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Canada's Financial Sector: Responses to the Global Crisis

To the Colombian Banking Association
Cartagena, Colombia
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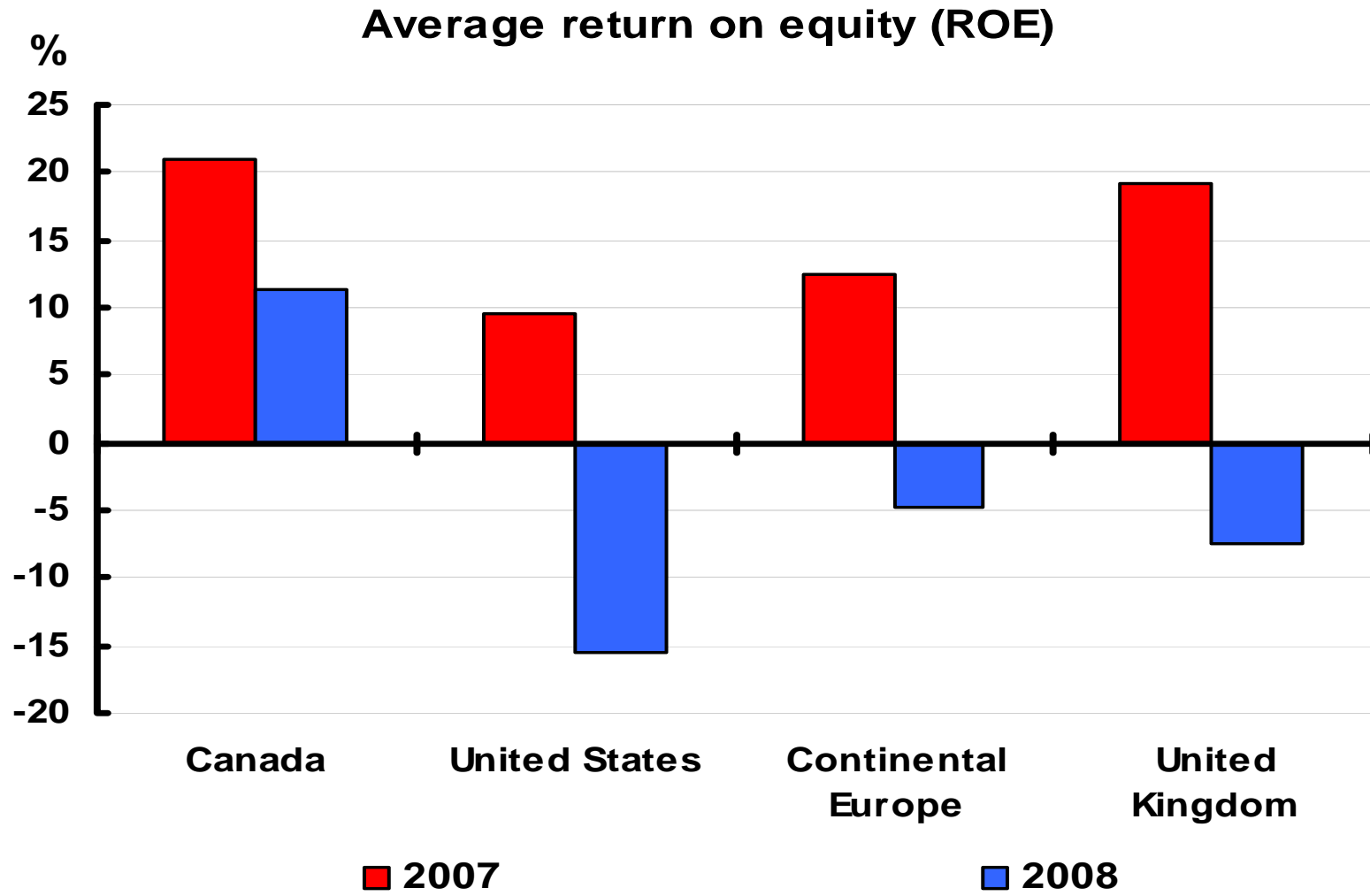
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Introduction

Building on a strong, coherent policy framework

- Credible monetary policy framework
 - Conventional
 - Unconventional
- Sound fiscal management
- Systemwide financial stability focus
 - Liquidity facilities
 - Risk assessment (*Financial System Review*)
- Financial sector's management of risk
- Credible and sound regulatory environment

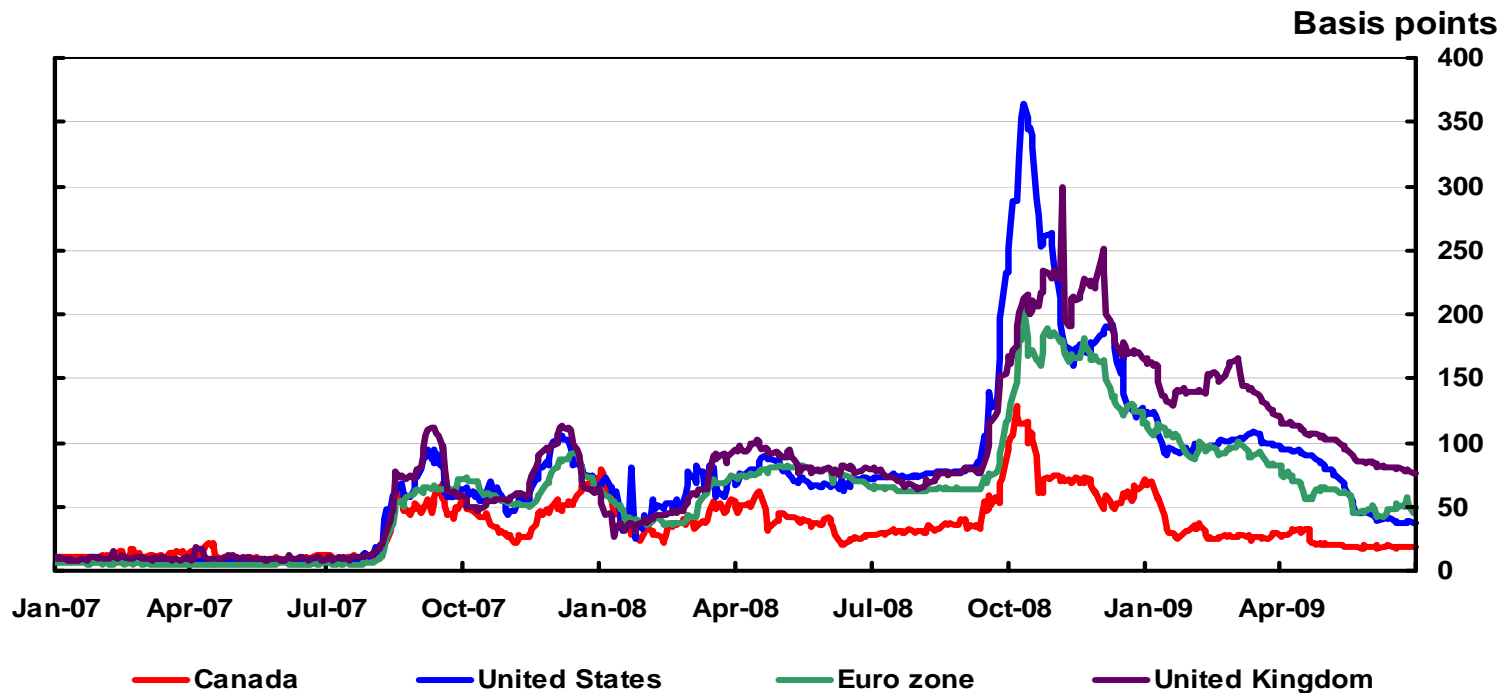
Rate of return of Canadian banks



Source: Bloomberg and banks' financial statements

Funding spreads

Conditions in short-term funding markets have improved*

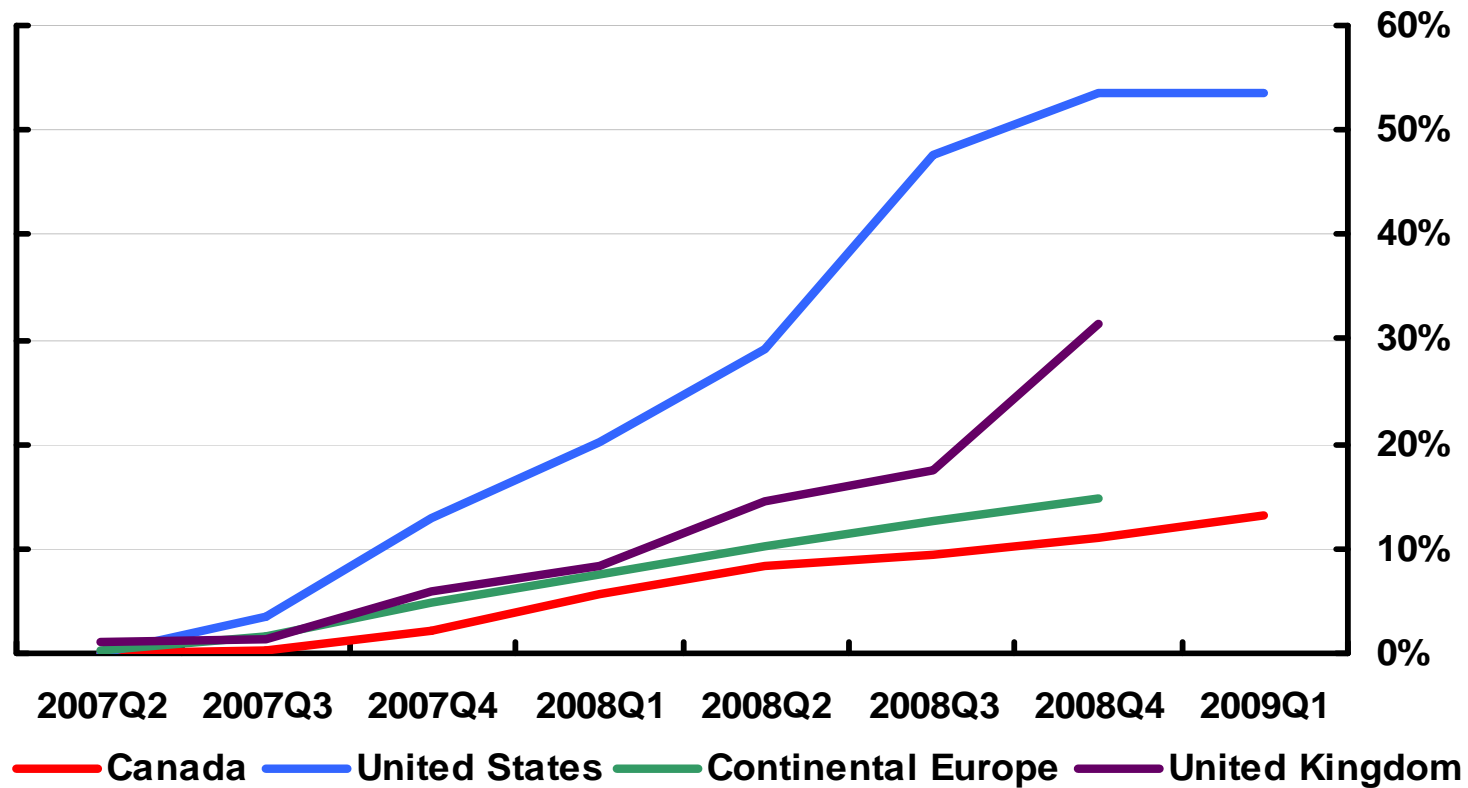


Source: Bloomberg

* The difference between 3-month interbank offered rates and their respective overnight index swaps: for the United States and the United Kingdom, LIBOR; for the Euro zone, EURIBOR; and for Canada, CDOR.

Relatively conservative risk appetite of Canadian banks

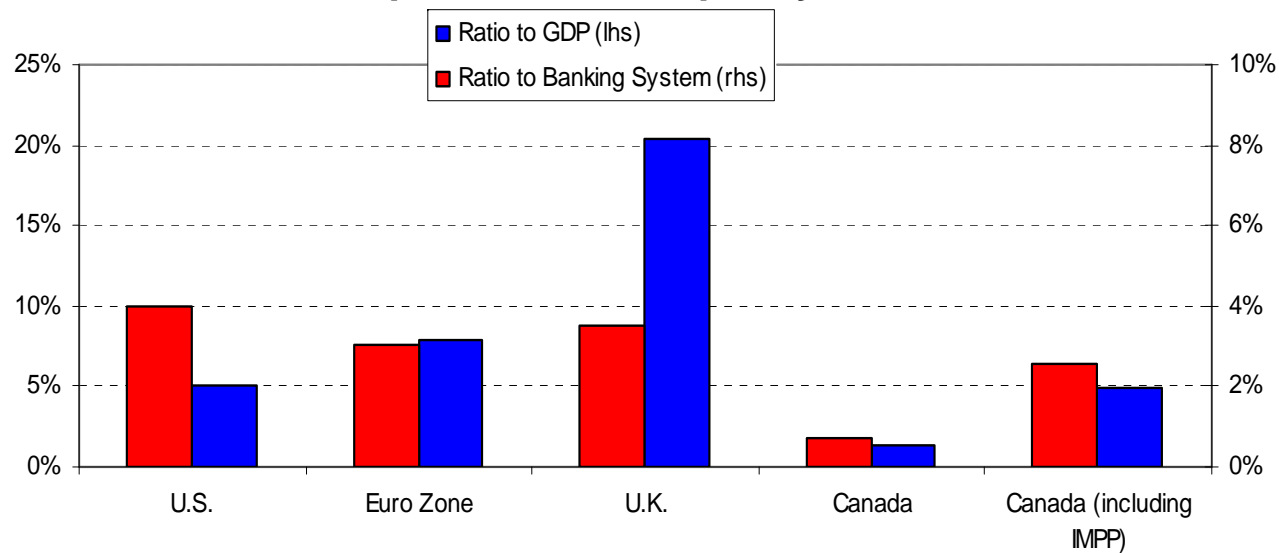
Cumulative writedowns as a share of shareholders' equity



Source: Bloomberg and banks' financial statements

Need for liquidity extension lower in Canada

Total public sector liquidity extension



Note: Liquidity extension refers to central banks' liquidity provision operations, as well as foreign currency swaps with other central banks, but excludes outright securities purchases.

IMPP: Insured Mortgage Purchase Program provides for government purchases of insured mortgage pools.

Sources: Bank of Canada, U.S. Federal Reserve, Bank of England and European Central Bank



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Structure of Financial Regulation

Four features

- Regulatory framework
- Market structure and product design
- Principled, reliance-based supervision
- Risk-based prudential regulation

See also: “Lessons for banking reform: A Canadian perspective,” by Carol Ann Northcott, Graydon Paulin, Mark White, *Central Banking*, Volume 19, Number 4.

Regulatory framework

- Independent, clearly mandated agencies
- Opportunities for regulatory arbitrage constrained
- Good inter-agency communications
- Structured settings for discussion and information sharing

Regulatory framework

Financial Institutions Supervisory Committee (FISC)

Members

- Office of the Superintendent of Financial Institutions (OSFI): Chair
- Bank of Canada
- Canada Deposit Insurance Corporation (CDIC)
- Department of Finance
- Financial Consumer Agency of Canada (FCAC)

Purpose

- Share information regarding condition of financial institutions
- Discuss and analyze developments as they relate to financial institutions
- Coordinate intervention in a troubled institution

Market structure and product design

- Banking system dominated by a handful of systemically important institutions
 - Extensive, nationwide retail distribution networks
 - Diversified through wholesale and international operations
- Three internationally active insurance companies
- Wide range of smaller (domestic and international) institutions
- Only about 30 per cent of mortgages in Canada are securitized
- Banks retain a degree of risk on their balance sheets

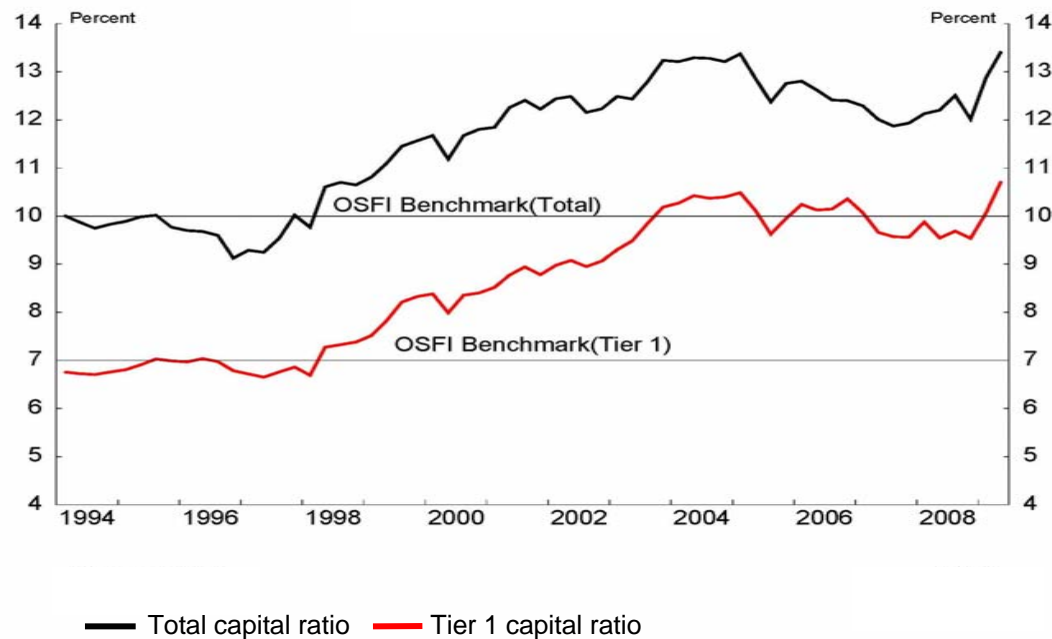
Principled, reliance-based supervision

- Adaptable, less open to arbitrage, as banks use own judgement and must prove compliance
- OSFI has substantial discretion to issue guidance
- Comprehensive, risk-based methodology – applied on a consolidated basis
- Guide to Intervention promotes awareness and transparency

Risk-based prudential regulation

**Canadian capital requirements are higher than Basel II:
Major Canadian banks also maintain a sizable buffer above OSFI's
requirements of 7% Tier 1 and 10% total**

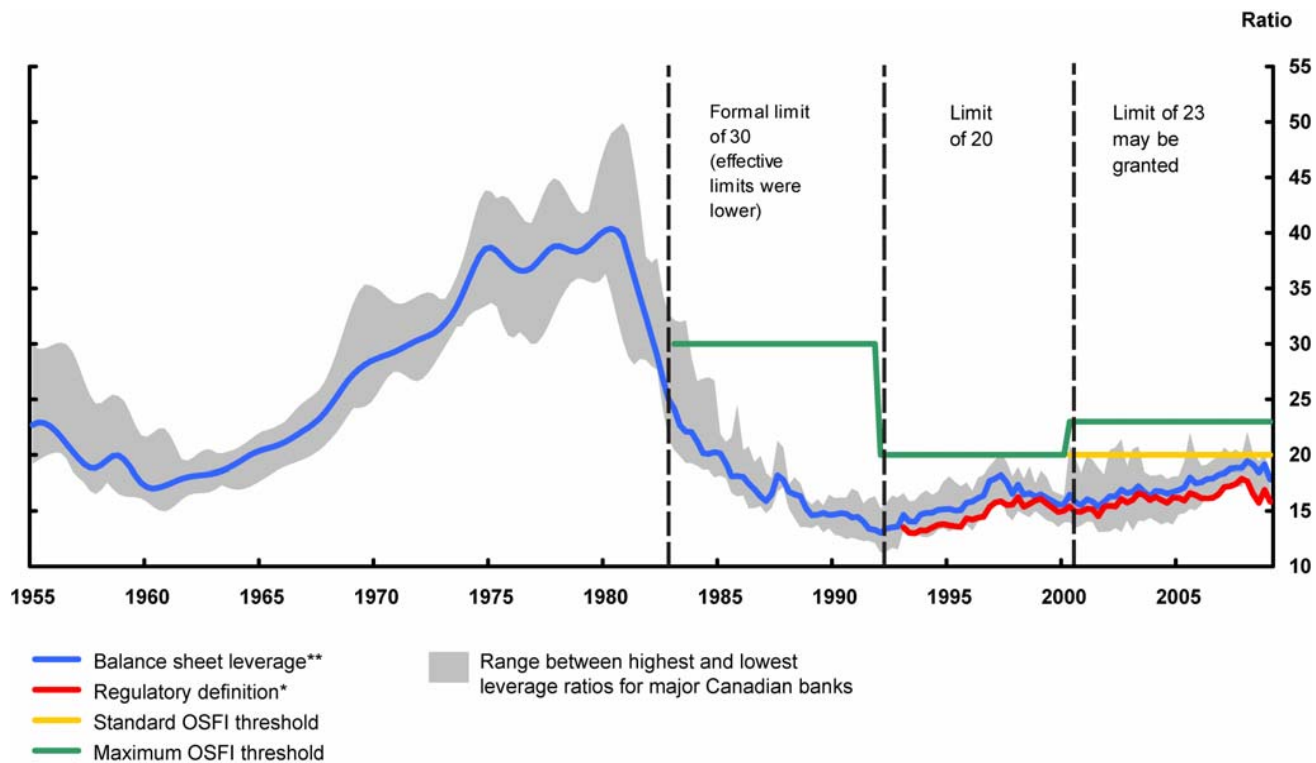
Risk Weighted Regulatory Capital Ratios
Six big banks



Source: OSFI

Risk-based prudential regulation

OSFI also imposes an upper limit on bank leverage



* On-balance-sheet assets plus certain off-balance items as a ratio of regulatory capital

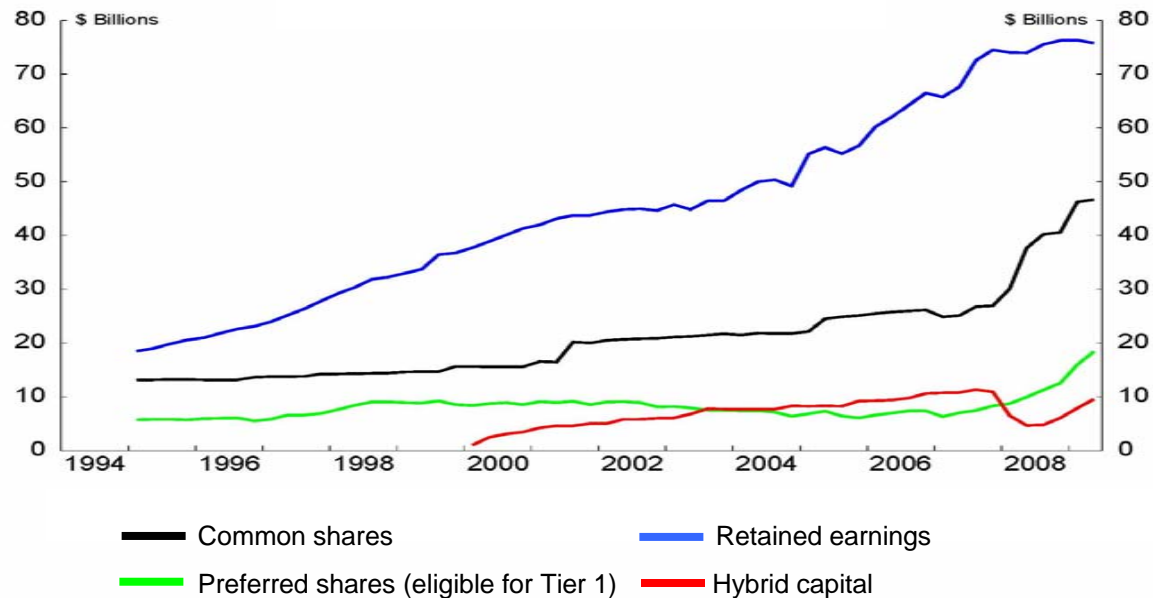
** On-balance-sheet assets to shareholders' equity plus subordinated debt

Source: OSFI

Risk-based prudential regulation

OSFI requires high-quality capital: Tier 1 must be made up of common shares and retained earnings

Components of Tier 1 Capital
(Big 6)



Source: OSFI

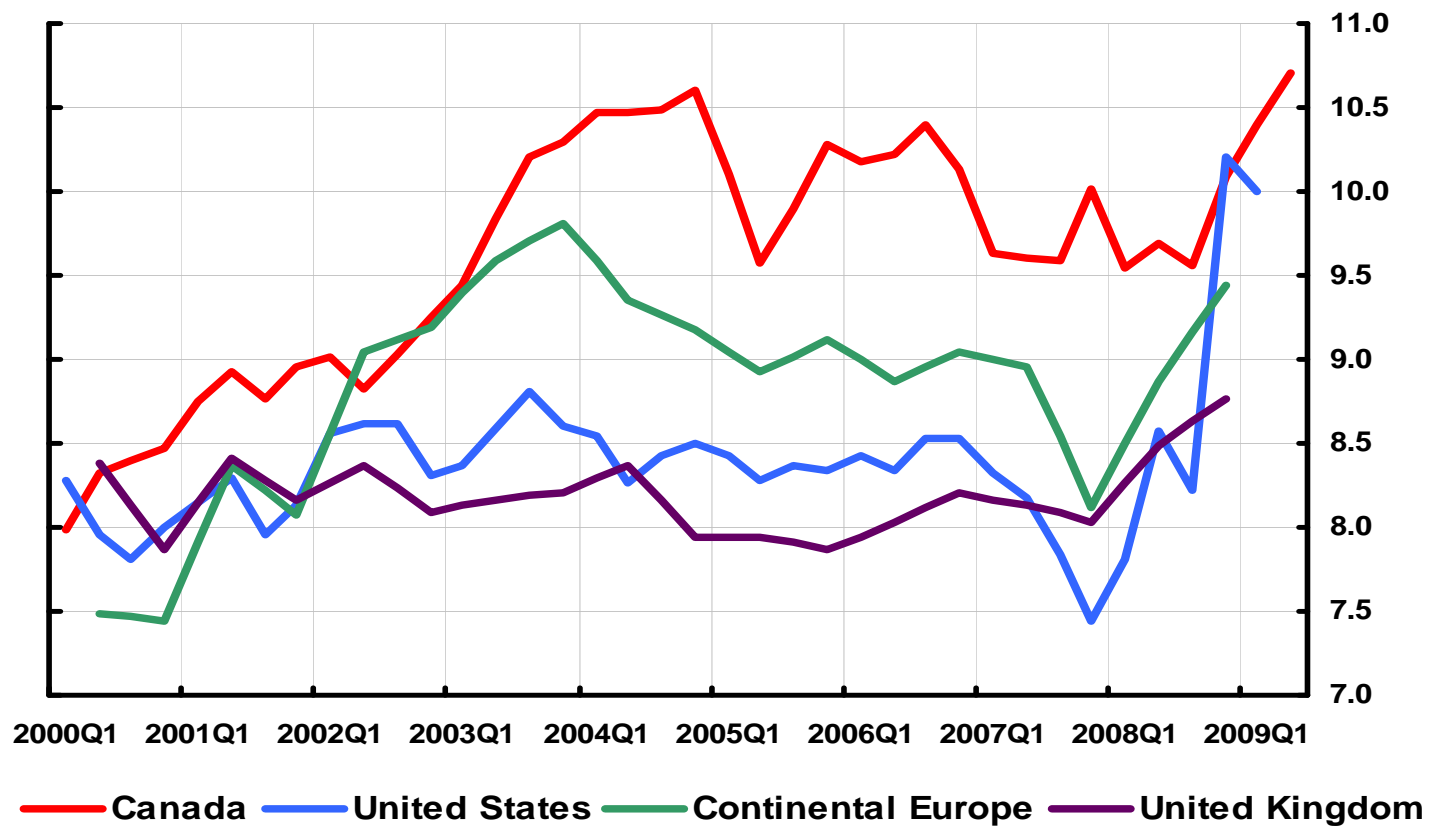


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Key Lessons from Canada

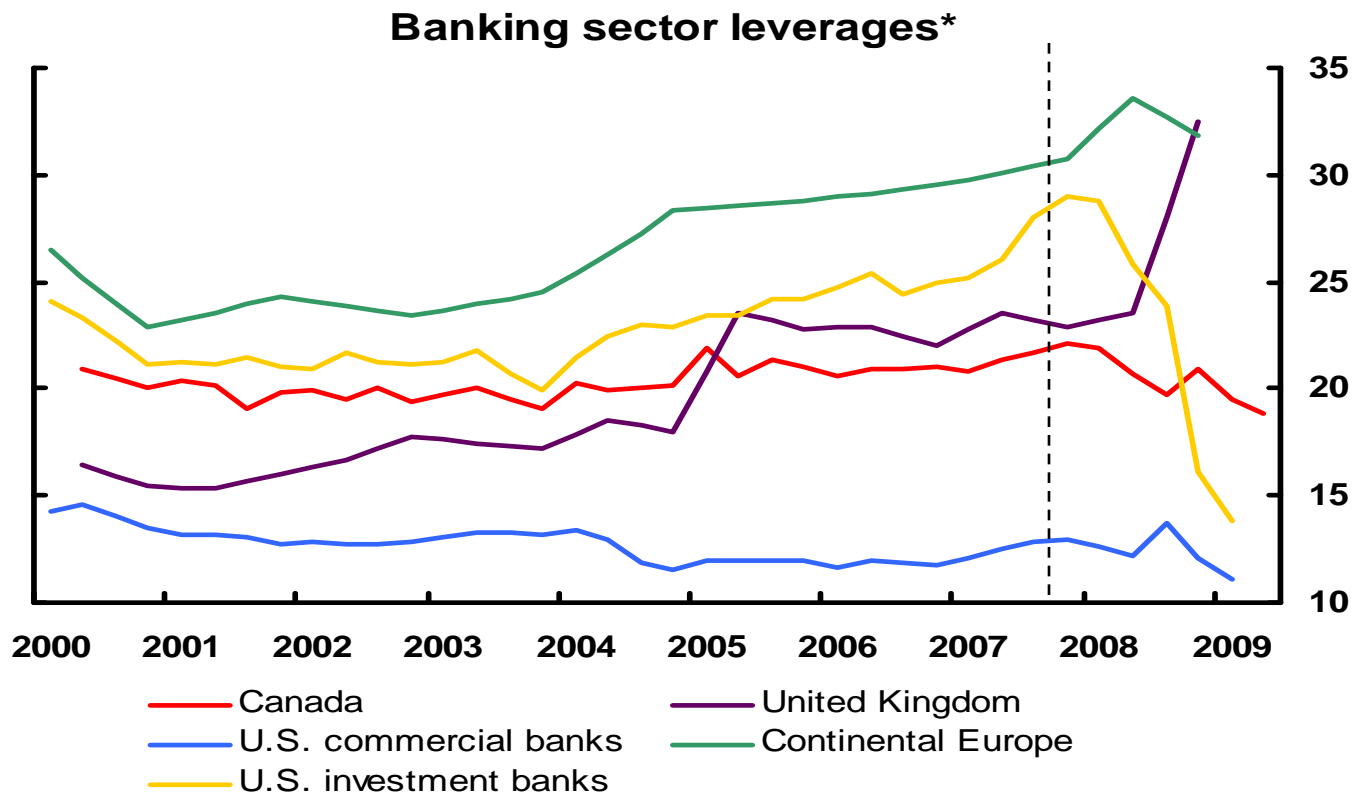
Canadian bank capital well managed

Tier 1 capital ratio



Source: Bloomberg and banks' financial statements

Leverage in Canadian banks well managed

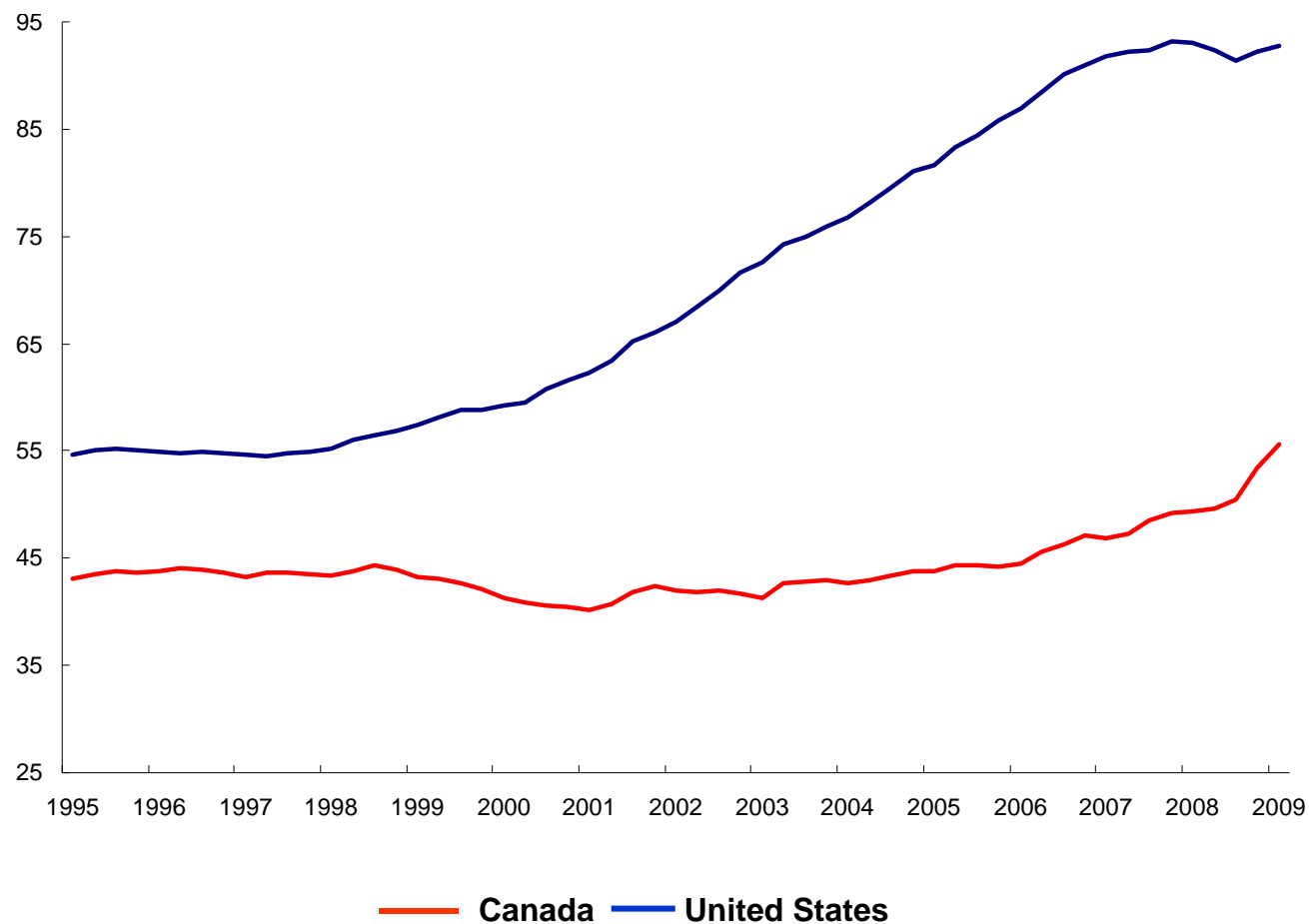


* Ratio of on-balance-sheet assets to total shareholders' equity

Source: Bloomberg and banks' financial statements

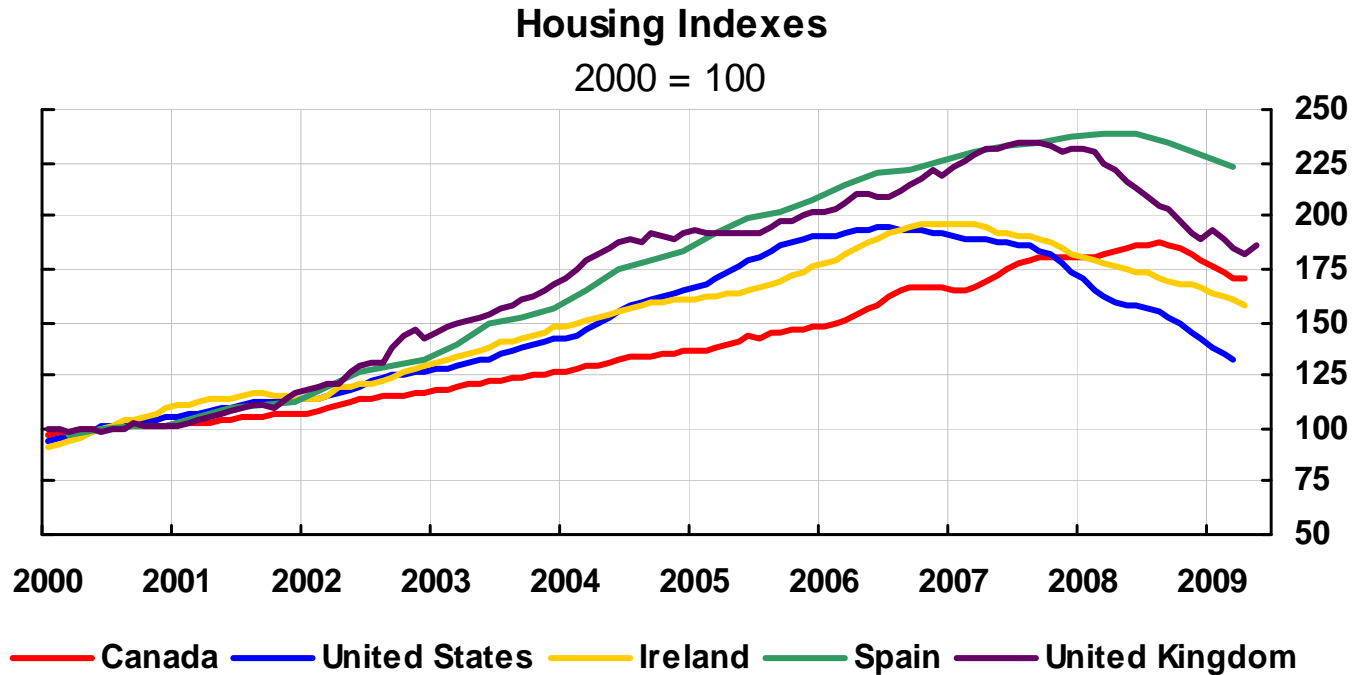
More conservative housing market (1)

Mortgage debt as a per cent of nominal GDP



Source: Statistics Canada, U.S. Federal Reserve

More conservative housing market (2)



Source: Canada—Teranet in alliance with National Bank of Canada; United States—S&P/Case-Shiller Home Price Index; and Ireland, Spain, and the United Kingdom—IHS Global Insight.

Mortgage market: Key reasons Canada didn't have same stresses in housing market as in U.S. (1)

- Banks required to have insurance on mortgages if purchaser has loan-to-value ratio over 80%
- CMHC, a federal agency, has explicit sovereign guarantee and is largest insurance provider
- Lenders relying on private mortgage insurers receive government guarantee of losses (from insurer failure) above 10% of original mortgage
- Canadian market for non-prime mortgages has been limited and ended for banks in 2008 when CMHC ceased insuring such mortgages

Mortgage market: Key reasons Canada didn't have same stresses in housing market as in U.S. (2)

- Mortgagors personally liable for loan
- Mortgage interest not tax deductible
- Most mortgages originated by banks for own balance sheets and, as a result, higher underwriting standards are applied
- Securitization of mortgages primarily for liquidity rather than risk transfer



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The Forward Agenda

Four key elements

- Continuously open markets
- Sustainable securitization
- Bank capital requirements
- Macroprudential approach to regulation

Continuously open markets

- Core funding markets should be made more efficient and less susceptible to extreme price movements
- Crisis clearly exacerbated by seizure of interbank and repo markets
- Robust and efficient financial system needs interbank, commercial paper, and repo markets that are continuously open, even under stress
- Ensure robust infrastructure

Sustainable securitization

- Transparency should be increased so that risk can be identified more effectively and priced more efficiently
- Models and data underlying securities could be published
- Skin in the game (keep similar products or first loss)

New bank capital requirements

- **Higher:** Overall capitalization in regulated financial system will rise
- **Better quality:** Greater focus on loss-absorption capacity
- **Simpler:** Use of leverage caps
- **More dynamic:** Countercyclical capital buffers
- **Less procyclical:** Through-the-cycle approaches

Macroprudential approach to regulation

- Not enough for prudential regulators to adopt new measures within their current frameworks
- Need for oversight of the system as a whole—including both systemically important institutions and systemically important markets
- **Macroprudential surveillance:** Identify buildup of risks to financial system
- **Macroprudential regulation:** Strengthen resilience of financial system



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