



TRUST THE SYSTEM

Unlike some financial institutions to the south, Canadian banks have proven their resilience and durability through financial upheaval

BY JEFF BUCKSTEIN

ILLUSTRATION BY MATTHEW BILLINGTON

financial shock jolted the United States last March when Silicon Valley Bank (SVB), the 16th largest bank in the country with about \$209 billion (U.S.) in assets, was shut down by the California Department of Financial Protection and Innovation. It was the second largest bank failure in U.S. history.

Just two days after SVB folded, New York-based Signature Bank, with more than \$110 billion (U.S.) in assets, became the third largest bank in U.S. history to fail when this regional financial institution was seized by the Federal Deposit Insurance Corporation.

Then, on May 1, 2023, San Francisco-based First Republic Bank, with \$229 billion (U.S.) in assets, displaced SVB as the second largest U.S. bank to fail, although its assets were bought by JPMorgan Chase & Co., the nation's largest bank.

Yet, in spite of this industry turmoil, a decade and a half after the 2008-09 financial crisis, and with more than 560 U.S. bank failures since 2000, no Canadian banks have gone under in the 21st century. Indeed, even during the Great Depression of the 1930s, when more than 9,000 U.S. banks failed, none failed in Canada.

The U.S. controls about 24.6 per cent of the global economy, calculated by gross domestic product. Yet the Canadian banking system, in a country that represents 2.2 per cent of the world economy, has proven to be quite resilient and even relatively insulated from financial crises.

"The U.S. and Canadian banking landscapes are completely different," says Shilpa Mishra, CPA, MBA, a Toronto-based partner and managing director with BDO Canada, and also the firm's national leader of capital advisory.

One key differentiator is that while the U.S. system consists of thousands of mostly regional banks, Canada's national banking system is dominated by six very large institutions that serve individual and business customers alike: Royal Bank of Canada, Toronto-Dominion Bank, Bank of Montreal, Canadian Imperial Bank of Commerce, Bank of Nova Scotia, and the National Bank of Canada.

Every one of the big banks in Canada is essentially too big to fail, and there are very high odds the federal government would step in and rescue any of them, if needed, to prevent a failure, says Alfred Lehar, an associate professor with the University of Calgary's Haskayne School of Business. "I think the knowledge [that] the government is there also makes the banks less susceptible to any crisis," he adds.



Silicon Valley Bank's collapse in March 2023 represents the largest bank failure since 2008

The prevailing thought is that Canada's banks can't fail because the government won't let them fail

"A strong and stable banking sector with well-diversified, well-capitalized banks [is] the best defence against an SVB-style scenario," says Mathieu Labrèche, director of media strategy and communications at the Canadian Bankers Association in Toronto. "We have that here in Canada, which is why we haven't had a major bank fail in 100 years."

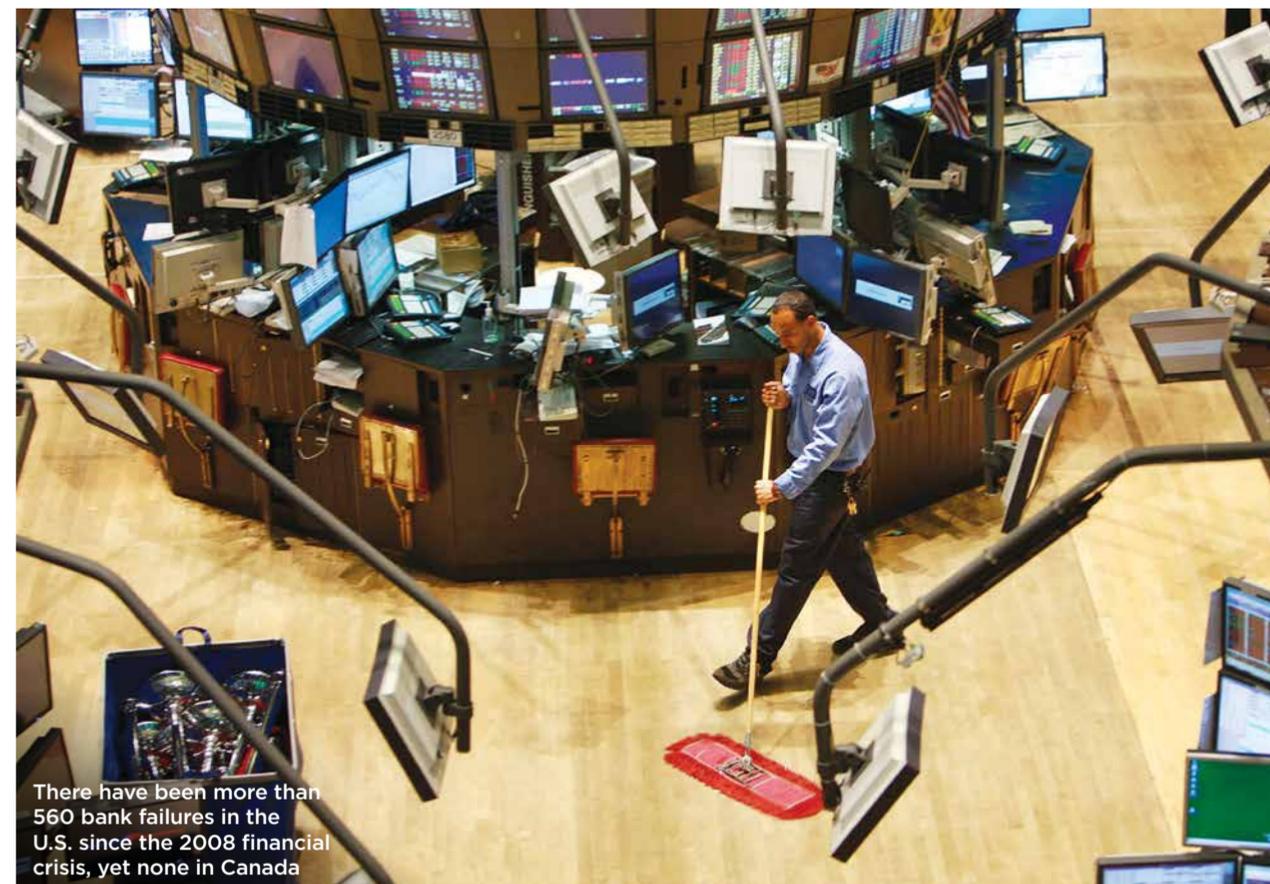
He adds, "Many people who once perceived Canada's banking system as stodgy or risk averse finally recognized it for its prudent lending practices, diligent government oversight and sensible regulation based on two core tenets—safety and soundness."

That has also been recognized internationally: the World Economic Forum consistently ranks Canadian banks as being among the world's most stable, says Labrèche.

"We have a more concentrated, less competitive banking system here in Canada," says Ing-Haw Cheng, an associate professor of finance with the University of Toronto's Rotman School of Management. "On the plus side, I think that has contributed toward a culture of less risk taking, and thus fewer failures here in Canada. You see this, for example, [in] the greater reliance on deposit funding as opposed to wholesale funding, which I think was key in the 2008 financial crisis."

The financial crisis was sparked by sub-prime mortgages when some U.S. banks started to lend to consumers who otherwise might have been considered high-risk. With more banks and therefore more competition for those customers, many quickly found themselves overburdened and overleveraged.

PHOTOGRAPHS BY GETTY



There have been more than 560 bank failures in the U.S. since the 2008 financial crisis, yet none in Canada

In Canada, there are, to some extent, more conservative lending practices when it comes to mortgages, he adds.

Canadian consumers also bear some of the interest rate risk associated with a mortgage, whereas, in the U.S., there is less risk on the consumer and more on the bank. Canadian consumers also help to keep banks profitable by paying for things like chequing accounts, and paying greater fees than U.S. consumers, Cheng says. More concentrated regulation is another key factor that experts cite to explain stronger Canadian banking stability.

All Canadian banks are subject to a single national prudential regulator, known as the Office of the Superintendent of Financial Institutions (OSFI), as well as a single consumer and market conduct regulator, which is the Financial Consumer Agency of Canada. As a result, "we have clear lines of sight in terms of what the expectations are from a regulatory perspective," says Alex Ciappara, vice-president and head economist at the Canadian Bankers Association in Toronto.

Regular legislative reviews also take place, typically about every seven years. The government and industry examine the legislative foundations of the banking system and raise questions about whether and what changes are required in order for Canadian banks to stay durable and resilient, says Ciappara.

However, regulation in the U.S. is "a bit more fragmented," says Cheng. For example, even at the federal level there are different authorities, including the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and, in certain cases, the Office of the Comptroller of the Currency (OCC), he notes.

Especially during the 2008-09 banking crisis, "banks in the U.S. could pick and choose which regulator they wanted. There were instances where a bank didn't like the regulations of one particular regulator, and they moved to another," says Ciappara.

Moreover, some financial institutions in the U.S. aren't subject to certain regulations because of their size, says Rajesh Vijayaraghavan, an assistant professor of accounting and information systems at the University of British Columbia's Sauder School of Business in Vancouver.

For example, banks with assets between \$50 billion (U.S.) and \$250 billion (U.S.) are subject to less stringent capital and liquidity requirements than banks with assets in excess of \$250 billion (U.S.), he elaborates. Mishra notes that over the past couple of years, prior to its demise, SVB had successfully lobbied the U.S. government to roll back regulations such that they were not required to conduct stress testing or regularly review their liquidity coverage ratio.

There are, says Mishra, three major factors that have insulated Canada's banks from the financial crises that have emerged in the U.S. with bank failures in 2008 and 2023.

First is a much more conservative regulatory regime in Canada, with a strong focus on interest rate risk management, balance sheet management, and liquidity risk management. “The issue that occurred with a lot of the bank failures south of the border had to do with two things—interest rate risk management and liquidity risk management, which are tightly regulated in Canada,” explains Mishra.

The second factor is that Canadian banks have much more robust capital requirements than other parts of the world, so even if there is more pressure on the value of Canadian banking assets, they have a lot of capital available to provide a buffer against those losses.



Third, Canadian bank deposit and lending come from very diverse sectors, whereas, for example, Silicon Valley Bank was heavily focused on the technology sector.

Ciappara adds that Canadian financial institutions were less highly leveraged than their international peers in the pre-2008 financial crisis period. This reflected the fact that Canada had a regulatory cap on leverage at an asset-to-capital ratio of 20 to 1. As a result, major Canadian banks had an average asset-to-capital multiple of around 18 in 2008, while the comparable figure for many U.S. investment banks was over 25, and numerous European banks were well over 30.

Further, “with the reforms coming out of the global financial crisis, global regulators instituted a regulatory cap on leverage just as OSFI had done before the crisis,” says Ciappara.

“We have strong levels of capital. Not only does OSFI set a minimum target—banks exceed

that target. That was the case going into the financial crisis, and that’s the case right now,” he adds.

Mishra expects that the coincidence of the U.S. bank failures and the unprecedented speed with which they occurred will result in changes to both regulation and supervision. Those could include a re-evaluation that results in tighter capital requirements and stronger liquidity risk management, and possibly tighter supervisory frameworks.

In addition, Mishra also predicts that U.S. regulators will enhance and expand stress tests involving deposit analysis and customer behaviour analysis, as well as how bank security portfolios match with deposit characteristics.

In the week following the collapse of SVB, and subsequent fall of Signature Bank, the largest 25 domestic banks in the U.S. recorded an inflow of \$120 billion (U.S.) in deposits, while small domestic banks had an outflow of \$108 billion (U.S.).

But since then, according to Federal Reserve Board statistics, both large and small banks have experienced outflows, although smaller banks have seen a significantly larger decline.

Between February 2023 and April 2023, seasonally adjusted deposits at all domestic banks dropped by \$402.7 billion (U.S.). The 25 largest domestic banks recorded a decrease of \$168.3 billion (U.S.), which is a 41.8 per cent decrease, while deposits with the rest of the domestic institutions collectively declined by \$234.4 billion (U.S.), or by 58.2 per cent.

It is hard for the U.S. to emulate the national Canadian banking structure because its current structure is so different, with many counties within states across the country, says Vijayaraghavan. “There are many counties in the U.S. that do not have one of the large banks’ presence in [them]. A household in the county might have to bank with only a small, very regional bank,” he elaborates.

Ciappara says that with more than 4,000 banks, and facing increasing regulation, the U.S. still has a long way to go to move toward a Canadian-style system where investors and

“We have clear lines of sight regarding the expectations from a regulatory perspective”

depositors rely so heavily on the larger banks.

In contrast, there is a high degree of trust and brand recognition in Canada’s national banks, which is important in times of crisis. Because depositors trust their institution, they’re not going to run to the bank and pull their money out, says Ciappara.

“Canada’s banks are tested and trusted. They’re strong and durable, and we’ve seen that time and time again. Think of the last three external shocks—the 2008-09 financial crisis, the pandemic, 2023. Tested and trusted is our brand here,” says Labrèche. “Canada really is a paragon of safe banking,” he concludes. ♦