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# The Community Lender

from FOSTRIAN | Business Capital Corporation

*Fostrian Business Capital is a commercial lender specializing in working capital loans to emerging companies through the factoring of their accounts receivable.*

*From Jeff:*

While we in the United States continue to go through our most severe banking crisis since The Great Depression, the Canadian banking system has more than weathered the storm. In fact the consensus in the press is that our brothers to the north have the best banking system in the world.

Given our current banking problems, the amount of press that's been devoted to extolling Canada's system and finally the fact that many receiving this newsletter work in the banking/financial services industry, I thought a quick sketch of Canada's banking system, and how it compares to that of the U.S., would make for a good topic to write about in this issue of The Community Lender.

On another note, the "Look Who's Making The World A Better Place" section of the newsletter is taking a break for this issue, but will be back stronger than ever in the next issue!

Lastly, the warm weather is here. Chicago in summer has the best climate in the world – let's get outdoors and enjoy it!



# THE CANADIAN BANKING SYSTEM... SHOULD THE U.S. GO TO SCHOOL?

To date, throughout "The Great Recession" with which we continue to struggle, the U.S. has had 200 bank failures – Canada has had zero. During The Great Depression of the 1930s, Canada then also had zero bank failures. Less than 1% of Canada's mortgages are in default compared to 10% in the U.S. While TARP has become a mainstay in the American vernacular, no bank in Canada has required a bailout. Canadian banks' 90+ day delinquency is 10% of the figure for U.S. banks. Home prices in the U.S. have decreased 25% versus 12.5% in Canada. All 5 of Canada's big 5 banks (these 5 control 80% of Canadian bank assets) were profitable in 2009. Lastly, in 2008 The World Economic Report ranked Canada as having the world's soundest banking system. The U.S. ranked 40th.

All this begs for a closer look at Canada's banking system. How does it differ from that in the U.S.? What governmental policies (or lack thereof) were promulgated in Canada that might explain why Canada's banks are so healthy relative to banks in the U.S.? Should the U.S. adopt the Canadian system outright? Should the U.S. at least go to school and learn from what Canada has done right?

This is a bigger issue than can be dealt with in a short newsletter like this one. But what I would like to do is lay out a comparison of the two systems, highlight some major differences, and end with some closing thoughts.

## U.S. BANKING SYSTEM, CANADIAN BANKING SYSTEM – DIFFERENCES

### GSEs (Government-Sponsored Enterprises)

While the U.S. has Fannie Mae and Freddie Mac (and many other programs to promote home ownership), Canada has no GSEs. Regardless of one's politics, it's clear that in the U.S. Freddie and Fannie incentivized lenders to make loans to borrowers unable to repay these loans. Freddie and Fannie contributed to the artificial skyrocketing in U.S. home prices, and thus the bubble that eventually burst. None of this took place in Canada. The Canadian government does promote home ownership, but nowhere near the (irresponsible) degree to which was promulgated by the U.S. government. And to the degree Canada did support home ownership, money was appropriated for that specific purpose and it was on budget (versus U.S. GSE's whose ultimate cost to taxpayers is deceptively off budget).

### Industry Concentration/Regulatory Oversight Structure

The U.S. has 8021 banks incorporated to do business. Canada has only 82. Of the 82, 5 dominate Canada's banking market. These 5 possess 80% of all Canadian bank assets and are all headquartered within a few miles of each other in Toronto. With regard to Canada's regulatory structure, it is less complicated and better coordinated than the U.S. system (the U.S. system with its panoply of state and federal agencies regulating U.S. banks). To sum up this section, Canada has fewer banks to regulate, its banks are headquartered in close geographic proximity to one another and it's government has set-up a simpler and more cohesive system of regulation than that of the U.S. Because of all this, many consider ease in regulation and oversight a huge advantage of the Canadian system.

### Securitization/Rating Agencies

Canadian regulation is more stringent with respect to the securitization of mortgages. The consequence is that the percentage of mortgages securitized in Canada is less than half that of the U.S. (27% versus 67%). Banks in Canada hold on to the mortgages they originate. The securitization problem that occurred in the U.S. was also made more egregious because of the failure of U.S. rating agencies to correctly rate the mortgaged backed securities eventually bought and held by U.S. banks. U.S. banks bought most of these securities at AAA ratings, later finding out the securities' inherent strength were much weaker than AAA. The banks paid the price by ultimately taking losses on these securities. Many contend the rating agency failures can be tied to U.S. government policy in that these rating agencies were not pushed by competition.... as they enjoy near monopoly status – this monopoly status being granted by the U.S. government.

### Culture

Canadians are inherently more conservative (small c) than Americans. As Roger Martin put it when comparing the cultures of Canada and the U.S. (Martin is a Canadian and Dean of The Rotman School of Business at the University of Toronto): "We are peace, order and good government. They are into the pursuit of happiness." The Financial Times put it this way when commenting on Canada's relative conservatism vs. that of the U.S.:



*"It is hard to be a shoot-'em-up frontiersman when your cultural hero is the law-enforcing Mountie."*

Because of this cultural difference, Canadians on the whole are more risk averse than Americans. This is not necessarily good or bad; but in regards to how it relates to this story, Canadian individuals and businesses are less likely to borrow money they may not be able to pay back. Canadian banks are less likely to lend money that may not be paid back. Cultural differences between the two nations cannot be overlooked as a factor in this discussion.

### Loan Structures

Common sense is the hallmark of loan structures in Canada versus what we saw in the U.S. over the last decade. 20% down payments are still the standard in Canada. If a down payment is less than 20%, the loan must be insured. Adjustable rate mortgages were the rage here; in Canada they were practically unheard of. Long-term fixed rates up to 30 years exist in the U.S. and are not always bank friendly for obvious reasons; in Canada interest rates are typically fixed for only up to 5 years.

### Miscellaneous

- the U.S. allows mortgage interest to be tax deductible, whereas this isn't the case in Canada. This makes U.S. housing less expensive and thus was another element contributing to the U.S. bubble.
- Canadian banks have full recourse to their borrowers' assets in the case of a mortgage default. This isn't the case in the U.S. Canadian homeowners thus are more incentivized to work through tough times and stay in their homes, versus the case with homeowners in the U.S.
- Canadian banks are required to hold more capital in relation to their assets than what's required in the U.S.
- Sub-prime lending is sharply restricted in Canada relative to restrictions on these types of loans in the U.S.

## CONCLUSION

While the consensus seems to be that the Canadian banking system is superior to that of the U.S., I'm not willing to go that far. Many elements of the U.S. banking system considered to be weak links are also our strengths (guts to take on reasonable risk, more fragmented but competitive banking industry etc.). In stable times American banks are more flexible when lending to small business and individuals. This is good for those small businesses and individuals, but is also good for the American economy from a macro perspective. There are many more elements of American banking that could be considered pluses when comparing the American system to the Canadian system; but itemizing these pluses is outside the scope of the theme of this newsletter, and therefore not needed here.

The important point is that Canadian banks weathered The Great Recession in stellar fashion; Canadian banks experienced a fraction of the problems faced by American banks during this time. Surely there is much for us in the U.S. to learn by studying what Canada did right.

I say let's not tear down our banking system. But I also say let's DO go to school on what our brothers to the north did right.

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