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Financial Market Supervision: Canada's Perspective

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Summary

The international financial crisis has spurred policymakers in the United States and elsewhere to consider changing the way they currently supervise financial institutions and financial markets to reduce the prospects of experiencing another global financial crisis. Canada's financial system, in particular is garnering attention, because it seems to be more resistant to the failures and bailouts that have marked banks in the United States and Europe. In particular, some observers are assessing the merits of the way Canada supervises and regulates its banks, as one possible model for the United States. There likely are aspects of Canada's financial supervisory framework that may offer an approach to supervising financial markets that may be useful for the United States to consider. However, the smaller scope of Canada's financial system and its economy likely lessen the transferability of systems or procedures used in Canada to the vastly more complex U.S. financial system. This report presents an overview of Canada's financial system and its supervisory framework and draws some distinctions between that system and the current U.S. framework.

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Background

The current financial crisis is prompting U.S. and foreign leaders to search for national models that have proven superior in supervising and regulating financial markets and for a new international order that can help mitigate any recurrence of the crisis. Canada's financial system, in particular, is garnering, attention because it seems to be more resistant during the crisis to the failures and bailouts that have marked banks in the United States and Europe. In particular, some observers are assessing the merits of Canada's financial system, especially the way it supervises and regulates its banks, as one possible model for the United States. Currently, advanced economies employ a number of institutional structures to supervise and regulate their financial sectors.

No single model of market supervision has proven to be clearly superior, but the trend seems to be toward more integrated arrangements. Reportedly, the Obama administration considered at one time replacing the multiple agencies that supervise and regulate the U.S. financial system with a single regulator.[1] It has proposed instead changes to the existing system that enhances the role of the Federal Reserve and creates two new agencies and a new Financial Services Oversight Council.[2] Members of Congress are likely to propose alternative approaches to reordering the supervision of U.S. financial markets. A number of countries have opted for a twin peaks approach where prudential regulation (focusing on the long-term view of market performance) is assigned to one regulator and market conduct regulation (focusing on the day-to-day operation of the market) to another. Great Britain employs a different model where there is a fully unified regulator that is separate from the central bank. Others, like the United States, have opted for specialized federal regulators, while reserving a role for state regulators in securities regulation. Canada's model assigns the central bank the main role of conducting monetary policy and maintaining price stability. It has assigned the core responsibility for supervising and regulating some aspects of the financial system to a separate federal agency, while also giving provincial governments authority over other parts of the financial system.

While Canada has not injected capital directly into its banks to forestall a failure, the financial crisis and global economic recession are battering the Canadian economy in ways that are similar to those in the United States and in Europe. The International Monetary Fund (IMF) recently forecast that the Canadian economy, as represented by gross domestic product (GDP), could contract by 2.5% in 2009, before rebounding with a positive rate of economic growth of 1.2% in 2010, as indicated in **Table 1**. The Bank of Canada, however, projected that the Canadian economy would contract by 3.0% in 2009, and then rebound in 2010 at a 2.5% annual rate of growth.[3] In comparison, the U.S. economy is forecast to decline by 2.8% in 2009 and remain flat in 2010.[4] The IMF forecast also indicates that unemployment in Canada will rise to 8.4% in 2009 and 8.8% in 2010. The slowdown in economic growth, in large part, reflects Canada's

[1] Appelbaum, Binyamin, and Zachary A. Goldfarb, U.S. Weighs Single Agency to Regulate Banking Industry, *The Washington Post*, May 28, 2009, p. A1.

[2] Cho, David, Binyamin Appelbaum, and Zachary A. Goldfarb, Goals Shift For Reform of Financial Regulation, *The Washington Post*, June 10, 2009, p. A1, Cho, David, and Zachary A. Goldfarb, Core Reforms Held Firm As Much Else Fell Away, *The Washington Post*, June 18, 2009, p. A1..

[3] *Monetary Policy Report*, The Bank of Canada, April 2009, p. 19.

[4] *World Economic Outlook*, The International Monetary Fund, April, 2009, p. 69.

vulnerability to spillover effects from the U.S. economy, since three-fourths of Canada's exports are bound for the United States and about one-fourth of Canadian corporate finance is sourced there.[5] Canadian exports of automotive products, forest products, and industrial materials posted steep declines in the first quarter of 2009, and Canadian firms cut about 270,000 jobs in the first quarter and reduced the average work week.[6] The slowdown was especially pronounced in the first quarter of 2009, when GDP fell by 7.1%, according to the Bank of Canada.[7]

Table 1. Canada's Actual and Projected Real GDP, Consumer Prices, and Rate of Unemployment

(Annual percentage changes and percent of labor force)

	2007	2008	2009	2010
	Actual		Projected	
Real GDP	2.7%	0.5%	-2.5%	1.2%
Consumer Prices	2.1	2.4	0.0	0.5
Unemployment	6.0	6.2	8.4	8.8

Source: *World Economic Outlook*, International Monetary Fund, April, 2009.

Canadian banks are also expected to face a number of challenges over the next year that include a continued contraction in output, falling household incomes, and rising unemployment. Although Canadian credit markets have improved over the first half of 2009, certain markets for asset backed securities (ABS) remain frozen. The Bank of Canada indicated in June 2009 that the number of such securities had fallen by about 20% since June 2007, because maturing securities are not being replaced by new issues.[8] The IMF has indicated that Canada is generally better situated than many other countries to weather the financial crisis and the global economic downturn. This resilience can be attributed to three factors. First, Canada positioned itself well prior to the financial crisis through a conservative macroeconomic policy that reduced the federal government's debt relative to GDP and through a relatively tight monetary policy that focused on price stability.[9]

Secondly, the IMF argues that Canadian banks have performed better, because Canadian authorities acted proactively in addressing the potential economic slowdown. They did this by: 1) adopting a major fiscal stimulus of Can$65 billion on October 30, 2008; 2) adopting an additional fiscal stimulus program in early January 2009; and 3) easing monetary policy through a series of cuts in key interest rates. As part of Canada's Economic Action Plan adopted in January 2009, officials implemented additional policy measures they can employ should further actions be necessary. The economic plan comprises five elements: 1) funding for job and skills training; 2) funding to stimulate housing construction; 3) investment in infrastructure; 4) support for major export sectors, including automotive, forestry, and manufacturing; and 5) improving access to

[5] Klyuev, Vladimir, *Real Implications of Financial Linkages between Canada and the United States*, IMF Working Paper WP/08/23, International Monetary Fund, January 2008.

[6] *Monetary Policy Report*, the Bank of Canada, April 2009, p. 9-10.

[7] Ibid, p. 22.

[8] *Financial System Review*, the Bank of Canada, June 2009, p. 13.

[9] *Concluding Statement of the IMF's 2009 Article IV Mission to Canada*, International Monetary Fund, press releaser no. 09/73, March 11, 2009.

financing through the Extraordinary Financing Framework. In the early stages of the financial crisis, the Bank of Canada also provided liquidity by expanding its liquidity facilities and the Government of Canada purchased some insured mortgages through the Canada Mortgage and Housing Corporation.[10]

In addition, the Extraordinary Financing Framework is comprised of five elements: 1) providing funding to Canadian financial institutions through the Insured Mortgage Purchase Program and the Canada Mortgage Bond program; 2) expanding financing for Canadian businesses through Export Development Canada and the Business Development Bank of Canada; 3) increasing collaboration between financial Crown corporations[11] and private sector lenders and credit insurers under a business Credit Availability program; 4) designing a Canadian Secured Credit Facility; and 5) initiating a Canadian Lenders Assurance Facility and the Canadian Life Insurers Assurance Facility to provide insurance on the wholesale term borrowing of federally regulated deposit-taking institutions, and life insurers. Additional measures include the ability to offer guarantees on bank and insurance liabilities, and the authority to engage in transactions to maintain financial stability, including providing capital injections. [12]

Finally, the IMF argues that financial conditions have remained more favorable in Canada, because Canadian banks are managed conservatively. Canadian banks are required to maintain larger capital requirements than elsewhere, which has meant that Canadian banks had a stronger balance sheet position as the crisis developed. The regulatory structure also discourages Canadian banks from taking excessive risks. This system is centered around two key thresholds: minimum risk-based capital ratios; and a maximum assets-to-capital multiple. Canada requires banks to hold capital at rates that are higher than those set in the Basel Accords; Canada requires its banks to hold tier 1 capital[13] of at least 7% and total capital of 10%, compared with 4% and 8%, respectively, for the Basel Accord. In addition, Canada requires that 75% of the tier 1 capital be in the form of common equity and it restricts innovative instruments to 15% of tier 1 capital. In addition, the assets-to-capital multiple is set at 20, which translates into a leverage ratio of 5%. The capital requirements not only provide an enhanced capital cushion for Canadian banks, but they restrict rapid balance sheet expansion and discourage engaging in wholesale operations.[14] Nevertheless, as the financial crisis unfolded, the banks came under pressure from markets to increase their capital ratios, which they apparently did by tapping private sources.[15] In addition, the IMF points out that Canadian banks have been more resilient, because Canada has a strong financial regulatory and supervisory framework.[16]

As a result of these three factors, no Canadian bank has needed public capital injections and none have used public guarantees.[17] Nevertheless, the banks suffered a loss of 50% in the value of their equities, similar to the experience of such equities in the United States and Europe. The Canadian

[10] *Financial System Review,* p. 3.

[11] State-owned corporations at either the federal, state, or territorial level.

[12] *Canada's Economic Action Plan, 2009 Budget,* Chapter 3, Ministry of Finance.

[13] Tier 1 capital is the core measure of a bank's financial strength from a regulator's perspective. It generally is comprised of common stock and disclosed reserves.

[14] Rostnovski, Lev, and Rocco Huang, Why Are Canadian Banks More Resilient? IMF Working Paper WP/09/152. International Monetary Fund, July 2009, , p. 16.

[15] *Financial System Review,* p. 4.

[16] *Concluding Statement on the IMF's 2009 Article IV Mission to Canada.*

[17] *Financial System Review,* p. 1.

Imperial Bank of Commerce lost $2.1 billion in derivatives in 2008. The drop in commodity prices also caused the Canadian dollar to fall relative to the U.S. dollar, which would improve the cost competitive position of Canada's exports, once a recovery begins. As the recovery begins, however, demand for raw materials will increase, which, in turn, will cause the Canadian dollar to appreciate. At the present time, the slowdown in global trade, the shake-out in the auto industry, and a slowdown in exports of construction-related products are having far-reaching negative effects on the Canadian economy. In January, 2009, the Canadian Government announced about a Can$40 billion fiscal stimulus package over two years in infrastructure spending, tax decreases, worker retraining, housing, and aid to struggling industries to spur the Canadian economy, as indicated in **Table 2**. The stimulus to the Canadian economy provided by this economic package is expected to be supplemented by spending by the provincial governments. In addition, on April 21, 2009, the Bank of Canada lowered the nation's key interest rate to 0.25%.

Table 2. Canada's Economic Action Plan

(in millions of Canadian dollars)

	2009	2010	Total
Action to Help Canadians and Stimulate Spending	$5.880	$6.945	$12.825
Action to Stimulate Housing Construction	5,365	2,395	7,760
Housing leverage	725	750	1,475
Immediate Action to Build Infrastructure	6,224	5,605	11,829
Infrastructure leverage	4,532	4,365	8,897
Action to Support Businesses and Communities	5,272	2,255	7,527
Sectoral leverage	1,300		1,300
Total Federal Stimulus	22,742	17,200	39,942
Total Stimulus (with leverage)	29,298	22,316	51,613
Total Stimulus as a share of GDP (%)	1.5	1.1	2.5
Total Stimulus (with leverage) as a share of GDP (%)	1.9	1.4	3.2

Source: *Canada's Economic Action Plan, 2009 Budget*, Chapter 3, Ministry of Finance.

A recent IMF staff report used three measures to assess the financial strength of Canada's banks as a way of understanding the relative success the banks experienced in avoiding the same intensity of financial troubles that afflicted banks in other major economies. These measures include: 1) capital-assets ratios (total equity divided by total assets), since better-capitalized banks likely can sustain higher losses without becoming insolvent; 2) balance sheet liquidity (total liquid assets divided by total liabilities), because a buffer of liquid assets allows banks to cover transitory cash-flow shortfalls; and 3) the funding structure of the banks, or the share of their funding that is derived from deposits, since deposit insurance likely improves the stability of this source of funding. The results of the measures are presented in **Table 3, Table 4, and Table 5**. The three tables also include a measure of the percentage decline from January 2007 to January 2009 in the value of the equity of the individual banks. They also provide some basic information on the nature of any government intervention that was needed to assist the individual banks.

Table 3, Table 4, and Table 5 indicate that Canadian banks are not exceptionally financially strong relative to banks in other OECD countries. In some cases, the capital ratios of Canadian banks were half or less than that of a number of U.S. firms that experienced significant liquidity problems as the financial crisis progressed. Similarly, Canadian banks did not have balance sheet liquidity that was significantly different from that of other banks. As indicated by the IMF report, and as indicated in **Table 5** the major difference between Canadian banks and banks in other OECD countries is the funding source of those banks. Canadian banks generally relied much less on wholesale funding, or borrowing short-term from money markets. Instead, the banks relied on depository funding, much of which came from such retail sources as households, for a higher share of their funding.[18] This success in attracting household deposits may in part stem from the ability of Canadian banks, as universal banks, to offer one-stop service in mutual funds and asset management.[19]

Table 3. Capital Ratios of Major Banks

Bank	Country	Capital Ratio	Value decline	Intervention
Hypo Real Estate Holding AG	Germany	2.1	97%	Asset guarantees and public loans
Deutsche Bank AG	Germany	2.1	81	
UBS AG	Switzerland	2.3	79	Capital injection
Commerzbank AG	Germany	2.5	89	Capital injection
ABN Amro Holding NV	Netherlands	2.6	NA	Nationalized (carved out from Fortis)
Barclays Plc	United Kingdom	2.7	85	
Fortis	Belgium	2.8	94	Broken up, part nationalized
Dresdner Bank AG	Germany	3.0	NA	Capital injection
Northern Rock Plc	United Kingdom	3.2	100	Nationalized
Dexia	Belgium	3.3	89	Nationalized
ING Groep NV	Netherlands	3.3	81	Recapitalized, asset guarantees
Lloyds TSB Group Plc	United Kingdom	3.3	78	Capital injection
HBOS Plc	United Kingdom	3.6	100	Recapitalized (part of Lloyds)
Canadian Imperial Bank of Commerce	Canada	4.1	54	
Royal Bank of Canada RBC	Canada	4.3	44	
Credit Suisse Group	Switzerland	4.7	66	
Banque de Montreal-Bank of Montreal	Canada	4.8	53	
Bank of Nova Scotia (The)	Canada	4.9	42	
Royal Bank of Scotland Group Plc (The)	United Kingdom	5.2	96	Capital injection, asset guarantees

[18] Ratnovski, Huang, *Why Are Canadian Banks More Resilient?,* p. 4.

[19] Ibid., p. 11.

Bank	Country	Capital Ratio	Value decline	Intervention
Westpac Banking Corporation	Australia	5.3	38	
Commonwealth Bank of Australia	Australia	5.7	46	
National Australia Bank	Australia	5.7	53	
Toronto Dominion Bank	Canada	5.7	43	
Australia and New Zealand Banking Group	Australia	5.9	54	
Citigroup Inc	USA	6.4	94	Recapitalized, asset guarantees
HSBC Holdings Plc	United Kingdom	6.6	41	
Washington Mutual Inc.	USA	8.5	100	Failed, taken over by FDIC
JP Morgan Chase & Co.	USA	8.6	50	
Bank of America Corporation	USA	9.3	87	Capital injection, asset guarantees
Wells Fargo & Company	USA	9.5	47	
Wachovia Corporation	USA	10.3	100	Failed, acquired by Wells Fargo
Capital One Financial Corporation	USA	16.9	80	

Source: Ratnovski, Lev, and Rocco Huang, *Why Are Canadian Banks More Resilient?,* IMF Working Paper WP/09/152, International Monetary Fund, July 2009.

Note: Capital represents bank equity divided by total assets. Value decline is a measure of the percentage decline from January 2007 to January 2009 in the value of the equity of the respective bank. Intervention represents some basic information about the nature of any government intervention.

Table 4. Balance Sheet Liquidity of Major Banks

Bank	Country	Liquidity	Value decline	Intervention
Capital One Financial Corporation	USA	3.70%	80%	
National City Corporation	USA	4.00	100	Acquired by PNC Bank
Citizens Financial Group Inc.	USA	4.30	NA	NA (owned by RBS)
SunTrust Banks, Inc.	USA	4.30	85	
US Bancorp	USA	4.40	58	
Washington Mutual Inc.	USA	4.80	100	Failed, taken over by FDIC
Regions Financial Corporation	USA	5.00	90	
Nomura Holdings Inc	JAPAN	5.60	76	
Wells Fargo & Company	USA	6.00	47	
Northern Rock Plc	United Kingdom	6.70	100	Nationalized
Kookmin Bank	Korea	7.80	56	

Bank	Country	Liquidity	Value decline	Intervention
Bank of Ireland	Ireland	8.40	96	Capital injection, liabilities guarantee
Commonwealth Bank of Australia	Australia	8.90	46	
Australia and New Zealand Banking Group	Australia	10.32	54	
Westpac Banking Corporation	Australia	10.42	38	
Wachovia Corporation	USA	10.69	100	Failed, acquired by Wells Fargo
HBOS Plc	United Kingdom	11.14	100	Capital injection (part of Lloys)
National Australia Bank	Australia	11.15	53	
Lloyds TSB Group Plc	United Kingdom	15.67	78	Capital injection
Banque de Montreal-Bank of Montreal	Canada	23.99	53	
Toronto Dominion Bank	Canada	24.37	43	
Bank of Nova Scotia (The)	Canada	24.43	42	
Royal Bank of Scotland Group Plc (The)	United Kingdom	25.11	96	Capital injection, asset guarantees
Bank of America Corporation	USA	25.59	87	Capital injection, asset guarantees
Canadian Imperial Bank of Commerce	Canada	26.00	54	
Royal Bank of Canada RBC	Canada	32.11	44	
HSBC Holdings Plc	United Kingdom	33.20	41	
Citigroup Inc	USA	39.46	94	Recapitalized, asset guarantees
Barclays Plc	United Kingdom	40.75	85	
JP Morgan Chase & Co.	USA	46.80	50	
Credit Suisse Group	Switzerland	64.93	66	
UBS AG	Switzerland	65.20	79	Capital injection

Source: Ratnovski, Lev, and Rocco Huang, *Why Are Canadian Banks More Resilient?,* IMF Working Paper WP/09/152, International Monetary Fund, July 2009.

Note: Liquidity represents total liquid assets divided by total liabilities. Value decline is a measure of the percentage decline from January 2007 to January 2009 in the value of the equity of the respective bank. Intervention represents some basic information about the nature of any government intervention.

Table 5. Depository Funding of Major Banks

Bank	Country	Depository funding	Value decline	Intervention
Hypo Real Estate Holding AG	Germany	24.0%	97%	Asset guarantees and public loans
Northern Rock Plc	United Kingdom	28.7	100	Nationalized
Deutsche Bank AG	Germany	34.1	81	
BNP Paribas	France	36.7	65	
Citigroup Inc	USA	37.8	94	Capital injection, asset guarantees
HBOS Plc	United Kingdom	41.0	100	Capital injection (part of Lloyds)
Société Générale	France	42.0	74	
Banca Monte dei Paschi di Siena SpA	Italy	44.1	68	
Dexia	Belgium	44.9	89	Nationalized
DnB Nor ASA	Norway	45.4	74	
Danske Bank A/S	Denmark	46.3	78	
Commerzbank AG	Germany	47.0	89	Capital injection
JP Morgan Chase & Co.	USA	47.3	50	
Barclays Plc	United Kingdom	47.7	85	
Bank of America Corporation	USA	47.9	87	Capital injection, asset guarantees
National Australia Bank	Australia	51.7	53	
Commonwealth Bank of Australia	Australia	53.4	46	
HSBC Holdings Plc	United Kingdom	54.9	41	
Credit Suisse Group	Switzerland	55.6	66	
Capital One Financial Corporation	USA	57.3	80	
Lloyds TSB Group Plc	United Kingdom	58.7	78	Capital injection
Royal Bank of Scotland Group Plc (The)	United Kingdom	59.3	96	Capital injection, asset guarantees
Wachovia Corporation	USA	62.8	100	Failed, acquired by Wells Fargo
UBS AG	Switzerland	64.1	79	Capital injection
Wells Fargo & Company	USA	64.4	47	
Royal Bank of Canada RBC	Canada	65.1	44	
Banque de Montreal-Bank of Montreal	Canada	65.2	53	

Bank	Country	Depository funding	Value decline	Intervention
Australia and New Zealand Banking Group	Australia	65.4	54	
Toronto Dominion Bank	Canada	67.9	43	
Canadian Imperial Bank of Commerce	Canada	68.2	54	
Bank of Nova Scotia (The)	Canada	71.4	42	
Westpac Banking Corporation	Australia	74.1	38	
Washington Mutual Inc.	USA	74.6	100	Failed, taken over by FDIC

Source: Ratnovski, Lev, and Rocco Huang, *Why Are Canadian Banks More Resilient?,* IMF Working Paper WP/09/152, International Monetary Fund, July 2009.

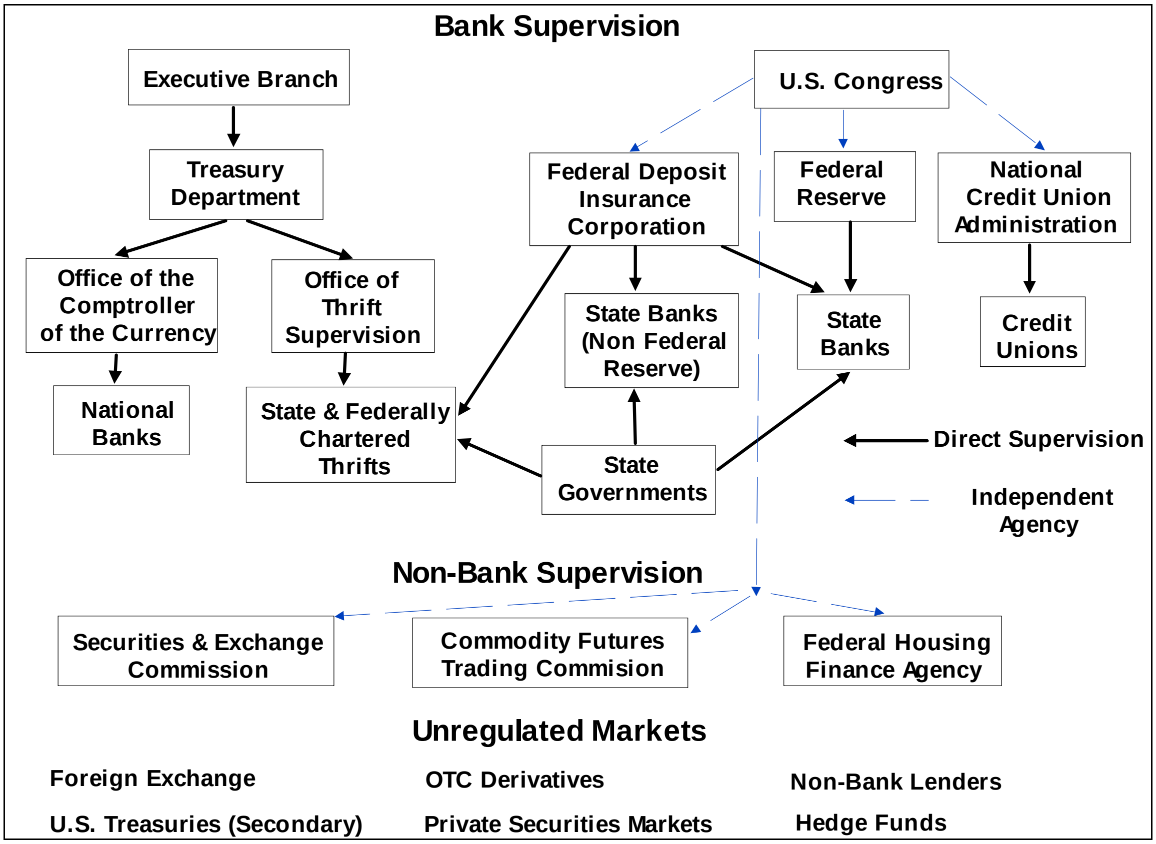
Note: Depository funding represents the share of total bank funding that is derived from deposits. Value decline is a measure of the percentage decline from January 2007 to January 2009 in the value of the equity of the respective bank. Intervention represents some basic information about the nature of any government intervention.

The U.S. Financial Supervisory System

Currently, the United States has a complex regulatory framework in which agencies have overlapping jurisdiction, and in which there are some regulatory gaps.[20] Congress and the Administration are considering a number of changes to the supervisory framework in an effort to improve the system and to correct weaknesses. Not all of the regulators have the authority to address systemic risk, and no single regulator has jurisdiction over all the financial institutions and markets. As indicated in **Figure 1**, financial supervision can be separated into three main categories: supervision of banks, supervision of non-banks, and those markets that are unregulated. For ease of presentation, the figure shows only the major lines of supervisory responsibility. For instance, the President nominates the Governors of the Federal Reserve Board, but the Treasury Department closely coordinates with the Federal Reserve in developing and implementing policy. The Chairman of the Federal Reserve, however, formally reports to Congress, so the figure shows only this line of responsibility. Similarly, the Administration coordinates closely with many of the other independent agencies that supervise parts of the financial system.

[20] For greater detail, see: CRS Report R40249, *Who Regulates Whom? An Overview of U.S. Financial Supervision*, by Mark Jickling and Edward V. Murphy.

Figure 1. U.S. System for Supervising Financial Markets



Source: Developed by CRS.

The U.S. financial system is also characterized by a combination of federally chartered financial institutions and financial institutions chartered by the individual 50 States. This system, some observers argue, has allowed banks that faced federal regulatory action to walk away from federal regulators and move under state supervision by converting their charters to a state charter.[21] National banks are supervised by the Office of the Comptroller of the Currency that is under the direction of the U.S. Treasury Department. The Office of Thrift Supervision, also within the Treasury Department, supervises State and federally chartered thrift institutions. Next, the U.S. Congress has established a number of independent agencies that supervise various parts of the financial system. These agencies include the Federal Deposit Insurance Corporation that directly supervises State banks that are not part of the Federal Reserve System and indirectly supervises State and federally chartered thrifts and State banks, such as commercial banks and industrial banks. Next, the Federal Reserve System is the central bank of the United States and is comprised of the Board of Governors and 12 District Federal Reserve Banks. These banks supervise all State banks that are part of the Federal Reserve System, bank holding companies, the foreign activities of member banks, the U.S. activities of foreign banks, and Edge Act, or limited-purpose institutions that engage in foreign banking business. The National Credit Union Administration supervises the many credit unions. In addition to these federal entities, State entities supervise State chartered thrifts and State banks.

[21] Applebaum, Binyamin, By Switching their Charters, Banks Skirt Supervision, *The Washington Post*, January 22, 2009, p. A1.

In the area of non-bank supervision, the U.S. Congress has chartered three independent agencies. These agencies include the Securities and Exchange Commission, which supervises all securities trading and securities firms, the Commodity Futures Trading Commission, which supervises the trading of commodities, and the Federal Housing Finance Agency, which supervises the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Association (Freddie Mac), and the Federal Home Loan Banks. State agencies also regulate and supervise insurance activities. Beyond this area of supervision, there is a broad group of financial activities that have not been directly supervised, including the rapidly growing area of derivatives trading.

On June 17, 2009, President Obama presented his plan for overhauling supervision of the financial services sector. Prospects for the plan are uncertain, since Members of Congress likely will propose alternative approaches to reordering the supervision of the U.S. financial markets. The Obama Administration's plan has a number of components. First, the Federal Reserve would gain the authority to supervise any large firm, regardless of which specific sector of the financial markets the firm is involved with, if the Treasury had determined that the firm poses a threat to the overall financial system. The Fed could also require such firms to hold more reserves and to take fewer risks. This proposal would significantly broaden the supervisory reach of the Federal Reserve over its current responsibilities. Next, the proposal would create a new Financial Services Oversight Council that would be chaired by the Department of the Treasury and include the heads of the principal federal financial regulators.

Third, President Obama's plan would create the Consumer Financial Protection Agency, which would set and enforce regulations regarding consumer loans, including credit cards and mortgages. Fourth, the plan would create a new National Bank Supervisor to replace the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). Fifth, the plan would give the Federal Deposit Insurance Corporation (FDIC) the authority to take over and shut down financial institutions whose failure would threaten the stability of the financial system. Sixth, the Commodities Futures Trading Commission and the Securities and Exchange Commission would have more authority to regulate derivatives. Finally, the Securities and Exchange Commission would also gain the authority to supervise hedge funds and mutual funds.

On March 23, 2009, Senator Collins introduced S. 664, the Financial System Stabilization and Reform Act of 2009. A companion measure, H.R. 1754, was introduced in the House of Representatives by Representative Castle. These proposals would create a Financial Stability Council that would be chaired by an individual appointed by the President and confirmed by the Senate, with the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the FDIC, the chairman of the National Credit Union Administration, the Chairman of the Securities and Exchange Commission, and the chairman of the Commodities Future Trading Commission serving as members of the Council. In addition, the Federal Reserve would be granted authority to examine the soundness and safety of the financial system posed by bank holding companies.

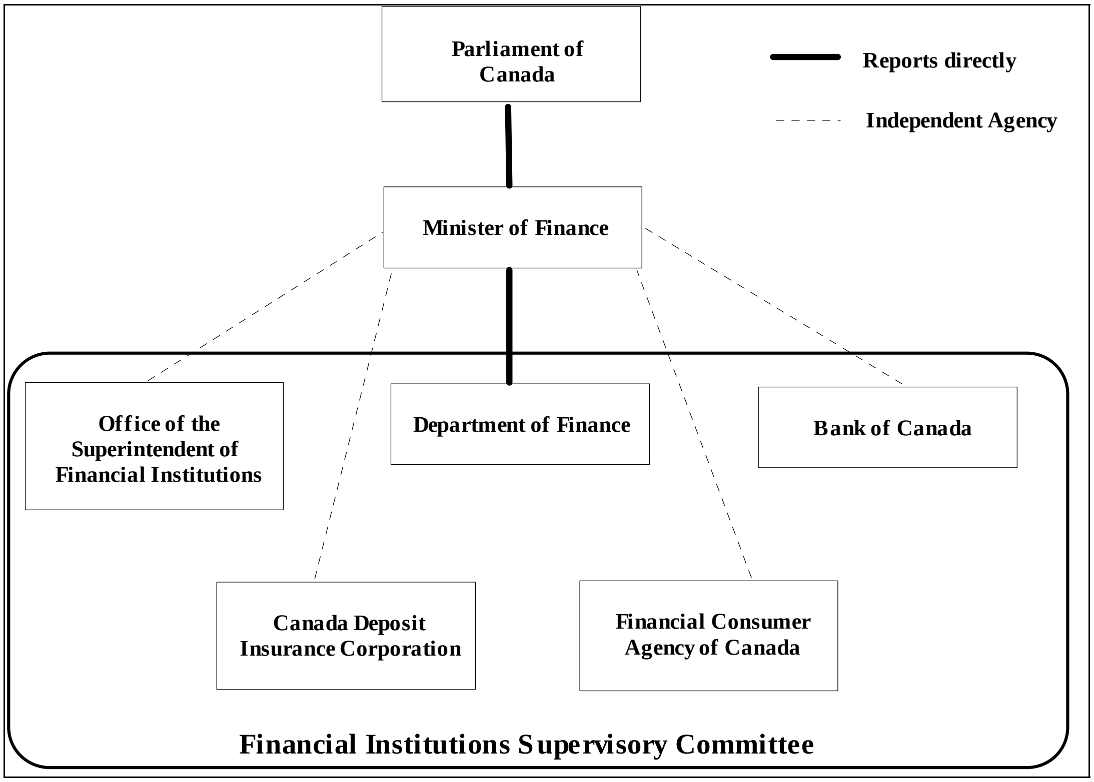
In addition, the Securities and Exchange Commission would be required to designate a clearinghouse for credit default swaps and to prohibit "fraudulent, deceptive, or manipulative acts or practices" in connection with credit-default swaps. Next, the Office of Thrift Supervision would be abolished with the functions performed by that office transferred to the Comptroller of the Currency.

Canada's Financial System

In a recent assessment of Canada's financial system, the IMF concluded that Canada's system is highly mature, sophisticated, and well-managed. In addition, the system is characterized by strong prudential regulation and supervision and a well-designed system of deposit insurance and arrangements for crisis management and resolution of failed banks. Supervisory responsibility for the financial sector in Canada is divided among the federal government, among the provincial governments, and among a group of agencies within the federal government. The federal government is responsible for supervising all banks, federally incorporated insurance companies, trust and loan companies, cooperative credit associations and federal pension plans. Regulations separating banks, insurers, trust companies, and investment dealers in Canada were largely eliminated in the 1980s. Also, by the 1990s, all of the major investment dealers in Canada were owned by banks, which not only created an integrated bank model, it also placed such dealers under close regulatory supervision. Provincial governments are responsible for supervising securities dealers, mutual fund and investment advisors, credit unions, and provincially incorporated trust, loan, and insurance companies. As a result, there are 13 provincial regulatory authorities, each administering securities laws and regulations. The Minister of Finance, however, oversees the incorporation of banks, permitting foreign bank branches, and reviews of large bank mergers. In particular, the Minister has broad discretionary authority to disapprove mergers, which has effectively eliminated such transactions.

Within the federal government, the Financial Institutions Supervisory Committee (FISC) acts as the chief coordinating body that sets regulatory policy and supervises financial institutions. The Committee is comprised of the Department of Finance of the Ministry of Finance and four independent government agencies: the Office of the Superintendent of Financial Institutions (OSFI); the Bank of Canada; the Canada Deposit Insurance Corporation (CDIC); and the Financial Consumer Agency of Canada (FCAC), as indicated in **Figure 2**. These five semi-official agencies report to the Minister of Finance, who is responsible to the Canadian Parliament.

Figure 2. Canada's Financial System Supervisory Structure



Source: Office of the Superintendent of Financial Institutions.

FISC generally meets quarterly, but can meet more often if needed. In addition, FISC conducts a legally mandated five-year review of the National Bank Act to ensure that federal regulatory legislation is modernized periodically. Within FISC, the OSFI plays a key role in supervising Canada's financial sector. The OSFI supervises all domestic banks, branches of foreign banks operating in Canada, trust and loan companies, cooperative credit companies, life insurance companies, and property and casualty insurance companies. The OSFI has set limits on the ability of Canadian banks to leverage their capital and has set target capital ratios that are higher then the international standard. In broad terms, the OSFI is responsible for a number of activities including: 1) assessing the financial conditions and operating performance of the institutions under its jurisdiction; 2) reviewing information obtained from statutory filings, financial reporting, and management reporting requirements; 3) conducting meetings with institutions; 4) attending board meetings when necessary of institutions to discuss the results of supervisory reviews; 5) providing composite risk ratings to institutions; 6) advising institutions of any corrective measures that the institution will be requested to take; 7) monitoring any corrective measures; and 8) reporting to the Minister of Finance on an annual basis.[22]

The OSFI also has considerable enforcement powers, including the authority to intervene progressively in problem institutions under "structured early intervention" provisions that articulate a four-stage process culminating in closure, even while an institution's capital may remain positive. The four-stage process is comprised of the following:

[22] *Guide to Intervention for Federally Regulated Deposit-Taking Institutions*, Government of Canada.

- Stage 1. – **Early Warning**. If an institution has been identified as Stage 1, the OSFI has identified deficiencies in the institutions financial condition, policies, or procedures that could lead the institution to fall into a Stage 2 category where there is the risk of insolvency or failure.
- Stage 2.- **Risk to Financial Viability or Solvency**. At this stage, an institution is judged to pose material safety and soundness concerns and is vulnerable to adverse business and economic conditions.
- Stage 3. – **Future Financial Viability is in Serious Doubt**. At this stage, the OSFI has identified that the institution has failed to remedy the problems that were identified in Stage 2 and the situation is worsening. The situation poses severe safety and soundness concerns and is experiencing problems that pose a material threat to its future viability or solvency unless effectiveness corrective measures are initiated.
- Stage 4. – **Non-Viability/Insolvency is Imminent**. At this stage, OSFI has determined that the institution is experiencing severe financial difficulties and has deteriorated to such an extent that: 1) the institution has failed to meet regulatory capital requirements; 2) the statutory conditions for taking control have been met; and 3) the institution has failed to develop and implement an acceptable business plan.

In addition, the OSFI plays a key role in regulating Canada's financial sector, providing a nearly unified regulatory and supervisory framework. As is the case with supervision, OSFI is responsible for regulating federal financial institutions, including banks, insurance companies, foreign bank representative offices, and pension plans that are under federal jurisdiction. One weakness of this system is that there are gaps in the regulatory framework concerning such collective investment schemes as mutual funds, where the operators of such funds have not been subject to a registration regime.

The Bank of Canada is responsible primarily for conducting monetary policy by setting interest rate targets and adjusting the supply of credit. The Bank also serves as the key component in the payments system by providing a check clearing function, and it serves as the traditional lender of last resort. In its conduct of monetary policy, the Bank of Canada adopted in 2000 a system of eight pre-set dates per year on which it announces its key policy rate – the target overnight rate of interest. It has veered from these pre-set dates only under exceptional circumstances.[23] While the Bank of Canada reports to the Minister of Finance, this public announcement system acts as an important element in making the Bank's activities transparent to the public and to the financial markets and relatively free from non-economic considerations. The Bank also has three credit facilities at its disposal in its traditional role as the lender of last resort, including a facility to provide liquidity to any financial or nonfinancial firm through outright purchases of a wide range of claims in the event of "severe and unusual stress on a financial market or financial system."

Canada's financial system is dominated by five large banking groups (Royal Bank of Canada, TD Canada Trust, Bank of Nova Scotia, Bank of Montreal, and Canadian Imperial Bank) that account for about 60% of the total assets of Canada's financial sector, as indicated in **Table 6**. In comparison, foreign banks account for about 4% of Canada's total assets in the financial sector.

[23] Macklem, Tiff, Information and Analysis for Monetary Policy: Coming to a Decision, *Bank of Canada Review*, Summer 2002, p. 12.

The low representation by foreign banks is attributed to the "widely-held" rule for large banks that limits the concentration of bank share ownership and, therefore, reduces the scope for mergers and for foreign entry through acquisitions or mergers. This lack of competition, combined with Canada's financial legal framework, allows Canadian banks to concentrate more on their low-risk, profitable domestic retail banking activities (services provided to individuals including: deposits, savings accounts, mortgages, credit cards, etc.), generally leaving large domestic borrowers to conduct their wholesale banking activities (services provided to corporations, governments, and other entities) abroad. Some observers argue that this framework also reduces incentives for innovation among Canada's protected banks and has proved to be difficult for small businesses and venture capitalists. Canada's insurance sector is dominated by three large domestic groups, which account for over 80% of the assets in this sector. The securities sector is marked by large Canadian, as well as U.S. and UK securities firms.

Table 6. Canada: Financial Sector Structure, End-2006

	Assets		
	Billions of $Can.	**Percent of Total Assets**	**Percent of GDP**
Banks	$2,389.0	59.3%	166.0%
Canadian	2,214.0	54.9	153.8
Foreign	175.0	4.3	12.2
Trusts (including bank subsidiaries)	254.7	6.3	17.7
Credit unions	193.8	4.8	13.5
Life insurance companies	346.5	8.6	24.1
Canadian	331.1	8.2	23.0
Foreign	15.4	0.4	1.1
Property and casualty insurance	93.2	2.3	6.5
Mutual funds	660.2	16.4	45.9
Asset based financing and leasing	92.3	2.3	6.4
Total	4,029.7	100.0	280.0

Source: Canada: Financial System Stability Assessment – Update, International Monetary Fund, January 15, 2008, p. 11.

Unlike the United States and some European countries, subprime mortgages account for fewer than 5% of Canadian mortgages, which sharply limited Canada's direct exposure to the meltdown that occurred in the subprime mortgage market. Although Canada's mortgage markets are somewhat less innovative than in the United States, Canadian consumers seem to be well served and home ownership rates are comparable with those in the United States.[24] In addition, Canadian law requires that all bank-held mortgages above a loan-to-value ratio of 80% be insured, which

[24] Kiff, John, *Canadian Residential Mortgage Markets: Boring But Effective?*, IMF Working Paper WP/09/130, International Monetary Fund, June 2009, p. 12.

has curtailed the securitization of mortgages by banks in Canada. About one-third of mortgages are securitized in Canada, about half as much in percentage terms as in the United States.[25] In addition, prepayment penalties and the lack of interest deductibility reduces the demand for long-term mortgages, so the maturity of most mortgages generally does not exceed 5 to 10 years.

Economic Effects of Canada's Supervisory System

Canada's financial system has been relatively more resilient during the financial crisis compared with counterparts in the United States and Europe. Nevertheless, Canada's financial system has not been immune to the financial crisis nor has it escaped the economic downturn that has stalled global economic growth. The Canadian economy is linked with the international economy. As a result, a sharp drop in exports and a decline in commodity prices have negatively affected the Canadian economy. Household wealth has declined, unemployment is rising, and the economy is expected to post a negative rate of economic growth in 2009, worsening the condition of Canada's financial sector. So far, Canadian banks have suffered a loss of 50% in the value of their equities. Consequently, the banks faced pressure from financial markets to increase their capital ratios, which they apparently did by tapping private sources.

As a result of the financial crisis, aspects of Canada's financial system are being closely scrutinized as the United States considers ways to amend its own financial system to limit the possibility of another financial crisis. However, the smaller scope of Canada's financial system and its economy likely lessen the transferability of systems or procedures used in Canada to the vastly more complex U.S. financial system. In addition, it can be argued that Canada's supervisors and regulators can take a more conservative approach than their U.S. counterparts as a result of Canada's proximity to the U.S. capital markets. Nevertheless, Canada's financial supervisory system and regulatory structure have proven to be less susceptible to the bank failures that have loomed in the United States and Europe and may offer some insight for U.S. policymakers. Canada's reliance at the federal level on a unified supervisor and regulator appears to have some merits as compared to a more decentralized approach.

Canada's approach does have some drawbacks. Specifically, Canada's system of regulating securities markets at the provincial level means that regulations regarding market participants and investor protection differ by province, creating inefficiencies in the system and raising costs to providers and consumers. Differences between provinces also mean that coordinating policy approaches across the 13 provinces can be slow and cumbersome.

Furthermore, the nature, structure, and powers of the provincial regulators vary, which increases the costs to financial services providers and to consumers, because financial services providers are required to pay fees to the regulatory authorities in all of the provinces where they raise capital. This ultimately raises the cost of capital and limits access to funding. It also inhibits the growth and development of the markets and innovation in developing financial instruments. In addition, while the conservative, risk-adverse approach employed by Canada's banks helped to shield them from some of the current financial turmoil, the approach also reduces efficiency in the market and reduces competition. Acquisitions of Canadian banks are significantly impeded by the rule that bank stocks be widely held and mergers are effectively prohibited. With reduced competitiveness pressures, Canadian banks maintain low-risk balance sheets at the expense of

[25] Ibid, p.5.

greater innovation and more efficient capital allocation. This approach also means that financing for small firms and venture capital for potentially high-growth companies is sharply reduced.

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