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How Canadian Banks have managed the Economic Crisis so well

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In this article, the authors explains how and why the banks in Canada faired extremely well during the financial and liquidity crisis of 2007-2008-2009 and lessons to be learned from same.

Introduction

Canadian banks faired extremely well during the financial and liquidity crisis of 2007-2008-2009. In fact, no Canadian banks went bankrupt, incurred catastrophic losses, or asked the Government for taxpayer-financed assistance. On the whole, Canadian banks remained stable and well-capitalized. They even made a decent profit, all things considered.

All of this was in stark contrast to the experience of banks in the United States and Europe. In fiscal 2008, Citygroup (which includes Citibank and related entities), wrote-off more than USD 39 billion in subprime loan losses. Similarly, UBS lost USD 30 billion and Wachovia lost USD 24 billion, respectively, before being absorbed by Wells Fargo. Since 2008, the World Economic Forum has ranked the Canadian banking system as the healthiest in the world. The U.S. banking system is ranked 40th, and the UK 44th. This resulted in Canadian banks moving up in the ratings table of the biggest banks in the world. For example, The Toronto Dominion Bank is now the 5th largest in North America, while in 2008 it occupied only 15th place. The truth is that TD Bank has not really grown in size; the other banks have, in fact, shrunk. So, what did the Canadian banking system do right? How did they manage to do this? Which economic, cultural and political factors helped Canadian banks to stay afloat in this perfect (economic) storm? Could the Canadian banking system be a model for the rest of the world? Is it crisis-proof?

The Canadian Banking Environment

To understand the resilience of Canadian banking institutions in the 2007-2008-2009 crisis it is very important to familiarize yourself with the structure of Canadian banking.

How Canadian Banks have managed the Economic Crisis so well

Canadian banking is highly centralized. The founders of the earliest Canadian banks were Scots who established in Canada a prudent Scottish-type banking system, which was the successful eighteenth century system they themselves were accustomed to. In fact, the Canadian banking system precedes the formation of the Canadian nation. When the Dominion of Canada was created in 1867 the Scottish banking system was based on a few large banks which had a significant number of geographically spread branches already in place. In 1874 Canada had 51 banks. By 1928, through mergers, acquisitions and few failures, the number of banks was reduced to 10. But even before the 1920s the five largest banks owned 80% of all assets. Today, five major banks control 96% of all national deposits and their portion of all Canadian banking assets exceeds 90%.
Since 1867 (the year Canada became a nation), the federal government of Canada has had exclusive authority over banking. The federal government favours big national banks: the Canadian Bank Act has protected Canadian banks from foreign takeovers since the 1960's. (The federal government prevents further concentration of banking power by not allowing mergers of the existing institutions. This law prevents the accumulation of a large number of banking shares in small number of hands. Banks with assets over CAD 8 billion (the value of the Canadian Dollar (CAD) is within approximately 5% of the USD) must be widely held, and no single party can own more than 10% of a bank's shares. The government supervision of banking activity is performed by The Office of the Superintendent of Financial Institutions (OSFI). Historically, Canadian banks are very cautious, conservative institutions - until recently, the bank branch managers were discouraged from owning their own homes; instead the bank would issue them a free apartment in the bank building. This allowed the banks to move their staff to different locations wherever they were required and to help build seasoned teams of banking professionals.

Historically, bank failures are extremely rare in Canada. Even during the Great Depression of the 1930's not a single Canadian bank failed. The federal government issues banking licenses according to strict rules established by the Canadian Bank Act which, by law, is reviewed by Parliament every 5 years to bring the Act in line with current economic and financial conditions. All bank licenses are also reviewed and renewed for the same period. Historically, the Canadian federal government opted for a de-facto banking cartel of a few big, well-capitalized banks, a position which was well supported politically by federal and provincial politicians. The Canadian public does not bear populist hostility towards large banks and generally supports the existing banking system politically, and although limited competition between banks increased the cost of financing for Canadian businesses, it also established a stable financial environment. Canadian banks managed to stay solvent through various monetary crises of 1893, 1907, 1930 and 2008.

The Canadian Banking System vs. the U.S. Banking System

It very important to compare at this stage the Canadian banking system and the banking system of Canada's southern neighbour and biggest trading partner: the United States of America. The economies of both countries have been highly integrated for decades, much more so then the economies of the E.U. countries, but the U.S. and Canada use their own currency and have very different banking systems.

In the U.S. there is a deep-seated populist distrust of big banks. The mistrust of a farmer towards the reach of bankers is in the American political blood and popular culture. Over the centuries there were numerous attempts to bring the American banking system under federal control and make the American system closer to the Canadian model - however, all attempts failed for political reasons. Most states eagerly protected their rights to regulate banking in their own territory, as the American political system makes the congressmen and senators servants of their electorate, not their political party. Thus, it is very difficult for an elected American politician to ignore the wishes of his constituents and vote for federal issues that could harm the economic position of people in his home base.

Historically the American states chartered their banks; they also prohibited banks and bank branches from other states from being opened in their territory. Some states even enacted legislation preventing banks from opening any branches (over the "home/head office"), even within the state. This created the system populated by small and very small (in some cases single branch) banks. Small as they were, they nevertheless exercised big influence locally, preventing federal politicians from voting for federal banking control. The presence of a large number of banks created competition amongst them and created the culture of risk-taking, and being locally based made American banks more attuned to the financial requirements of their communities. These local banks were always ready to advance credits to more risky customers than Canadian banks, which did help many small start up business ventures States-side. On the other hand, small American banks could not support big industrial projects, thus industries had to look for financing on the equity market. As a consequence of this, traditionally, the U.S. has much more developed equity markets than Canada.
State regulators in the U.S. try not to antagonize local banks with heavy regulations; they know that bank can always move to another state where regulations are lighter. The regulatory and political environment of the U.S. allowed creation of much greater variety of financial institutions: investment banks, hedge funds, mutual investment funds of different types, etc. All those institutions collectively are known in the U.S. as the "shadow" banking system. The

"shadow" banking system came to control a substantial amount of assets. In addition, different types of institutions are under regulatory control of a variety of federal and state regulators. Therefore, the innovative character of institutions in the US sometimes overtakes the ability of regulators to control them. By comparing the Canadian and U.S. banking systems, it is clear that the perfect banking system has to strike the right balance between the ability to take risk to stimulate economic growth and financial stability to prevent catastrophic losses. The American system errs on a side of risk, the Canadian on a side of stability - there are pros and cons to both.

The Canadian Banks in the Crisis of 2007-2008-2009

It is important to understand that Canadian banks, despite their solid grounding, did incur substantial losses during the crisis. The crisis put pressure on the banks in terms of liquidity, funding for financial institutions as well as capital adequacy. Furthermore, Canadian banks incurred losses due to the exposure to U.S. (and some Canadian) real estate; for example, they had several billion dollar write-downs at several large lenders. Canadian banks were affected by the lack of liquidity in global markets, and many businesses in Canada were unable to access the capital markets. However, regardless of a huge reliance in Canada on the U.S. for trade and investment, there were no bailouts or rescue plans and no risk of systemic collapse.

There are many opinions about the factors that influenced the resistance of the Canadian banking system to the worst parts of the crisis. Below is a listing of the major factors that most economists consider important.

The Structure of the Banking System, Banking Regulations and Banking Culture

- The Canadian banking system is an oligopoly. Five universal banks (plus a couple of others) dominate the market and entry into the banking business is prohibitively expensive for any newcomers. The banks are federally controlled and the laws governing the banking business are much tougher on their activities than in the U.S. in most respects. The OSFI demands higher capital requirements, lower leverage and less securitisation as well as restricts the type of assets banks can purchase. Over the years, Canadian commercial banks built up and/or purchased mortgage lending portfolios and now have majority ownership of this key line of business. Since 1987, when universal banking was allowed to operate in Canada, the major commercial (deposit taking institutions) banks purchased the investment banks providing for some stability in the capital markets businesses.

- **Toxic Assets, the Securitisation of Mortgages and Innovative Financial Instruments**
  Unlike the U.S., Canada never had a significant sub-prime mortgages market. Requirements for mortgage are strict, generally requiring a permanent job and good credit history. In fact, rates of mortgage defaults in Canada are much lower than in the U.S. Also, Canadian mortgage interest is not tax deductible as in the U.S. The majority of all mortgages In Canada have interest rate fixed for only 5 years and amortization period of 25 years. U.S. mortgages are normally amortized over 30 years with the fixed interest rate over the same period. When inflation rose, American mortgage lenders were forced into the securitisation of their mortgages. In 2007, 60% of American mortgages were securitised, while in Canada it was only 25%. The Canadian mortgage-based securities had been based on mortgages of much higher quality and were therefore less risky. The last three decades witnessed the emergence of new financial instruments: collateralized debt obligations (CDO), interest rate swaps, credit default swaps, derivatives and mathematically-complicated securitisation techniques. The complexities of these instruments hide from the users their extremely risky nature, stemming from the possibility of the rapid loss of value in adverse economic conditions - many financial institutions in the U.S. and in Europe accumulated a substantial amount of the mortgage-backed securities and the innovative financial instruments. In contrast, the Canadian banks had the tightest regulatory capital standards in the years before the financial crisis. The Canadian bankers viewed new financial instruments with suspicion and caution. In Canadian banks, the innovative financial instruments cannot exceed 15% of capital, while no less than 75% must be invested in common equity. Banking regulations in Canada also impose capital requirements that are exceeding the Basel II requirements: tier 1 assets amounting to 7% versus 4% in Basel II, and total capital amounting to 10% versus 8% at Basel II.

- **Bank Funding: Wholesale vs. Retail Funding**
  The funding structure of Canadian banks is based on depository funding, which was more resilient during the crisis than wholesale funding. The majority of "shadow" banking institutions in the U.S. and Europe relied heavily upon the wholesale funding including federal funds, public funds (such as state and local municipalities),the U.S. Federal Home Loan Bank advances, the U.S. Federal Reserve's primary credit program, as well as foreign deposits and brokered deposits. Wholesale funding providers are generally sensitive to changes in the credit risk profile of the institutions to which they provide these funds, and to the interest rate environment.

For instance, such providers closely track the institution's financial condition and may be likely to curtail such funding if other investment opportunities offer more attractive interest rates. As a result, an institution may experience liquidity problems due to lack of wholesale funding availability when needed. In Canada the reliance on depository funding instead of wholesale funding circumvented this issue of liquidity, while in the U.S. and Europe their use of wholesale funding became problematic when the wholesale funding was pulled.

How to Make the System even Better

Today, the Canadian banking system is in the process of the largest regulatory implementation exercise in its history. Canadian financial regulators are introducing new mortgage underwriting guidelines, Basel III capital and liquidity requirements, as well as recovery and resolution plans (RRP) in addition to a comprehensive review of capital requirements for the trading book.

The Canadian banking community continues to conduct an extensive dialogue with financial regulators on the ways to prevent future crisis.

Conclusion

The banks in Canada have done a very good job managing the economic crisis of recent years. Banking is a delicate art of balancing between stability and risk - increasing stability leads to decrease in competition and the rising cost of financing, while increasing risk leads to more competition as well as more creative ways of financing the economic growth. The current crisis showed that Canadian banks may have found the golden mean between stability and risk. It is impossible to predict what factors may create the new crisis in the future, and there is no magic vaccine to immunize the banking system against the possibility of failure. Numerous other factors besides liquidity risk such as the dismantling of the Glass-Steagall firewalls between commercial and investment banking, behaviour of the credit rating agencies, the risk bias of in the structure of executive compensation amongst others have been blamed for the crisis - each of those factors requires their own analysis and regulatory approach. The government regulators of banking activity throughout the world have a lot of work in front of them, but they may find it instructive to look to the Canadian banking system as a model for their own countries. Irrespective of the banking model chosen, the effective Management of Risk must be a core competency within the financial institutions and specifically the identification (i.e., recognize), assessment (i.e., evaluate), mitigation, monitoring and management of risks in banking.

With thanks to Yan Fishman.

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27 November 2012.
Mark Carney, a Canadian banker, has been appointed the first non-British Governor of the Bank of England.

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