

# CANADA IN TWO WORLD FINANCIAL CRISES: WHY NO CANADIAN BANKS FAILED OR WERE BAILED OUT IN THE 1930S OR 2000S

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**Abstract:** Both during the debt-deflation of the early 1930s and the global financial crisis that began in August 2007, the Canadian financial system behaved very differently from its US and European counterparts: no Canadian banks or other major financial institutions collapsed, even when Canada's nonbank asset-based commercial paper (ABCP) market suddenly became illiquid. The paper examines the structure and conduct of the Canadian banking system in these two crises, and especially the distinctive Canadian regulatory environment, with emphasis on the debates leading to the creation of the Bank of Canada in the 1930s and to the rejection in the 1990s of demands by the major Canadian banks for permission to merge, to increase their leverage, and to move beyond their traditional banking into new financial businesses, so that they could compete globally with the likes of Citigroup and UBS. It is argued that the Canadian banks owe their current global reputation for prudence and wisdom, and Canada owes its escape (so far) from systematic fragility of its financial sector, less to a risk-averse corporate culture than to the good fortune of losing a political battle for the right to behave as recklessly as the foreign rivals they admired, and that (although there certainly were critics of the proposed systemic risk) the decisive factor in that defeat was the fortuitous concern of politicians that bank mergers would lead to job losses from closing of bank branches and to increased market power of banks in setting service charges (although Canada's bankers and its policy-makers now retrospectively claim greater foresight).

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## INTRODUCTION: THE COUNTRY THAT GOT IT RIGHT?

Canada's banking system has received much international praise during the current financial crisis, which has been echoed in the fulsome self-congratulation of Canada's bankers and policy-makers. Hailing Canada as "A More Prudent Society," Sherry Cooper (2009), executive vice-president and chief economist of BMO Capital Markets, celebrated the fact that "It has now been publicized around the world just how strong our banking system is in Canada," notwithstanding an accompanying chart showing that the Bank of Montreal (BMO) had been North America's tenth-largest bank by capitalization in 2006 but only twelfth-largest in February 2009 and just a few months before a headline, "Downgrading possible, Moody's warns BMO" (Greenwood 2009a). In *Newsweek*, Fareed Zakaria reported that "Canadian banks are typically leveraged at 18 to 1 – compared with U.S. banks at 26 to 1 and European banks at 61 to 1. Partly this reflects Canada's more risk-averse culture, but it is also a product of old-fashioned rules on banking" (Zakaria 2009, quoted by Cooper 2009). The vice-president of economics at Scotia Capital (part of the Bank of Nova Scotia) declares that "U.S. banking's problem is fractured regional system of smaller banks. It needs big Canada-style institutions" (Holt 2009). Harvard financial historian Niall Ferguson argues that "It was the Basel system of weighting assets by their supposed riskiness that essentially allowed the Enronization of banks' balance sheets, so that (for example) the ratio of Citigroup's tangible on- and off-balance-sheet assets to its common equity reached a staggering 56 to 1 last year. The good health of Canada's banks is due to *better* regulation. Simply by capping leverage at 20 to 1, the Office of the Superintendent of Financial Institutions spared Canada the need for bank bailouts" (Ferguson 2009, p. 20, emphasis in original). Amid the collapse of Lehman Brothers, Washington Mutual, and Bear Stearns, the bailouts or imposed take-overs to Merrill Lynch, Royal Bank of Scotland, HBOS, AIG, Fannie Mae, Freddie Mac, Fortis Bank, Citigroup, and UBS, the Icelandic and Irish banking crises, the unravelling of Madoff's Ponzi scheme, and Dubai World's halt on debt payments, no Canadian financial institution has failed or been openly bailed out -- except that Canada's nonbank asset-based commercial paper (ABCP) market abruptly became illiquid, just as the market for auction-rate notes had done in the United States. Similarly, in the early 1930s, when thousands of U.S. banks failed in the years leading to the "Bank Holiday" of March 1933 (after which another four thousand banks never reopened), and when Germany and Italy experienced banking crises following the Kreditanstalt collapse in Austria, all eleven Canadian chartered banks survived, apparently without being bailed out by the government.

"Boring" banking is now fashionable (see Krugman 2009 on "Making Banking Dull"), so that for once national stereotypes work in Canada's favour. So a headline on an article summarizing the views of Finance Minister Jim Flaherty declares, "Our 'boring' rules just fine, Flaherty says: No bailouts needed – Most Canadian banks reporting healthy profits" (Greenwood 2009c). "Financial Services: Slow and steady wins the race" (*Financial Post* 2009) announces the headline of an article about how the Royal Bank of Canada, although its capitalization has declined, has surpassed the capitalization of nine non-Canadian banks whose capitalization has declined even more severely. The opposition Liberal Party has not wished to let Flaherty and the governing Conservatives, or the bankers, hog the credit, emphasizing that former Finance Minister Paul Martin and Prime Minister Jean Chretien refused bank proposals to merge and become more adventurous, expanding into investment banking and insurance. The scramble to allocate kudos has not been universal: in a newspaper very much not noted for hostility to Conservatives or banks, Eric Lam (2009) remarks, in an article entitled "CIBC named world's 15<sup>th</sup>-worst bank," that

“Contrary to Mr. Flaherty’s rhetoric, no Canadian bank made it into the top 30 of *The Banker* magazine’s annual list of 1,000 banks, sorted by capital strength, released on Tuesday.”

Were Canadian bankers really wiser and more prudent than their counterparts elsewhere in the twenty years from the Bank Act revision of 1987 to the credit crunch of 2007? Did Canada’s political leaders block bank mergers because of a deep sensitivity systemic risk and fundamental uncertainty? Did Canada decide in 1933 to establish a central bank because the existing system was working so well? The Office of the Superintendent of Financial Institutions (OSFI) did display prudence in continuing to limit the leverage ratio of chartered banks, but did not regulate, or try to regulate, the near-banks central to the ABCP collapse – and has been more concerned to emphasize its lack of responsibility for the actions of such financial institutions than to draw lessons about the need to control them in the future (see Greenwood’s 2009b interview with the head of OSFI, Julie Dickson, and see also Le Pan 2009 by her predecessor as head of OSFI). Apart from the limit on the leveraging of chartered banks, however, much of the vaunted wisdom came only after the fact.

## **HOW CANADIAN BANKS SURVIVED THE GREAT DEPRESSION**

No Canadian bank failed in the 1930s (or indeed at any time between 1923 and 1985<sup>1</sup>), even though the central bank, the Bank of Canada, did not begin operation until 1935. Until the Bank of Canada became the lender of last resort, chartered banks could borrow reserves directly from the federal Department of Finance, subject to approval of the advances by the Treasury Board, chaired by the Minister of Finance (Bryce 1986, Watts 1993, C. A. Curtis in Neufeld 1964). As Canada’s bankers and economic policy-makers proudly recall, no Canadian bank was directly bailed out by the Government of Canada during the Great Depression of the 1930s, let alone the banking system as a whole. But the key word in that sentence is “directly.” The Dominion of Newfoundland, a self-governing British dominion since 1855, found itself with a public debt of \$85 million in 1929 (having had a budget deficit in every one of the boom years of the 1920s) and \$100 million in 1932 – three times its GDP, a financial debacle which led in 1933 to the abandonment of dominion status and resumption of direct British rule as a Crown Colony. Most of Newfoundland’s public debt was owed to a syndicate of Canadian banks (described by the subsequent British commission of inquiry as “a continuous stream of willing lenders”) – banks which were spared default on those loans when the Government of Canada assumed Newfoundland’s debt charges (Plumptre, Fraser and Innis 1937, Reinhart and Rogoff 2009, Reynolds 2009). The federal government assumed nine-tenths of Newfoundland’s debt when Newfoundland joined Confederation in 1949 as the tenth province. Canada’s banks dodged another bullet in the 1930s when the federal government stepped in to prevent default of the provincial debts of Saskatchewan and Manitoba in 1937 (Bryce 1986), following the April 1, 1936 default by Alberta’s Social Credit government (Ascah 1999). Member banks of the Canadian Bankers Association had owned \$38 million of Alberta, Saskatchewan,

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<sup>1</sup> The Home Bank foundered in 1923 as part of the tangled affairs of Sir Henry Pellatt, builder of Toronto’s palatial folly Casa Loma, and six decades later, unwise insider loans brought down two small banks in western Canada (Canadian Commercial Bank in Edmonton and Northland Bank in Calgary) and, from 1982 to 1985, twelve trust companies. MacIntosh (1991, p. 225) reports that among “the greedy institutions looking for an extra one-eighth percent on their thirty-day deposits, regardless of risk” by lending to these small, shaky institutions beyond the limits on deposit insurance was the City of St. Catharines.

and Manitoba provincial and municipal bonds in 1931 (MacIntosh 1991, p. 83). The Government of Canada did not bail out any banks in the 1930s. Instead, it bailed out the provincial governments and neighbouring dominion whose default could have brought down Canada's banks. Having a few large banks with nation-wide networks of branches, rather than thousands of local banks, many of them small, contributed to the stability of Canadian banks in the 1930s, but so did intervention by the Government of Canada to prevent default on the public debts of Newfoundland, Manitoba, and Saskatchewan.

Before the creation of the Bank of Canada, chartered banks could borrow Dominion bank notes from the Department of Finance under the Finance Act of 1914, but the banks did so in a pro-cyclical manner, without a central bank guiding such lending in the interests of economic policy. Borrowing by chartered banks under the Finance Act rose from \$12 million in January 1927 to \$113 million in December 1929 (almost the maximum allowed by the Dominion Notes Act), as banks made call loans to investment and bond dealers in the New York money market, but after the 1929 stock market crash the banks rushed to repay their debts to the government, contracting their loan portfolios and deposit base as they reduced their borrowed reserves, until in 1932, acting on the suggestion of Graham Towers of the Royal Bank, Conservative Prime Minister R. B. Bennett forced the banks to increase their cash reserves by borrowing \$35 million in notes<sup>2</sup> (Watts 1993, pp. 5-6, MacIntosh 1991, p. 70, Babad and Mulroney 1995, pp. 7-8). Towers, assistant general manager of the Royal Bank of Canada in the early 1930s before becoming the first Governor of the Bank of Canada, later described the post-1929 Canadian monetary contraction as “a catastrophic experience, really, and a very sad and unnecessary one” (Fullerton 1986, p. 37). The creation of the Bank of Canada emerged from a widely-held perception that, even though no Canadian banks collapsed in the early 1930s, the existing Canadian banking system was unsatisfactory (“catastrophic” according to Towers) in that it provided a strongly pro-cyclical money supply with no mechanism for using monetary policy for economic stabilization (Innis and Plumptre 1934, Plumptre 1940, Watts 1993, Grayson 1974). A Royal Commission chaired by the Scottish jurist Lord Macmillan (recently chair of Britain's Committee on Finance and Industry, of which J. M. Keynes was a leading member) recommended the creation of a central bank – as it had clearly been intended to do. A leading role in the campaign for a central bank and a policy of monetary management for macroeconomic stability was taken by Wynne Plumptre of the University of Toronto, as Assistant Secretary of the Macmillan Commission, as a scholarly authority on central banking (e.g. Plumptre 1940), and as organizer in 1933-34 of roundtable discussions among academics, bankers, businessmen, and policy makers (Innis and Plumptre 1934). As a student at Cambridge, Plumptre had attended Keynes's lectures, Political Economy Club, and tutorials in the late 1920s, returning to Canada with page proofs of Keynes's then-forthcoming *Treatise on Money* (see Plumptre 1947).

## **DID CANADIAN BANKERS WISELY REFUSE TO IMITATE CITIGROUP AND RBS?**

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<sup>2</sup> The chartered banks were obliged to borrow in proportion to their capital. They had to buy \$35 million of two-year Treasury notes yielding 4 per cent interest, and pledge those notes as collateral to borrow an equal amount of Dominion notes at 3 per cent interest (reduced from the previous rate of 4.5 per cent), not to be repaid until the Treasury notes matured – but instead of using all the borrowed notes to increase the reserve base for their lending, the banks used some of it to repay earlier borrowing at 4.5 per cent (Bryce 1986, pp. 131-132, Babad and Mulroney 1995, pp. 7-8).

In 1987, as soon as the decennial revision of the Bank Act legalized it, five of the six largest Canadian chartered banks bought investment dealers for two or three times book value, in what even the president of the Canadian Bankers' Association called a "rush to pay premium prices for discount merchandise" (MacIntosh 1991, p. 278). The chartered banks also wished to move into insurance, which would have allowed them to offer as wide a range of financial services as Citigroup, which emerged from the merger of Citibank, Travellers Insurance, and the Salomon Smith Barney investment bank, and which experienced much-admired growth (see, e.g., Reguly 2004) as it nearly destroyed itself. As well as wishing to move beyond traditional banking, in 1996-98 mergers were proposed that would have reduced Canada's five largest chartered banks to three banks (Royal Bank of Canada to merge with Bank of Montreal, Canadian Imperial Bank of Commerce to merge with Toronto-Dominion Bank). Despite making record profits, the banks argued that only by merging would they be large enough to compete globally with the likes of Citigroup, Royal Bank of Scotland, and UBS (formerly Union Bank of Switzerland). One might have thought that mere size did not guarantee success for banks: at the end of the 1980s, nine of the world's ten largest banks were Japanese, yet in the decade the Japanese banking system struggled with a trillion dollars of non-performing loans. But mergers, take-overs, and expansion beyond traditional banking would have given top Canadian bank executives the flattering attention and enhanced stock options of their international peers. But the banks were not allowed to do what they wanted. According to Eric Reguly (2004, p. 19), "Six years ago, they tried to merge to give themselves the bulk to make big acquisitions. The Liberal government killed the idea, and the banks had to pursue a slow-burn expansion policy outside of Canada, with decidedly mixed results. They still have dreams of merging, and the Liberals have dreams of stopping them again." Reguly pointed to the enviable market value of Citigroup, "the leader in both categories [largest bank and largest financial institution] by a long shot." Because of the parallel names, the slower growth of the assets of the Royal Bank of Canada was often contrasted with the enormous, rapid expansion of the Royal Bank of Scotland. More recently, after the Royal Bank of Scotland lost US\$59.8 billion in 2008 and Citigroup lost US\$53.1 billion that year (Lam 2009), the slower growth of the Royal Bank of Canada compared to the Royal Bank of Scotland is no longer lamented (the title of Reguly 2004 was "Might have been giants"), but instead celebrated as evidence of prudence and foresight (notably by *The Economist*, which used a graph of the asset growth of RBC and RBS to illustrate its view that Canada was "the country that got it right").

## **DID THE GOVERNMENT BLOCK THE BANK MERGERS TO AVOID SYSTEMIC RISK?**

If Canada's chartered banks owe their reputation for wisdom and restraint to government veto of their merger plans and to the leverage limit maintained by OSFI, do policy-makers deserve the credit for a Minskyian grasp of the risk to which such mergers would expose a fragile financial system? Post Keynesian economists, informed by reading Minsky, raised the issue of systemic risk, but that was not one of the main concerns of the political decision-makers and the most influential critics of the bank merger proposals. Look at Walter Stewart's *The Bank Heist: How Our Financial Giants are Costing You Money* (1997) or John Crispo's 1998 *Globe and Mail* articles (reprinted in Crispo with Raycheba 2002, pp. 314-320). The two main objections to the bank mergers were that, to increase the value of the stock options and bonuses of senior executives, the merged banks would close duplicate branches and lay off workers, and have increase market power to raise service charges. Worries about systemic stability came a poor third, getting a paragraph from Crispo as an afterthought, and somewhat more attention from

Stewart, in his eighth chapter. This weighting of the different objections to the bank mergers reflects the political pressures on Finance Minister Martin and Prime Minister Chretien in 1998.

Canada's bankers owe their recent global reputation for wisely being "boring" and prudently risk-averse to a government that did not let them do what they wanted to do, which was to imitate the rapid expansion of Citigroup, RBS and UBS. The policy-makers owe their reputation as the national government that got it right to widespread fear among voters that merged banks would close branches, lay off tellers, and raise service charges. Without question, OSFI's maintenance of a limit on the leverage ratio of chartered banks was valuable and important (and would have been even more so if extended to the near-banks issuing ABCP), just as a system consisting of a small number of large, nation-wide banks held Canada's banks weather the earlier credit crunch of the 1930s. But Canada also owes much to public alarm about the danger of bank tellers losing their jobs and of banks hiking ATM fees, just as Canada's banks owed much in the 1930s to federal intervention to prevent default by some major debtors.

## **CONCLUSION: A LUCKY COUNTRY?**

The recently-acclaimed success of the Canadian banking system in weathering the credit crunch that began in August 2007 (and the debt-deflation of the early 1930s) is due in part to institutional features (Greenwood 2009d), but also in part to luck (and, in the 1930s, to more active government intervention than is generally realized). No Canadian bank failed or was directly bailed out in the 1930s, in part because of the strength of a system of a small number of large, nation-wide banks, but also because the Government of Canada prevented defaults by Newfoundland, Saskatchewan, and Manitoba – and until the creation of the bank of Canada, the system provided dangerously pro-cyclical monetary fluctuations. Canada's banks and the Conservative government of Prime Minister Stephen Harper have celebrated the strength of the country's financial system to the point that an article in a notably pro-business, pro-Conservative newspaper carried the headline "Tory adoption of bank PR even surprises banks" and the subhead "Question depth of understanding of Harper's advisors" (Callan 2008). A tradition of risk-aversion supported the OSFI's maintenance of a 20 to 1 limit on the leverage ratio of banks, but near-banks were beyond the control of the OSFI and the largest banks would have merged to become mini-Citigroups or mini-RBSs if allowed. Canada's banks survived (even though CIBC reported a loss of US\$4.3 billion for 2008, see Lam 2009), thanks in part to a hasty change in accounting rules on how to value bank assets (Perkins 2008), but C\$35 billion of non-bank asset-backed commercial paper (ABCP) became illiquid: "Here in Canada, however, the challenge of marking bad assets to market is that, in the most serious cases, there is no market" (Corcoran 2007b, see also Corcoran 2007a). In retrospect, the Liberal government made the right decision when it blocked the proposed bank mergers in 1998, but they were responding not to heterodox economists worrying about the risk and fragility of a more concentrated banking system (since the mainstream view then held that banking crises happen in developing countries) but to public fears of closed bank branches, unemployment tellers, and higher service fees. Canada's government and banks bask in the plaudits of the world's financial press – but may wish to borrow Australia's nickname, "The Lucky Country."

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