The Way of the North

Canada's banking system has earned praise for standing tall during the global financial crisis. Its sterling performance—and conservative bent that irks some Canadians—is no accident of history.

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Earlier this year Paul Volcker, the former chair of the Federal Reserve Board of Governors who now chairs President Barack Obama's Economic Recovery Advisory Board, traveled to Canada to praise its banks. In a Toronto speech about the global economic crisis, he suggested revamping financial systems to avert future catastrophes—namely, by developing a core of large institutions that focus on traditional banking functions such as gathering deposits and lending. Riskier financial pursuits should be left to noncore investment firms dealing in private equity and hedge funds. "It's interesting that what I'm arguing for looks more like the Canadian system than the American system," Volcker said in remarks widely reported in the Canadian media.[1]

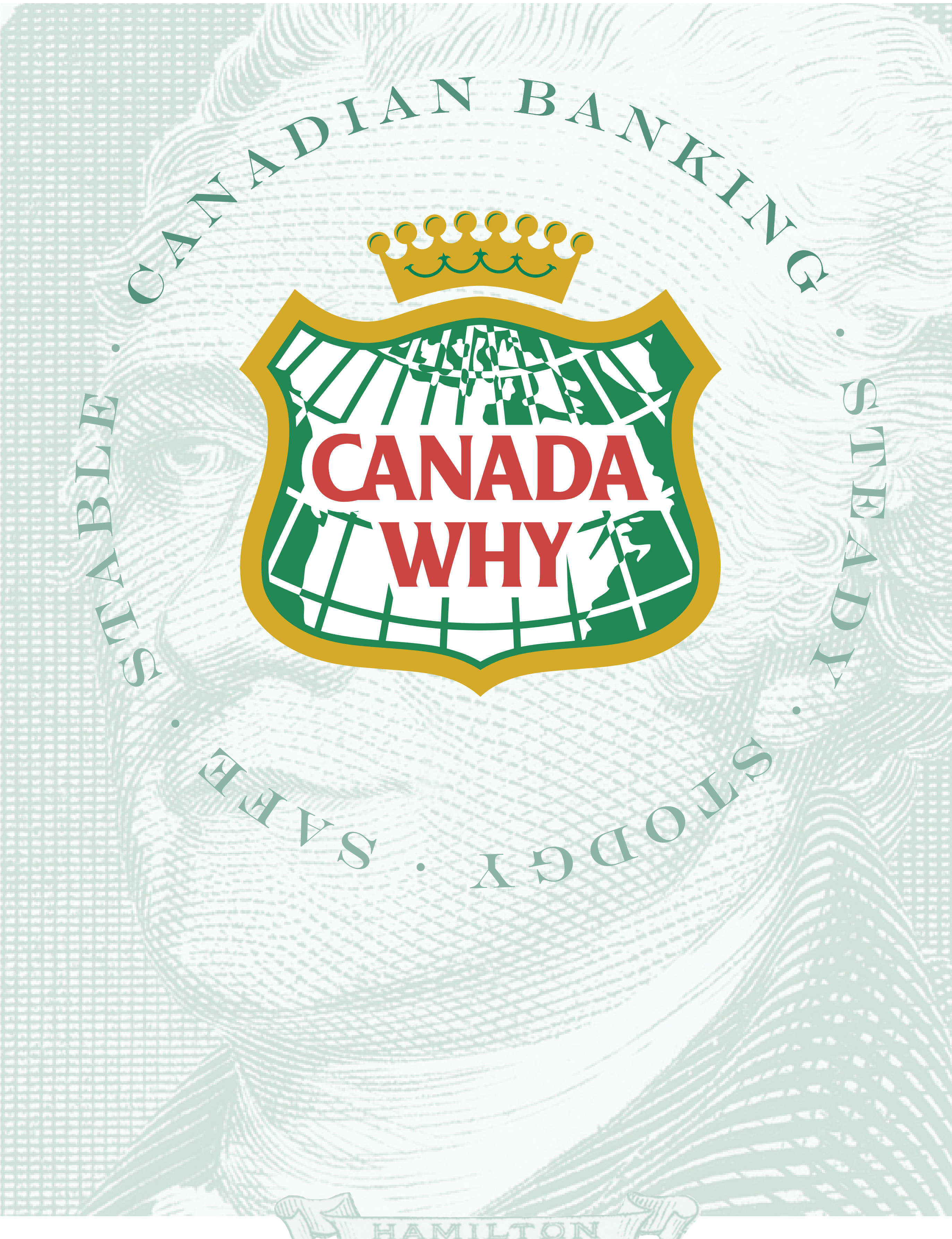
Volcker is not alone in his admiration for the Canadian banking system. Since the global financial crisis erupted last year, economists, editorial writers and Obama himself—who has proposed an overhaul of U.S. financial-market supervision—have lauded Canadian banks for their stability and fiscal prudence. Canadian banks largely avoided the housing finance quagmire by steering clear of murky investments in subprime mortgages. As a result, no large-scale government bailout of the kind afforded financial institutions in the United States, Britain, Iceland and other nations was necessary in Canada. In a 2008 survey of business executives by the World Economic Forum, Canada's banking system was judged the soundest in the world. (The United States ranked 40th.)

Today Canadian commercial banks are in good shape, in a position to lend and to gain global market share as the world emerges from recession. Four of Canada's largest banks posted C$2.1 billion (US$1.85 billion) in combined profit in the second quarter of this year.[2]

However, Canada has made its banking system the toast of the financial world at a price; it's an oligopoly, an exclusive club of federally chartered banks that rules retail banking in Canada and brooks little opposition. The "Big Six"—the largest of which are Royal Bank of Canada, Toronto-Dominion Bank and Bank of Nova Scotia—collect 96 percent of national deposits and control over 90 percent of Canadian banking assets.

Over a century ago Canada opted for safety and stability in its centralized banking system, instead of innovation and efficiency—the hallmarks of the U.S. model, with its thousands of national and state banks. Close federal control of a select group of chartered banks has prevented failures but possibly dampened competition, both domestic and foreign.

This cozy concentration of financial power is resented by some Canadians, who complain that their stodgy, highly profitable banks withhold credit and overcharge for services. A few Canadian economists argue that by restricting access to credit, the banking system hampered economic growth during the nation's formative years. Whether or not these charges are accurate is an empirical question. Oligopolies can, in theory, result in competitive


CANADIAN BANKING
STEADY
STODGY
SAFE
STABLE
CANADA
WHY
HAMILTON

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outcomes, and to date, definitive empirical research has yet to demonstrate that Canada's banking markets are in fact noncompetitive.

For better or worse, Canadian banks stand apart from U.S. institutions in their structure, regulation and credit philosophies. How did two neighboring countries with similar geography and much shared history and culture develop such starkly different banking systems? Chalk it up to economics and politics; over the past 200 years, each system arose from a unique nexus of market forces and public policy—the latter profoundly influenced early on by two men with diametrically opposed visions of banking: Alexander Hamilton and Andrew Jackson.

Looking to Hamilton

Early in their history the American and Canadian banking systems were virtual twins, separated only by the fact that the United States had revolted against British rule while its northern neighbor had not. Both in the young republic and in British North America—later to become Canada—banking was centralized in large, nationally chartered institutions with multiple branches. Today this is the standard pattern for most of the world's banking systems.

In 1817 a group of Montreal merchants intent on founding a bank looked south for inspiration. Twenty-five years earlier Hamilton, the first U.S. Treasury secretary, had been the driving force behind the creation of a federally chartered bank of issue with branches throughout the former 13 colonies.

Hamilton designed the First Bank of the United States, modeled after the Bank of England and partly owned by the federal government, to rejuvenate the nation's tattered economy after the Revolutionary War. In large measure it succeeded; by helping to pay off the government's war debt and providing sound currency and credit to businesses, the First Bank put the government's finances in order and stoked the fires of American enterprise. Later Hamilton's ideas were embodied in the Second Bank of the United States, a larger and more powerful institution founded in 1816. (See September 2007 and September 2008 *Region* articles at minneapolisfed.org for more on the First and Second banks.)

The Articles of Association of the Bank of Montreal, the first bank established in Canada (and one of the Big Six today), were taken almost word for word from the charter Hamilton wrote for the First Bank of the United States. Like that institution and its successor, the Bank of Montreal was a government-chartered, well-capitalized bank that issued its own banknotes, took deposits and made loans. (However, unlike the First and Second banks, all its stock was in private hands.) A network of branches extended its influence throughout the colony of Lower Canada (now Quebec). Other chartered banks with branches followed: the Bank of New Brunswick in 1820, the Bank of Upper Canada (now Ontario) in 1821, the Bank of Nova Scotia in 1832.

These early Canadian banks, formed to finance the movement of staple products such as furs, timber and grain, were molded not only by Hamilton's ideas but also by conservative financial practice in England and Scotland. Many Canadian bankers of the period were Scottish immigrants who learned

In Brief

Oh, Canada

- Canadian banks have been lauded for their soundness during the financial crisis. No big bailout of financial institutions was necessary in Canada, as it was in the United States and other countries.
- Canada's centralized banking system emphasizes safety and stability; tight regulation of a small number of banks has prevented bank failures, but may have dampened competition.
- Characteristics that helped Canadian banks weather the recent storm, such as federal control and high capital requirements, were part of the system from the beginning. U.S. banking may be able to learn from the Canadian experience without jeopardizing competitiveness and innovation.

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the banking trade in the old country, notes Duncan McDowall, a history professor at Carleton University in Ottawa who has written about Canadian banking. "The saying goes that the Scots brought two things to Canada: the rules of banking and the rules of golf," he said in an interview. "We're still addicted to both."

In the same cautious spirit, rules promulgated by British-controlled colonial legislatures fostered stability and discouraged risky lending. Banks were required to amass a large amount of capital before opening their doors; merchants and other investors in the Bank of Montreal, for example, had to raise the princely sum of 250,000 British pounds—about US$1 million at contemporary exchange rates. Note issue was limited to an amount equal to a bank's paid-up capital. And banks were forbidden to accept land as security for loans because real estate was considered an insufficiently liquid asset.

Meanwhile, the U.S. banking system was developing rapidly, largely along Hamiltonian lines. More populous and industrially advanced than Canada in the early 1800s, the United States had numerous state-chartered banks, but its banking system was dominated by the First Bank and, after the War of 1812, by the Second Bank, which performed central bank functions such as issuing a widely accepted currency and regulating the money supply.

Branching—which allowed banks to balance deposits and demand for credit over wide areas—was commonplace in the United States. In the late 1820s the Second Bank operated 25 branches serving every part of the country. Many state-chartered banks, particularly in the South and Midwest, maintained multiple branches in cities and small towns.

Centralized vs. "free"

American banking might have continued along this path if not for an epic struggle that raged in the early 1830s over the structure and governance of the country's financial system. The Bank War, a face-off between President Andrew Jackson and the Second Bank, caused an irrevocable break from centralized banking as practiced in Canada and much of Europe.

Jackson considered the Second Bank an unconstitutional, elitist "money power" oppressing farmers and other working folk, and he aroused populist passions and the envy of state banks to destroy it. After a protracted, bitter struggle with the bank and its supporters in Congress, Jackson refused to renew its charter and removed its government deposits, forcing it to close its doors in 1836.

Jackson's victory in the Bank War marked the beginning of the so-called Free Banking Era, when hundreds of banks operated under state charters. Free banking laws enacted in a majority of states allowed anybody to open a bank with relatively little capital—$5,000 in some states. Banks were permitted to issue notes as long as they were backed by government bonds and redeemable on demand for gold or silver coin. But branching was outlawed in many states; stand-alone or "unit" banks were free to thrive or fail with no interference from the federal government. And indeed, many small banks did fail in states that passed free banking laws.

Canada stuck with its centralized plan—a much smaller number of big-city, branched banks sanctioned by colonial governments with royal assent. There was no Canadian equivalent of Jackson to raise the populist banner and challenge this concentration of financial power.

The British Colonial Office, an entity that could modify or rescind colonial legislation, fostered a conservative approach to bank formation, currency and lending. In addition to requiring government charters, setting a high bar for starting capital and restricting note issue, Canadian regulations in the 1840s made bank shareholders doubly liable if a bank failed. Not only would shareholders lose their initial investment to creditors; they might also be assessed an additional amount up to the par value of their shares. In the United States double liability was not mandatory for federally chartered banks until the 1870s.

After a Canadian depression in 1847–48 put a crimp in credit, merchants and other borrowers

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challenged the sway of the chartered banks by pushing for free banking as practiced in the United States. In 1850 the Province of Canada (Upper and Lower Canada had united nine years earlier) enacted a free banking law modeled on a New York statute. The law banned branching and set much lower minimum capital requirements than were the norm for chartered banks. And it provided for bond-backed note issue—a major departure for Canadian banks, which were accustomed to issuing unsecured notes, backed by a bank's general assets instead of government bonds.

But the free banking movement never took root as it did in the United States; only six banks formed under the act, and they all either failed or reverted to conventional charters, leaving the big chartered banks firmly in control.

Canada's economy began to hit its stride in the 1850s and 1860s. Grain and timber shipments rose on the St. Lawrence canals, manufacturing increased and Canadian entrepreneurs built railways with support from British and American investors. The banking system grew along with the economy; established banks expanded their operations, and a number of new banks opened. Still, the number of new institutions was just a fraction of the number that formed—and often quickly closed—in the United States during the Free Banking Era.

By 1867, when Britain's North American colonies coalesced into an independent confederation of provinces, the template for Canadian banking was established. Large banks based in the major cities of Toronto, Montreal and Halifax dominated financial affairs. The need to apply for a charter and high minimum capital requirements discouraged new market entrants. And branching was widespread; Canadian banks strived to expand their spheres of influence by setting up satellite offices in smaller communities.

Big banks rule, eh?

At Confederation the fledgling national government gained exclusive control over currency and banking. There would be no provincial institutions in Canada analogous to U.S. banks chartered under state laws. The desire for a strong, truly national banking system to foster trade across provincial lines and on the expanding frontier was codified in Canada's Bank Act of 1871, which drew up a general charter of banking.

"There was just no debate whether we would have regional banks or national banks," McDowall said. "Right from the beginning … it was to be a federal system. The banks were to be federally chartered and federally regulated."

The Bank Act required all new banks to be chartered by a special Act of Parliament and set minimum subscribed capital at C$500,000, an enormous sum in the 1870s. In addition, it affirmed already established rules intended to ensure a stable banking system: restricted note issue, shareholder double liability, the right to branch and a ban on loans against real estate.

In the United States a very different type of banking system was taking shape in the years during and after the Civil War. The National Bank Act of 1863 created a dual system of federally chartered and state institutions. Politically, the system was a compromise; Congress wanted to establish a uniform currency and stimulate demand for war bonds without creating a single, powerful entity like the Second Bank.

The Comptroller of the Currency, a bureau of the U.S. Treasury, would supervise national banks, which were allowed to issue paper money secured by government bonds. State regulators were left in charge of banks operating in each state under free banking statutes. Although the National Bank Act didn't specifically ban branching, an 1865 comptroller interpretation of the law barred national banks from conducting business at more than one "office or banking house," making them unit institutions like most state-chartered banks.

Thus public policy in the United States fostered the development of a two-tier banking system with thousands of individual banks. Relatively large national institutions held sway in big cities, while

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state banks—many of them small and light on capital—fought for market share in regional centers and rural areas. "If you have prohibitions on branching, and easy entry, you'll get a lot of small banks," observed Eugene White, an economics professor at Rutgers University, in an interview.

In Canada, regulatory and market forces continued to drive the banking system in a different direction. Seamless federal regulation, high minimum capital requirements and the freedom to transact business across provincial lines favored a system of big urban banks that grew ever larger by expanding their territories and leveraging economies of scale to outcompete smaller, weaker banks.

This trend accelerated in the two decades before World War I, a period of robust economic growth spurred by rising crop prices and the development of western Canada. Bank capital, deposits and lending increased dramatically. Free to operate from coast to coast, large banks aggressively extended their branch networks, throwing up wooden, prefab offices in frontier areas to capture deposits and make short-term loans to farmers, prospectors and lumber mills.

However, as banking activity and credit expanded, the number of banks shrank. Unable to compete with the burgeoning assets and geographic reach of giant banks such as the Bank of Montreal and Canadian Bank of Commerce, smaller banks sought mergers. Newly chartered banks were absorbed into large banks, or they failed. By 1913 Canada had only 24 banks—a minuscule number compared with the thousands of national and state banks operating in the United States. The banking industry had become an oligopoly ruled by the Canadian Bankers' Association, an organization with allies in government that discouraged the chartering of new banks and suppressed open competition through "gentlemen's agreements" among banks.

Safety first

The triumph of the big chartered banks in Canada achieved the goal that public policy had strived for since colonial times: stability. Small banks merged with bigger institutions—by 1930 the ranks of Canadian banks had further thinned to 10—but they hardly ever went bust. (Between 1913 and 1980, the only chartered bank to fail was the Home Bank of Canada, in 1923.)

Government considered the banks so sound that in monetary matters they were mostly left to their own devices in the early 1900s. Relying on the gold standard[3] to automatically rein in any credit excesses, banks continued to issue their own unsecured notes (a national currency backed by government bonds was used for smaller note denominations). There was no central bank to regulate currency and act as a lender of last resort until the formation of the Bank of Canada in 1935—22 years after the creation of the Federal Reserve System in the United States. The Bankers' Association cleared payments for banks and arranged for sound banks to lend to weak banks during times of stringency.

The Canadian banking system passed its sternest test during the 1930s. The worldwide collapse of financial markets in the Great Depression severely damaged both Canada's economy and its banks; deposits shrank by about the same proportion as in the United States. But north of the border there were no bank runs, and not a single bank failed. In the United States, about 9,000 banks closed their doors.

Scholars generally attribute the resilience of the Canadian banking system during the Depression to its structure: a handful of well-capitalized banks with branches. In the United States many independent banks in small towns failed because of bad loans to local farmers; all their eggs were in one basket. In Canada, big banks took advantage of their far-flung branch networks to pool their deposits and diversify their asset portfolios. If loans went bad at a branch in a Manitoba farm community, the parent institution would survive.

"The fact that we didn't have this small-unit-banking system but rather had a large-branch-banking system was pretty critical in why we didn't have bank failures," said Angela Redish, an economic historian at the University of British Columbia, in an interview. White of Rutgers notes

Continued on page 52

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Way of the North *from page 35*

that during the Depression many Canadian banks closed distressed branches—amputating an injured limb to save the body.

Since the 1930s the Canadian banking system has remained a model of safety and prudence. The regulatory formula for stability, periodically adjusted in revisions of Canada's Bank Act, has discouraged risk-taking and shielded banks from competition.

For much of the 20th century, the "four pillar" approach to financial regulation kept banks out of risky activities in the investment and housing markets. Commercial banks were allowed to collect deposits and make loans, but not to delve into the other three areas of the financial market: trusts (including mortgages), corporate securities and insurance. Other regulations capped interest rates on loans, lest banks engage in risky behavior in pursuit of high returns.

In the 1960s fears of an American financial invasion led to de facto prohibitions on foreign ownership. Amendments to the Bank Act provided that no individual entity could own more than 10 percent of a Canadian bank, effectively blocking U.S. or other foreign companies from gaining a significant share of the market through acquisition. Secure in their hegemony, the big chartered banks earned handsome profits from loans and transaction fees.

Deregulation in the 1980s swept Canada as it did the United States and much of Western Europe. Further changes in banking law toppled the four pillars, allowing banks and other types of financial institutions to compete on each other's turf.[4] But barriers to foreign competition remained, and the big chartered banks arguably became even more dominant than before, extending their reach throughout the financial sector. By the late 1990s the largest banks had acquired virtually all of the major trust and brokerage firms in the country.

In the current decade chartered banks have faced little competition from credit unions, a handful of regional banks and subsidiaries of foreign-owned banks that have managed to get a toehold in the Canadian market (foreign companies account for less than 1 percent of Canadian banking assets). In early 2006, before the global financial meltdown, Royal Bank of Canada and Bank of Nova Scotia raked in record profits.[5]

Lessons from the north

A full analysis of why Canadian banks fared so well during the worldwide financial crisis, largely avoiding the afflictions of banking systems in the United States and many other countries, is beyond the scope of this article. Economists point to stricter rules in Canada on capitalization, mortgage lending and securitization as factors. For example, capital-to-assets ratios for financial institutions are higher in Canada than in the United States,[6] and most Canadian banks keep home mortgages on their books rather than bundling them for sale on the secondary market.

But surely history has something to do with it. Characteristics that helped Canadian banks weather the storm were part of the system from the beginning, when Canada stayed the course laid down by Hamilton while the United States under Jackson took a different road. Early influences such as the mercantile origin of Canada's banks, federal control after Confederation and the freedom to branch—in the United States Congress didn't permit interstate branching until 1997—favored bigness and stability. Long-standing regulations banning the use of land as collateral, requiring double liability and keeping banks out of risky investments fostered a conservative approach to lending. In recent decades protection from foreign competition for deposits provided Canadian banks with a stable source of funding in times of trouble.

Not everyone is enamored of Canada's tradition of steady, careful banking. Before the financial crisis the major banks routinely came under fire for their alleged stinginess and inefficiency. The Canadian Federation of Independent Business, a lobbying group, has criticized Canada's "ultraconservative" banks for their reluctance to lend to creditworthy businesses.

R. T. Naylor, a professor of economics at McGill University in Montreal, depicts commercial banks of the late 19th and early 20th centuries as cartels

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that were unwilling to extend long-term credit to businesses and colluded to keep interest rates high, retarding industrial development in Canada. However, most Canadian economists are not so quick to blame Canada's conservative, insular banking system for the country's historically lower per capita GDP relative to that of the United States. Instead they point to other factors, such as protectionist government policies instituted in the 1870s that coddled domestic industry.

Today, it's unclear whether the dominance of a few big banks has made credit scarcer or pricier in Canada than in the United States. By some measures, borrowing costs and access to funds are more favorable or at least comparable to credit conditions south of the border. For example, Canadian loan authorization rates are 80 percent to 90 percent, about the same as in the United States.

But a 2008 report on Canadian finance by the International Monetary Fund concluded that innovative small- and medium-sized businesses have a harder time obtaining financing in Canada than in other countries, possibly because of a "reluctance by the banks to price risk." Surveys show scant variation in loan terms across banks, suggesting that loan officers deny risky enterprises credit rather than charging them higher interest rates.[7] Still, definitive conclusions about whether Canada's bank market is actually noncompetitive await further empirical research.

What can U.S. policymakers learn from the Canadian experience, as they contemplate revamping the financial regulatory system? That for the most part, Canada's centralized, stolid banking system has served the country well, especially in times of economic stress. However, adopting the Canadian model in the United States may be neither politically feasible nor economically wise. Dual state/federal regulation of banks, stemming from strong states' rights, is probably here to stay. And American firms and consumers have become accustomed to a multitude of banks competing for their business.

But it may be possible, as Volcker has suggested, to incorporate aspects of the Canadian system into American banking without putting competiveness and innovation at risk. "I'm not arguing that you need an oligopoly to the extent you have one in Canada," he said in his Toronto speech. The Obama administration's blueprint for regulatory reform, slated to be taken up by Congress this fall, includes at least one element of the Canadian model: higher capital requirements for the largest financial institutions.

Endnotes

[1] "Paul Volcker: The banking world needs more Canadas," *National Post*, posted Feb. 17, 2009 (blog, ed. Kelly McParland). Online at http://network.nationalpost.com/np/blogs/fullcomment/archive/2009/02/17/paul-volcker-the-banking-world-needs-more-canadas.aspx.

[2] "Canadian bank earnings beat expectations," *Vancouver Sun*, May 27, 2009.

[3] Canada was continuously on a gold standard from 1854 until 1914. As in the United States during most of the 19th century, notes were freely convertible into gold coin—a natural brake on inflation.

[4] While deregulation in Canada allowed banks to engage in heretofore prohibited investment banking activities, they were still held, under Canada's Bank Act, to stricter standards than those seen in the United States after the Gramm-Leach-Bliley Act eliminated the 1933 Glass-Steagall Act's barriers between commercial banks and securities firms. Many observers contend that the effective repeal of Glass-Steagall contributed to the recent U.S. financial crisis, but the Canadian experience was not strictly parallel because of these tighter restrictions, even after its deregulation in the 1980s.

[5] "Canadian banks hit record results," *Financial Times*, March 4, 2006. Whether these large profits were due to lack of competition, though, remains an open question. Many large U.S. banks also enjoyed high returns in that precrisis period.

[6] Canadian banks must maintain Tier 1 capital, primarily common shareholder's equity, of at least 7 percent, compared with 4 percent for U.S. banks.

[7] "Canada: Selected Issues," R. Balakrishnan, et al., International Monetary Fund, Feb. 25, 2008. Online at www.imf.org/external/pubs/cat/longres.cfm?sk=21735.0.