TD Bank Financial Group

TD Economics

Economic Notes

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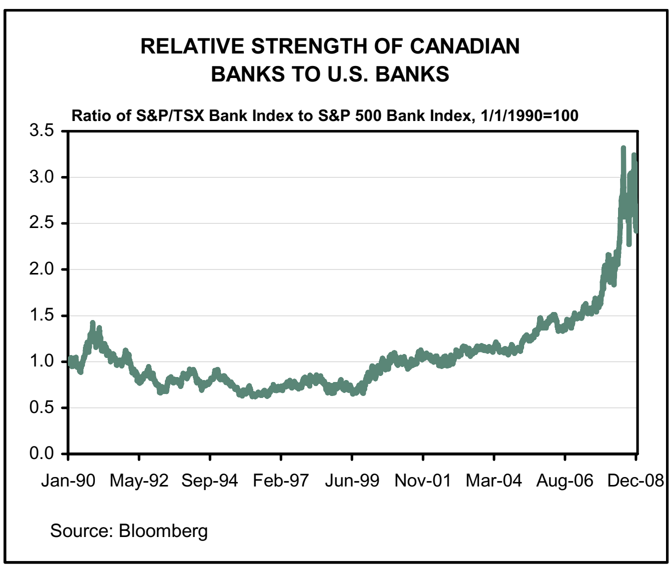
WHY CANADA'S BANKS HAVE FARED BETTER THAN THEIR INTERNATIONAL PEERS DURING THE CREDIT CRUNCH

- **There appears to be a more risk averse culture in Canada running through government, the public and banks**
- **Canadian banks benefited from prudent and disciplined risk management practices**
- **Higher capital ratios pre-crisis and the fact that Canada's major investment banks were part of a large diversified financial services institution also played a role**

In the midst of the recent global financial carnage, the Canadian banking system has weathered the storm far better than its international peers. Canada has not experienced the failure of any major financial institution. While financial losses were incurred and mistakes were made, as evidenced by the exposure of some Canadian firms to U.S. subprime paper, the degree of the losses experienced in Canada have paled in comparison to those recorded in the U.S. and European banking systems. This outcome supports the World Economic Forum assessment in October 2008 that Canada had the soundest financial system in the world, with a rating of 6.8 out of 7. The natural question is why Canadian banks have fared so much better?



There are number of reasons. The most basic answer is that Canadian banks pursued more prudent and more disciplined risk management practices. This can be observed by a number of trends.

Solid capital ratios

Canadian banks are regulated by the Office of the Superintendent of Financial Institutions (OSFI). And, OSFI was one of the first national regulators that signed on to the Basel II capital framework. The Canadian regulator requires the banks to have a Tier 1 capital ratio of 7%. However, the Canadian banks view the regulatory requirement as a minimum, and in practice the median was well above the requirement. In December 2007, before the credit crunch intensified the following year, the median Tier 1 capital ratio of the Canadian large cap banks was 9.6%. This is a higher capital ratio that in many other countries. For example, the regulator in the U.S. is the Board of Governors of the Federal Reserve System (FRB) and it did not sign on to Basel II. The FRB requires a bank holding company to have a Tier 1 capital ratio of 4% if it is to be deemed adequately capitalized. To be considered well capitalized, a bank holding company requires a capital ratio of 6%.

However, it should be stressed that many U.S. banks were well capitalized heading into the financial turmoil and most U.S. banks well exceeded the minimum requirement. Nevertheless, the U.S. capital ratios were below those in Canada. For example, many of the U.S. large cap regional and super-regional banks had Tier 1 capital ratios of around 7.5% in December 2007. Meanwhile, a Time magazine article from November 2008 reported that European commercial banks had a Tier 1 capital ratio of 3.3%.

More conservative lending practices

Canadian banks avoided the adoption of the high risk lending practices being conducted abroad. In 2006, subprime mortgages accounted for close to 25% of all new mortgage originations in the U.S., while in Canada the ratio was 5% and subprime mortgages only represented 3% of all outstanding Canadian mortgages. Adjustable rate mortgages (ARMs) became popular in the United States, and the interest rate adjustment on these products is a leading reason for the dramatic increase in mortgage delinquencies in that country. In Canada, ARMs were never introduced. Canada did allow greater leverage in the mortgage market through no money down and extended amortization mortgages, but the risk profile on these products was much less than on new U.S. products.

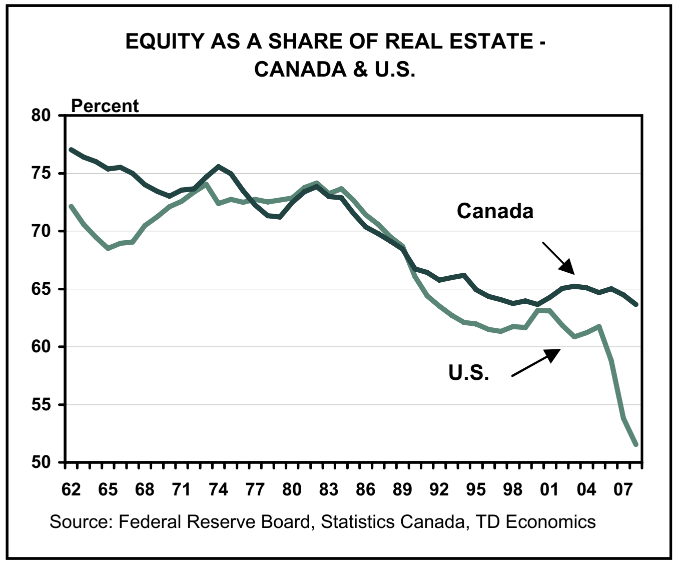
Strong risk management culture

The Canadian banks stuck to their long standing risk assessment systems. Indeed, the criteria for getting a mortgage did not change considerably during the real estate boom. For example, a mortgage borrower taking out a variable rate mortgage still had to qualify on the basis of a 5-year fixed mortgage rate. In contrast, the U.S. had a proliferation of NINJA loans (loans with no demonstration of income, job or assets) and when mortgage qualification was being done it was often assessed at the low introductory rate on the ARM.

Prudent regulatory oversight

The Canadian regulatory system and Government of

Pre-Crisis* Tier 1 Capital Ratios for U.S. and Canadian Bank Aggregates	
(all figures are in reporting currency)	
Canadian Large Cap Banks	9.6%
US Money Centre Banks	8.4%
US Super Regional Banks/Thrifts	8.0%
US Large Cap Regional Banks/Thrifts	7.6%
US Mid Cap Regional Banks/Thrifts	8.5%
*As of December 2007; Source: TD Newcrest	



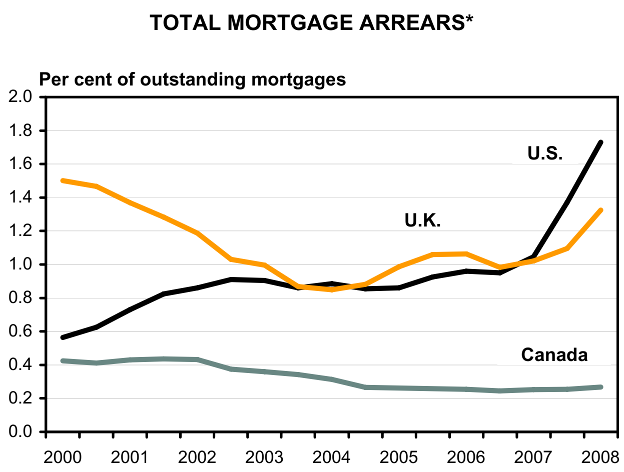
Canada policy has also served the nation well. OSFI provided prudent oversight. Moreover, the Government of Canada did not push for imprudent lending practices like in some jurisdictions abroad. In the United States, the Community Reinvestment Act encouraged higher risk mortgage lending. Fannie Mae and Freddie Mac, the two U.S. government sponsored enterprises in the mortgage sector, also pushed hard to expand home ownership and may have contributed to higher risk activities. The U.S. government also allows mortgage interest deductibility, which deters homeowners from paying down their mortgages as quickly as possible. It should be noted, however, that mortgage insurers in Canada did influence lending practices by opting to insure no-money down and extended amortization mortgages. But, as mentioned above these were lower risk than some of the international practices and the Government of Canada has since eliminated insurance on no-money down and 40-year mortgages.

More risk averse behaviour by households

Canadian homeowners were also more cautious in the their activities. Canadians were less inclined than Americans to drawdown on the equity in their homes. The more conservative behaviour of both lenders and borrowers has resulted in a more modest rise in mortgage arrears.

Canadian investment banks part of a larger diversified financial institution

The structure of the Canadian financial system also provided some important stability. In the late 1980s, the Government of Canada allowed commercial banks to acquire investment dealers. This set off a wave of mergers and acquisitions, with the result that no large independent dealers were left. So, the investment banks in Canada folded into a larger diversified institution. Investment banking takes inherently more risk than retail and commercial banking, so the combination allowed the former to benefit from the lower risk balance sheets of the latter. In the United States, some have argued that the U.S. investment banks were only lightly regulated. The U.S. investment banks also had very low capital ratios that averaged around 4%. When the dust settles from the recent financial turmoil, it would appear that independent U.S. investment banks will be a thing of the past.



*Mortgage arrears past due 90 days or more
Source: CBA, MBA & U.K. Council of Mortgage Lenders

Conclusions

These are the results and facts. The practices in Canada stand in sharp contrast to those in the U.S., Europe and elsewhere. It is more difficult to pinpoint why. Why has the regulatory environment been tougher in Canada? Why have Canadian banks had tougher risk management cultures? Why have Canadian households chosen to taken on less leverage? All of these aspects likely intertwine in a virtuous circle. There appears to be a more risk averse culture in Canada running through government, the public and banks. One feeds off another. It may be instrumental that Canadian banking is relatively dominated by a fairly small number of large banks that have been in business for a very long time – most dating back in one form or another since prior to Confederation. Perhaps this long history deters actions to boost short-term profits at the expense of long-term risk.

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