

**CIPF Podcast Series – Leadership
No. 20 – Regulation and Supervision in Evolving Times**

Transcript¹

Intro:

You are listening to the Canadian Investor Protection Fund podcast channel. Here we connect with industry leaders and experts in the financial sector.

Ilana Singer:

Hello and welcome to the CIPF Podcast Series on Leadership. I am Ilana Singer, Senior Vice-President and Corporate Secretary at the Canadian Investor Protection Fund, or CIPF for short. I am so pleased to have Peter Routledge as our guest today. Peter Routledge is the Superintendent of Financial Institutions appointed in June 2021 for a seven-year term. In 2021, we had the pleasure of hosting Peter for one of our earlier podcasts to discuss Leadership in Times of Crisis. At that time, Peter served as President and CEO at the Canada Deposit Insurance Corporation. If you have not yet listened to that episode, I would highly recommend it.

Peter, welcome.

Peter Routledge:

Thanks Ilana, great to be here. Thanks for inviting me to be back.

Ilana Singer:

Well, thank you for accepting our invitation to return. We are delighted and honored to have you here with us again today. You bring a wealth of valuable knowledge, experience, and insights to every conversation that we have with you.

As you know, our topic for today's podcast is Regulation and Supervision in Evolving Times. During today's discussion, Peter will highlight some key OSFI initiatives and achievements since he joined in 2021. We will then delve into one of the principal pillars of OSFI's strategic plan and the new supervisory framework that is coming into effect in April of this year. Lastly, we will end the discussion with key insights from Peter on innovation in the industry, including artificial intelligence and crypto assets, as well as their potential impact on entities regulated and supervised by OSFI.

To begin, let's start with our first question. Peter, you have been in your role as the Superintendent of Financial Institutions for almost three years now. Can you share with our listeners some key initiatives or achievements that you are most proud of having accomplished during your tenure to date?

¹This transcript has been edited for clarity and ease of reading. This podcast is for informational purposes only and is not intended to constitute advice of any kind.

Peter Routledge:

Well, thanks Ilana. So when I joined OSFI, I joined, by any objective measure, a fairly successful organization. Canada's financial system is rightly hailed as a very, very stable financial system – one that is resilient to its risk environment year after year. The challenge we faced is that risk environment in the years prior to my joining had grown progressively more complex - I think dangerous, certainly more volatile and uncertain. And the lesson we learned in the last financial crisis, big one anyway, 2007 and 2008 and through the COVID stress was the earlier you act as a supervisor and the earlier the institutions you supervise act in the face of very significant risks, the better all players do it managing the system and managing for resilience.

So we set upon our challenge as a leadership team here at OSFI, after I joined, a determination to transform OSFI so that it continued to thrive in a very, very different and more dangerous risk environment. We call it internally to thrive in uncertainty and part of thriving in uncertainty means acting early and part of acting early means accepting that there are risks when you act early just as there are risks when you act a little late. And we welcome the risks of acting early and we repel from the risks of acting too late. And so our organizational transformation is just founded around that idea, that fundamental shift in our risk appetite. And so what are some specific things that have flown or came out of that shift in our risk appetite?

First of all, we have read our mandate more broadly and our mandate is to promote and contribute to public confidence in Canada's financial system. Now we do that through supervising and regulating financial institutions, but our true north again is just public confidence. And when we see risks to public confidence emerge, we act promptly and we oblige the institutions we supervise to do the same.

So other things that we did that fall out of that we have rewritten or maybe written for the first time a risk appetite statements available up on our website that clearly defines the risk that we accept, the risk we try and minimize. Newsflash act early, and we accept the risks of acting early, don't act too late, we don't like those trade-offs. And that is what our risk appetite statement says.

One risk that was coming up at us pretty quick was the risks that flow out of climate change. And so we have established a climate risk division at OSFI and grown it from two to just under 30 people. We have put in place a regulatory guideline to help guide the institutions we supervise towards smarter climate risk management. We built a Chief Risk Officer function and organization for the first time really within OSFI. And we asked that group to do three things really. One, scan the outer risk horizon and make sure that we see risk coming at us early so we can act early. Two, articulate and cascade our risk appetite throughout a 1200-person organization. Easier said than done, I can guarantee you that. And three, structure our governance so it flows from (a) clear set line of sight on our risk horizon and (b) clear application of our risk appetite to that risk horizon. And the final thing I know we will come to is that we have articulated and soon bring into force a new supervisory framework which will fundamentally transform the day-to-day supervisory experience. The institutions we regulate must take on and we think it will be better for them and better for us.

Ilana Singer:

Thanks so much Peter. It sounds like since you have joined, you have been a real thought leader in assessing and looking and considering very carefully the risk environment, how it has fundamentally

shifted and really trying to create and refine an enterprise-wide risk appetite as you described it. And as you noted towards the end of your remarks, we understand that one of the pillars of OSFI's 2022 to 2025 strategic plan is policy innovation. In what ways do you believe that innovation, some of which you have already talked about in the context of risk, manifests itself in OSFI's approach to regulation and supervision?

Peter Routledge:

Yeah, I would say in a myriad of ways. It starts with, okay, we want to act early and be in front of risks, not behind them. Part of that we articulate through how we supervise and part of it we articulate how we regulate. And so an example of how we have acted early in regulation, one I would think, and I mentioned it earlier, the work we have done on encouraging sound management of climate risks. We will be the only North American regulator to propagate empirical measurement of climate risk through scope one, scope two, scope three, emissions analysis or data gathering. That work will lend itself then to better understanding how climate risk will change the cash flows to the assets on our financial institutions balance sheets. And as the boards of directors that oversee those institutions get a better empirical sense of how those risks are shifting, they will make smart decisions. And it is that forward-looking empirically driven dedication to risk analysis that we sort of used our policy function to expand into climate risk management.

I think another area I would like to mention is just the work we have been doing around integrity and security over the last 10 years. We have done a lot of work in what we have at least formerly called non-financial risks – cyber risk management, third party risk management, culture and compliance, governance, accounting, and assurance around accounting. And that work didn't really have a name other than non-financial, which was kind of a misnomer because everything we do is financial.

So as we were sort of wrestling with that, this past summer, parliament amends OSFI Act and our mandate in a substantive way. For the first 36 odd years of OSFI's existence in applying our mandate, the government's or parliament's instruction was to ensure the institutions we oversee remain in sound financial conditions and then notify boards when that does not happen or when that is beginning to weaken. They amended our mandate, and they said keep doing sound financial conditions and ensure that institutions have protections in place against threats to their integrity or security including foreign interference.

As we sat back and thought about that, we realized that integrity and security really, far better than the name non-financial risk, capture all the work we have done over the last decade. And so we really categorized all that work as integrity and security work. And then we built a broad-based integrity and security guideline, which is now operative and active, that doesn't add too much new to our regulatory framework but brings together a bunch of formerly disparate risk management disciplines into a broader idea.

And what I think that is going to give way to is an honest reckoning of we have an extensive regulatory guidance and there is probably some repetition and some redundancy there. And the integrity and security concept and new guideline gives us an opportunity to ask where is that redundancy and where can we lessen that redundancy to lessen the unnecessary regulatory burden that FRFIs or federally regulated financial institutions experience.

Ilana Singer:

Peter, thank you for that valuable set of insights. I think that we can all agree that what we often call non-financial risks is more aptly termed, as you mentioned, as integrity and security. And on the topic of OSFI's approach to regulation and supervision, I also understand that there is a new supervisory framework guiding OSFI's oversight of federally regulated financial institutions and pension plans, which will come into effect on April 1st. Can you tell us more about this upcoming change and how the framework will allow for more effective intervention if and when issues arise? And I think this ties in really nicely with your discussion about risk and all of your new approach to risk frameworks.

Peter Routledge:

So when I joined OSFI and one of the things I did was learn about how we interacted bilaterally with federally regulated financial institutions. And your listeners may be interested to know that we meet with these institutions, with the boards of these institutions annually and we give them a letter and the letter is a to-do list of what we think the institution needs to do to make itself more resilient. And as I read those letters, I thought they could be a little more transparent and maybe a little bit more outcome focused and maybe there should be a bit more disclosure of our thinking so that our thinking could be challenged by the regulated.

So I realized that and then probably made one of my smartest decisions as superintendent. I asked our now deputy superintendent Ben Gully to take the job as deputy superintendent of supervision and we really mind melded instantly on what we wanted to do. What we decided to do, big picture, is to change the framework or the supervisory framework that we apply to institutions and we thought that that would improve our regulatory outcomes and improve the experience that regulated institutions have with OSFI. And the three goals we set about were (A), to increase the transparency of OSFI's thinking and judgments for financial institutions. (B), to create accountability moments for OSFI as an institution and for individual supervisors. And (C), to be a bit more proportional in how we approach supervision, more flexibility for supervisors to apply OSFI's principles to the institutions they oversee.

Maybe to explain how we apply those, I will just give you a quick what we started with and where we are now. What we started with was a fairly summarized and therefore opaque risk rating, which basically told the institution you are average, above average, way above average in terms of risk; and we are not intervening you, which means your rating is stage zero or we are intervening with you, which means your intervention stage rating is 1, 2, 3 or 4: One being early warning, four being lights out. We thought, wow, (a) only one rating doesn't really explain the discipline we put into that rating. And (b), when you go from zero to one, it is a pretty big shift. And so therefore wouldn't it be great if we were a bit more transparent and the institutions we oversee could understand the change in our point of view earlier?

So now today we provide a single overall risk rating to an institution. It goes from one to eight. One to four is stage zero; you are not intervened. One is really good and you really don't have to worry about being intervened if you are at one, if you are at four time to start worrying but you are not intervened yet. And then 5, 6, 7 and 8 are the four different stages of intervention. So instantly you are expanding the idea of an intervened institute and you are giving some sense of distance to intervention and that is the transparency we think is really important.

Second thing we did is rather than just only give a single risk rating, we gave four subsidiary ratings for the four different risk categories that are generically appropriate for financial institutions, their business risk or business model risk, their financial resilience (think capital liquidity), their operational resilience, (think operational risk, think third party risks, cyber risk, et cetera). And then risk governance, how does the board do in overseeing the management of those risks?

And so now we are giving you four subcategories if you are a FRFI's board and if we give you a rating of say three on business risk, you can, well why did you think that? So what that does is it makes OSFI and our supervisors accountable to the institutions they regulate to providing clarity to mature proportionality.

We have introduced this concept of a tier rating. So tier one is an internationally active conglomerate financial institution. As you go lower in tier rating, you are more and smaller. And then our supervisors then don't apply the same regulatory scrutiny and the same expansive regulatory tools to smaller institutions.

And finally, out of all that, and this is sort of, I wouldn't call it a surprise, but something I did not set out to achieve when we started this framework renewal, but we did rather fortunately achieve is because we were giving more detailed risk ratings, the guidance or directions we gave to institutions became far more focused. So now we will say you have to correct 10 deficiencies in operational risk management, and they are in technology and core business operations and those outcome focused directions, it turns out boards really find useful because then they can go to their management teams and say, well, your regulator says you need to do X, Y and Z. So now we would like to see X, Y, and Z achieved within the next X months or Y years. And so the early feedback is really positive and I know Ben and I feel like we are just upping our own game through the enhanced accountability and we hope it is a better service and dealing with OSFI is of higher utility to the boards that we work with.

Ilana Singer:

That is interesting to hear Peter, and also very timely given the increased focus on transparency and specificity and collaborative early warning relationships that can help fend off issues and problems in the future.

Peter Routledge:

Yeah, we are not done yet, but by this time next year we will have a year under our belt and then we will reflect on our successes and our opportunities for improvement.

Ilana Singer:

Yes. Well, it is a really admirable innovative approach and a new way of dealing with your member institutions, so congratulations on putting that in place.

Let's shift gears a little and talk about innovations that you are seeing in the industry. I understand that OSFI is part of the Financial Industry Forum on Artificial Intelligence, FIFAI, which is a global community that advances the conversation around appropriate safeguards and risk management in the AI space. Can you tell us about this forum, the important role that OSFI plays in it and what OSFI has learned thus far through its participation?

Peter Routledge:

Yeah, we are very proud of the work we did at FIFAI and that really came out of a partnership between OSFI and the Global Risk Institute (GRI) in Toronto. And the basic idea working with the GRI is let us create kind a safe harbor for managers and executives from the institutions we regulate from academics, other regulators and other thought leaders and talk about what AI and machine learning and digitalization might mean for the financial sector in Canada. And we came up with a broad framework for thinking about how AI would responsibly be applied to our financial system and we set up 4 guiding principles for responsible application of artificial intelligence in the Canadian financial system. Explainability: make sure that in plain language institutions can explain to their regulator or to their customers how their AI thinks and evaluates them. Data: ensure that institutions articulate the type of data they need and have, the type of data they would like to have but don't have and want to go get. And what are the protections around that data. Some of that data is obviously protected by privacy law. The third one is governance, which is how do institutions govern the application of AI to their customers, to their decision making and to their data? And then in ethics, how do you construct an AI approach that if you were in a fishbowl and people were watching everything you do, they would say, well, you were doing the right thing. And ethics to me in simple language is doing more than you are supposed to and less than you are allowed. And so we took Explainability, Data, Governance and Ethics and of course in true OSFI fashion, turned it into an acronym we called EDGE. And I should say the co-authors on this were of course GRI, so they are sort of critical to developing that framework. And that informed our update to our guideline on model risk management. The EDGE work helped us think about the update to that particular guideline.

We have a lot more work to do. I mean the Canadian financial system does not exist on its own island. We are interconnected to global financial systems. So we are working with our regulators in a variety of international forums. Then we are also working domestically with our partners, including most recently we have launched with the Financial Consumer Agency of Canada a questionnaire on artificial intelligence and machine learning and quantum computing. And that questionnaire to the institutions we oversee will yield results and we will use those results to do three different things, increase our understanding of financial institution's involvement in a AMIL, try to understand what the differences are across institutions to get some core research done that will inform our policy and supervisory work. And then to assess current state of quantum readiness, understanding that the institutions that we regulate will compete against other institutions that have their own regulatory systems and their own pursuit of the benefits of artificial intelligence and machine learning and quantum computing more broadly.

Ilana Singer:

Thank you, Peter. Artificial intelligence, machine learning, these are all areas that we need to collectively better understand and get into as you have done both through your collaboration with the Global Risk Institute as well as with FCAC. And we look forward to reading all of your various collaborative reports and documents that you are putting out in that regard.

And unfortunately, we are coming to our last question, Peter. So, to end the discussion today, we would like to talk about another hot topic in innovation, namely crypto assets. As our listeners may

already know, CIPF does not at this time cover crypto assets. What are OSFI's views with respect to these types of activities from a risk perspective?

Peter Routledge:

So digital currencies which would include “unbacked crypto assets” and fiat referenced crypto assets, not infrequently called stable coins, are, or have been since I began in my service as superintendent major, innovations in financial services that have largely occurred outside the regulated perimeter, not entirely but largely fair to say outside the regulated perimeter. The crypto winter of 2022 taught us a valuable lesson on the costs of innovation outside a regulated financial system. And they are quite severe. And if you want proof of that, ask any customer of FTX for example.

And so digital currencies and digital assets offer a lot of exciting utility for consumers of financial products and for financial systems more broadly provided those currencies and the applications of that technology is in line with the principle of same activities, same risk, same regulatory outcome. For example, if a fiat referenced cryptocurrency issues liabilities, payable on demand, similar to for example a checking account, bank deposit, it ought to be subject to exactly the same prudential regulation. And some of those stable coins are not subject to that regulation. And so there is material risk associated with the holders of those assets.

If you have a debit card or cash in your wallet, those are credits or liabilities issued by financial institutions that are regulated by OSFI that have access to central bank facilities, for example, the Bank of Canada, that are protected by the consumer protection regime put in place by the FCAC, that have some form of deposit from CDIC, and that are ultimately part of a system that is overseen and governed by the government of Canada and in particular the minister of finance. So that regulated system is not perfect, but safe, resilient, and by and large, run by responsible boards of directors and overseen by responsible public servants. You don't have that outside the regulated perimeter. So my challenge to the innovators in the space is they ought to be climbing over the walls to join the regulated system and I would like nothing better than to be pressured to do more to facilitate more rapid and regular entrance into the regulated system. And I look forward to that day when that starts to occur.

In the meantime, we are developing guidelines for regulatory capital and liquidity treatment of crypto asset exposures, not only for deposit taking institution but for insurers. We are working through policy responses to manage risks posed by fiat referenced crypto assets and we recently consulted on the public disclosure of crypto asset exposures by federally regulated financial institutions. We have finished that up last month, in January 2024 and this fall we will issue draft guidelines for comment.

Ilana Singer:

Peter, it sounds like you at OSFI together with many other regulators, both domestically and internationally are very active in the crypto space and also that you have been considering how important it is for regulation and supervision to be in the mix with respect to this asset class as well. So thank you for that.

Well Peter, unfortunately we have come to the end of our podcast, and it was truly a pleasure to have you with us today. It is clear that since you joined OSFI in 2021, you have been a thought leader in a number of different areas. And I will name a few.

First in the area of risk, you mentioned a fundamental shift in the risk environment, namely that it is more complex, dangerous, volatile, and uncertain. And with that in mind, you have instituted a risk appetite statement and also a principle of acting early.

Second, in the area of innovation, you have created innovative approaches to climate risk and integrity and security, also known to many of our listeners as non-financial risks. And I believe that these are very forward-thinking and innovative in approach.

Third, you discussed and described the supervisory framework renewal initiative. The fact that the risk rating scale has been expanded, is more proportionate and it is also more transparent, all of which sounds like has been quite welcomed by the financial institutions. And you also mentioned guidance and directions to institutions has been more focused and boards have found it quite useful. This has all lent itself to enhanced accountability.

And finally, with respect to innovation such as AI, machine learning and crypto assets, you talked about the responsible application of artificial intelligence in the Canadian financial system through both the collaboration with the Global Risk Institute and the EDGE principles as well as collaborations with the FCAC.

Peter Routledge:

Ilana, thank you. I guess one thing I would say in closing is maybe some of the secret sauce into the transformation at OSFI has just been an embrace of the principles of diversity, equity, and inclusion. When you are dealing with this complex risk environment, you need people who have seen the world and life from multiple vantage points. You usually see risk more clearly when you have four or five people looking at it from different places on the hill. And our commitment to diversity, equity, inclusion principles have really unleashed talent at OSFI to get after and really thrive in this environment. And if your listeners are wondering how do you drive the kind of innovation we are driving at OSFI, you can't do it on your own. And if everyone around you sees things the way you do, chances are you are going to miss something pretty big and pretty important.

Ilana Singer:

Peter, so well said. Thank you for those remarks about diversity, equity, and inclusion and the importance of putting those in practice as you have done in this transformative time at OSFI.

So we have come to the end of our recording, and thank you again for taking time out of your busy schedule to provide us with all of these insightful comments. I would also like to thank our listeners for their attention, and I hope that you have found the discussion as stimulating as I have.

We always welcome your comments. The best way to reach us is through our website at www.cipf.ca. Finally, we invite you to listen to CIPF's other podcasts, including the one recorded with Peter in 2021, available on CIPF's website and podcast channels. Or feel free to read the transcripts, which are available in both English and French on our website. I am Ilana Singer, goodbye for now.

Intro/Outro:

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