Regulation and Supervision of the Canadian Financial System

notes for an address by

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Mr. Minister, Distinguished Colleagues, Ladies and Gentlemen –

I would like to begin by expressing my sincerest appreciation to the Financial Supervisory Authority of Iceland for the kind invitation to address your annual meeting. In offering a few observations on the Canadian financial system, I thought I would begin with a brief description of how the financial services industry in Canada is structured, a description of the regulation and oversight of financial markets, and a word or two on the mortgage and housing market.

The Canadian financial system has historically been an exclusively private sector market, with the exception of the central bank – the Bank of Canada – and the Export Development Bank – a government run bank which, as its name implies, is exclusively used by companies seeking financing for Canadian exports. There are several categories of banks in Canada, defined by ownership. There are about 20 Canadian-owned banks, about 25 foreign banks with Canadian operations and another 25 who have subsidiaries of their home-country banks. There are about 1500 bank cooperatives, called Credit Unions or Caisses populaires. This being said, six major Canadian banks account for approximately 90% of the operations of the Canadian financial system.

Historically, the financial services sector has been strong in Canada. No banks collapsed during the Great Depression of the 1930s. Only two small regional banks have gone out of business since 1923.

The Canadian financial system has performed relatively well during the financial market turmoil and current economic recession. This relatively strong performance can be attributed to a number of factors – key among them are:

- a strong regulatory regime
- strong capital requirements and mortgage market regulations
- a conservative appetite for risk
- generally strong macroeconomic fundamentals.

This does not mean that Canada has been immune to the fallout of the financial market turmoil, but it did place Canada in a position to respond effectively and flexibly.

Financial Market Regulation and Oversight

The structure of the Canadian financial system, mortgage and housing markets, and the overall regulatory regime is somewhat different from most others, notably that of the United States. Following major reforms to banking sector regulations in the late 1980s, most investment banking has been carried out within the major commercial banks, and has therefore been subject to prudential regulation.

The Office of the Superintendent of Financial Institutions (OSFI) is the sole prudential regulator of banks in Canada. It requires Canadian banks to maintain capital in excess of international minimum requirements as outlined in Basel II.

Basel II requires banks to hold minimum Tier 1 and Total capital ratios of 4% and 8% respectively. The OSFI requires Canadian banks to hold minimum requirements of 7% and 10% respectively, and in any case, Canadian banks tend to hold substantially more capital as buffers above these minimum requirements. At the end of July 2007, the six largest banks, who collectively represent 90% of the deposits in the Canadian financial system, held average Tier 1 and Total capital rations of 9.59% and 12.27% respectively in July 2007, when symptoms of growing market instability became more visible. At the end of the first quarter of 2009, the average Tier 1 capital ratio was 10%, and the Total Capital ratio stood at almost 13%.

The OSFI requires all financial institutions to establish internal capital targets to provide an operating cushion. The Boards of Directors of the banks have the responsibility to establish internal capital targets to cushion against volatility and unexpected losses from inherent risks, which means that the Board of Directors has the responsibility to ensure that the supervisory targets are never breached. During the financial crisis, all major banks maintained capital in excess of supervisory targets, without receiving injections of government capital, and at the same time did not have to reduce dividends to shareholders. Using internal capital targets played an important role in achieving this.

Perhaps even more revealing is the ability of Canadian banks to continue to raise high quality capital in private markets. As the global financial turmoil continued, markets demanded high capital ratios of financial institutions. Between the onset of the crisis and June 2009, Canadian banks issued close to $14 billion of Tier 1 capital from private markets, largely in the form of preferred shares, but also common shares and hybrids. This suggests confidence in the Canadian banking sector.

As common equity is permanent and absorbs losses, the OSFI requires that it be the predominant component of Tier 1 capital. Given that it can be both difficult and expensive to raise common equity during times of stress, the OSFI has had a longstanding requirement that common equity comprise 75% or more of Tier 1 capital. This has been a source of strength, since markets tend to value highly common equity during times of stress.

Capital adequacy also depends on a bank's risks. The OSFI established principles to help manage the concentration of risk: banks limit single name exposures to 25% of regulatory capital. Basel II establishes higher risk-weighted assets for riskier business, but the OSFI demands that banks with higher risks offset that risk with higher capital targets.

Another key regulatory factor supporting the safety and soundness of the banking system in Canada is the ceiling on the leverage ration – the ratio of total assets to capital – of Canadian banks. This is capped at no more than 20x capital. While the leverage ratios at major Canadian banks have risen steadily in recent years, the ceiling has ensured that average leverage among the major banks has remained markedly lower (an average of 18) than comparable figures for major investment banks in the US and UK (over 25) and Europe (over 30).

A word about the administration of the regulation of the Canadian financial system. The federal Department of Finance has overall responsibility for federal financial sector policy. The OSFI, which is part of the Department of Finance, is responsible for the prudential regulation of banks, and the paramount focus on prudence ensures that the soundness of Canadian banks is not compromised by competing objectives. The Department of Finance is responsible for the prudential supervision of most of the financial institutions central to the system, including both banks and federally-incorporated insurance companies. This minimizes the potential to play one regulator against another.

The Bank of Canada – the central bank – conducts monetary policy, is the lender of last resort, and oversees payment, clearing and settlement systems. The Canada Deposit Insurance Corporation provides industry-funded deposit insurance protection for federally-regulated financial institutions. There are in addition a number of federal and provincial agencies, such as the Financial Consumer Agency of Canada, which protect consumers through regulating market conduct, and capital markets are regulated through provincial security commissions, since this is an area of provincial rather than federal authority under Canada's constitution.

Canada maintains a number of mechanisms to ensure collaboration, information sharing and issue resolution between the various regulatory bodies. These include the Financial Institutions Supervisory Committee, which is embedded in legislation as the primary federal inter-agency group that deals with financial stability issues. The Committee includes the top management of the OSFI, the Department of Finance, the Bank of Canada, the Canada Deposit Insurance Corporation and the Federal Consumer Agency of Canada.

Mortgage and housing markets

An important factor underpinning the soundness of the Canadian financial system is how mortgage finance markets are structured and regulated.

A quick word about Canadian mortgages. These are normally issued for a fixed term – generally 25 years is the maximum – at an interest rate that either floats, or is fixed for certain intervals (frequently five years). Mortgage payment rates are geared to paying off the mortgage at the end of the mortgage period, which means that if interest rates go up, payments will go up at the time of the periodic renegotiation of the mortgage at the fixed intervals mentioned above. Most mortgages have provisions so that they can be paid off in less than the term of the mortgage through accelerated payments (e.g., payment weekly rather than monthly, with the incremental difference credited against the capital of the mortgage) or periodic extra payments against capital.

Canadian legislation requires that all high-ratio residential mortgages (currently defined as those having an initial down payment of less than 20% of the value of the property) made by banks be insured against default by either the Canada Mortgage and Housing Corporation (which is government owned) or a private insurer. This legislative requirement, which has been in place since the 1960s, protects banks against the higher risk of default associated with high ratio mortgages. These mortgage insurance providers are backed by the federal government, and use fairly conservative underwriting criteria, which essentially renders as minimal the sub-prime market in Canada. In other words, a consumer must demonstrate that they can afford the loan.

Unlike in many other jurisdictions, mortgage interest is not deductible for tax purposes in Canada, which means that Canada has not seen a tax-driven distortion in the level of housing debt. This has contributed to the fact that Canada did not experience the same degree of housing boom that occurred in many other countries – the growth of house prices was much more limited than in many other countries. Home ownership levels are similar to levels in the united states – ie. in the 65-70% range.

Conclusion

In summary, a conservative and entrenched regulatory structure for Canada's financial services industry has enabled Canada to survive the recent economic turmoil with a lower drop in our GDP than the US, the UK, Japan or the Eurozone. A series of regulatory mechanisms are collaborative and coordinated, and large scale investment dealers have been bank-owned since the early 1990s, making them subject to the prudential regulation as their bank parents. Canadian capital requirements for financial institutions are above minimum international standards, and are higher than in other jurisdictions, and include a cap on overall leverage. Because mortgage interest is not tax-deductable, Canadian households have smaller mortgages relative both to the value of their homes and disposable incomes than in many other countries, and Canada has a minimal sub-prime housing finance market.

I do not mean to imply by my remarks that Canada has been immune to the international financial crisis. An international crisis needs an international response, coordinated among international partners and aimed at finding a workable solution rather than scapegoats to gang up upon. But I hope that Canada's system may be able to provide ideas and possible avenues that have applicability to situations elsewhere.