Why Was Canada Exempt from the Financial Crisis?

Canada has avoided crises for 180 years, while we have been prone to them. Can we recreate its stability here?

BY RENEE HALTOM

As the worst financial crisis in generations hit the United States in 2007 and 2008, Canada was a pillar of resilience.

No Canadian financial institutions failed. There were no government bailouts of insolvent firms (just a couple of lending programs to address market volatility relating to problems in the United States). Canada was the only G-7 country to avoid a financial crisis, and its recession was milder than those it experienced in the 1980s and early 1990s. For the last six years, the World Economic Forum has ranked Canada first among more than 140 countries in banking stability.

It's not just one-time luck. If you define "financial crisis" as a systemic banking panic — featuring widespread suspensions of deposit withdrawals, bank failures, or government bailouts — the United States has experienced 12 since 1840, according to a recent study by Charles Calomiris, professor of finance and international affairs at Columbia University, and Stephen Haber, professor of history and political science at Stanford. That's an average of one every 14 and a half years. Canada has had zero in that period. Its largely export-driven economy has seen more than its share of recessions, and even some notable bank failures, but it has almost completely avoided systemic problems. Even during the Great Depression, when more than 9,000 of our banks failed, Canada lost a grand total of one — to fraud.

One might suspect that it's because Canadian financial institutions tend to be more tightly regulated; they have higher capital requirements, greater leverage restrictions, and fewer off-balance sheet activities. But Canada's financial system was largely unsupervised until the late 1980s. In a period in which both Canada and the United States had virtually no official supervision or regulation of bank risk-taking — from the 1830s to the advent of the Fed in 1913 — America experienced no fewer than eight systemic banking crises, while Canada had only two short-lived episodes in the 1830s relating to problems here. That suggests regulation alone can't explain Canada's stability.

All the while, Canadian banks provide ample credit to the economy. According to the World Bank, Canada ranks in the middle among high-income countries in the provision of credit, with bank lending as a percent of GDP averaging 95 percent over time, compared with 52 percent here.

Canada has seemingly found a way to balance the provision of credit with the containment of risk. The question is, would adopting some of its characteristics produce the same success here?

What's Different in Canada?

The financial systems of Canada and the United States provide the same basic services. The striking difference is in how they are provided.

America has one of the world's more fragmented financial systems, with almost 7,000 chartered banks and a legion of regulators. Depending on its charter, an American bank can be regulated by the Fed, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, or state regulators — and that's just the list for banks. By contrast, Canada has just 80 banks, six of which hold 93 percent of the market share, according to the International Monetary Fund. It has one overarching financial regulator, the Office of the Superintendent of Financial Institutions (OSFI), which oversees all manners of financial firms: banks, mortgage lenders, insurance companies, pension funds, and more. (Securities markets are regulated by Canada's 13 provincial and territorial governments, but their regulations are largely harmonized.)

What explains these differences? The answer requires a bit of onion peeling. A financial system's structure is, in part, a response to regulation. But regulation is an evolutionary process; policymakers tend to tweak regulatory rules and procedures in response to financial crises or major bank failures. So to truly understand a country's financial landscape, you have to go back — all the way back — to its beginning. Financial regulation in a new world typically starts with one question: Who has the authority to charter banks?

This seemingly small choice sets off a chain reaction, according to Michael Bordo and Angela Redish, Canadian economists at Rutgers University and the University of British Columbia, respectively, and Hugh Rockoff, a monetary expert also at Rutgers. They've studied the differences between Canada and the United

States in several papers dating back to the 1990s.

They argue that the states here prohibited banks from branching, while Canada did not. These differences don't exist today; American and Canadian banks alike are free to establish branches virtually anywhere they are economically viable. But for most of U.S. history, up to 1994, most states had some form of restrictions that prohibited branching across state lines, and within states in some cases. The result: a lot of U.S. banks. At the peak almost 100 years ago, there were 31,000 individual institutions, virtually one distinct bank for every city and town, and almost no branches.

Many economists have argued that this "unit banking" in the United States made banks more fragile. For one thing, banks were rather undiversified. "Their assets would be mostly local loans, mortgages on farms or farm machinery, depending on whatever crop was grown in the area. If the price of wheat fell, loans depending on those local crops could be in trouble," says Rockoff. A single bad harvest was liable to set off a wave of local failures, tightening credit to the entire region.

Unit banking aggravated other unstable features of U.S. banking. Regional shocks often produced bank runs, and the rush of deposit withdrawals would drain banks of cash. It was difficult to issue more currency because all notes had to be backed by government bonds, which were costly and slow to obtain. Addressing this problem is one reason the Fed was created in 1913, to expand the currency supply quickly in times of need.

Canadian banks solved the bank run problem with no central bank. Scholars have chalked this up to a few things. First, its banks were inherently less risky because diversification helped them absorb shocks. Second, its banks could respond to depositors' demand for cash by printing their own currency backed by general assets. Third, the system's high concentration facilitated coordination in emergencies. The Canadian Bankers Association, a private consortium of banks, established a fund to honor notes issued by failed banks and arranged takeovers of failing banks when our country was enduring the panics of 1893 and 1907. As a result, note holders and depositors rarely experienced losses. Competing banks had an incentive to prevent such losses because, in a highly concentrated banking system, a single failure would be bad for everybody. In exchange for support, they policed each other to prevent excessive risk-taking.

"People were fairly confident that something would be worked out, so Canada didn't get the panicky bank runs that we did in the United States," Rockoff says. American banks tried the same with private clearinghouses and coinsurance schemes, but these efforts often failed; the banks' interests sometimes proved too diffuse to provide confidence that panics would be averted. (The Canadian government did backstop the banking system on some occasions, mostly through regulatory forbearance, Redish says. At the request of farmers, it loosened collateralization requirements on note issuance in 1907 and itself issued additional notes in 1914. Some scholars have also argued that banks were insolvent during the Depression but avoided runs because of an expected backstop by the government.)

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From its beginning, Canada's banking system was structured to be less vulnerable to shocks and thus did not give rise to the need for a central bank to achieve stability. By contrast, the Fed was created to offset vulnerabilities in the American banking system.

Political Roots of Instability

The Fed's founders didn't address branching restrictions, however, even with full understanding that small, vulnerable banks were part of the core problem. In 1910, the financial scholar O.M.W. Sprague of Harvard University, studying on behalf of the congressionally established National Monetary Commission, concluded that unit banking was "a deep-seated cause of weakness in the financial system" and the single most important difference between banking in the United States and other countries, almost all of which allowed branching. But if unit banking was known to be such a problem, why was it allowed to persist?

According to the recent study by Calomiris and Haber, set out in their 2014 book *Fragile By Design*, united factions with an interest in keeping banks small succeeded in shooting down attempts at branching liberalization until the 1980s. They argued that the unique structure of the U.S. political system allows popular interests to sway policy more than in other countries. The U.S. Constitution gave all functions not explicitly handed to the federal government, such as regulatory policy, to the states. Interests needed only to win legislative fights at the local level, which was a far easier task than in today's relatively more federalized system, Calomiris and Haber contended. Thus, they argued that the origins of a country's financial stability — or lack thereof — are mainly political.

Small farmers opposed branching because it would allow banks to take credit elsewhere after a bad harvest. Small banks wanted protection from competition. And many others opposed any signs of growing power concentrated in any one institution — or bank. "Even in recent years, there was a feeling that local community banks were doing something really good and should be protected or encouraged in some way," Rockoff says.

As the financial system evolved, branching was defeated at every turn. The first attempts at creating a central bank — in 1791 and 1816 — temporarily established a dual system of both state- and nationally chartered banks. But fears about the concentration of power, including opposition to branching, led to the charters of both central banks not being renewed. After 1830, several states experimented with "free

banking," which allowed individuals to establish banks anywhere, but free banks were still prohibited from branching. National banks were created to fund the Civil War by issuing notes backed by government bonds but were forced to honor state branching limitations. The political infeasibility of branching meant the Fed's founders, despite Sprague's conclusions, barely even discussed it as a realistic option.

North of the border, the balance of power was different. "In Canada those same groups existed, and they tried the exact same things as in the U.S., but they didn't succeed," Calomiris says.

The architects of Canada's Constitution had precisely the opposite objective from those of the U.S. Constitution: After the French population in Quebec staged a revolution in 1837-1838, "the British realized they had to build a set of institutions to make it hard for the people who hated their guts to create disruptions," Calomiris says. Canadians weren't as fearful of the concentration of power; their independence came in 1867 through legislation, not revolution. The first Canadian banks were established by Scots, who mimicked Scotland's branched system. In addition, Canada's export-based economy was better served by a national system that could help products move not from city to city, but from country to country.

The Canadian constitution gave the regions equal weight in the upper house of the legislature, much like the U.S. Senate, to dilute the French influence in Quebec. Population determines representation in the lower house, much like the U.S. House of Representatives, creating incentives for centrist parties that cater to the median voter. Laws passed by the lower house can be overruled by the Senate, whose seats are filled by appointment of a governor general of Her Majesty the Queen and held until age 75.

Many times, the Canadian government defeated populist measures that would have changed the banking system. One law passed in 1850 tried to replicate U.S. free banking, including the requirement that notes be backed by government bonds to encourage government bond purchases. But the legislature refused to end branching, and the free banks simply weren't viable in comparison. Few free bank charters were ever issued. In response to the episode, provisions were included in the 1867 constitution to ensure that banking policy was made at the national level.

Domino Effects

Not only did branching restrictions persist in this country, but new laws served to protect small banks. Many such laws were enacted after the Depression, when a third of the nation's banks, most of them small, failed. Federal deposit insurance, created in 1933, originally applied only to small banks. It was added to the Glass-Steagall Act of 1933 at the last minute to gain support from Henry Steagall, the powerful representative from agrarian Alabama. The Act was the culmination of no fewer than 150 attempts over the previous 50 years at passing a federal deposit insurance system for small banks, Calomiris and Haber argue. Other bank restrictions in Glass-Steagall — like Regulation Q's ceilings on the interest rates that banks could pay depositors, and rules prohibiting banks from securities dealing — were intended to prevent excess speculation but also served to keep banks small.

That had a side effect: The shadow banking system took off. "Regulations limited the amount of credit that the commercial banking system could extend to industry, so instead it was provided through other financial markets — the stock and bond markets, investment banks, and others," Rockoff says. With shadow banking came a disparate set of nonbank regulators, such as the Securities and Exchange Commission and others, helping to explain the relatively fragmented regulatory system we have today.

Canada also suffered during the Great Depression when its money supply plummeted. "The political situation was as dire in Canada as it was in the United States; the government has to do something in the depths of a depression," Redish says. The prime minister launched the Royal Commission on Banking and Currency to consider a central bank. Some scholars, including Redish and Bordo, have argued that there was no economic necessity for a central bank. Instead, it was seen as something that could be done in the national interest — meeting the political demand for reform — that wouldn't do much harm. The Bank of Canada opened its doors in 1935.

Though deposit insurance finally stemmed bank runs in the United States, it wasn't instated in Canada until 1967. But overall, says Redish, "there was very little regulation of the Canadian banking system until 1987. There were two bank failures in the early 1980s that kind of woke everybody up; they were the first bank failures in 60 years." By comparison, the United States had 79 bank failures in the 1970s alone. The precursor to OSFI, Canada's current regulator, had just seven bank examiners in 1980, compared with thousands of examiners here. When OSFI was established in 1987, it encompassed most financial activity, including off balance sheet activities.

When the economy changed in the decades preceding the 2007-2008 financial crisis, the financial systems of Canada and the United States were structured to respond differently. This was especially true during the inflationary 1970s. With interest rates on deposits capped here, investors sought protection from inflation elsewhere, such as money market mutual funds that allowed check writing and other deposit-like features. Deregulation moved additional funds out of the banking system.

In Canada, the reverse happened; after walls between securities brokerage and banking were removed in 1987, banks absorbed securities brokerages, mortgage lending, and other activities that occur outside of the banking sector in America. According to a June 2013 study by Bank of Canada economists Toni Gravelle, Timothy Grieder, and Stéphane Lavoie, shadow banking activities are about 40 percent the size of Canada's economy, compared with 95 percent in the United States. Not only is a significant

portion of that activity in Canada undertaken by banks, 60 percent is regulated and explicitly guaranteed by the government, for example, through insurance or access to a lender of last resort. Canada's bank regulations and charters — all of them — are revised every five years, an attempt to help regulation adapt to innovation and emerging risks.

Nowhere did Canada's structural and regulatory differences manifest themselves more clearly than in mortgage finance. Canadian banks tend to hold on to mortgages rather than selling them to investors. Fewer than a third of Canadian mortgages were securitized before the financial crisis, compared to almost two-thirds of mortgages in the United States. Some have argued that this, combined with tight regulatory standards, gives Canadian banks stronger incentive to make those mortgages safe. Fewer than 3 percent of Canadian mortgages were classified as subprime before the crisis, compared with 15 percent here. In Canada, banks can't offer loans with less than 5 percent down, and the mortgage must be insured if the borrower puts less than 20 percent down. Mortgage insurance is available, moreover, only if the household's total debt service is less than 40 percent of gross household income. Not only did Canada have a much smaller housing boom than us, but its mortgage delinquencies barely rose above the historical average of less than 1 percent. At the peak, 11 percent of American mortgages were more than 30 days overdue.

The lesson is not that shadow banking is bad, Rockoff says, nor that regulations and a lender of last resort are a panacea. It's that if you have two parallel banking systems within a country, and one is regulated but the other has only vague constraints, it's clear where the risks will gravitate. At the same time, it's hard to use regulation to bring risk into the fold. "I think next time around we'd just find problems somewhere else," Rockoff says. The better solution, he says, is to align private incentives against excessive risk-taking. For much of Canada's history, that has occurred naturally because banks monitored each other in exchange for the implied promise of mutual support in crises. Overall, monitoring has been made more feasible by the fact that its system includes only a small number of players.

Branching was finally made inevitable after the 1980s by globalization and technological innovation, which made the geographic boundaries of banks less relevant. The final U.S. restrictions were repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994. But by then, our fragmented system was already in place.

Working With the System We Have

It can be tempting to look at the outward characteristics of another country's stable financial system and conclude that its regulations or structure will produce the same stability here. But doing so may not address the fundamental sources of instability and could create new problems. "It's very hard to imitate success once you realize that success is based on political institutions with deep historical roots," Calomiris says.

Moreover, there may be ways in which our financial system outperforms Canada's. Critics claim that Canada's tightly regulated system is slower to innovate and fund entrepreneurs. And because there are only a few large banks, the failure of one could be difficult for the financial system to weather.

As for the way policy is made here, there are important cultural reasons for it. "If you went to Americans right now and said, 'We can fix our problem; let's just change the 17th Amendment so we no longer have a popularly elected government,' I don't think you'd find many takers," Calomiris says. He is quick to point out that a less representative government does not produce greater stability; he and Haber overwhelmingly found that democracies outperform autocracies in financial stability. Instead, they emphasize that stability tends to prevail in democracies in which policy is made with an eye toward overall stability rather than popular interests.

Democracies do tend to take constructive steps when financial problems affect the median voter. That happened when President Carter nominated Paul Volcker to the Fed chairmanship in 1979 to end rampant inflation. But households could understand inflation and felt directly that it harmed them. The challenge today is that banking is nuanced; on that topic, it is harder to create an informed electorate.

There have been many proposed explanations for why our financial system proved much less resilient than Canada's in 2007 and 2008, from insufficient regulation, to lax mortgage lending, to our history of government rescues. The longer lens of history shows, however, that any one explanation for financial instability — and therefore any one regulatory attempt to fix it — may be too simple.

Even if unit banking is a relic of the past, it is still with us through its effects on the evolution of the U.S. financial system — just as reforms today will determine the shape and stability of the financial system of the future. **EF**

Readings

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