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What Toronto can teach New York and London

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There's something about Canada that inspires gentle mockery from foreigners, especially those who live south of the border. Kelly Ripa, the co-host of a popular US talk show, this month engaged in an extended on-air riff with her husband (don't ask) about the absurdity of Canadian place names; Regina came in for a particular beating. South Park once invented a ditty – "Blame Canada" – devoted to bashing the Great White North. And at the elite end of the spectrum, Michael Kinsley, then editor of The New Republic, wondered what the most boring possible headline for a news story might be, and determined that "Worthwhile Canadian Initiative" was the winner.

This tendency to react to the mere mention of Canada with either yawns or guffaws may be why, as the world struggles to figure out what went wrong in 2007 and 2008, not much international attention is being devoted to figuring out what went right in Canada. Canada is the only G7 country to survive the financial crisis without a state bail-out for its financial sector. Two of the world's 15 most highly valued financial institutions – a list dominated by China – are Canadian and a recent World Economic Forum report rated the Canadian banking system the world's soundest. Even Barack Obama, on the eve of a visit last year to Ottawa, the Canadian capital, admitted: "In the midst of the enormous economic crisis, I think Canada has shown itself to be a pretty good manager of the financial system and the economy in ways that we haven't always been."

One of the most important policy debates today – particularly in countries hardest hit by the crash, such as the US and UK – is what caused the crisis and what should be done to prevent a repetition. Inevitably, the discussion is hypothetical: even if we could agree on exactly what went wrong, no one can prove that any recommended policy changes would have averted the meltdown. That's where Canada comes in. It is a real-world, real-time example of a banking system in a medium-sized, advanced capitalist economy that worked. Understanding why the Canadian system survived could be a key to making the rest of the west equally robust.

View from the Top

Mark Carney, governor, Bank of Canada

Julie Dickson, Canadian bank regulator

The first argument you are likely to hear when you start asking what made Canada different is cultural. Depending on your degree of fondness for Canucks, this thesis comes down to the notion that Canadians are either too nice or too dull to indulge in the no-holds-barred, plundering capitalism that created such a spectacular boom, and eventual bust, in more aggressive societies. A senior official in Ottawa likes to say that Canadian bankers are "boring, but in a good way. They are more interested in balance sheets than in high society. They don't go to the opera." Some of them – including the chief executive of the Royal Bank of Canada, the country's largest bank – have never even been to Davos. According to Matt Winkler, editor-in-chief of Bloomberg News, "Canadians are like hobbits. They are just not as rapacious as Americans." And Paul Volcker, the legendary inflation-slaying former head of the US Federal Reserve and an adviser to Obama, told me that Canada's strength is "partly a cultural thing – they are more conservative".

Canadian facts and figures

- 6 big banks, approximately 73 banking institutions in total
- The big banks are all universal – offering retail, commercial and investment banking services. Some boutique investment and commercial banks exist but they are relatively small
- Banks have minimal off-balance-sheet holdings
- Banks' return on equity generally 13% to 20%
- Home ownership rate: 68.4% of the population
- Subprime less than 5% of the mortgage market
- Relatively low penetration of derivatives and securitisation (27% of mortgages repackaged and sold as bonds)
- Mortgage default rate less than 1%

Source: McKinsey
Dates: 2008 & 2009, except Canadian home ownership figures, which come from the 2006 census.

Roger Martin, dean of the Rotman School of Business at the University of Toronto – I should admit here that not only am I Canadian, but I also serve on Martin's advisory board – went to Harvard and Harvard Business School and worked as a management consultant in Boston. His professional experience on both sides of the border has convinced him there is a meaningful cultural difference, one which he traces to the founding philosophies of the two north American states: "We are 'peace, order and good government'. They are into the pursuit of happiness. The US banks were pursuing their own happiness, with sort of an ideological assumption that it would all work out fine."

The culture of Canada's bankers also gets high marks from the governor of the Bank of Canada. Born in the Northwest Territories, educated at Harvard and Oxford, and trained in global markets during a 13-year stint at Goldman Sachs, Mark Carney brings an international perspective to his elegant boardroom with its 10ft windows overlooking Parliament Hill. Asked to account for the resilience of his country's banking system, Carney started with the fact that "Canadian bankers are still bankers. They still – through the organisations and up to the top of the organisation – are proficient at managing credit risk and market risk … they have retained a banking culture through[out] the organisation."

Ed Clark CEO, TD Bank

In the skyscrapers of Toronto's Bay Street, Canada's banking hub, with their sweeping views over Lake Ontario, the cultural thesis wins some support, too. Sprawled in an armchair in his eighth-floor office, Gordon Nixon, the lanky,

"US bankers maybe see themselves as more important than we do"

bespectacled chief executive of Royal Bank of Canada, admitted that "the US system is less risk-averse than the Canadian system".

Ed Clark, CEO of TD, Canada's second-largest bank, works from a fourth floor office just around the corner from Nixon's. He told me that "I don't take myself so seriously. US bankers maybe see themselves as more important than we do." In Clark's view, Canadian culture imposes a limit on CEO megalomania: "Canada is a more egalitarian society; Canadians are less hierarchical. In the US, you can tell people to do something. In Canada, you have to ask them to do something – and hope they will do it!"

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The most convincing testimony I heard to Canada's culturally distinct approach to banking came during an interview at RBC's offices on the southern tip of Manhattan. There I met Kevin Lewis, a 44-year-old investment banker wearing a navy suit but no tie, with a shaven head. Lewis used to work at Lehman Brothers, one of Wall Street's most aggressive firms, until it went bankrupt. "I don't want to sound condescending to Canadians," he said, "but there is a 'being nice' mentality that exists in the institution. There is a priority on decorum, on being friendly, on being collegial. It's a subtle thing. It is like soft music playing, rather than hard rock."

The financial crisis has given this sort of argument fresh intellectual respectability. One of the winners in the crash was behavioural economics, with its emphasis on the ways in which individual and group psychology shape financial outcomes. If you buy this approach, Canada's small "c" conservatism and its egalitarianism may well have served as a check on excessive risk-taking: it is hard to be a shoot-'em-up frontiersman when your cultural hero is the law-enforcing Mountie.

Yet I'm cautious about buying the niceness argument wholesale. What seems prudent in the immediate aftermath of the crisis may well seem dangerously stagnant once we focus again on innovation and growth. Even now, Lewis told me, being nice is not exactly a compliment on Wall Street, and he was anxious to qualify such impressions: "We have all the competitiveness and drive to succeed, we just don't have some of the hard elbows that characterise it elsewhere." A friend who runs a hedge fund in Toronto and who conforms to the stereotype of that sub-species – a 51-year-old, loft-living bachelor who runs marathons and cycles competitively – put it more directly. "Please," he wrote in an e-mail, "don't say it is just because we Canadian bankers are all so boring!!!"

Moreover, while the Canadian hobbits are to the fore at the moment, the country has had its orcs, too. Indeed, two of America's most notorious corporate felons were born Canadian: WorldCom's Bernie Ebbers and Hollinger's Conrad Black. There are other examples in Canada itself: BreX, one of the mining industry's great scams, was a Calgary company. Canada even had its own home-grown embarrassment in the financial crisis when, in the summer of 2007, its asset-backed commercial paper market threatened to collapse.

Most important of all, one of the lessons of the global economic transformation of the past 20 years is that when incentives change, cultures can change, too. Two decades ago, selling a pair of jeans was illegal in Russia; now that country is home to some of the most aggressive capitalists on the planet.

If Canadian culture isn't the key, the alternative explanation must be the country's rules and institutions. TD's Ed Clark, who spent a decade in federal government from 1974 to 1984, favours this argument. "There's probably a range of views, from heroic bankers to heroic regulators," he told me. "While it might make me unpopular in my industry, I think the key is the structure of the industry."

US facts and figures

- 8,021 banks ranging in size from large multinationals to small community banks
- Many independent boutique investment and commercial banks
- Banks have significant off-balance-sheet holdings
- Banks' return on equity generally -25% to 10%
- Home ownership rate 67.6% of the population
- Subprime approximately 11% of the mortgage market
- Significant penetration of derivatives and securitisation (67% of mortgages repackaged and sold as bonds)
- Mortgage default rate approx. 10%

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The civil servants who police Canada's banking system agree. The industry's senior watchdog is Julie Dickson, a delicate-featured blonde who heads the Office of the Superintendent of Financial Institutions (OSFI). In person, Dickson is the embodiment of all of those putatively Canadian national virtues – she is quiet, deliberate and so much of a self-effacing team-player that she would not allow a national magazine to illustrate a recent profile of her with a photograph on its cover.

But Dickson believes it is rules and not individuals that account for her sector's survival. She points to three specific restrictions: capital requirements, quality of capital and a leverage ratio. "We had a tier one capital target of 7 per cent going back to 1999," she says, referring to the proportion of the bank's equity considered to be of the highest grade. "We also paid attention to quality of capital, so 75 per cent of that tier one had to be in common shares [as opposed to preferred stock, which is considered a hybrid of equity and debt]. And our leverage ratio [of debt to equity], of 20 to 1, was very important, we think."

Mark Carney at the Bank of Canada cited those same three rules, and this nearly word-perfect unanimity between the two speaks to a fourth, structural advantage – Canada's uncomplicated and well co-ordinated regulatory framework. This consists of the central bank, which is responsible for the stability of the overall system; the superintendent, responsible for the stability of the financial institutions; a consumer protection agency, which looks out for individuals; and the finance ministry which sets the broad rules on ownership of financial institutions and the

design of financial products such as mortgages and tax-deferred investment vehicles. The four actors meet regularly. As a result, says Robert Palter, director at McKinsey in Toronto, "there are no gaps."

Mark Carney Governor, Bank of Canada

"Canadian bankers are still bankers. They are proficient at managing risk"

The way rules are enforced seems to matter, too. The Canadian system is based on principles, rather than rules. It is about the spirit, rather than the letter, of the law. For Dickson, that means "we want to be told everything that is going on. We don't want to have a list of boxes that we tick because that's not very effective." She is particularly disdainful of a legalistic approach. "Having lawyers looking at this line or that clause and debating with you about whether something is do-able or not is not the right conversation to have. The right conversation is the principle. You have to know what risks you are undertaking."

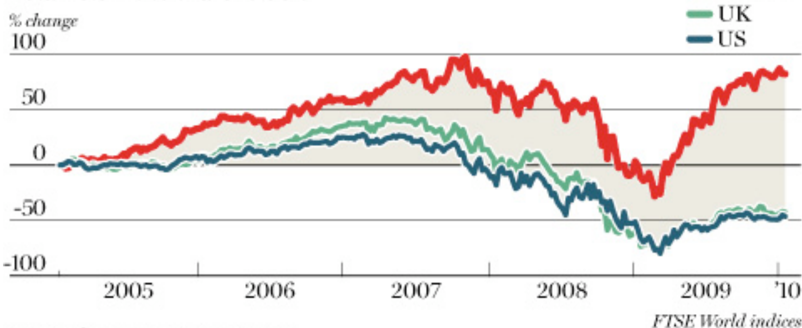
The bank chiefs seem to get the message. According to Clark, whose TD bank has significant operations in the US: "The message in the US is it's your responsibility to meet our rules. In Canada, the responsibility is to run the institution right. Julie says [to the CEO]: you are the chief risk officer of the bank."

Dickson gets executives' attention in part by attending bank board meetings, including a session with just the non-executive directors. Geoff Beattie, one of Canada's most influential investors and a member of the RBC board, says Dickson's reports "have a big impact. It creates a nice check and balance in the boardroom when they are focused on being real risk managers and regulators for Canadian banks".

With hindsight, all of this seems obvious: lots of quality capital, limits on leverage and a simple and co-ordinated regulatory system that forces bank bosses to take personal responsibility for managing risk. But it didn't look that way five or 10 years ago when, across the world, financial engineering was in vogue and light-touch regulation seemed a prerequisite for success. The real mystery is why Canadian policy-makers weren't tempted to get into that race to the bottom, and why their bankers didn't push them into it.

One reason may be that on his first day as finance minister in 1993, Paul Martin got very scared. Martin, a snowy-haired, charming Anglophone businessman now living in Montreal, who went on to serve as prime minister, remembers that "the first file on my desk was Confederation Life" – an insurance company that eventually failed. "We had gone through a period of failures of trust companies," Martin recalled. "Personally, the lessons … were very important."

Martin decided that his job was to figure out how to make sure "these things never happened again". David Dodge, who went on to become governor of the Bank of Canada, was deputy minister of finance at the time. He, too, remembers the early 1990s as a formative period. "We were starting out basically not knowing how to deal with this. It prompted a decade of legislative change."



For Martin and Dodge, there was a shared conviction, as Martin told me, that "we could never afford to go through with our banks what we went through with our trust system. I knew there was going to be a banking crisis and so did everyone else who has read any history. I just wanted to be damn sure that when a crisis occurred it wouldn't occur in Canada."

Don Drummond, now the chief economist at TD, was a senior official at the finance ministry in the 1990s. "The perspective of government on the financial sector is: 'We are the regulator – our job is to tell you what to do, not to help it grow,'" he told me. "The government has always felt its job was to say no." Because of this, Martin and his team were uninterested in what became the contest to create the most attractive haven for global capital. Canada raised its capital requirements as they were lowered in other parts of the world. "I think one of the things that happened was the great competition between New York and London pushed the two into more of a light touch in terms of regulation," Martin recalled. "I remember talking to [the regulator] and we agreed that we were not prepared to take that approach. Light-touch regulation in an industry that was totally dependent on solvency didn't make any sense."

Again, with hindsight, Canada's opt-out seems logical. But it wasn't seen that way at the time. One measure of how powerfully the country was swimming against the tide is that the International Monetary Fund chided Canada for not doing enough to promote securitisation – restructuring debt into tradeable financial instruments – in its mortgage market. Even communist China accused Canadians of being too cautious about capitalism. Jim Flaherty,

Canada's finance minister, recalls that on a visit to Beijing in 2007, "they were suggesting that maybe Canadian banks were too timid."

Canada's bright young things were sympathetic to this critique. One newspaper columnist liked to write about "the tale of two Royals", comparing the stodgy Royal Bank of Canada with its buccaneering, world-beating Edinburgh cousin, the Royal Bank of Scotland. A Canadian finance executive who spent the 1990s in Toronto and now lives in Asia sheepishly recalls thinking: "Come on, guys, get in the game! The world's changing."

Although they don't like to admit to it now, some of Canada's bankers sang along with this deregulatory chorus. But somehow they failed to effect the kind of change seen elsewhere. One reason is certainly the resolute attitude of the Canadian government – its national-stereotype-busting toughness was most clearly seen when Martin refused to allow the banks to merge. But another reason Canadian banks didn't persuade the government to loosen up was that they didn't try very hard. "I received huge pressure on the mergers," Martin told me. "But when I raised tier one capital I did not receive delegations of bankers to protest. They didn't raise hell."

The source of that restraint isn't that Canadian bankers are culturally cautious or naturally nice. It is that the structure of their business allows them to make very healthy profits without taking extreme risks. As David Dodge puts it, "You had a set of banks that had essentially very profitable domestic commercial banking franchises. They had to be pretty bad in their other businesses to lose money overall."

The heart of the franchise – and probably the true key to the stability of the Canadian financial sector – is mortgages. Unlike many of the economies that were hardest hit by the crisis, particularly the US and the UK, Canada has a highly restrictive mortgage market. All mortgages with less than a 20 per cent down payment must be insured. Adjustable-rate and interest-only mortgages are practically unheard of. One obvious result is a more robust mortgage market: Palter at McKinsey says that less than 1 per cent of Canadian mortgages are currently in default, compared with 10 per cent in the US, with almost no difference in the home ownership rate, around 67 per cent in both countries.

The regulator's emphasis on quality of capital means that instead of securitising most of their mortgages – according to Palter, in 2007, 27 per cent of Canadian mortgages were securitised, compared with 67 per cent in the US – banks held on to them. According to Carney, the central banker, if you run a Canadian bank, your calculation is that "at the start of the year, I know I have got $1bn net of income, because they are Canadian mortgages. I know I have very low credit risk. Why would I get rid of that earnings base?"

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Palter offers this comparison with the US banking sector: "The big Canadian banks typically generate return on equity of between 13 per cent and 20 per cent, and rarely produce negative returns on equity. Comparable US banks earn ROEs that range from negative 25 per cent to 10 per cent over the past 18 months."

"We are extremely non-capital-intensive," TD's Ed Clark told me. "That is because of the regulatory regime. If we were an American bank I couldn't do it. I would be forced up the yield curve."

To figure out why Canada survived the banking crisis, I visited Ottawa and Toronto, talking to regulators, central bankers, investment bankers and investors. It turns out that I could have found the answer on the streets of my hometown, asking my father's neighbours about the terms of their mortgages. For more credit-addicted societies, this may, however, be the hardest part of the Canadian experience to replicate: it is one thing for voters to support tougher rules for banks, it is quite another to agree to tougher rules for themselves.

Gordon Nixon CEO, Royal Bank of Canada

"In Canada, residential real estate was the strongest asset class"

"At the heart of the problem was the fact that you had this bubble in US residential real estate that was fed by inappropriate lending standards; it was fed by public policy," RBC's Gordon Nixon told me. "In Canada, that was the strongest asset class throughout this crisis."

In my conversations with Canadian bankers, one of the things that struck me was how often they referred to mothers. Nixon mentioned his mother and her good opinion when explaining why he gave back his bonus in 2008; Clark uses the mother-in-law test, as in "Would you sell it to your mother-in-law?" to help TD employees figure out if they should be hawking a product to their customers. In an era when Wall Street investment banks issue notes warning their clients they may be short-selling the investments they are marketing, this sounds like a charmingly Canadian attitude. But it is easier to be nice if you don't need to be nasty just to make a buck.

Chrystia Freeland is the FT's US managing editor. Her last piece for the magazine was about **Russian journalists working in Ukraine**

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