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Canada's Financial Framework: The Model for the Future?

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Check Against Delivery

Good evening ladies and gentlemen. Thank you, Mr. Everett Schenk,
(CEO – North American, BNP Paribas) in particular for your very kind comments.

It truly is a great pleasure to be here tonight – to be honoured by the Foreign Policy Association – and to be here in New York City.

Scotiabank was founded more than 175 years ago in Halifax – but we have a strong connection to New York. Just two years ago, we celebrated the 100th anniversary of our Agency here.

New York is also a city I and my family enjoyed for more than eight years when I worked here leading Scotiabank's U.S. corporate operations in the late 80s, early 90s. My youngest son was born in New York, actually in Ridgewood, New Jersey. My family loved it here. And the day we had to leave, my wife had to be pried out of our home with a crow bar. In fact, when I told her we were transferred back to Toronto, I did it by phone as a safety precaution!

Of course, to be honoured by the FPA – is a unique pleasure. The commitment and dedication of the association to helping Americans better understand policy issues that affect them and the rest of the world is both commendable and important.

My presence here tonight as a banker is a recognition that over both the short-term and the long-term global foreign policy issues are interlinked and significantly impacted not only by macroeconomic issues, but by the global financial sector and its institutions. This crisis, which has impacted economies and driven government policy worldwide, started with the financial sector. Until we solve the financial crisis, the real economy will not begin to respond to all the policy initiatives that have been taken.

No one, and I mean no one, could have predicted that over the span of the last several months, we would witness the collapse of some of the world's largest financial institutions. Unfortunately, there is some likelihood of more failures yet to come.

The confidence and trust underpinning the world's financial sector has been fundamentally shaken with implications not only for the economy, where the principles of globalization, open markets and free trade are being severely tested, but also for the long-term business models of the surviving participants and how these participants will be regulated both in home markets and abroad.

Wall Street has always been a source of innovation and leadership for the global financial sector, and must continue to be so, remaining open to new ideas.

The new reality however, is the future will not only come from Wall Street and Washington, but will also be directly influenced by international regulation and policy. The future will need global cooperation and collaboration by both public and private sectors, on a multi-lateral basis. The crisis has shown the degree of inter-connectedness, reach and complexities of today's global companies and markets. This will have to be built into the new financial structure going forward.

I've had the honour of leading significant work being done by the Institute of International Finance in looking at private sector best practices to respond to the crisis.

The IIF is the largest private sector association that represents the top 375 global financial companies. The IIF produced a report on market best practices outlining 150 recommendations endorsed by its Board of Directors and contributed to by the top risk managers and banking executives. It has been presented to central banks and governments around the world and is part of a major collaboration that is being undertaken by both the official sector and global banks.

One of the outcomes led me to an interesting, although admittedly biased, conclusion.

In looking for what works and best practices, I found a significant guiding light in my own home, Canada. Canada has a record of performance that suggests that the approach we've taken as a country is the one that works and may be relevant to future solutions.

More specifically, the combination of our macro-economic framework, regulatory oversight of our financial sector and the specific management practices of the private sector has resulted in a strong, well-capitalized and successful banking sector. And while not immune, Canadian banks have weathered this storm relatively well. And I humbly suggest that when it comes to ways to improve the global financial sector – and ultimately the global economy – Canada offers a model that's worth careful consideration.

I'd like to take the remaining time I have tonight to explain why Canada's economy, and particularly our financial sector, has been one of the best performing and why the World Economic Forum ranked our banking system as the soundest in the world, compared to 40th for the US and 44th for Britain. It was also similarly ranked by the IMF, and only last month, rated by Standard & Poor's as among the healthiest in the world, even through this crisis.

First – Canada has had a good macro-economic policy framework that has produced excellent results.

The country has its fiscal house in order. Finances were put into surplus over a decade ago. This wasn't always the case. Canada had significant debt challenges in the early 1990s. In 1995, the Wall Street Journal ran an editorial with the headline "Bankrupt Canada?" It stated "Turn around and check out Canada, which has now become an honorary member of the Third World."

Back then, Canada had the second highest ratio of debt of any industrialized economy. Today, Canada's net debt-to-GDP ratio is the lowest in the G-7 economies. Even with the Canadian government's recently announced stimulus package taken into account, the net debt to GDP will remain under 30 per cent. Compare that to the U.S. where, after the current stimulus package is included, the debt to GDP ratio will exceed 60 per cent.

On almost all debt leverage and servicing measures, Canada leads the G7.

Also, Canadian monetary policy has been consistent and effective. Canada was one of the first countries to establish inflation targeting. Since the 1990s, Canada has successfully kept inflation low and stable – in the 2 per cent range.

Second - Canada has a strong financial sector regulatory policy approach.

For those of you who are less familiar with it, the Canadian financial sector is diverse, but with a strong banking system at its core. The banking sector holds about 60 per cent of financial assets.

The five major banks represent about 85% of this amount. Scotiabank, with over $500 billion in assets, is the third largest of the banks. We're also third by market capitalization and our $25 billion in market cap ranks us in the top 35 in the world. Some might assume that our financial sector is over-concentrated and overly risky as a result. Of course, the opposite has proven to be the case.

Since its creation in 1867, Canada has had a "national" banking system, not a regionally based one. This provides a real advantage of geographic diversification, and economies of scale.

Federal legislation that governs the banking sector – called the Bank Act – is overhauled every five years. This mandated, regular review is fairly unique. It allows for change and evolution, but in a disciplined, and measured manner.

Also, we've had a progressive approach to business powers in the past. During the 1980s, as part of the Bank Act's mandated review, regulations separating the traditional four pillars of the financial sector – banks, insurers, trust companies and investment dealers – were largely eliminated. Most significantly, by the 1990s, all the major investment dealers were owned by banks, creating an integrated bank model.

We did not have the lightly regulated, independent dealers that have been at the centre of the problems in the U.S. Our dealers have been managed under a single, prudential financial institution framework for more than 20 years.

The Office of the Superintendent of Financial Institutions – which I'll refer to as OSFI – plays the central regulatory role of federally regulated financial institutions.
OSFI works closely, but independently, with the banking community.   Its approach is principle-based, rather than rules-based.

It should be very evident to policy makers that prescriptive rules have not kept us out of this crisis or others.

Sarbanes Oxley is a case in point. Largely a response to Enron to protect against fraudulent reporting and off-balance sheet financing, it has done little to protect us from the bad part of securitizations, conduits and high profile frauds.

Even the resulting accounting rules of FASB and IFRS have yielded significant unintended consequences, rather than reinforcing an accurate description of business models of our financial institutions. It has added fuel to the fire on issues in mark to market and accounting for financial instruments, among others.

Canada was one of the first jurisdictions to implement Basel II, which required years of preparation, stress testing, and hundreds of millions of dollars on the part of the banks and OSFI to ensure it was done properly.

But OSFI did not rest solely on Basel or rules, they retained some proven safeguards, such as leverage ratios, intensive onsite inspections and its own self and peer evaluations on performance.

In addition, OSFI's experience and oversight turned out to be quite relevant to this crisis. By virtue of banks owning the largest domestic dealers for several years, OSFI has overseen the major bank groups on a consolidated basis. The necessary shock absorbers, principles and oversight were well-established.

This has resulted in good, usually prudent oversight and collectively with the private banks, produced strong risk and liquidity management by banks and their dealers.

While our regulatory framework is a good story – I'm also the first to say it can be improved. Canada needs to move towards having stronger, system-wide regulatory oversight especially on securities' regulation – and better surveillance of potential international market risks and the impact on our system.

The strength of Canada's regulatory leadership also led the G20 to recently name Canada co-chair of the G20 group responsible for enhancing the regulation of financial services and improving transparency. OSFI is also actively involved as a member of both the Financial Stability Forum and Senior Supervisor's Committee.

Third – and my final point – is that in addition to good fiscal, monetary and regulatory framework, we have a private banking sector that is performing well due to sound and profitable business models and proven risk management practices.

We've traditionally and voluntarily maintained strong capital positions. For example, while Basel II requires a minimum 4% tier 1 capital, OSFI has set a target of 7% -- one of the highest in the G-7. Still, Canadian banks voluntarily choose to hold even higher levels – around 9-10%, and we continue to do so.

Canadian bank managers have also, on their own, taken dramatic steps to maintain these high capital levels. Canadian financial institutions have raised over $10 billion in capital in the last quarter. None of this is from government sources. All of it is from private investors, which is virtually unheard of in the world today.

We also retained low leverage ratios of under 20, compared to 25 and higher for the US investment banks, and leverage in the 30s and 40s for some European banks and dealers.

The result is that our leverage is one of the best in the world, significantly below others. It was one of the best going into the crisis, and remains so now.

Underpinning this success is the conservative, pragmatic, risk culture of Canada and its bankers, combined with a strong internal governance structure.

This is reflected in Canadian banks' tendency to follow a strategy of diversification.

Scotiabank takes this strategy as far as we can – diversifying across businesses, products and geography. That's why we have operations in some 50 countries, some for over 100 years.

While Canada is our base, almost half of our earnings are generated outside the country. We have chosen the emerging markets, not retail banking in the United States and Europe. This includes the Caribbean, Central America, Latin America and Asia.

We have been in many of these countries for decades providing local, full-service banking. In 2008, our International Banking Division produced over 30% of our earnings, grew assets at double-digit rates and over the past several years earned returns on capital of about 20%.

Canada's banks' risk management practices have resulted in healthy, less-leveraged balance sheets that nevertheless produce sustainable, profitable earnings year over year. We have maintained a more conservative but profitable approach to our core business. We have few risky mortgages and no sub-prime exposure. We didn't rely on securitization for financing. No rules prohibited any of this, we just chose not to heavily participate.

We never significantly pursued the "originate and distribute" model. Instead we focused on keeping good assets on our balance sheet and the capital to support them. It also meant we remained accountable for the risks that we underwrote, ensuring sound underwriting, documentation and monitoring. A very traditional, prudent and profitable banking model, yet very competitive in Canada and around the world.

The practices we follow – largely retaining our customer's loans -- mean that we have lower risks, deeper relationships with our customers, and more stable and predictable income flows.

Each year we start off with sustainable revenue from our existing customers and portfolios, so there's no need to aggressively pursue new loans or new customers just to maintain income. That means less risky behavior and strong customer relationships – overall a virtuous circle.

I mentioned internal governance as an important feature. This takes two forms.

First is strong internal audit, compliance and risk management, which goes to all levels of the Bank, including the board.

Second, and I believe something the U.S. has to move forward on – is a truly independent board and an independent chair. When I became CEO in 2003, for the first time ever at Scotiabank, this position was separated from the chairman, and a non-executive chair was appointed. All Canadian banks now have non-executive chairs and in our case I am the only management representative on Scotiabank's Board.

American and a number of European CEOs and boards have not embraced this governance structure to any great extent and they should. The Canadian model is a model of checks and balances.

And of course, and not unrelated, is how Canadian executives and CEOs have been paid. This has also been part of the reason we have avoided the excess.

Despite our banks being in the top 50 in the world in terms of size, our levels of senior executive compensation have been at only one-third to one-half of the levels of our U.S. counterparts. But more importantly than level is how compensation is measured and paid out.

For example, Scotiabank's compensation is aligned to shareholders' interests by having risk-adjusted and performance measurements that take into consideration risk and cost of capital, the deferral of compensation going forward and potential for significant decreases in the value of past compensation if performance objectives have not been achieved going forward.

All this is not new to Scotiabank; it has been in place for several years and the plans are working as intended.

We've known for years that the right incentives lead to the right behaviour. This was not, nor should it be, regulated. It was only common sense, developed by a prudent Board and Management team over several years, and yet providing positive incentives to our investment bankers and traders.

During this financial crisis, Canadian banks have had their own challenges to contend with. No one has been completely immune and we have made mistakes. But on the whole, we have also had very strong performance relative to American and European banks.

International consulting firm Oliver Wyman produces an annual report on the state of financial institutions and their performance, which they adjust for risk. For the most volatile period for the financial sector – the period from August 2007 to December of

2008 – Scotiabank ranked in the top 10 in the world, and first among the Canadian banks, based on their shareholder performance index ranking.

Ladies and gentlemen, this is the worst financial crisis we've experienced in decades, but it will come to an end.

Over-leveraging, poor risk management and governance, bad incentives, poor regulation and government policies have all contributed.

The financial sector has to be stabilized and then all must be reassessed -- business models, regulation and government policies. Many changes need to be made and some changes will need to be significant.

My message, which I hope hasn't over-stepped or been self-serving, has been to look at or at least consider a model that has more than less worked – and that's Canada's model. We have a country that respects open and free markets, but has retained its own unique and balanced social system in healthcare, education and social support systems. A country which believes in private innovation and ownership, but in moderation, balance and in good governance.

We are lucky in Canada – absolutely.

We are a country rich in resources. But we have also been a country and a financial system that has been well-managed.

As governments, policy makers and private firms contemplate the future and make more lasting changes, keep Canada in mind.

Thank you – and thank you once again for the honour and recognition you have given me this evening.