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Worthwhile Canadian Initiatives: On Banking and 'Getting Government Right'

A Policy Update Paper

By

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NOTE

This paper is based on notes used for a presentation to a visiting congressional delegation organized by the Franklin Institute, Ottawa, August 13, 2009.

Years ago *The New Republic* had a competition for the most boring headline. The winner? "Worthwhile Canadian initiative".

Boring occasionally has its uses. Today, alone in the industrialized world, can you name the country that has not faced a single bank failure, calls for bailouts or government intervention in the financial or mortgage sectors? Canada.

In 2008, the World Economic Forum ranked Canada's banking system the healthiest in the world. America's ranked 40th, Britain's 44th. Boring, anyone? Today at the G-20 and G-8, Canada is pushing for new rules for financial institutions that would reflect the Canadian approach.

On Banking

Canada has developed a strong system, but the economic crisis has demonstrated that policy-makers need to innovate and continuously improve to make our financial system resilient and efficient. An improved regime, says Bank of Canada Governor Mark Carney, needs to be dynamic (with buffers and provisions moving through the cycle) simple (featuring Canadian-style leverage caps), and coherent. In essence, plan for the worst by building a system that can absorb blows rather than amplify them.

Internationally we are leading the charge for a system that can withstand failure based on four principles. As Carney describes it: first, robust system markets that are independent of core counterparties; second, staged intervention regimes; third, capital requirements consistent with business risk; and fourth, deeper international cooperation.

A worthwhile Canadian initiative? We think so.

The Economist, the *Financial Times*, even the *Wall Street Journal* has praised the Canadian model. Former Federal Bank Reserve chair Paul Volcker has said that what he's arguing for "looks more like the Canadian system than the American system."

Can the Canadian system be improved? Of course. Parochialism amongst some provinces, for example, has prevented the overdue development of a national securities regulator. But Canadians can take pride in their system, even though the sin of pride is one to which we Canadians are particularly susceptible.

Dean Acheson, a prominent American statesmen, once described Canadian sanctimony, as the "stern voice of the daughter of God". Acheson knew of which he spoke. His Canadian father was an Anglican priest. Canadian sanctimony, I think, has something to do with geographic propinquity and the inferiority complex of living next to America but like it or not, the standard of success in Canada is making it in the United States.

In a *Newsweek* column Fareed Zakaria described the Canadian system as rooted in 'common sense'[1] and a blend of principle and pragmatism. As the United States and Europe loosened regulations on their financial industries, the Canadians, ever prudential (after all, it was the Scots who built Canada and created our banks), held back.

The vision behind Canada's banking system, made up of a few large, national banks with branches from coast to coast, taking deposits from a wide range of customers, actually had its

[1] Fareed Zakaria, "Worthwhile Canadian Initiative," *Newsweek*, February 16, 2009.

beginnings in the United States. Canada’s system was partly inspired by Alexander Hamilton, the first American Secretary of the Treasury who envisioned the First Bank of the United States, chartered in 1791, as a central bank modelled on the Bank of England.

The five major chartered banks, the few regional banks and handful of large insurance companies are all regulated by the federal government. Canadian banks are relatively constrained in the amounts they can lend. Canadian banks are required to have a bigger cushion to absorb losses than American banks. Canadian banks self-originated most of their mortgages in their real estate sections, thus ensuring higher underwriting standards, and they were more likely to retain the mortgages on their books rather than collateralize them. Both helped prevent "dumb mortgages" being written.

In addition, Canadian government regulations protect the domestic banks by limiting foreign competition. They also keep banks broadly owned by public shareholders. This latter factor – a wide deposit base secured by a regulatory insurance authority was critical to preserving public confidence. With this in place, observes McGill economist William Johnson, you don't need new rules on capital adequacy or balance-sheet liquidity.[2]

Canadian banks are typically leveraged at 18 to 1 compared to U.S. banks at 26 to 1 and European banks at 61 to 1. Technically, all the major banks were Basel II (new risk-based capital standards) compliant in Canada in late 2007. Again, this reflects Canada's more risk-averse business culture – not always a good thing, but it is also a product of old-fashioned rules on banking, and a reaction to those days when we let debt get out of hand.

There are problems and limitations to the Canadian approach. Our Big Five enjoy a virtual retail oligopoly. In most things, the ratio between Canadian and American scale is one to ten, just as in population. The U.S. has over 8,000 financial institutions – by U.S. standards we are ‘under-banked’.

Having fewer financial institutions probably affects our entrepreneurial ethic, which is strong, but not as strong as that of the U.S. It also affects the density of our business culture – not as vibrant as it could be – and inevitably, our wealth (our per capita income is only 83% of our closest neighbour).[3]

But there are times when these limitations can be strengths and these are some of those times. Again, it bears repeating – there was no government bailout of Canadian banks. Meanwhile, over eighty U.S. banks have failed so far in 2009 – more than failed in the previous 16 years combined. As the *Financial Times* pointed out before the London G-20 Summit last April, of the seven institutions in the world that still retained a triple-A Moody's credit rating, two were Canadian banks. And as their competitors have tumbled, so they have ascended the global rankings: the five Canadian banks now rank in the world top 75.

[2] William Watson “Why our Banks did Better,” *Ottawa Citizen*, August 19, 2009.

[3] In dollar terms, the Canada–U.S. income gap doubled between 2004 and 2008, to $6,400. Why? The biggest component of the income gap between Canada and the United States is labour productivity and fewer hours worked. However, Canada has a higher ratio of employment to its labour force, higher labour force participation rate, and higher proportion of working age people. Conference Board of Canada, “How Canada Performs” (July 2009) at: http://www.conferenceboard.ca/hcp/details/economy/income-per-capita.aspx#Lower_usa.

Canadian banks were never able to securitize their mortgage market the way the U.S. did, and Canadian banks were not allowed by their regulators to invest in huge quantities of those securitized products, as British banks did. Nor were Canadian banks heavily invested in the U.S. mortgages. RBC, for example, disappointed by the returns of its U.S. investment, had sold off its U.S. mortgage assets well before the crisis.

As a result, Canadian banks knew and, more importantly, could quantify, their risk and where it was coming from, when the mortgage market collapsed. For the U.S., it was a shot in the dark, or, a series of volleys. Bear in mind, the Canadian approach is no more controversial than insisting that firms publish proper accounting statements; hence, a strong governmental hand on the tiller doesn't necessarily create onerous compliance costs or constrain business models. This acknowledges, of course, that the Canadian banking system is arguably a constrained business model.

This approach to 'risk' can also be attributed to the broad based business model of major Canadian banks. All of them are 'money centre' banks in the US parlance – a strong retail presence with an investment banking arm – so their risk isn't all clustered in one area. The U.S. money centre banks were hurt by the crisis, but none of them were mortally wounded pre-TARP.[4]

A slightly unpopular point may be the power of lobbyists in DC to forestall invigilation of the rules. In thinking of Fannie Mae and Freddie Mac, one can only attribute their lack of restraint to a combination of the non-enforcement of existing rules abetted by political pressure and lobbying. Mark Carney has made the following observations about the Canadian financial structure: first, we have independent, clearly mandated agencies; second, the opportunities for regulatory arbitrage are constrained by law; third, we have good inter-agency communications – easier in a country with a population less than California and an economy slighter bigger than Texas; and fourth, there are structured settings for discussion and information sharing.

Getting Government Right: Lessons Learned

Helping us to weather the storm were a series of reforms, implemented in the '90s and stuck to consistently, to government spending habits, including the big ticket items of health care and the pension system.

These came after a decade of government overspending during the '80s when we had 'gotten government wrong'. The governments' debt to GDP ratio reached nearly 100% when in 1993, the *Wall Street Journal* pronounced Canada "an honorary member of the third world". And so we set about 'getting government right', starting by assessing programs on six principals:

1. Is it in the public interest?
2. Is it a legitimate role for government?
3. Is it federal or provincial?
4. Is it public or private?
5. Is it affordable?
6. How can we make it more efficient?

The overall economic approach was based on fiscal and monetary responsibility, open trade and economic growth. It also meant getting our social security system, unemployment insurance and the pension plan, into sound long-term health. Open trade made possible economic growth

[4] The U.S. government established the Troubled Asset Relief Program (TARP) in 2008 in response to the sub-prime mortgage crisis.

and prosperity. Fiscal responsibility meant cutting back the size of government and we cut a quarter of the workforce. It caused a lot of pain. In the nineties, Canadian employment lagged far behind the United States. Our taxes were higher. Many of the most ambitious moved south.

But the results of this effort have been worthwhile. Government spending from 1992 to 2008 declined from 53% to 40% of the gross domestic product. Canada's federal debt was halved, falling from 70% in 1995 to 32% in 2008 with commensurate reduction by provincial governments. We made significant progress in stabilizing the long-term funding for health care and pensions in the following ways.

First, with significant and ongoing reform, our health-care system is significantly less expensive than that of the United States: it accounts for about 12% of GDP, versus 17% in America. Notwithstanding what you see on tv and the commentary of Shona Holmes – this season's Howard and Louise – the Canadian health system, with all its warts, works; however, as President Obama observed during the August Trilateral Summit in Guadalajara, the Canadian model works for Canada but it would not work for the United States, in part because we've evolved differently. The U.S. has an employer-based system and a private-based health care system that stands side-by-side with Medicare and Medicaid and the Veterans Administration health care system.

Second, we restructured the national pension system, putting it on a firm fiscal footing. American car companies have moved so many jobs to Canada to take advantage of lower health-care costs that since 2004, Ontario, not Michigan, has been North America's largest car-producing region. Private pensions are another matter as we've learned in the GM bailout.

Third, our housing prices have not fluctuated as wildly as those in the United States. Home prices are down 25% in the United States, but only half as much in Canada. Of course, the values never got as high. Our housing prices have been more stable partly because the interest on Canadian mortgages is not deductible. The American dream of home ownership comes with a price: interest deductibility costs the US Treasury $100 billion a year. Home loans in the United States are "non-recourse," which basically means that if you go belly up on a bad mortgage, it's mostly the bank's problem, or at least it used to be. In Canada, it's your problem. We also oblige banks to have insurance if the loan to value is greater than 80%. Underwriting standards are also higher. So what is the rate of home ownership in Canada and the United States? Sixty-eight percent of Americans own their own homes. The rate of Canadian homeownership is 68.4%.

The biggest change and most positive consequence of 'getting government right' was the attitudinal evolution across party lines. Balanced budgets became the norm at both the federal and provincial levels. Until this year we had 12 years of budget surpluses which began under our Liberal Government and now allow our Conservative Government to spend money to fuel our stimulus to recovery.

Finally, a lesson that applies to all: Government does not need to lead on or micro-manage everything. Industry and labor also have a responsibility for involvement. The real challenge in the current situation will be for government(s) to resist the temptation to either over-regulate or leave the situation in limbo too long. Knowledge of the rules and clarity in regulations, monitoring and enforcement are essential for restoring business confidence necessary for a return to growth and prosperity.

Sustaining Prosperity
Revenge, goes the Italian proverb, is best served cold. Twenty-two years later, *The New Republic*, which came up with the ‘most boring’ of headlines, was rescued from its economic troubles by a Canadian media company. But lest we suffer from hubris, Canwest, like so many other media companies that are struggling to find a successful business model, is now seeking restructuring to avoid bankruptcy. The angel investor is based in the U.S.

It underlines, yet again, the continuing economic integration and interdependence of Canada and the United States. We don’t so much trade things anymore as make them together and most of what is called trade between the two countries is actually inter-corporate transfers. The Conference Board reckons that as much as 40% of bilateral trade is intra-firm, i.e., involving different parts and services from within the same company.

As Conference Board Chief Economist Glen Hodgson observes, most of our companies now operate continentally, including energy and resource development, as well as manufacturing and retailing. A third of Canadian unions are affiliates of American ‘internationals’, including the United Steel Workers that is leading the ‘Buy America’ campaign. The livelihood of working men and women depends on an economy that has become increasingly integrated.

We manage our economic affairs independently but not separately because interdependence is a fact of mutually reinforcing prosperity. The past half century of economic integration is proof that we can achieve economic integration and successfully preserve and strengthen our political independence. Protectionists, on both sides of the border, should take note before they beat the ‘begger thy neighbour’ drum.

Canadian Defence & Foreign Affairs Institute

CDFAI is the only think tank focused on Canada's international engagement in all its forms: diplomacy, the military, aid and trade security. Established in 2001, CDFAI's vision is for Canada to have a respected, influential voice in the international arena based on a comprehensive foreign policy, which expresses our national interests, political and social values, military capabilities, economic strength and willingness to be engaged with action that is timely and credible.

CDFAI was created to address the ongoing discrepancy between what Canadians need to know about Canadian international activities and what they do know. Historically, Canadians tend to think of foreign policy – if they think of it at all – as a matter of trade and markets. They are unaware of the importance of Canada engaging diplomatically, militarily, and with international aid in the ongoing struggle to maintain a world that is friendly to the free flow of goods, services, people and ideas across borders and the spread of human rights. They are largely unaware of the connection between a prosperous and free Canada and a world of globalization and liberal internationalism.

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