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THE BLOG

The Canadian Banking Fallacy

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As a serious financial reform debate heats up in the Senate, defenders of the new banking status quo in the United States today - more highly concentrated than before 2008, with six megabanks implicitly deemed "too big to fail" - often lead with the argument, "Canada has only five big banks and there was no crisis." The implication is clear: We should embrace concentrated megabanks and even go further down the route; if the Canadians can do it safely, so can we.

It is true that during 2008 four of all Canada's major banks managed to earn a profit, all five were profitable in 2009, and none required an explicit taxpayer bailout. In fact, there were no bank collapses in Canada even during the Great Depression, and in recent years there have only been two small bank failures in the entire country.

Advocates for a Canadian-type banking system argue this success is the outcome of industry structure and strong regulation. The CEOs of Canada's five banks work literally within a few hundred meters of each other in downtown Toronto. This makes it easy to monitor banks. They also have smart-sounding requirements imposed by the government: if you take out a loan over 80% of a home's value, then you must take out mortgage insurance. The banks were required to keep at least 7% tier one capital, and they had a leverage restriction so that total assets relative to equity (and capital) was limited.

But is it really true that such constraints necessarily make banks safer, even in Canada?

Despite supposedly tougher regulation and similar leverage limits on paper, Canadian banks were actually significantly more leveraged - and therefore more risky - than well-run American commercial banks. For example JP Morgan was 13 times leveraged at the end of 2008, and Wells Fargo was 11 times leveraged. Canada's five largest banks averaged 19 times leveraged, with the largest bank, Royal Bank of Canada, 23 times leveraged. It is a similar story for tier one capital (with a higher number being safer): JP Morgan had 10.9% percent at end 2008 while Royal Bank of Canada had just 9% percent. JP Morgan and other US banks also typically had more tangible common equity - another measure of the buffer against losses - than did Canadian Banks.

If Canadian banks were more leveraged and less capitalized, did something else make their assets safer? The answer is yes - guarantees provided by the government of Canada. Today over half of Canadian mortgages are effectively guaranteed by the government, with banks paying a low price to insure the mortgages. Virtually all mortgages where the loan to value ratio is greater than 80% are guaranteed indirectly or directly by the Canadian Mortgage and Housing Corporation (i.e., the government takes the risk of the riskiest assets - nice deal if you can get it). The system works well for banks; they originate mortgages, then pass on the risk to government agencies. The US, of course, had Fannie Mae and Freddie Mac, but lending standards slipped and those agencies could not resist a plunge into assets more risky than prime mortgages. Let's see how long Canada resists that temptation.

The other systemic strength of the Canadian system is camaraderie between the regulators, the Bank of Canada, and the individual banks. This oligopoly means banks can make profits in rough times - they can charge higher prices to customers and can raise funds more cheaply, in part due to the knowledge that no politician would dare bankrupt them. During the height of the crisis in February 2009, the CEO of Toronto Dominion Bank brazenly pitched investors: "Maybe not explicitly, but what are the chances that TD Bank is not going to be bailed out if it did something stupid?" In other words: don't bother looking at how dumb or smart we are, the Canadian government is there to make sure creditors never lose a cent. With such ready access to taxpayer bailouts, Canadian banks need little capital, they naturally make large profit margins, and they can raise money even if they act badly.

Proposing a Canadian-type model to create stability in the U.S. is, to be blunt, nonsense. We would need to merge our banks into even fewer banking giants, and then re-inflate Fannie Mae and Freddie Mac to guarantee some of the riskiest parts of the bank's portfolios. With our handful of new "hyper megabanks", we'd have to count on our political system to prevent our banks from going wild; Canada may be able to do this (in our view, the jury is still out), but what are the odds this would work in Washington? This would require an enormous leap of faith in our regulatory system immediately after it managed to fail repeatedly and spectacularly over thirty years (see 13 Bankers, out next week, for the awful details). Who can be confident our powerful corporate lobbies, hired politicians, and captured regulators can become so Canadian so soon?

The stakes would be even greater with these mega banks. When such large banks collapse they can take down the finances of entire nations. We don't need to look far to see how "Canadian-type systems" eventually fail. Britain's largest bank, the Royal Bank of Scotland, grew to control assets equal to around 1.7 times British GDP before it spectacularly fell apart and required near complete nationalization in 2008-09. In Ireland the three largest banks' assets combined reached roughly 2.5 times GDP before they collapsed. Today all the major Canadian banks have ambitious international expansion plans - let's see how long their historically safe system survives the new hubris of its managers.

There's no doubt that during the coming months many people will advocate some form of a Canadian banking system in America. Our largest banks and their lobbyists on Capitol Hill will love the idea. For some desperate politicians it may become a miracle drug: a new "safer" system that will lend to homeowners and provide financing to Washington, while permitting politicians and regulators to avoid tough steps. Let's hope this elixir doesn't gain traction; smaller banks with a lot more capital - and able to fail when they act stupid - are what U.S. citizens and taxpayers really need.

An edited version of this post appeared on the NYT's Economix this morning; it is used here with permission. If you wish to reproduce the entire post, please contact the New York Times.

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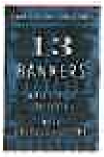

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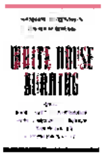

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