

Crisis-proofing financial integration: Canada

Abstract

The 2008 global financial crisis crippled or brought down financial institutions across the developed world and forced bailouts of banks as well as countries. But Canada's banking sector survived the 2008-09 crisis without a taxpayer-financed bailout, and its banks remained stable and well-capitalized. What did Canada do right? First, heading into the crisis, the structure of bank funding was more favorable, as banks relied much more on depository funding than wholesale funding. Second, the country has one of the most restrictive capital adequacy regulatory standards in the world in risk-weighting, allowable capital deductions, and definitions of permissible regulatory capital. Third, the structure of the Canadian banking system has traditionally made the sector more stable. Heavy regulation and tight restrictions on entry led to a highly concentrated banking system dominated by five large competitors. While this system made the sector less competitive, it also made the sector easier to regulate, limiting the size of the shadow banking sector. Supervisors always face a trade-off between competitiveness and stability—the "regulator's dilemma". The economy's performance before the crisis – annual GDP growth rates between 2 and 4 percent during 1999-2008 – and the banking sector during the crisis suggest that Canada has struck the right balance.

The 2008 global financial crisis felled many financial institutions, tarnished the reputations of others, and forced bailouts of banks and countries. But Canada's banking sector survived the crisis without a taxpayer-financed bailout, and its banks remained stable and well-capitalized. This note will provide a few insights on how Canada managed to shelter its financial system from the global meltdown.

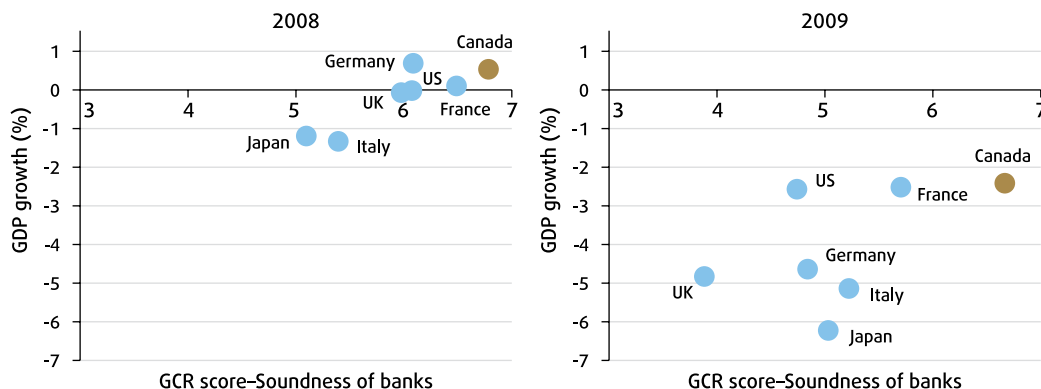
Escaping the global turmoil

Unlike many industrialized countries, the Canadian financial system weathered the recent global financial crisis well. Many who perceived the Canadian system as too risk averse in the boom years praised it after 2008 for its prudent lending practices. The country topped the World Economic Forum's ratings for banking sector soundness for three consecutive years between 2008 and 2011 (figure 12). Canada also came first in Moody's Banking Sector Outlook in 2008. Jim Flaherty, the Canadian minister of finance, was voted the Finance Minister of the Year in 2009 by Euromoney Magazine. These results are particularly impressive given Canada's economic and financial integration with the United States. Duttagupta and Barrera (2010) suggest that US real GDP growth explains almost half of the variability in Canadian growth over the long run.

Although prudent, Canadian banks were affected by the crisis. So was the economy.¹ The crisis put pressure on the banking market in terms of liquidity, funding of financial institutions, and capital adequacy. Yet despite global meltdown, Canadian banks remained profitable and were able to raise equity capital (figure 13). More interestingly, Ratnovski and Huang (2009) show that, although precrisis capitalization and liquidity ratios of Canadian banks were higher than the sample average, capitalization itself was not enough to protect banks from the crisis.² Some US banks with higher capital ratios than their Canadian counterparts and/or relatively average liquidity levels defaulted during the financial turmoil. So why did Canadian banks do so much better? And is there a price for more prudent banking sector regulation?

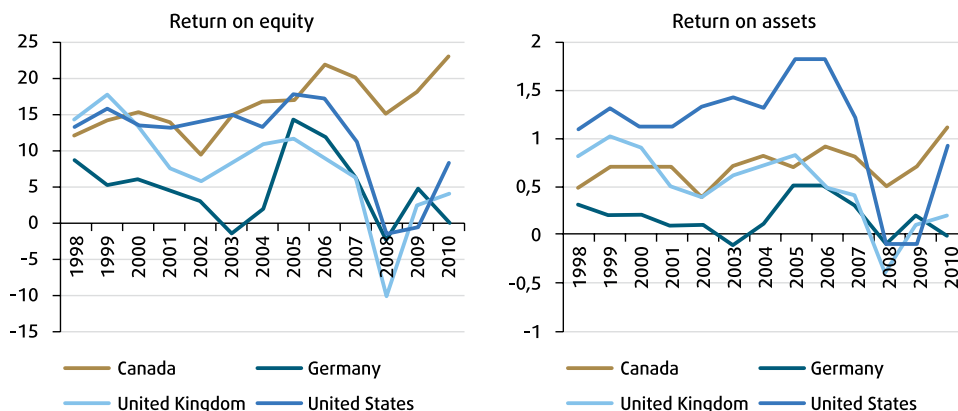


Figure 12: GDP growth (%) and soundness of banking systems according to GCR (scale 1-7, 1=need bailout, 7=sound) in G7 countries, 2008-09³



Source: World Economic Forum Global Competitiveness Report (GCR), IMF WEO.

Figure 13: Return on assets and return on equity of the banking sectors in Canada, Germany, the UK, and the US, 1998-2010



Source: IMF FSI.

Making the rules

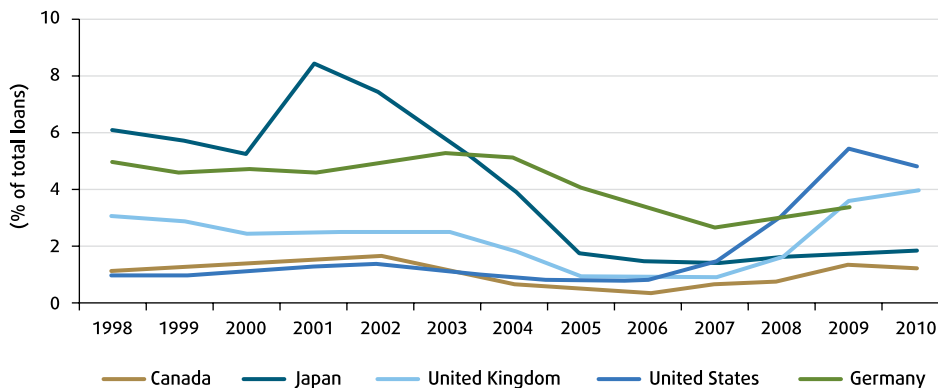
First, the structure of funding was more favorable, because Canadian banks relied much more on depository funding than wholesale funding. According to Huang and Ratnovski (2009), banks whose funding relies more on deposits were more resilient during the crisis than those with a higher ratio of wholesale funding. Capitalization and liquidity ratios, though not the highest in the OECD region, probably strengthened the position of Canadian banks. More importantly, Canada’s exposure to US mortgage assets was limited (when compared with other OECD countries) and domestic mortgage lending was much more cautious than in the United States.⁴

Second, the regulatory framework restricts the risks undertaken by the banking sector. The country has traditionally had stricter capital adequacy regulatory requirements than other developed economies, even prior to the Basel Accord. One study found that Canada had the tightest regulatory capital standards in the years before the financial crisis (Quillin 2008).

Innovative financial instruments can amount to only 15 percent of capital, while 75 percent must be invested in common equity.⁵ The regulatory framework also restricts the maximum multiple of assets to capital at 20 (though exemptions up to 23 may be granted).⁶ Such regulations limited the exposure of Canadian banks to assets that turned toxic: according to Lynch (2010), the asset-to-capital multiple of major Canadian banks amounted on average to 18 in 2008, whereas it stood above 25 for many US banks and even above 30 for some European banks. Finally, regulations imposed higher capital requirements beyond the Basel Accords requirements, with the tier 1 capital requirement amounting to 7 percent of risk-weighted assets (as compared with 4 percent in Basel II) and a total capital requirement amounting to 10 percent of risk-weighted assets (as compared with 8 percent in Basel II).⁷

Third, the structure of the Canadian banking system has traditionally contributed to stability of the sector (figure 14). Heavy regulation and tight restrictions on entry and have led to a highly concentrated banking system dominated by five large competitors. While it made the sector less competitive, it has made the sector easier to regulate, limiting the size of the shadow banking sector. Bordo et al. (2011) point out that between 1900 and 1980 Canadian system was not only more stable than the US one, but also brought higher returns on equity.

Figure 14: Bank nonperforming loans (as % of total loans) in Canada, Japan, the UK, and the US, 1998–2010⁸



Source: IMF FSI.

Risk versus stability

Canadian financial system provides a few insights on how to create a sound banking system: well-capitalized banks with limited leverage; system transparency; links among risk, performance, and reward; and prudent culture. In the end, however, Canadian banks did well during the crisis because they did not engage in complicated financial trades to the extent that their US counterparts did. Thus, even with similar ratios of bank regulatory capital-to-risk-weighted assets, Canadian banks were able to withstand the turmoil without bailouts.

Supervisors always face a trade-off between competitiveness and stability in the banking sector, the “regulator’s dilemma” (Singer 2007). Regulators must balance the desire of banks and investors to provide for a light touch regulation that encourages competitiveness and rewards risk taking while also ensuring stability and soundness. The economy’s performance before the crisis – annual GDP growth rates between 2 and 4 percent during 1999–2008 – and the banking sector during the crisis suggest that Canada has struck the right balance.



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Notes

- 1 Financial distress and plunging global demand pushed GDP down by 2.5 percent in 2009, but growth recovered in 2010, reaching 3 percent (IMF WEO).
- 2 Authors include 72 banks from OECD countries.
- 3 Indicator measures soundness score according to Global Competitiveness Reports by the World Economic Forum.
- 4 However, the government is involved in the mortgage financing.
- 5 Due to the recent crisis, the share of innovative instruments in capital was temporarily extended to 40 percent.
- 6 $(\text{Total assets})/(\text{tier1} + \text{tier2})$.
- 7 These requirements are now strengthened in Basel III, which sets minimum tier 1 capital at 6 percent.
- 8 Nonperforming loans defined in line with the IMF methodology. Data for Germany ends in 2009.