# Liquid Canada, the tipping point?

By Mark Sibthorpe

This report examines liquidity issues in the Canadian financial service industry.

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## Trust

Richard S. Fuld, final chairman and Lehman Gorilla, who re-appeared from under his rock recently, set the stage for liquidity issues that caused the Lehman bankruptcy. His failure: he did not anticipate the risks related to such things as liar loans, overly leveraged assets, and his banks deceptive accounting practices which, "gave the impression it (Lehman) had a strong and robust liquidity pool." (Tomasic R, 2012)

According to Tomasic's report, financial ecosystems (liquidity) require the following to work smoothly:

- A means of ensuring meaningful credit ratings;
- Shift from technical compliance to substantive compliance with respect to financial accounting;
- Transparency;
- Contractual relationships backed by good faith, integrity and truthfulness.

### The pre-crisis situation in the US

In late 2007 and all through 2008 Lehman increasingly used accounting devices, known within Lehman as Repo 105 and Repo 108, to temporarily remove billions of dollars of securities inventory from its balance sheet. Repo 105 and 108 were similar to standard repurchase and resale (repo) transactions used by investment banks to secure short-term financing but had one critical difference: Lehman accounted for Repo 105 and 108 transactions as 'sales' rather than financing transactions - a re-characterisation that removed such inventory from its balance sheet. Lehman never publicly disclosed its use of Repo 105 and 108 transactions, its accounting treatment for these transactions or the material impact these transactions had on its publicly reported net leverage ratio. (Tomasic R, 2012)

Another factor that eroded trust was conflict of interest. For example, Goldman Sachs helped its clients, "make huge bets against the very same mortgage-backed assets that it was selling to other clients, and as having failed to disclose this conflict of interest to investors." Goldman Sachs also duped investors into buying CDOs that contained RMBS with low borrower FICO scores in regions that had recently experienced high price appreciation. Meanwhile it had taken a short position on these assets (Tomasic R, 2012, p. 29)

None of these conditions were present at Lehman prior to its bankruptcy.

## Contrasting liquidity situation in Canada

In contrast the US, Canada escaped the worst of the credit crisis due to prudent strategies by banks like TD, which held no subprime mortgages, the expanded role of the Canada Mortgage and Housing Corporation (CMHC), and luck. That is not to say that Canadian banks escaped unscathed, CIBC took a $3 billion write-down in 2008 due to CDOs (Business, 2008), and a foreign subsidiary/partnership of RBC (Dexia) required $9 billion to stay afloat in September 2008 (Management, 2008).

### Risks

#### *Reputation*

Canada's resilience is a cause célèbre, and has led to the widespread, ongoing reputation for having the soundest banks in the world. Despite these accolades, insulating the financial services sector has not come without incident and risk to taxpayers. For example, fiscal policies, including the CMHC's expanded role, while stabilizing the economy, as shown by reduced cost of funding earning assets (chart 1), have also contributed to a significant increase in the consumer debt to income ratio, which is now 163% (see table 1) and taxpayer exposure in the event of large scale mortgage defaults.

#### *Economic*

Trade policies that support Canada's resource industry have become problematic. For example, fueling the resource sector at the expense of other sectors has left the economy exposed given the fact that a resource based economy has weakened Canada's ability to compete in manufacturing and cheap oil is the catalyst for Alberta's current fiscal crisis. As a consequence, banks, policy makers and regulators must have effective liquidity strategies in place in anticipation of the worst economic scenarios.

### Indicators of financial soundness

The following charts (1,2,3 &4) and table 1 demonstrate various key indicators that indicate that Canada's banks have the capacity to absorb considerable economic decline and remain liquid without government intervention. Following these example, the report provides an overview of various actions by policy makers and regulators designed to fill in any gaps in the event of an actual financial crisis.

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### Charts

**Chart 1 overview:** the data from the chart to the right show two important facts. First, the cost of funding chart demonstrates that post-crisis liquidity issues increased the cost of funds for selected Canadian banks significantly. Evidently, the impact was even more dramatic for banks (not shown) like Canadian Tire Financial Services (CTFS) and Presidents Choice Financial, due to relatively disproportionate credit card assets.

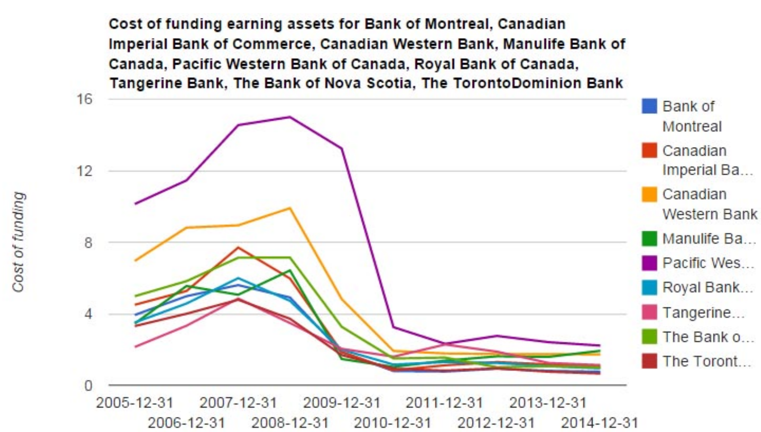


**Chart 1, cost of funding earning assets %, source www.banknews.tv: analytics**

**Chart 2 overview:** Canadian banks have increased their deposit significantly since the crisis. This is one of the best defenses against potential liquidity issues.

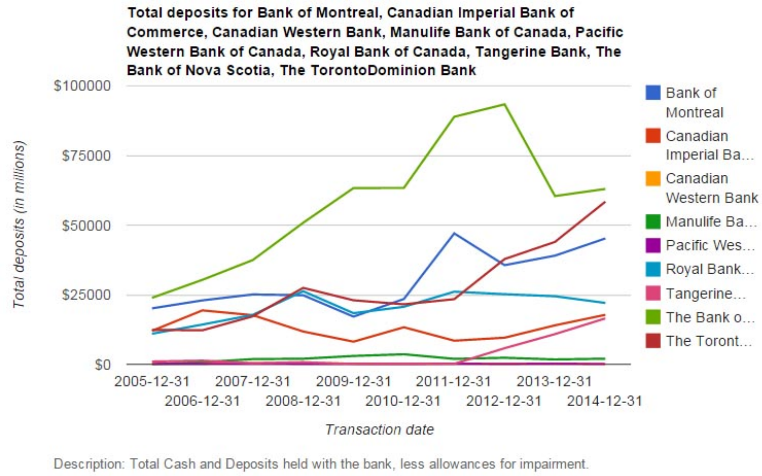


**Chart 2, deposit growth for select banks, source www.banknews.tv: analytics**

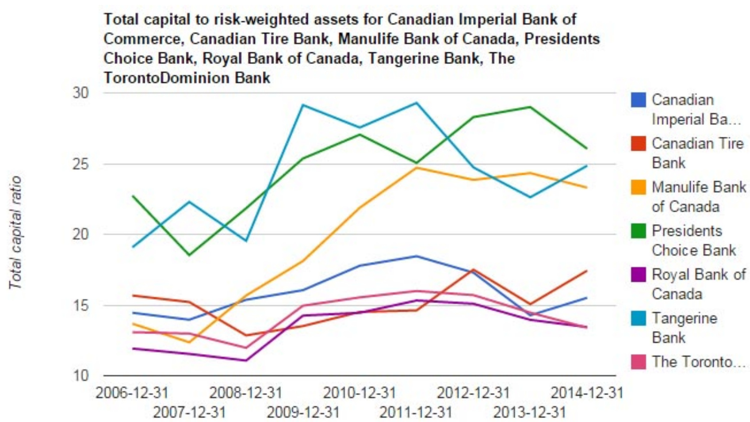


**Chart 3, capital adequacy ratio % for select banks, source www.banknews.tv: analytics**

**Chart 3 overview:** capital adequacy ratios for Canadian banks have increase since pre-crisis levels and are subject to Basel III guidelines as well as OSFI.

**Chart 4 overview:** YOY income growth and buying opportunities South of the border has allowed Canadian banks to balance out weakness in the Canadian market due to strong US profits.

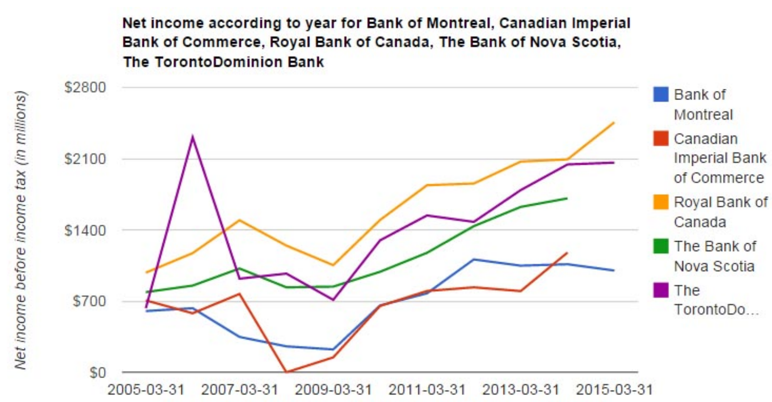


**Chart 4, net income large Canadian banks, source www.banknews.tv: analytics**

## Regulatory controls

Canada's regulators and policy makers recognize the risks, and have taken steps to head off liquidity issues at the pass. For example, May 14th, BoC Deputy Governor, Lynn Patterson announced structural shifts in the financial system. This announcement is related to liquidity issues. Some changes include Basel III and proposals to reduce intraday friction through a framework for market operations. Patterson says, "We are proposing to adjust the format of these SPRA (and SRA) operations from offering primary dealers a fixed amount at the target rate, to a competitive and discriminatory price auction at market rates. We will also increase both the aggregate amount of each SPRA and SRA operation and the limit for each counterparty. These changes will allow firms that need liquidity to bid for a higher amount in any given round. We expect that this will help distribute liquidity more efficiently to those that need it most."

Other support proposals include:

- Term repos
- Purchasing Government of Canada securities in the secondary market
- Securities lending
- Contingent term repo facility (CTRF)

**CTRF**

According to Patterson:

*The CTRF proposal* (similar policies already in place in the UK) *would offer liquidity on a bilateral basis for customized variable terms of up to one month, and be available to a range of counterparties, against a broad set of securities, at a fixed price. The specific parameters would be confirmed upon activation. "We expect that if the CTRF were activated, the counterparties eligible would be primary dealers and their affiliates. However, the number of counterparties could be extended to include other institutions—subject to certain criteria—should the Bank consider it necessary for the stability of the financial system.*

*At the same time, we may accept larger deviations from the target rate before we step in. Doing so will give the market more room to manoeuvre and clear itself without our intervention.*

**Basel III?**

Basel III is a framework that sets out global regulatory rules for bank capital and liquidity. These rules were originally published in December 2010 in response to the global financial crisis and are subject to ongoing review and updates.[4]

The phase-in of Basel III capital rules began in 2013. Canada implemented these changes in January 2013, well ahead of many other countries and well ahead of the Basel III timeline. The phase-in of Basel III's liquidity rules begins in 2015.

# Report summary

Canada's reputation for having the soundest banks in the world is supported by strong indicators as shown in table 1. In particular, capital adequacy ratios, deposit based funding and strong income, when taken together indicate that the current system can withstand a significant decline before intervention by regulatory and policy makers.

In the event that an immense systemic failure were to occur regulators have put in place liquidity solutions designed to minimize the impact to taxpayers, ensure uninterrupted bank operations and protect deposits.

## Appendix: various bank/economic stability indicators table

| | US | UK | Canada Small | Canada Large |
|---|---|---|---|---|
| Central bank rate | 0.25% | 0.5% | 0.75% | 0.75% |
| Concentration of largest 4-6 banks | 53% (2009) | 75% | | 85% (2012)[1] |
| Insurance revenue | 88% of large FIs sell insurance. For Wells Fargo it means growth. | Lloyds and other large insurers would make this area hard to grow. | | Insurance comission fees 0.13% |
| NIM (2011) | 2.95% | .087 | | 3.23 |
| ROA | 1.04 | 0.16 | Top performers 1.5 and 2.7. | 0.32 and 0.44 |
| ROE | 8.98% | 2.61% | 9.96 | 16.15% |
| Avg Net Income | $4.2 bn US | $2.4 bn CDN | $145 million CDN | $6.3 bn CDN |
| Risk | • Regulatory risk<br>• Tapering<br>• Asset inflation. | • Regulatory risk<br>• Exposure to EMEA<br>• Lloyds 80% of revenue outside UK | Regional risks for Alberta FIs. Exposure to Canadian market risk. | Limited regional risk. U.S. dilutes Country specific risk for most large banks. |
| Book value | Below, tangible book value | 0.89 times tangible book value | Data not available | 1.8 and 3.1 times tangible book value |
| PE ratio avg | 14.96 | 11.5 | Data not available | 12.5 (12.15 2014) |
| Investment banking versus traditional ratio | Neutral growth | -3% decline | Data not available | 19%[1] of total + growth expected[8] |
| Capital ratios | 7% possibly going to 11.5% | 4.5% - 4.95%[2] | 13%-26% | 13%+ |
| Regulatory risk | Punitive and restrictive | Punitive and restrictive | Meeting regulatory requirements challenging | Supportive |
| Current GDP growth rate | 3% | 2.4% | .6% | .6% |
| Commercial lending | 8.2% YoY Trend from corporate loans to corporate securities could explain downward | Down 4.5bn GBP in 2013.[3] | Large banks going for smaller deals. | 9.9%[6] but $55 billion direct exposure to energy.[4] |

| | | | | |
|---|---|---|---|---|
| **Consumer lending** | 10% YoY growth. 140% Debt to income. Debt to GDP 81% | Demand for borrowing subdued Debt to income 140%[5] | 163.3% debt to income | 6.6% from 13.5% growth. 163.3% debt to income. RBC drop in profit. Debt to GDP 95% |
| **Commercial deposits** | 50 US companies hoarding $1tn in cash. 4 per cent growth | $100 bn CND | | $626-billion |
| **Technology** | 4.3% increase | 10.5% (2013) | Heavy investment | 4.7% increase |
| **Cost of funds** | 1.4% | 0.9% | 3.5% | 0.9% |
| **Tax friendly** | 33 | 21 | 19 | 19[9] |
| **Non-interest income** | 15% | | | 12% |
| **Bank fees** | $350 to $450 per account per year | Competition high switching between larger FIs. | Often free | Basic account fees 2005 $8.32 2010 $8.82 2013 $9.45 |
| **Liquidity** | $3.5 tn QE tapering | €2.3 Tn | $30-billion in various securities from private institutions over the last six months | $30-billion in various securities from private institutions over the last six months |
| **Oil/Commodity risk** | Limited | Limited | High | High/Moderate |

Notes to table
1 http://dtpr.lib.athabascau.ca/action/download.php?filename=mba-12/open/eggertclaudioProject.pdf
2 http://www.institutionalinvestor.com/article/3396825/banking-and-capital-markets-banking/uk-banks-rally-on-announcement-of-new-leverage-ratio.html#.VUzAlflVhBd
3 http://www.theglobeandmail.com/try-it-now/try-it-now-streetwise/?contentRedirect=true&articleId=21015554#dashboard/follows/
5 http://www.bbc.com/news/business-25152556
4 http://credit.bankofcanada.ca/businesscredit
4 http://business.financialpost.com/news/fp-street/oil-price-plunge-at-worst-could-wipe-out-earnings-growth-at-canadas-big-banks-bmo
8 Bank Trading Revenues Expected To Show Another Big Gain In Quarter
9 Canada Ranked World's Most Tax-Friendly Country For Business

**Additional notes to table: comprised of key indicators for Canadian small and Canadian large banks, and large US and large UK banks.**

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n, S. (n.d.). Bankruptcy Report. pp. 69, 734.

Tomasic R, A. F. (2012). The Role of Trust in Maintaining the Resilience of Financial Markets. *Durham Univeristy: Principles-based Approach to Financial Regulation*, pp. 24, 29.