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How Canada Does Banking

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Updated 6/11/09 to clarify figure and source for bank capital in the United States.

This is the first in a series about how Canada regulates its economy.

Prime Minister Stephen Harper is among many Canadians these days who are boasting about the strength of the country's banking system.

During the credit crisis, no Canadian banks failed, and none required government capital infusions. And last week when Canada's major banks issued their quarterly statements, all but one were profitable. Even that exception, a second-quarter loss of 50 million Canadian dollars (on 6.8 billion Canadian dollars in revenue) at the Royal Bank of Canada, was largely related to a write-down in the value of its American operations.

Mr. Harper, a Conservative who generally favors limiting government influence in markets, credits Canada's regulatory system for the banks' good fortune and suggests that it should be a model for the world.

He's not alone. Julie Dickson, the superintendent of financial institutions, has gone from being an obscure bureaucrat to something of a minor celebrity. A recent cover story in The Report on Business Magazine, which is published by The Globe and Mail newspaper, said she was "integral to the policy that is being credited with keeping the nation afloat during a financial storm that saw banks just about everywhere else in the world pushed to the brink because they had taken on too much leverage and excessive risk."

Canada's regulatory system, of course, is not perfect. And Mr. Harper's enthusiasm aside, the health of its banking industry may have more to do with its structure than its watchdog.

Ms. Dickson's office is known to be risk-averse. When the market for Canadian structured debt products collapsed because the banks, apparently at the suggestion of the regulator, declined to support it, Ms. Dickson rejected criticism from investors.

"Our primary job is to protect the interests of depositors," she said at a news conference.

Her office also requires Canadian banks to maintain relatively large capital holdings. Brenda Lum, the managing director for Canadian financial institutions at DBRS, a debt rating agency in Toronto, said that Canadian banks have an average Tier 1 capital level of 10.8 percent.

The Federal Deposit Insurance Corporation calculated the similar number for all American banks at 10.74 percent as of March 31. But unlike banks in Canada, some large American banks

fall far from that figure. Wells Fargo, for example, was at 8.3 percent on that date, and Bank of America stood at 4.5 percent, although it has since raised more than $26 billion in capital to improve that ratio.

Helping Ms. Dickson with her job were other government policies that ensured that subprime mortgages accounted for only a tiny portion of Canada's housing market. And because Canadian tax rules never allowed mortgage interest deductibility, home purchases in Canada are not effectively subsidized by the government.

But looming above all of those factors is the scope and market power of Canadian banks within their home market. While many foreign banks have subsidiaries in Canada, Ms. Lum estimates that Canadian banks hold 80 to 85 percent of their home market. Most of that business, in turn, is concentrated in the five largest banks.

The big five are also one-stop shopping banks offering everything from retail services (a particularly profitable line of work) to investment banking through networks of branches and offices spanning the country. On top of that, government rules prohibit anyone or any company from owning more than 20 percent of a Canadian bank, effectively making it impossible for foreign competitors to enter the market through an acquisition.

All that makes for what Ms. Lum described as "an orderly market."

While such order may seem desirable compared with the current alternative in the United States, it is not without significant side effects.

A report by the International Monetary Fund last year found that the resulting lack of competition makes life difficult for small borrowers.

"A range of analysts and business representatives have argued that the major banks, comfortable in their entrenched positions, have little incentive to venture into areas where borrowers are small, the cost of ascertaining creditworthiness may be higher and returns are more uncertain," the I.M.F. paper said.

Catherine S. Swift, a former government and bank economist who is now the chairwoman and chief executive of the Canadian Federation of Independent Business, a lobbying group, criticized the banks for "going around and beating their chests right now."

"While the United States has what we economists refer to as destructive competition, in Canada we have the opposite: ultraconservative financial institutions," she said. "What we'd like to see is some true competition in the Canadian market."

Being a central banker, Mark Carney, the governor of the Bank of Canada, is not as blunt as Ms. Swift. In fact, when testifying before the banking committee of Canada's Senate last month, he didn't even directly name the country's bank regulator when speaking about it.

But Mr. Carney did suggest that Canada, and all Western countries, should control banks in a way that considers not just the health of those financial institutions, but the broader needs of the economy: "one of the most important things is that all regulators, in the broadest sense, must take into account the implications of their actions for financial system stability, that is,

they must think about the system as a whole as well as their core responsibility."

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