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Op-ed: Financial system soundness, is this déjà vu all over again?

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Note: This Market View comment, which may read to some like a public service announcement, evokes memories of the 2008 Global Financial Crisis (GFC). We do not position this as corporate credit analysis. Rather, we highlight a long-standing feature of Canada's financial system—its relative strength and soundness—which is presumably a consideration for any number of investors, whether taking exposure to Canada in rates, credit, equity or currency markets.

Let's take a quick trip down memory lane if you'll permit. Below are two sets of remarks from two different Canadian finance ministers from two different political parties at two different points of time (one from 2009 and another from yesterday). Nonetheless, both statements address the country's banking sector health. If they look, feel and sound similar, that's really no coincidence:

> *"The Canadian financial system is better equipped to cope with the challenging global financial situation than financial systems in most other countries. Canada has a less-leveraged and better-capitalized banking sector compared with other countries. As a result, wholesale borrowing costs paid by Canadian banks have risen less than for banks in other countries."* – Finance Minister Jim Flaherty via Government of Canada Budget 2009 (budget presented 27-Jan-2009)

> *"We have strong institutions, and we have a financial system that has proven its strength time and again. Our financial institutions have the capital they need to weather periods of turbulence. A hallmark of Canadian banks is prudent risk management—and this is also a core principle for those of us who regulate the financial system… Canadians can and should be confident that at a time of global uncertainty, there is no better place to be than Canada."* – Deputy Prime Minister & Finance Minister Chrystia Freeland via speech ahead of Government of Canada Budget 2023 (remarks delivered 20-Mar-2023)

Freeland's fresh comments were meant to soothe frayed nerves in the wake of U.S. bank failures and the rushed consolidation of a venerable Swiss financial institution with a long-time rival/peer. For some, this may spark feelings of déjà vu. Thinking back on the GFC, pronouncements regarding the soundness of Canada's financial system were an almost daily occurrence. We joke, but only a little. Countless times, Canadian officials trumpeted the strength, stability and oversight that characterized banking in Canada. Back then, you'd see Canadians proudly waving an international ranking of banking soundness assembled by the World Economic Forum (as part of its annual competitiveness report). After all, there was Canada taking pride of place in the #1 spot, where we stayed for a number of turbulent and influential years.

Around this time, other rankings focused on the strength of individual institutions. Rewind a dozen years or so and scan Bloomberg's annual tally of the 'world's strongest banks'; you would have seen five of Canada's big-six banks (including National Bank) in the top-20 list. That was a truly dominant showing given the country's relative size and total number of eligible financial institutions.

Ironically, as we gained some distance from the GFC and as attention shifted away from financial system health, Canada's banking system scores become somewhat less impressive (relatively speaking). Canada lost its #1 ranking in the WEF's listing of 'soundness of banks' back in 2016, as Finland took over top spot. By 2019—the last time the WEF produced a full competitiveness ranking of 140-odd countries—Canada had slipped to 6th place in banking sector soundness. An abbreviated WEF competitiveness report from late 2020, although absent a fresh or full list of rankings, focused on the relative change in banking system soundness vs. 2008, giving the impression Canada was losing ground.

Meanwhile, you won't find as many Canadian banks clustered on Bloomberg's 'strongest banks' list these days. Technically, there are now two in the top 20 compared with the rather impressive five Canadian institutions that once crowded this list. What was once Canadian dominance has seemingly shifted to Asia and the Middle East (at least according to Bloomberg). We caution about placing too much stock in these types of rankings. Case in point: Guess which institution ranked #20 on Bloomberg's latest list of the world's strongest banks? That's right, Credit Suisse Group. As it happens, UBS is also on Bloomberg's list, so the absorption of the former by the latter presumably creates space for another bank to join the list. Perhaps there's a Canadian financial institution just waiting in the wings? We'll have to wait and see.

The point is Canada's financial system (and more specifically the nation's banking sector) doesn't seem to have as complete a set of international bragging rights the way it did back in 2008-09. There are financial risks in Canada to be sure, not least of which is a heavily indebted consumer class now contending with a rather aggressive adjustment in borrowing rates. But as Deputy PM/Finance Minister Freeland was right to point out yesterday, Canadian banks continue to operate in a structurally sound financial ecosystem, highlighted by stringent regulation, forceful oversight, sophisticated risk management, relative deposit stability and adequate capitalization among other things.

We may not have fresh WEF rankings to hold aloft in 2023, but Canada's banking system continues to rank relatively favourably with credit rating agencies. Consider: S&P assigned Canada some of the best scores (in absolute and relative terms) in its latest banking industry country risk assessment (or BICRA for short). Again, one should always be careful about the pounding the table with such things, as Switzerland was also included with Canada (and nine other advanced nations) at the top of S&P's BICRA rankings.

It's presumably worth asking if this message of 'relative financial system soundness' is getting through to investors? Judging from the last couple of weeks—much of it characterized by acute turbulence—the answer appears to be 'yes'. We have witnessed relatively less noise and damage to financial spreads in Canada's corporate bond market vis-à-vis the U.S. or Europe. It's a similar story in equity markets, where our well capitalized Canadian financials have suffered relatively less… and for good reason in our opinion. Canada's apparent financial system superiority (at least in terms of soundness/stability) is no birthright and it must be guarded assiduously. The risk is that in calmer times, financial system soundness may appear an undervalued element on Canada's list of strategic advantages/selling points. But if anyone needed reminding, all it takes is a banking system wobble to reinforce the inherent value and appropriateness of our nation's approach to banking.

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