**Financialization and the Transformation of Commercial Banking in Canada**

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Over the last few years the international financial system has undergone a dramatic reconfiguration. In the pre-2007 brave new world, money manager capitalism reigned supreme and, almost as in the caricature of Mickey Mouse in *Fantasia*, the so-called masters of the universe seemed to be engaged in financial wizardry. In the post-2007 world, finance has become feeble and heavily dependent on the handouts offered by national governments for its survival, as seen in the 2008 bailouts of numerous financial institutions, most notably in the United States and Europe. Indeed, while the financial community previously demanded a minimalist State whose primary objective was the removal of regulations so as to ensure unfettered financial markets and governments were called upon to target budget surpluses, the financial sector has now come to rely on large infusions of public funds to keep it afloat and prevent national economies from falling into a 1930s-style abyss. This profound transformation has been both swift and dramatic, triggered by a remarkable implosion of asset values that only keen observers from outside of mainstream circles had been predicting for many years, such as Wynne Godley (1999), on the basis of the growing sectoral financial imbalances since the 1990s. For economists trained in neoclassical equilibrium analysis, the existence, the duration and the severity of the crisis have been difficult to comprehend. There are others instead, primarily heterodox economists, espousing the ideas of such less well known but still highly-influential Post-Keynesian/Institutionalist economists, such as Hyman P. Minsky, who were often touted by many in the profession for doing "sociology" because of the emphasis on institutional analysis, have seen their views achieve ever increasing popularity in media circles.

In this article we shall be pointing primarily to those institutional details that featured so prominently in the writings of these heterodox economists. In order to understand how this hyper-financial capitalism could collapse so spectacularly under the weight of its own contradictions, one must first understand the institutional transformations that preceded it and which eventually rendered the system so financially fragile, with the potential to paralyze finance and contaminate the whole fabric of the international economy. The purpose of this article is to highlight some of the important transformations in the role played by the banking sector in the economy and to explain why Canadian banking institutions, while having undergone a similar makeover, have fared somewhat better than, say, their U.S. counterparts during the recent financial crisis.

## The Metamorphosis of the Banking Sector: From Industrial Capitalism to Hyper-Financial Capitalism

### (i) The Pre-Financialization Era

Since the emergence of commercial banking in Canada in the early nineteenth century, banking institutions were authorized by the colonial authorities and were given a "charter" to meet certain important social obligations in compensation for being allowed to make a profit from their banking operations with clear public externalities (Hammond

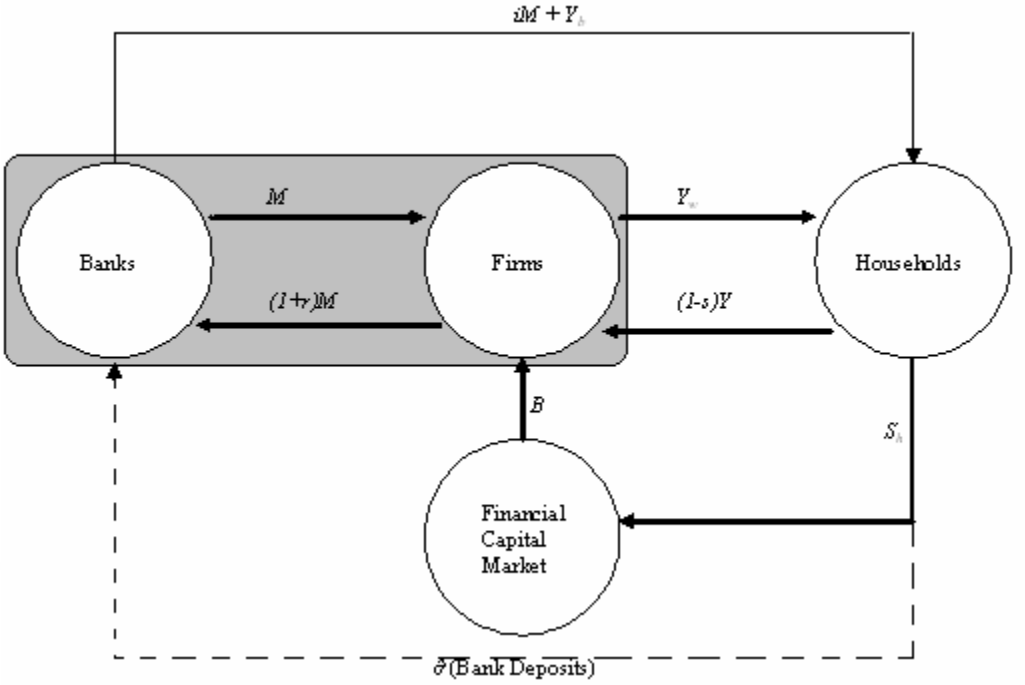
1967). Given the growing needs for a viable circulating medium as commercial activities flourished, especially after the post-Napoleonic era, commercial banks were licensed under the charter to provide for a payment system by issuing their own private bank notes, on the basis of sufficient paid-up capital (Paquet and Wallot 2007: 239-40). They were also permitted to issue loans to creditworthy borrowers whose liability side came to constitute itself a critical part of the country's payments system. Because of the frequency of bank failures during the first half of the nineteenth century, numerous federal Bank Acts, starting in 1871, raised what nowadays we would commonly describe as their capital adequacy requirements. By the early twentieth century, the effect of these measures was to make the Canadian banking system more highly concentrated, but also more stable, than its U.S. counterpart. This is why by the 1930s, while U.S. banks had faced insolvency on a large scale, this was not a characteristic feature of the Canadian banking system, with banks being bailed out by the federal government (Dimand and Koehn, 2009).

Since their inception, however, banks could earn revenues in meeting their social obligation from direct service charges and/or from the interest spread pertaining to their lending and deposit-taking activities. Given the private/public purpose of chartered banks and the tremendous externalities arising from their key activity as creators of credit-money, these institutions were always heavily regulated by the public authorities, especially in preventing banks from engaging in "derivative" activities (deemed outside of their charter) which could endanger the viability of the complete credit and payments system.

This need for a properly regulated, yet highly accommodating, banking system has always been greatly acknowledged historically as being critical to the viability of a dynamic industrial capitalism by such towering economists as Joseph Schumpeter (1934) and John Maynard Keynes (1936). For instance, in his *Theory of Economic Development*, Schumpeter emphasized the crucial link between business enterprise and commercial banks as purveyors of credit in promoting entrepreneurial activity and sustaining the overall growth process. Perhaps even more forcefully, in Chapter 12 of the *General Theory*, Keynes recognized the need for finance to be at the service of industry (or productive "enterprise") and noted that an important feature of the 1930s crisis was the breakdown of this relationship as the system had come to be dominated by unfettered rentier speculative activity (Seccareccia and Lavoie, 1989).

Partly as a result of these concerns and partly as a result of the international policy drift in favour of greater regulation that had been put in place as a result of the experience of the Great Depression, a key feature of a growth-oriented productive system (as during the early postwar "golden age" of industrial capitalism) was the centrality of bank financing of production, reflecting industry/finance complementarities. This crucial link between industry and finance is well highlighted in the traditional depiction of banks as creators of money in the financing of productive activity. This is perhaps best captured in the usual canonical model of the monetary circuit — with the fundamental relation between banks and business enterprises being at the centre stage (see, for instance, Graziani 1990, Bellofiore and Seccareccia 1999, and Parguez and Seccareccia 2000). This relation is well described in Figure 1 below.

**Figure 1: Traditional Role of Banks in the Pre-Financialization Era**




As the above diagram illustrates, of the three major sectors (that is, the banking, the business, and the household sectors), it was the shaded firms/banks axis which was critical to the process of monetary circulation and was the engine of growth. The banking sector would finance the short-term needs of trade. In particular, banks were assumed to advance funds to the consolidated business sector ($M$) for the purpose of, say, obtaining labour services from households, with the latter receiving $Y_w$ in the form of wage income. Banks also paid income $Y_b$ to their own bank workers as well as interest $iM$ on deposits $M$ (the counterpart of the loans) in the banking system. Households, on the other hand, allocate their total income, $Y$ (the sum of wage income $Y_w + Y_b$ as well as rentier income $iM$ which, for simplicity, we abstract from the return on their holding of financial assets other than their deposits) either for saving $S_h$ or consumption $(1 – s)Y$ (with $s$ being the average propensity to save). With the household sector being a net lender and firms being net borrowers, the strategy of the business sector was ultimately to acquire as much revenues as possible from the consumption expenditures of households and to capture the remaining portion of their initial spending in the form of household saving, $S_h$, via the financial capital market by issuing securities ($B$) purchased by households so as to finance business long-term investment. In sum, the object of firms would be to reimburse the principal of their loans plus interest $(1 + r)M$, by capturing sufficient funds from household consumption directly as well as siphon indirectly to them household saving through the financial markets by the selling of securities. In this context, financial markets played a passive role in channeling household saving towards the long-term financing of business enterprises. As long as the overall reflux $(1 + r)M$ equaled the efflux represented by $(1 + iM) + Y_b$, that is equivalent to $(1-s(Y_w + Y_b + iM)) + S_h$, the monetary circuit would come to a closure. It is only when household liquidity preference

($\theta$) (the leakage from the circuit, as shown by the broken line in the above diagram) became significant, that the non-financial business sector would have difficulty in meeting its financial obligations.

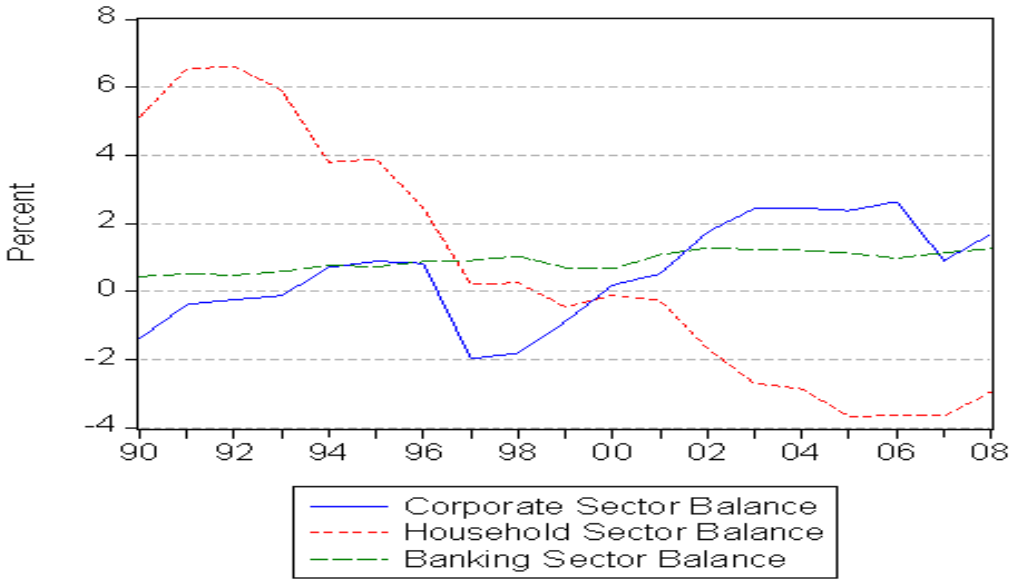
Given the institutional arrangements that regulated and prevented speculative excesses, bank profits depended directly on the growth of the productive sphere — that is to say, bank revenues were associated with the expansion of loans for production and were earned primarily from their net interest income, i.e. their net revenues from their interest spreads *(r-i)M* (the difference between the lending and deposit rates multiplied approximately by the overall loans outstanding (less loan defaults) (Seccareccia 2005a). Problems of commercial bank viability (and bank failures) could potentially arise because of sharp movements in household liquidity preference (as Keynes had hypothesized in his *General Theory* during the 1930s). However, as long as the central bank would intervene as a lender of last resort, fluctuations in household liquidity preference ($\theta$) would not sufficiently short-circuit the banking system; and, in any case, while the magnitude of $\theta$ could be significant, the proportion of it being held in its most liquid form (currency) would normally be insignificant as a result of the existence of household deposit insurance. Consequently, difficulties of the closure of the monetary circuit would not easily threaten the banking system and lead to a systemic crisis, since problems of the type that were bringing down the banking sector in numerous countries during the 1930s (because of, say, bank runs or shortages of liquidity within the banking system) could not easily arise within the institutional structure of the postwar (pre-1980) era.

**(ii) The Financialization Phase**

This model of commercial banking, as reflected in the traditional theoretical framework of the monetary circuit, has been somewhat stood on its head during the recent phase of what has been dubbed as hyper-financial capitalism. Financialization, as the term has been described by Epstein (2005), Krippner (2005), and Orhangazi (2008), refers to a process in which the financial markets have taken on a central role in bank-based economic systems. In part, this has been fueled by a dramatic change in the industry/household relationship vis-à-vis the banking system. Instead of industry being the net borrower in relation to the banking sector, growing profits and retained earnings associated with a relatively weak business investment have slowly transformed (or "rentierized") the non-financial business sector itself into a net lender that seeks profitable outlets that provide high financial returns for its internal funds. Indeed, in some more exceptional cases, we even have seen major non financial corporations extending progressively their activities into the banking sphere (with such new members of the so-called Schedule I banks, as the Canadian Tire Bank and the President's Choice Bank, which are purely an outgrowth and instrument of the Canadian retail trade).

These major sectoral balances are displayed in Figure 2 below, which show a stable, yet mildly growing, net lending position of the banking sector, a significant increase in the net lending position of the non-financial business sector, and a dramatic fall in the household sector balance, with the latter sector positioning itself as an overall net borrower since the late 1990s. As will be discussed below, this reversal of the net lending/borrowing position of the business and household sectors is of critical importance in understanding the evolution of financial capitalism over the last decade.

**Figure 2: Corporate, Household, and Banking Sector Balances as a Percentage of GDP, Canada 1990-2008**



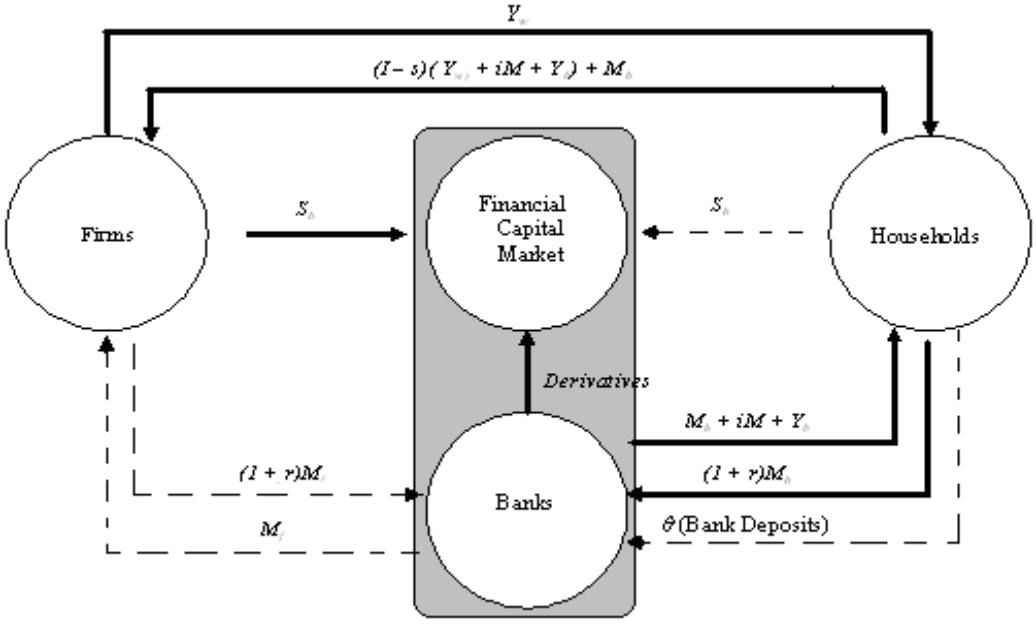

Source: Statistics Canada, Financial Flows Accounts, CANSIM, Series V31751, V31786, V32037, and V498086.

On the supply side, the confluence of deregulation, globalization, and computerization has brought about a significant structural transformation of the delivery of finance, especially over the last two decades. As Guttman (2009: 47) put it so succinctly, the financial system has evolved from one that "was tightly controlled, nationally organized, and centered on commercial banking (taking deposits, making loans) to one that is self-regulated, global in reach, and centered on investment banking (brokerage, dealing, and underwriting of securities)." Banks have become financial conglomerates engaged in lucrative investment banking, by layering their assets and dealing in securities, engaging in cross-border arbitrage, and loosening credit by permitting the household sector to take on an increasing debt load (without a concomitant rise in real personal disposable income) on a scale that has not been seen hitherto. In part, this transformation has been aided by the appearance of large funds (from pension funds to hedge funds). However, the most important factor contributing to this change has been the emergence of the non-financial business sector itself as a major net lender over the last decade, which has shifted the dynamics in favour of greater speculative excesses.

As depicted in Figure 3, we have a complete reversal of the traditional view of banks that are financing business enterprises. In this hyper-financialized system, the dynamics of credit creation has been sustained not by business indebtedness but by household indebtedness, $M_h$. Hence, as shown in the diagram, the traditional link between firms and banks has been largely severed (see the broken lines), and it is the dynamics of the bank/financial markets axis (highlighted in the shaded grey area) which has taken center stage. While the traditional link between firms and households has not changed in terms of generating income and being on the receiving end of household consumption

expenditures, the practical disappearance of household saving and the ever growing household indebtedness has fueled the expansion of speculative derivatives because of the demand arising from the growing savings of the non-financial corporate sector. Hence, owing to the corporate sector's position as net lender, rentier speculative behaviour (that Keynes had so vehemently criticized in the *General Theory*) has slowly prevailed in the financial sector and has probably been the largest impetus in pushing this financialization frenzy into hyper drive over the last decade. It is, therefore, in large part due to the growing proportion of corporate saving that has been directed towards speculative ventures in a way that household and even, say, group pension funds would be less likely to do, because of legal restrictions imposed on portfolio managers regarding the risk structure of their portfolio of pension assets.

**Figure 3: Strategic Role of Banks during the Financialization Era**




It was Minsky (1986: 256) who argued vigorously that banks are *not* passive managers of household savings but are, instead, in the business of making profit by actively seeking creditworthy borrowers, in this case in the household sector (see heavy dark line going from banks to households above). Indeed, Figure 3 shows how commercial banks have played a key role by being the primary providers of the financial raw materials that have gone into feeding, through securitization, the financial markets via the investment banks (in the case of Canada, it is primarily the investment branch of the chartered banks) with new, and ever more sophisticated, speculative derivatives — that are then sold in the financial markets, through hedge funds, etc., to the new corporate rentiers. For instance, in the Canadian context, the chartered banks are the primary issuers of mortgage loans in this new "originate and distribute" model of banking, which are then repackaged and financially redesigned for financial acquisition, while in the U.S. these commercial bank loans are then sold to the investment banks, which would, in turn, sell these securities to the final purchasers both domestically and internationally. In the face of declining returns from traditional lending, investment banks (or the investment arm of

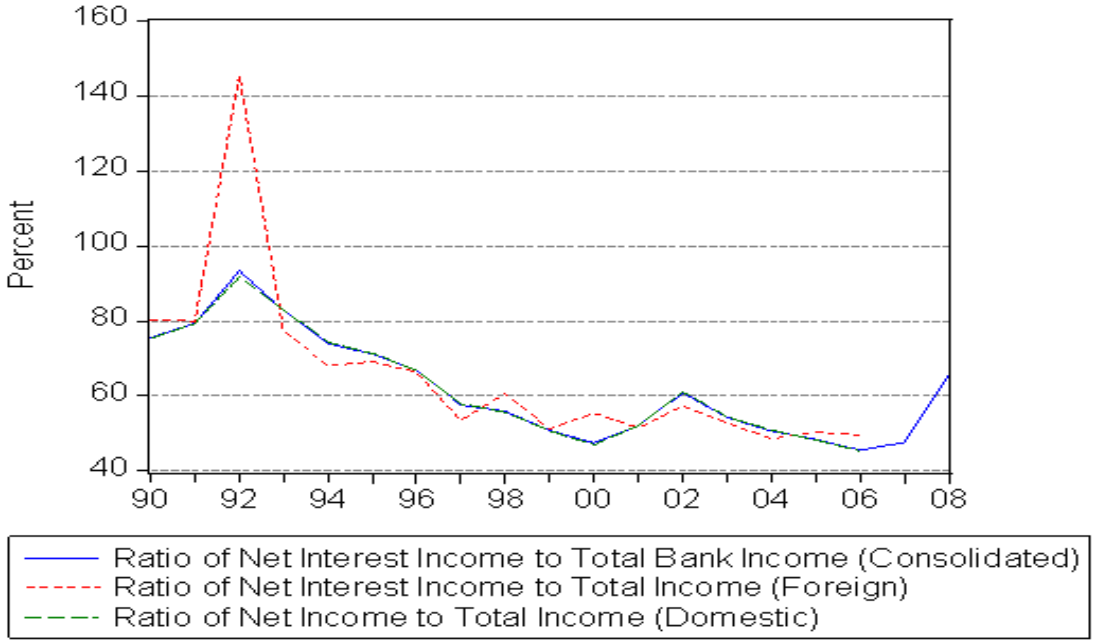
commercial banks) spurred on the lucrative business of securitizing and, through financial innovations, re-securitizing. Hence, investment dealers would pool their collateralized mortgage obligations (CMO) and redesign them. These collateralized debt obligations (CDO) could then be further securitized into $CDO^2$ and even $CDO^3$ and sold in these emerging casino-style financial markets, with some investors choosing to have these derivatives insured via credit default swaps (CDS) by paying periodically a premium to the dealer and, in return, receiving a reward if the underlying financial instrument defaults.

In Canada the insurance arm of the banks would be insuring these securities at each stage of the financial layers, while in the U.S. it would have been the major insurers, such as the American International Group (AIG). Indeed, since many of these functions (commercial banking, investment banking, funds management, and insurance) reside more and more in one single entity, these financial institutions benefited from economies of scale, scope and network, and were thus highly profitable activities until this big financial house of cards began to collapse after August 2007 (Guttmann 2009).

**(iii) The Central Role of Banks**

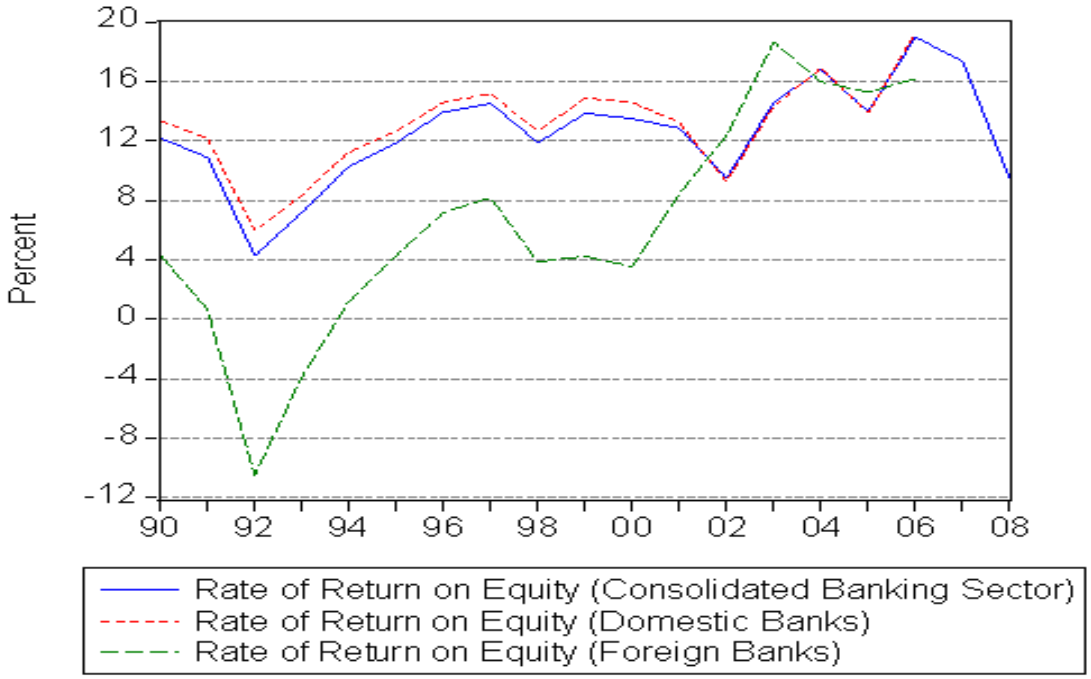
The upshot of all of this is that financial innovations, together with these economies of scale and unlimited securitization, have made banking into what some have described as a giant "transaction generating machine" — a machine that increases turnover of assets while increasing commissions, fees and bonuses via the trading of complex derivatives (Centre for Research on Socio-Cultural Change 2009). Indeed, facilitated by deregulation, computerization and globalization, this process of financialization has brought about a complete transformation in the source of revenues for the banking sector in Canada (see Figure 4). From as much as 90 percent of total revenues being derived in the early 1990s from the traditional interest rate spreads related to their activities in making loans to creditworthy borrowers, by the 2000s this had gone down to less than 50 percent, with more and more of these bank revenues earned from commissions, administrative and user fees, and other forms of compensation unrelated to their traditional role in providing loans to the public. This pattern of revenue was the same for both domestic and foreign-owned banks, with a significant gap appearing in the early 1990s as the latter sought to penetrate the Canadian market and suffered significant initial losses. As shown in Figure 5, this activity has been very lucrative for Canadian banks, with a trend upward movement in the rate of return on equity until its spectacular reversal in 2007 after these banks began to suffer major losses triggered by the U.S. subprime crisis. However, despite the sharp decline in profitability because of the subprime financial crisis, in 2008 the consolidated banking sector was still earning a healthy average rate of return on equity of around 10 percent, well above the dismal returns, say, in the Canadian manufacturing sector.

**Figure 4: Proportion of Net Interest Income to Total Income of Chartered Banks in Canada: Canadian, Foreign-Owned, and Consolidated Banking Sector, 1990-2008**




Source: Bank of Canada, *Banking and Financial Statistics*, Various issues.

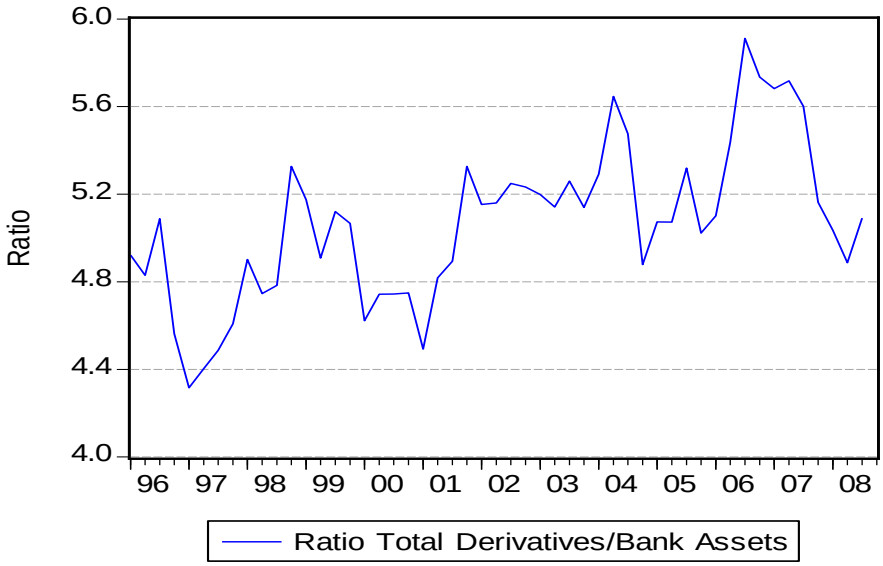
**Figure 5: Rate of Return on Equity of Chartered Banks in Canada: Canadian, Foreign-Owned, and Consolidated Banking Sector, 1990-2008**




Source: Bank of Canada, *Banking and Financial Statistics*, Various issues.

Given the lucrative nature of these non traditional banking activities and the increased competition from U.S. banks, particularly under the Canada-U.S. Free Trade Agreement and then under the NAFTA, Canadian banks did progressively engage in securitization on a significant scale via the creation of off-balance sheet items within the financial system. Financial derivatives of all sorts surfaced in Canada during this era — whether these were over-the-counter (OTC) contracts or exchange-traded contracts. According to estimates from the Office of the Superintendent of Financial Institutions (OSFI), the value of these contracts of derivative items grew more than threefold between 1996 and 2008 within the Canadian banking system. As a proportion of total bank assets (shown in Figure 6), these went from a ratio of about 4.5 in 1996, reaching a peak at a ratio of nearly six at the end of 2006 and early 2007, and then falling precipitously since 2007.

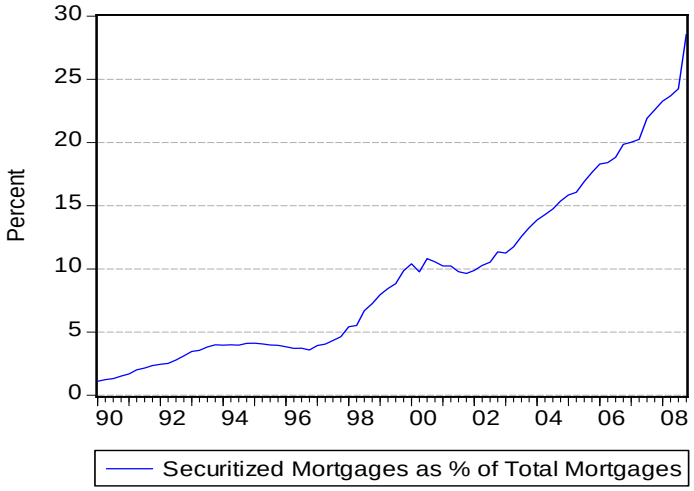
**Figure 6: Value of Total Derivative Contracts as Proportion of Total Bank Assets, 1996-2008 (Quarterly Observations of the Consolidated Banking Sector)**




Source: Office of the Superintendent of Financial Institutions Canada

Not only was it highly profitable for banks and security dealers in general but, both through emulation and competitive pressure, securitization flourished under the new institutional structure of NAFTA in a big way over the last two decades (Correa and Seccareccia 2009). This growth relied heavily on the mortgage market, which surged forward in Canada partly as a result of a general North American economic expansion in the housing market, with strong pockets of growth particularly in the major urban centers and in the energy-producing regions of Western Canada during the late 1990s and then again since 2002. As shown in Figure 7, mortgage assets of issuers of asset-backed securities which have permeated a growing portion of Canada's mortgage sector rose a great deal from practically zero in 1990 to reach a peak of almost 30 percent of total mortgages by 2008. Hence, when the crisis took hold beginning in 2007, Canadian banking institutions were in a somewhat vulnerable position and, therefore, as we shall see, increased their own liquidity preference.

**Figure 7: Mortgage Assets of the Issuers of Asset-Backed Securities as a Percentage of the Economy-Wide Mortgage Loans, Canada 1990-2008 (Quarterly Observations)**




Source: Statistics Canada, CANSIM II, Series V20683513 and V20683968.

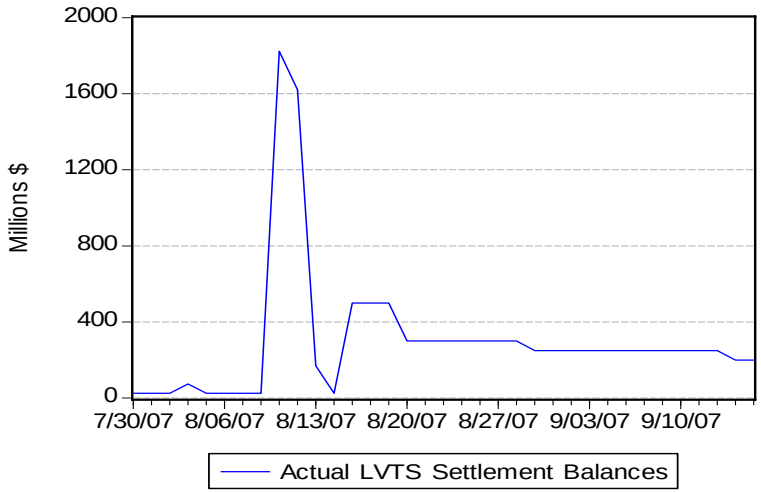
**The Virtual "Run on the Banks" by the Banks and Central Bank Intervention in the Canadian Inter-bank Market for Funds**

We have seen that, over the last two decades, banking has gone from the traditional model of "originate and hold" to one of "originate and distribute" where banks can originate loans, earn their fees, and then sell these assets off to investors who would be prepared to accept different layers of exposure to risk depending on the particular properties of these redesigned financial instruments through creative financial engineering. As the experience of the 2008 financial crisis advises, problems of moral hazard and adverse selection are rampant in such an unregulated financial system that emerged in both Canada and internationally during the 1990s with mark-to-model accounting techniques proliferating and with asset values that eventually were kept aloof only by their own bootstraps (Berndt and Gupta 2008).

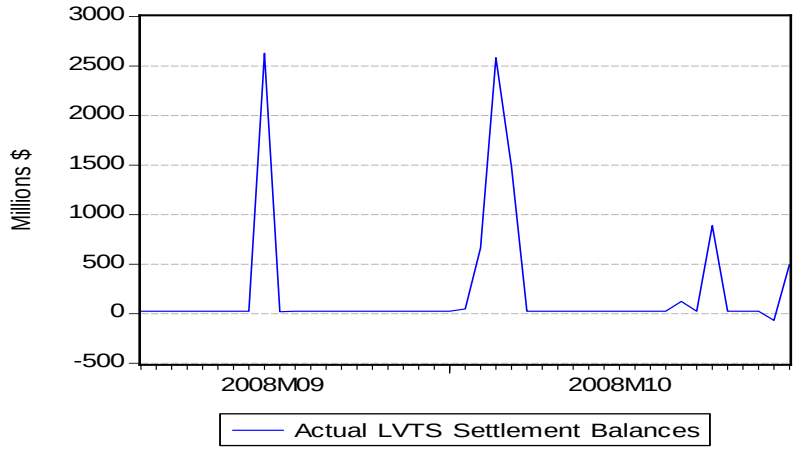
Since the basis of banking is ultimately confidence and trust, when fear and panic replaced market euphoria this resulted in non traditional forms of "bank runs" among the banks themselves as the latter scrambled for liquidity during the worst of the financial crisis, especially with the collapse of Lehman Brothers in the U.S. in September 2008. By the third quarter of 2008, the consequence of this loss of trust was a complete paralysis of the inter-bank market. While, nowadays, there are no longer traditional bank runs on the part of the public largely because of deposit insurance, the effects of a loss of confidence are the same in the banks' struggle to acquire liquidity. In conformity with previous studies of the anatomy of financial crises (cf. Wolfson 1994), whenever there is a loss of trust (in this case because of fears of offloading of toxic assets by other financial institutions), there is an abrupt demand for liquidity which is then supplied by the government through its central bank. As can be observed in Figure 8 below, this is exactly what happened in both 2007 and 2008 when the inter-bank market began to freeze up in Canada, much as it did in the U.S. With growing fears of counterparty default, banks no longer wanted to lend to each other in the inter-bank funds market because of perceived high credit risk, with the result being that those with negative settlement balances within the Canadian main clearing system (the Large Value Transfer

System (LVTS)) lined up for funds from the Bank of Canada. As discussed in Lavoie and Seccareccia (2009), this was done largely via (day-to-day or term) Purchases and Resale Agreements (PRAs) and transfer of government deposits — the byproduct of which is what is currently referred to as "quantitative easing". Figure 8 shows how there was a sharp jump in the overall LVTS settlement balances in the banking system as the Bank of Canada sought to provide liquidity to a distrustful banking system with a growing preference for liquidity.

**Figure 8: Actual LVTS Balances,**
**July-September 2007 and September-October 2008**




Source: Bank of Canada, http://www.bank-banque-canada.ca/en/rates/interest-look.html

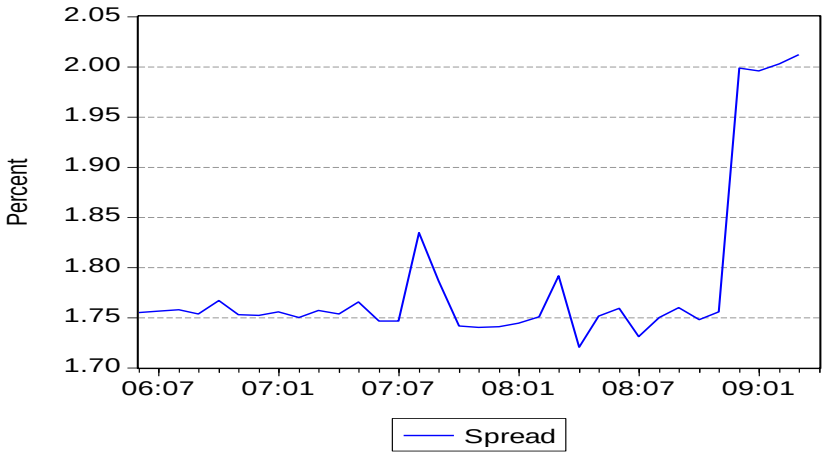



Source: Bank of Canada, http://www.bank-banque-canada.ca/en/rates/interest-look.html

However, these measures taken by the monetary authorities were not sufficient to deal with the major crisis of confidence in the Fall of 2008. As the crisis deepened, the Minister of Finance also had to intervene directly in order to prevent the credit market from seizing. This entailed foremost the guaranteeing of inter-bank lending, as well as broadening the list of assets eligible as collateral for central bank advances, and then by offering to engage in direct purchases in the order of up to $125 billion of mortgages held

through the Canada Mortgage and Housing Corporation (CMHC) via its Insured Mortgage Purchase Program (IMPP), with about $60 bil. of these having been purchased during the first half of 2009 (Bank of Canada, 2009: 17). Although this had some mitigating effect, it did not prevent altogether the collapse of the credit market as the financial crisis accelerated during the third quarter of 2008.

**Figure 9: Interest Rate Spread between the Prime Lending Rate and the Overnight Rate in Canada, June 2006 to March 2009**




Source: Statistics Canada, CANSIM II, Series V122495 and V122514.

At the same time, given the highly oligopolistic nature of the Canadian banking sector, as Figure 9 indicates, their traditional bank markup, reflected in an otherwise relatively rigid spread between the lending rate and the overnight rate, widened significantly during the crisis, as banks sought to recover their losses by maintaining more stable lending despite the sharp fall in the overnight rate. Some analysts of the banking sector have interpreted the widening spread merely as a natural market phenomenon that compensated for the major jump in risk faced by banks after the third quarter of 2008 as the economy faced a credit crunch. However, while that may be a factor, especially in possibly explaining part of the momentary August 2007 jump in the mark-up and some of the minor reverberations that followed, it would not as easily explain (in Figure 9) the persistence of the shift during the first quarter of 2009 since the government intervention in Canada in the Fall of 2008 and the various government bailouts internationally should have reduced some of the banks' exposure to risk. Because of the highly concentrated nature of the Canadian banking system and the historically low level of interest rates, our interpretation of an interest rate mark-up in trying to increase bank profitability would perhaps more correctly describe the behaviour of the banks as they had suffered significant losses and writedowns and thus were very eager to recoup some of their losses simply by cutting their lending rates *less* than the central bank target overnight rate during a period of dramatically falling central bank rates. Hence, it was not so much a matter of dealing *ex ante* with current risk as it was a matter of recovering past losses *ex post* due to previous speculative excesses. As the overnight rate fell to its low historical level of 0.25% by the Spring of 2009, banks simply did not lower their lending rates proportionally, as had largely been the case previously.

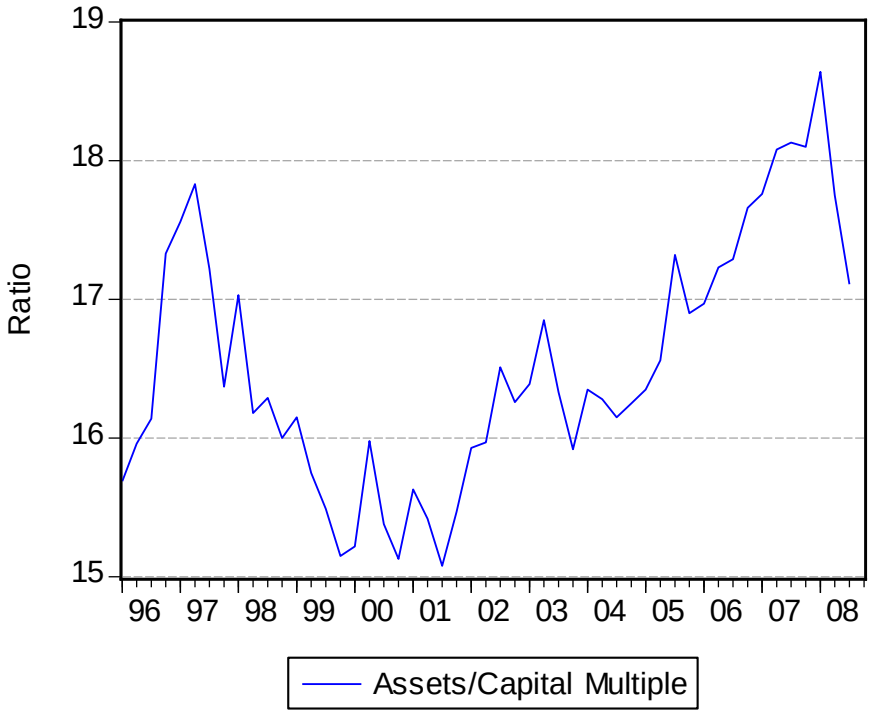
**Why Did the Canadian Banks Weather the Financial Crisis Better than U.S. Banks?**

Canadian banks were moving in essentially the same direction that ultimately led to the 2007 subprime crisis in the U.S. However, the Canadian financial system revealed some important features which prevented it from falling in the same turmoil that plagued its U.S. counterpart. Firstly, unlike the case in many financially dependent countries, such as in Latin America, the Canadian banking system remains national in scope in terms of its ownership base with foreign banks having a subordinate role in the domestic credit market, with, for instance, even before the financial crisis, foreign financial institutions constituting less than 6 percent of mortgages provided by all banks (Traclet 2005: 9). Despite the general pressure to liberalize under NAFTA, the Canadian banking system has remained relatively sheltered from foreign competition. Even under the current looser regulatory system since 2001, the foreign acquisition of the major Canadian banks (the Schedule I banks) is very difficult since an investor cannot hold more than 20 percent of voting shares and not more than 30 percent of non-voting shares of the larger banks, and would require direct approval from the federal Minister of Finance, thereby making the decision highly visible and a politically thorny one for the government in power. U.S. banks have not been able to penetrate the Canadian banking sector very much and, as was shown in Figure 5, they suffered huge initial losses to establish a foothold in the industry. This has meant that the Canadian economy has not been unduly affected by decisions taken by head offices of U.S. subsidiaries in Canada as it has been the case in, say, Mexico with such major financial groups as Citibank that pulled back somewhat from the Mexican credit market as a result of problems in the U.S. (Correa and Seccareccia 2009)

In terms of Basel II capital adequacy requirements, Canadian banks have shown themselves to be somewhat better capitalized than their American and European counterparts and thus tend to be less leveraged than other banking institutions internationally and this had been so since the 1970s. In part, this may have been the result of more stringent regulatory controls, as Canadian banks try not to operate too close to authorized limits and tend to hold a significant buffer of safety in face of balance sheet volatility (see Crawford, Graham and Bordeleau 2009: 46-48). Any imprudent bank will face serious sanctions from the federal Office of the Superintendent of Financial Institutions (OSFI) in the form of lower limits of their assets-to-capital ratio for an extended period of four consecutive quarters before being allowed to return to the previously higher regulatory limit. Perhaps because of these greater margins of safety, the Canadian banking system did not suffer any bank failures as a result of the financial crisis and these banks have faced significantly less losses and writedowns than banks in the U.S., the U.K. and continental Europe. For instance, by the fourth quarter of 2008, Canadian banks had reported losses of about $12 billion from the financial fallout, while the figure for the U.S. and Europe combined was over $700 billion in U.S. funds (cf. Bank of Canada 2008: 9). Figure 10 below traces the evolution of the asset/capital ratio as measured by the OSFI in Canada for the post-1996 period. While there is general belief in the pro-cyclicality of bank leveraging, in fact the ratio does not follow any discernable business cycle pattern, since it *declined* during the relatively high growth era of the late 1990s, but it *rose* during the post-2001 growth period and fluctuated around a stationary trend during the 2000-2001 slowdown. It peaked late 2007 at 18.6 — a level that was still below the OSFI upper limit of 20 for the asset/capital multiple — and

declined sharply during 2008 as banks became more prudent in their new lending to creditworthy borrowers and also sought to recapitalize in the face of growing uncertainty.

**Figure 10: Total Canadian Bank Assets to Adjusted Measure of Tier 1 and 2 Capital Multiple, 1996-2008 (Quarterly Observations of the Consolidated Banking Sector)**




Source: Office of the Superintendent of Financial Institutions Canada

The fact that Canadian banks hold significantly more core equity and are less leveraged than their U.S. and international counterparts may not be the result only of a less loose regulatory structure. As pointed out by Coyne (2009: 2), tighter capital requirements applied to the Canadian banking sector could have actually encouraged more securitization, if the purpose of securitization is to remove risky assets off the bank books. The fact that the country has a deeply embedded and highly concentrated national multi-purpose system of branch-banking with a fairly captive deposit base and thus less leakage to other financial institutions may constitute a better explanation. Possibly because of the national scope of both their loan-making and deposit-taking activities and their lower international exposure from their investment operations, Canadian chartered banks have been more sheltered from the worst effects of the financial crisis. With less exposure to risk because of the less fragmented and more monopolistic nature of the Canadian banking system — with a wide base in regionally diversified markets and a fusion of investment and deposit banking operations into large single institutions — Canadian banks have actually been under less competitive pressure to overextend themselves, as well as to securitize their loans and engage in domestic and offshore operations of the type characteristic of U.S. investment banking (Booth 2008: 43-44).

High equity and low leverage also constitute significant barriers to entry. Hence Canadian banks are more capitalized because of this highly oligopolistic banking structure, with Canada's six largest banks accounting for over 90 percent of total bank assets domestically and over three-quarters of the assets of the deposit-taking sector. This makes their activities highly lucrative with less pressure to involve themselves in more risky financial innovations. In part, this can be seen by the high returns in the banking sector in Figure 5 which are often double those from non-financial industrial activity. These high returns have allowed these major Canadian banks to penetrate aggressively the U.S. banking sector and, during the financial crisis has provided the former lots of buying opportunities because of failing U.S. banks. The outcome of all this is that the biggest four chartered banks — the Royal Bank of Canada Financial Group (RBC), Toronto-Dominion Bank Financial Group (TD), the Scotiabank, and the Bank of Montreal (BMO) — are now securely placed in the top ten of North-American rankings.

Neither can it be said, on the other hand, that there was no pressure to engage in high stakes mortgaging of the type that resulted in the subprime crisis in the U.S. According to industry statistics, in 2006 sub-prime mortgages accounted for less than 5 percent of overall outstanding Canadian mortgages, while in the U.S. this figure was 22 percent (Bergevin 2008). However, in the wake of the oil and commodity price boom and the ensuing hot real estate market, there was growing demand for looser mortgage lending. Indeed, under pressures to deregulate further the financial markets (in the name of providing competitive financial services under NAFTA), the door was opened wide for the subprime market to move north in May 2006 in the first Conservative budget of the newly-elected Harper minority government. Owing mostly to the lobbying effort of AIG which recruited the support of some former officials of the federally-owned CMHC, they finally succeeded in persuading the Harper cabinet to open Canada's mortgage insurance sector to greater foreign competition (McNish and McArthur, 2008). Hence, in 2007 and early 2008, even as signs were emerging of the gravity of the problem south of the border, subprime mortgages were actually proliferating in Canada. This was so even with the formal opposition of the former Governor of the Bank of Canada, who feared possible inflationary consequences of this type of credit expansion not only in the hot Canadian housing market at the time but also on a broader scale in the overall product market, thereby possibly frustrating the Bank of Canada's own low inflation targeting policy. In fact, if it was not for the severity of the U.S. financial crisis in 2008 which, in a sense, nipped the problem in the bud in Canada, one would have probably seen the development of a serious Canadian subprime crisis as well. The fact that the government offered $125 billion through CMHC to buy up mortgage assets would suggest that there was indeed a significant number of such high risk mortgages in the banking sector that have slowly been absorbed by CMHC, a public institution, in 2009.

It was therefore the strength of a national banking system, a somewhat stronger regulatory structure, as well as a more favorable conjuncture of factors, including timing of policy changes, which would explain why the Canadian banking system was able to ride out the financial storm a bit better than that of a number of other countries internationally. Despite these positive features that may have helped the banking sector to weather the financial crisis, it did not prevent the inter-bank funds market from seizing up and requiring government guarantees during the Fall of 2008 to keep the system from collapsing.

**Some Concluding Remarks on Policy**

Since their inception in nineteenth century Canada, and because of their charter, banks are a blend of private/public institutions that are the foundation of our payments system. Securitization has offered banks a means to offload risky assets while earning revenues. One could easily argue that, since the benefits that such a secondary/derivative market confers to a small group of individuals engaged in high stakes speculation is minimal relative to the damages that their activities could inflict on society as a whole because of its macroeconomic externalities, securitization should either be severely regulated (as suggested by the Centre for Research on Socio-Cultural Change (2009) but with all the dangers that circumventing innovations could lead to over time) or outrightly prohibited as a legitimate "banking" activity with a return to a narrow system of "originate and hold" banking — that is, a straight "hold to maturity" approach to banking (Auerback, 2009). Therefore, banks should be prevented altogether from fueling a casino economy through their role in creating a secondary market from their initial credit advances. As the experience of the Great Depression informs, there should be a clear separation between the activity of banking proper and the activity of buying/selling secondary assets for the purpose of making capital gains (including credit default insurance). Hence, there should be a much stronger separation between the banks and the financial markets depicted in Figure 3 by separating the link that fed the financial sector and a return to the model in Figure 1 of the banking system.

While such separation would not in itself prevent casino instincts from taking hold of the financial markets proper, the moral hazard associated with such an incestuous relation between the banks and financial markets is potentially just too damaging to be left to its own accord. Needless to say, there is still the underlying imbalance between household indebtedness and the corporate sector surplus that needs to be attended to, which we have argued has been a critical factor in contributing to this hyper-financialized system. This will only arise through strong economic growth coming from longer-term fiscal stimulus that will ultimately push up household real incomes and, eventually, household savings.

On the other hand, the US experience with the *de facto* nationalization of some important private financial institutions (via the so-called "Paulson Put" – see Ferguson and Johnson 2009a, 2009b) and the long history of public banking institutions in Europe suggests that ownership will not necessarily lead automatically to a change in the nature of banking unless one delineates clearly the domain within which these banks can conduct their activities. While, to some on the political Left, the option of nationalization of the banking sector has come back on the table after a long hiatus (Arnold, 2009), the abolition of secondary market for bank assets could perhaps be just as, if not more, effective in addressing the current problem. What clearly is not tenable is the political status quo. There are surprisingly some on the political Right who still believe that the root of the problem were the remaining regulations themselves and the government intervention that triggered the initial subprime crisis (see Halinka, 2008), but a consensus is emerging for a strong re-regulation of the complete financial sector both in Canada and internationally.

## Note

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