CCB's paper at R-1 (low).

On 30 June 1983, McLaughlan took further steps to tighten the lending policy by placing a lending limit of $10M on any one loan, and restricting the types of real estate loans that could be made. Real estate loans were 40 per cent of all loans at this time. They were not being reduced, however, because existing real estate loans were not being retired. In further response to the crisis, McLaughlan strengthened the Special Credits Group to provide intensive care to troubled loans. The types of workouts pursued by this group included the transfer of troubled real estate loans to special purpose companies with little or no

capital, and with funding advanced by the bank for the purchase of the security held by the bank. The bank would also take a profit-sharing position in the purchaser. Bad loans continued to increase throughout 1983. MULs, which had stood at 16 per cent of the portfolio as of 30 September 1982, had increased to 17.88 per cent as of 25 January 1983. However, the increase in MULs in the U.S. portfolio for the same period was 60 per cent. Further, the loans judged by CCB to be "more than average risk" stood at 31.45 per cent as of 25 January 1983, even though MULs stood at only 17.88 per cent.

Table C.5

CCB Financial Indicators 1983-84

Financial Indicators (OOO's)	*1984*	*1983*
Loans	2,415,927	2,006,231
Appropriations for contingencies	16,596	23,947
Contributed surplus	25,680	25,334
Retained earnings	112	7,372
Interest income	284,128	221,587
Total interest expense	256,883	191,419
Net income for the year	804	6,505
Loss experience on loans	25,000	14,500
Provision for loan losses	14,800	9,000

It can be seen from the financial indicators set out in Table C.5 that the appropriations for contingencies account declined in 1984 by 30 per cent. The function of this account is to act as a reserve for unforeseen future loan losses. An unsophisticated reader of bank financial statements might conclude from the decline in the account that the affairs of the bank were improving while, in fact, the opposite was true. The account is depleted by rising loan losses which are recorded in the financial statements. It is replenished by transfer from retained earnings or surplus. Acting with the encouragement of the auditors, CCB applied to the OIGB to increase the account for fiscal year 1984 by transfer from contributed surplus. The OIGB denied this

transfer on the ground that the entire capital of the bank is a buffer for loan losses. As well, it was impossible to make the transfer from retained earnings because it is not in compliance with generally accepted accounting principles to force the retained earnings account into a deficit. The account can only be forced into a deficit from operating losses. In the 1984 financial statements, this account did not present the true picture of losses, actual or apprehended.

The notes to the CCB financial statements are mostly unexceptional. Loans were stated to be carried at their principal amount less any specific provisions for anticipated losses. The accrual of loan interest income was discontinued where interest or principal is contractually past due 90 days unless senior credit management determines that there is no reasonable doubt as to the ultimate collectability of principal and interest. Practices underlying the determination of the principal value of the loan (such as capitalization of interest), and of the establishment of a provision (such as the use of baseline values for security valuation) are not required to be disclosed in the financial statements of a bank, nor are such matters customarily disclosed in the statements of the major banks. These practices and their significance are discussed fully in the Analysis section of this Report.

Table C.6

CCB Income Trend 1981-84

Year	*Net Income*	*Percentage Change in Net Income*	*Pretax Income*	*Percentage Change in Pretax Income*
1981	9.9M	76.8%	17.4M	68.9%
1982	8.5M	(14.1%)	12.6M	(27.6%)
1983	6.5M	(23.7%)	8.2M	(34.9%)
1984	0.8M	(87.6%)	(6.9M)	(184.1%)

A trend of declining net income from 1982 to 1984 is revealed in Table C.6. In 1981, the bank's net income of $9.9M had been a 76.8 per

cent increase over 1980. By 1984, the bank had suffered its first loss (before recovery of income taxes).

The deterioration of assets in CCB (Canadian and U.S. Division combined) after 1981 was very dramatic, as illustrated by Table C.7.

Table C.7

CCB Asset Quality 1981-85

Type of Loan	*1981*	*1982*	*1983*	*1984*	*31 Jan. 1985*	*30 Apr. 1985*	*31 July 1985*
MULs	42M	298M	466M	574M	744M	691M	723M
MULs as a % of total loans	3.4	17.8	20.2	25.4	29.2	29.0	29.0
Non earning loans	13M	79M	120M	194M	255M	409M	434M
NELs as a % of total loans	0.9	4.2	5.9	7.9	10.1	17.2	18.9
Loan loss experience (millions)	1.9	10.9	14.5	25.2			
As a % of eligible assets	0.13	0.58	0.72	1.03			
% increase over year		465.2	33	74			

I. CALIFORNIA OPERATIONS AND U.S. REGULATION

1. Westlands

Following a consultant's favourable study and examination, CCB acquired an interest in Westlands, a California bank, in September 1981. The acquisition of a 39 per cent interest was consistent with CCB's original intention to operate outside Canada's borders. California was considered to be a suitable region for expansion because of certain similarities with the Canadian banking environment, notably a perceived gap in banking services in the middle market. (Details of the Westlands capital structure and holding company arrangements are omitted as unnecessary to an understanding of the Westlands investment.)

Westlands was acquired because the CCB's L.A. Agency had no deposit-taking authority; hence, acquisition of a U.S. domestic bank was necessary to pursue a fully integrated expansion into this market. Westlands was recommended for acquisition by a consultant's study commissioned by Eaton. It was presented to the Board in November 1980. After vigorous debate, it was agreed in principle to acquire 39 per cent of the bank along with sufficient warrants to take CCB to a controlling position. Consolidation with CCB's operations was not desired at the outset for, while Westlands had some attractive features including its ability to generate deposits and its computer software services provided to title and escrow agents, the bank had suffered in the California real estate recession, and had indeed suffered losses from 1974 to 1976. Consolidation of accounts was therefore undesirable and so a majority position was not taken. Even by 1980, capital was impaired, growth was restricted by the capital problems, profitability was low, a number of long term low yield mortgages remained on the books, and the deposit base, consisting mostly of demand deposits from the escrow industry, was unstable. Some directors expressed their view that Westlands had problems, that it had not yet demonstrated a return to profitability, and that CCB was overpaying to buy into a turnaround situation. The majority of directors, however, considered that Westlands had good prospects for a return to profitability, and indeed, forecasts prepared by the consultant showed rising profitability for all the forecast years, 1980 through 1984. In the result, the purchase of this bank, with a loan portfolio highly concentrated in real estate and funded on the volatile wholesale deposit market, was approved. This improvement was to proceed under control of Westlands' existing "good professional management", with the close monitoring of CCB's Executive Vice-President, United States. Upon return to profitability, Westlands would become CCB's U.S. banking vehicle, and the Agency would be wound down.

By 1983, the truth about Westlands had been revealed. Management were incompetent, the portfolio had not been diversified, and deposits had become even more concentrated in the brokered deposit market. DesBrisay testified that these matters had not been obvious in 1981.

> The mistake was, after acquiring Westlands, we did not go into it, as we later found out, and put in our systems and see that there was a first-class management team. We put somebody in charge of the whole United States banking operations that was not a banker. That was certainly one of the dumb things, in retrospect, that we did.

McLaughlan stated that Westlands had been treated as a passive investment.

On 17 October 1983, the results of an inspection of Westlands by the Federal Deposit Insurance Corporation of the United States, which was the federal inspection authority for that bank, reached the OIGB in Canada. The FDIC report indicated inadequate supervision by the Board, an excessive volume of adversely classified loans, inadequate capital, poor earnings, inadequate liquidity, highly volatile liabilities, and incompetent management. The report indicated that Westlands was in worse condition than both CCB management and the OIGB had thought. Although some CCB directors or officers were on the Westlands Board, the OIGB did not take this as a criticism of the CCB Board since CCB advised the OIGB that steps were being taken to replace Westlands' management and directors with CCB personnel. The OIGB concluded that the problems arose from the days when Eaton was on the Board of Directors of Westlands. The FDIC inspection of Westlands began in March 1983 when the impact of the Eaton Board would still be felt on Westlands.

McLaughlan joined the Westlands Board in April 1983 and directed a series of measures designed to strengthen operations. He caused CCB Bancorp Inc., the U.S. holding company of the CCB, to withdraw from certain real estate activities in the United States, and removed from the Westlands Board the directors who had been involved in these activities. A new Chief Executive Officer, Linwood Boynton, was appointed at Westlands, and by February 1984, the President, Chairman, Chief Credit Officer, and Controller of Westlands had been replaced with CCB personnel. Much of this was in response to a "cease and desist" order issued against Westlands by the FDIC in October 1983.

On 27 June 1984, CCB purchased the remaining 61 per cent of the outstanding shares of Westlands. CCB took full control of Westlands for a number of reasons. First, the U.S. regulators had exerted pressure on CCB to save Westlands because CCB was a large minority shareholder. Second, CCB had obliquely agreed in 1981 to be a potential source of capital to Westlands. In 1983, the FDIC demanded a $5M capital contribution which CCB was unwilling to give without full control. Third, California was still regarded as an attractive place to diversify. If Westlands and its existing branch network were abandoned, CCB's opportunities to do business in the United States would be destroyed because the L.A. Agency could not take deposits. Fourth, Westlands had a line of computer software products which could be profitably marketed to other financial institutions. The software earned $1M in revenue in 1984; for 1985, the budgeted figure was $4M or $5M (Cdn.). Finally, by 1984, the Westlands loan portfolio seemed purged of problem accounts, management had been improved, and Westlands was

not paying tax because of a large loss carry-forward. CCB therefore expected to enjoy a net after-tax profit from the Westlands operation.

Westlands was an expensive acquisition. The 39 per cent interest had been acquired for $5.4M (U.S.) plus a capital note advanced by CCB in the amount of $3M. In July 1983, CCB extended a $10M credit facility to Westlands in lieu of an immediate capital injection demanded by the regulators. The balance of Westlands' shares, 61 per cent, cost $3.6M. Further, between 28 June 1984 and 2 July 1984, CCB acquired loans from the Westlands Bank for $87.3M (U.S.). These loans were problem loans which were taken over by CCB in order that Westlands could make profit and thereby use its tax loss carry-forward. Between June and October 1984, CCB contributed $44.5M in capital to Westlands by a transfer of better quality L.A. Agency loans. CCB also loaned to Westlands, at fiscal year end 1984, a $41M discount debenture. The income earned on this debenture was applied to pay down the $10M credit facility and the capital note with the object, again, to accelerate recovery by Westlands of its tax loss carry-forwards. In short, CCB injected $98.8M (U.S.) into Westlands over and above the $87.3M (U.S.) purchase of problem loans from Westlands.

By February 1984, the only outstanding issue regarding Westlands was the capital contribution to be made to Westlands, the other matters in the cease and desist order having already been resolved. However, the poor performance of Westlands affected CCB's results. On 23 March 1984, McLaughlan reported to the OIGB on CCB's 1984 first quarter results. Earnings declined 37 per cent from the comparable period in 1983. The major factor was the recognition of CCB's 39 per cent share of losses sustained by Westlands following a substantial increase in Westlands' provision for loan losses. The impact of the affiliate's loss was amplified through equity accounting as the CCB was unable to generate any tax relief in the transaction. From September 1981 to 27 June 1984 CCB took into its accounts 39 per cent of the earnings or losses in Westland. Thereafter 100 per cent of Westlands' losses were consolidated into CCB's accounts.

It appears, however, that the directors had for sometime been unaware of the extent of the problems in Westlands Bank. One CCB director, Peter Darling, in a letter of 6 April 1984, described CCB's investment in Westlands as "an appalling legacy from the Howard Eaton days". Darling stated that the directors had consistently underestimated Westlands' capital needs. After the initial acquisition, some indication of how the Westlands' investment was treated in CCB can be seen from the following quotation from this same letter:

> ... Subsequently to our initial investment, Westlands became a taboo subject at CCB board meetings and questions addressed to Eaton were turned aside, but it is clear that further infusions of capital far in excess of our expectations were required. Can we be sure the same will not be true in the future if Westlands is to prosper rather than just survive?

In reply, McLaughlan assured Darling that "we have the requisite talent and market opportunities to rebuild Westlands and restore it to profitability over the next 18 to 24 months".

The magnitude of problems in Westlands Bank was not disclosed or understood until CCB management was installed in Westlands Bank. The absorption of unanticipated losses at Westlands Bank reduced CCB's 1984 earnings by $6.5M. The impact of the acquisition of Westlands on CCB net income for the year ended 31 October 1984, taking into account acquisition costs, share of Westland losses, contributed loans, bad loans assumed, loss of earnings on advances to Westlands, amounted in all to $7.5M. Loss recognition in the CCB accounts for 1983 brings the total impact (subject to some technical adjustments under taxation statutes) to approximately $9M (Cdn.).

Once the course of investment in California was set in 1981, the losses in the later years became as unavoidable as some of them were unforeseeable. Westlands was not without prospects. It had an apparently valuable property in computer software. It was earning a profit in 1981. 1983 was the first year that Westlands had suffered a loss since CCB's initial involvement in 1981. Net income had remained more or less stable from 1979 until 1981, and a rapid decline in net income was experienced in 1982 due to the sagging California real estate market. Perhaps even more serious was the drain on CCB's managerial energies in 1983-85 at a time when the Canadian base of the bank's operations came under siege. In CCB's *Strategic Plan 1985-1987*, a document completed in December 1984, McLaughlan described Westlands as "consuming an inordinate amount of senior management time". Westlands' loan portfolio being concentrated in real estate was hardly a sound diversification measure.

2. L.A. Agency

CCB operated a branch, called an Agency, in Los Angeles, California from 19 November 1979 onwards. The Agency was established with the object of diversifying geographically the bank's loan portfolio. Other branch offices were later established elsewhere in the United States.

The loans outstanding in the L.A. Agency over the past several years are set out in Table C.8.

Table C.8

CCB L.A. Agency Loans
1982-85

Date	*U.S. Dollars (000's)*
31 October 1982	256,900
31 October 1983	370,100
31 October 1984	343,190
31 January 1985	257,900

The condition of Westlands as described in the preceding section precluded its immediate use as the CCB United States marketing vehicle. Hence, in the interim, the L.A. Agency was maintained as a lending base. By February 1984, the FDIC cease and desist order had been satisfied in all respects but for the infusion of additional capital into Westlands. This was resolved, and in June 1984, CCB acquired a 100 per cent interest in this California bank. As a result, it became CCB policy to wind the Agency down.

As has already been seen, bad loans were transferred from Westlands into the Agency, and good loans were transferred from the Agency into Westlands. The effect upon the Agency is, in part, illustrated by the comments of Bruce Cockburn, who was appointed as a Special Representative of the Inspector General pursuant to the CCB support arrangements of March 1985. Out of the 76 support group loans in the L.A. Agency, 46 were real estate loans, accounting for $42M of the $142M of loans from the Agency in the support group. Cockburn testified that approximately 2/3 of those real estate loans originated in Westlands Bank. The Agency also possessed a large number of energy loans, which must now be described.

Prior to the economic collapse of the U.S. oil and gas sector in 1982, CCB had been lending aggressively to the contract drilling industry for the purchase of land drilling rigs. This policy left the U.S. Agency with a number of difficult situations where land drilling rigs served as collateral in an environment in which equipment values were falling as much as 80 per cent and very little profitable work was available to the bank's customers. To assist borrowers and to avoid the alternative of liquidating drilling equipment in a distressed market,

CCB (L.A. Agency) initiated a bank-sponsored drilling program (BSDP) in mid-1983. This program entailed CCB funding single-purpose third party oil companies (the "Operator") for some combination of the costs of lease acquisition and drilling "low risk" development-type drilling locations in proven oil and gas fields. The bank took a small equity participation in the resultant oil and gas wells as well as the normal cash flow dedication required to repay the drilling loan. As a condition of the loan, the Operator was required to use a drilling-rig operator designated by CCB (the "Driller"). CCB would then finance the acquisition of rigs either from troubled borrowers of the CCB or from CCB itself. The acquisition price was in most cases the face value of the existing CCB loan. CCB would then fund the Operator, who in turn would pay the Driller, who in turn would pay the interest on the acquisition loan to CCB, which CCB would show as income. The economics of the project were based on stable oil prices at between $28 to $30 per barrel. The availability of far cheaper rigs threatened the project's economics from the outset.

In a memo dated 5 April 1983, Boynton, the then Vice-President, Special Credits, stated with respect to the BSDP, that:

> You will appreciate that the program described above is not without considerable risk to the bank and goes beyond ordinary lending criteria. The willingness of the bank to undertake such risk is a reflection of the concern over the non-earning rig loans and the conclusion that the risks are worth taking, subject to scrupulous engineering, *to avoid substantial and unpalatable write-offs.* (emphasis added)

McLaughlan acknowledged that the drilling industry was volatile and that the bank had excessive exposure to it. However, he testified that, because the rigs were involved in development drilling rather than exploration, he did not agree that the BSDP was a high risk loan recovery strategy and that the CCB risked "any additional money".

On 5 December 1983, Neville Grant of the OIGB visited U.S. banking regulators associated with the Federal Reserve Bank of San Francisco, FDIC, and California State inspectors. These officials had completed an examination of CCB's U.S. Agency in late 1983. Grant was told that there were concerns with the quality of the loan portfolio in the L.A. Agency in energy and real estate. California banks were then writing down loans in the drilling rig sector, and CCB should be doing the same. Grant testified that he was advised by "CCB's Canadian auditor" that the auditor was satisfied that there had been no significant deterioration in the loan portfolio of the L.A. Agency. Grant did not identify his informant.

McLaughlan attended the exit interview of the California State Examiners in late 1983. He testified that the examiners agreed with CCB loan classifications; NELs had been written down, and loans in the rig program were satisfactory to the examiners. The examiners subsequently changed their position, and advised the OIGB on 12 December 1983 to expect a bad report on the Agency. Between the exit interview and the report, a state examiner had decided that there was an inadequate track record regarding the rig program. Accordingly, writedowns were necessary. Doyle told the CCB, as he would have advised any foreign bank in a similar dispute, to write the loans down or "take them home". Starting in March 1984, CCB elected the latter course; marginal loans and loans criticized by U.S. regulators were transferred to head office in Canada. McLaughlan admitted he was fed up with the regulatory system in the United States, but stated that he decided to transfer these loans to the head office in order to wind down the Agency in accordance with plans to utilize Westlands as the sole CCB market vehicle in the United States. He denied that the transfer was made to avoid tougher regulation over the quality of CCB loans. In any event, the Inspector General was supportive of CCB's workout programs and critical of the more general U.S. approach of writing down loans by sector.

CCB recognized certain weaknesses in the BSDP. Due to the rig surplus, one could purchase a rig for less than the amount for which CCB could transfer repossessed rigs to other customers. Therefore, competition could drill more cheaply than a CCB client, and any drop in the price of oil from the $28 to $30 (U.S.) range would have an amplified impact on CCB's client drilling contractors. In a falling market, CCB's client drilling contractors would be unable to compete. Yet there were several offsetting factors: (a) CCB drillers were experienced; (b) not all surplus rigs were located in California where loans were booked (CCB drillers had their rigs on location, which was an advantage); and (c) production funding was drying up. Since the CCB was prepared to fund production, leaseholders and their assignee operators were attracted. Thus, prior to February 1985, the BSDP was generally considered to have merit. Indeed, an experienced outside observer later gave the opinion that in late 1983, and through 1984, the program was working and appeared to have merit. On 1 February 1985, Robert Heisz assumed control of the Special Credits Department of the L.A. Agency. Credit officers in the Agency had found evidence of a decline in drilling activity. Heisz therefore caused an examination to be made of the energy portfolio which resulted in serious alarm. The contents of Heisz' report on the U.S. energy loans, the communication of his findings within the CCB, and the extent to which officials of the bank had reason to anticipate or were actually aware of existing

difficulties in the U.S. portfolio are important in relation to the CCB's search for assistance in March 1985. Accordingly, fuller consideration of these factors is undertaken in Appendix D.

J. BANKING PRACTICES AND OIGB SUPERVISION

1. Workouts

The recession forced the bank, in 1982, to commence various types of complex workout arrangements. New companies were established and financed to take over real estate securities, manage them expertly, and thereby enhance recovery. In the United States, the bank initiated the BSDP. In some cases a profitable oil and gas security would be married to a problem real estate loan by merging the two borrowers to carry both through the recession. In one case, money was loaned to purchase a strip coupon bond, which on maturity would be of sufficient value to secure the loan workout and the money loaned to purchase the bond.

Shortly after becoming President and Chief Executive Officer, McLaughlan called a meeting, on 26 January 1983, to investigate means of reducing the percentage of nonearning assets on the bank's balance sheet. The senior officers of the bank agreed that, while usual collection procedures that would see the bank recoup its funds should be pursued, difficulties would arise as a result of the depressed values of security held in support of loans. It was further agreed that "some stretch-out of existing arrangements on a basis that would see interest serviced in a regular manner would afford the possible benefit of economic turnaround and workout as well as removing the concentration of difficulties and spreading them over a longer earning period". As a result of this meeting the special credits group was formed and substantial resources were committed to this loan recovery unit. McLaughlan made it clear that this group would develop procedures which went beyond the usual collection procedures:

> The President and Chief Executive Officer made it clear that innovation should be exercised to see clean-up or extension of these troublesome assets effected.

The following extracts from McLaughlan's testimony set out the problems facing management and the approach adopted:

Q. What could have been done and by whom and when to save CCB?

A. The reasons that I have mentioned earlier, I am not sure, short of a merger, that CCB could have been saved.

Q: How far back was that condition irreversible? Where did it start?

A. It really started in 1983.

. . .

Q. And from that time on, merger was the only sure-fire solution?

A. Well, it was not obvious until much later.

. . .

Q. It was not apparent in 1983. When did you first realize the only way out of the quagmire was a merger?

A. February 27, 1985.

Q. Why was the condition cloaked so deeply that it went two years before a banker of your experience realized it?

A. Because I had certainly concluded, in terms of the U.S. energy loans, that the programs that had been in place were going to deliver the planned results. In terms of the balance of the problems in the bank's portfolio being primarily Western Canada, the recovery that was underway would have seen the bank slowly recover to respectable and stable profits. Until the U.S. energy loans collapsed, I certainly felt we had a reasonable chance of making it, a very good chance of making it.

. . .

Q. Then, what is wrong with management in trying to skate across the thin ice about from early 1983 to September 1985 in adopting accounting procedures which would enhance assets and sustain revenues and still not violate any of the CICA code; what is wrong with that?

A. I see nothing wrong with that.

Q. Is that not the reason that your management, before you took over and during your regime, adopted baseline average and capitalization of interest, workouts, rollovers, Newcos and all these things within the rules of accounting; is that not really the reason that you had to do that?

A. Well, really, the reason, in my impression, was to get through a difficult trough that the bank was in, and not going into a liquidation scenario in that period.

Q. Right, and that was the mode adopted?

A. That was the mode adopted. Using a going concern approach and loan recovery strategies in those two industries – real estate in the west and U.S. energy. Again, these ifs, I guess, are pretty difficult to grasp, but I think this bank, as I said earlier, would have made it without, again, the volatility of that U.S. energy industry.

Robert Lord of Clarkson, Gordon, one of the auditors of CCB, described the generic term workout as follows:

> In the case of problem loans, the bank would be faced with a choice of either collecting the loans, forcing the collection of the loans on an immediate basis, or restructuring them to achieve a better collectability in the future.
>
> The choice really involves the bank as a business decision in deciding whether it should liquidate a loan and dispose of the security in a very depressed market in the case of a number of these loans, taking the large loss that that would involve or, on the other hand, whether they should carry the loan until it could be fully or more fully collected. ...

... In the simplest form, carrying a loan at a reduced interest rate or at no interest to provide time to allow the security value of the loan to recover would be one example of a workout ...

... You might also rearrange the terms of the loan to enable the borrower to repay it over a longer period of time. You might restructure a loan either as to the terms for the payment of interest or the interest rate. You might use an income debenture, which, if you could qualify under the Income Tax Act, would allow a business currently suffering losses to pay interest at a substantially reduced rate, which would assist, or you could convert a portion of the loan to equity and retain a portion as debt ...

... The bank might provide additional financing to the borrower to enable the purchase of assets which would provide cash flow to service the debt. This may involve the use of a tax loss in the borrower to shelter the new income and to enable it to service both the old and the new debt.

An example of this kind of workout would be the use of a new loan to allow a company to acquire, for example, oil and gas properties which would have cash flow or to use, in a more complicated workout, a new loan to allow the use of a stripped bond which, over a long period of time, would provide funds to repay both the debt and the return on the debt. In addition to the financing, another method would be to arrange to bring in new management for the business to improve the operation of the business so it becomes viable and able to pay the loan and service the loan.

The security underlying such workouts was valued on a going concern basis, with expected realization in two to three years. The value thereby determined was referred to in the bank as "baseline value". Such a valuation was meant to meet the problem that security posted with the bank in good times was from 1982 onwards very much undervalued due to the depressed market. This practice (as opposed to a normal going concern valuation) commenced in 1982, and continued on a bank-wide basis in 1983 and 1984. It affected the financial statements of the bank because the value of security is a factor to be accounted for when determining whether to establish a provision for loss in an account, accrue interest, or capitalize interest.

"Company Zero" is a good example of a significant workout. This was an experimental new company which acquired, at the lesser of appraised value and the bank's cost (being principal plus uncollected interest), real estate properties held by the bank after security realization. The bank, in turn, would finance these companies with cost-of-funds loans and effectively retain the same security with the addition of a floating charge debenture. The company was also granted an operating line of credit, secured by a joint and several guarantee of the principals of the company. This line was authorized at $250,000. The sale to Company Zero often included capitalized interest. The loan to Company Zero eventually reached about $23M. The company's principals (one in Canada and one in the United States) were chosen

because they had successful records in the real estate business. They invested no equity into the company, and gave no guaranties apart from the guarantee of the operating line. Company Zero was contractually required to pay interest on its loans. However, most of the property transferred had no cash flow and so no interest was paid. Accrued interest was added on to the Company Zero loan but not taken into income of the bank.

There were two concerns with Company Zero. The auditors were concerned that it was the bank's intention to capitalize interest on loans to these companies to the extent of appraised values rather than loan values (capitalization to loan values was the policy of the bank at that time). This concern was brought to the attention of the Audit Committee. The practice of capitalizing to the extent of appraised values was identified as less conservative, and a recommendation that interest only be capitalized up to the loan value was approved. The OIGB was concerned because Company Zero allowed CCB to create a "pool" of assets. Upon a sale, if the price for the asset was below the price for which CCB had sold it to Company Zero, CCB would not recognize the loss nor make a provision on the Company Zero loan. When this actually happened on one property, resulting in a $700,000 loss that CCB did not recognize, the OIGB dispatched a staff member, Courtright, to discuss the matter with Gaudet, a senior bank officer. Courtright's report explains the reasons for the Company Zero deal, CCB's defence of its accounting treatment, and the concrete consequences on the income statement from CCB's "rather liberal and inappropriate" treatment of Company Zero as a "stand-alone vehicle".

> The problem with the [Company Zero] loan is that the valuations have proven to be too great. A sale scheduled to close on April 2, 1983, will see virtually half of the properties sold for $1.1 million. This would leave a loan outstanding of $1.7 million and the most realistic value which could be given to the remaining property is perhaps $1 million. This means that there will be a $700 thousand loss on this transaction.
>
> I enquired with Gaudet whether this would mean that the Bank would write off $700 thousand and was startled to find that it was not planning to do so.
>
> I suggested that in reality the Bank had lost the $700 thousand at the time that it had to foreclose the [1.7 mm] loan and that conservative provisioning would have taken the loss at that point. Gaudet admitted that with hindsight this was true. However the Bank had felt at the time that it could realize the roughly $3 million or more on the properties and had in good faith not taken the provision.
>
> I conceded this point to Gaudet but enquired why now that the facts were known a provision would not be taken at this point. Gaudet indicated that now the loan was part of the [Company Zero] deal and was no longer a tag-end of the [other] deal. He indicated that while [Company Zero] may be down $700 thousand on this property it could make that much or more on the sale of subsequent properties.

Gaudet indicated that he keeps a careful tab of the estimated realizable values on the [Company Zero] properties and the loan values against them. By loan value he means the cash advance and the amount of interest which had been capitalized. Gaudet indicates that he does this for all of the [Company Zero] properties collectively and that at this time in spite of the loss of $700 thousand on the [1.7 mm] property, there is only a marginal discrepancy between his estimate of the value of all of the properties which [Company Zero] is trying to sell and the Bank's loans to [Company Zero]. He suggested that if this gap was to become significant then provisions would have to be made against it.

I questioned this practice indicating that it appeared to be open ended and that the Bank could presumably defer a provision that it should make by transferring into [Company Zero] a property which it estimated would sell at a good premium over the transfer price.

I suggested that in reality that Bank had underprovisioned on the [$1.7 mm] deal and that it would be appropriate for it to recognize this now that the property was liquidated.

Gaudet indicated that there was nothing that the principals of [Company Zero] would hate more than for the Bank to take such write-downs or losses because the Bank's deal with [Company Zero] regarding profit sharing between the principals and the Bank meant that the loss of some $700 thousand on the [$1.7 mm] properties would have to be more than offset by gains on the sale of subsequent properties before there was a defined profit which could be split between the Bank and the principals.

I indicated to Gaudet that this was immaterial to whether the Bank took a provision or not and that its accounting and its deal with [Company Zero] could proceed as planned and quite independently of the Bank taking any provision on this transaction.

Gaudet did not seem to see things this way and argued that the [Company Zero] company was a unity and the twelve or more properties in it formed a diversified portfolio on which the Bank hoped that gains would more than offset losses. While there was valid reason for this hope to persist, he would not recommend that provisions be taken on the loss on the sale of certain properties.

I raised this concern with Mr. Macpherson who agreed that it certainly appears to be rather liberal and inappropriate to treat [Company Zero] as an arm's length and bona fide and stand-alone vehicle when in fact it was very much a creature of the Bank which had been formed for the expressed purposes of liquidating properties.

A third concern which comes out of the [Company Zero] type dealing is the matter of interest which has been capitalized prior to the properties going into [Company Zero].

Courtright contacted the auditors on 21 April 1983 to discuss Company Zero. While the auditors had recommended to the bank, at 1982 fiscal year end, that interest not be capitalized beyond the normal lending value of the underlying security, the bank had apparently disregarded this advice. Further, the establishment of provisions on a

pool basis, allowing the off-setting of potential losses against anticipated gains on the remaining properties, had been discussed with senior management by the auditors at 1982 year end. The auditors had understood that the properties would be evaluated on an individual basis. Eventually, bank management agreed to assess properties in Company Zero on an individual basis. The bank entered into other similar arrangements.

The auditors reported to the Audit Committee their estimate that, as of the 1984 year end, approximately $350M of the bank's loan portfolio was committed to limited recourse workout loans. These were situations in which the bank had taken control of security and entered into arrangements with new borrowers to acquire such properties, usually on the basis that the bank would provide financing to allow the new borrower to acquire the related assets.

2. Baseline Values

The concept of "baseline value" was extensively discussed in the hearings because it was an integral part of the CCB strategy. Several definitions emerged. McLaughlan testified initially that:

> First of all, you are dealing with a concept that was not widely in application within the bank in the terms of the label you are using, baseline values. It was essentially dealing with assets in a depressed marketplace, in endeavouring to determine its going concern value would be as opposed to a liquidation value, not a fair market value as you describe it, a liquidation value, a forced sale value.
>
> The term baseline value, or the label baseline value, has been blown up, I think completely out of proportion. It was simply an addition to the glossary of banking terms that we use to communicate in this particular market on what is the going concern value of this collateral securing a loan.

Gaudet, the Senior Vice-President, Special Credits, testified as follows:

> But basically baseline is an internal term that we came up with which is short sic: form for the estimated value of our security on a going concern basis. It is no more than that.

Gaudet later stated:

> ... so today when you look at properties that have decreased in value by 50 or 70 or 80 per cent because of the economics and the lack of buyers, I think it behooves us to look at the property in terms of what its real worth is, and I guess that gets us back to our so-called baseline value, which is our calculation of what those properties are worth in a real market place.

Both Gaudet and David Smith, Executive Vice-President, Canadian Credit, subsequently used the term in testimony as equivalent to "net realizable value".

By memo dated 14 September 1983, everyone in the bank was instructed to use baseline values, defined in that memo as:

> ... the price at which the asset will change hands between a willing buyer and a willing seller. The recent recession has for example caused real estate prices to fall very quickly from a record peak to well below "baseline value".

Bank officials were also required to estimate "sell-out time" which was the "time period required to attract purchases at baseline values". Further, in establishing recoverable value of assets, the time required to sell the asset was not to be discounted from the value. McLaughlan testified that the purpose of the memo was to advise the loan reviewers not to use existing (that is, pre-downturn) appraisals and not to get current appraisals as it would be "a waste of time". Instead, they were to "tell us what the security is worth and what basis you arrived at that through a comprehensive analysis":

> ... prepare the report, make it more comprehensive than the past, because we have a lot more of them [NELs]; we want a condensed analysis of each of these accounts in arriving at either the need for a reservation or not a need for a reservation.
>
> In doing that, give us far more history so we do not have to read a big file in every situation ... and, in doing that, do not rely—wake up—on the appraisals you have in your files. Things have changed drastically in the previous 6 months, is what is in that message. And, we are not going to rely on the old appraisals you have. We are not also going to go out and get our whole portfolio appraised, because it would be a waste of time. There was no market value in the fall of 1983 in Alberta, in particular.
>
> So, tell us what the security is worth and what basis you arrived at that through a comprehensive analysis which you have not given us in earlier reports. That is what the September memo is directing them to do.

Management admitted that, by the latter half of 1983, had the current value of assets been obtained, it would basically have been liquidation value in the market circumstances prevailing at the time.

The memorandum of 14 September, 1983 was up-dated on 21 August 1984. The revision recognizes that, at the bottom of a recession, value would often be based on fire sale offers and it would be the bank's preference to hold the assets pending a recovery of values to more realistic levels wherever that was considered feasible. However, the proviso was added that there would, of course, be some situations where liquidation may well be the best course.

As has been seen, CCB began to use baseline values in 1982. In a memorandum dated 28 May 1982, recording a meeting between the auditors and the OIGB, it is recorded that:

> ... Bill Kennett thought it was appropriate for banks to re-evaluate security and recognized our concern with appraised values which might indicate adequate security although there is no market at the present time. Bill suggested that banks would rightfully view the security value in the longer term and would, in a number of cases, be in a position of riding with customers and treating loans as a semi-investment. ...

The auditors discussed this matter with management in November of 1982 and also with the Audit Committee. Bank management contended that the concept of baseline value was not something new. Smith said:

> We have always looked at estimated realizable value of security in establishing reservations. That is general in the banking industry.

The question then becomes, if the practice was not new, why was it necessary to issue the memorandum of 14 September 1983. Management responded that the memorandum was issued in response to the collapse in security values which arose as a result of the recession. This was accomplished in May 1982 but apparently not on a bank-wide basis. It had been the practice of the bank to supply security evaluations based on appraisals since they were the only independent information on hand. However, appraisals taken in 1981 or 1982 were later too high in light of the recession. Indeed, during their evidence in Edmonton, management was able to show instances of baseline values below the values assigned by appraisals on file. According to management, had the memo not been sent out, reports would have shown appraised values, whatever dates those appraisals may have carried. The concept of "baseline value" was, in fact, a change from previous going concern valuations in the sense that the fundamental premise of establishing a baseline value was that there would be future economic recovery in the Alberta economy and the energy sector in Canada and the United States. The following is a statement made by the auditors in their discussion memorandum for the 1983 meeting with the Audit Committee:

> ... to the greatest extent possible, the bank attempts to maintain the going concern value of the security by taking control of the assets and finding competent new management thereby allowing time for the market value of depressed assets to return to more normal levels. We would cite as specific examples some of the real estate loans in Alberta and the drilling rig loans in Alberta and the United States. In both cases, success of the bank's strategy in avoiding major losses on these accounts is dependent upon future economic recovery in the Alberta economy and the energy sector in Canada and the U.S.

From this perspective, what was involved was indeed a going concern valuation, but with very heavy emphasis placed upon economic recovery, and values at some future time were taken into account. Therefore, the issue surrounding baseline values boils down to this: To

what extent can the future economic outlook, as viewed by the valuer, be considered in establishing a property value as at the effective date of a financial statement or report?

The testimony shows that the time horizon employed in these valuations, in almost all cases, was between two and three years. The auditors testified that a time frame of three to five years would be reasonable. In one case, the bank had estimated a workout of between three and five years, and the auditor had estimated a workout of between seven and ten years, but the judgment as to the time frame of the workout was not one in relation to which the auditors could contend that they were right and the bank was wrong.

In short, both management and auditors of CCB contended that the "baseline value" method of valuation was not new in the bank, and simply reflected going concern valuations. As revealed by the testimony and documents of both these parties, the fundamental reason for the use of baseline values was the fact that security values were depressed as a result of what was perceived to be a temporary and severe recession. It is, therefore, obvious that baseline was a practice which was new because never before in the life of CCB would it have been necessary to place such a heavy emphasis on the future economic outlook. Clearly, commencing with the recession, the bank placed very heavy reliance upon the expected turn-around in the market. The bank had two alternatives: dispose of the foreclosed security in bad loans on a very weak market and suffer severe realization losses, or hold the asset through a workout process and dispose of it in a better market. In the meantime, what value should be assigned to such a loan in the loan portfolio as carried on the balance sheet? The issue is not so much whether this was a new or an old practice, but whether it was justified in light of the increasing number of troubled loans and the severity of the recession, and whether its adoption with all its consequences in financial statements would fairly represent the financial position of the bank.

The obvious problem with the baseline value approach is that the market may not recover as anticipated. Smith stated, in relation to a loan in which interest was capitalized, and subsequently some $2M was written off in the support package:

> If I could just expand a bit on that, I believe the situation was while this credit was not fully drawn at the point of this board sheet, that sometime in the not too distant future, I think a few months, this loan would have been nonearning, because we would have arrived at the baseline value. We would not go beyond that and a loan would be a nonearning loan at that point in time and *markets had not recovered to the extent anticipated* and by March [1985] we were then contemplating liquidating as many assets as we could and this was assumed to become a nonearning loan that we wanted to liquidate. (emphasis added)

3. Interest Capitalization

CCB policies allowed capitalization of interest on both new loans and problem or restructured loans after the head office Credit Department had satisfied itself about the ultimate collectability of the amount of the loan, including any capitalized interest. CCB felt that, in this respect, it was very similar to other Canadian banks. The bank capitalized and took into income interest on some loans until the loan was equal to the estimated worth of the property.

The auditors, in 1983, reported to the Audit Committee that the bank's policy of capitalizing interest on problem loans increased the difficulty in demonstrating full collectability of these loans, and the auditors returned to a similar theme in 1984, stating that the bank was somewhat more aggressive in its accrual and capitalization of uncollected interest than the auditors would prefer. In both years, as will be seen, the auditors were able to satisfy themselves that the CCB was inside the range of permissible practices. The underlying security values that the CCB would use in the decision on capitalization were, at least by September 1983, baseline values.

Similar practices were employed in the accrual of interest. Unpaid interest, ranging from 4 months to 10½ months in arrears, was being accrued on the basis that positive steps were being taken to recover amounts due by disposal of assets or injection of additional funds, or loans were being renegotiated with additional collateral. Again, interest was accrued up to the full value of the security, which was again a baseline value.

The liquidator produced CCB documents which appear to show the amount of capitalized interest in the years 1982, 1983 and 1984 for the Canadian division. These documents indicate the following amounts as capitalized interest:

1982 –	$ 2.261M
1983 –	$21.162M
1984 –	$30.460M
Total –	$53.883M

Documents subsequently put before the Inquiry indicate that U.S. figures are available as well, and that the total figure for the three years for both Canada and the United States is $59.6M (Cdn.).

CCB's study of interest capitalization was commissioned by McLaughlan on 31 May 1985 in a memorandum to bank officials.

Amounts to be included were loans funded beyond normal lending guidelines for the purpose of taking interest into revenue, which, in most cases, would require the original terms and conditions to be changed to accommodate this increased facility. Lending officers were directed to exclude several categories of loans: first-time borrowers where interest capitalization was a feature of the credit (but Newcos resulting from a restructured credit were not considered first-time borrowers), construction project loans where interest capitalization was an accepted practice, operating loans utilized to pay interest costs assuming margin conditions are observed, loans since fully repaid (repayment by a Newco/workout agreement does not qualify as an exclusion), and loans provided to cover interest arrears in which sufficient additional security was obtained to cover funds advanced.

The information, at least in the case of the Canadian division, was required by 10 June 1985. Each branch was provided with a computerized report which listed all interest payments on loans which had a funding on the same day. This report, therefore, contained potential interest capitalization entries. Each branch produced a schedule showing the name of the account, principal balance at year end, total level of interest capitalization for the year, loan status at year end (earning or otherwise), current status, and industry classification. Each schedule was signed by the regional vice-president. The regional vice-president for the Atlantic provinces advised Head Office that because the exercise was subject to some judgment, there could be imperfections in the findings of that office.

McLaughlan and Smith were recalled by the Commission to explain the CCB interest capitalization report. They submitted that the document was inaccurate but that the amounts reported for the U.S. Division could be understated. The Controller's Department, headed by Paul Melnuk, had performed testing on the document and discovered a number of errors. In addition, R.J. Pogue, of the Controller's Department, stated that his impression from the lenders in the field was that McLaughlan's definition of capitalized interest "was not very concise and left room for interpretation". Because the House of Commons Finance, Trade and Economic Affairs Committee had already delivered its report, which was the reason for CCB's interest capitalization study in the first place, no attempt was made to discover the extent of the inaccuracy or the true amount of capitalized interest within the bank.

Despite the weaknesses of the capitalization study as explained by McLaughlan, Melnuk, in a memo dated 10 July 1985, instructed that the capitalization records were to be kept on a prospective basis for the use of the OIGB, and that such records should be based upon the same

criteria and instructions as were used to develop the earlier information. William H. Broadhurst, Chairman and Senior Partner of Price Waterhouse, and several bankers testified that it is not the practice of Canadian banks to record this data. They indicated that although a system could be developed to capture this information in advance, it would be difficult to capture the information retrospectively. Paine testified that if CCB's capitalization records were accurate, which he did not believe, then the auditors and the Inspector General were "blithering idiots". The total of interest capitalized, $59M, must be considered in its relationship to the bank's net income over the same period of about $16M. Any significant reversal of such an amount of interest taken into income (although no cash was received by the bank on the loans) would have placed the bank in a loss position throughout these years.

The problem of assessing the extent of interest capitalization is further complicated by evidence tendered by the auditors, who examined their working papers in relation to the loans where interest was alleged to be capitalized. They noted a number of cases where the principal balance of the loan appeared to have been reduced, or had not been increased, to reflect the amount of interest allegedly capitalized. They concluded that there are a significant number of the loans where the interest, if capitalized, appears to have been repaid. All this is reviewed in Chapter 4.

4. Nonperforming Loans and Loan Loss Provisions

CCB used a fairly narrow test in providing for a loss: a loss must be known or likely before a provision was taken. The bank's accounting for specific loss provisions tended towards the less conservative end of the range of accounting for loan losses. One result of management's approach was that a significant amount of the problem loan portfolio had been classified as earning where the same would otherwise have been classified as nonearning. Again, decisions whether to provision for an account were based upon baseline values with all the expectations incorporated therein.

5. OIGB Supervision and Knowledge

Much of the material contained in this section of the report has been presented previously in connection with the history of the CCB. In light of the Inquiry's mandate to assess the Canadian bank supervisory process, it is appropriate to review certain aspects of the narrative with an emphasis on the regulatory perspective. It sheds some light on the relationship between the OIGB and the bank that the Inspector General

learned on 7 May 1981 from the Federal Reserve Bank of San Francisco that CCB had made an application to acquire a 40 per cent interest in Westlands. On 26 May 1981, the OIGB obtained by telephone from the bank information regarding Westlands, including the type of bank, size, number of branches, management, and problems in the new acquisition. The OIGB was advised that it was not the intention of CCB to take an active part in the day-to-day management of the bank; CCB was satisfied with the officers in place.

On 30 April 1982, the OIGB learned that Greymac Mortgage Corporation had purchased approximately 10 per cent of the issued and outstanding shares of CCB, and that Leonard Rosenberg, who controlled Greymac Mortgage, had been elected to the Board of Directors on 27 April 1982. In May 1982, the OIGB became aware that the bank had made a loan to Greymac Credit, a company associated with Rosenberg. This subject was to be pursued at the annual inspection. The 1982 annual inspection by the OIGB revealed nothing considered to be alarming although there was some concern about asset quality, liquidity, and overhead expenses. The inspectors found that actual loan losses and NELs had begun to rise in 1981. There was also a narrowing of interest spreads, and income was dropping off slightly.

On 3 June 1982, the Governor in Council approved an increase in CCB's authorized capital by the creation of two classes of preferred shares and additional common shares.

After 1982, the OIGB received regular reports regarding the financial status of CCB. On 19 October 1982, OIGB officials visited CCB and learned that 16 per cent of all loans were classified as MUL. The percentage of these loans had quadrupled in the past eight months. In the British Columbia and Rocky Mountain regions, MULs stood at 26 per cent of the loan portfolio. The bank's practice of interest capitalization was discussed at this time. The bank said that capitalization was done only in "exceptional" situations. The OIGB found that interest was accrued where unpaid for periods ranging from four to ten and one-half months, in situations where "positive steps" were being taken, such as disposal of assets, injection of funds, and renegotiation of loans with additional security. The Inspector General considered that the bank had a good grasp of the problems and had taken steps to correct them. However, the OIGB recognized that recovery from the recession was not imminent, and Grant speculated that uncollected and capitalized interest could overstate profits for 1982 by $5.2M. This matter was left to the auditors. In the light of the 1985 study made by the bank and produced by the liquidator, this comment takes on added significance.

A "secret" memorandum prepared by an official of the Bank of Canada and dated 6 October 1982, has previously been discussed. It stated, in part, that a representative of the Bank of Canada "called this morning to report that he has been getting a noticeable increase in comments from his contacts about the health of the Canadian Commercial Bank in Edmonton". The report goes on to state that two representatives from the Bank of Canada called on McLaughlan at CCB and expressed "some concern about the bank's exposure to a loss of confidence which might culminate into a run on the bank". The report details a loss of deposits experienced by the CCB and difficulties in oil industry loans in both Canada and the United States. McLaughlan thereupon inquired as to what the Bank of Canada's role would be in the event of a run on his bank. There is no record of any action having been taken by anyone in the OIGB from whose files the memorandum was produced to the Inquiry. Similarly there is no indication of any action on the part of the Bank of Canada although the memo indicates on its face a wide distribution throughout senior executives, including the Governor.

On 11 January 1983, the Assistant Inspector General contacted Robert Lord, one of the bank auditors, to discuss generally the lending practices of the bank. Lord stated that he was satisfied that although the bank had a relatively high volume of substandard loans, the credit people were "on top" of the situation and were being quite innovative and aggressive in seeking ways to improve individual situations. He informed the Assistant Inspector General that the regional economy had caused difficulties in the bank's forest product, oil and gas, and real estate loans. He further stated that the assessment of real estate loans was particularly difficult at the time because there was no market for the properties, but that he did not feel that the bank would be in serious trouble in its real estate lending. He was confident that the bank's review of credits would ensure that there would be no surprises in 1983, other things being equal. Grant's speculation that CCB profits could be overstated by $5.2M does not appear to have been raised with the auditors, but Grant was satisfied because the auditors attested to the fairness of the financial statements for 1982.

As early as mid-1982, the OIGB was aware of some of the accounting practices in use in the bank, and was discussing them with the auditors. At the meeting between the auditors and the OIGB during the 1982 inspection, the parties discussed loans in some detail and particularly the valuation of loan security and the practice of capitalizing interest. In response to the extremely depressed market values for real estate and drilling rigs in Western Canada, the bank valued security by taking into account the expected recovery of market prices.

This approach was considered to be justified on the basis that a liquidation approach would not be appropriate considering the depressed market conditions for securities such as real estate and drilling rigs and because of the bank's stated intention to support companies which were in difficulty as a result of the economic climate.

The auditors expressed to the Inspector General their concern about appraised values which might indicate adequate security although there was no market at the time. The Inspector General suggested that banks could rightfully review the security value in the longer term and could, in a number of cases, be in a position to ride with customers and to treat loans as a semi-investment. With respect to capitalized interest, the Inspector General indicated that it was a general practice in the industry to take a conservative approach and not recognize interest revenue that was overdue; however, each loan had to be reviewed individually. The Inspector General testified that while security could be valued in this way during recessionary times, if the gap between such a value and the current market value did not narrow on its own, the value should be written down or a specific loan provision should be established; a gap should not prevail for a very long time. This qualification does not appear in the auditors' memoranda nor in the Inspector General's documents. Indeed, it was not until July 1985 that the Inspector General recommended to Northland's auditors that some provision would be necessary on real estate as the Alberta economy had not yet recovered, rendering Northland's concept of going concern values suspect.

In late March 1983, McLaughlan informed the OIGB that 18 per cent of all loans were classed as unsatisfactory, including the noncurrent loans (as defined in s. 58 of the *Bank Act*) which represented 4.5 per cent of the total loan portfolio. In addition, 31.45 per cent of all loans were judged "more than average risk". Grant could not recall whether the OIGB ever ascertained whether these loans should be classified as MUL. McLaughlan also indicated that there had been a 60 per cent increase in unsatisfactory loans in the U.S. portfolio since September 1982. He indicated to the OIGB that 45 per cent of the loan portfolio remained concentrated in Alberta and British Columbia, and that the bank was also under funding pressures. He reported that by virtue of the Greymac Trust incident, CCB believed that it was paying a premium of 15 to 25 basis points for its deposits and that noninterest expenses had substantially increased by reason of the 1981 commitment to expansion. As a result of all these matters, and in order to relieve funding pressures, the development of new business was terminated.

In April 1983, the OIGB was advised by a third party about supposed unorthodox practices at the CCB. The office was told that the

bank was transferring troubled real estate loans to special purpose companies with minimum capital, the bank advancing the funds for the purchase. The largest of these arrangements was entered into in 1982 between CCB and a corporation that was identified for the purposes of the hearings as Company Zero. An officer of the OIGB investigated the use of Company Zero thoroughly. His discoveries have been outlined earlier.

The OIGB took the matter up with management so as to gain a clear understanding of the bank's policies regarding the accounting treatment of interest on loans where no interest is being paid, and of the effects of these policies on the income statement and the balance sheet. The office also wished to determine the circumstances in which the bank would cease the accrual or capitalization of interest, and would reverse any such interest which had been taken into income. While no such policy understanding appears to have been reached, the OIGB was provided with reports on all cases where a Newco workout plan was used. The applicable policy on income recognition is discussed below. On 22 July 1983, the office informed the CCB that the office had gained a fuller understanding of the Company Zero workout arrangements, and of the bank's accounting treatment of them. The office was "generally satisfied" with the accounting treatment, but wished to keep in touch with these arrangements.

On 24 May 1983, the OIGB annual inspection of the CCB commenced. The office was concerned that the bank's inspection department did not evaluate the quality of loans in the course of their lending platform reviews, it being the bank's approach that the valuation of credits is the responsibility of the credit department and that the inspection department should limit its procedures to ensuring that bank policies are adhered to. The auditors gave their opinion that present procedures were satisfactory.

The 1983 post-inspection report indicates that the OIGB remained concerned with the following issues: capitalization of interest up to realizable value (as opposed to lending values) of security in some cases, treatment of gains and losses on the sale of property, the treatment of specific provisions (insufficiently conservative), the quality of the loan portfolio, and the lack of diversification therein. On the other hand, the office was pleased about the planning policies of the bank, about the good quality of management information systems reports, and generally about the quality of management. This post-inspection report contains no overall rating for CCB as this practice began with the introduction of the CAMEL system in 1984.

On 23 June 1983, Macpherson summarized the operating results for second quarter 1983. The bank's performance was "one of the poorest of the Schedule A banks". Current quarter results were deteriorating; net income declined by 20 per cent, and return on assets declined by 22 per cent to 0.32 per cent. Spreads had increased to 1.16 per cent. In comparison to the 2nd quarter 1982, net income had decreased by 30 per cent and return on assets had decreased by 40 per cent, even though assets grew by $255M. Loan loss provisions rose by 88 per cent, and noninterest expenses had increased by 46.6 per cent. In October, 1983, the third quarter 1983 operating results were received by the OIGB. All major indicators had dropped from the previous quarter and from the same quarter a year earlier. Net income was down 60 per cent from the previous quarter. Return on assets was down 37.5 per cent. Spreads decreased by 8.2 per cent. Loan assets, however, had grown by 6 per cent. Actual loan losses were $3.2M, against a provision of $2.4M.

In December 1983, the DBRS downgraded the CCB credit rating from R-1(low) to R-2(high). The bank expressed a concern for liquidity, and the office agreed that there was a distinct possibility that the downgrading increased CCB's cost of doing business through increased interest costs.

On 7 February 1984, the CCB reported its 1983 accomplishments to the OIGB. There had been a $19.5M common share issue by private placement. The trust company shares had been dealt with in a satisfactory fashion. The bank had successfully issued $10M in subordinated debentures and $30M in preferred shares. The bank had experienced no serious disruption in funding arising from the DBRS downgrading. Overall operating expenses had been reduced. In addition, CCB reported that nonearning loans had been reduced to $119.5M from $177M. At the end of the 1984 fiscal year, the bank expected them to be further reduced to $66.7M. In fact, by 31 March 1984, NELs had increased to $166M.

The 1984 inspection was made on 15 May 1984. The OIGB was very concerned that NELs had risen from $71.4M (1982) to $161M (end of first quarter 1984), especially since CCB had earlier projected a decline in 1984. Accounting concerns were again discussed with the auditors. The office noted in its post-inspection report that present appraised values for real estate were virtually useless in the British Columbia and Alberta markets, and that, where the bank had control of a difficult loan situation, it placed a "holding value" on the security. The auditors had initially drawn attention to this practice in 1982. In the 1983 Memorandum for Discussion with the Audit Committee they

again highlighted the practice. The size of provisions against specific loans was also discussed. The auditors informed the office that there could be larger specific provisions on certain loans. Grant testified that he did not recall the auditors indicating how much larger the specific provisions should be, or upon which loans. Either during the course of this meeting, or subsequent thereto, the OIGB would have reviewed a copy of the 1983 Memorandum for Discussion with Audit Committee. Attached to that Memorandum as a schedule is a list of problem loans where additional provisions could have been justified. The additional provisions aggregate $3.36M for the Canadian Division and $13.8M in security shortfall for the United States Division. The appropriations for contingencies account stood at $24M, and the auditors took the view that this represented additional protection on unforeseen loan losses. Grant was, therefore, satisfied that the provisions, plus the capital of the bank, plus the appropriations for contingencies account, were sufficient to cover any losses that could be incurred.

The auditors also discussed the concept of going concern security valuation, and informed the OIGB of the auditors' heavy reliance upon senior management decisions relating to specific loss provisions and when to cease accrual of interest. A list of interest capitalized on problem loans was also attached to the Memorandum for Discussion. The schedule amounts to $6.578M, and indicates capitalization on soft, nonrecourse financing. In one case, interest was capitalized in relation to baseline values, and, in one other case, interest was capitalized after a settlement offer was received by the bank. In 1983, the net income of the bank was $6.505M.

In the post-inspection report prepared by Watt, the bank was rated satisfactory. Grant, who had more experience with CCB, rated the bank unsatisfactory; however, the written report was never changed to reflect Grant's views. The Inspector General advised the Minister by letter dated 24 September 1984 that the bank's profitability had been adversely affected by nonperforming loans and the need to make provision for loan losses. The letter did not actually reveal that in the opinion of the Director of the Inspection at the OIGB the bank was in an unsatisfactory condition. Indeed, the letter concluded that "the bank is in sound financial condition". Furthermore, the letter attributed the poor performance of the bank in fiscal 1984 to the need to absorb losses related to its 39 per cent interest in Westlands. By the time of the letter, Westlands had become a wholly-owned subsidiary and no mention was made of the magnitude of the loss absorption in CCB thereafter. It is the position of the Inspector General that the format of the letter would reveal the opinion of the OIGB that the bank was in an unsatisfactory condition.

On 9 October 1984, the 1984 third quarter results were received by the OIGB. NELs now stood at $175.6M, and the level was estimated to be $183M by year end. In February 1984, CCB had predicted NELs would be down by year end to $66.7M. Loan loss experience was escalating; the estimated annual loss was one per cent of eligible assets, up from 0.72 per cent for the same period the previous year. The bank reported a profit of $2.1M, after income tax recoveries. In December 1984, the 1984 fourth quarter results were received. The bank reported a loss before taxes of $5.3M due mostly to the drag created by the Westlands Bank.

The OIGB remained concerned through the end of 1984 about CCB's security valuation, and of the problems inherent in assessing CCB. An example is a memo written by Grant, directed to the Inspector General and the Assistant Inspector General, dated 18 October 1984:

> We in the Inspection Division, and I am sure you are also concerned from a prudential viewpoint about the valuation of property generally in Alberta. However, as we know the problem with valuation in Alberta is dreadfully difficult. [name deleted] letter appears to highlight this matter even further. He believes ... that some of the properties are overvalued and others undervalued. Presumably the bank obtained a professional appraisal on these properties. In our discussions with banks and their auditors about properties in Alberta one gets the view that there can be a significant range of values depending on certain assumptions.

By an Addendum to the Non Performing Loan Paper dated 18 June 1984, the OIGB's views on the definition of nonaccrual loans were crystallized as "loans on which interest is not being accrued due to the existence of reasonable doubt as to the ultimate collectability of principal or interest". The directive requires that where interest is "contractually past due 90 days these loans are automatically to be placed on a nonaccrual basis, unless senior credit management determines that there is no reasonable doubt as to the ultimate collectability of principal or interest". The effective date for the implementation of this directive was 1 November 1984, that is with respect to fiscal year 1985 in all banks. In the directive, the Inspector General also expressed the intent that loans "where interest is contractually in arrears 180 days be classified in nonaccrual status ..." because such estimated nonpayment constitutes grounds for doubting the borrower's ability to repay the loan. Some elasticity was permitted, however, "only in extenuating circumstances" past the 180-day line. This directive, in dealing with restructured and renegotiated loans, however, does not clearly catch transactions such as those involving a Newco. Where a loan has been stripped of its nonaccrual status by interest capitalization or otherwise and set running again under the auspices of a Newco, the directive should require the disclosure of such

transactions in a table of prescribed returns. However, the Inspector General stated in the paper that "the restructured loan definition will usually apply for large ... loans where more than one bank is at risk". There is also nothing to suggest that the definition covers workouts using new borrowers.

By a further term, these guidelines provided that all interest previously recorded but not thereafter collected was to be reversed in the quarter in which the loan is reclassified as nonaccrual. The rigorous application of this directive would have had serious implications for the accounting profitability of the CCB. Finally, the directive dealt with the accounting treatment for fees received by a bank at the time of a restructuring of a loan. The directive permits the recognition of these fees as income to the extent that they offset costs and expenses associated with the renegotiation of the loan. Otherwise such fees were required to be amortized over the term of the loan.

On 22 January 1985 and on 4 February 1985, the OIGB received first a preliminary prospectus, and then a final prospectus regarding the bank's merger with CCB REIT, an unincorporated trust. In connection with the prospectuses, the auditors supplied a comfort letter to the effect that they had no reason to believe that the financial statements contained in the prospectus did not present fairly the financial position as at 31 October 1984. The OIGB did not require disclosure of its own "unsatisfactory" rating assigned to the bank (but not disclosed to the bank) after the 1984 inspection. The final prospectus, in the view of the OIGB, contains no statements that would alert a reader to the material changes that occurred in the CCB loan portfolio in 1985. The Inspector General accepted this prospectus for filing on 4 February 1985 and issued a receipt on 6 February 1985. No reference is made to the report from the Federal Reserve Bank of San Francisco regarding the L.A. Agency which did not come to the attention of the Inspector General until mid-February 1985. It was received by CCB in Edmonton on 12 February 1985 and about 6 February in Los Angeles.

On 6 March 1985, Grant expressed his concerns about the viability of the CCB. NPLs at fiscal year end 1984 stood at $194.2M. First quarter 1985 earnings were unsatisfactory, the bank having produced an after-tax profit of $200,000. Economic conditions in the West continued negative. At this point, Grant concluded that the cost of carrying the NPLs was well in excess of earnings. The bank would, in his view, be hard pressed to survive in its current form. In a memo of 6 March, Grant advised the Inspector General that he did not believe the bank could continue as presently structured. Some time after 8 March 1985, the OIGB received a report that NPLs as at the end of January 1985

stood at $292M. The Auditors' 1984 Memorandum for Discussion with the Audit Committee, received by the OIGB on or about 7 March 1985, outlined continuing practices at CCB which distorted the financial statements.

6. The General Decline of the Bank

The beginning of 1982 marked a period of financial difficulty for the bank. The record shows a rising trend for NPLs and MULs, and the record is punctuated with examples of the OIGB seeking from the bank explanations regarding specific loan transactions, and seeking from the auditors their impressions as to lending practices of CCB. The OIGB was receiving regular reports regarding the financial status of the bank from McLaughlan. The Assistant Inspector General analyzed the operating results for the bank on a quarterly basis and was tracing the major indicators, which were dropping. In June 1983, he noted that the bank's performance was "one of the poorest of the Schedule A banks". The OIGB was aware that the MULs, NPLs, and NELs were rising, even though the bank had predicted a decline of NELs in 1984. The office was also aware of various workouts undertaken by the bank, and that the bank was not conservative in booking loan provisions or in recognizing interest.

Grant and d'Entremont visited CCB on 29 October 1982. At that meeting, Grant reported that the officers were assured that "the collateral values shown were rock bottom" in response to a question by the officers about the narrow margin of collateral value over outstanding loans in a number of instances which could result in losses for the bank if there existed a slight error in appraisal of collateral values. The officers also reported that CCB assured them that capitalization of interest was done only in very exceptional situations where the bank was convinced that it would be temporary and that cash flow from another source would correct the situation. Yet the office was also informed that unpaid interest, ranging from four months to ten and a half months in arrears, was being accrued on the basis that positive steps were being taken to recover amounts due by disposal of assets or injection of funds, or loans were being renegotiated with additional collateral. While the bank believed that it had identified all the weak situations and that rising levels of troublesome loans would be halted, the officer wrote:

> We are not so optimistic. The solution to the problem is not in their hands. While lower interest rates will certainly help some of their customers there is no evidence that recovery from the current recession is imminent. If the decline in corporate profits and the pace of corporate failures continue we cannot see how the bank can isolate itself from these effects.

Finally, based on information obtained from the bank it could be argued that this year's profits will be overstated by some $5.2M due to uncollected interest taken into revenue ($4.2M) plus capitalized interest ($1M).

There is also evidence that the OIGB was aware of the bank's practices in the capitalization of interest. The practice was discussed in relation to Company Zero in 1983. In a letter from David E. Smith, dated 7 June 1983, to an officer of the OIGB, it was stated that the bank ceased to accrue or capitalize interest once the loan approximates the estimated realizable value of the security. Further, it was reported that interest capitalized on the Company Zero account aggregated $208,940 in fiscal 1982 and $519,146 in the first half of fiscal 1983. The 1983 post-inspection notes also reveal discussions on the following matters:

1. The OIGB was concerned with the high amount of unproductive loans and the bank's ability to monitor them. Problem loans appear to be well monitored, although the amount of interest capitalized appears high.
2. Except in exceptional circumstances, capitalization of interest was being made up to current realizable value and not loan values.
3. Banks' provisioning policy may not be sufficiently conservative, since the bank has a low ratio of provisions compared to other banks. The auditors were also concerned.
4. Uneasy at the amount of loans secured by land, because of falling values.

Further, as of the 1983 inspection, the OIGB extracted agreement from the bank that accrual of up to 100 per cent of security value was too aggressive and would increase exposure dramatically, but extracted no undertaking from the bank that it would change its practices. The only undertaking obtained from the bank in this regard related to being notified of any further arrangements similar to Company Zero, and there is no evidence that the bank did not comply with this undertaking.

The pre-inspection notes for the 1984 annual inspection also demonstrate that the OIGB was not satisfied with the answers it was receiving from CCB. The office again planned to ascertain during the inspection "whether the bank has a proper handle on the quality of their portfolio". The OIGB was again planning to determine bank policy regarding reversal of interest, accruing of interest, and capitalization of interest. Indeed, it appears that the OIGB was very concerned about capitalization of interest. The pre-inspection notes contain a list of

capitalized interest aggregating approximately $2.48M for the period from the end of fiscal year 1983 to the first quarter of 1984, which did not include costs capitalized of $5.725M. The office speculated that profit was overstated in the first quarter of 1984 by 36 per cent.

The post-inspection notes for 1984 again outline the concerns of the OIGB: the large amount of nonearning loans, the bank's ability to properly monitor them, the bank's practices regarding accruing and capitalizing of interest on certain problem loans, and decreased profitability. The OIGB was aware of the contents of the auditors' 1983 Memorandum for Discussion with the Audit Committee, the contents of which have been outlined elsewhere. That section of the post-inspection report dealing with the concluding interview with McLaughlan states: "The bank's accrued interest and nonperforming loans are still a worry to us."

Finally, the OIGB received a copy of the 1984 Memorandum for Discussion with the Audit Committee on 7 March 1985, which again illustrated the accounting practices in the bank which would have an impact upon any decision to bail out this bank. At around the same time, on 6 March 1985, Grant concluded that it would be difficult for the bank to survive in the absence of a merger or write-off of nonperforming assets combined with a substantial capital injection.

In the last fiscal periods of the bank the OIGB gradually increased its awareness of troubles in the bank and while concern mounted, the disclosure of the crisis on 14 March was largely unanticipated. Testimony given by the Inspector General seems to indicate an uncertain hope that the condition of the bank would ultimately improve:

> Clearly, the conclusion is that the bank is struggling, that its earnings are marginal and that it needs close supervision. That is, indeed, what this is all about and what this suggests what we were doing. We were revisiting the bank every quarter ... although it was struggling still, the trend was not all that clear that it was getting worse, at least considerably worse, ... but in fact, for one reason or another, a bank ends up with a difficult portfolio, a portfolio that is full of trouble, there is no magic that will make it disappear. You either write it off in an orderly way or you work with the companies involved in the hopes that the workout arrangements will salvage value and will restore the bank to health, and that is where we were.

Further:

> While, as I have said before in the commission, we have no magic. We were discussing regularly with the bank, its condition, the procedures it was following; we were improving our accounting processing in the handling of nonperforming loans but regardless how you handle them they are still there; they are on the books of the bank and they are either earning or nonearning in some real cash-flow sense. But, finally, we were hoping and expecting, as the

bank was and as other observers were, that this economy would turn around and the problems, finally the most severe problems, would be short-lived. It turned out that the economy did not turn around ....