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# Canadian Autonomy and Systemic Financial Risk after the Crisis of 2008

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## INTRODUCTION

Canadian policy makers were tested during the 2008 global financial crisis. Subsequent journalistic and scholarly accounts commonly assert that they had passed with flying colours. In fact, stories told before, during and after the crisis seemed to readily fit an old pattern: sound Canadian regulatory principles and supervisory practices had helped offset the potentially devastating effects of manic shocks emanating from turbulent US and European financial markets. Those stories were not false, but most missed deeper truths concerning the origins of those principles and practices, and about the tightening constraints around Canada's broader economic policies.

Canada's success in avoiding the worst effects of the crisis of 2008 reflected the legacy of its own financial disasters in the distant and not-so-distant past. Its preference for stability in the face of systemic risk was hard won. In the context of much deeper financial market integration across the 49th parallel, Canada also increasingly entailed more intensive collaboration with the

United States and other economic partners. Systemic risks cumulated across financial intermediaries that were active internationally. When they threatened to overwhelm integrated payments systems, central bankers became the market-makers of last resort. In the wake of the crisis, governments and central banks in Canada and other leading countries moved to complement microprudential supervision with macroprudential measures designed to enhance the resilience of markets they hoped would remain integrated. Political interaction would determine whether that hope was justified.

Complex interdependence only begins to suggest the existential situation of Canadian financial policy makers today. Canada is not alone in this new world, where intergovernmental coordination on financial crisis management and prevention is hardly voluntary. Its past experiences and geographic location, however, have prepared Canada to be among the first to pragmatically understand the implications of deep integration in financial markets. The scope for the country's economic policies to be crafted autonomously had become quite limited, even if past policy choices favouring open but concentrated capital markets, national control of key intermediaries and a flexible exchange rate still provided tactical room for manoeuvre.

Tony Porter, David Longworth, Lawrence Schembri and Eric Santor concisely summarize the key policy decisions accounting for Canada's enviable performance during the crisis in their chapters in this volume and elsewhere (see also Porter 2010; Lynch 2010, 12–15). This chapter provides historical context and an assessment of the future implications of those decisions.

## THE FINANCIAL CRISIS IN CANADA AND ITS LEGACY

Despite its confederal structure, by the 1980s Canada had successfully consolidated its regulation of banks, insurance companies, investment dealers and trust companies. The process was rooted in the path-breaking recommendations of the Royal Commission on Banking and Finance (Porter Commission) in 1964, which originally opened up the postwar financial system and expanded the scope of competition. The big six banks now compete energetically, but they also own the largest investment dealers and trust companies, and are permitted to sell limited types and amounts of insurance, such as travel and personal accident insurance.

In the years before 2007-2008, Canadian authorities, priding themselves on a combination of intensive supervision and principles-based regulation that put the onus for soundness and stability on the integrated financial institutions, clearly encouraged greater managerial prudence than was evident south of the border. For example, despite a regulatory cap on leverage of $20 in assets for every $1 in capital, the biggest Canadian financial institutions maintained average ratios of 18 to 1 in 2008; their peers in the United States and Europe averaged ratios between 25 and 35 to 1. The so-called Basel Tier 1 bank capital standards, moreover, were generally more rigorous in Canada than elsewhere and, as Longworth notes in his chapter, loss-absorbing capital was of higher quality (see chapter 5 of this volume).

More generally, if concentration and barriers to entry are a force for stability, the Canadian banking system has long been stable. The big six banks have come to dominate a system that spans the country's regions and, most importantly, gathers its retail banking deposits. That retail market is not closed, but, as discussed later in this chapter, it is no accident that foreign banks together have never held more than 10 percent of all banking assets in the country.

Complementing the Canadian banks' retail deposit base are requirements and practices governing the country's home mortgage market. Before the crisis of 2008, about 25 percent of Canadian mortgages were packaged as securities and sold off by the originating banks. The rest were held on the banks' books. In the United States, the comparable number was around 60 percent (Ratnovski and Huang 2009, 11). Also, by way of contrast, only some five percent of Canadian mortgages would have failed to meet a "prime" standard when the Canadian Mortgage and Housing Corporation, a federally controlled entity, stopped insuring them in 2008. The banks subsequently grew more cautious. Even before the crisis, however, the overall mortgage business in Canada was quite safe: down payments on house purchases tended to be high, almost half of all mortgages were insured and mortgage interest payments were not deductible for tax purposes. Cautious bank management,

intensive supervision, tax policy and government-sponsored insurance all reinforced one another.[1]

Notwithstanding their solid domestic foundations, Canadian banks were among the key beneficiaries of both Canadian and American monetary and fiscal largesse during the darkest days of the crisis. In the immediate aftermath of the collapse of Lehman Brothers in September 2008, Canadian banks, like their counterparts around the world, confronted a drastic shortage of liquidity. In coordinated operations, central banks pumped billions of dollars into money markets. US authorities also took the unprecedented step of lending the insurance giant American International Group (AIG) US$85 billion in exchange for nearly 80 percent of its stock. Simultaneously, leading governments moved to ban the speculative short selling of financial stocks. Then, during the first days of October 2008, US President George W. Bush signed the US$700 billion Emergency Economic Stabilization Act into law. Fearing a global economic collapse, central banks simultaneously slashed short-term interest rates. On October 14, the US Treasury announced its intention to take US$250 billion from the new US$700 billion fund to purchase troubled assets from US banks and the US operations of Canadian and other foreign banks.

On December 17, the Fed lowered its base interest rates to near zero percent, and initiated a massive government bond purchasing program. Two days later, President Bush announced plans to lend General Motors and Chrysler US$17.4 billion to prevent their collapse; their Canadian subsidiaries were quiet beneficiaries. The Canadian federal and Ontario governments supplemented this bailout with funds of their own, totalling CDN$3.3 billion in loans and equity purchases. The Canadian component was agreed to be about 20 percent of the value of the American package, commensurate with the relative size of the auto industry in Canada.

On February 10, 2009, the US Treasury announced a Financial Stability Plan involving purchases of convertible preferred stock in eligible banks, the creation of a Public-Private Investment Fund to acquire troubled assets from financial institutions, complemented by massive expansions in the Fed's

1 Note the less-than-cautious behaviour of Canadian financial consumers. By mid-2013, International Monetary Fund (IMF) data suggested that Canadian household debt as a percentage of GDP at 95 percent remained on an increasing trajectory, while the equivalent ratio in the United States was just above 80 percent and falling.

discount window liquidity operations, as well as in its special and temporary Term Asset-Backed Securities Loan Facility and Commercial Paper Financing Facility. One week later, a new US$787 billion fiscal stimulus plan, the American Recovery and Reinvestment Act of 2009, was signed into law. On March 1, the US Treasury provided US$30 billion in capital to AIG and took over two divisions of the company after it announced a US$61.7 billion loss, the largest in US corporate history. Subsequent decisions were made to use some of the proceeds, US taxpayer dollars, to pay AIG's obligations in full to major counterparties — dollar for dollar, without a haircut. Major foreign intermediaries benefitted directly (Broz 2012). Canadian banks featured prominently among the leading, and lucky, beneficiaries.

The following table gives a sense of the scale and scope of the liquidity assistance provided to Canadian banks by the Federal Reserve.

**Table 1: Federal Reserve Bank Loans**
**(August 1, 2007–April 30, 2010, in US$ billions)**

| Beneficiary | Peak Amount of Loans | Average Daily Balance | Number of Days in Debt | Peak Loans/ Market Value (in %) |
|---|---|---|---|---|
| Bank of Nova Scotia | 9.5 (1/2/09) | 1.9 | 798 | 40 |
| Royal Bank of Canada | 6.9 (12/18/08) | 1.8 | 588 | 21 |
| Toronto Dominion Bank | 6.6 (4/19/09) | 2.3 | 679 | 28.5 |
| Canadian Imperial Bank of Commerce | 2.2 (4/19/09) | 0.4 | 364 | 16.5 |
| Bank of Montreal | 1.8 (10/9/08) | 0.4 | 462 | 11.5 |

Source: Author from Federal Reserve data, summarized at www.bloomberg.com ("The Fed's Secret Liquidity Loans"). For comparative purposes, note peak amounts of loans for Citibank (US$99.5 billion); Morgan Stanley (US$107.3 billion); Bank of America (US$91.4 billion); and Goldman Sachs (US$69 billion).

In turn, US authorities asked the Canadian banks simultaneously to provide more high-quality capital to their US operations. This led former Canadian Minister of Finance Jim Flaherty to propose a new ministerial authority to veto the future expansion plans of the banks and insurance companies (see

*The Globe and Mail* 2011).[2] More threat than follow-through, Flaherty's reaction underlined the increasing political sensitivities involved in cross-border policy interaction in the financial sector.

The banks also benefitted indirectly from domestic emergency facilities, both official and officially backed.[3] One program involved asset-backed commercial paper (ABCP). The market for ABCP in Canada stood at CDN$115 billion in 2007, CDN$32 billion of which was based outside the mainstream banking system. In August 2007, the non-bank ABCP market froze. With the finance minister's encouragement, creditors formed the Pan-Canadian Investors Committee of Third Party ABCP Investors in an attempt to restructure and resuscitate the ABCP market. Their plan, dubbed the "Montreal Proposal," is widely understood to be unique in that it was initiated and run by the private sector. Unlike rescue efforts in the United States, an explicit transfer of public funds was not used to prop up the Canadian version of the shadow banking system. However, the quiet encouragement of the federal government, along with the governments of Ontario, Quebec and Alberta, should not be discounted. In fact, they provided critical support for the plan. They collectively agreed to act as the ultimate backstop for the newly created multi-billion dollar margin funding facilities, which, if needed, would make funds available to cover potential shortfalls on margin calls on the credit default swaps at the centre of the frozen ABCP market. Failure to make good on margin calls could have resulted in the collapse of the non-bank ABCP market and spilled over into the bank-centred payments system. The implicit official backstopping of these facilities shed light on another key difference across the 49th parallel. Unlike their American peers, Canada's regulators did not lack the authority to govern domestic institutions that can deliver bank-like services.[4]

In addition, the federal government created the Insured Mortgage Purchase Program, which allowed the official buying of up to CDN$125 billion in securitized mortgages from the banks. By the time the program ended in

2 The proposal specified that ministerial approval would be necessary for any bank or insurance company to increase its consolidated assets by more than 10 percent through a foreign acquisition. In between mandated reviews of the major act governing financial institutions, such a proposal may be interpreted as firm guidance in the absence of final parliamentary action.

3 For more information on the principles guiding liquidity support from the Bank of Canada (BoC), see Longworth (2010).

4 For details on how an equivalent form of deposit insurance was created in the American shadow banking system, see Pozsar et al. (2010).

March 2010, CDN$69 billion had been injected into the banking system. The program was justified by the overriding interest in increasing liquidity within constrained credit markets, as well as by providing a level global playing field with newly "subsidized" foreign competitors. So too were monetary measures designed to lower funding costs for banks at the core of the national payments system. Even though such programs were wisely structured to ensure a long-run profit to the national treasury and, thus, to mitigate somewhat the moral hazards implied, one could hardly defend the argument that Canadian markets functioned efficiently during this period without assistance from the visible hand of government. Indeed, one analysis estimates the net flows of official funds from US and Canadian sources to the Canadian banks at CDN$114 billion between 2008 and 2010, and the scale of this support at the most extreme moments exceeded the market value of three of them (Macdonald 2012).

Notwithstanding this emergency support, the journalistic and policy literature since 2010 suggests that there is much for others to emulate in recent Canadian experience. Beyond the issue of whether larger political and social conditions permit such emulation, more fundamental questions remain: how did the effective microprudential supervision in place in 2008 actually arise and what does the emergency support nonetheless provided to Canada's financial intermediaries tell us about residual gaps in the global supervisory system? A look back at the distant past is useful to help answer these questions.

## CRISIS AND STABILIZATION IN THE EARLY CANADIAN BANKING SYSTEM

Before Confederation, banking in Canada was characterized by repeated growth phases followed by catastrophes. New banks were not difficult to start and they could operate under either royal charters or licenses from colonial legislatures. Fifty-four charters were granted by the Crown or by colonial legislatures between 1820 and 1867 (Neufeld 1972, 553-54). Ease of entry and lax oversight increased competition and expanded credit, but eroded bank profits and encouraged excessive risk taking. Unlucky banks failed, and if they had not put aside a sufficient cushion of capital, their depositors were left with worthless claims. Indeed, spectacular and frequent bank failures

were on the minds of Canada's founding fathers in 1867, as well as in 1871 when they promulgated the first Bank Act (Turley-Ewart 2004).

After 1871, granting new bank charters became the sole responsibility of the federal government. Nationwide branching put Canadian banks under a uniform regulatory setting, something the fragmented American system of the day did not offer. It also provided a natural hedge against regional economic downturns, not uncommon occurrences in the boom-bust cycles of Canada's early economic development (Bordo, Redish and Rockoff 2010; Carr, Mathewson and Quigley 1995). Regional instability, however, often did leave local bank depositors with outright losses. Bank failures were in fact quite common and geographically quite widespread during the final decades of the nineteenth century (Breckenridge 1910, 117). In the run-up to the Bank Act of 1890, fearing political threats to their operational autonomy, leading banks proposed a Bank Circulation Redemption Fund, an early form of deposit insurance. The new fund required all banks to deposit five percent of their annual note circulation at the Finance Department, which would be used to compensate depositors in the event of a failure. The quid pro quo was that the federal government would remain on the sidelines with respect to the day-to-day banking activities. The idea soon bore fruit, and the Canadian Bankers' Association (CBA) was established with the stated objective of securing the assets of the fund (Turley-Ewart 2000). In practice, however, a CBA fragmented by geography and bank scale was incapable of serving as the government's night watchman. The Redemption Fund, moreover, proved inadequate on many occasions and depositors continued to face losses when mismanaged banks failed. Most were accompanied by news of fraud and incompetence, and other banks proved reluctant to compensate either perpetrators or victims.

Up until 1910, bank failures averaged one every two years and new bank charters did not keep pace with the number of banks going out of business. In principle, this Darwinian process promised to leave the group of surviving banks larger and more stable. Enhanced capital requirements and mandatory auditing were included in the 1913 revision to the Bank Act, revisions that also favoured large and diversified banks.

On the eve of World War I, steady consolidation had reduced the number of banks to less than half of the 50 in existence in 1875, despite the economy becoming almost five times as large in real terms (Neufeld 1972, 77–80).

Also gone by this time was the serious prospect that Canada might be annexed outright by the United States. The two facts reinforced one another. The big six banks were beginning to emerge as dominant weavers of a resilient national fabric, and they would prove most useful to a federal government preparing for war. Their new obligations to help finance the war effort — directly by way of loans and taxes, and indirectly by selling government bonds — were enshrined in the Finance Act of 1914; in exchange, the federal government agreed to act as their lender of last resort.

One of the first banks to seek out an emergency loan under the new regime was the Home Bank, which was incorporated in Toronto in 1903. The government acquiesced. Despite the failure of the Bank of Vancouver in 1911, the years following 1914 proved to be a relatively stable time in Canadian banking. No bank failed outright again until 1922, although 11 weaker banks merged with stronger ones. In 1922, 17 chartered banks remained. The lender-of-last-resort policy, and the often-quiet compensation or regulatory deference offered to merger partners, facilitated the process of consolidation. The policy was kept in place inside the Finance Department until 1935, when it was delegated to the new central bank.

With moral hazard issues much in mind, Parliament incorporated more rigorous regulation into the Bank Act in 1923. The Home Bank, however, propped up by an emergency loan and dubious accounting, found it impossible to comply and maintain the confidence of its depositors. Shortly after the death of its general manager and the son of its founder, its parlous condition was uncovered in an audit. Actual losses soon dwarfed all those that had come before in Canadian history, and both the government and its correspondent banks were overwhelmed by the scale and suddenness of the shock (Macmillan, 1933).

The bank failed catastrophically. Among other immediate consequences, 60,000 prairie farmers soon saw their life savings vanish (Johnson 1986, 11). The national press also made much of the ensuing struggle of a group of disabled miners from Fernie, British Columbia to cover their medical expenses after the only bank in town had simply closed its doors (Turley-Ewart 2004, 39). Committees of aggrieved depositors were set up across the country in a vain attempt to receive compensation. Both a paralyzed government and competing banks stood back and refused to bear the extravagant losses. The

unthinkable had now happened and political passions ignited right across the country.

If observers of Canadian politics today wonder why the image of Toronto and its banks remains capable of generating antipathy across the provinces, they need only recall that painful episode. For Canada, it was akin to the failure of Lehman Brothers in the United States in 2008. It turned out to be the last outright bank failure in the country until the 1980s, not coincidentally because it led to tough-minded federal supervision by the new Office of the Inspector General of Banks (OIGB). Modelled on a similar institution created in the United Kingdom in similar circumstances, the OIGB oversaw the continuing consolidation of the banking system. It also continued to rely on principles-based discipline by the banks themselves; its staff consisted of no more than four permanent employees as late as 1974.

Despite its humble beginnings, the OIGB signified the end of five decades of policy patchwork at the federal level. The mindset of national policy makers had decisively shifted. From the time of Confederation, new regulations were aimed at creating an essentially private incentive structure to reduce moral hazard and the risk of contagion. Revisions of the Bank Act incrementally filled gaps exposed by repeated failures, and the government moved decisively toward more intensive supervision. In contrast to the situation a few decades earlier, the impulse to encourage competition took a back seat to an overarching national interest in financial stability. Bank customers might grumble about credit availability and pricing, but the underlying political trade-off proved enduring.

The Great Depression was as severe in Canada as it was in the United States. GDP fell by 40 percent, and national unemployment reached 27 percent in 1933. Yet, for all of the macroeconomic similarities between the two countries, the ensuing record of the banking industry on either side of the border could hardly have been more different. To the astonishment of many observers abroad, the only Canadian bank to close was the Weyburn Security Bank, a small bank concentrated in southern Saskatchewan, which

was quietly merged into the Imperial Bank of Canada in 1931with no loss to its depositors.[5]

Unlike many of their forebears, the remaining 10 banks became renowned for their cautious management. Owing to this caution, loans that were not made surely reduced the losses those banks could have faced when the Great Depression began. Moreover, that risk-aversion was deliberately constructed by national policy makers. Affirmed in the Weyburn case, an implicit government guarantee existed, and was matched by intensive supervision when possible and regulatory forbearance when not (Brean, Kryzanowski and Roberts 2011, 252).

The BoC was established in 1935, and by 1944 it had finally achieved a monopoly over currency issuance. After the war, as in the United States, currency and price controls eased only gradually. Again, interest rate ceilings on personal loans were not completely abolished until 1967, when Porter Commission reforms were adopted. That same year, banks were permitted to issue home mortgages for the first time, and a new Canadian Deposit Insurance Corporation (CDIC) formalized the system that had long since evolved in practice. The few bank mergers during the 1950s and 1960s occurred quietly. Also advancing from the late 1950s through the early 1980s was increasing mobility of capital, especially across the 49th parallel as American and Canadian banks and their customers sought direct access into one another's home markets, a theme that is discussed in the final section below (see also Pauly 1988).

## CRISIS AND STABILIZATION IN THE CONTEMPORARY CANADIAN SYSTEM

The spectre of past Canadian banking disasters made a surprising reappearance in the mid-1980s. Two Alberta-based banks, the Canadian Commercial Bank (CCB) and the Northland Bank, had built up risky loan

5 Although clearly in trouble, the Weyburn Security Bank was deemed solvent at the time of the merger by the Inspector General of Banks (Carr, Mathewson and Quigley 1995, 1150). Weyburn's underlying troubles, associated with crop failures and declining local markets, were hardly unique. Indeed, reliable estimates would later indicate that nine out of the 10 banks operating during the Depression would have been insolvent if they were in fact forced to value their assets at market prices (Krysanowski and Roberts 1993).

portfolios by lending to the local oil industry, funding their positions on wholesale markets. Without a retail deposit base to fall back on, this left them vulnerable to new-style runs at the first sign of trouble. Questionable accounting tactics allowed the two banks to survive for a time, but a rapid fall in oil prices following the worldwide recession of the early 1980s and collapsing real estate prices in Western Canada soon brought the banks' problems into the open. CDIC guarantees were limited to CDN$60,000 per depositor and, in any case, they failed to impress large, sophisticated dealers in short-term and increasingly global money markets. Why should they risk even the hassle of legal proceedings if a counterparty failed? Better to run first and ask questions later.

The response from policy makers was swift, as the emergency immediately spread beyond the troubled Alberta banks (Estey 1986). The BoC publicly reminded the government that its legal mandate prevented it from lending to insolvent institutions. When markets began to believe that the banks faced more than liquidity problems, and that there was some confusion over whether the finance ministry or the central bank was responsible, confidence quickly collapsed. Naturally, dealers in wholesale instruments began to wonder if other Canadian financial institutions would be implicated. As usual, ever since 1923, moral hazard considerations disappeared from regulatory calculations as fast as cash flew out of the two failing banks. Bailout packages were quickly put together by the CDIC, a consortium of the big six banks, the federal government, and the governments of Alberta and British Columbia. And, despite its solvent counterparty rule, the BoC opened its spigot.

The details of this support are as fascinating for the aficionado of clearing and settlement systems as they are tedious for the casual observer. What is important to note is that, at the crucial moment, when Canadian clearing banks were left with unrecoverable claims on the defunct banks, such as cheques payable to wholesale depositors of those banks on the day of effective closure, the BoC assumed the obligations and maintained them on its balance sheet as "other assets" (Dingle 2003, chapter 5). It was a convenient conceit that this was construed as "liquidity support" and not as a straightforward cash transfer from public coffers to private parties, resident or non-resident in Canada.

In the end, other banks were caught up in the turmoil. With wholesale depositors now highly risk-averse and threatening to run, the Bank of British

Columbia was quickly judged by Canadian authorities to be solvent and merged with the Hongkong Bank of Canada (Chant et al. 2003). Continental Bank was sold to Lloyd's Bank, and later passed on to the Hongkong Bank of Canada when Lloyd's closed its Canadian operations. Mercantile Bank, which had once been a subsidiary of the First National City Bank of New York and was still 25 percent owned by Citibank, had to be backstopped with emergency facilities from the big six Canadian banks and its US parent before being sold to Canada's sixth-ranked bank, the National Bank of Canada. Two small banks, the Bank of Alberta and the Western Pacific Bank merged to become the Canadian Western Bank, and Morguard Bank was sold to the Security Pacific Bank of Canada. Meanwhile, residual claims on CCB and Northland Bank that were already in the payments system were being unwound and shared by the big Canadian clearing banks and other counterparties. As a definitive BoC study later concluded, "The reversals required by the default-sharing procedure had the effect of widely redistributing the financial burdens associated with the event — often in unforeseen ways....The result was most painful for the corporate and government treasurers involved" (Dingle 2003, 29-30).

Despite the fact that the assets of CCB and Northland Bank comprised no more than 0.75 percent of total banking assets in Canada, the cost of their failure amounted to about 0.3 percent of Canada's 1985 GDP. In his study of the affair, Charles Goodhart estimated the ultimate losses to Canadian taxpayers at about CDN$900 million; he also underlined the fact that the big six Canadian banks were left with significant and uncompensated losses (Goodhart 1995, 377).[6] Although it could have been worse, the impact on the national payments system was profound. "In addition to developments caused by 'contagion' among similar institutions, the extensive court proceedings surrounding the closures of the CCB and the Northland continued for a full 15 years" (Dingle 2003, 30).

One longer-term effect of the crisis came in the supervisory system. Despite the much-vaunted caution of Canadian bankers, the OIGB was judged to have had too little power to prevent individual banks from building

6 In contrast to the recent AIG case, where taxpayers essentially bought the firm at rock-bottom prices, sold the shares in a restructured profit-making entity back to the private sector and reaped large capital gains, it is important to underline the fact that CCB and Northland Bank were simply liquidated.

up excessively risky portfolios. It had been tasked with devising regulatory principles for safe banking operations, and with closing insolvent banks in an orderly fashion. The risk of contagion, including contagion across diverse but integrating financial sectors, demanded greater powers of pre-emption and liquidity provision for banks judged to be potentially solvent during and after a crisis. The government, therefore, decided to merge the OIGB with the federal Department of Insurance to create a new and more fully staffed body, the Office of the Superintendent of Financial Institutions (OSFI). The powers of this new agency were then greatly expanded to include an "early resolution" mandate allowing it to pre-empt problems it saw brewing in any financial institution. For example, OSFI now had the power to close a bank down, at its discretion, if it approached a position of negative equity.[7]

The bank failures of 1985 had another effect, more subtle but more profound. Stanley Hartt, deputy finance minister at the time, later explained it this way:

> The conventional wisdom about what happened next is that Canada tried to emulate the 1986 development in Margaret Thatcher's United Kingdom that has come to be known as the "Big Bang." While there is an element of truth to this, Canada was actually driven more by its own domestic policy needs. The CEOs of the Big Six banks asked the minister of finance, Michael Wilson, for an emergency meeting….The bankers made a plea to be allowed to enter the securities business, which had been denied them for decades so as to minimize the risk to bank capital resulting from securities market volatility....The banks' best customers could [now] finance themselves directly in the London Interbank Market, in essence in competition with the banks themselves, by issuing Eurodollar securities, leaving to the banks the worst credits....Dick Thomson of the Toronto-Dominion Bank, speaking for the group, pointed out that while we were still dealing with the frightening implications of the recent run on virtually all of the country's smaller banks, the government needed to consider the possibility of failures among the Big Six. (Hartt 2005, 74)

7 That discretion, again, likely manifested itself in some regulatory forbearance during 2008.

Not unlike the US government later contemplating the final end of Glass-Steagall Act restrictions — indeed, helping to hasten that end — the Canadian government soon agreed with the bankers. Competitive impulses reasserted themselves, as they often do, after, not during, crises. In 1992, most functional restrictions on Canadian financial institutions fell away. The banks were transformed into comprehensive institutions analogous to Europe's universal intermediaries, able to bring under one corporate roof activities as diverse as retail deposit taking, and investment underwriting and trading. Although this set the stage for the cascading events of 2008, bank failures such as those witnessed in 1923 and 1985 did not recur. To be sure, the legacy of those earlier crises placed the full faith and credit of the Government of Canada behind dominant national intermediaries, which span all geographic and virtually all functional limits. Together with a decision taken in 1998 to prevent those intermediaries from engaging in voluntary mergers to increase their scale and capacity to take on new risks, it is reasonable to conclude that successful microprudential policies in place in 2008 limited the potential liabilities of Canadian taxpayers. Nevertheless, individuals and institutions providing vital funding to Canada's dominant intermediaries still plausibly threatened to run that same year.

## POLICY AUTONOMY IN OPEN MARKETS

Why would any investor run from a triple-A national credit risk in uncertain times? Much hyperbole concerning debts, deficits and commodity busts notwithstanding, the time to finally flee from contemporary Canada — and the American markets within which it is now deeply integrated — is when the serious prospect looms that all paper claims denominated in Canadian dollars are about to become worthless. The panic in 2008 at least suggested that many investors and depositors believed that such claims could soon be significantly devalued. In this context, the effective microprudential policies born of Canada's experiences in 1923 and 1985, and of American and European experiences in the 1930s, proved to be inadequate. What was needed were the macroprudential foundations necessary for the next phase of transnational competition in finance.

To the extent that a more centralized and vigorous OSFI was a harbinger of things to come in more integrated North American markets, it is worth noting

that its mandate was tested during several turbulent periods from the late 1980s through 2008. Its success throughout this period was likely reinforced by one other long-standing element of continuity in Canadian financial policy — namely, the assurance that dominant intermediaries would remain accountable to the federal government and the BoC. Although ownership structures were loosened over time, the institutions at the core of the payments system remained under national control through a "widely held" rule. This prevents any domestic or foreign entity from owning more than one-fifth of the voting shares (or 30 percent of any non-voting shares) of large financial institutions. The rules were adjusted in 1992 and again in 2012 at the request of banks and demutualized insurance companies concerned about their own ability to compete in external markets, especially in the United States where provisions of bilateral freer trade arrangements had come into play. For the big institutions, expansion in US markets became ever more important. A few years after the crisis of 2008, moreover, the intermediaries at the top of a more concentrated American system hardly seemed to be in retreat from global markets. The coordinated interventions of Canada and the United States in 2008, therefore, likely set the pattern for the future. Prudential policies now had to be more collaborative — regionally and, apparently, globally — and they had to have a macro dimension. Intermediaries competing for the same business would certainly complain if they faced highly differential capital requirements, required leverage ratios and other general operating strictures.

Canada's leading financial institutions, and many of their customers, are today deeply integrated into American markets, which are now clearly backed by the US Federal Reserve and the US Treasury. At the same time, they have also managed to maintain a dominant position in their home markets with the backing of the BoC and other agencies of the Canadian state. Canadian policy makers can present the price of their remaining autonomy as reflective of a deep-seated and prudent national preference for financial stability. Hard-earned by their constituents and ancestors, that preference is on full display during crises. Just as noteworthy today, however, is the new role of foreign governments and central banks in helping to underwrite that stability.

It cannot be denied that moral hazard is now reinforced in unbounded, but state-backed markets. As central bankers and finance ministers certainly recognized in 2008, key financial intermediaries in Canada, and indeed across most advanced and emerging market countries, are indeed too big and

too interconnected to fail. The post-crisis response from leading countries, including Canada, is that clearer multilateral understandings on burden sharing between the home and host states of the most systemically important financial institutions must be underpinned by tighter and more collaborative macroprudential oversight. This constituted the post-crisis agenda for financial supervisors, and it was apparently fairly easy to agree upon in principle. In practice, and in the absence of emergency conditions, robust, common and enforceable macroprudential policies are proving elusive. Policy makers are pressed once again to preserve national advantages. Also obvious once more are long-standing differences between countries that prefer statutory rules and competition among domestic regulatory agencies and countries that complement basic rules and standards with intensive supervision and consolidated authority. Canada is in the latter camp, while its markets are tightly integrated with the United States, the key exemplar of the former approach. This core dilemma is compounded by deep macroeconomic imbalances and the massive global liquidity that accommodates them.

Effective governance of the systemic risks embedded in markets dominated by intermediaries that are too big and too interconnected to fail depends on finding a workable compromise for the time being. An extreme alternative is to break apart those intermediaries and prevent the expansion of alternative and equally risky investment and financing vehicles in the shadows of vital payments systems. Although the years immediately following the crisis of 2008 were marked by renewed debates on the value of short-term capital movements and by heightened home bias in certain financial markets, there was little evidence of political appetite for seriously downsizing or limiting the operational range of national champions or of returning to the Bretton Woods ideal of "inclusive multilateralism" outlined by Eric Helleiner in chapter 1. Instead, the revealed preference of the leading states inclined in the direction of returning to the status quo observed before the crisis of 2008: open capital markets and low-profile, and often frustrating, technical work on convergent or at least tolerably different national and regional regulatory standards. Behind that inclination lies the market stabilizing faith that "ad hoc" coordination by leading central banks and finance ministries will again prove adequate to the task of managing systemic risks during the next great financial crisis. Although much discussed, "resilient" markets are hardly assured.

In such a context, the scope for autonomous policy making in Canada is ever more highly constrained as commodities remain vital to the national economy and flows of goods, services, financial claims and people across North American and international borders intensify. It also remains true, however, that history has made Canada's financial policy makers masters at exploiting their tactical room for manoeuvre — by relying on a flexible exchange rate, restraining public-sector indebtedness and intensively supervising Canadian intermediaries, and by promoting their preferences for official discretion and effective macroprudential oversight in every global forum available.

## Author's Note

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