



PROFIT FROM PRUDENCE

How Canadian Banks Avoided
the Recent Financial Crisis

By Gregory DL Morris

WHILE BANKS IN THE US and Europe faced existential risks in the financial crisis of 2007–2008, and many are still shaky, there was a reassuring quiet north of the 49th parallel. Like the dog that did not bark in the night in the Sherlock Holmes *Adventure of Silver Blaze*, the Canadian banking system was notable for what did not happen. There were no failures, no seizures for lack of liquidity and no collapse of the mortgage market. There was one brief crisis relating to asset-backed commercial paper, but the federal Office of the Superintendent of Financial Institutions (OSFI) acted quickly, and the problem was resolved in short order.

For two countries that are so intimately interconnected in finance, trade and language, the difference in regulation and risk management could not be more stark. And it is important to stress that the difference is not merely a function of Canada having about a tenth of the population of the US, or a largely resource-based economy. Often the distinctions between the US and Canada have been attributed to the disparate basic principles of the two countries. The US was founded on the ideals of life, liberty and the pursuit of happiness, while Canada was founded on the ideals of peace, order and good government.

Within the patriotic flourishes lie the kernels of truth. In the banking crisis, the biggest difference is most often attributed to the regulatory structure, both in its simplicity and in regulators' willingness to act swiftly. Don Drummond, former chief economist for TD Bank, and also former financial regulator, said he agrees the laws governing the financial system in Canada and the interaction between banks and regulators were factors. But he ascribes the true difference to prudence and sound risk management by the senior executives at the big national banks.

"Most people grab the government line that regulations and regulators were the difference," said Drummond, who is now a professor of economics at Queen's University in Kingston, Ontario. "Certainly the regulators did play a role, but the banks never ran to their regulatory capital or leverage limits. They were risk averse. They were profitable because they were prudent."

More than all the exposés of misdeeds by US bankers or lax oversight by US regulators, Drummond's assertion calls into question the very driving force behind the risks taken by US bankers: higher returns for higher risks. The 300-page report issued on March 14 by the US Congressional subcommittee investigating the \$6.25 billion in trading losses by JPMorgan Chase, the so-called "London Whale" scandal, found that all the mischief was done in the name of big profits.

It is a classic manifestation of the tortoise and the hare; US banks were swinging for the fences and struck out, while the Canadian banks just kept hitting for percentage.

"If you look at the Basel recommendations for Tier 1 banks' capital ratios, it is 6%," says Drummond. "US and European banks all resisted that level, and in recent history have run ratios of 4–5%. Canadian banks are restricted to 7%, and yet none of them ever ran less than 10%. Same with leverage: Lehman was running 40:1. Canadian banks are limited to 22:1 and none ever ran worse than 18:1."

Drummond dismisses the disparagement that Canadian banks can afford to be more conservative because there is less competition. "Yes, there is an oligopoly of five big banks, but the risk aversion does not mean they have not been able to make incredible rates of return. The history of Canadian banks has been high and steady risk-adjusted profits. Typically they have made 20–27% return on equity without taking huge risks."

One of the major demons often cited for the meltdown in the US financial sector was the repeal of the Glass-Steagall Act of 1933, which separated investment banking from retail banking. That rule held for seven decades, but in 1999 Sanford Weill, chairman and CEO of Citigroup, led the charge to support the Financial Services Modernization Act, known as Gramm-Leach-Bliley, that broke the glass.

Citi alumni have since come to rue their championing of that cause. In April 2012, Citi Chairman Richard Parsons said in his valedictory address to shareholders at the annual meeting, "The 2007–2008 crash was the result of the throwing off of Glass-Steagall." And Sandy Weill himself said in an interview on CNBC in July 2012 that

the major financial empires like the one he built should be dismantled.

Those policy debates are still raging, and too-big-to-fail remains a flashpoint, but Drummond notes that the big national Canadian banks have been involved in both wholesale and retail banking for decades, and it was no liability during the financial crisis. "All the big stand-alone brokerages in Canada were bought up by the banks in the late 1980s. As stand-alone operations, wholesale banking tends to make money nine out of 10 years, and then lose much of it all in that 10th year."

Having the two operations together under the same corporate roof is not inherently bad, Drummond argues. Indeed, the two can act as counterbalances. "Having the profitability of the wholesale banking is great in the good years, and having the safety and security of retail deposits and lending is great in the bad years. When the big Canadian banks started to acquire the wholesale banks, we originally set the target ratio at 60% retail to 40% wholesale. After a while we pushed that to 80:20."

This is not to say there was never any trouble. Indeed there was a test of retail and investment banking cohabitating. "CIBC got into some serious trouble," Drummond said, "and the wholesale banking group would have gone broke if it had been out on its own. It would have been another Lehman Brothers except for the strength of the deposit base."

Canada as a whole economy also went through its cycles. Peak to trough, Drummond said, the Canadian gross domestic product numbers were similar to those in the US. He said that with so many close correlations, the major factor that stands out is that his country did not have a housing crisis.

"Canada is the only major country worldwide that did not have a collapse in the real estate sector," said Drummond. "From 2006 through 2008 you saw housing values in the US drop by a third. While there were some local markets in Canada that had some dislocations, overall Canadian housing prices continued to go up. There was also no big drop in employment."

According to Drummond, one major reason there was no housing collapse is another stark tortoise-and-hare contrast

to the US. “Canadian banks kept most of their mortgages on their balance sheets. In 2007, just before the collapse, about 67% of US mortgages were securitized as compared to about 27% in Canada. Securitization is a stupid practice. When banks have those loans on their books, they have skin in the game. That adds to the security and safety of the system. Securitization was designed to spread risk, which is fine in theory. But I don’t think they ever thought of systemic risk.”

Drummond is not just speaking from the safe remove of academia. As recently as November 2012, Mark Zelmer, OSFI assistant superintendent, voiced many of the same ideas in his address to the Canadian Financial Services Insolvency Protection Forum in Toronto. In particular, Zelmer dismissed the idea that only simple banking rules are wise. He also emphasized the principle of sound risk management and prudence beyond what regulations dictate.

“Nobody argues with the objective of [international financial regulation such as] Basel III. But some observers claim we should scrap what they see as an unduly complex, opaque set of capital rules and replace them with simpler rules like the classic capital-asset leverage test. This would see regulatory capital requirements set as a function of the size of bank balance sheets or total assets—not as a function of bank risk-weighted exposures, be they on or off-balance sheet. I appreciate their concerns.”

Zelmer also said that although risk models used by banks are very complex, they remain a crude simplification of reality. “The information needed to run those models is expensive to acquire. And, setting risk factors using past data can be akin to driving using only the rear-view mirror; especially if one is relying on short data samples,” he said. “Clearly there is a risk that bankers and their regulators may become overly attached to complex risk models. If they are not careful, they could lose sight of the bigger picture needed to conduct proper risk management. Turning back the clock and scrapping all those fancy risk models in favor of simpler tests is not an option from OSFI’s perspective. Basel capital rules are complex because internationally active banks are complex.

They supply very sophisticated risk intermediation services to meet the needs of their clients in the economy and other parts of the financial system. And, they tend to look for ways to minimize capital requirements.”

Zelmer then turned his attention to the separation of retail and investment banking. “The financial crisis has also sparked debate on whether there should be some separation between commercial and investment banking activities. This idea has its roots in a previous financial crisis, the Great Depression of the 1930s. That crisis led to the introduction of the Banking Act of 1933, commonly known as the Glass-Steagall Act, in the United States,” he said. “The goal was to protect the core commercial banking system from distress elsewhere in the financial system in the wake of the 1929 stock market crash. Recent proposals in the wake of the latest financial crisis are not so draconian.”

Zelmer added that the Dodd-Frank legislation will restrict US banks from engaging in proprietary trading through the “Volcker Rule.” In Europe, the Vickers Commission in the UK and the Liikanen Panel in the EU have been proposed to limit the funding of investment banking activities by deposits backed by government safety nets. Proponents of these proposals claim that some separation between commercial and investment banking activities generates two types of financial stability benefits.

“First, it is thought to protect the core commercial banking system from losses in riskier investment banking activities. And, second, it may result in a better allocation of resources from a societal perspective by limiting the cross-subsidization of investment banking activities by commercial banking,” Zelmer said.

Just two months before Zelmer delivered his address, Malcolm Knight, Canadian economist, banker and policymaker, published a comprehensive comparison of the US and Canadian banking systems in *The American Review of Canadian Studies* (Vol. 42, No. 3), a publication of the Association for Canadian Studies in the United States. In it, Knight traces the many strengths, as well as a few of the weaknesses, in the Canadian banking system back to the same Depression that

gave the US Glass-Steagall and numerous other financial reforms, including federal deposit insurance.

With a note of irony Knight wrote, “Suspicion of the ‘money trust’ led US authorities to try to control consolidation in banking early on; in Canada bank consolidation was well underway by the turn of the 20th century.” He added with emphasis that “not a single Canadian chartered bank or major insurance company failed” during the Depression.

Narrowing the focus he explained that, “In the US, excessive risk-taking by banks was widely seen as a trigger of the Great Depression. The key to mitigating banking risks is to address the dilemma that bank depositors want to be able to withdraw their funds on demand, whereas banks earn profits by lending for much longer periods with significant risk that the loans will not be fully repaid.”

Knight details the growth of both US and Canadian banking and regulation, laying out how “by the eve of the financial crisis in mid-2007, succession revisions of the Bank Act had established a Canadian banking system that was *well-capitalized, not excessively interconnected or complex, closely supervised, generally conservatively managed and grounded on a stable nationwide funding base.*” [Emphasis his.]

It has been argued in various forums and by many different advocates that risk taking is as American as apple pie. In the early 1970s, Canadian radio host Peter Gzowski held a contest to establish the analogous “as Canadian as...” The winning entry came from Heather Scott, a 17-year-old music student from British Columbia. It showed a wry sense of humor and perspicacity beyond her years. As debates rage today in Washington, DC seeking a new model for sound but profitable banking, the advocates might do well to heed Miss Scott’s insight: “as Canadian as possible, under the circumstances.” \$

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