The world economy is now emerging from the shock of the first global financial crisis and synchronized worldwide recession since the 1930s. Given the perceived sophistication of financial markets, the regulatory and surveillance structures established by major countries and international bodies, and the perception of structural changes to better absorb risk, how did this happen? And why did some countries avoid the full brunt of the financial market disruption?

As a recent Financial Times article by Chrystia Freeland noted: “One of the most important policy debates today... is what caused the crisis and what should be done to prevent a repetition... That’s where Canada comes in. It is a real-world, real-time example of a banking system in a medium-sized, advanced capitalist economy that worked. Understanding why the Canadian system survived could be a key to making the rest of the west equally robust.”

Canada was hit by the worldwide recession, the Canadian financial system weathered the global financial crisis relatively well. Canadian financial institutions were not unscathed by the financial crisis, but none was excessively impacted by toxic assets, no public funds were injected into financial institutions, Canadian banks remained profitable and dividend-paying and, importantly, they continued to lend. Interestingly, in the halcyon years before the financial crisis, Canadian practices were often criticized in New York and London as being too conservative, too prudent and too unwelcoming of the new financial innovations sweeping global balance sheets.

The sharp contrast between the Canadian experience and how differently the financial crisis impacted the US, the UK and much of Europe reflects different regulatory regimes, as well as different corporate governance systems, financial institution lending practices and different structures.

On the regulatory side, Canada has integrated regulation of banks, insurance companies and large investment dealers. The Office of the Superintendent of Financial Institutions (OSFI), Canada’s regulator, meets regularly with the management of the largest financial institutions and their boards of directors to ensure that they are governed to be sound and stable. In the banking sector, Canada allows securities firms to be bank-owned (and the largest are), and the OSFI regulates the banks on a consolidated basis (retail, commercial, investment and wealth activities) worldwide, in contrast to the regulatory silos of the United States. The Canadian regulatory approach is both prescriptive and principles-based. This combination put the onus on a financial institution to assure itself that it has met the intent of the legislature in addition to what is explicitly prescribed.
However, there remain areas of the financial services sector that fall under provincial regulation and, given both the inefficiency of 13 regulators in a market the size of Canada and the risk of regulatory gaps and arbitrage as highlighted by the financial crisis, many believe structural changes are needed to make the Canadian system even safer and more efficient. The federal government is moving forward with a proposal to establish a national securities regulator to ensure comprehensive and consistent coverage of financial market activities.

With respect to how they use their balance sheets, Canadian financial institutions were less highly leveraged than their international peers in the precrisis period. This reflected the fact that Canada has a regulatory cap on leverage at an asset-to-capital ratio of 20 to 1. As a result, major Canadian banks had an average asset-to-capital multiple of 18 in 2008, while the comparable figure for many US banks was over 25, and numerous European banks were well over 30.

A key asset class that fuelled the global financial crisis was subprime mortgages. The vast majority of Canadian mortgages are originated by banks to hold, thereby providing a “front-line” incentive to not lend where there is a high risk of default; in the US, the majority were originated to sell. In Canada, this practice is further buttressed by government regulations that require insurance for high-ratio mortgages and impose high credit standards on the eligibility for mortgage insurance. Interestingly, notwithstanding Canada’s more stringent creditworthiness system for mortgages and the absence of tax expenditures for mortgage payments, home owner-ship levels are slightly higher in Canada than in the US.

Capital requirements for Canadian financial institutions were above international standards, and higher than in jurisdictions such as the US and the UK before the financial crisis. Canadian banks typically maintained capital above these minimum requirements. Further, Canadian banks rely more on depository funds than on wholesale funding compared to banks in many other countries, providing more stability in times of market volatility. These structural features, which make Canadian banks among the most resilient in the world, are well documented in a recent International Monetary Fund report by Lev Ratnovski and Rocco Huang.

This financial sector framework has to be overlaid on a Canadian economy that has strong fundamentals. This reflects a decade of sustained government surpluses, solid corporate balance sheets, low and stable inflation, low net foreign indebtedness (less than that of the US), the lowest net government debt as a proportion of GDP among the G7 countries and a national pension plan that is actuarially sound even with today’s demographics. Taken together, this combination of macroeconomic management, regulatory systems, corporate governance structures and banking practices has produced what the World Economic Forum rates as the soundest financial system in the world.

Canada was one of the very few advanced Western countries to avoid the financial crisis, although it, like the rest of the world, was hit with the ensuing recession. There are many lessons to be drawn from this extraordinary crisis for the global economy, and Canadian experience provides useful counterfactual insights. The follow-
Third, prudence may be boring, but it pays off, particularly when viewed over the complete economic cycle. Despite some ill-timed pronouncements to the contrary, economic cycles have not been consigned to the dustbin of history. Regulatory systems and business planning should assume economic cycles as the norm, not presume benign economic growth. And they should stress-test accordingly.

The value and effectiveness of safety net systems, whether they are financial system capital requirements or economy-wide programs such as employment insurance or access to basic health care, have to be evaluated over the complete business cycle, not just in the growth phase of a cycle. The very different levels of consumer confidence in Canada and in the US through the recession — a recession where Canadian unemployment rates were below those of the US for the first time in generations — are in part due to the fact that the Canadian safety net cushioned the economy from extreme shocks.

Fourth, while regulatory systems have to be made more effective, they can’t be the first line of defence in our complex, decentralized, market-based system. That first line of defence has to be at the level of the firm, and has to be imbedded in its corporate governance structures, procedures and values. Since incentives to innovate around regulatory systems are a market reality, this suggests there needs to be a better balance of principles-based regulation and prescriptive rules, and simplicity over complexity in rule setting. Regulatory systems have to put more onus on firms and their boards of directors to manage for safety and soundness as principles, in addition to meeting the required prescriptive rules. This is the regulatory equivalent of general anti-avoidance legislation in the tax system.

Fifth, better and smarter regulation, not simply more regulation, is what financial reform should focus on. New regulations should aim first and foremost to remove the weaknesses that most contributed to the crisis. Policymakers need to be wary of building too much complexity into the reforms; sometimes simple rules are most effective. The Canadian leverage ratio limit of 20 to 1 on a consolidated enterprise, without complex carve-outs, was both simple and effective. Indeed, if the purpose of policy is to change behaviour, it has to be reasonably clear and certain to achieve its objective.

Sixth, financial sector reform needs to increase the quantity and quality of capital that financial institutions are required to hold, and there is little disagreement with this in principle, although there is much debate about what the optimal capital levels might be. But it also needs to address the problem of procyclicality, and build cyclicality explicitly into the regulatory framework.

Procyclicality, which is a feature of current regulatory systems, effectively requires more capital in downturns when you actually could use the capital buffer you have established against just such rainy days. This can lead to deleveraging, which exacerbates the economic cycle. The solution, which is easier in theory than in practice, is to take a complete-cycle view of appropriate average levels of regulatory capital, and allow additional capital accumulation during the expansion phase that can be drawn down during the contraction phase of the cycle. As in the implementation of all theories, the devil is in the details.

Seventh, there is much consideration being given to the twin challenges of systemic risk and moral hazard. These are not easy issues. Some argue that the solution to “too big to fail” is to introduce more functional separation in what a financial institution can or cannot do; others make the case that more consolidated management, strengthened regulation and greater transparency are a more practical way to proceed. In seeking the right balance, policy-makers need to bear in mind that any separation of functions may make an institution, but not the system, less risky depending on where and how the separated functions are regulated. The paucity of information about, and regulatory oversight on, over-the-counter trading, hedge fund positions and counterpart risk concentrations played a role in the dynamics of the financial crisis. These activities have to be better integrated into the regulatory environment.

Eighth, we need to move to a new and more effective stage of international regulatory cooperation. While national regulatory systems need to be strengthened, we cannot lose sight of how integrated the global financial system is, something that became shockingly evident during the crisis. This points to the necessity of regulatory reforms that are consistent across the major economies to the extent possible; least incentives for regulatory arbitrage or regulatory black holes are created anew. The reformed system also needs to balance national sovereignty and international coordination. All systemically important economies need to be fully engaged, and there needs to be real and rigorous peer review of their systems and mutual assessment of their macroeconomic policies and the potential to contribute to global imbalances.

Now more than ever, markets and consumers want signs of concrete progress, and financial institutions want certainty about the reformed system and its rules. Protracted and divisive debates about fundamentally different regulatory approaches will not restore trust and rebuild confidence.

The financial crisis made self-evident the necessity for reform of national financial systems, particularly in the US and the UK; the requirement for greater harmonization across national financial systems in a world of pervasive globalization; and the need for more effective...
international cooperation. More fundamentally, global reform has to rebuild trust in the financial system, in financial institutions and in financial regulation.

The G20 took the lead in organizing the international response to the global financial crisis in a series of pivotal meetings in Washington, London and Pittsburgh. The Washington G20 summit in November 2008 created the consensus for large fiscal stimulus packages and unprecedented monetary policy interventions. The April G20 2009 summit began to lay out the framework for financial sector reform and established the Financial Stability Board, with a more inclusive membership (all G20 countries) and a broader mandate. At the Pittsburgh summit in September 2009, the G20 leaders made several far-reaching governance decisions.

They designated the G20 as the key forum for international economic cooperation, with all the responsibilities, challenges and expectations that entails. Beyond that, they set out an ambitious agenda for strengthening the international financial regulatory system and modernizing the Bretton Woods institutions.

The reforms agreed to at the three G20 summits are solid steps forward. They include consolidated regulation, caps on leverage, more and higher-quality capital, mutual assessments of national systems, governance reforms to make international cooperation more effective and the reinvigorated Financial Stability Board.

As this complex international process unfolds over the coming months, it will also have to interact with national proposals for financial sector reform coming forward in the United States (the Restoring American Financial Stability Act in the Senate and the Wall Street Reform and Consumer Protection Act in the House), the European Union, the UK and elsewhere.

The risk in all this is that the urgency and cohesion of 2009 could give way to complacency as the recovery strengthens and policy divisions among countries reassert themselves. Neither development would serve the global economy well. Canada, as both chair of the 2010 G8 summit and co-chair of the G20 summit, has the opportunity to play a leadership role in an effective reform process. Canada’s unique experience in avoiding the worst of the financial crisis gives it the credibility to lead.

The financial crisis was both stunningly modern and as old as markets themselves. Financial products of amazing complexity were traded 24/7 around the world, but markets were suffering from excess liquidity, asset bubbles, greed and the ascendancy of hope over common sense, which is hardly new. Markets are efficient but not always right, as they can only process the available information. Transparent information and early warning systems for both market investors and policy-makers were less than stellar. Regulatory gaps and regulatory arbitrage opportunities were evident, as were shortfalls in regulatory cooperation across nations and even within certain major countries.

The financial crisis provides the impetus to learn from what went wrong, and to introduce reforms that will make such crises less likely and less traumatic in the future. It will be important to learn these lessons well.

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