Introductory Remarks for the Woodrow Wilson Center (Canada Institute) and Brookings Institution event:

Stable Banks, Stable Finance – The Canadian Experience

June 23, 2009

Thank you, Jodi.

And thanks to Lee Hamilton and the Wilson Center, David Biette and the Canada Institute, and D.J. Nordquist and her colleagues at Brookings, for holding this important seminar on the Canadian experience with banking, finance and regulation.

As we begin to see an end to what many have described as the worst financial crisis since the Great Depression, attention is now being turned to how to avoid such crises going forward.

As we are all aware, President Obama last week unveiled comprehensive reform proposals aimed at overhauling financial market regulation and, more generally speaking, strengthening the 'rules of the game' underpinning America's dynamic market economy.

While these reform proposals are considered by various parties, the current juncture provides an opportunity to examine the experience of other countries – countries whose financial systems have remained relatively intact over the past two years.

Canada stands out in this regard.

But before getting into the broad aspects of the Canadian experience – which others will cover in more detail shortly – I think it is crucial both to be humble about what we

Canadians have to teach the world about finance and to put this issue into its broader historical context.

Modern finance stretches back for many years.

And the U.S. – and Wall Street in particular – has taken finance and modern capital markets to new heights and degrees of sophistication during the 20th century.

Some of these financial heights have been followed by deep lows. These are times when we should reflect on lessons learned.

In this instance, Canada offers a model that is worth careful consideration.

Interest in the Canadian model has never been as great as it now. A number of reports and articles have been written.

I have been asked on numerous occasions – and not just here in Washington – "What is it that you are doing right up north? Why hasn't the Canadian financial system suffered the same fate as the U.S. and European systems?"

Because of the unusual amount of attention being paid to the Canadian experience, and because of my background in finance, I have given some thought to these issues.

Generally speaking, I would highlight four aspects of the Canadian economic model that I think are relevant here:

- the overall macroeconomic environment;
- the idiosyncrasies of the Canada's financial system;
- the regulatory regime; and,
- cultural factors.

With respect to the first point – the macroeconomic environment – I think it is worth highlighting the obvious: stable banks and stable capital markets would not be possible if the broader macro-economy in which they operated was unstable and constantly threatened by systemic instability.

On this point, Canada's track record in recent years has been strong. We have worked hard for over 20 years to achieve this.

Canada has been a world leader in terms of macroeconomic stability.

This was made possible by comprehensive tax and expenditure reforms that produced balanced budgets or surpluses for more than a decade.

This has allowed us to sharply reduce our net-debt-to-GDP ratio from over 70 per cent in the mid-1990s to less than 30 per cent today.

Another critical pillar of macroeconomic stability has been our monetary policy, which is embedded in a transparent inflation-targeting regime that has helped establish a long track record of stable prices and predictability.

These sound macroeconomic policies created an environment conducive to stable banking and finance. This in turn helped Canada avoid the type of housing bubble-and-bust dynamic – and other system-wide threats – that we have witnessed in many other countries.

While sound macroeconomic policies are a necessary condition for a stable financial system, they are not, however, sufficient by themselves.

And this leads naturally to the next two points – the unique aspects of the Canadian system and our regulatory policy.

For those who are not acquainted with our model, I'll spend just a moment to highlight its key features.

The Canadian financial system is quite diversified, but has at its core a large, robust banking system. In fact, banks dominate lending and credit creation activity, and account for over 60 per cent of total financial assets in Canada – with the five major banks representing the lion's share (85 per cent) of this total.

These 'big 5' operate on a nation-wide basis, which allows them to benefit from both geographical diversification and economies of scale. And there's been a national, federally-chartered banking system since Canada's creation in 1867.

In the past, critics have argued that our system was either, (i) too concentrated and protected from global competition, or (ii) that our banks were too small and domestically-focussed relative to the big global players.

Thus far, at least, such criticism has not been justified by reality.

By nearly every measure of consumer satisfaction or protection – whether it is banks' service charges or the practices of credit card companies or interest rate spreads – the banking experience of Canadians' compares very favourably with other advanced industrial countries.

Furthermore, Canadian banks and other financial institutions are – contrary to a popular opinion – not only well diversified across business lines, but also well-diversified globally.

Canadian banks generate approximately 30 per cent of their earnings outside of Canada.

Neither is the Canadian financial system protected from the pressures of global competition. Leading banks from the Europe and the U.S. all have operations in Canada and compete for business with Canadian banks.

With regard to the regulatory policy, Canada has a strong and centralized approach to banking and financial market regulation.

Banking activity is governed by the *Bank Act*, which is a regulatory framework that is reviewed every five years. This mandated, systematic review ensures that regulation never falls too far out of sync with the continuous, rapid evolution of financial markets.

Moreover, successive governments – whatever their political stripe – have taken a progressive approach to the business of banking and finance.

When I was Minister of Finance back in the 1980s, as part of one of our updates to the *Bank Act*, we largely eliminated regulations that separated the four traditional pillars of the financial sector: banking, insurance, investment dealers and trust companies.

This has produced an integrated, seamless banking system. Indeed, by the 1990s, all of the major investment dealers were owned by the big banks.

Like the banks that own them, our investment banking firms have been regulated and supervised under a single prudential regulatory framework since the late 1980s.

While there are other regulatory bodies, such as the Department of Finance, the Financial Consumer Agency of Canada and the Canadian Deposit Insurance Corporation, our Office of the Superintendant of Financial Institutions (OSFI) plays the central supervisory role for all federally-regulated financial institutions.

OSFI's focus has been two-fold:

<u>First</u>, on capital and – particularly – on the quality of capital. Prior to the current financial crisis, to be considered well-capitalized in Canada required a Tier 1 ratio of 7 per cent, of which 70 per cent had to be common equity. And, while OSFI had set a pre-crisis target of 7 per cent, in practice they mandated banks to have strong internal capital adequacy processes. As a result, banks' Tier 1 ratios have tended to be higher than 7 per cent – closer to 9 and even 10 per cent.

<u>Second</u>, OSFI's has taken a less detailed and more principles-based approach to regulation. Specifically, they have sought to ensure that financial institutions properly assess any risks that they might be taking.

While Canada was one of the first countries in the world to implement Basel II, OSFI did not rely solely on Basel rules. Rather, they held on to proven safeguards such extensive on-site examinations, peer evaluations and – crucially – caps on leverage ratios.

During this period of stress there have been no injections of equity capital into the banks by the Government.

As a final point on the Canadian financial model and our regulatory approach, it is worth noting that there are a small number of players in the Canadian financial system – three large insurance companies and the big 5 banks that operate nationally, and *Banque Nationale* that operates primarily in Quebec.

This consolidated, compact structure has helped to simplify regulation and supervision.

At the same time, there are well-established mechanisms to ensure collaboration, information-sharing and issue resolution between the various regulatory bodies.

This includes the FISC – the Financial Institutions Supervisory Committee, which is established in legislation as the primary inter-agency group that deals with systemic stability issues. In effect, the FISC is Canada's Council of Regulators.

I would like to finish on what I think is the fourth factor that has helped our system weather this recent crisis.

And this is Canada's corporate and overall culture of financial conservatism. Canadians – whether we are talking about business people or households - are by nature financially conservative.

Canadian banks have few risky mortgages and negligible sub-prime exposure. They didn't rely heavily on securitization for financing or the "originate-to-distribute" model.

No explicit regulations prevented this. Rather banks chose not to participate.

From a Canadian perspective, I think there are some lessons to be learned from our experience that hopefully can contribute to the current debate here in Washington.

In particular, weaknesses in three areas have been significant contributing factors which must be properly addressed in the final outcome.

- Capital adequacy or appropriate leverage levels.

- Systematic oversight within domestic financial systems.
- And global systemic understanding of the knowledge gained from analysis and cumulative assessment of the domestic systemic oversight processes.

In each of these three areas, the Canadian experience can be instructive.

I hope today's presentations and discussions are helpful in this regard.

Thank you.