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The Global Financial Meltdown and Financial Regulation: Shirking and Learning – Canada in an International Context

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Shirking and Learning -- Canada in an International Context[*]

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INTRODUCTION

The overarching mission of prudential regulators of financial services is "to preserve a safe and sound financial system." This is a widely accepted yet simple and straightforward objective. The meltdown in global financial markets began in early 2007, but reached crisis proportions in September 2008. It is the assertion in this paper that at the global systemic level, the financial catastrophe can plainly be attributed to the phenomenon of "shirking."[i] In short, those responsible for preserving a safe and sound financial system did not do their jobs effectively. Another factor contributing not only to the crisis itself, but also to its severity, was the absence of policy learning[ii] by key global state actors. Government policy actors, the regulators and central bankers in the industrial democracies, learned little it seems from the earlier episodes of global financial calamity caused by the imprudent behavior of private actors and institutions they are authorized to oversee. Financial safety and soundness was not protected. This was a crisis that surely did not have to occur.

In addition, the scope of responsibility for the global economic and financial collapse extends to risk committees of boards of directors of financial institutions who feigned knowledge of what they in fact did not know, and to CEOs and COOs whose ignorance of the complex instruments their financial engineers were fashioning approached gross negligence. The regulators and private non-government actors – particularly those in the US, the UK, in Iceland and a number of countries in continental Europe, and in Asia and Canada as well can be assumed guilty of not adequately protecting the financial system from calamity. It is not simply that these actors shirked – they can be accused of creating a reality for themselves about how financial markets behave – a reality which turned out to be absolutely incorrect.

In Canada, the impact of the global meltdown was less severe than it was in virtually every other industrial democracy. This appears due to the more conservative management practices in the country's largest banks and to a lesser extent to the character of aggregate

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prudential oversight. However, there were a number of episodes that did threaten financial instability in the country. The collapse of the asset-back commercial paper (ABCP) market represents the most serious one and was accompanied by the Office of the Superintendent of Financial Institutions (OSFI) denying any culpability for the market's collapse despite OSFIs overarching mission.[iii] Two commercial banks had to raise additional capital to meet OSFI requirements and the Bank of Canada's provision of extraordinary liquidity to the money market peaked at $37 billion in late 2008 to prevent it from totally seizing up and causing further damage to the economy. The provision of liquidity continues but at more modest levels and at the end of October stood about $28 billion.[iv] In addition, the Minister of Finance directed the Canada Housing and Mortgage Corporation (CMHC) to buy mortgages from the chartered banks to supplement their liquidity positions. Purchases have totaled about $60 billion of the $125 billion authorized by the Minister of Finance.[v]

It is important to determine why Canada fared better than most other countries since 2007. Is Canada's performance attributable to measurably better prudential supervision or is it attributable to better management in the financial services industry? Or some combination of both? At the global we will want to explore whether past financial calamities have informed regulators' activities, ex ante.

A good deal of the public discourse has focused on how the crisis manifested itself – crudely characterized by greed and irresponsibility by private non-state actors. On the other hand, public statements of key government actors claim to understand why the meltdown occurred and have sought to assure observers that each of them was carrying out their respective responsibilities -- but check with the other actors because perhaps they were at fault, or that market participants behaved in unexpected ways, or it was really someone else's responsibility. Everyone claims to have done his or her job. The purpose of this project is first to validate the hypothesis of shirking: did those with an official role in this debacle in fact carry out their responsibilities – globally and in Canada? And, second, to explore the extent of policy learning from previous national and global systemic crises.

The chapter will proceed as follows: the first section will provide an explanation of the role of the state in prudential supervision of the financial services industry; the second section will provide a stylized exposition of how the global financial meltdown materialized; the third section will analyze the Canada's ABCP crisis and the regulatory response; the fourth section will explore the phenomenon of "policy learning" in finance; and, the final section will provide some conclusions.

THE CHANGING FINANCIAL STRUCTURE AND THE STATE

The structure of global finance has changed over the past 25 – 30 years in large part because of the commingling of traditional banking, investment banking and insurance which over time gave rise to financial mega-institutions in the Anglo-Saxon countries. Commingling – or one stop financial shopping – began and evolved into a well-

established practice in continental Europe. There were benefits for both the users of financial services and the owners (shareholders) and employees of the industry. There was clearly an incentive for the segmented industry in North America and the UK to strive for the more efficient model. Furthermore, the establishment of mono-line financial service providers whose sole business was the issuance of credit cards, or mortgage lenders and/or originators whose primary focus was the residential market, served to change the competitive environment in finance – particularly in the United States.

While there were risks associated with this new structure: power concentration, market concentration, conflicts of interest, etc… regulations at the global level recognized these risks and responded with new institutional structures. For example the UK established the Financial Services Authority, the Australians established a new prudential regulator and a securities commission, OSFI was established in Canada, and the US introduced strict accountability and reporting standards (corporate governance) for all public companies. In addition, regulators, central bankers and treasury officials convened at frequent intervals under the auspices of the Bank for International Settlements (BIS) and the Financial Stability Forum (now the Financial Stability Board),[vi] the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), and the World Economic Forum (WEF) to review economic and financial stability issues.

The establishment of the mono-line institutions precipitated a commoditization of finance, which underpinned the whole financial crisis. Commoditization in finance is the situation where the street level originators of loans, led by the mono-lines and as well adopted by some traditional financial institutions, immediately sell these assets in the market with no intention of establishing a relationship with the borrower. The profitability of these transactions is based on both the loan origination fees and the interest rate spreads on the subsequent sale of the loans. The historic “relationship banking” paradigm now was not part of the marketing strategy of this “new financial services” model. Institutional activities were focused on the “bottom line” and so-called “shareholder value,” and on compensation rewards for activities that increase shareholder value. It is fair to say that the public interest was not on the radar screen.

This commoditization gave rise to innovations facilitating the transformation of high yielding and highly risky assets (mortgage loans and credit card receivables) into complex above average yielding financial market instruments -- sold mainly to institutional investors. This complexity was clearly not understood by the regulators,[vii] risk committees, ratings agencies and importantly the ultimate investors whose risk taking during and after the crisis was subsequently underwritten by the state – or more accurately the taxpayers.

The commoditization of financial services phenomenon and the rise of instrument complexity were not accompanied by parallel regulatory developments within states. The riskiness of the “originate to sell” phenomenon was all but ignored in the US and global investors who subsequently purchased the resulting derivative instruments were insufficiently familiar with evolving institutional-client autonomy to introduce the

appropriate risk calculus into their investment decisions. The US institutions who bought these instruments from the originators did not undertake adequate due diligence because their primary goal was to sell them in short order. In addition, the ratings agencies gave comfort to investors in these highly risky and misunderstood assets by assigning investment grade assessments to them. Ultimate investor comfort was provided by default insurance (known as credit default swaps) on these instruments sold by such institutions as the American International Group (AIG) in the United States. It is clear in retrospect that AIG did not understand what they were insuring and so the cost of the default risk insurance was low – reflecting everyone's assessment of the low probability of default. However, bank capital was indeed exposed.

It is important to note that while Canada was not caught up in the severity of the collapse in the fall of 2008, its financial services industry was not exempt from the global negligent behavior that has already been discussed. Canadian banks and non-bank entities began to repackage similar cash generating assets into short-term instruments. The total size of the market in Canada was about $116 billion[viii] before the global financial collapse and the chartered banks had originated some 75 percent of the total.[ix]

Globally, regulators, ex post, were diligent in explaining what they are particularly responsible for and how the crisis emerged, but have been unable to adequately explain, ex ante, why they were unable to stem the activities that would ultimately debilitate global finance and wreak havoc in the global economy. Part of the explanation of course is structure of power in the industrial democracies and part is information asymmetries. If the state was acting in the public interest, then those who had the power to at least flag the risks should have been using their leadership positions to arrest the imprudent behavior.

As will be explained below, implicitly the state was acting at the behest of finance and not of the public interest. And, while the words of the regulators suggest support for safe and sound financial system their deeds did not provide compelling evidence that this was their objective. Regulators at the global level did not adjust their practices to fully account for the riskiness and complexity associated with this new financial structure.

A STYLIZED VIEW OF THE GLOBAL FINANCIAL MELTDOWN IN THE U.S.

There were a number of crosscurrents at work in the US economy which caused the germ of imprudent behavior to spread like a virus around the globe. *First*, there was a glut of global savings in the world economy that caused longer- term interest rates to fall to historic low levels. Among other activities, this precipitated strong demand for both residential property and mortgage financing and refinancing. This strong demand fuelled a bubble in housing prices. Because Americans viewed the resulting increase in house equity as a source of spending power, many mortgages were refinanced at prevailing lower interest rates. This allowed Americans to purchase all kinds of goods from offshore -- particularly from China and elsewhere in Asia – which exacerbated the US current

account deficit and contributed to another set of global financial troubles that continue to percolate.

Second, home ownership was an important public policy objective in the US, facilitated not only by the favorable personal income tax treatment on mortgage interest, but also by the Community Reinvestment Act (CRA) which was designed to encourage, among other financial services, the provision of mortgages in low- and moderate-income neighborhoods.[x] In the case of the refinancing of existing mortgages, the financing of new home purchases and CRA-facilitated home financing, the mono-line mortgage originators captured an increasing share of the mortgage financing business by providing credit to borrowers who clearly did not have the resources to carry the liability they were taking on. As has been widely reported, moreover, many borrowers did not understand the terms of the mortgage instrument itself. These individuals were known in the market as NINJAs (no income, no job, no assets) – or subprime borrowers. By late 2007, the number of outstanding subprime mortgage loans totaled some 8 million, or about 15 percent of the overall mortgage market.[xi]

Third, the clear risks and potential carnage associated with the subprime mortgage lending activities were well know by the principal banking and financial regulator – the Board of Governors of the Federal Reserve System. Indeed, as early as 2000, the late Ned Gramlich, a Governor of the Fed, proposed to the central bank Chairman, Alan Greenspan, more intensive oversight of the institutions involved in subprime lending. However, the proposal never went to the full Board after it had been submitted to Greenspan.[xii] Some seven years later, only days before he passed away and a year before the US financial system virtually collapsed, Gramlich set out a plan to fix the percolating subprime crisis.[xiii] It too fell on deaf ears. This is a rare example of what Bachrach and Baratz identified as a non-decision – "the practice of limiting the scope of actual decision-making to 'safe' issues by manipulating the dominant community values, myths, and political institutions and procedures."[xiv] The structure of power in finance prevented the Fed from tightening regulation to dampen the market's enthusiasm for what was thought to be high yielding but low risk investments because Greenspan *first* did not think the market would act to its own detriment and *second* he feared a backlash against the Fed in the Congress and the Administration[xv] -- even though the central bank is assumed to be "independent" of political influence.

Fourth, the originate-to-distribute culture that permeated American finance contributed to the spreading of the subprime virus around the world. The originators of the subprime mortgages because they had no intention of keeping these assets on their books failed to undertake the typical due diligence in which lenders engage before approving a loan. These loans were subsequently offloaded to commercial and investment bankers who sliced and diced these mortgages (creating so-called derivative instruments) and then sold them to investors around the world. These derivative instruments were attractive to global investors because their yields were relatively high in a world with a glut of savings and low long-term interest rates.

Fifth, in addition to the high yield on these derivatives, demand was also fuelled by the decision of the bond ratings agencies to give these instruments an investment grade evaluation. Moreover, these instruments had the names of JP Morgan, Lehman Brothers, Goldman etc… associated with them in addition to the insurance provided by AIG. Because of the names and default insurance, investors assumed there was little to no risk and consequently avoided undertaking their own due diligence. So we had a perfect storm.

CANADA'S SUBPRIME CRISIS: THE ABCP MELTDOWN

The global financial meltdown has clearly had less impact on the Canadian institutional structure than was experienced in most of the other industrialized democracies – although the "real" economy has clearly been negatively impacted. The popular press has heaped praise on the Canadian regulatory system as being the "best" in the world – and the chartered banks being among the strongest, safest and best managed.[xvi] Current and former elected officials have taken credit for this state of affairs despite their own policy actions that did little to nurture the Canadian financial services industry as national champions. Indeed, "bank bashing" was a national sport not many years ago when there were moves afoot in the industry to consolidate.[xvii]

The fact that our banks avoided the full consequences of the meltdown is unmistakable. The cause of this state of affairs is less clear. It could be because of the regulatory system is robust; it could be that the culture of the key actors in the industry is more conservative/risk averse than experienced in other jurisdictions; or it may just have been fortuitous. In this regard it is useful to explore the collapse of the ABCP market in the summer of 2007 to provide some insight and understanding about the character of Canada's oversight regime.

In August 2007 the Canadian ABCP market seized-up because issuers of this paper could not rollover their maturing liabilities into newly issued paper. The confidence squeeze in this market was clearly attributable to the problems in the US subprime and banking markets. The uncertainty was such that the typical market operators withdrew from the market and simply parked their funds until the air cleared and special liquidity facilities were established by the key global central banks. This event, however, underscored serious shortcomings in the Canadian regulatory regime – including its fractured nature, which appeared to inhibit proper communication among the key regulators and a clear reluctance of the key state actors to take the lead to preserve a safe and sound system. Officialdom, at both the federal and provincial levels performed their functions in a balkanized structure that resulted in no one working to preserve a safe and sound financial system. Some $32 billion of non-bank sponsored ABCP effectively defaulted leaving both sophisticated institutional investors and individuals at the mercy of a restructuring process designed not to make them whole, but to preserve the legitimacy of the public authorities that failed to carry out their responsibilities. Most of the paper was

in the form of credit default swaps (CDS), collateralized debt obligations (CDO), and consumer and mortgage receivables.

The ABCP crisis in Canada had similar characteristics as the subprime mortgage catastrophe in the US. *First*, it was rooted in the phenomenon of “originate to distribute” discussed above. This characteristic undermined the due diligence in which lenders and borrowers traditionally engaged before consummating a “deal.” The sponsors of the organizations established to distribute this paper were known as *conduits*.[xviii] This paper typically had terms to maturity of money market instruments – less than one year. The conduits used the proceeds of the sale of their paper to purchase additional assets from originators -- mortgages, household sector loans including credit card receivables, commercial leases, CDSs and CDOs. The underlying assets clearly had a longer term to maturity than the liability used to acquire them. This mismatch was not unlike other term-to-maturity mismatches that characterized many financial crises during the latter part of the 20th century.

Second, investors’ understanding of the ABCP instruments was as opaque as the underlying assets in the US subprime paper crisis. Importantly, the Provincial Securities Administrators (PSAs) did not require a prospectus for the issuers of ABCP because there was a legal exemption for “knowledgeable” investors, although collectively they had the power to require one. It is probably the case that the Administrators themselves did not understand the inherent risks in these instruments – particularly the CDSs – and therefore failed to properly protect both institutional and individual investors.[xix] As it turned out the ABCP “was not the type of investment that many holders appear to have imagined”[xx] they were.

Third, it was not only the PSAs who failed to understand, ex ante, the underlying problems in the ABCP market. The Bank of Canada, whose implicit responsibilities extend to assessing and reporting upon systemic financial stability, ex post, was able to effectively point to all the market anomalies that gave rise to the observed disruptions generally, but failed to wave the “red flag” before authorities had to intervene and give life to moral hazard.[xxi] Henri-Paul Rousseau, CEO of the Caisse de Dépôt et placement du Québec noted in testimony before the provincial legislature's public finance committee that “There was some thinking out there that this was very risky. We thought it was not plausible and it happened. That's it.”[xxii]

The real problem is that very few people responsible for prudential oversight and systemic stability understood what was taking place, ex ante. Indeed, in June 2007, the Bank’s *Financial System Review* stated: “our assessment is that the Canadian financial system is sound and is likely to remain so for the foreseeable future.”[xxiii] The purpose in highlighting this point is to demonstrate the extent of the ignorance of the risks percolating in the Canadian financial system, rather than to point the finger of blame at the central bank for the events that ultimately materialized. Admittedly, the Bank on a number of occasions leading up to the ABCP fiasco and the global turmoil more generally, had pointed to the fact that financial risk had been under-priced. All “regulators” however, failed to implement measures that would have quashed this imprudent behavior by market participants before harm was done. Regulators were not

regulating, they were observing. Society would have been better served if the market innovations had been better understood – or even removed from the market place until proper transparency and comprehension had been achieved.

Fourth, while David Dodge absolved the ratings agencies for providing comfort to investors in the ABCP debacle,[xxiv] it is obvious that the Dominion Bond Rating Service (DBRS) did not fully understand these structured instruments. If they had fully understood the liquidity and market risk associated with them they would not have been evaluated in a manner that would have so easily enticed investors into them. This assertion can be interpreted as an oversimplification. However, the Bank's defense of these agencies essentially calls for the status quo in respect of the oversight of the work of these actors.[xxv] The Bank's conclusion, while suggesting that the rating agencies have erred in the past concludes on balance that they have done a good job as measured by their ability to properly predict "actual default experience."[xxvi] This is certainly a problematic conclusion.

Fifth, as discussed above, the problems associated with the "originate-to-distribute" or "acquire-to-distribute" phenomena have contributed to financial instruments being put on the market by financial institutions to unsuspecting investors as prudent investment vehicles. It would to be unfair to accuse institutions of a conspiring to sell risky assets as safe assets. However, because of the ignorance associated with so-called innovations in financial markets both individuals and institutional investors have been lulled into complacency by relying on expert opinion -- which in hindsight was not expert at all. The historical rule of "know your client" is not as important as it once was even when the client is a state sponsored investment fund or an institutional investor. The public interest has not been well served a consequence.

Sixth, the key actor regulating financial institutions in Canada, OSFI, was really an observer of the ABCP meltdown. Indeed, the Superintendent stated publicly that it was not her role to tell investors what to do. While the technical correctness of this statement cannot be debated, it is fair to speculate why a senior bureaucrat, with the key responsibility of preserving a safe and sound financial system did not use her bully-pulpit to warn investors of the imprudence of the ABCP venture. The Superintendent has built a wall around OSFIs responsibilities and took little initiative while the crisis was percolating to step up to warn the market of the risks associated with these ABCP instruments. Indeed, the *Office of the Superintendent of Financial Institutions Act* requires OSFI "to monitor and evaluate system-wide or sectoral events and procedures that may have a negative impact on the financial condition of financial institutions."[xxvii] The Superintendent clearly did not do this.

In testimony before the House of Commons Finance Committee, responding to questions the sluggishness of OSFIs response to the emerging ABCP problems, the Superintendent stated: "It's not a market that we oversee. We've spoken in the past about the kind of work we do, which is focused solely on bank safety and soundness. We would put investor alerts on our website if we saw someone saying it was a bank and taking money from Canadians when it's not really a bank. There would be an investor alert on that. But

when you're talking about asset-backed commercial paper and the fact that the market was different from what existed elsewhere, we would look more to other agencies that have responsibility for investor protection." The Superintendent also failed to convince Parliamentarians that OSFI understood the complexities of the ABCP market by shifting blame to the institutions that created them: "First of all, it's the institutions that have to say whether they're understanding it or not. One institution can say they don't understand it and another can say they understand it completely…This is what institutions are doing around the world. We need to be able to compete. We would see the boards of directors, we would do reviews of what we were seeing, and we would be explaining to the boards that it is their responsibility to know what they're doing…"[xxviii]

The Bank of Canada, appearing before the same Committee and responding to a question about the role of the ratings agencies in providing false comfort to investors, Deputy Governor Pierre Duguay noted: "Obviously, we are not directly responsible for ratings agencies. Generally speaking, as regards the commercial paper crisis, there were problems with ratings agencies. Commercial paper was greatly lacking in transparency. Certain structured products were very opaque, and few people knew what they truly were. Ratings agencies were specifically assessing what we call credit risk, and not liquidity. After the losses, investors who were buying up ABCP like hot cakes suddenly decided that they did not want any of it anymore."

So those responsible for a safe and sound financial system claimed no responsibility for the collapse. Obviously, this is not good enough.

Seventh, with a multi-agency regulatory system at the federal level and dispersed securities regulation at the provincial level it is really unclear who speaks for the system as a whole. It is not the central bank (although it does provided a semi-annual assessment of the system's stability), it is not OSFI (although OSFI does have the mandate to monitor system-wide activities), and it is not the provincial regulators. Indeed, this decentralized structure has allowed bureaucrats to avoid responsibility for ensuring a safe and sound financial system. There is no authority representing the interests of Canadians generally. Each institution defends its own interests while Canadians pick up the tab for errors or negligence.

Eighth, despite the balkanization of the financial regulatory system in Canada there are a number of bureaucratic institutions designed to provide coherence to the objective of prudential oversight. At the federal level, the Financial Institutions Supervisory Committee (FISC) chaired by the OSFI Superintendent comprises, the Governor of the Bank of Canada, the Chairman of the Canada Deposit Insurance Corporation, the Deputy Minister of Finance, and the Commissioner of the Financial Consumer Agency. In addition the Minister of Finance indicated that the Canadian Securities Regulator, contingent on the establishment of a single securities market regulator, would also be a member of this coordinating committee.[xxix]

The Minister, in a speech in August 2009, identified the work and the composition of the FISC – but did not identify the Committee by its legal name, nor did he reaffirm that the OSFI Superintendent would continue as it Chair. The Minister did point out that "the Department of Finance…has the ultimate authority for the financial system and for all financial sector regulation and legislation. It is our job to ensure effective coordination of all of the pillars as well."[xxx] However, no state actor yet speaks with legitimate authority to preserve a safe and sound financial system.

So what can we conclude about regulatory and stability oversight. The central bank, responsible for assessing systemic stability clearly underestimated the risks to Canadian financial stability associated with offshore spillovers; the market regulators, because of their fractured character and the complexity of the instruments being sold in the market were unable to dampen the demand for financial instruments whose risk was clearly opaque; and the senior regulator, OSFI, simply washed its hands of the mess by telling Canadians it was someone else's' responsibility.[xxxi]

Finally, it should be noted that the Conservative government attempted to introduce competition into the mortgage insurance business – a carryover of an initiative of the previous Liberal government, in its *Budget 2006,* by permitting zero down, 40-year mortgages and encouraging companies such as AIG to come to Canada to "help" increase home ownership in the country. The banks approved such loans. Thus, it was possible that the events in the US and Europe, partially, could have been replicated in Canada. Indeed in 2007 CMHC was on track to insure such mortgages – but for the intervention of David Dodge, then Governor of the Bank of Canada who criticized the proposal for a number of reasons. The proposal was ultimately dropped by the CMHC and such high-risk mortgages legislatively banned by the government in June 2008.[xxxii] Governor Dodge was the only senior federal or provincial bureaucrat to step outside his direct sphere of responsibility and raise the red flag about imprudent lending practices. Other bureaucrats (and politicians) were quiet or suggested these matters were others' responsibilities. Dodge provided an important lesson to emulate for others involved in oversight activities.

THE CHARTERED BANKS AND THE CANADIAN REGULATORY CLIMATE

The banks in Canada have in recent memory not been respected as national champions. Ordinary citizens, following the lead of politicians at the national level, have taken every opportunity to "bash" the banks. The complaints have ranged from fees to withdraw funds from ATM machines unaffiliated with the customers' bank; overcharging for credit card balances; opaqueness of rules regarding loans and accounts; inadequately serving the SME sector; and generally not serving the needs of ordinary Canadians. This bank-bashing phenomenon was behind the refusal of the Chretien-Martin administration to allow consolidation in the banking industry for purely political reasons; to prohibit cross-pillar consolidation – particularly between banks and insurance companies; and by refusing to allow the banks to propose remedies to address the issues raised by the competition authorities when its report was issued on the bank merger question.[xxxiii] More recently, there has been renewed bashing of the banks as this time the Conservative

government is trying to eliminate the banks insurance offerings on the Internet. This is being undertaken at the behest of the Insurance Brokers Association.[xxxiv] As was the case about a decade earlier, particularistic interests are being put ahead of the public interest.

Canadians were never told that the quality, choice and efficiency of the services provided by Canadian banks far exceeded anything offered by their American and European counterparts.[xxxv] For example, in most European countries all one can do with an ATM machine is withdraw cash. Customers cannot pay bills, or transfers funds between accounts, for example. And, with the exception of one or two institutions, Canadian banks did not manage their risk exposures in an imprudent fashion. It is for this reason that the Canadian banks were not sucked into the global financial meltdown. That is the recent historical pattern of action – the policies – pursued by Canadian banks. So if Canadian banks are on balance both prudent risk managers and service oriented -- can this behavior at all be related to their performance leading up to the meltdown. The answer is obvious and the evidence is displayed in Table A[xxxvi] below. Canadian banks managed their capital positions in a much more prudent fashion than did their counterparts in other countries.

Part of the explanation for the more robust capitalization of Canadian banks relative to their international counterparts is explained by the limits imposed by the OSFI on banks' leverage (capital to asset) ratios. This ratio is limited to 20 times (assets can exceed non-risk weighted capital by a factor of 20). This is about the same leverage ratio as in place in the United States, but considerably less leveraged than institutions in the Euro-zone.[xxxvii] Internationally, "Canadian banks are generally seen as strong counterparties as they tend to be more conservative …than many other banks.[xxxviii] Having said that, it is the case that there is not a lot to distinguish Tier 1 capital in Canada and the United States, although the quality of the capital in Canada is higher as measured by common equity. And, North American banks are clearly better capitalized than their European counterparts. So we are still left with the conclusion that the Canadian banks are more conservatively managed than are their counterparts elsewhere in the world.

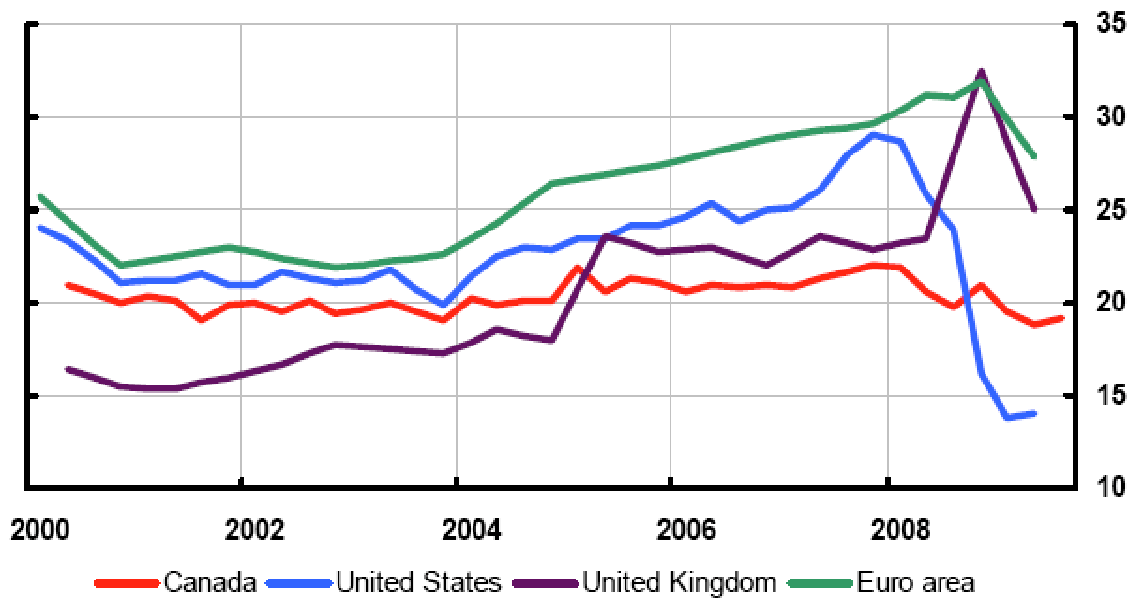
Table A: Average Capital Adequacy of Major Peer Banks[a]

Per cent of risk-weighted assets	Region	2007Q2	2009[b]
Tangible common equity	Canada	7.2	7.4
	United States	5.7	4.8
	United Kingdom	6.1	5.2
	Euro area	6.0	6.3
Tier 1 capital	Canada	9.7	10.7
	United States	8.3	10.4
	United Kingdom	8.6	8.6
	Euro area	7.8	8.7

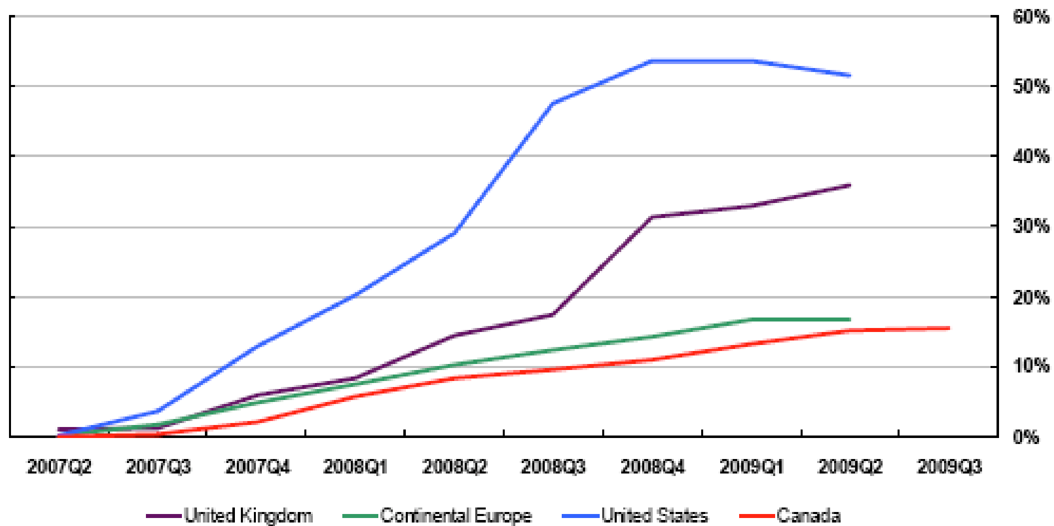
a. Peer groups include 6 major Canadian banks, 8 major U.S. commercial banks, 6 major U.K. banks, and 7 major banks in the euro area.

b. Latest available data: Canada, fiscal 2009Q2; U.S., calendar 2009Q1; U.K. and euro area, calendar 2008Q4.

Bank Leverage Ratios[xxxix]



Last Data Point: Fiscal 2009Q2, Canada; Calendar 2009Q1, U.S.; Calendar 2008Q4, U.K. and Europe
Sources: Bloomberg and bank financial statements



<u>**POLICY LEARING IN FINANCE**</u>

I reach the conclusion that the most recent financial crisis was in a fundamental sense not unlike earlier ones – only more severe. In the case of the Asian financial crisis, for example, traditional offshore bankers *and* dealers were lending to South Korea and to other South East Asian nations at interest rate spreads that clearly did not reflect the inherent risk.[xl] If the cost of borrowing does not reflect the inherent risk of the asset in question then default materializes. This, in part is what happened during the evolution of the current crisis. The regulators were shirking in the late 1990s, as they were most recently, in the face of the inadequacy of the due diligence undertaken by the institutional actors.

The Long-Term Capital Management (LTCM) crisis almost sank the global financial system because the Federal Reserve was unaware of the connected risks that LTCM had spread around the financial system. The Fed was of the view that any miscues by their large banks would only amount to "rounding errors."[xli] That premise was clearly incorrect and the key actor responsible for the safety and soundness of the US financial system was asleep at the switch.

In addition, the Nordic financial crisis, of the late 1980s and early 1990s occurred in the aftermath of a significant period of deregulation – when the banking system was permitted to participate in new household lending activity. The lesson here is that a nation cannot simply deregulate and hope that markets will behave.

I have already explored how the US subprime crises and the ABCP fiasco in Canada can be laid at the doorstep of the regulatory community.

The obvious lesson: there is a need for regulators to learn from past financial crises in order to preserve a safe and sound financial system. Ex ante avoidance of a financial crisis would undoubtedly result in a welfare improvement vis-à-vis ex post bailouts and economic collapse. So how is it that what seems so obvious has not materialized?

Part of the explanation lies in the structure of power in democratic capitalist countries. That is to say, finance can engage in risky imprudent behavior on the one hand and rightly assume that the state will bail them out somehow (a lesson reinforced by the dramatic fallout of the decision to permit the exit of Lehman Brothers) and on the other, coerce the state into supplying policies that are advantageous to finance. In crude terms, the power of information (the *information asymmetry* problem) clearly favors the institutions. And, only the institutions know if they will have to go to the state for a bailout (the *adverse selection* problem).

Moreover, the states implicitly understand that if they get in the way of finance, with tough prudential regulations, the consequences for general economic performance may be harmful because finance is mobile. For example, this was the case of the deregulation of finance in the US following the 1960s growth of the Eurodollar market that wreaked havoc on New York as the world's financial capital to the benefit of London. And, there are many other examples.[xlii]

The poor record speaks for itself. Regulators are not up to the task of preserving a safe and sound financial system because of an unreasonable belief in the efficiency of markets. Canada was fortunate to have a conservative business and investment culture and thus the strength of the Canadian financial system has more to do with the private sector actors than it does with the quality of oversight. Unfortunately, the same cannot be stated for other jurisdictions.

We seem to have entered a period in global finance where moral hazard is the accepted principle for large institutions. Nothing has occurred in Canada or elsewhere to put at rest the assumption that the state will ultimately step up with its unlimited resources to bail out imprudent risk taking. That has been the pattern of action since the 1980s and it continues as of this writing.[xliii] That is what private financial actors have learned; but public actors have not really changed their patterns of actions or learning skills.

The policy response in the industrial democracies to the meltdown was to give life to moral hazard. The bank bailouts began in the UK with the $42 billion rescue of Northern Rock, spread to the UBS who needed $7 billion from the Swiss government, the purchase of Bear Stearns by JP Morgan in the US, the failure of Lehman Brothers which triggered the stock market meltdown in September 2008, the US government takeover of AIG, Dresdner Bank sold to Commerzbank by Allianz in Germany, Merrill Lynch acquired by Bank of America, IHBOS taken over by TBS in the UK with the help of a $21 billion bailout by the UK government, the failure of Washington Mutual and Wachovia – both essentially bailed out by the US government, Citigroup rescued by the state, Hypo Real Estate Bank went bust in Germany to the tune of $68 billion, AIG was taken over by the US government…and the story could go on. In Canada, the central bank and the CMHC

had to take extra-ordinary actions to deal with the ABCP crisis and the externalities of the global crisis.

Generally, these actions are not the story of regulators doing their job, but of regulators observing and hoping for a better outturn – but ultimately bailing out the imprudent actors.

CONCLUSIONS

The international response to the crisis is the story of shirking *and* the absence of learning. There have been proposals to restructure the international financial architecture; discipline market participants by regulating their compensation contracts; mitigate procyclicality regulation; create special rules for systemically important institutions; improve the IMF surveillance; change the name of the Financial Stability Forum and broaden its membership; formally create the G-20 institution to replace the G-7, partly. So far not much has occurred – except for the creation of the Financial Stability Board. The EU has attempted to strengthen the regulation of offshore ratings but the consequences are difficult to assess presently. In one from or another, this backward looking response has been tried before and it does not work. Rules cannot be fashioned for all potential risky activities. This is the clear lesson of the official meetings in Basle and Washington over past 30 years.

Thus, this buffet of suggestions and/or initiatives to cure the frequent burdens financial crises in capitalism is not very helpful. The real requirement is to regulate the domestic regulators. Individual states must take measures to appoint regulators: who can speak truth to power; and, who are not fearful of raising the flag and calling a time out when the market is behaving in a fashion that cannot be easily understood. These powers already exist. They should have been used. And, proportionate penalties for those who instigate systemic meltdowns should provide an incentive for sober second thought before imprudent ideas turn to action.

In Canada, for example, the penalties incurred by the institutions that "engaged in activities contrary to the public interest,"[xliv] in the ABCP fiasco, amounted to only $140 million[xlv] – some .04 percent of the $32 billion "default". This is clearly not a proportionate penalty and moreover no individuals have been held directly accountable. Moreover, unlike the public disgrace and incrimination that occurs in the US (and imprisonment at times), the deliberations by the Canadian regulatory authorities were held in camera. This is clearly a reflection of the power structure in Canada.

In the Canadian case, the state did not incur any direct costs for the ABCP collapse although holders of the debt have incurred enormous costs – particularly the Caisse de Depot in Quebec and the City of Hamilton. The central bank and the CMHC have had to alter their lending and investment practices to deal with both the fallout of the ABCP and global financial crises while in a number of countries the state is now key shareholder in financial institutions (particularly the U.S. and U.K.). It seems unreasonable for the state

to act as the lender or owner of last resort without having an unequivocal opinion about the conditions under which an entity can borrow in credit markets. This is clearly not a responsibility that should be left to an unregulated actor (the ratings agency) who is accountable to the entity underwriting the cost of the rating. This should have been learned long ago. The situation in the US and UK are broadly similar – but solutions do not seem to be directed at the problem – but at absolving state actors for their shirking and ignorance.

Activist regulators and central bankers will be vilified by the market but the costs of such vilification – both private and public -- will be less than the social costs incurred as a consequence of events under consideration here. There is no need for any grand reregulation plan at the country or the global level. There is a need for state actors to do nothing but reflect upon and act in the public interest. This is the learning that is required. In Canada, the current Governor has recently reflected on the household debt situation.[xlvi] There may be a time when the Governor's bully pulpit will be inadequate to the task at hand. It may be that the central bank will have to use a long dormant tool of moral suasion – direct coercion of the credit grantors to change their lending practices or activities. It is this direct incursion that is required not only in Canada, but also globally. Markets make mistakes, as Alan Greenspan, Ben Bernanke and Mervyn King have belatedly admitted and it is the role of the state to preserve safety and soundness. Subtleness to this end just does not work.

Prudential regulators should be placed in the same position. If financial market activities seem opaque or misunderstood then the oversight responsibility requires action, ex ante. It is hard to imagine a regulatory error ex ante exceeding the ex post costs of a calamity. There will of course be headlines in the financial press, questions in the legislatures about state interference. However, markets left to adjust on their own do from time to time err. This has been the history of finance. Of course market participants and regulators will worry about stifling innovation and competition. But this has all been heard before. The answer to the question: were we better off before the financial engineers got hold of subprime mortgages or ABCP and turned them into CDOs and CDSs is obvious.

The familiar argument that severe sanctions would stifle innovation cannot be accepted anymore. We have known for a long time what doesn't work – its time to approach the regulation of finance by regulating the regulators – not repeating the "solutions" that have failed in the past.

Endnotes

[i] Shirking refers to bureaucrats and other actors (agents in principal-agent relationships) who take actions that do not advance the objectives or policies of the organization of which they are a member.

[ii] Policy learning reflects evidence to adjust present policy decisions in the face of the consequences of past policy and new information to realize the objectives of governance – in the present case a safe and sound financial system. See Peter Hall "Policy Paradigms,

social learning, and the state: the case of economic policy making in Britain," *Comparative Politics*, 25(3), 275– 296.

[iii] Rita Trichur, "Watchdog calls capital rules 'robust'", *Toronto Star.* October 2, 2007, p. B8.

[iv] Bank of Canada, *Weekly Financial Statistics*, various issues.

[v] Canada Mortgage and Housing Corporation, *Press Release*, various issues.

[vi] The Financial Stability Forum, established by G-7, provides opportunities for regulatory authorities to review and promote international financial stability. Membership also included Australia, the Netherlands, Singapore, the Bretton Woods Institutions, and international regulators. In April 2009, at the London Summit, membership was expanded to the G-20 and renamed the Financial Stability Board (FSB). Its Secretariat is housed at the BIS in Basle Switzerland. See Financial Stability Forum, Press Release, 2 April 2009.

[vii] Alan Greenspan, on CNBCs "House of Cards," admitted that he was puzzled by the more complex mortgage-backed securities on the market. CNBC broadcast Sunday, 28 July 2009.

[viii] Bank of Canada, *Weekly Financial Statistics*, various issues.

[ix] The incentive for banks to sell balance sheet assets is first to generate resources to make new loans and keep such lending from impinging on regulatory capital.

[x] See Federal Reserve Banks of Boston and San Francisco, *Revisiting the CRA: A Policy Discussion*, February 2009, at <http://www.frbsf.org/publications/community/cra/ revisiting_cra.pdf>

[xi] Randall S. Kroszner, Board of Governors of the Federal Reserve System, Speech "The Challenges Facing Subprime Mortgage Borrowers," at the Consumer Bankers Association 2007 Fair Lending Conference, 5 November 2007 Washington, D.C.

[xii] Craig Torres, "Edward Gramlich, Fed Governor Under Greenspan, Dies" Bloomberg.com, 5 September 2007, at < <http://www.bloomberg.com/apps/news?pid=20601087&sid=aREkzGFdsxpI&refer=home> and Patricia Sullivan, "Fed Governor Edward M. Gramlich," *Washington Post* 6 September 2007, B07.

[xiii] Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages," presented in Jackson Hole Wyoming (read by David W. Wilcox), 31 August 2007.

[xiv] Peter Bachrach and Morton S. Baratz, "Decisions and Non Decisions: An Analytical Framework, *American Political Science Review*, Vol 57, No. 3 (September 1963) 632 – 642.

[xv] Alan Greenspan, on CNBCs "House of Cards."

[xvi] Canwest News Service, "Canada's banks ranked the soundest," 9 October 2009 at <http://www.canada.com/topics/news/story.html?id=c3a67e3b-1aef-4daf-a768-a54eedb80185>; Doug Alexander and Sean B. Pasternak, "Canadian Banks, World's Best, Step Up Job Cuts," Bloomberg News, 10 June 2009 at <http://www.bloomberg.com/apps/news?pid=20601082&sid=aTeyKOgRudns>

[xvii] Stephen L. Harris, "Financial Sector Reform in Canada: Interests and the Policy Process," *Canadian Journal of Political Science*, 37:1 (March 2004), 161 -184.

[xviii] The distribution agents for the conduits were: Bank of Montreal, BNP Paribas, CIBC World Markets, Dejardins Securities, Deutche Bank Secuities, HSBC Securities, Laurentian Bank Securities, National Bank of Canada, RBC Dominion, Scotia Capital and Societe General Securities. See John Chant, "The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets," A Research Study Prepared for the Expert Panel on Securities Regulation," 46. <http://www.expertpanel.ca/documents/research-studies/The%20ABCP%20Crisis%20in%20Canada%20-%20Chant.English.pdf mimeo 2008>
[xix]John Chant, "The ABCP Crisis in Canada…"
[xx]John Chant, "The ABCP Crisis in Canada…," 39.
[xxi] See David Dodge, "Turbulence in Credit Markets: Causes, Effects and Lessons to be Learned," Remarks by Governor of the Bank of Canada, to Vancouver Board of Trade, Vancouver, British Columbia, 25 September 2007; Mark Carney, "Reflections on Recent International Economic Developments " Remarks by Governor of the Bank of Canada to the Canadian Club of Montreal, Montréal, Quebec 25 September 2008.
[xxii] Bertrand Marotte, "Caisse has $13.2-billion of ABCP," *Globe and Mail* 28 November 2007, at http://www.theglobeandmail.com/report-on-business/article799959.ece
[xxiii] Bank of Canada, *Financial System Review: June 2007*, 2.
[xxiv] David Dodge, Governor of the Bank of Canada, Remarks to the Canadian Club of Toronto and Empire the Empire Club of Toronto, Toronto, 10 December 2007.
[xxv] Mark Zelmer, "Reforming the Credit-Rating Process," Bank of Canada, *Financial System Review: December 2007*, 51 – 57.
[xxvi] Mark Zelmer, "Reforming the Credit-Rating Process," 56.
[xxvii] Canada. *Office of the Superintendent of Financial Institutions Act*, S. 4(2)(d)
[xxviii] Canada. House of Commons, Standing Committee on Finance, Number 050, *Evidence*, 16 June 2008.
[xxix] Jim Flaherty, "Speech to the 63rd Congress of the International Fiscal Association," Vancouver, BC 30 August 2009.
[xxx] Flaherty, Speech to the 63rd Congress.
[xxxi] These conclusions are supported in testimony, by the same actors, before the House of Commons Finance Committee. See Table One.
[xxxii] Jacquie McNish & Greg McArthur, "Special investigation: How high-risk mortgages crept north," *Globe and Mail*, Tuesday, Mar. 31, 2009 at http://www.theglobeandmail.com/report-on-business/article727831.ece
[xxxiii] Stephen L. Harris, "Financial Sector Reform in Canada."
[xxxiv] Tara Perkins, "Ottawa scuttles online insurance marketing by banks," *Globe and Mail*, 8 October 2009, B1; Steve Chase and Tara Perkins, "How scattered army of insurance brokers outmuscled the Big Five," *Globe and Mail*, 9 October 2009, B1; Derek DeCloet, "Flaherty's blow to banks goes one click too far," *Globe and Mail*, 10 October 2009, B2.
[xxxv] Recent surveys undertaken by the Strategic Council for the Canadian Bankers Association suggest that Canadians overall have favorable impression of these institutions. See Canadian Bankers Association, "Assessment of Canada's Banks – Fall 2008: An Update," conducted by the Strategic Council, November 2008.
[xxxvi] Bank of Canada, *Financial System Review: June 2009*. 27.

[xxxvii] Bank of Canada, *Financial System Review: December 2008,* 24
[xxxviii] Julie Dickson, "Remarks by the Superintendent, Office of the Superintendent of Financial Institutions of Canada to the Financial Services Institute," Toronto 24 June 2008, 1.
[xxxix] John Murray, "Canada and the Economic Crisis: Our Performance and Near-Term Prospects, presentation to the 80th International Business Cycle Conference of the Kiel Institute, Berlin Germany 15 September 2009, 15
[xl] Stephen L. Harris, "Financial Governance and Policy Learning in Korea: Analyzing the Post-Crisis Experience," *Journal of Asian Public Policy*, November 2008; "Korea and the Asian Crisis: The Impact of the Democratic Deficit and OECD Accession," in eds., Geoffrey Underhill and Xiaoke Zhang, *International Financial Governance under Stress: Global Structures versus National Imperatives* (Cambridge University Press, 2003).
[xli] Based on confidential interviews at the Federal Reserve Bank of Boston, December 2003.
[xlii] For a detailed discussion of the power phenomenon see Stephen L. Harris, "Regulating Finance: Who Rules, Whose Rules?" *Review of Policy Research* Volume 21 Number 6 November 2004.
[xliii] CMHCs mortgage insurance cap has been raised to $600 billion from $350 billion in 2007 with problematic prudential oversight. See Boyd Elman and Tara Perkins, *Report on Business*, 16 October 2009, B1.
[xliv] Ontario Securities Commission, In the matter of *The Securities* R.S.O. 1990, c. S.5, as amended and In the matter of the Canadian Imperial Bank of Commerce and CIBC World Markets Inc, *Statement of Allegations*, Staff of the Ontario Securities Commission, 18 December 2009.
[xlv] Sunny Freeman, ABCP penalties near $149-million," *Globe and Mail Report on Business,* 21 December 2009 at http://www.theglobeandmail.com/globe-investor/abcp-penalties-near-140-million/article1408089/
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