

Well-regulated, well-managed Canadian banks overshadow freewheeling U.S. colleagues

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OTTAWA -- TD Economics senior vice-president Don Drummond got a phone call recently from a friend who was standing in front of an enormous green TD sign in the heart of New York City.

There, with a prominent place in the financial capital of the planet, was a branch of Canada's second-largest bank.

Canadians who get puffed up like peacocks at the sight of maple leaf-spawned businesses popping up in the U.S. better get ready to preen.

While it is not new that Canada's banks have a presence in the United States, they have come through the global banking system's meltdown with a somewhat rosy sheen. They are leaping and bounding up the list of the world's biggest banks, ranked by size. They are among the most profitable in the world at the moment.

And while banks elsewhere continue to struggle just to stay afloat, Canada's banks are well positioned to take advantage of the mess that has been left behind.

"It will be a tragedy if we don't exploit it," said Drummond.

Much of Drummond's time these days is spent explaining to the world how Canada got it right.

"I'm getting calls from journalists in countries I've never heard of," joked Drummond.

Everyone from the International Monetary Fund to major U.S. publications such as Newsweek and the New York Times have lauded the Canadian system.

"Keep in mind that the one advanced industrial country where the banking system has weathered the storm superbly is Canada," wrote Newsweek international editor Fareed Zakaria in June.

But why is it that while international banking and investment giants such as Lehman Brothers, Bear Stearns and the Royal Bank of Scotland succumbed or were bought out to prevent their collapse, not a single Canadian bank has failed or required a bailout from the federal government?

In the United States, at least 69 banks have failed this year alone, including a record-breaking 11 banks in a single day in early July. Another 25 failed last year. The cost to the U.S. Federal Deposit Insurance Corp. is more than \$30 billion for the last 18 months.

The U.S. government spent more than \$200 billion bailing out more than 250 banks so far, including \$45 billion to each of Bank of America and Citigroup.

Canada's banks didn't exactly come through the last two years without a scratch. Share prices for the big six banks dropped between 16.4 and 46.4 per cent in 2008 and combined annual profits fell to \$12 billion in 2008 from \$19.5 billion in 2007. But all but one of the banks (Canadian Imperial Bank of Commerce) still recorded a profit in 2008.

They all climbed up the global and North American bank rankings determined by the amount of their capital holdings.

The Royal Bank of Canada, the country's largest, climbed more than 10 spots to number 13 among global giants. In North America, four of the big six had cracked the top 10, with RBC fifth, Toronto-Dominion eighth, Bank of Nova Scotia ninth and CIBC 10th.

Drummond notes this rise is mainly because of how much other banks were faltering, rather than serious growth of Canada's banks.

"Yes, our market size has improved, but it's like winning a race when you're walking backwards and everyone else is running backwards," he said.

It's an interesting scenario for banks which just a decade ago went to the federal government asking to merge with each other because they couldn't compete globally unless they were bigger. RBC wanted to merge with the Bank of Montreal and TD wanted to merge with CIBC.

Canada said no, mainly from fears the lack of competition would affect consumers, and it seems that decision may have been far more fortuitous than anyone thought at the time.

Liberal Finance Critic John McCallum, who in 1998 was a vice-president at the Royal Bank of Canada and among those pitching for bank mergers, says he realizes now that would have been a mistake.

"I don't mind doing a bit of a mea culpa," said McCallum. "The mindset was we need to be more global, more like a Citibank. But we've seen what happened to Citibank."

Citibank, in 2007 the largest bank in the United States, was rescued by the U.S. government with \$50 billion in aid to keep it from crumbling under the weight of more than \$300 billion in risky assets.

McCallum said had the banks merged in Canada, it's possible they would have taken on more risks and done more of the things that left U.S. and other global banking leaders needing bailouts or going under.

In fact that lack of risk-taking is one of the main reasons most cite for Canada's banking success.

Terry Campbell, vice-president of policy for the **Canadian Bankers Association**, said there are three main reasons why Canada's banks stand out as the tall poppies of the world's banks right now.

"They had enough capital, were well regulated and well managed," he said.

Canada has a single regulator for its banks -- the Office of the Superintendent of Financial Institutions, which keeps a close eye on the regular dealings of Canada's banks and can spot problems early then influence banks not to take certain risks.

"In the U.S. the regulatory system is fragmented and things fell between the cracks," said Campbell.

Canada's banks also held far more capital as a cushion to offset losses, says Campbell.

Canada has about two dozen domestic banks, but the big six -- Royal Bank, Toronto Dominion, Scotiabank, Bank of Montreal, Canadian Imperial Bank of Commerce and National Bank of Canada -- account for more than 90 per cent of the assets of all domestic banks.

All of them have capital holdings to back up their loans and investments that far exceed the minimum requirements of either international or Canadian regulations.

They exceed the capital holding requirements of both national and international standards by significant amounts.

Tier one capital ratios, for example, a figure comparing core capital holdings to outstanding risks, ranged from 9.6 per cent (Bank of Nova Scotia) to 11.5 per cent (CIBC) in April.

OFSI requires domestic banks to have a tier one capital ratio of seven per cent.

Last fall, when the banking crisis really began to hit, the average U.S. bank had a tier one ratio of five per cent. In Europe, that figure was four per cent.

Campbell also points out that the more capital a bank has, the more money it can lend. Strong capital bases also allow banks to cover off defaults on loans. In a recession, loan defaults mount, but having a lot of capital to fall back on keeps the banks on solid ground.

A lot of credit for Canada's banking prowess has been given to OFSI's oversight of the banks, but Drummond said on capital holdings the banks themselves realized they needed to keep capital up because they saw what was happening to other banks when the markets were tumbling.

Bank management practices are also far more conservative in Canada, driven in part by more risk-averse decision makers, and in part by more risk-averse consumers.

"Canadian banks are prudent lenders, and Canadian individuals are very prudent borrowers," said Campbell.

A main example of this is the mortgage crisis that was a major factor in the collapse of the U.S. banks but which never really affected Canada.

Sub-prime mortgages are loans for home buyers offered at really low interest rates. They are high-risk because they tend to be given to people who would not normally qualify for a mortgage due to bad credit histories or who are asking for a much higher amount of money than they could afford through a traditional prime mortgage.

In the U.S., the subprime lending system led to a lot of people buying houses they couldn't afford and the default rate on mortgages soared.

In April, seven per cent of American mortgage holders were at least 30 days behind in their payments. That is 17 times the 0.4 per cent of Canadian mortgage holders who were in arrears the same month.

Drummond also notes Canada's banks have the advantage of being truly national in nature. With the exception of National Bank, all of the big six have offices in every province. Officials with the **Canadian Bankers Association** say they know of no U.S. bank with an office in all 50 states. Because of their national nature, Canada's bank holdings aren't concentrated in any one region and can transfer capital from one region to another as various parts of the economy ebb and flow.

But because Canada's banks are big, and do more than just retail servicing, they have more than one type of enterprise to keep them afloat. In the U.S., until recently there were bread-and-butter retail banks focusing on personal banking needs such as deposits, mortgages and car loans. And there were separate companies to handle investments and wealth management.

Canada's big banks are more financial groups, combining retail banking with investment and securities services. In this crisis, the solidness of their deposit-taking enterprises helped anchor their investment services, particular the U.S. operations which took a hit.

Drummond believes the financial systems elsewhere are already beginning to move toward the Canadian approach -- mainly with higher capital holdings and more diversified companies.

"I think looking forward, we will see the U.S. (banking sector) looking more like Canada," he said.

In the fall of 2008, the last two Wall Street banks left standing -- Goldman Sachs and Morgan Stanley -- applied for commercial bank status so they could raise deposits.

Canada's influence on the world stage is noticeable with Finance Minister Jim Flaherty getting a lot of attention at meetings of G20 finance ministers and Julie Dickson, head of OFSI, holding a spot on a forum which is advising the G7 on international banking reforms.

Canada's banks are also keeping watch on the time to pounce and move even further into international markets.

Drummond notes so far they have been prudent and the banks haven't made too many big purchases south of the border.

"At the moment, there are too many bad assets on the books," said Drummond.

But he said as the U.S. government figures out how to get the toxic assets out of the way, Canada's banks have both the will and the way to move in.

Canada's banks are already a huge factor in this country's economic situation.

They employ more than 263,000 people in Canada, including 5,550 in Manitoba.

In 2008, they paid \$21 billion in salaries in benefits, made \$155 million in charitable donations in Canada and spent \$9.8 billion on technology.

In 2007, the six largest banks alone paid \$8.7 billion in taxes.

If the banks -- as TD has done, notes Drummond -- keep administration of U.S. holdings in Canada, the further expansion will continue to boost the Canadian economy and our national pride.

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Canada's banks

Big six

1. Royal Bank of Canada (RBC)

Number of clients: 17 million

Number of employees: 72,479

Tier 1 Capital ratio: 11.4 per cent

Total assets: \$680 billion

2. Toronto Dominion (TD)

Number of clients: Approximately 17 million worldwide

Number of employees: 74,713

Tier 1 Capital ratio: 10.9 per cent

Total assets: \$574.9 billion

3. Bank of Nova Scotia (BNS)

Number of clients: 12.5 million worldwide

Number of employees: 67,698

Tier 1 Capital ratio: 9.6 per cent

Total assets: \$513 billion

4. Bank of Montreal (BMO)

Number of clients: 8.2 million

Number of employees: 36,924

Tier 1 Capital ratio: 10.7 per cent

Total assets: \$432 billion

5. Canadian Imperial Bank of Commerce (CIBC)

Number of clients: 11 million worldwide

Number of employees: 42,305

Tier 1 Capital ratio: 11.5 per cent

Total assets: \$347 million

6. National Bank of Canada

Number of clients: 2.35 million

Number of employees: 17,343

Tier 1 Capital ratio: 10.3 per cent

Total assets: \$137 million

-Information taken from individual bank websites, annual reports, and quarterly reports. Unless otherwise indicated the financial results are from the second quarter of 2009, and are accurate as of April 30, 2009.

Big Banks of the World

2008 top global banks by market capitalization (2007 ranking)

1. Industrial and Commercial Bank of China (1)

2. JP Morgan Chase and Company (6)

3. HSBC Holdings (2)

4. Wells Fargo & Co. (n/a)

5. Bank of China Limited (4)

13. Royal Bank of Canada (24)

22. The Toronto-Dominion Bank (37)

28. The Bank of Nova Scotia (38)

44. Canadian Imperial Bank of Commerce (63)

-PriceWaterHouse Coopers, Canadian Banks 2009

Banking glossary

Hear someone talking about derivatives or capital ratios and wonder if you are the only one who thinks they're speaking in another language? Never fear. You're not alone.

A quick primer to some of the words used often in the banking sector meltdown.

Capital ratio - a figure comparing a bank's capital holdings to their assets and risks. The higher the number, the more financially sound a bank is, because it means the bank has more capital on hand to cover off things like loans and investments. A Tier One capital ratio uses only core capital holdings, like retained earnings and common shares, rather than all capital holdings. It is one of the

more common ratios you might hear bankers discussing in talking about the soundness of Canada's banks. The tier one capital ratios for Canada's major banks are generally around 10 per cent.

Market capitalization - this figure is the amount of money a bank is worth by multiplying the number of shares held in the company by the current cost of a share. It is used by the investment community to determine a company's size.

Subprime mortgage - a high-risk mortgage offered at interest rates far below the prime rate to people who wouldn't normally qualify for a mortgage. Many of them were given on variable rates however and people who bought houses they couldn't afford at normal interest rates were suddenly unable to pay their mortgage bills when the interest rates went up. It led to a huge number of people defaulting on their mortgages, leaving banks with houses they had to sell at hugely deflated prices, if they could sell them at all. These types of mortgages were very limited in Canada - less than five per cent of all mortgages. In the U.S. they made up more than 20 per cent of all mortgages.

(Mia Rabson, Winnipeg Free Press, August 9, 2009; reprinted with permission.)