HOW CANADIAN BANKS BECAME THE ENVY OF THE WORLD

BY PROF. ANITA ANAND

In September 2008, the U.S. economy was crippled with the collapse of major investment banks and the corresponding stock market decline. The U.S. government passed its bailout plan under which it authorized the Department of Treasury to purchase troubled assets and other financial instruments with a newly created body to oversee the program. Since this time, the government bailout and the prospect of global financial regulation have been daily news items. The effects of the crisis have rippled throughout the world and like the United States, the governments of other individual nations – including the U.K., France, Belgium and Greece – also intervened to create liquidity and guarantee deposits in their respective economies.

While Canada's securities markets have been vastly affected by the credit crisis, Canadian banks have been relatively insulated from the economic turmoil that has crippled their U.S. counterparts. Indeed, Paul Volker, former Federal Reserve chief and an adviser to President Obama, has argued for a U.S. structure that is similar to the Canadian financial system.[1] Ireland's Prime Minister has indicated that Ireland's new financial system will be modeled after the Canadian banking system.[2] Of course, it is not the case that Canadian banks have been unaffected – market activity has slowed and credit markets are tight. However, Canadian financial institutions have not collapsed, unlike some of their U.S. counterparts (e.g. Lehman Bros., Bear Stearns etc.). Why is this the case? What characteristics particular to the Canadian economy and corresponding legal regime have protected Canada's financial institutions?

UNDER CANADA'S BANK ACT, Schedule I and Schedule II, banks are both investment banks and deposit-taking institutions. They therefore have a steady, secure stream of capital. On the contrary, under the Glass Steagall Act, U.S. institutions were prohibited from engaging in investment banking as well as commercial banking. Arguably, the U.S. investment banks that failed were holdovers from Glass Steagall (despite the fact that the U.S. legal regime changed in 1999).[3] They did not have this retail base of capital. Indeed, there are no more stand-alone investment banks in the U.S., as even Goldman Sachs and Morgan Stanley were forced to become bank holding companies in order to survive the turmoil in the capital markets that Lehman's bankruptcy set in motion. As Gerald McCaughey, CEO of the Canadian Imperial Bank of Commerce has stated, "market conditions worldwide for banks remain difficult. Yet arguably one of the better places to be right now is in Canada. At CIBC, the majority of our revenue is derived from retail markets, where we enjoy strong market positions in a broad range of products and services."[4] Thus, there is in the structure of the banking regime a partial explanation for the relative stability of the big five Canadian banks.

IN ADDITION, we need to consider that Canada's banking system has proven to be well-regulated by the Office of the Superintendent of Financial Institutions (OSFI). Unlike the U.S. where regulatory jurisdiction is fragmented, OSFI has jurisdiction over a broad list of financial institutions including banks, trust and loan companies, insurance companies and other financial institutions. OSFI's broad mandate is "to ensure that financial institutions are regulated…so as to contribute to public confidence in the Canadian financial system."[5] While OSFI's approach is to supervise financial institutions to ensure that they are in sound financial condition,[6] it leaves the management of the financial institution to individual boards of directors and management of the institution itself. Thus, in understanding why Canadian banks have been relatively successful, it is also important to examine approaches to systemic risk at the bank level.[7]

Throughout the credit crisis, Canadian banks have remained well capitalized, being not only Basel II compliant but also by maintaining high Tier 1 ratios relative to banks in other countries. For example, at the end of the third quarter in 2008, these ratios ranged from 9.47 per cent to 9.81 per cent compared to other global banks that were in the 6, 7 and 8 percentage range.[8] Thus, it is unsurprising that Julie Dixon, Superintendent of OSFI has stated that, "[t]he first lesson is capital, capital, capital. We have seen how strong capital cushions have paid off to the benefit of our institutions and overall financial system."[9] In addition to relatively high capital levels, the quality of the Tier 1 capital is also said to be high in Canada with banks common equity representing a greater portion of their regulatory capital relative to banks in other jurisdictions, which have a greater reliance on preferred shares and other hybrid forms of capital such as trust-preferred securities. Thus, both the level and quality of capital have placed Canadian financial institutions on a strong footing vis à vis their counterparts in other countries.[10]

While it is clear that levels of capital are relevant, one may question why the quality of capital matters. Where capital injections are in the form of preferred shares, these shares often have a redemption feature (such as step-ups or other incentives to redeem) that undermines the capital's overall permanence. In OSFI's view, "…permanence is a critical element for OSFI to consider something as Tier 1 capital."[11] The Canadian government has not made capital injections of this sort into the banking system. Rather, the level of its intervention has been relatively limited, e.g. purchasing $125 billion of insured mortgages (thereby increasing banks' capacity to make new loans) and increasing the borrowing limit of the Canada Deposit Insurance Corp.[12]

The point about permanence is a broader one that speaks to the importance of the quality of the banks' assets. Hindsight now tells us that there were loans that should not have been made: loans with no covenants, leverage ratios that were sky-high, and sub-prime loans that could barely cover the asset values at their peak. The fact that a bank's Tier 1 ratio is at 10 per cent is not centrally relevant when we consider that this means that for every $100 of capital, the bank's assets sit at $1,000 and third-party debt at $900. A decline in the value of the assets by 10 per cent means that the bank's capital base is eradicated. When global stock markets declined by 35 per cent in 2008, the problem was clear to see. Capital adequacy is significant but it only takes us so far in understanding the issue. The quality of capital is crucially important.

In addition to strong regulation, Canadian banks have survived because a more conservative culture pervades all aspects of banking business, from lending to trading.

To understand further the stability of Canadian banks, we also need to examine risk management. Though difficult to document, there appears also to be a more conservative understanding of, and protection against, systemic risk within Canadian banks. The approach to the housing sector is instructive as Canadian banks (and brokers) have exhibited more restrictive mortgage lending practices than their U.S. counterparts. They did not rely on third-party brokers/originators to the same extent or succumb to ninja and liar loans with the result that the likelihood of defaults on their mortgage portfolios remained, and continue to remain, relatively low. As a general rule, Canadian banks did not vary the standard mortgage model (e.g. no loans with 50-year amortization periods or negative amortization). While U.S. banks sold a large portion of their mortgages, Canadian banks did not. In fact, Canadian banks tended to keep the mortgages on their balance sheets and therefore were more diligent in their credit assessment of their borrowers. Even now with federal aid available, Canadian banks are choosing to refrain from selling mortgages to the government under the $125-billion plan if they do not need to.[13]

WITHOUT QUESTION, Canadian financial institutions have been well-regulated. However, in addition to strong regulation, Canadian banks have survived because a more conservative culture pervades all aspects of banking business, from lending to trading. With other countries turning to examine the Canadian financial system in redesigning their regulatory regime, it is important to remember that prudence and conservatism are not necessarily creatures of law. Rather, they are cultural phenomena particular to this country and this economy. Law can only do so much. ■

---

[1] This is The Emergency Economic Stabilization Act of 2008 enacted October 3, 2008 (H.R. 1424; Public Law No. 110-343).
[2] Tara Perkins and Boyd Erman, *The Globe and Mail,* 7 March, 2009 "Why Canadian Banks Work" B1, B5.
[3] *Ibid.*
[4] The 1999 Gramm-Leach-Bliley Act removes many of the restrictions in place under Glass Steagall including previous prohibitions on banks from offering investment, commercial banking, and insurance services.
[5] Gerald McCaughey, cite in Perkins and Erman, supra note 2 at B5.
[6] *Office of the Superintendent of Financial Institutions Act,* R.S., c. 18 (3rd Supp), Part 1.
[7] *Ibid.,* section 106(2).
[8] *Ibid.,* section 106(4) which states, "Notwithstanding that the regulation and supervision of financial institutions by the Office and the Superintendent can reduce the risk that financial institutions will fail, regulation and supervision must be carried out having regard to the fact that boards of directors are responsible for the management of financial institutions, financial institutions carry on business in a competitive environment that necessitates the management of risk and financial institutions can experience financial difficulties that can lead to their failure."
[9] Julie Dixon, "Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Langdon Hall Life Insurance Forum" (Cambridge, Ontario November 12, 2008) at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/Julie_Dickson_Langdon_speech_2008_e.pdf.
[10] *Ibid.*
[11] Note that OSFI recently stated in a press release that "OSFI has not pushed for higher capital ratios across the board…OSFI agrees that capital is a cushion that should be available to be drawn down when faced with unexpected losses." See News Release, December 19, 2008 at www.osfi-bsif.gc.ca/app/DocRepository/1/eng/media/cap_lvl_e.pdf.
[12] Julie Dixon, supra note 8.
[13] See Kevin Carmichael, "New Moves to ease strain of credit crisis" The Globe and Mail (28 November 2008) B1; Perkins and Erman, *supra* note 5; Tara Perkins, "Banks begin to decline federal aid in first sign of recovery" The Globe and Mail (17 March 2009).
[14] Perkins, *ibid.*