REGULATING FINANCIAL INSTITUTIONS:
THE VALUE OF OPAcity

Anita Anand & Andrew Green*

In this article, we explore a question of institutional design: What characteristics make a regulatory agency effective? We build on the growing body of administrative law literature that rigorously examines the impacts of transparency, insulation, and related administrative processes. We argue that there are certain benefits associated with an opaque and insulated structure, including the ability to regulate unfettered by partisan politics and majoritarian preferences. We examine Canada’s financial institution regulator, the Office of the Superintendent of Financial Institutions (OSFI), whose efficacy in part explains the resilience of Canada’s banking sector throughout the financial crisis of 2008. In particular, OSFI operates in a “black box”, keeping information about the formation of policy and its enforcement of this policy confidential. With its informational advantage, it is able to undermine the possibility that banks will collude or rent-seek. Our conclusions regarding the value of opacity cut against generally held views about the benefits of transparency in regulatory bodies.

Introduction

I. Financial Institution Regulation: Rationales and Structural Characteristics

II. Optimizing Administrative Design
   A. Insulation
   B. Transparency and Opacity
   C. Combining Insulation and Opacity

III. Regulating Financial Institutions

IV. Policy Implications

Conclusion
Introduction

The global financial crisis highlighted profound difficulties in the banking sector, which in turn cast attention on differing regulatory approaches across countries.1 Drawing on the administrative law literature, we examine the characteristics of a regulatory agency that oversees financial institutions and ask how these characteristics influence the strength of its oversight. In particular, we analyze the agency’s insulation from political control and the opacity in its operations.2 We discuss both the value of these characteristics in the regulation of financial institutions themselves and also how these characteristics interact—when are they complements and when are they substitutes?

In order to ground the theoretical discussion, we examine the regulator of Canadian financial institutions, which is called the Office of the Superintendent of Financial Institutions (OSFI). Canada’s financial institutions weathered the crisis well relative to their international peers, an outcome that has been attributed at least in part to the presence of an effective regulator.3 The academic literature points to Canada’s regulatory structure as a factor that discouraged banks from taking excessive risks.


2 We use the terms “opacity” and “transparency” throughout the text as two sides of the same coin. Each term refers to certain costs and benefits related to institutional design.

Ratnovski and Huang, for example, examine the performance of the seventy-two largest commercial banks in OECD countries during the financial crisis, analyzing the factors behind Canadian banks’ relative resilience at this time.\(^4\) They identify two main causes, one of which is regulatory factors that reduced banks’ incentives to take excessive risks.\(^5\) This view of the efficacy of banking regulation permeated Canada’s own government. For example, OSFI was not subject to regulatory reform following the crisis, and the government in fact relied on the structure of OSFI, and new guidelines that OSFI proposed, to stave off an international bank tax.\(^6\)

Building on the existing literature, this article assumes that OSFI played a role in ensuring the stability of Canadian financial institutions relative to their international peers during the financial market meltdown of 2008.\(^7\) Of course, we do not mean to exclude factors other than Canada’s regulatory structure that likely contributed to the stability and performance of Canadian financial institutions, such as: Canada’s oligopolistic market (consisting of five big banks);\(^8\) macroeconomic policies emanating from the Bank of Canada; the historical structure of the banking system; the approach to regulating the Canadian mortgage market; and, a generally conservative approach that pervades the banking sector.\(^9\) Given the


\(^5\) Ibid. Other factors included a higher degree of retail depository funding, and to a lesser extent, sufficient capital and liquidity.

\(^6\) The government argues that such a plan is unnecessary in Canada and has instead proposed a solution that it calls “embedded capital”. This proposal would require each country’s regulator to set rules or guidelines concerning financial institutions that issue debt convertible to equity as a means of self-insuring against failure. The proposal is controversial and is not supported by other G-20 countries: See e.g. Paul Vieira, “G20 May Fail to Agree on Financial Reform: Flaherty”, Financial Post (16 April 2010) (Factiva); Andrew Mayeda, “Flaherty Calls for G20 to Refocus Financial Reforms on Bank Capital”, Canwest News Service (18 May 2010), online: Global News <http://www.globalnews.ca>.


\(^8\) See Franklin Allen & Douglas Gale, “Competition and Financial Stability” (2004) 36:3 Part 2, Journal of Money, Credit and Banking 453 at 472. Comparing the United States, whose history is marked by greater financial instability, to the United Kingdom and Canada, where the banking sector is dominated by a few big banks, they argue that supervision is more effective in a concentrated banking system.

international interest in the structure and role of OSFI, however, we examine whether there are characteristics of Canada’s financial institution regulator that may be worth emulating.

OSFI’s efficacy may at first be surprising. It is the primary regulator of Canada’s five big banks (which account for approximately 85 percent of Canada’s banking sector). Its power to overcome the possibility for rent seeking or capture by these institutions depends on its rule making and enforcement processes, and forms of accountability for its actions. That is, if not sufficiently independent, regulated institutions might seek rules that favour their profitability at the expense of consumers. Yet on many important issues, including capital adequacy requirements, OSFI relies on guidelines rather than regulations. OSFI creates these guidelines through a largely opaque process in which the regulated parties have early input. Other parties (such as consumers) not only face considerable collective action problems but are limited to a stunted notice and comment process. The comment process thereby potentially privileges the views of regulated institutions. Further, in addressing compliance with regulations or guidelines, OSFI attempts to work informally with regulated parties, ultimately rendering it unnecessary for it to take formal enforcement action. This structure seems to point more towards capture by the large (albeit regulated) players. To aid in the discussion of the appropriate institutional structure for banks, we examine whether Canada’s financial institutions—and banks in particular—have been successful because of, or despite, the presence of OSFI.

OSFI is an independent federal agency whose role is to supervise financial institutions and pension plans. Its specific mandate is to determine whether these institutions are in sound financial condition and whether they meet minimum plan funding requirements, governing law, and supervisory requirements. OSFI must advise these bodies if there are material deficiencies, and if there are, it is to require management and boards of directors to take necessary corrective measures expeditiously. OSFI must also advance and administer a regulatory framework that

---


11 The Office of the Superintendent of Financial Institutions was established in 1987 pursuant to the Office of the Superintendent of Financial Institutions Act, being Part 1 of the Financial Institutions and Deposit Insurance System Amendment Act, RSC 1985, c 18 (3d Supp), as amended by SC 1996, c 6 [OSFI Act].
promotes the adoption of policies and procedures designed to control and
manage risk. It must also monitor and evaluate system-wide or sectoral
issues that may negatively impact institutions.\textsuperscript{12} OSFI functions within a
web of other bodies discussed below.\textsuperscript{13}

We argue that OSFI exhibits two traits in particular that are connect-
ed to its efficacy: it is both insulated and opaque. Insulation refers to its
separation from elected officials in key respects. This separation can be
seen, for example, in the appointment and removal requirements for OSFI
members, the lack of control by elected officials over the structure and
procedures of OSFI, and the weak powers of elected officials to review or
issue directives to the body.

OSFI's opacity—or lack of transparency—exists in the processes for
establishing rules and guidelines. While the federal cabinet makes regula-
tions that OSFI must administer, OSFI itself develops and implements
other forms of regulation, such as guidelines and policy statements. There
is no prescribed process, no mandated public consultation, no necessary
stakeholder input or cost-benefit analyses required with regards to the
formulation of either policy statements or guidelines.\textsuperscript{14} The process by
which OSFI’s capital adequacy guideline is developed is a particularly
striking example of opacity. The guideline seeks to provide a framework
“within which the Superintendent assesses whether a bank ... maintains

\begin{footnotes}
\item[12] \textit{Ibid}, s 4(2). As part of discharging this mandate, OSFI administers the \textit{Bank Act}, which
grants authority to Cabinet for establishing regulations that define the regulatory capital
of a bank and authority to OSFI for capital and liquidity requirements (SC 1991, c 46, s 485). Section 648 sets out the conditions under which supervisory intervention
may occur, one of which is contravention of OSFI guidelines for capital and liquidity
\textit{(ibid)}.

The OSFI also administers a host of other pieces of financial legislation that pre-
scribe constraints on where and how it can regulate: \textit{OSFI Act, supra} note 11, s 6,

\item[13] For example, the Financial Consumer Agency of Canada (FCAC) has responsibility for
consumer protection and exercises authority in relation to the consumer provisions of the
\textit{Bank Act} \textit{(supra} note 12); \textit{Financial Consumer Agency of Canada Act}, SC 2001, c 9, ss 2-3. The Bank of Canada is responsible for the economic and financial welfare of
Canada. It regulates credit and currency “in the best interests of the economic life of the
nation” and controls national monetary policy: \textit{Bank of Canada Act}, RSC 1985, c B-2,
Preamble.

\item[14] There is a public process for formal regulations involving pre-publication consultations
and analysis. For federal guidance on the regulation-making process, see Canada,
Treasury Board Secretariat, “Cabinet Directive on Streamlining Regulations” (Ottawa:
Treasury Board Secretariat, 2007), online: Treasury Board Secretariat <http://www.tbs-
sc.gc.ca/ri-qp/directive/directive-eng.pdf> [“Cabinet Directive”].
\end{footnotes}
adequate capital pursuant to the acts.”¹⁵ In the guideline, the superintendent establishes two minimum standards: assets to capital multiple and risk-based capital ratio. The guideline indicates that OSFI may also issue further “notes” to clarify “expectations on compliance with the technical provisions of the internal ratings approach” set out in the guideline.¹⁶ While OSFI is actively engaged in international discussions around appropriate standards for financial regulation, such as for the Basel III standards, OSFI is not mandated to adopt these standards. For our purposes, the key point is that in an area of crucial importance to the stability of financial institutions, OSFI is able to pass and implement guidelines without Cabinet approval or an open process. Rather, they are established by a relatively insulated body through a partially opaque process.

Despite its insulation and opacity, however, OSFI is almost universally viewed to be an effective regulator.¹⁷ In this article, we ask: What is it about institutional insulation and opacity that may lead to effective regulation of banks? Part I examines the purposes of financial institution regulation. Part II then discusses the characteristics of administrative agencies, and particularly the relationship between transparency (or opacity) and insulation. We build on the growing body of administrative law literature that rigorously examines the impacts of transparency, insulation, and related administrative processes.¹⁸ We argue that there are certain benefits associated with an opaque and insulated structure, including the ability to regulate unfettered by partisan politics and majoritarian preferences. Our conclusions regarding the value of opacity cut against generally held views about the benefits of transparency in regulatory bodies.

The article then uses OSFI to illustrate the theoretic discussion of financial regulation and administrative structures. Part III outlines the administrative structure, accountability, and functioning of OSFI—to whom it is accountable and how it works—paying particular attention to its level of transparency and insulation. Part IV explains why insulation

---

¹⁵ Canada, Office of the Superintendent of Financial Institutions, Capital Adequacy Requirement (CAR) – Simpler Approaches, No A (Guideline), (Ottawa: Office of the Superintendent of Financial Institutions, 2007) at i.
¹⁶ Ibid.
and opacity may be positive attributes that enable OSFI to function effectively. We argue that OSFI operates in a “black box” of sorts relative to both the government and financial institutions. It encourages co-operation between itself and financial institutions by protecting information about its policy agenda and formation. We argue that OSFI profits from its informational advantage by weakening the ability of regulated entities to collude amongst themselves or rent-seek. We conclude by drawing out the lessons for the institutional form of financial institutions regulation.

I. Financial Institution Regulation: Rationales and Structural Characteristics

Regulation governing financial markets generally seeks to address macro- and microprudential issues. Macroprudential regulation focuses on the financial system as a whole, seeking to minimize system-wide distress in order to avoid reductions in aggregate output (which may be measured by GDP). By contrast, microprudential regulation seeks to minimize distress in individual institutions in order to protect depositors. In short, macroprudential regulation focuses on common exposures across financial systems and institutions rather than the entity-specific focus of microprudential regulation.

Understanding the differences between these two types of regulation highlights the purposes of various regulators in a financial system. According to Herring and Carmassi, alternative models of financial supervision exist, with the two most common being a “single” or “unified” regulator model on the one hand and a “twin peaks” or “integrated” model on the other. Under the former, a country’s central bank conducts both macro- and microprudential supervision, while under the latter an independent authority external to the central bank is responsible for the microprudential function.

While the United Kingdom’s Financial Services Authority exemplified the unified model (prior to recent reforms), Canada’s regulatory structure follows the twin-peaks approach, with OSFI and the Bank of Canada at


the centre of its financial market regulatory regime. OSFI is an arm’s-length governmental agency that supervises individual financial institutions to determine whether they are in sound financial condition and to promote the adoption of sound risk management policies. By contrast, the Bank of Canada regulates credit and currency, and controls national monetary policy. It is also the lender of last resort and is ultimately charged with promoting the economic and financial welfare of the country.

Despite the differences between the two models, the (obvious) overarching purpose of both is to ensure the stability of the financial system. In the twin-peaks model, the focus of the independent regulatory body is on financial institutions and the consequences of their behaviour on financial markets. This body monitors compliance with standards and guidelines and establishes new standards as necessary in order to protect the economy at large. It also seeks to ensure that banks’ incentives are consistent with the objective of systemic stability. We focus on this type of institution in this article.

The interplay between the level of competition and economic stability ultimately highlights the importance of the regulatory structure. In general, studies suggest that Canada’s financial regulation preserves competition between banks despite—or perhaps because of—greater bank concentration. Further, Canada’s combination of a competitive but concentrated sector is consistent both with international evidence that such sys-

---


23 See OSFI Act, supra note 11.

24 See also Herring & Carmassi, supra note 21 at 57.

25 Allen & Gale report that the costs of financial instability are high (supra note 8 at 454). They cite Glenn Hoggarth, Ricardo Reis & Victoria Saporta, who find that fiscal and quasi-fiscal costs of banking crisis resolution averaged 16% of GDP in their sample (“Costs of Banking System Instability: Some Empirical Evidence” (2002) 26:5 Journal of Banking & Finance 825 at 831).

26 Allen & Gale, supra note 8 at 472; Klaus Schaeck, Martin Cihak & Simon Wolfe, “Are Competitive Banking Systems More Stable?” (2009) 41:4 J Money, Credit, Banking 711 at 714, 719 (finding that Canada is relatively more stable than most other OECD countries); Michael D Bordo, Hugh Rockoff & Angela Redish, “The U.S. Banking System from a Northern Exposure: Stability Versus Efficiency” (1994) 54:2 J of Econ Hist 325 (comparing the US and Canadian financial systems from 1920 to 1980 and finding that Canada’s branch-banking model was more competitive than the unitary banking model that predominated in the US, which resulted in spatial monopolies. The branch model also diversified Canadian banks across regions, lessening its susceptibility to region-specific shocks).
tems are more stable and with the hypothesis that Canada’s regulatory structure strikes an appropriate balance between reducing risks of collusion and preserving ease of monitoring for regulators. This literature emphasizes the importance of regulatory structure in maintaining economic stability. We turn now to examine regulatory structure from the standpoint of institutional design before analyzing OSFI specifically.

II. Optimizing Administrative Design

Against this backdrop of the structure and purposes of financial institution regulation is the basic point that the regulatory structure, especially under the twin-peaks model sketched above, interfaces with administrative law. Administrative law is concerned in part with the appropriate institutional structures by which government makes and enforces regulations. These institutional structures include not only large-scale institutional choices between governments, courts, and markets but also related issues such as the degree of insulation of administrative bodies from the legislature, the level of transparency, the nature of accountability, and the processes for public participation. These structures may affect the power of interest groups, the nature of deliberation, and the rationality of the


29 A further point to be drawn from the literature is that there is a public good character to financial institution regulation. Ensuring the stability of financial institutions preserves the integrity of the economy and its payment system. Further, there is an interplay between the financial institution regulator and other bodies, which provides checks on the ability of the financial regulator to act in an unfettered manner. The central bank’s role as the lender of last resort is one such example. Agencies that administer deposit insurance (in Canada, the Canadian Deposit Insurance Corporation) are another. These bodies contribute to systemic stability by “backstopping” risk taking by the financial institution regulator. The incentives are perverse; knowing that such institutions exist may render financial regulators more inclined to take on risks. Analogous processes exist in other jurisdictions, namely the United States. This suggests that there is some other factor(s) that is important to analyze in the Canadian context. (Thanks to Grant Bishop for making this point.)

30 See Vermeule, Mechanisms of Democracy, supra note 18 (discussing the effects of different institutional features on legislative and administrative decision making); David Markell, “Slack’ in the Administrative State and Its Implications for Governance: The Issue of Accountability” (2005) 84:1 Or L Rev 1 (discussing the debate over the structure of administrative decision making).
administrative decisions. Choosing among these structures requires taking account of their costs and benefits.31

Much of the administrative state operates through delegation: legislators delegate various powers to make rules and/or decisions to other bodies such as agencies, boards, or tribunals. Powers may be delegated for a range of reasons that include the delegate’s possession of greater expertise, time, or information than the legislator, which may render the delegate better able to make the decision at issue.32 However, this delegation gives rise to two types of principal-agent problems. First, the legislators (the principal) delegate decision-making power to another body (the agent) which may or may not seek or be able to fulfill the legislators’ interests adequately.33 Second, there is a deeper principal-agent problem, as the ultimate principals (the citizens of the country or jurisdiction) have granted authority to their agents (the legislators) the power to make decisions on their behalf.

In part, the nature of and solutions for this principal-agent problem depend on the underlying theory of the administrative state.34 On one view, legislators and regulators are attempting to determine the optimal outcome for society. This optimal outcome could, for example, be viewed as maximizing welfare or satisfying the preferences of the majority of the population. Pluralist theories identify the aggregation of the existing interests or preferences of different groups within the relevant society. Civic republican theories, by contrast, argue that there cannot be a mere aggregation of preferences but that instead, there must be some informed deliberation behind policy decisions, as such deliberation helps inform the decision and shape the preferences themselves.

On these theories, the principal-agent problem arises because the agent may either incorrectly determine the principal’s preferences or seek to implement its own preferences regarding the optimal welfare-enhancing policy. Institutional design to address the principal-agent problem is concerned with ensuring that the delegated party is in a position to obtain the appropriate information or to engage in an appropriate process to make the decision that is in the public interest. The agent wishes to

31 See Vermeule, Mechanisms of Democracy, supra note 18 at 10 ff.
make the decision that is in the interests of its principal and the design question concerns how best to help it make this decision.

Alternatively, public choice theory holds that legislators and regulators make decisions in their own interests. They may, for example, use their powers to favour well-organized groups in exchange for benefits such as electoral funding or future job opportunities. They may also simply attempt to increase the scope of their power or the size of their budget. The principal-agent problem under this theory is not based on the possibility that, despite the agent’s desire to make a decision in the principal’s interest, it fails to do so. Instead, the problem rests on the desire of the agent to make decisions in its own interest rather than those of the principal.

A multitude of institutional design features may be used to address the principal-agent problem in light of these different theories of the administrative state. Vermeule argues that each design feature has costs and benefits in terms of various democratic values such as impartiality, accountability, and deliberation, and that the goal of institutional design should be to optimize across these values.\(^3\) We focus on the effect and interactions between two design features central to financial institution regulation: insulation and transparency.

### A. Insulation

The appropriate degree of insulation of executive bodies from the legislature has been a long-standing subject of debate in administrative law.\(^3\) By insulation, we mean the degree to which the executive body is separated from the legislature. It is not a threshold variable (that is, insulated or not insulated) but a sliding scale. At one end of the scale are decisions made purely by legislators. Such decisions obviously include the enactment of statutes. At the other end of the spectrum are decisions made by bodies that are removed from legislative control. Some administrative tribunals, for example, may possess a level of independence from the legislature and other executive bodies that approaches that of the judiciary.\(^3\) Indicia of insulation include fixed terms of appointment for the members of the administrative bodies, limits on the power of the legislative or


\(^3\) See Markell, supra note 30; Stephenson, supra note 18 at 54.

\(^3\) See Laverne Jacobs, “Independence, Impartiality, and Bias” in Flood & Sossin, supra note 32, 139 at 153-55.
elected officials to remove the members of the regulatory body, lack of political control over the body’s structure and procedures, lack of political review of the body’s decisions, and absence of a power for elected officials to issue directives to the body.\textsuperscript{38}

Insulation or independence of an executive body from the legislature does not mean that the body is not accountable to the legislature or elected officials. First, as the legislature establishes or authorizes the continuance of these bodies, elected officials are accountable to the electorate for the decisions made by these bodies. The public may have difficulty monitoring exactly how the decisions of these bodies relate to legislative control, but there remains an element of accountability.\textsuperscript{39} Second, there are varying mechanisms by which legislatures can control all executive bodies. The most extreme control mechanism is, of course, abolishing executive bodies that make decisions that conflict with the legislators’ preferences. Less extreme control mechanisms include limiting the delegated body’s budget, limiting the power to remove and appoint members, and limiting the power to make regulations that overturn the body’s decisions.\textsuperscript{40} There is also legislative review of decisions of these executive bodies, though lack of constant supervision is the whole point of delegation and undermines its benefits.\textsuperscript{41}

The value of insulation (or independence) is that the delegated body has the ability to use its expertise, time, and information to make a decision, to a greater or lesser extent, free of political interference.\textsuperscript{42} Such interference may be negative to the extent that legislators are attempting to alter a decision for self-interested reasons as opposed to welfare-maximizing reasons. For example, legislators may serve their own interests by providing benefits to concentrated interest groups—a type of responsiveness that Vermeule labels “bad accountability”.\textsuperscript{43}

\textsuperscript{38} Stephenson, \textit{supra} note 18 at 68.

\textsuperscript{39} \textit{Ibid} at 75-76, 80 (elected officials retain accountability for delegated decisions because they have the ability to control the bodies or their decisions; monitoring costs should be endogenous to the delegation). But see Justin Fox & Stuart V Jordan, “Delegation and Accountability” (2009), online: Social Science Research Network <http://www.papers.ssrn.com> (arguing that there is a gap in monitoring or accountability due to delegation, but that under certain conditions the gains from expertise may outweigh the costs in terms of democratic accountability).

\textsuperscript{40} See Jacobs, \textit{supra} note 38; Stephenson, \textit{supra} note 18 at 68; Green, \textit{supra} note 32 at 343-56 (discussing mechanisms of controlling executive bodies).

\textsuperscript{41} \textit{Ibid} at 345-46; Vermeule, \textit{Mechanisms of Democracy}, \textit{supra} note 18 at 81-82.

\textsuperscript{42} Insulation can have other values such as allowing faster decisions during a crisis.

\textsuperscript{43} \textit{Ibid} at 184.
The level of insulation can be thought of in terms of the cost to the legislature of altering the decisions of the delegated body; the higher the cost of altering the decision, the more insulated the body. Control is costly both directly (for instance, the costs of drafting and enacting regulations to reverse a decision of an executive body) and indirectly (given the opportunity costs of the time used to monitor and control delegated decisions). As Stephenson argues, the costs of control by the legislature tend to be increasing in the sense that the larger the change needed to be made by the legislature, the higher the costs of change, and there are increasing marginal costs of change.

The costs of insulation itself can be thought of in terms of the difference between the decision of the delegated body and the decision of either a fully informed legislature or informed voters. Insulation in such a case may reduce “good” accountability—that of a well-meaning legislature attempting to control the outcome of delegated decisions. Such a difference may arise for a number of reasons. First, the delegated body (e.g., a regulator of financial institutions) may be acting in its own self-interest, attempting to obtain benefits from concentrated interests for non-welfare-maximizing decisions. Second, the delegated body may be seeking to decide in accordance with the preferences of the legislature but may be mistaken concerning those preferences. Third, the delegated body may wish to make a decision that maximizes social welfare but seeks to implement its own preferences in this regard (as opposed to those of the legislature).

Finally, there may be something about the legislative process, such as its deliberative nature, that shapes the preferences of the legislature as distinct from the delegated body. Vermeule notes that there can be

44 Stephenson, supra note 18 at 69.
45 Ibid. In Stephenson’s model, the president (the executive) seeks to change the preferences of the bureaucracy, and the costs of control increase with the desired size of the preference change.
46 Ibid. This difference may be termed “slack”; see Markell, supra note 30.
47 See Vermeule, Mechanisms of Democracy, supra note 18 at 81-2 (discussing the connection between delegation and accountability).
48 Stephenson models the legislative choice concerning a bureaucratic body’s degree of insulation from control. Examining the difference between the bureaucratic decision and the majoritarian decision, he finds that some insulation is always desirable. The benefit derives from the reduction in the variance in policy outcomes. The degree of insulation, therefore, relates to such factors as the responsiveness of the elected officials to majoritarian preferences and voter preference instability (Stephenson, supra note 18).
49 But see Vermeule, Mechanisms of Democracy, supra note 18 at 80-1 (discussing the relationship between delegation and deliberation and noting that legislators may ensure that delegated decisions have good deliberative features).
“good” deliberation and “bad” deliberation. “Good” deliberation is informed argumentation that seeks to understand the issue and possibly to come to a common understanding of what is at stake and the optimal decision to be reached. “Bad” deliberation involves political posturing and hardening of positions to score political advantage. To the extent that insulation reduces good deliberation, it is costly; conversely, to the extent that it avoids bad deliberation, it is beneficial.

B. Transparency and Opacity

Transparency is touted as a central feature of democratic governance. It is argued, for example, that transparency will reduce the power of interest groups, allow monitoring of decisions by the public, and increase deliberation in policy decisions. However, just as insulation is not an unalloyed good in a democracy, so too transparency has both benefits and costs. For any particular policy, such as financial regulation, these benefits and costs must be traded off to determine optimal institutional design.

We focus on transparency in the sense of an open process for decision making in either policy or adjudication. Again, as with insulation, it is not an all or nothing concept; transparency in decision making comes in degrees. Transparency includes the information provided to the public by the decision-making body about its proposed decision and its implications, the ability of the public or regulated parties to make oral or written submissions concerning the decision, the information provided by the decision-making body about the decision process, and the extent to which the resulting decision and its bases are made available to parties outside the decision-making body. Thus, the indicia of transparency relate solely to the decision-making processes (i.e., which parties contribute to the making of a decision or set of decisions), including decisions about the substantive content of legislation.

The benefits of transparency centre on its connection to good and bad deliberation and accountability, and the impact of these factors on the rationality of the ultimate decision as well as the connection of the decision to the preferences of either the legislators or the public. In terms of accountability, transparency lowers the monitoring costs for parties external to the decision-making process. It therefore allows voters and legislators to determine more easily if the party that was delegated the power is act-

50 Ibid at 11.
51 See Fenster, supra note 18 at 897, 899.
52 See e.g. Vermeule, Mechanisms of Democracy, supra note 18 at 11; Fenster, supra note 18.
53 Ibid at 186.
ing in accordance with its own interests or some version of social welfare that does not accord with that of legislators or voters. Such good accountability lowers the risks and costs of capture and may shift the decision of the decision-making body towards that of the principal.

Transparency may also enhance the rationality of the decision by providing opportunities for various parties to provide the decision maker with information. For example, a process that relies on a broad notice and comment process or requires public hearings provides interested parties with the ability to provide such information. The decision maker may not decide in accordance with that information or even use the information in all cases, but the information may change decisions on the margin. It may also enhance good deliberation both because the transparency may provide the decision maker with information and because it allows parties to debate the merits of any decision more openly.54

However, transparency also has potential costs because it might increase both bad deliberation and bad accountability. As noted above, “bad” deliberation involves political posturing and inflexibility in policy positions.55 “Bad” accountability arises because transparency allows not only voters and legislators but also concentrated interests to monitor the actions of the decision maker. To the extent that the decision makers have entered in non-social-welfare enhancing bargains with interest groups, transparency allows interest groups to determine if the decision maker is actually following through on the bargain. The more transparent the process, the more difficult it is for a member of the decision-making body to deceive the interest group about whether she held her end of the deal.56

The desirability and degree of transparency, therefore, will depend on the balance of these costs and benefits in the particular policy context. To the extent that there is a greater concern with enhancing good accountability or deliberation (because, for example, there may be less concern about capture of legislators than members of the executive), transparency should be enhanced. If there is more of a concern about bad accountability of decision makers, some opacity may be warranted.

54 See Vermeule, *Mechanisms of Democracy*, supra note 18 at 180-81 (discussing the connection between transparency, deliberation, and other values); contra Fenster, *supra* note 18 at 908-909.

55 *Ibid* at 196.

56 *Ibid* at 197.
C. Combining Insulation and Opacity

Both transparency and insulation have costs and benefits that relate to the connection between the ultimate decision and the preferences of the relevant principal (either the voter or the legislator). They also connect to the rationality of the decision, where rationality requires that the decision be based on full information, with appropriate levels of expertise, and with proper deliberation. The appropriate administrative structure in each case will depend on an understanding of the nature of the underlying principal-agent problem and the concerns that arise about the ability and willingness of the delegated decision maker to enhance social welfare.

However, there is more to understanding institutional design. Different institutional features, such as transparency and insulation, not only give rise to particular costs and benefits, but they also interact with each other.\textsuperscript{57} There can be various combinations of mechanisms. Figure 1, for example, illustrates the broad possibilities relating to transparency and insulation. Bodies exercising delegated powers that lie in Quadrant I are both more transparent and insulated from political control than bodies in the other quadrants. An administrative tribunal modeled on a court may lie in this quadrant—it is designed so that political control is weak (costly) such as where an apolitical process appoints members for a lengthy, fixed period of time. To the extent that the materials and hearings (and possibly even deliberations) are open to the public, such tribunals can be very transparent.

Figure 1: Transparency and Insulation in Institutional Design

<table>
<thead>
<tr>
<th>Insulated</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>II</td>
</tr>
<tr>
<td>Transparent</td>
<td>Opaque</td>
</tr>
<tr>
<td>III</td>
<td>IV</td>
</tr>
<tr>
<td>Legislative</td>
<td></td>
</tr>
</tbody>
</table>
Decision-making bodies in Quadrant II are more insulated than other bodies but are also more opaque. There may be little opportunity for public, or interest, groups to be involved in the decision-making process. Even the decisions themselves may be kept from public view. An example of a body in Quadrant II is one that addresses issues requiring a high degree of expertise as well as privacy such as a body determining mental health issues or national security issues. As discussed in the next section, we place OSFI in Quadrant II.

Bodies in Quadrants III and IV are subject to greater political control over the ultimate decision or process. Bodies in Quadrant III are subject to political control and are transparent. Such bodies could include commissions composed of elected officials, which typically hold open hearings. Quadrant IV encompasses bodies that are subject to political control but are more opaque than other bodies. Such bodies may be responsible for highly political decisions that at the same time require secrecy. A tribunal or commission making national security decisions is an example of such a tribunal.

There are, therefore, four combinations relating to insulation and transparency, with varying degrees of each characteristic (that is, the bodies can lie anywhere in the Quadrants and they need not be at the extremes). The design of the particular institution will depend on how the two features interact. They may be complements in the sense that an increase in one feature (such as transparency) increases the benefits, or decreases the costs, of the other (insulation). Alternatively, transparency and insulation may be substitutes in the sense that an increase in one decreases the benefits, or increases the costs, of the other.

To understand the relationship between transparency and insulation, it is useful to consider two (related) aspects of policy decisions—the extent to which the decision accords with the preferences of the principal (whether it be voters or legislators) and the rationality of the decision (such as whether the decision accurately rests on and incorporates the relevant costs and benefits of the policy options). The interaction of transparency and insulation will be important to the extent that there is a concern about matching the preferences of the decision maker with those of the principal. If good accountability is important and possible, an increase in transparency should reduce the costs of insulation in the form of “slack”—or the difference between the decision and preferences—by reducing the monitoring and, therefore, the control costs. It requires that the legislators or the public be both willing to obtain the information and

---

58 Ibid at 21-22 (discussing the possibility that mechanisms may be complements or substitutes).
able to understand it.\textsuperscript{59} However, if there is a concern about bad accountability in the form of interest group monitoring of bargains (to the detriment of social welfare), transparency and insulation would be substitutes—an increase in transparency would increase the costs of insulation (or the slack available given the costs of control). The nature of the relationship will then depend on the context and the nature of the concern about accountability.

This same contextual concern holds for the impact of transparency and insulation on the rationality of the decision. Transparency and insulation are complements to the extent that transparency results in greater information for the decision maker and enhances good deliberation about the decision. An increase in transparency would increase the benefits of insulation in that it enhances the ability of the decision maker to utilize its expertise. However, to the extent that there is a concern about bad deliberation, transparency and insulation may be substitutes. The members of the decision-making body may engage in political posturing or they may become inflexible in their positions and rely less on their expertise. Transparency would, therefore, decrease the benefits of insulation. Furthermore, transparency and insulation may be substitutes if transparency allows regulated parties, or others, to use their ability to provide information to control the outcomes of the decision-making body.

The nature of the relationship between transparency and insulation will, therefore, depend on the nature of the policy context. They may in certain cases be complements pushing towards the desirability of creating bodies that fall within Quadrants I or IV. Alternatively, they may be substitutes pointing towards creating a body lying within Quadrants II or III. Of course, an administrative body need not lie solely within one quadrant for all issues or even for all aspects of a particular issue. For example, in discussing transparency, Vermeule proposes altering the budgetary process of the US federal government to delay disclosure so that good deliberation is enhanced and bad accountability is reduced.\textsuperscript{60} Further research is needed on how to design combinations within and across specific administrative bodies to take advantage of transparency and insulation as complements and substitutes.

\textbf{III. Regulating Financial Institutions}

The previous Part focused on general characteristics of administrative agencies in terms of the extent of their transparency and insulation. This

\textsuperscript{59} See Fenster, supra note 18 at 940-41.

\textsuperscript{60} Vermeule, Mechanisms of Democracy, supra note 18 at 186.
Part discusses the choices concerning transparency and insulation that underlie the design and structure of regulators of financial institutions. As we noted in the introduction, we have chosen to study the Canadian OSFI because it is seen as being an element in the relative success of Canadian banks during the recent financial crisis. This analysis forms the basis for the discussion in Part IV, which points to aspects of OSFI’s regulatory structure that may serve as a model for other countries to emulate.

OSFI is both insulated and opaque. Recall that indicia of insulation include considerations relating to the extent to which decision making in the administrative body is removed from legislative control or control by elected officials. It depends on such factors as: the process for appointing and removing the superintendent; the process for assessing the competence and performance of the administrative body; the degree of political control over OSFI’s structure and procedures; and the process for making binding rules (this latter indicium overlaps with those that relate to transparency, as we discuss below).

The minister of finance “preside[s]” over and is “responsible [for]” the office.61 However, the locus of power in OSFI rests in one individual: the superintendent of financial institutions. She has the powers, duties, and functions assigned to her by various named statutes, including the Office of the Superintendent of Financial Institutions Act as well as others like the Bank Act and the Insurance Companies Act. The superintendent is appointed by the Governor-in-Council (i.e., the federal Cabinet) to hold office for seven years. She can be reappointed for a further term and can only be removed for cause.62 The superintendent may appoint officers (called deputy superintendents) and employees but all must act under her instructions.63

In terms of accountability provisions, the superintendent is required to “report to the Minister [of Finance] from time to time on all matters connected with the administration” of these acts.64 As noted above, the OSFI Act specifically notes that the minister is responsible for the office. Further, the superintendent is required to submit an annual report to Parliament showing the operations of the office for that year.65 The lines of accountability therefore flow through the minister to Parliament. This accountability does not encompass budget control. Under the act, the superintendent recovers the costs of her activities mainly through assess-

61 OSFI Act, supra note 11, ss 3, 4(1).
62 Ibid, s 5. The current superintendent is Julie Dickson.
63 Ibid, ss 8, 9, 11.
64 Ibid, s 6.
65 Ibid, s 40.
ments on regulated parties with small amounts coming from some user pay programs. In addition, the minister is able to override OSFI decisions in some instances.

In general, the Governor-in-Council has authority under the various statutes that apply to OSFI to make regulations and the superintendent is responsible for administering these regulations. The *OSFI Act* also contains a broad provision that permits Cabinet to make regulations, “prescribing anything that is required or authorized by this Act to be prescribed; and ... prescribing the way in which anything that is required or authorized by this Act to be prescribed shall be determined.” In terms of rule making, the federal government has put in place requirements for prepublication of proposed regulations along with a form of cost-benefit analysis. The guidelines also mandate a public consultation process. OSFI itself “may ... provide input to the Department of Finance with respect to regulations that support the various Acts. In some cases, OSFI will be the sponsor of a regulation and will work with the Department of Finance and Justice to complete the process of developing and issuing of a regulation.” Thus, communication between OSFI and federal ministries occurs as a matter of practice and there is an open process for making regulations.

While Cabinet may make regulations that OSFI must implement, the enabling statute has left considerable room for OSFI to make policy through various forms of guidance. These include: guidelines describing OSFI’s view of such matters as risk management; advisories setting out OSFI’s interpretation of different requirements; and guidelines and rulings on specific matters. In addition, in its supervisory role, OSFI uses a principle-based as opposed to a rules-based approach. This approach “relies heavily on the judgment of its supervisory staff.”

The guidelines can relate to crucial areas of OSFI’s mandate. For example, OSFI relies on a guideline (360 pages in length) to establish capi-

---


68 Email from Correspondence Officer, OSFI (4 October 2011) [Email correspondence].


70 *Ibid*, ch 5 at 19: “[The Auditor-General] found that OSFI followed its supervisory approach in assessing the activities of the large banks for the year.”
tal adequacy requirements.\textsuperscript{71} While the formulation of guidelines may follow from participation in discussion around international regulatory standards, such as the Basel III process, no formal consultation process is prescribed for making guidelines. OSFI describes its process as follows:

The development process usually involves a research and drafting phase followed by informal industry consultations with knowledgeable parties where the draft is further revised and then approved for posting in draft on our Web site for formal consultations. Comments are received and analyzed, after which appropriate amendments are made and a final version of the guidance is issued.\textsuperscript{72}

OSFI seems, therefore, to have some interest in receiving comments from the public or relevant stakeholders, but this is not a mandatory aspect of the process.

OSFI’s guideline and policy-making processes are opaque relative to other financial regulatory bodies, both in the United States and in Canada. The legislation contains no procedures that must accompany OSFI’s development of guidelines in marked contrast to rule-making procedures that constrain other administrative agencies in the financial sector. For the Ontario Securities Commission, for example, the rule-making process requires proposed rules to be published for comment for ninety days;\textsuperscript{73} and if there are material changes that are made to the proposed rule thereafter, the rule must be republished for a further “reasonable” comment period as the Commission deems appropriate.\textsuperscript{74} The proposed rule must be accompanied by a cost-benefit analysis. Once all comment periods have expired, the proposed rule must be sent to the provincial minister of finance for approval.\textsuperscript{75} This process would fall on the transparent side of the scale in Figure 1 above.

OSFI’s process, on the other hand, requires no cost-benefit analysis and no public comment periods for guidelines.\textsuperscript{76} There is only limited ability for members of the public to provide input to the rule-making process through its informal notice and comment process while financial institu-

\textsuperscript{71} Canada, Officer of the Superintendent of Financial Institutions, \textit{Capital Adequacy Requirements, No A-1}, (Guideline) (Ottawa: Officer of the Superintendent of Financial Institutions in Canada, 2007).

\textsuperscript{72} Email correspondence, \textit{supra} note 71.

\textsuperscript{73} \textit{Securities Act, RSO 1990, c S.5, s 143.2(3)}.

\textsuperscript{74} \textit{Ibid}, s 143.2(9).

\textsuperscript{75} \textit{Securities Act, RSO 1990, c S.5, ss 143.2, 143.3. The rule-making process in Ontario was preceded by a policy-making phase that was challenged before the courts. See Ainsley Financial Corp v Ontario Securities Commission} (1994), 21 OR (3d) 104, 121 DLR (4th) 79 (CA).

\textsuperscript{76} “Cabinet Directive” applies to regulation making (\textit{supra} note 15).
tions have greater input at least at the initial policy-formation stage. What is involved in these “consultations” is not clear, although OSFI likely chooses with whom it will consult. The Auditor General notes that “[f]requent and open dialogue between OSFI and the banks and OSFI’s willingness to consider the banks’ views were also credited as promoting a positive working relationship.”

Interestingly, OSFI extends this use of relatively opaque processes in its enforcement role. The various statutes that OSFI administers provide tools that can be used where OSFI determines that a financial institution under its supervision is following unsafe or unsound practices. OSFI’s formal powers include: the ability to issue directions of compliance, disqualification, or removal of directors or senior officers; taking control of a financial institution; and a request for a winding up of a financial institution. In addition, OSFI has the power to issue administrative monetary penalties under the *OSFI Act*. However, OSFI tends to employ a hands-on style of negotiation and “works with” these institutions in order “to address areas of concern before they lead to a situation where more formal mechanisms can be used.” The enforcement process is thus based, to some extent, on informal, nonpublic negotiations rather than a more transparent, formal, penalty-based approach.

---

77 OSFI has indicated that it posts its proposed guidelines for comment. Email correspondence, *supra* note 71, which states:

[guidance may be developed as a result of legislative changes or due to various environmental factors that indicate new or revised guidance is needed. The development process usually involves a research and drafting phase followed by informal industry consultations with knowledgeable parties where the draft is further revised and then approved for posting in draft on our Web site for formal consultations. Comments are received and analysed, after which appropriate amendments are made and a final version of the guidance is issued.

78 Auditor General, *supra* note 72 at 20. The OSFI has commissioned confidential consultations with deposit-taking institutions: see The Strategic Counsel, *supra* note 17 at 8.

79 See *Bank Act*, *supra* note 12, Part XIII, ss 960 (directions of compliance), 620 (supervisory intervention), 963 (removal of directors or senior officers), 621 (winding-up); *Insurance Companies Act*, *supra* note 12, Part XV; *Trust and Loan Companies Act*, *supra* note 12, Part XII, s 509.1 (disqualification from election or appointment), 509.2 (removal of directors or senior officers), 510 (supervisory intervention), 515.1 (winding-up); *Cooperative Credit Associations Act*, *supra* note 12, Part XIII, s 439 (directions of compliance), 441.1 (disqualification from election or appointment), s 441.01 (removal of directors or senior officers).

80 Email correspondence, *supra* note 71.
IV. Policy Implications

In the previous Part, we set forth the way in which rules and policies relating to financial institutions are made and OSFI’s roles in these processes. In this Part, we explore why OSFI appears to have been an effective regulator despite its insulated and opaque structure.

There are at least two possible stories. The first revolves around capture. Legislators wish to retain the high tax revenues and the primary and secondary business activity from the banks (or merely succumb to lobbying). The government therefore established a structure that enables banks to operate without government or public intervention. The minister of finance has oversight over the body and Cabinet can make regulations. However, these powers are rarely used and are weak or costly (such as the difficulty in removing a supervisor who is acting against the preferences of the government). OSFI operates as a true arm’s-length body with a substantial portion of its administration accomplished through guidelines and negotiations with regulated entities.

This story is not entirely satisfactory. It is not clear why the government would provide banks with such freedom. OSFI has an explicit public interest role to play in protecting the rights and interests of depositors, policyholders, and creditors of financial institutions. It is also ultimately accountable to an elected official, who will presumably have an interest in maintaining the integrity of the body he oversees if only to ensure that the voting public will retain its confidence in him and the government he represents. Permitting the banks such freedom may increase tax revenue and economic activity but would likely undermine this objective. The story would, therefore, likely have to be more than one of a desire to foster growth to increase tax revenue and economic activity.

Furthermore, even if the federal government supported collusion, why would it not provide itself with more direct oversight and control over OSFI? For example, the seven-year term of the superintendent means that one federal government is able to impose the preferences and direction of one superintendent on another (governments change at least every five years). The government could have provided for shorter terms or some bases on which the superintendent could be removed other than for cause, expanding its ability to exercise control. Even if the government wished to allow for collusion, it would seem advantageous to retain

---

81 As noted in the introduction, there are a number of other factors than the regulatory structure that have been advanced regarding the relative success of Canadian banks at weathering the economic crisis.

82 OSFI Act, supra note 11, s 4(3).
stronger forms of checks by the party in power. OSFI’s highly insulated and opaque structure does not provide for such controls.83

A second possible story for the existence of this structure rests in its benefits. The benefits arise because of the nature of the regulatory subject matter (i.e., financial institutions) and the nature of the financial sector in Canada. In substantive terms, banking regulation can be highly dense and technical. (The capital adequacy guidelines referred to above are a case in point.) Rationality in regulation and related decision making requires the exercise of considerable expertise to understand banks’ risk management models and the application of policy to these models. In addition, stability of policy in this area is necessary in order to provide confidence to the financial markets and to enable regulated entities, and those who seek credit from regulated entities, to structure their businesses efficiently.

As an insulated body with an expert superintendent and staff, OSFI is effectively removed from legislative processes dominated by partisan politics and majoritarian preferences. Insulation ensures that the policy-making process will be undertaken by those with expertise. It also allows policy-making to be buffered from shifts in public opinion. This would not be the case if elected officials were able to participate more broadly in the policy-making process.

In this sense, the value of good accountability (i.e., a well-intentioned legislature attempting to control the outcome of delegated decisions) is low. These same factors also feed into the benefits of opacity in this area. The fact that the process is opaque and does not allow for considerable public input is beneficial to the extent that there is no need or desire to closely tie banking regulation and policy to shifts in public preferences. Further, given that financial institution stability and market confidence are important, there are risks to regulation from bad deliberation—that is, political posturing (such as vilifying the banks when it is politically advantageous to do so). The opacity and insulation of the process reduce the negative impact of bad deliberation.

An insulated and opaque OSFI can also be effective because of the oligopolistic nature of the banking sector, which is dominated by five big banks. These banks engage in considerable lobbying of politicians who are responsive to their concerns because they comprise approximately 85 per-

83 Further, at least in some cases, it appears that the minister does indeed take his supervisory role seriously, as evidenced most recently with his rejection of the global bank tax and support for the contingent capital proposal, regardless of OSFI’s stance on these issues: see Peter Foster, “Flaherty’s Silver Bullet”, Comment, The Financial Post (10 June 2010) online: The Financial Post <http://opinion.financialpost.com>.
cent of the banking sector. The risks of bad accountability of OSFI to politicians as a result of such lobbying would be relatively high if the costs of control were lower. But in an oligopoly, opacity in the policy-making process is not as problematic. The existence of fewer banks reduces information costs for the regulator, allowing greater control through less formal processes.

In addition, an opaque structure is necessary and even desirable to encourage co-operation by financial institutions. Where OSFI’s intentions, process, and exercise of power are not fully clear to banks, it is more difficult for banks to “manage” their regulator. OSFI “profits” from its informational advantage: it can effectively prevent banks from gaining information about its views on particular conduct or policy and also effectively prevent banks from colluding. OSFI may be able to keep the banks at bay by providing them with little information about its intentions.

The insulated and opaque nature of the processes used by OSFI can be contrasted with the more transparent and public approach that the government would need to take if it attempted to put in place regulations to govern the banks at every turn (as in the area of capital adequacy requirements). Such processes would not only be time-consuming but also concluded only after legislative debate, stakeholder input and bank lobbying. Highly sensitive policy, and the process of making such policy, would be more closely tied to shifts in public preferences and to the effects of lobbying of elected officials by the banks, potentially reducing the rationality and effectiveness of the policy.

For their part, financial institutions do not want to fall out of favour with OSFI. In particular, the five big banks comply not because they fear enforcement but likely because of possible reputational effects among their peers and the public at large of being sanctioned by OSFI (a fact that could quickly become publicized). They also want to stave off mandatory regulation, which would be more public. For this reason, banks voluntarily comply with requests for information, meetings, transaction changes, and internal policy amendments. The benefits of a formal legal system

84 Authors’ calculations using OSFI monthly banking data, available at “Financial Data - Banks” Office of the Superintendent of Financial Institutions Canada, online: OSFI [http://osfi-bsif.gc.ca]. As of October 31, 2011, the “Big Five” banks (RBC, TD, Bank of Nova Scotia, Bank of Montreal and CIBC) held 86% of the assets of all banks in Canada (which includes “Total Domestic Banks”, “Total Foreign Bank Subsidiaries” and “Total Foreign Bank Branches”).

85 The deferential view that financial institutions hold towards OSFI arose in our discussions with Canadian banks. The interviews took place in May and June of 2009. One financial institution stated that OSFI has voluminous information about all banks. It is, therefore, difficult and unwise to challenge OSFI because it can penalize banks by, for example, closing loopholes that may be open to them.
are reduced in part because of these broader forms of accountability or control while the costs are potentially high.

Insulation and opacity, therefore, work as complements in this area. In terms of preferences underlying policy, as opacity increases there is an increase in the benefits of insulation—stability in policy increases and the influence of majoritarian preferences shrinks (since the value of good accountability is low). At the same time, in terms of rationality of policy, an increase in opacity reduces the risks of bad accountability from elected officials without significantly reducing the harm from less information (as the banking sector is so concentrated).

A final question concerns regulatory capture of individuals working within OSFI. If an institution like OSFI is opaque and insulated, what, if any, controls exist to prevent capture of individual regulators such as the superintendent or her deputies if they hope to secure employment opportunities and other benefits once they leave OSFI? Indeed, studies indicate that regulatory capture exists in the banking industry, especially in concentrated sectors. However, independence of a supervisory body is argued to reduce capture in the financial sector. This conclusion is consistent with our discussion of independence, transparency and accountability above. OSFI establishes fairly strict guidelines and closely monitors financial institutions. One would expect more relaxed standards if OSFI personnel were trying to curry favour with regulated entities in the long-term. We recognize that context—and in particular the degree of independence and transparency of the regulated entity—is crucial, perhaps determinative. We need to test our hypothesis empirically before pronouncing on whether regulatory capture is an issue for the regulation of Canada’s financial institutions.

Conclusion

Since the global financial crisis, Canada’s banking sector has been the subject of favourable attention as it remained strong (e.g., free from federal government support in the form of bailouts), unlike banking sectors

---


in other developed countries. Part of this success has been attributed to Canada’s financial regulatory system including the effectiveness of its financial services regulator, OSFI. Thus, we have sought to explore a question of institutional design: What characteristics make a regulator effective? OSFI provides an ideal case to examine this question.

We have argued that OSFI’s insulated and opaque structure provides certain benefits that enhance its efficacy. In particular, it is able to regulate unhampered by political lobbying, partisan politics, and majoritarian preferences. OSFI operates in a “black box”, keeping information about its policy formation and enforcement confidential. With its informational advantage, it is able to undermine the possibility that banks will collude or rent-seek. Our conclusions regarding the value of opacity cut against generally held views about the benefits of transparency in regulatory bodies.

We recognize that further research is warranted in this area. In particular, it would be beneficial to broaden the analysis to include other administrative bodies in the financial area generally as well as other aspects of OSFI’s mandate. We might ask: Is it the case that the qualities of opacity and insulation are advantageous in other legal settings, or is there something specific about the financial services area that allows the benefits that we have outlined to outweigh the costs (i.e., costs associated with opacity and insulation)?

A related issue to explore further is the role of the oligopoly in this area. As we noted above, it may be the case that OSFI’s structure works well because the regulated entities that it must supervise are relatively few in number (five big banks). An opaque and insulated structure, under which the regulator maintains close relationships with the regulated entities, holding closed-door confidential meetings and negotiations, may not be as effective in a market such as that of the United States where many more banks populate the financial markets. In practical terms, it certainly would be difficult for the regulator to function as OSFI does now. In other words, there may be features particular to Canadian financial markets that enable OSFI’s structure to work well. Such a structure may not be readily transferable to another jurisdiction.

While there may be other factors at play, OSFI has contributed to the maintenance of a stable banking system. Other jurisdictions, in reforming their own financial regulatory structure, would benefit from understanding the connections between the insulation and opacity at the core of OSFI’s structure. Moreover, as we have discussed, an understanding of the costs and benefits of opacity, transparency, and insulation in administrative bodies in general and the trade-offs involved in structuring administrative bodies with any of these characteristics could aid in designing regulatory institutions in other areas.