CHAPTER 9

THE CAISSES POPULAIRES AND CREDIT UNIONS

While all but one of the ten chartered and savings banks have played an important role in the Canadian economy since before the turn of the century, virtually all of the 4,700 caisses populaires and credit unions in Canada were founded during the past generation. The movement now has close to three million members in its local societies, holds assets of more than $1.6 billion and has emerged as a significant part of the financial system. This growth has been due in large measure to the co-operative basis, local roots, and diversified character of individual credit unions and caisses populaires—a striking contrast to the factors underlying the development of many other institutions. The number of local societies shows signs of levelling off but we have no doubt that the movement will continue to expand rapidly in dollar terms and will further broaden the range of services offered to its members.

The first caisse populaire was established in Lévis, Quebec in 1900 by Alphonse Desjardins who took as his model the co-operative "Peoples' Banks" which had grown up in Europe. This co-operative society was to promote thrift by collecting the savings of its members and, when members had good reason to borrow, to lend to them at lower rates than they could obtain elsewhere. Controlled by its members through elected officials, it stressed the "self-help" which a community of people of limited means could give each other by joining together to make sound and productive use of their own savings. The movement spread slowly among the French-Canadian population and then across the border to the United States where its orientation was distinctly altered. Whereas the caisses stressed the virtues of thrift, and lent to members only for productive purposes or to meet emergencies, the American "credit" unions were less inclined to view borrowing as a necessary evil, emphasized their ability to lend to members at low rates, and introduced the principle that membership should be limited to people having a "common bond" of association based on employment, social or other factors. This philosophy has led to the formation of many small societies devoting their resources largely to consumer lending to their members, but because of its limited objectives and the competition of other savings institutions—some of them mutual—credit unionism in the United States has not achieved the position it now holds in Canada.

In this country, the second major impetus came in the 1930's from a group working at St. Francis Xavier University in Antigonish, Nova Scotia, which promoted credit unions as part of a broad program of co-operative economic organization. They retained the American "common bond" philosophy, but with their general interest in adapting co-operative principles to business as well as consumer needs they interpreted it more broadly to cover communities as well. Credit unions of the Antigonish type sprang up rapidly in the Maritime provinces during the 1930's, most of them in farming and fishing communities

where they accepted funds from and lent to small local business members and other co-operatives as well as individuals. The movement also took root in Western Canada before the Second World War. While these two forms of financial co-operative, the caisses populaires and Antigonish credit unions, were expanding in different parts of the country, the third variant returned from the United States and developed rapidly in English-speaking Canada, particularly in Ontario.

It will be seen from table 9-2 that at the end of 1960—the most recent date for which we have complete information—about 70% of the credit unions in the Atlantic Provinces and more than one-half of those in the Western provinces were organized along the community lines favoured by the Antigonish tradition while in Ontario most locals were of the common bond type favoured by the American-inspired strand of the movement. While there are exceptions, the community credit unions dealing with a cross-section of individuals, and sometimes small businesses, tend to be larger than those which follow the American consumer-oriented lending tradition. Those in towns and cities are bigger than the rural societies; for example, only 35% of the caisses populaires are in urban communities but they had 73% of total assets at the end of 1960. As shown in Table 9-3, the caisses populaires tend to be larger than credit unions, 15% of them having assets in excess of $1 million compared to 3% of credit unions. There are also relatively fewer small caisses populaires, while the majority of credit unions organized on the strict interpretation of the common bond are small, having between $25,000 and $150,000 of assets. Those organized on community lines in rural areas tend to run between $100,000 and $300,000, also well below the average size of caisses populaires which was $563,000 in 1960. Averages can of course be misleading, and in some provinces such as Saskatchewan where many community credit unions have been estab-

TABLE 9-1

THE GROWTH OF CAISSES POPULAIRES AND CREDIT UNIONS

—	CAISSES POPULAIRES			CREDIT UNIONS[a]			TOTAL	
	thousands of members	number of locals	assets $ millions	thousands of members	number of locals	assets $ millions	assets $ millions	ratio to chartered bank personal savings deposits %
1930	45	150	11.2	n.a.	n.a.	1.2	12.4	n.a.
1940	119	549	21.2	77	605	3.7	24.9	1.7
1945	389	912	124.5	210	1,302	20.9	145.4	5.5
1950	619	1,088	234.5	418	1,789	74.5	309.0	7.4
1955	883	1,146	425.8	844	2,947	218.2	645.0	11.5
1960	1,268	1,243	738.8	1,288	3,418	541.9	1,280.7	17.8
1961	1,355	1,261	834.8	1,396	3,436	656.6	1,496.4	19.6

[a]Including caisses populaires outside Quebec. Here and elsewhere in the chapter, references to the caisses populaires relate only to the societies affiliated to the two federations in the Province of Quebec.

SOURCE: Submissions of caisses populaires and credit union associations.

TABLE 9–2

DISTRIBUTION OF LOCALS BY TYPE[a]
(END 1960)

—	CREDIT UNIONS						CAISSES POPULAIRES	
	New Brunswick and Nova Scotia		Ontario and Quebec		Prairie Provinces and British Columbia			
	number	%	number	%	number	%	number	%
Urban community	54	14	42	3	142	13	424	35
Rural community	211	55	105	8	445	40	797	65
Occupational groups	117	31	818	59	346	31	—	—
Other associations[b]			409	30	183	16	—	—
	382	100	1,374	100	1,116	100	1,221	100

[a]Credit unions are grouped according to the type of common bond. Caisses populaires, which do not apply the common bond principle, are grouped by location.

[b]Racial, religious, etc.

SOURCE: As for Table 9–1.

TABLE 9–3

DISTRIBUTION OF LOCALS BY SIZE
(END 1960)

—	CREDIT UNIONS				CAISSES POPULAIRES			
	No. of Locals	%	Total assets[a] $ millions	%[a]	No. of Locals	%	Total assets $ millions	%
Assets of								
$5 million and over	n.a.	n.a.	n.a.	n.a.	15	1	99	14
$1 million to $5 million	n.a.	n.a.	n.a.	n.a.	163	14	331	48
Sub total: $1 million and over	110	3	245	45	178	15	430	62
$½ million to $1 million	137	4	110	20	152	12	107	16
Less than $½ million	3,171	93	190	35	891	73	150	22
TOTAL	3,148	100	542	100	1,221	100	688	100
Average assets per local	$159,000				$563,000			

[a]Asset distribution is partially estimated.

SOURCE: As for Table 9–1.

lished a higher proportion have passed the million dollar line.

Most of the 4,700 caisses and credit unions are federated in 18 distinct, and sometimes rival, leagues. They have also established 27 central credit societies (or "central" departments of their leagues) for pooling some of their financial operations. While these leagues, centrals and other common activities integrate the network of locals in a number of important respects, each society is essentially independent and conducts its affairs in ways suited to its particular environment. Each is managed by its own board of directors and committees elected by and from the membership

and in most cases serving without pay. This democratic and local character follows naturally from the societies' co-operative organization—all depositors and borrowers must be members and have equal voting rights regardless of their shareholdings. It is also enforced by the broadly similar credit union legislation passed by all provinces. These acts restrict membership to a group having a common bond of association or living in a well-defined neighbourhood (which can be as large as a city). They also set out the duties of directors and management committees and limit or prohibit their borrowing from their society. Finally, most provinces impose a limit on the size of unsecured loans and restrict investment in securities, generally to types listed in trustee acts. In two provinces the legislation also establishes minimum liquidity requirements.

Both the size of a local society and the character of its membership influence its policies and manner of carrying on business. A relatively large local will probably have a modern office, professional management, trained employees and regular hours of business while a small one may operate with an unpaid treasurer conducting the business at odd hours on the corner of a desk. An urban society inviting membership from all residents of a heavily populated area will differ from one whose members are all employees of a particular firm or belong to an ethnic organization or to a co-operative in a farming community. Most, however, seem able to maintain the sense of involvement and interest of large numbers of their members, even though the bigger locals are of necessity more impersonal in their operations.

THE BUSINESS OF LOCAL SOCIETIES AND THE GROWTH OF THE MOVEMENT

The different attitudes of caisses populaires and credit unions towards borrowing by members have resulted in a striking difference in the structure of their assets, as shown in Table 9-4. Credit unions invest about 65% of their resources in loans to members, mainly for consumption purposes, although societies of the Antigonish type do a more diversified lending business in the communities where they are established. For instance, in Saskatchewan some 40% of their loans are to farmers for current operations and the purchase of equipment. The share of credit union funds devoted to mortgage loans has been quite stable in recent years: most of them are small short-term loans secured by mortgages rather than long-term residential mortgages but there has been increasing demand from members for housing finance.

Credit unions are limited to a 1% per month maximum rate on their loans in most provincial acts; their effective charges, after allowance for insurance benefits and the partial rebates of loan interest which are a regular part of the annual distribution of some co-operatives' income, range between 8% and 10% for most credit unions and a little lower for the larger ones and for rural societies. Most personal loans are secured by a chattel or real estate mortgage or by personal guarantees. The provincial acts usually set a limit

TABLE 9–4

COMBINED BALANCE SHEETS OF LOCALS[a]
(December 31, 1961)

—	CAISSES POPULAIRES		CREDIT UNIONS	
	$ million	%	$ million	%
Assets				
Cash: Deposits at Centrals	111.0	13.2	33.4	5.1
Other cash	29.0	3.4	20.4	3.1
Shares of Centrals	6.5	0.8	23.0	3.5
Other Investments	246.5	29.4	49.8	7.6
Personal Loans	56.8	6.8	429.7	65.4
Mortgage Loans	346.5	41.3	83.5	12.7
Other Assets	43.4	5.2	16.9	2.6
TOTAL	839.8	100.0	656.6	100.0
Liabilities				
Borrowings and other Liabilities	2.7	0.3	29.7	4.5
Deposits	734.8	87.5	78.9	12.0
Shares	56.7	6.8	499.8	76.1
Reserves	38.1	4.5	25.4	3.9
Undivided earnings	7.6	0.9	23.0	3.5

[a]See the appendix volume for additional balance sheet data and sources.

varying from $200 to $500 on individual unsecured loans, which in total account for less than 10% of the amount of outstanding loans. Many societies charge the same rate on all loans, this being a rather surprising extension of their policy of equal treatment for all members in view of the variation in the risk, term and costs of administration of different loans. It seems particularly inequitable when the standard rate is charged for loans secured by the member's own shares and deposits.

In contrast to the credit unions, some of which have half of their members borrowing from them at any one time, only 10% to 15% of caisses populaires members are normally borrowers. Moreover, only one-half of their funds is invested in loans to members and most of these are conventional residential mortgages. The average term of these loans is thus a good deal longer than those of credit unions, a high proportion of which are paid off within a year of two. The rapid repayment of their loans provides credit unions with a steady inflow of cash which contributes to their aggregate liquidity, while the caisses with longer-term loans and a somewhat more conservative tradition lend less to members and carry much larger and more liquid security portfolios, either directly or through their centrals. They invest heavily in municipal issues, and in this market as well as in residential mortgage finance are the largest institutional participants in Quebec. Their wide network of locals enables them to meet the needs of small communities as well as the larger centres in both activities. The caisses have not attempted to offer the strong competition to other institutions in the personal loan market which has been typical of the growth of credit unions, although attitudes towards personal borrowing are changing. Interest rates are low, varying from 6% to 8% on the limited amount of such personal lending they have undertaken and being somewhat lower for mortgage loans. Quebec law does not prescribe a maximum value of unsecured personal loans although the by-laws of locals usually do.

Neither the credit unions nor the caisses populaires attempt to adjust the allocation of their resources in the short run primarily in response to the rates of return available on different assets, although their lending and investment policies do alter to keep attuned to the wishes of their members. Thus, the credit unions are beginning to shift into mortgage lending, either at the local level or through their central societies, and the caisses are becoming more interested in consumer loans. These trends are not rapid because of the commitment of both sides of the movement to the traditions of their origins. We do not, however, accept the view sometimes expressed to us that because they are not as concerned with yield as other lenders these societies have seriously misallocated their resources and those of the community as a whole. Their knowledge of their members has enabled them to make sound loans at favourable rates in areas of the market where demand has been strong, particularly the consumer credit and mortgage markets. Their continued growth will depend on their ability to meet the needs of their members on terms not out of line with those available elsewhere. These members are always free to turn to other lenders and no doubt are increasingly aware of these alternatives. We believe that changes in credit demand, the trend toward professional management and larger societies, and the rising dollar investment of the average member will combine with competitive forces to bring about a more conscious response of the movement to price considerations. This is in fact already happening in the centrals and in the more highly developed parts of the movement.

Credit unions and caisses populaires issue shares and accept funds in deposit accounts. All members must own at least one share, entitling them to a voice in the affairs of the local and to dividends from its earnings. Shares, normally valued at $5.00, may be purchased and redeemed on demand, although usually being nominally subject to notice of 60 to 90 days. However, among the caisses populaires large shareholdings are deliberately discouraged by charging a fee which is normally set at 2% but in some instances runs as high as 10%. As a result of this policy, the amount of outstanding shares is small compared

to the volume of deposits.[1] Caisses deposits are very much the same as bank savings deposits in that they are chequable and widely used as a means of payment, turning over around 2½ times a year compared to once every 15 years for shares. As with their shares, caisses populaires may require notice of withdrawal of deposits but do not in practice do so.

In contrast to the caisses populaires, credit unions draw most of their funds from the sale of their shares, which at the end of 1961 accounted for over three-quarters of their liabilities compared to only 12% in the form of deposits. However, a few societies limit each member to a single share and in these cases most of their liabilities are non-chequable deposits. The low annual rate of turnover of credit union shares, about once every two years, is evidence that they are not generally used by the members as a close substitute for chequing accounts. Indeed, accumulation of these shares often appears to be part of the members' longer-term savings programs rather than short-term savings. Credit union deposits, on the other hand, are for the most part chequable accounts in very active use, similar in this respect to the personal chequing accounts of the chartered banks and to bank current accounts of small family businesses and co-operatives. They turn over from 15 to 40 times a year and members of credit unions which offer chequing services are urged to use them rather than drawing on their share balances. We were told that it was usually not feasible for credit unions to offer such services unless their assets exceeded $200,000 and they employed skilled full-time help. Moreover, some provinces prohibit or limit chequing facilities and societies of the American tradition tend to oppose them on principle. The result is that only 10% of the locals offer such services, with the proportion being significantly above average in Saskatchewan and British Columbia.

Although the caisses populaires and credit unions have the power to enforce the notice requirements on withdrawal of shares and deposits and could do so to protect themselves against drains on their liquidity in unusual circumstances, this step is rarely taken. They prefer to borrow from their centrals when temporarily short of cash rather than run the risk of damaging their reputation with members by requiring notice. In the rare instances—involving perhaps a dozen or so local societies each year—when the notice provisions are formally invoked the society doing so is usually in more serious difficulty and this measure may well be part of a more far-reaching plan to set its affairs in order or, at the extreme, to liquidate it.

We do not have complete information on the size distribution of caisse populaire and credit union accounts. Sample information prepared for us suggests that the distribution is much the same as chartered bank personal savings accounts, with the important exception that the co-operative societies do not attract the very large balances held in a limited number of bank accounts. About 86% of accounts hold amounts of less than $1,000 compared to 84% in personal savings accounts. The caisses populaires have fewer small accounts and more large accounts than credit unions, although there is much variation between credit unions in different provinces.

While the amounts of credit union deposits and caisses shares have grown steadily, the success of these institutions in attracting funds has resulted principally from the rapid growth of the other two much larger classes of liability—caisses deposits and credit union shares. In Quebec, one-quarter of the population now appears to hold a quarter of all savings deposits in the form of caisses populaires deposits, while in the rest of Canada about 10% of the population are members of credit unions which hold less than 10% of savings, mainly in share form. The share of savings held in credit unions is lower in Ontario than in the Western Provinces, where there are fewer industrial societies and the community-based locals have been more effective in inducing savers to invest in their shares.

Although caisses deposits provide the same service as chartered and savings bank accounts,

[1] The policy was originally intended to prevent a few members from dominating a local by threatening to withdraw their large shareholdings. It also serves to sustain the dividend rate by keeping the amount of shares low in relation to income.

the interest paid on them is frequently higher; about one-third of the locals usually pay the same rate, but one-third pay ¼% more and the remainder ½% more. However, growth rates of different caisses do not seem to be closely related to these yield spreads. Dividends paid on credit union shares, which are subject to maximum levels in most provinces, are set by each society at the end of its fiscal year so that members do not know the exact return on their funds in advance. The rates vary considerably within a range from 0% to 6%, with a large number of locals paying about ½% over the banks' savings deposit rate. The effective return in some provinces is raised a further ½% or so by the inclusion of insurance coverage without an explicit charge. As with the caisses populaires, there does not seem to be a close association between dividend rates and the growth of individual societies, although a number of credit union officials referred to adjusting rates to keep them in line with rates available elsewhere.

In spite of this increasing concern with the competitive importance of the rates paid on funds, it seems clear that other factors have contributed more to the movement's success. Some of these, such as the location of offices, hours of business and the lending and other services provided for members, are forms of competition found throughout the financial system. For instance, caisses populaires are to be found in most Quebec parishes, no less than 500 of the 1,261 being located where there is no bank branch; this extensive network has brought caisses populaires within easy reach of the population. Similarly, the credit unions are conveniently located, many of them actually in the plant or office building where members work and —like caisses populaires—doing business at hours which suit the membership. Some of these credit unions have been further assisted by payroll deduction schemes and by employer donations of office space and, occasionally, office equipment. Moreover, the ability of the credit unions and caisses to offer mortgage and other personal credit at attractive rates to people who might well be considered less credit-worthy by institutions lacking such close personal knowledge of their character and financial position has undoubtedly put them in a particularly favourable position to profit from the strong post-war demands for funds in these markets. Finally, credit unions have for many years offered their members life insurance coverage on their share holdings and on loans: caisses populaires have begun doing so in the last decade, although they usually levy a specific charge for this service. The evidence is not clear, but many credit union witnesses stressed the importance of the insurance feature in attracting funds, and the fact that competing institutions are now using this feature more widely supports their contention.

All these factors serve to attract members and their savings, but the rapid growth of the movement has been based also on the special appeal of small co-operatives which offer their members a share in the management of a common venture. One should not exaggerate the strength of this sense of involvement because a high proportion of members do not in fact participate actively in the management of locals or even attend general meetings. Nevertheless, it is characteristic that the members feel more closely associated with their caisse or credit union than they do with a bank branch, believe themselves freer to discuss their finances with an officer of a local society, and have more confidence that they will get sympathetic treatment from them than from officials of larger and more remote institutions. In Quebec, nationalistic and other social forces may be a factor in the growth of the movement, but in all provinces it has been helped by the missionary zeal and education efforts of its organizers. The fact that some 50,000 people give their time without pay to their caisses populaires and credit unions is impressive evidence of the dedication and strong appeal which the movement engenders in its members.

The incomplete data which we have on credit union revenues and expenses must be used cautiously because of wide variations in the positions of individual societies. Gross income seems to be a little over 8% of average assets in most provinces, running up to close to 11% for smaller consumer-loan oriented locals, compared to average levels around 7% ten years ago. With

the exception of Saskatchewan, where the investment portfolio and deposit account charges provide about 30% of income, all but 5% or 10% comes from interest on loans. Administrative expenses now average about 2¼% of assets, which is about the same ratio as for the chartered banks, although the expenses of bank personal lending are no doubt considerably higher. The heavy reliance of small credit unions on unpaid help is an important explanation of their relatively low administrative costs in the personal lending business. Their costs are well below those of consumer loan companies which incur much heavier credit evaluation, processing and collection costs. The cost of insurance amounts to a further 1% of assets, leaving most societies with 4% to 5% for retained earnings and payments to members on their shares and deposits. For the few large societies charging the full 12% on loans, this return may run as high as 7% and in some locals where volume is small and unit costs high it may be as low as 2%.

Heavy investment in securities and mortgages rather than personal loans yields the caisses populaires a much lower gross income: in 1961 it amounted to 5% of average assets. Administrative expenses at 2.2% are about the same as for credit unions: the expense of administering assets is lower because they do less personal lending but this is offset by the cost of offering deposit service to virtually all members. Their expenses, like those of the credit unions which have broadened their services, have risen steadily in recent years. The return to caisse populaire members, including allocations to retained earnings, has risen relatively slowly from about 2¼% ten years ago to 2.9% in 1961.

We received many submissions that the caisses populaires and credit unions owe no small part of their success to the fact that as co-operatives they are virtually exempt from corporate income tax and therefore have an advantage over competing institutions which must pay taxes on their profits. While it has not been our job to examine the merits of this feature of the tax law as applying to all types of co-operative, we have considered its effect on the competitive position of the caisses populaires and credit unions. Dividends paid on their shares are in all essentials similar to the interest paid on deposits. Indeed the similarity is so close that if taxes were to be applied to this part of income the credit unions could comparatively easily alter the form of payment to their members so that it became in all respects a fixed interest cost deductible for tax purposes. Nor would this change the position of their members since earnings on credit unions shares are now taxable in their hands as interest. It would, however, pose some problems for the locals in forecasting their financial position to ensure that they did not pay out too much or too little of their earnings, a consideration that does not now arise since most returns are only determined after the results of the financial year are in. Thus, from the point of view which particularly concerns us—that of the competitive positions of different financial institutions—the practical effect of taxing dividends would not be significant. We are not therefore prepared to recommend such a change, especially in view of the fact that another Commission has under study the question of the taxation of co-operatives generally.

Thus the question of equity or competitive advantage relates only to the fact that retained earnings are not taxed. While this does give the co-operative institutions an advantage, much of the discussion suggests a greater competitive edge than in fact exists. The allocations to retained earnings have averaged about .7% of credit union assets and .5% for the caisses populaires. Since most of the earnings of locals are less than $35,000, the 21% tax rate would apply so that tax payments would average something between .1% and at most .25% of assets. They would therefore be able to meet the tax liability on all retained earnings and maintain the rates paid on deposits and shares unchanged by raising their lending rates relatively little. Since these rates are usually below, and often well below, those of competing institutions, the caisses and credit unions could presumably make this adjustment without undue difficulty.

However, even co-operative doctrine itself supports the view that retained earnings in excess of

allocations to specific reserves and current write-offs are in the nature of a profit. Such earnings are accumulated against unknown risks which may materialize in the future and benefit the members at that time at the expense of current users of the co-operative's services. We therefore recommend that the taxation rules regarding permitted reserves and retained earnings applying to caisses populaires and credit unions should be the same as those applicable to other banking institutions.

The present provincial legislation usually requires credit unions to allocate 20% of net earnings before dividends to reserves: most credit union locals meet but do not exceed this requirement. Caisses populaires reserves, governed by somewhat different rules, have averaged about 4.5% of total liabilities for some years; those of credit unions have been rising and are now close to 4%. These figures tend to overstate the true reserve position because the societies are frequently slow to write off loans and do not generally write securities down to market values. As small, local institutions they are not able to diversify their risks as well as larger intermediaries, but in most provinces they have set about meeting this problem by establishing "mutual aid" funds to meet difficulties wherever they may arise. This pooling of a part of contingency reserves in a common fund is a very valuable form of self-insurance but unfortunately does not yet cover all locals and is perhaps not being pursued aggressively enough in some areas. If the credit unions and caisses populaires have no alternative forms of insurance, it should be compulsory for all societies to join mutual aid funds, as it now is in British Columbia and Saskatchewan. Larger initial assessments should be drawn from existing reserves as well as current income. Reserves held in this form should be considered part of the reserves of local societies and the administration of the funds should be linked to an effective supervisory system.

RESPONSE TO MONETARY POLICY

Caisses populaires deposits are a close substitute for chartered bank savings deposits and are similarly affected by changes in interest rates and the availability of funds in the economy.[2] They have been growing a good deal more rapidly than bank deposits, but in periods such as 1956-57 and 1959, when the Bank of Canada was bringing pressure to bear on the financial system, the growth rate fell noticeably. Credit union shares, the main form of their liabilities, are more akin to longer-term savings and somewhat further removed from the area of price competition. Their very rapid growth rate varies from year to year and from one province to another for many reasons including surges of organizing activity, but also appears to have been reduced a little in periods of restrictive monetary policy. Because of the importance of special factors in the performance of different parts of the movement it is difficult to judge the influence of general monetary policy, but it is in any case much less pronounced than for caisses populaires. Credit union deposit business, while small, appears to be more sensitive to market developments than share business in provinces where it is most developed. For instance, in Saskatchewan deposits rose 9% in 1959 compared to 26% in 1958 and 23% in 1960.

It is worth emphasizing that the limited sensitivity to monetary policy shown by the credit unions does not stem from the fact that they do not carry cash reserves at the Bank of Canada but from the fact that funds flow to them in response to factors other than just prices and yields. Even if they were required to hold reserves at the central bank, their position would not alter since the initial effects of central bank action on cash reserves spread through the financial system in response to price and yield changes. The less important are price factors alone in the competition for funds, the weaker will be the initial impact of that action on any institution.

To the extent that these institutions, particularly the caisses populaires, do feel the impact of a restrictive policy on the growth of funds

[2] See Charts 2 and 3 in Chapter 11.

TABLE 9–5

ANNUAL PERCENTAGE CHANGES IN LIABILITIES

Year ending Dec. 31	All chartered bank deposits	Chartered banks' personal savings deposits	Caisses populaires[a]	Credit unions[a]
1951	− 0.9	2.9	13.1	23.4
1952	6.0	7.1	14.5	29.7
1953	5.4	3.4	9.1	30.0
1954	5.9	9.7	10.1	17.7
1955	11.2	8.0	16.8	19.6
1956	− 0.1	6.6	14.5	16.7
1957	4.3	4.0[b]	10.0	18.7
1958	11.8	12.0	15.4	23.3
1959	− 0.1	0.8	8.4	20.2
1960	6.0	4.6	9.9	19.3
1961	9.7	5.6	13.6	21.2

[a]Shares and deposits.
[b]Adjusted for a change in the definition of personal savings deposits.

available to them, they normally respond by cutting back on all types of lending and investment rather than by limiting their investment in liquid assets or selling securities. (There have been exceptions, particularly among the central societies, to this as to most generalizations about the caisses and credit unions.) Like most other institutions, the caisses and credit unions experience strong loan demand from members in a boom period and find that their supply of available funds is limited in relation to this demand. (In contrast, the sales finance and consumer loan companies are able to obtain the funds necessary to finance rapid asset expansion in such periods.) The movement tries to adjust to this pressure on its resources through the rationing of funds—by holding up lending approvals for a number of weeks,[3] by pruning down loan applications, and by discriminating against the larger borrowers. Attempts are also made to obtain speedier repayment of outstanding loans and, sometimes, to curtail lending to recent members who may have joined primarily to obtain credit they have been unable to get elsewhere. In periods such as 1956-57 and 1959, some centrals cushioned the strain on their locals by increasing their borrowing from chartered banks and, when their lines of credit were frozen, by selling securities to make funds available for locals to re-lend to their members. Some centrals also sent letters to their locals warning that funds were in short supply and advising them to be careful in their lending policy,[4] while some raised their own rates and in rare instances advised their locals to do so.

The centrals, which are the main link between locals and the rest of the financial system, play a leading role in guiding the response of the movement to changing credit conditions. This response is by no means as dramatic as that of many other institutions and has, particularly among the credit unions, been necessitated more by strong loan demand than by pronounced reductions in the growth of funds. Caisses populaires have, as we noted above, felt a more distinct decline in the growth of funds available to them and have normally adopted the policy of rationing the extra loan demand, their centrals restricting loans to locals at all times as a matter of policy and being if anything rather less willing to sell securities for lending purposes than are those of the credit union movement.

THE LINKS AMONG LOCAL SOCIETIES

Most of the preceding discussion has been about the business of local credit unions and caisses populaires. We come now to the interconnections among them which serve to integrate the independent societies into a system, or rather a number of regional systems. The majority of credit unions and all caisses populaires belong to provincial leagues. These associations have been established to carry on educational work, to promote the spread of credit unionism and to encourage the adoption of uniform standards of service. In the latter context, some of the leagues carry out inspections of the locals and have responsibilities for their supervision under various

[3] See for instance Transcript page 1019 (Manitoba), page 3229 (Ontario).

[4] See for instance Transcript page 224 (British Columbia), page 524 (Saskatchewan), page 1136 (Ontario), page 2260 (Nova Scotia).

working arrangements with the provincial authorities. There are at present 18 of these voluntary leagues, one in each of the provinces except Newfoundland and more than one in provinces where separate leagues of English and French speaking credit unions and caisses have been formed or where different groups have wished to emphasize particular features of the movement's tradition. Some of them, notably the Fédération de Québec des Unions Régionales des Caisses Populaires Desjardins which embraces most of the caisses populaires, are strong organizations providing many services to their member societies and serving to integrate their locals quite closely into a system with considerable uniformity of standards and procedures. In other cases, the leagues are much looser organizations. The individual societies are voluntary members which retain their independence and may at times be resentful of suggestions and directions from league officials. In a few provinces, moreover, significant numbers of local societies are not affiliated to any league.

There has been a tendency in some parts of the country for the societies to move into associated types of financial business. In Quebec, the caisses populaires control life and general insurance companies and have recently taken steps to enter the trust business. Except for the Saskatchewan group which has established its own trust company, the credit unions have not moved far in the direction of this sort of common action but it is probable that they will do so at some stage. The caisses populaires, which are a substantial part of the financial system in Quebec, have also entered into joint ventures with other institutions, notably by investing in the provincially-sponsored General Investment Corporation formed to finance Quebec enterprises.

The credit unions and caisses populaires have also established the central credit societies or central departments of their leagues referred to earlier. These provide a variety of banking services for the local societies. Although most centrals are not yet very large, some—particularly those established by the caisses populaires and three or four in provinces where the movement is most mature—are well established and are an important unifying force. The locals carry excess funds in deposit and share accounts at the centrals which in turn carry cash accounts with the chartered banks, re-lend to locals in temporary need of funds and invest the remaining pooled reserves of their locals in securities. Thus, as bankers for the locals, the centrals consolidate their liquid assets and provide the main pool of reserves for the system. They may also handle clearings for societies with transferable deposit accounts, although some locals run their clearings through their own chartered bank accounts. Moreover, they buy and sell securities for locals and in general act for them in their relationships with other parts of the financial system in the ways indicated in the preceding discussion of monetary policy. Three or four of them also offer a fairly complete banking service to other co-operatives and some lend to members when the type or size of accommodation needed out-runs the resources or capabilities of their local societies.

There is a striking difference in the policies of caisses populaires and credit union centrals. The

TABLE 9–6

COMBINED BALANCE SHEETS OF CENTRALS
(December 31, 1961)

—	Caisses Populaires Centrals		Nine Credit Union Centrals[a]	
	$ mn	%	$ mn	%
Assets				
Cash	41.8	34.3	5.7	8.0
Loans—to local societies	1.9	1.6	20.6	29.0
—to others	3.2	2.6	15.8	22.3
Investments	72.9	59.8	27.7	39.0
Other Assets	2.0	1.6	1.1	1.6
TOTAL	121.9	100.0	71.0	100.0
Liabilities				
Bank Loans, etc.	—	—	4.2	5.9
Deposits of locals	111.0	91.1	34.3	48.3
Shares of locals	6.5	5.3	23.7	33.4
Other shares and deposits	0.1	0.1	6.0	8.5
Reserves	3.6	3.0	2.1	3.0
Undivided earnings	0.6	0.5	0.5	0.7

[a] These nine centrals on which full information is available have more than 90% of the assets of all centrals. See the appendix volume for details.

former accept funds only from the local caisses and as a matter of policy invest nearly all of their resources in cash and securities, lending very little to the locals which, as noted above, maintain cash and investments equal to about one-half of their resources. Although the centrals' investments include substantial amounts of municipal issues which are not readily marketable, the caisses are highly skilled appraisers of such securities, their average term is short and the centrals are in a highly liquid position. Securities are not normally traded extensively although the centrals usually act as agents for their locals in their purchases and sales. Credit union centrals, on the other hand, accept funds from and lend to other co-operatives as well as their locals and invest a much lower share of their resources in cash and securities and a higher share in loans to the local societies. Security dealings of the locals are not nearly as centralized as those of the caisses and holdings of both centrals and their members are generally longer in term and less marketable, although some centrals are making a conscious effort to shorten portfolios and increase their marketable investments. Thus, while credit union locals rely on their centrals as a temporary source of funds to a much greater extent than do the caisses, the centrals themselves are in a less liquid position.

We have shown the combined balance sheets of the locals and of the centrals separately in order to comment on their different functions. A consolidated statement, in which the claims of locals and centrals on each other have been netted out and which differs in this respect from hitherto published data, brings out quite clearly the difference in the asset structures of the caisses populaires and the credit unions.

The consolidated position of the caisses populaires at the end of 1961 shows cash reserves of just over 8% in the form of Bank of Canada notes and chartered bank deposits as well as 38% of assets invested in securities, while about one-half of the assets were mortgages and other loans to members. On the other hand, the consolidated credit union balance sheet reveals that they had lent 81% of their funds to members,

TABLE 9–7

CONSOLIDATED BALANCE SHEETS OF LOCAL SOCIETIES AND CENTRALS[a]
(December 31, 1961)

—	Caisses Populaires		Credit Unions	
	$ mn	%	$ mn	%
Assets				
Cash	70.9	8.4	25.2	3.9
Investments	319.4	37.9	76.8	11.8
Loans to members	421.8	50.1	529.0	81.5
Fixed and other assets	30.1	3.6	18.0	2.8
TOTAL	842.2	100.0	649.0	100.0
Liabilities				
Bank loans and other liabilities	0.7	0.1	13.3	2.0
Shares and deposits	791.6	94.0	584.6	90.1
Reserves	41.7	5.0	27.5	4.2
Undivided earnings	8.2	1.0	23.5	3.6

[a]Only the nine centrals shown in the previous table are included.

held investments of 12%, and cash of 4%. These statements appear to be representative of the normal situation of the caisses populaires and the credit unions since the structure of their assets does not vary much. These figures bring out sharply the tendency of the credit union movement to operate with relatively low cash reserves and security holdings compared to the much more conservative policy of the caisses populaires. An earlier table showed that credit union locals themselves had cash reserves in excess of 8% and investments of about 11% but that more than one-half of the cash was in deposits at centrals and about a third of investments was in central shares. Thus, the locals rely heavily on the centrals for their liquidity, while they in turn, as we have seen, tend to maintain a relatively low cash and liquid asset position.

There is, of course, nothing unsound in the establishment of central societies to pool the liquid resources of locals and provide other services for them: indeed this development contributes much to the strength, cohesion and flexibility of the credit union system. However, in view of their position as specialized bankers to local societies, which because of their similarity

may well be subject to pressure on their resources at the same time, the centrals must pay close attention to their ability to meet whatever demands the locals may make on them. In spite of their excellent record and the fact that both locals and centrals can and do borrow from chartered banks when need arises, the low level of liquidity maintained by credit union systems in some parts of the country raises questions about future developments. As long as the movement grows rapidly, liquidity needs are in effect met by the inflow of new funds. However, if the growth rate were to drop at all suddenly because of a change in the competitive situation, because the fringe of potential new members shrank or disappeared, or because of increased sensitivity to general monetary policy, serious liquidity problems might develop. We do not see this as a present danger and wish to emphasize that credit union policies have not proved unsound in the circumstances prevailing to date. Nevertheless, we believe steps should be taken to ensure that these institutions are prepared for a change in the weather. We do not think a reasonable concern for overall liquidity need lead to any serious impairment of future growth.

The process of consolidation of the credit unions and their liquid resources is carried a stage further under the Co-operative Credit Associations Act, the only federal law respecting credit unions. This was passed in 1953 in order to remove any doubts about the constitutional position of the provincial centrals[5] by permitting them to register under a federal act, and to establish a national central, The Canadian Co-operative Credit Society Limited. Membership in this society, which is supervised by the Superintendent of Insurance, is limited to central co-operative associations declared eligible by Parliament and approved by Treasury Board, a maximum of 10 co-operatives other than credit unions and 15 individuals.[6] The society has not been very active: only four provincial centrals have taken out membership and their investment in its shares and deposits has not been large. Societies belonging to this national central are required to maintain cash reserves equal to at least 5% of their deposits and to hold a further 20% in cash and federal, provincial, municipal or school securities. They are also limited to issuing liabilities up to 10 times their capital and surplus and may not lend more than 10% of their funds to one member except for short periods, with "adequate" security and on the approval of two-thirds of the directors.

The fact that some of these restrictions are more severe than those in the provincial legislation and that many of the Act's provisions are inappropriate to the needs of the credit union movement accounts for the general lack of support of the C.C.C.S. In our view it is unnecessary to create a third tier in the pyramid of locals and centrals and undesirable to do so without adequately assuring the liquidity of the entire system. The present Act sets minimum liquidity standards for the members of the national society—which are the provincial centrals—without regard to the cash and liquidity needs of all the locals which belong to them. It is somewhat as if one tried to base a judgment of a bank's liquidity needs on the position of its head office without regard to its branches, although the parallel is of course not precise because credit union locals are independent entities, not branches of a single organization. Moreover, the investment and membership restrictions and limitations on capital ratios and loan size do not seem entirely relevant to credit union operations. We will put forward proposals later in this chapter to replace this Act with legislation more attuned to the character and needs of the credit union movement and the public it serves.

The basic job of protecting the public in its dealings with credit unions and caisses populaires is done not at the federal level but by the provinces. Each of the provincial credit union acts provides for a system of inspection and supervision. In all provinces except Prince Edward Island, where the league is formally responsible, and Quebec, where the law is unclear, a govern-

[5] Evidence of the Superintendent of Insurance: Transcript, page 6882.

[6] Provision was made for members other than centrals to join in order to enlarge the capital base of the new organization and enlist the support of a broader group in the co-operative movement.

ment agency is responsible for the supervision of credit unions. Paradoxically the caisses populaires have adopted the most thorough inspection procedures in spite of the fact that the Quebec legislation does not provide for any clear government responsibility in this area. One of the main purposes in establishing the Federation of Caisses Populaires in 1933 was to improve the supervision of locals, and the Federation now has a highly qualified inspection department with over 100 full-time professional employees, with each inspector carrying out an average 20 inspections a year. Methods are modern and efficient, surprise audits are used, and all findings are discussed with local management and committees. The calibre of the personnel has ensured a high standard of supervision by people thoroughly familiar with the business but in the absence of a clear delegation of authority by the government the continued adequacy of supervision depends on the willingness of the independent local societies to submit to inspection and to accept the advice and, when warranted, the reprimands of the Federation. The final responsibility of government might be further clarified in view of the difficulties that could develop if local officials became stubborn or if the inspectors were to abuse their ill-defined authority.

In other provinces where the governments are responsible for supervision, the supervisory staff is not always equal to the task expected of it. In some provinces the staff has expanded with the growth of credit unions but in all cases it is much more heavily burdened than the caisses populaires inspection department. In British Columbia, for example, we were told that one inspector and two assistants were responsible for no less than 326 local societies. Moreover, members of some provincial staffs do not devote all their time to inspections for they are frequently expected to do other work in connection with credit unions. In some provinces, inspections are regular and reasonably thorough but in others the staff is so small relative to the number of credit unions that it is not possible to carry out frequent or adequate inspections; in at least one province inspections are carried out only once in over two years. The problem is most severe in the case of smaller locals since a number of provinces require that societies over a certain size employ outside auditors to review their financial position each year. Understandably perhaps, provinces have been slow to incur the costs of expanding their credit union departments for, unlike the situation in the United States, it is they and not the credit unions which pay the bill. The caisses populaires receive a government subsidy for their inspection services but the Federation itself bears about 85% of the cost.

The leaders of the credit union movement are conscious of the dangers inherent in the present situation and some of them have indicated their willingness to contribute to the expenses of more adequate supervision. Some supervision is undertaken at the local level by supervisory committees elected by the annual meetings for this purpose but we were told they do not work effectively in a great many cases, largely because members of the committees have neither the training nor the time to do a thorough job of supervision.[7] In recognition of these facts, some leagues have taken the lead in supplementing the work of government and local officials by carrying out their own inspections and by encouraging or requiring larger societies to employ outside auditors. In addition, some centrals require full reports from member societies before they will lend to them. These are commendable steps indicative of the growing responsibility and maturity of senior credit union officials but they need to be integrated with a more complete system of inspection.

SUMMARY AND RECOMMENDATIONS

The caisses populaires and credit unions are now well past the initial stages in their development and are substantial and valuable members of the Canadian financial system. Their rapid growth is striking evidence that a great many people have found local co-operative societies able to meet some of their financial needs better

[7] Transcript pages 2233 ff and para. 101 of submission of the Nova Scotia Credit Union League. Transcript page 3634.

than other financial institutions and that the caisses and credit unions have served them well.

We believe, however, that a number of steps must be taken to ensure the continued sound development of the movement. Our recommendations do not involve new departures so much as the adoption throughout the credit union and caisse populaire systems of measures already introduced in many provinces by the authorities or by the movement itself. In framing our recommendations we have been careful to recognize that these institutions make a particular contribution to the financial system in large part because of their local character and adaptability to differing circumstances across the country and that it is therefore desirable to preserve as much local initiative and independence as possible.

Earlier discussion in this chapter has brought out the areas where latent weaknesses exist—the inadequacy of supervisory and inspection arrangements in some parts of the country, the need to strengthen the protection provided to shareholders and depositors by mutual aid funds, and the problems posed by the low liquidity of some credit union locals and their centrals. In each case our aim is to strengthen credit unions and caisses populaires so that their financial condition may fully justify the confidence which members place in them.

Before summarizing these main proposals, we wish to recommend that steps be taken to improve the published statistical information covering this part of the financial system. There is no reason why considerably more than the annual data prepared by the Department of Agriculture—which should be relieved of responsibility in this area—cannot be published. Monthly statistics are prepared by caisses populaires leagues for internal use and the same could be done by the credit unions for a large part of the movement.

Although the local credit unions and caisses populaires are, as we shall argue later in the report, banking institutions and as such might be brought under federal regulation, and although they asked for such regulation in the early part of this century, we agree with spokesmen for the movement that it is not now necessary or desirable to do so.[8] As relatively small, local and independent societies they can be regulated more efficiently by the joint efforts of provincial governments and officials of their own leagues who are thoroughly familiar with their methods and with the special problems they may encounter. However, the scope of this specific exemption from direct federal regulation should be restricted to local societies and should be conditional on the provincial authorities accepting full responsibility for supervision. In our view, it is essential that provincial staffs be adequate for the job and that when a province chooses to delegate part of the work to leagues or centrals its ultimate responsibility for inspection of local societies remain clear. All locals should be examined at least once a year, and more often if necessary, and the examining body should have the power to correct unsound lending practices. The authorities should also discourage the establishment of locals unless there is reasonable assurance that the founding group will be able to attract a sufficient pool of funds to constitute a viable society.

Leagues or centrals should be encouraged to continue to share in the work of inspection in order to take advantage of their expert knowledge and heighten their concern for the healthy growth of the movement. Indeed, we believe that expert and intelligent self-regulation under the final authority of government will best serve the needs of these societies, assuring that the interests of their members will be protected while avoiding the rigidities inherent in detailed and inflexible government regulations about investment and other powers. We believe also that the movement itself ought to pay more of the costs of inspection, as is now the practice with the caisses populaires and other institutions. Whenever part of the job is delegated in this way, it must be made compulsory for all locals to belong to whatever organization carries out the supervision for government, be it a league or a central. We will recommend below that locals should in any case belong to a central, whether or not it has supervisory responsibilities.

[8] Transcript, page 3148.

We agree with the views of the national organizations that all locals should also be required to belong to a mutual aid fund in order to provide an additional safeguard for their members.[9] As we pointed out earlier, credit unions and caisses populaires differ from other banking institutions accepting funds from the public in that they are restricted to operating locally and cannot diversify their lending risks as easily as other organizations operating over a broader area. They are thus especially vulnerable to severe local difficulties, and the assurance of help from the movement's own mutual aid funds is vital to them and to their members. If a more general system of deposit insurance were to be adopted in Canada, the mutual aid funds should be free to join it if they wished, although we believe it desirable in the movement's own interest that the primary source of insurance come from within its own ranks.

We turn now to our recommendations on the liquidity of the credit union and caisse populaire systems, a matter which concerns the centrals as well as the local societies. Whereas we think it desirable to leave the responsibility for mutual aid funds and direct supervision of locals with the provinces, we believe that the centrals should be brought into a national system of regulation since they are the bankers to their member societies and the principal links between the locals and the financial system of the country as a whole. Each central should be required to maintain adequate cash reserves in relation to its own liabilities and the liabilities of its member societies. Moreover, in order to integrate them more fully into the financial system and give them access to central bank credit when need arises, they should hold these cash reserves at the Bank of Canada.[10] As part of this framework of regulation, all locals should be required to belong to a central, preferably by provincial law, in order to ensure their access to temporary funds outside their own resources if their liquidity position is threatened. At the same time, the federal government should meet its responsibility for a sound banking system by examining and supervising the centrals to see that they are in a position to meet their locals' needs.

Having subjected them to meaningful cash reserve requirements and to uniform inspection and supervision, the laws should not unduly restrict the activities of centrals. In view of their position as specialized banks to the co-operative movement, they should be limited to issuing liabilities to credit unions, other co-operatives and public bodies specified in the legislation. This will serve to keep them focussed on their main job of managing the credit union and caisse populaire liquid resources. However, on the other side of their balance sheet, there is no reason to restrict their investment powers unduly provided that the federal supervisiory authorities are satisfied that their liquidity is adequate for their responsibilities.

Under the approach which we envisage, the credit unions and caisses would be free to form whatever national associations they wish, but the Canadian Co-Operative Credit Society would not function as the pinnacle of a three-tiered system of locals and centrals. The provincial or other regional centrals are and would remain the logical point at which to regulate and supervise the movement's liquid resources if one wishes to reconcile the national interest with the maximum of local flexibility and freedom for individual societies. These centrals would thus be brought into direct contact with the central bank and the federal banking authority. The Superintendent of Insurance could be relieved of responsibility for their supervision, a task which is in any event not closely related to his main functions.

The credit unions and caisses will no doubt continue to evolve and change, to become larger in size and more professional in operation, and to be more and more subject to market forces as a result of growing competition and narrowing earnings spreads. Yet we feel their emphasis will always be coloured by their wider social objectives of encouraging thrift, rehabilitating the financially improvident through the sound use of credit,

[9] Transcript, page 3158.
[10] See also the discussion in Chapter 19.

and giving priority to the smaller borrower who cannot turn elsewhere at reasonable rates. While naturally anxious to see the interests of the whole community safe-guarded, we have been no less concerned to ensure that the caisses populaires and credit unions are as free as possible to continue serving the local and special needs of their members in the spirit of co-operation and self-help which has been so largely responsible for their development.

CHAPTER 10

TRUST AND MORTGAGE LOAN COMPANIES

The earliest ancestors of the mortgage loan companies bore a close resemblance to the caisses populaires and credit unions of today in that they were mutual associations pooling their members' funds for a common purpose. Established like the Quebec Savings Banks in the 1840's, their aim was to lend to those wishing to build homes rather than to make personal loans or invest in securities. These early building societies were "terminating", winding up when each member in turn had taken out and repaid his building loan. In 1855 the first "permanent" society was established, and subsequent legislation clarified the powers of such continuing companies to borrow generally from the public. The mortgage loan companies have since remained in the same specialized business of borrowing by way of debentures and deposits and placing most of their funds in residential mortgages. Trust companies developed more recently, the first one having been incorporated in Ontario in 1882. They carry on an intermediary business similar to that of the loan companies, although placing less emphasis on mortgage lending and more on security investment, but differ from them and other institutions in having the right to act as trustee for property interests and to conduct other fiduciary business. Thus the Canadian trust company is a hybrid, being part administrator managing a great many separate trust and agency accounts and part financial intermediary handling a single pool of funds.

The trust and loan companies have been substantial members of the financial community since their establishment, but rapid expansion and extensive diversification of their activities have brought them new prominence in recent years. Their intermediary business has always been sizable, and from their earliest days has been exceeded only by that of the banks and insurance companies. In the 1920's they carried about one-half of the mortgages held by private intermediaries, and in the areas of the country where they operated they competed very successfully with the banks for savings. However, during the 1930's and the war years they lost position relative to the banks and other savings institutions. This resulted from the weak demand for mortgages, from the fact that they were not then particularly suited to play a major role in war finance, and from their own conservative reactions to the events of the period following the stock market crash of 1929, during which both they and their trust clients suffered serious losses. Their change of attitude and the dramatic growth of their intermediary business since 1945 thus stands out particularly sharply, while the substantial post-war increase in their traditionally important estates, trust, and agency business has contributed further to the renewed attention which the trust companies have been attracting. The fact remains, however, that it was not until the early 1960's, when the trust companies grew particularly vigorously, that the ratio of their size to that of the banks surpassed 10%, the

TABLE 10–1

GROWTH OF TOTAL ASSETS

—	Trust Companies[a]			Mortgage Loan Cos.			Chartered Banks[b]	
	$ millions	average annual rate of growth	% of bank assets	$ millions	average annual rate of growth	% of bank assets	$ millions	average annual rate of growth
		%			%			%
1935	225	—	8.9	230	—	9.1	2,514	—
1945	266	1.7	4.4	235	0.2	3.9	5,997	9.1
1950	441	10.6	5.6	367	9.3	4.6	7,918	5.7
1955	714	10.1	6.8	570	9.2	5.5	10,440	5.7
1960	1,284	12.5	9.8	945	10.6	7.2	13,121	4.7
1962	1,877	20.9	12.6	1,286	16.7	8.7	14,848	6.4

[a]Intermediary business only: does not include estate, trust and agency funds—(E.T. & A. business).
[b]Canadian and net foreign assets, excluding items in transit.
SOURCES: Dominion Bureau of Statistics and Bank of Canada.

level at which it had stood at the beginning of the 1930's. The loan companies, which were as large as the trust companies three decades ago, have grown less over the period as a whole despite their rapid gains since the end of the war.

In the course of this recent expansion, the trust and loan companies have come into increasing competition with the banks. Indeed, the willingness of these companies to become more competitive has been one of the main factors in their growth. On the savings side, they have opened new branches, tailored their liabilities with considerable skill to the preferences of individuals and others, and used higher rates and improved services to attract both personal chequing accounts and time deposits, the latter from a wide range of businesses and other organizations as well as from individuals. This competition comes mainly from the trust companies which on the lending side, too, have impinged increasingly on the banks' business even though they are not allowed to make unsecured commercial and personal loans. Instead, they have taken advantage of lending opportunities in the expanding money market and have become increasingly active term lenders through the purchase of short, medium, and longer-term securities. The strong post-war demand for mortgage funds, particularly against conventional mortgages—a field from which the banks are precluded—has however been the main underlying factor contributing to the growth of both loan and trust companies. The latter's non-intermediary business has benefited from the increase in public wealth, the spread of pension plans, and the growing complexity of investment and property management. More and more of this business is being turned over to trust companies because of their special knowledge of legal, estate-tax, and investment matters, and because their standards of performance and efficiency have risen.

The favourable environment that the industry has recently experienced has reversed the earlier tendency for mergers and acquisitions to shrink the number of companies. While at the turn of the century there had been about 100 firms in the industry, over 80% of them loan companies, by the mid-1950's this number had fallen by almost two-thirds. Most of the firms were by then trust companies, as many institutions which had begun as loan companies found it advantageous to acquire trustee powers as well. Moreover, a number of the major loan companies are now closely affiliated with trust companies, effectively operating in some instances as a single

unit. Within the last decade, however, despite some further amalgamations, the expanding opportunities in both industries have led to an increase in the number of companies and there are now some 25 loan and 35 trust companies dealing with the general public. Most of them are local despite the tendency for larger units to emerge: all but 14 have offices in one or two provinces only. However these larger companies have some 170 of the 270 or so trust and loan company offices and do a high proportion of the business.[1]

The industry is quite highly concentrated, particularly in the E.T. & A. business where the 10 largest companies have over 90% of the funds under administration and two companies alone have more than 50%. In the intermediary business, a slightly different group of 10 trust companies has about 75% of company and guaranteed funds, with the largest company having 15% of the total. The loan companies' business is more highly concentrated, the largest five having the vast majority of assets. Taken together, the 10 largest loan and trust companies have 60% of the intermediary volume, the largest firm—a loan company—having just over 10% of the total.

Loan companies run to a pattern in that they all concentrate on mortgage investment, but there is considerable diversity among the trust companies. Some—particularly those which have evolved from loan companies or which have been set up primarily to undertake mortgage lending and manage real estate—are in effect mortgage companies with trustee powers. Other trust companies give more emphasis to bond investment while some stress activities in the short-term market. Some companies rely heavily for funds on various kinds of deposits while others do not accept deposits at all.[2] Finally, some trust companies do a substantial estate, trust and agency business while others prefer to stress their intermediary activities, including those which come closest to banking.

This diversity, which is considerably greater than that of the banks, has been achieved despite the existence of legislation which is quite restrictive in some respects. The companies have been willing to experiment as much as these limits will allow and have obviously not been greatly hampered by legal restrictions in the recent past. The early legislation was enacted by the provinces and, although the federal government also chartered a number of companies by special acts it never made any move to regulate the banking side of the industry's activities. In 1914, however, federal legislation dealing with trust and loan companies as such was passed, and since then the companies have been able to choose between federal or provincial incorporation and regulation. The majority of the companies are in fact under provincial jurisdiction and the five loan and ten trust companies which are federally incorporated must be licensed to operate in each province, just as companies from one province must be registered for business in the others.[3] Moreover the estate, trust and agency business of all trust companies, being a matter of property and civil rights, is entirely subject to provincial jurisdiction.

In spite of the many differences in detail, the character of the various provincial laws is essentially similar. Moreover, since most companies operating in more than one province do business in Ontario and must therefore register under the Ontario Act, or are incorporated under the Ontario Act itself or the quite similar federal legislation, there is more uniformity in practice than the number of different laws might suggest. However, as the industry told us, progress towards uniform legislative standards in different juris-

[1] In some provinces, offices may only be opened if the supervising authority deems it to be necessary in the public interest, and this power has on occasion been used to limit branch opening. We do not regard such checks on competition as desirable. See our views on bank branching in Chapter 7.

[2] One very large company, for example, entered the deposit business only in early 1964.

[3] At the present time all provinces but Newfoundland and Prince Edward Island have trust company legislation either in separate acts, as a section of the Companies Act (Manitoba) or in a combined Trust and Loan Corporations Act (Ontario). Provincial loan companies are incorporated in the same way as trust companies in Ontario and Manitoba, under separate loan companies acts in Nova Scotia and Saskatchewan, and under the general companies legislation or by special act in the other provinces.

dictions is slow. Under most legislation, loan companies may accept deposits from the public or borrow by issuing debentures, while trust companies—by extension of their fiduciary powers—may accept funds in trust deposit accounts and issue "guaranteed certificates" or "guaranteed receipts". The legal distinction is that the funds held by trust companies are backed not only by a general claim on their assets, as in the case of most other financial institutions, but by specifically segregated and ear-marked assets. For this reason, their accounts must distinguish between the assets held against "company funds"—that is capital and reserves—and the assets in which "guaranteed" funds are invested. However, the fact that the funds are legally held in trust rather than borrowed does not make any practical difference to the trust companies or the financial system: the economic effects of their intermediary operations are the same as those of loan companies, banks and other institutions and the business is carried on in a similar way.[4] We therefore feel justified in referring to trust companies "borrowing" funds in spite of the legal inaccuracy of this term when applied to the guaranteed accounts.

The laws governing the trust and loan companies are unique in that they impose a minimum ratio of capital to liabilities. Thus the federal acts limit the amount of a company's deposits and debentures or certificates to 12½ times its capital, reserves and surplus, while in Ontario only the loan companies are subject to the same legal limit although it is also applied in practice to trust companies. Trust and loan companies in Nova Scotia are subject to a ratio of 10:1 and in Saskatchewan to one of 5:1.[5] These capital requirements have been gradually liberalized over the years from an original ratio of 1:1 on deposits and 4:1 on other liabilities in the Ontario Act.

Some firms have found these ratios confining despite the fact that the actual ratio for the loan companies combined was only six times in 1962: for the trust companies it was just nine times. They have accordingly suggested adoption of a uniform ratio of liabilities to capital of 15 to 1, which would require them to maintain capital, reserves and surplus of at least 6.25% of total funds less cash holdings. While we will reserve a full discussion of the usefulness of minimum capital ratios for a later chapter, it is worth noting here that it is all but impossible to prescribe by law what ratio is adequate to protect the companies' creditors against the risk of loss, to ensure that the owners have a sufficient interest in the successful management of their business, and—in the case of trust companies—to protect their trustee clients. Capital needs vary widely from company to company and are related to their size and to the character and diversity of their assets. Equity sufficient to meet the needs of one company might be quite inadequate in another, while conversely a requirement high enough for one might impose unnecessary penalties on another.

Turning to the asset side of their business, the loan companies are not subject to a legal cash ratio as are the banks. However, they are required by the Ontario law to hold cash and "liquid" assets equal to at least 20% of deposits and—an unusual feature—may not borrow this liquidity from the banks; British Columbia sets a minimum of 25%. However, liquid assets are so broadly defined—they include all federal, provincial and municipal securities—that most of the companies run well in excess of this rather meaningless requirement[6]. The acts also allow trust and loan companies to invest in a specified list of assets, in the manner of the Quebec Savings Bank Act, rather than adopting the Bank Act approach of permitting all investments not

[4] Transcript pages 3291, 3393-4.

[5] The formulas are a little more complicated for they also take account of cash holdings in arriving at the maximum borrowing levels. In Ontario, loan company deposit and debenture borrowing may not exceed the sum of cash and four times unimpaired capital and reserves (including undisclosed contingency reserves), the Lieutenant Governor-in-Council having the power to raise the capital factor to twelve and one-half times. New companies are generally held to the four times ratio but it is raised gradually to the maximum level as they become established and grow.

[6] The Trust Companies' Association of Canada, to which the 28 leading companies belong, is studying this question in line with its principal aim of maintaining and fostering high standards of industry management.

specifically prohibited. The effect is to permit purchase of a broad range of assets, including the conventional mortgages which are prohibited to chartered banks, but to prohibit unsecured commercial and personal lending even to the limited extent allowed the savings banks by the recent amendments to their act.

The acts usually prohibit loans to directors and also cover such matters as initial capital requirements (in Ontario the legal minimum is $300,000 of which $100,000 must be paid-up, but in practice the requirements are usually $500,000 and $250,000 respectively). The legislation also deals with audit requirements and supervisory arrangements. Because the companies are incorporated under many different acts and must abide by the law of each province in which they work, the present supervisory arrangements are somewhat complicated. The federal Superintendent of Insurance inspects the federally incorporated companies and, by arrangement with the provinces concerned, those incorporated in Nova Scotia, New Brunswick and Manitoba. Ontario reserves the right to inspect all companies registered to do business in the province as well as its own incorporations, but in practice accepts the federal Superintendent's inspections and those carried out by Quebec for companies chartered by the Quebec legislature. Similarly, while Quebec inspects its own companies, it accepts the work of the Ontario and federal authorities for other companies operating in the province. There is necessarily a good deal of overlapping among these three supervisory authorities even though in practice they often arrange to split the work of examining one company.

Most of the companies come under one or other of these authorities and are examined at least once a year. In Ontario, which has the most thorough system of any province, they must file lengthy annual statements and the same is true of companies inspected by Quebec and Ottawa. Inspection of the intermediary business is centred on verifying that the companies' capital position and assets meet the requirements of the law. It is backed up by power to write down the value of assets which are held to be overvalued, to call for full information from the companies and their auditors, and if necessary—to suspend a company's license to do business. Supervisory authorities do not examine the E.T. & A. business at all closely, although Ontario does spot check a certain number of accounts each year. The main burden of supervising the trustees falls on the courts which review their accounts periodically in provinces other than Quebec: in these provinces a trustee cannot collect his fee for an account until it has been passed by the courts.

The activities of these three separate supervisory authorities and the requirements of the three different acts raise problems for the companies which must satisfy them all. While far from perfect, supervision is much more thorough than in those provinces outside Quebec and Ontario which are not inspected by the Superintendent of Insurance. For instance, in Saskatchewan and Alberta there is no inspection of local companies, and although there is provision for it in British Columbia, we were told that it is not consistently carried out. In their evidence before us, spokesmen for the industry referred to supervision as being "nominal" in some provinces, and said that they would "welcome in certain provinces a stronger regulatory body than exists".[7] They also strongly urged that the legislation and supervision under which they operate should be uniform in all provinces.[8] Some spokesmen for the industry expressed the view that federal jurisdiction over the intermediary side of the business would be desirable, but one witness argued the case for provincial jurisdiction on the grounds that trustee matters are clearly a matter of property and civil rights.[9] We return to this general topic in Chapters 18 and 19 when we discuss the banking institutions as a whole.

[7] Transcript, pages 3293 and 3282.

[8] Transcript, pages 3282, 3290.

[9] Transcript, pages 3278, 3281. See also the submission of General Trust of Canada which argues for exclusive provincial jurisdiction over trust companies.

THE INTERMEDIARY BUSINESS

1. *Loan Companies*

In spite of the similarity in the laws governing trust and loan companies, the latter have chosen to give their business a sufficiently different character and emphasis to warrant separate discussion.

The mortgage loan companies obtain most of their funds from the sale of debentures, which accounted for two-thirds of their liabilities at the end of 1962, and invest about three-quarters of their funds in mortgages and agreements of sale. The share of debentures in total liabilities has risen substantially in recent years, while a declining share of the companies' funds has come from both deposits and capital and reserve accounts. The bulk of their assets are of medium and long term, and the loan companies have preferred to borrow mainly at comparable maturity dates rather than by short-term deposits in spite of the higher interest cost of doing so; the rate disadvantage is, however, offset in part by the lower administrative expenses of debentures. The relative decline in capital accounts is associated with the easing of minimum capital requirements discussed earlier, and with the enhanced ability to operate on lower equity ratios as larger scale operations have increased the diversity of assets and reduced the risks of loss. Loan company deposits, which are not issued by all companies, are nearly all held by individuals.[10] Most of them are chequable, although some companies have begun to accept funds in non-chequing accounts at a slightly higher rate during the past few years. Clearing arrangements are made with the chartered banks.

Most debentures are issued with maturities of from one year, the minimum term allowed in Ontario, to ten years. Shorter-term debentures have been issued by one or two companies, and at the other extreme one important institution

[10] Submission of the Dominion Mortgage and Investments Association, paras. 37-39, 43.

TABLE 10–2

MORTGAGE LOAN COMPANIES
(December 31)

—	1945		1950		1955		1962[a]	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Assets								
Cash	9	3.8	16	4.4	18	3.2	24	1.9
Securities:								
Govt. of Canada	60	25.5	44	12.0	55	9.6	100	7.8
Provincial	7	3.0	7	1.9	12	2.1	31	2.4
Municipal	3	1.3	5	1.4	8	1.4	8	0.6
Corporate[b]	21	8.9	29	7.9	36	6.3	95	7.4
Mortgages	124	52.8	255	69.4	427	74.9	981	76.3
Other Assets	11	4.7	11	3.0	14	2.5	49	3.8
TOTAL	235	100.0	367	100.0	570	100.0	1,286	100.0
Liabilities								
Deposits and other demand liabilities	53	22.6	90	24.5	128	22.5	204	15.9
Debentures	103	43.8	188	51.1	341	59.8	851	66.2
Other Liabilities	10	4.3	9	2.4	11	1.9	56	4.4
Shareholders' Equity and reserves	69	29.4	81	22.0	90	15.8	175[c]	13.6

[a]Data for 1962 not entirely consistent with earlier years. A new D.B.S. survey raises the coverage. At the end of 1961, the new series gives total assets of $1,107 million compared to $1,022 million in the earlier series.

[b]Includes equities, investment in subsidiaries and foreign bonds as well as Canadian corporate bonds.

[c]This figure includes a small amount of net accruals and payables.

SOURCES: Dominion Bureau of Statistics and Bank of Canada.

obtains most of its funds from 15 and 20 year debentures. The companies usually have their debentures continually on sale "over the counter" but the one firm selling long-term issues does so by means of periodic underwritings. Although debentures are sold principally to individuals—some companies limit them to relatively small denominations—corporations and institutions take them as a convenient investment which is normally acceptable under trustee laws. Because they invest so heavily in mortgages and because the borrower has the right under the federal Interest Act to repay his loan at any time after five years, loan companies prefer to issue five-year debentures in order to avoid the possibility of paying high rates on longer-term debentures when mortgage rates have fallen. There is often a good deal of variety in the rates paid on debentures of different maturities, with the companies tending to make rates on maturities of five years and upwards attractive when they believe interest rates generally are at relatively low levels; conversely, some companies set such rates at relatively unattractive levels when they believe funds will shortly be available on better terms. However, not all firms believe in using their shorter-term liabilities as a balancing mechanism in this way, and some prefer to keep their emphasis on borrowing long (i.e. on five year terms or more) even at high rates if the demand for mortgages is strong.[11]

The important generalization which emerges from the evidence is that the crucial determinant of debenture rates is the yield available on conventional mortgages, the preferred investment of the companies. Representatives of the industry told us that it is common for management to have a view of the minimum acceptable spread between rates on mortgages and the price of new debenture money; in fact, this spread has narrowed only slightly in recent years and was almost 2½% in 1961. We were also told that each company is faced with a competitive mortgage rate, and cannot obtain business at a higher rate than other lenders are asking, while for the industry as a whole the demand for mortgage funds tends to dry up as rates rise above the levels to which borrowers are accustomed.[12] In these circumstances, the yield at which mortgages can be obtained and the desired yield spread set the effective limit on debenture rates, and the demand for mortgages is the principal influence on the growth of loan companies.

The bulk of loan company lending is on conventional residential mortgages, which under federal and Ontario legislation may not exceed two-thirds of the appraised value of the property. Most companies have not until recently invested much in N.H.A. mortgages because of their lower rate, their longer term, and what they consider to be their excessive administrative costs. There are exceptions, of which the most notable is a recently incorporated company dealing exclusively in N.H.A. mortgages and financing in a more flexible way than many of the other companies.[13] Moreover, when the yield differential between conventional and N.H.A. rates is low, as it was in 1961, the companies are prepared to invest more heavily in N.H.A.'s. The same is true when competition for conventional business becomes intense.

In addition to investing in mortgages, the loan and trust companies are permitted by Ontario to buy government securities of all kinds, mortgage securities, bonds, debentures, and preferred stocks of companies which have paid dividends for five years, and common stocks subject to a seven year dividend record equal to at least 4% of capital. They may not, however, hold more than 20% of the stock or other securities of a corporation and—except for federal, provincial and municipal obligations—may not have more than 15% of their capital and reserves invested in any one security or the securities of any one company. Certain individual investments in excess of these limits may be made if specifically authorized by the Ontario Government. Income-producing real estate is permitted up to 5% of total funds subject to a 1% limit on individual parcels. Loans, other than mortgage loans, may in general only be granted if the company takes as collateral

[11] Transcript, page 5878.

[12] Transcript pages 5859 and 5876-5886.

[13] See Submission of Canborough Corporation.

those securities in which it may invest and, in the case of corporate securities, if collateral exceeds the loan value by 20%. Finally, among these main investment provisions the Ontario Act now has a basket clause allowing the investment of 15% of capital and reserves in assets which are not otherwise eligible. Other acts are substantially the same, although the basket clause is peculiar to Ontario and in other ways the Ontario Act is generally the least restrictive.[14]

While detailed and restrictive in their intent, these provisions have not in fact put any meaningful restriction on the investment activities of the loan companies under post-war conditions.[15] In fact, their holdings of securities of all kinds—particularly federal obligations—while growing absolutely, have declined in relative importance as the strong post-war demand for mortgages has enabled the companies to invest a growing share of their funds in mortgage loans. Moreover, the powers of the Act have given the companies ample scope to experiment, as far as they have chosen to do so, with newer types of securities and investments. They do not trade their securities actively, although they are prepared to run down their holdings to obtain mortgages when credit restriction limits the availability of new funds.

The loan companies' cash ratios have also declined in the post-war period, partly as a result of more aggressive management and more plentiful investment opportunities, but partly also because the money market's development has enabled them to satisfy their relatively low liquidity requirements with short-term investments. Cash now runs at below 2% of total liabilities, compared to 4% or more earlier, while securities portfolios, which include securities which are not very liquid, now run below 20%. The companies can run with these low liquidity levels (backed up by bank lines of credit) because their main liabilities, debentures, are not redeemable before maturity, although on occasion the companies will pay them off on compassionate grounds. Some dealers also make a limited market in some debentures, but in general they are not regarded as liquid or marketable claims by either the companies or their holders. The companies' only short-term liabilities therefore, are their deposits, and their cash holdings are equivalent to about 8% of these liabilities.[16]

The business of mortgage loan companies has thus remained quite specialized and has not changed a great deal since the industry's early days with the exception that farm lending—which used to be a significant part of their activity—now accounts for under ½ of 1% of new mortgage loans. This is the result of unfavourable experience in the 1930's and, more importantly, of the fact that the companies can no longer compete with the low rates of government farm lending programs. While the loan companies have grown and prospered in the post-war period, they have not been as aggressive as some institutions in seeking funds to meet the strong demand for mortgage credit. Despite their rapid growth, therefore, they have not fully regained the place in the financial system which they held three decades ago.

2. *Trust Companies*

The trust companies, although similar in many ways to the loan companies, have in recent years been more willing to experiment and to develop important new types of business. They have thus enjoyed a more rapid growth than the loan companies in their intermediary business. They borrow somewhat more of their funds by way of deposits and correspondingly less by issuing guaranteed investment certificates, the practical equivalent of loan company debentures. On the other side of the balance sheet, mortgages are now the most important single type of investment, but their current level of 44% compares to over 76% of assets for the loan companies. Moreover, as we have already indicated, there is more diver-

[14] The foregoing is only a general summary of the legislation. Appendix 3 to the submission of the Dominion Mortgage and Investments Association gives a more detailed review of loan company legislation.

[15] Submission of the Dominion Mortgage and Investments Association, page 47.

[16] This calculation is based on the first three quarters of 1962: the December figure is omitted because of year-end window-dressing. See also Table 2 in Chapter 19.

TABLE 10-3

TRUST COMPANIES[a]
(December 31st)

—	1945		1950		1955		1962[b]	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Assets								
Cash	15	5.6	24	5.4	35	4.9	53	2.8
Securities:								
Govt. Canada	106	39.7	151	34.2	151	21.1	301	16.0
Provincial	14	5.2	41	9.3	90	12.6	136	7.2
Municipal	9	3.4	25	5.7	47	6.6	90	4.8
Corporate	28	10.5	51	11.6	103	14.4	337	18.0
Mortgages	61	22.9	114	25.9	228	31.9	831	44.3
Other Loans	18	6.7	18	4.1	36	5.0	82	4.4
Other Assets	16	6.0	17	3.9	25	3.5	46	2.5
TOTAL	266	100.0	441	100.0	714	100.0	1,877	100.0
Liabilities								
Deposits and other demand liabilities	83	31.2	166	37.6	275	38.5	656	34.9
Investment certificates	98	36.8	177	40.1	322	45.1	1,026	54.7
Other liabilities	17	6.4	13	2.9	15	2.1	10	0.5
Shareholders' equity and reserves	68	25.6	85	19.3	102	14.3	185[c]	9.9

[a]In this table and in our discussion of trust companies we do not distinguish between the "company" and "guaranteed" accounts as it would complicate the presentation unnecessarily.

[b]The new comprehensive DBS series used is not entirely consistent with the earlier Bank of Canada data, but differs from it little in total.

[c]This figure includes a small amount of net accruals and payables.

SOURCES: Dominion Bureau of Statistics and Bank of Canada.

sity among trust than among loan companies, with mortgage investment accounting for as little as 10 to 15% of assets in some cases—including one large company—and as much as 76% in another. There is a correspondingly wide variation in other assets, which in some cases may be quite long-term bond holdings and in others may include substantial money market investments.

Trust companies offer both chequable and non-chequable demand accounts as well as term deposits and investment certificates: the demand liabilities in total represent just over a third of funds employed, more than double the figure for loan companies.[17] Subject to the qualifications noted in the preceding footnote, it appears that about two-thirds of all trust company demand liabilities are chequable deposits. Their deposit facilities have attracted the savings of individuals rather than corporate funds and the companies have made particular efforts to tailor this side of their business to the convenience of families and individuals. A classification of the accounts in a sample of trust and loan companies in October 1961 shows that 85% of the funds in chequing accounts and 73% in other demand accounts were owned by individuals.[18] In order to cultivate this market, many companies have expanded their branch systems in the suburban areas where family savings are higher than average, (the average deposit, for example, appears to be three times the size of those in caisses populaires), have adopted a variety of branch hours

[17] The figures are somewhat difficult to unravel since many term deposit accounts are classified by certain companies as guaranteed investment certificates; conversely, some companies classify as certificates what would more generally be regarded as deposits. The D.B.S., now publishing quarterly data on the companies, is taking steps to introduce a uniform classification.

[18] *The Role of Trust and Loan Companies in the Canadian Economy*, prepared at the University of Western Ontario, Table 11-19, reproduced in the appendix volume to this report.

to appeal to customers, and have tried to attract business by offering gifts and bonuses to new customers. In 1961, 44 of the 217 offices of members of the Trust Companies Association of Canada were savings offices of this type which did not offer the full range of trust company services.

Although many of their accounts offer chequing privileges and these deposits turn over three to four times a year—more than twice the rate of bank savings accounts—the companies are not anxious to have them used as current accounts. They discourage active use by means of service charges, which vary from company to company, and may on occasion even suggest that a customer use a chartered bank account for his regular payments.[19] Nonetheless, some of the companies have made very flexible use of free chequing privileges to attract business, although because they are precluded from making commercial loans this feature has not attracted many corporate current accounts from the banks. We were also told that some companies have stressed their non-chequable deposit business because they do not like to rely too heavily on chequable accounts for which they must apply to the chartered banks for clearing arrangements. It must be stressed that this is mainly a reflection of vague fears about the future and not of difficulty experienced to date.

Guaranteed investment certificates (GIC's) are also sold to individuals, but this type of trust company liability, unlike the deposit accounts, attracts a substantial amount of corporate funds. According to the survey already mentioned, about one-half of the funds invested in certificates, debentures and term deposits of trust and loan companies come from individuals and about 40% from business corporations. Although loan company instruments are included in this classification, most of the corporate funds were in trust company certificates and the sample shows that virtually all were in amounts over $5,000.[20] Certificates are made available in standard maturities of one year, two years and so on, but some companies will issue them in any maturity to suit the investor.

The trust companies borrow very little in over five-year maturities, unlike some loan companies, appearing to be even more worried by the possibility that the rates on their mortgage investments may be adjusted after five years. However, some companies, particularly the larger ones, have developed a large market for certificates of one year or less in competition with other short-term investments such as commercial paper, chartered bank deposit receipts and treasury bills: indeed, they were among the early borrowers in this market, having sold short GIC's before a money market developed in Canada.[21] This source of funds has accounted for a good part—perhaps as much as a third—of the recent rapid growth of some trust companies and has been a major factor leading them to expand more rapidly than the loan companies. Data on 17 trust companies at the end of 1962 shows that no less than 26% of outstanding GIC's were due to mature in under six months, a further 17% in under one year, and 14% more came due within two years. On the other hand, only 2% had a maturity of five years and over. It should be noted that these figures include what are in essence the time deposits of two Quebec companies, one of which did not then formally accept deposits at all. While the maturity of these GIC's when originally issued would be somewhat longer than the above data suggest, it is nevertheless true that some companies are very active issuers of short-term liabilities.

Corporate and other investors have been attracted by the convenience of GIC's and by the willingness of some of the companies to design them to individual requirements for size and term. Moreover, they are easily available, either directly or, in some cases, through investment dealers. These factors, and the safe nature of the certificates have, however, been less important than attractive interest rates in influencing the flow of funds into these liabilities: these rates have provided more than sufficient appeal to overcome the

[19] Submission, para. 3.34 and Transcript, page 3427.

[20] *Op. cit.* Table 11-20, reproduced in the appendix volume to this report.

[21] Submission para. 3.31.

disadvantage of lack of marketability, although some companies will redeem them in unusual circumstances.

We have already indicated the main lines of trust company investment policies and the legislation which governs them. The only major difference between their intermediary lending powers and those of loan companies in Ontario is that 50% of "guaranteed" funds must be kept in the narrower group of assets permitted by the Trustee Act: the remainder may be invested in the same way as company funds.[22] Like the loan companies, the trust companies had not been active N.H.A. mortgage lenders, preferring to stress conventional residential lending which is more closely related to the trustee and estates business and in which competition has been less intense than in the industrial mortgage field. However, stronger competition for conventional residential mortgages—in amount and term of loans as well as rates—has brought about a change in some companies' policies: the industry accounted for no less than one-third of institutional approvals of N.H.A. mortgages in 1960-62. Thus when N.H.A. mortgage rates and terms have moved closer to those on conventional mortgages, the companies have overcome their aversion to the longer term, lower rate, and increased paper-work of N.H.A. lending.

While all mortgages have grown in importance for the industry as a whole despite the virtual cessation of farm lending, many companies have a preference for longer-term corporate bonds when these are available: provincial and municipal obligations retain a relatively modest place in the portfolio of most companies. Government of Canada securities have been run down relatively to finance acquisition of mortgages and corporate securities, while equities have remained a small proportion of total investments. Total equity holdings, excluding investment in subsidiary or associated companies, were only $63 million at book value in December 1962. They represented just over 3% of trust company assets, a slightly higher share than for the loan companies.

The companies which have developed the short-term business are the most diversified, for they are in most cases important mortgage lenders as well. These companies invest in a broad range of short-term assets and have played a part in the development of the money market. They are permitted to make secured loans and as "country bankers" often supply a substantial part of the investment dealers' requirements for inventory finance. While not active in the treasury bill or pure day-loan market because of the low yields involved, they accept short-term investments in guaranteed investment certificates and term deposits for customers who are not permitted or not willing to make direct purchases of commercial paper or other instruments on which the yield may be somewhat higher. These transactions are often done through the dealers who, as part of the transaction, may also arrange an "offset" purchase of the higher-yielding investment for the trust company. In this and other ways the trust companies, particularly those in Toronto, work closely with dealers in their short-term business; the Montreal companies tend to arrange more of these transactions directly with customers.

Whether or not they are active in the money market, trust companies need to carry part of their assets in cash and other liquid forms to meet the ordinary needs of their business. The industry's average holdings of Canadian cash now normally run between 1½% and 3% of all assets, averaging 1.7% in 1962. The ratio has come down from somewhat higher levels as the companies have covered their short-run liquidity needs by carrying money-market assets. If these cash holdings are related only to demand liabilities, chequable and non-chequable, their cash ratio in 1962 was approximately 5%.[23] As noted earlier, the 20% liquidity requirement applying to the companies is virtually meaningless and they have no difficulty in meeting it, even though many of their government securities are not in fact very liquid. Securities outside the money market range

[22] Like the loan companies, they are permitted by Ontario law to lend against, but not invest in, GIC's although this is rarely done. Federal legislation allows funds to be invested in GIC's if they are a trustee investment in the province concerned.

[23] See Table 2 in Chapter 19.

are not very actively traded, although some companies are more market-conscious than others; securities in the companies' own accounts are rarely turned over because of concern that capital gains might not remain tax-exempt in these accounts if a policy of trading were adopted.[24]

Despite their rapid growth in the post-war period and despite the fact that bonds accounted for 35% of trust companies' assets at the end of 1962, they are by no means a major factor in the bond markets. The portfolios of the trust and loan companies combined accounted for only 2.7% of outstanding federal marketable securities at the end of 1962, and about the same share of provincial, municipal and corporate securities. In the mortgage market, however, they held no less than 23% of all mortgages held by institutions and 35% of conventional mortgages. While the role of the trust companies in the financial system is growing in importance due to the flexibility of their operations and to their willingness to innovate, it is well to remember that as intermediaries they are still only one-eighth the size of the banks and about a fifth the size of the life insurance companies.

TRUST AND LOAN COMPANIES IN CHANGING CREDIT CONDITIONS

The main factor influencing the flow of funds to trust and loan companies has been the rate of interest paid on their deposits, certificates and debentures. It appears from the record that the growth rates of their liabilities are decisively affected by the level of their rates relative to those on competing savings instruments, and that the companies have been affected by changes in monetary policy through its influence on their ability to pay rates sufficiently high to attract funds.

The rates on trust and loan company chequable deposits rose gradually during the 1950's in step with the general increase in rate levels but have not been sensitive to the short-run cycles in credit conditions. We were told that the companies adjust their rates only after the general level of rates has shifted and a new level appears to have been established.[25] The deposit rates have, in fact, been almost as inflexible as those on chartered bank savings deposits but about ½ of 1% higher, as shown in Chart 10-1. Rates on certificates and debentures have been more responsive to changes in the financial climate, rising rapidly in 1956-57, in 1959 (after being cut back in the easier conditions of 1958), and again in 1962. It will be noted in chart 10-2 that the differential between the average rate paid on five year debentures and certificates and the conventional mortgage rate, which widens in periods of easy money, narrows with tightening credit conditions as the companies' borrowing rate moves up closer to the less flexible rate on this important earning asset.

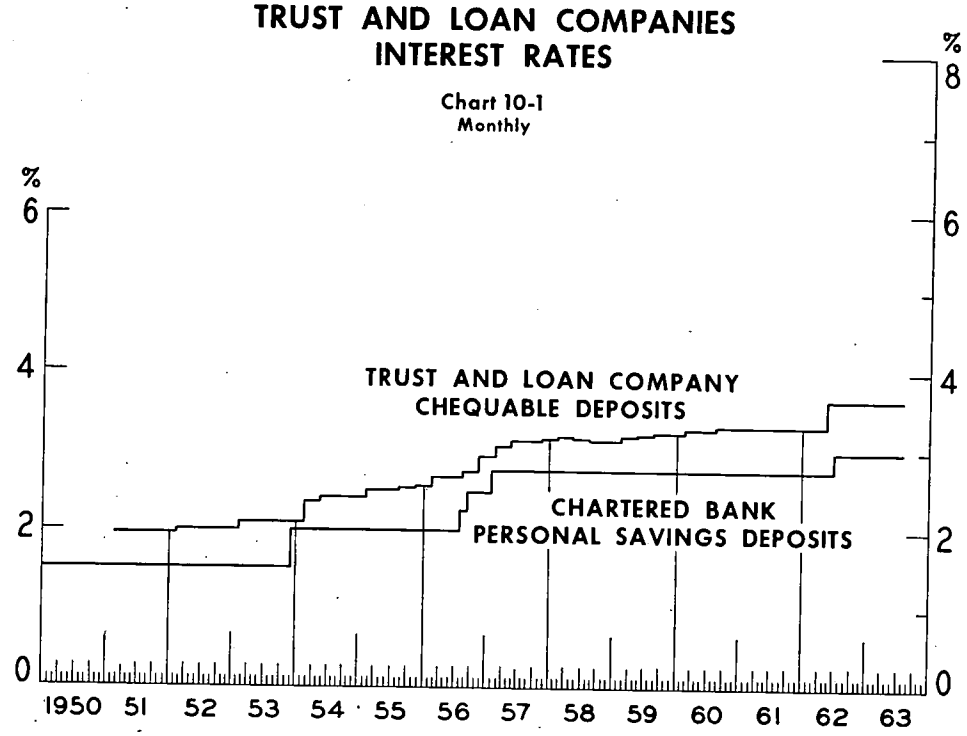
At the same time, the companies feel increasing competition for short-term funds because of the high yields available on such alternative investments as treasury bills, short bonds, and finance company and commercial paper. Thus their ability to attract funds is limited in periods of tight money by the effects of competition on the margin between the yields on their assets and liabilities. The result of these changes in the market has been that trust and loan companies have grown rapidly in periods when money was not tight but that their expansion has been curtailed when the Bank of Canada has adopted a restrictive policy which no longer enables them to pay rates which attract business from their competitors.[26]

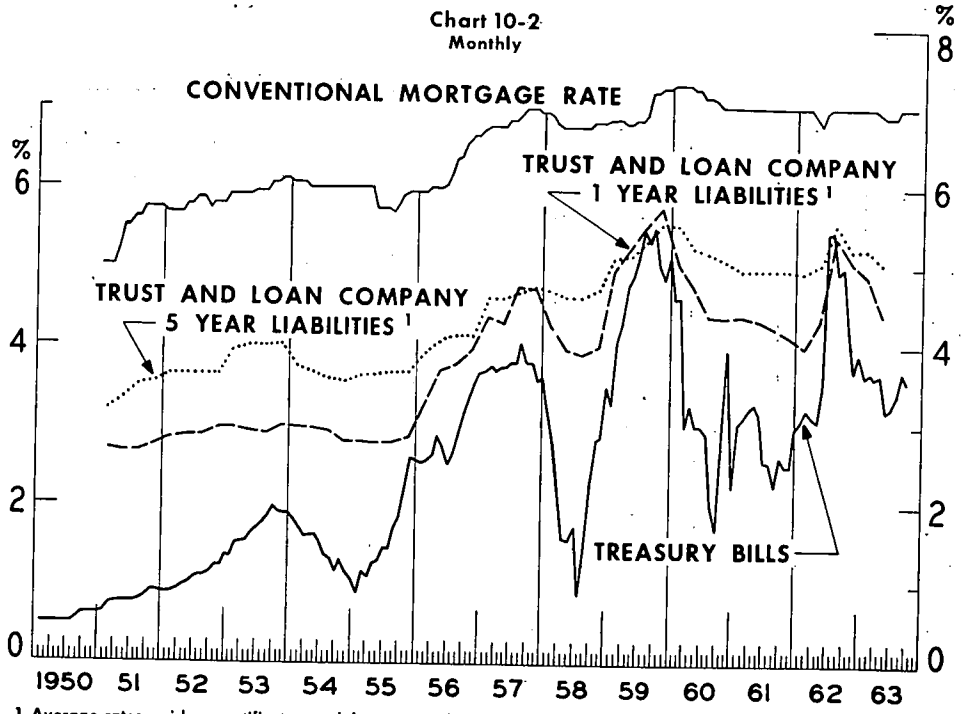
The impact of tight money has been more pronounced on the trust than on the loan companies. While the trust companies continued to grow, their rate of expansion fell dramatically in 1956-57 and again in 1959. (The fall was less sharp in 1962 in view of the fact that monetary restriction was short-lived in that year and had given way to easier conditions again in the autumn). This relatively heavy impact results partly from the fact that deposits, which are a relatively important source of funds and on which the in-

[24] Transcript, pp. 3589-90.

[25] See comments by spokesmen for the industry, Transcript pp. 3426 ff.

[26] See Charts 2 and 3 in Chapter 11.





1. Average rates paid on certificates or debentures with original terms of 5 years and 1 year.

terest rate is quite inflexible, are affected more severely than longer-term GIC's or debentures: this can be seen in the previous table. In addition, the rates on the trust companies' shorter-term GIC's, while flexible, rise less than those on many competing instruments. Thus, the very success which the trust companies have achieved as borrowers in the sophisticated and rate-conscious short-term market when rates are not at peak levels exposes them more quickly and completely to the volatility of short-term interest rates and to sharp changes in the flow of highly-liquid funds when the companies are unable or unwilling to raise their rates as high as other market rates. Loan companies are less dependent on deposits, and the industry as a whole succeeded in stepping up the growth rate of debentures in 1959 and again, but less noticeably, in 1962 by being prepared to pay the necessary rates.

ANNUAL PERCENTAGE RATES OF CHANGE

—	Trust Companies			Loan Companies		
	Total Liab.	Deposits and other Demand Liabs.	Guaranteed Certificates	Total Liab.	Deposits and other Demand Liabs.	Debentures
	%	%	%	%	%	%
1951	3.2	2.4	4.0	5.4	−2.2	13.8
1952	4.6	6.5	4.7	6.7	4.5	9.3
1953	1.7	3.3	−0.5	7.7	2.2	12.0
1954	30.8	32.6	44.2	15.1	17.0	17.2
1955	12.8	10.9	16.2	11.3	16.4	11.1
1956	3.8	6.2	1.0	7.2	−4.7	10.9
1957	5.3	−1.0	10.8	6.9	−0.8	10.3
1958	22.8	24.9	28.9	11.3	15.7	10.8
1959	10.8	−3.3	22.8	9.9	−9.3	18.0
1960	21.0	23.5	23.0	10.3	12.6	11.4
1961	23.8	26.0	23.4	17.1	31.9	14.4
1962	18.3	17.6	21.0	16.2	14.6	15.0

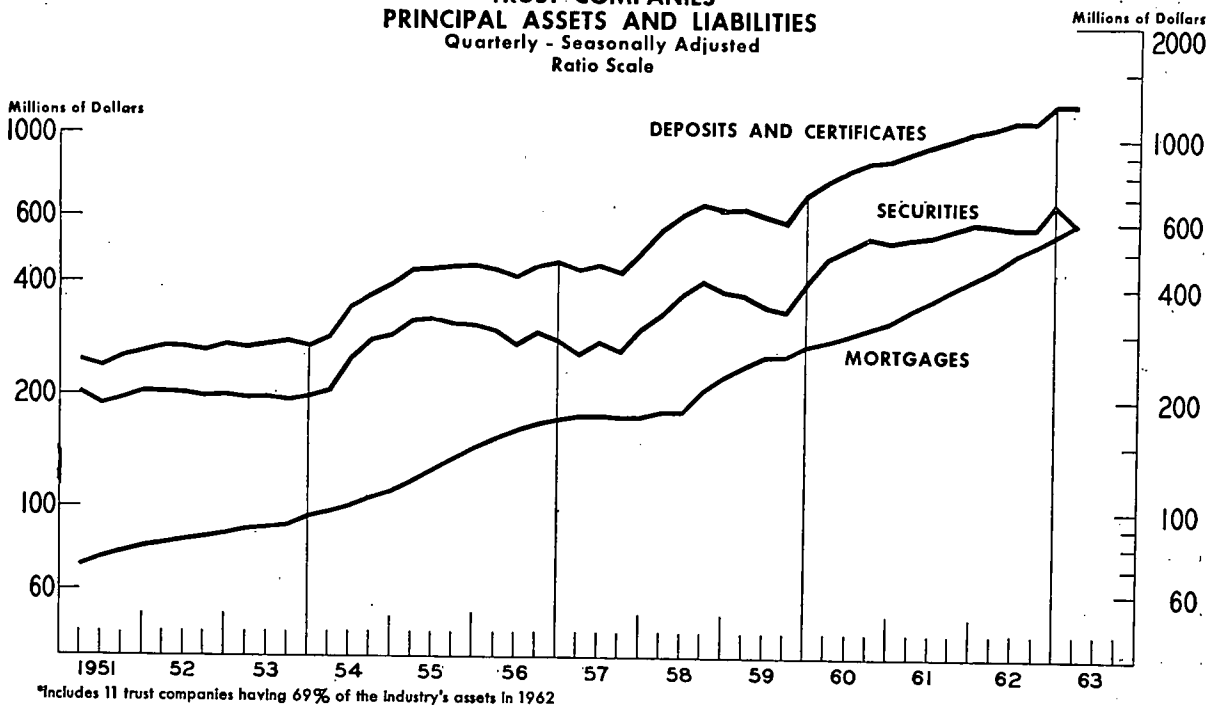
Apart from this difference in the size of the adjustment they are required to make in periods of credit restraint, the investment policies of loan and trust companies respond in essentially the same way. The accompanying charts, based on seasonally adjusted series covering companies having about 50% of the assets of all loan companies and almost 70% of trust company assets, show that when the funds available to them fail to grow or decline they continue to build their mortgage portfolios. Indeed, the rate of increase was stepped up in 1956 and again in 1959, for these were times when mortgage demand was strong. In order to obtain funds they run off their holdings of bonds, particularly Government of Canada and provincial issues. There is some tendency for the companies to run down their cash ratios as part of the adjustment process, but this contributes less to continued mortgage investment than does the selling of bonds. Finally, some rationing of credit is resorted to, particularly by those companies which are reluctant to issue longer-term debentures in periods of relatively high interest rates. The conclusion is inescapable that the trust and loan companies feel the impact of changing credit conditions clearly and must alter their operations accordingly, although the demands on them are not as insistent as those of chartered bank borrowers and they have not had to cut back on lending as severely as the banks in periods of extreme restriction.

TRUST COMPANY FIDUCIARY BUSINESS

The estate, trust and agency activities of the trust companies are quite different from the intermediary business we have been discussing. In the latter, funds gathered from many sources become a single pool available for investment in the company's portfolio of assets and the company retains any difference between revenues and administrative and borrowing expenses. On the other hand, estate and trust business—and much of the agency work—consists of managing individual asset holdings to maximize the objectives of the beneficiaries in return for a percentage or fixed fee. Provincial trustee laws, which govern estates and trusts, call for each account to be kept and managed separately, as do the agreements setting up agencies. This is true even though the account may itself be a large accumulation of funds drawn from many

Chart 10-3

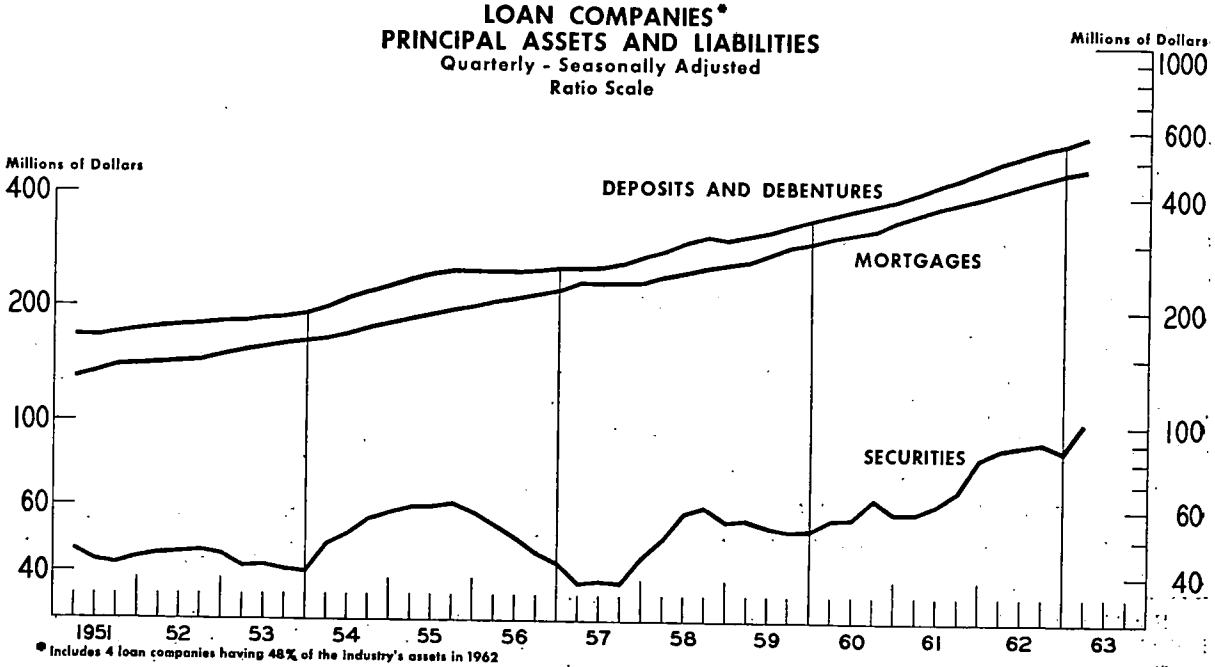
TRUST COMPANIES*
PRINCIPAL ASSETS AND LIABILITIES
Quarterly - Seasonally Adjusted
Ratio Scale



*Includes 11 trust companies having 69% of the industry's assets in 1962

Chart 10-4

LOAN COMPANIES*
PRINCIPAL ASSETS AND LIABILITIES
Quarterly - Seasonally Adjusted
Ratio Scale



* Includes 4 loan companies having 48% of the industry's assets in 1962

sources, as is the case with pension trusts. In effect, instead of managing his affairs privately or with the help of individual lawyers and investment advisors, the beneficiary or original owner of the property has chosen to buy the services and skills of a trust company to manage them for him. Thus these funds are more akin to the directly held financial assets of individuals and corporations than to their holdings of institutional liabilities, even though both share the benefit of professional investment management.[27]

Trust companies are not the only trustees: they compete for the business with individuals, particularly lawyers and notaries, who act as trustees and administrators for funds which, while not covered by available statistics, must be very large in aggregate. In Quebec, where trustee law differs from the common law provinces, individuals do a larger share of the business than in other provinces.[28] Provincial governments have also established trustee departments under various names to act for wards of the state, such as the mentally ill, and in general to provide trustee facilities for those unable to obtain them elsewhere. Given these facilities and those of the trust companies, we have not found strong evidence of a shortage of trust facilities in Canada. It is noteworthy, however, that the companies have less than 200 offices offering full trust services and that more than half of these are in Ontario. In the United States, where many banks are also trustees, facilities are more generally available.

Material on the size and composition of E.T. & A. funds in Canada has been sketchy since each company reports only the aggregate book value of the assets it administers and there are no standard valuation rules on which this reporting is based. Because most companies carry assets at their original cost, and in some cases use nominal values, the book valuation is often well below current market values. Even at book values the amount involved is very large and has been growing at an accelerating rate:

—	Total E.T. & A. Assets ($ millions)	Average annual rate of increase—%
1945	3,035	
1950	3,614	3.5
1955	4,713	5.4
1960	7,375	9.4
1961	8,270	12.1

SOURCE: *Bank of Canada Statistical Summaries*—includes pension funds under administration.

The principal factors leading to the expansion of E.T. & A. funds are the general increase in the wealth of the community, the attraction of new customers by direct solicitation, advertising and the expansion of trust company branch systems, the reputation of the companies for careful investment management, and an increasing awareness of the succession duty and estate tax savings which can result from trust company advice and management.

The spread of pension plans, many of which are trusteed with the companies, has also swelled the total of funds under administration. We estimate that the companies now administer something between 15% and 20% of the primary debt not held by financial institutions and a somewhat smaller proportion of Canadian equities. Data are not available to compare this with earlier periods, but rough calculations do not indicate that the recent tendency for a slightly larger share of such debt and equity holdings to gravitate to trust company administration has greatly altered this proportion since the end of the war.[29]

Largely because maximum fees for estate and trust work are set by the courts, the companies

[27] For this reason E.T. & A. funds were not included in the institutional sector in Table 6-1.

[28] Transcript, page 3349.

[29] In the first post-war decade, there appears to have been some tendency for the assets under trust company administration to decline relative to the total.

tend to adopt common fee schedules. However, there is some competition for business on a price basis, but it is not nearly as pronounced as in their pension fund business where price is an important part of the competition for accounts. As mentioned earlier, E.T. & A. business is more concentrated in the hands of a few companies than is the intermediary business. This is because established companies with skilled staffs, particularly those with bank connections, enjoy advantages in attracting large accounts, and because other companies, finding it more profitable and easier to engage in the intermediary business, have often preferred to concentrate on developing that side of their activities.

Three companies having about 60% of the assets under administration have greatly improved our knowledge of the E.T. & A. business by conducting a sample survey for us in four large Montreal and Toronto offices. The survey, conducted in mid-1962, was carefully designed to be representative of the business done in these offices, but unfortunately we have no way of telling how representative it is of the industry as a whole. It may well be that the inclusion only of metropolitan offices of large companies biases the results, for instance by exaggerating the importance of agency accounts and by including too high a proportion of large accounts. Nonetheless, this sample is all we have to go by and we have drawn on the results for the following discussion.

The survey did not cover pension funds or deposit securities held for insurance companies as both of these rather special fields are covered in other statistics. The book value of other accounts administered by all companies was $6.5 billion at the end of 1961 and the sample survey included accounts holding about one-eigth of these funds. On the basis of the relationship between book and market values for the three companies in the sample, and of descriptions of the valuation procedures followed by other companies, we estimate that the market value of the reported $6.5 billion of assets was about $8.7 billion. Adding back the pension funds under administration (reported by the companies at a realistic valuation of about $1.4 billion) and the market value of insurance company deposit securities as published by the Superintendent of Insurance ($1.8 billion compared to the much more nominal values placed on them by the trust companies) we arrive at a total of $11.9 billion for all E.T. & A. funds compared to the published book value of $8.3 billion at the end of 1961.[80]

The following table shows the distribution of the 798 accounts in the sample, which included all of the accounts of $10 million or more in the offices concerned and declining proportions of accounts in smaller size classes. The results were reweighted to bring them into line with the average size structure of all accounts and the following discussion is based on the resulting estimates.

[80] Since we have not attempted to place a market value on real estate holdings, which accounted for about ½ of 1% of the book value of the sample, there is still some understatement in this rough estimate of market values. A full description of the survey is given in the appendix volume.

TABLE 10–4

DISTRIBUTION OF ACCOUNTS IN THE SURVEY

	Number of Accounts		Assets Held in the Accounts			
			Book Value		Market Value	
		%	$ mn	%	$ mn	%
Estates	404	51	238.0	28	340.9	28
Living trusts of persons	97	12	53.8	6	86.9	7
Living trusts of institutions	22	3	89.6	11	110.9	9
Agencies	275	34	456.1	55	674.4	56
TOTAL	798	100	832.5	100	1,231.1	100

Almost one-half the funds (44%) were held by trust companies under agency agreements in which the company simply takes custody of the assets and carries out the instructions of the owner for their administration. The owner may choose a particular company partly for its investment skills and because he expects to receive good advice, but the company is not trustee for the assets and is not responsible for managing them beyond routine duties such as collection of dividends and interest. In addition to holding financial assets under agencies, trust companies offer a great many other services of a rather similar character. Perhaps the most important of these is property management, in which they have acquired special skills through their own mortgage business and through the management of real estate which they administer as executor under wills. Other agency services provided by them include the administration of custody and escrow arrangements and acting as receivers.

A high proportion of assets in agency and institutional trust accounts is held in relatively few large accounts. As the following table shows, about 30% of such funds are in accounts of $10 million or more, compared to 4% of estate account funds and 8% in other personal trusts.

The remaining 56% of funds administered by trust companies were held in estates and trusts set up under wills or in "living trusts" in which a trust agreement other than a will appoints them to hold and administer assets for individuals or other beneficiaries such as universities and charitable foundations. The trust, unlike an agency agreement, vests the legal ownership of the assets with the trustee but sets out the beneficiaries' rights and the limits on the trustee's freedom of action. Under some trusts the company may have little or no independence to manage the assets because the agreement names other trustees who make the investment decisions. According to our survey, this type of trust is unusual except in the case of institutional trusts, which are mainly of this character. Trusts arising out of wills may appoint co-trustees to act with the trust company but nearly always give the company a share in the management decisions. In the survey, 30% of estate assets were in accounts for which the trust company was sole trustee, and most of the remainder in accounts with co-trustees, with a small share in accounts for which the company had no trustee responsibility. Different views were expressed at our hearings on the desirability of having co-trustees: some companies seem anxious to have the views of family or friends while others prefer the freedom of sole trusteeship and do not relish sharing the fees with co-trustees.[31]

[31] Transcript, pages 3307-3311.

TABLE 10–5

ESTIMATED SIZE DISTRIBUTION OF ACCOUNTS[a]

—	Estates and Testamentary Trusts		Living Trusts				Agency Accounts	
			Personal		Institutional			
	no. of accounts	assets	no. of accounts	assets	no. of accounts	assets	no. of accounts	assets
Accounts of:								
less than $100,000	71%	14%	74%	14%	51%	3%	62%	6%
$100,000 to $1 mn.	27	58	24	53	30	12	32	32
$1 mn. to $10 mn.	2	24	2	25	17	55	6	31
$10 mn. and over	[b]	4	[b]	8	2	30	[b]	31
TOTAL	100	100	100	100	100	100	100	100

[a]This table, like the others in this section, is based on the market value of assets. Since it was not possible to place market values on real estate holdings, which account for .6% of the book value of funds, they are excluded from all classifications shown.

[b]Less than ½%.

While some trust instruments place no restriction on the way funds may be invested, others do establish specific limitations and thus serve to limit the trust companies' freedom. Many trusts are limited to assets eligible under the provincial trustee laws, and where the will or other instrument says nothing on the subject the trustee laws automatically prevail.[32] The trust companies prefer the instrument to leave them free of investment restrictions and told us that there is a definite trend towards the inclusion of unrestricted investment powers in wills and other trust instruments. Although we classified the survey according to the date at which accounts were established, the sample was unfortunately not large enough to confirm any trend to broader powers: it did show, however, that about three-quarters of the assets administered under wills were in unrestricted accounts, although views expressed at our hearings suggest that this may be too high a proportion for the industry as a whole.[33] Since smaller estates are more frequently subject to limitations than large ones, the proportion of unrestricted accounts was somewhat lower.

The trust companies feel that greater uniformity in trustee laws would improve efficiency and investment results, and also recommend that the legislation should permit investment of 35% of the funds in a trust in corporate stocks and bonds subject to quality tests.[34] Nova Scotia now permits 15% and we see no harm in the general adoption of more liberal trustee laws, particularly for professional trustees; however, it should be remembered that the laws are intended to protect the unwary and do not stand in the way of anyone wishing to place no restriction at all on his estate or trust.

Contrary to popular assumption, our survey showed that well over one-half of the funds in estates, trusts and agency accounts are invested in Canadian and foreign equities. A few large agency accounts are invested particularly in foreign equities. Smaller estates and those subject

[32] See page 48 of the trust companies' submission for lists of assets eligible under trustee laws. In general they include federal and provincial securities, municipal issues (sometimes only those in the same province), mortgage bonds and debentures, first mortgages on real estate, and trust and loan company liabilities. Corporate stocks and bonds are generally not eligible although Nova Scotia and British Columbia have liberalized their laws, while U.S. and U.K. government securities are permitted by some provinces.

[33] Transcript, pages 3319-3321 and trust companies' submission para. 2.25 and following.

[34] Trust companies' submission para. 2.32 and Transcript page 3343.

TABLE 10–6

ESTIMATED DISTRIBUTION OF ASSETS, MARKET VALUES

—	Estates	Personal Trusts	Institutional Trusts	Agency Accounts	Total
	%	%	%	%	%
Govt. of Canada securities	11	8	10	12	11
Provincial securities	13	10	12	7	10
Municipal securities	3	2	5	2	3
Corporate bonds and debentures[a]	8	10	21	12	11
Canadian equities	55	51	33	43	48
Foreign securities					
bonds	1	2	2	1	1
equities	4	13	16	18	12
Mortgages	3	1	[b]	1	1
Cash and other assets	2	3	1	4	3
Total excluding real estate	100	100	100	100	100

[a] Including short-term paper and trust company certificates.

[b] Less than ½%.

to investment restrictions tend to have higher bond and lower stock holdings but even in these the share of equities runs from 25% to 40%. (Restrictions such as those in trustee laws apply to new acquisitions only: equities included in the original assets taken under administration may frequently be kept.) The share of funds invested in mortgages in the sample accounts is much lower than the 7% or so reported for 14 companies in the University of Western Ontario study. We have no explanation for the difference.

Quite apart from the views of other trustees or any investment restrictions, the amount of trading and portfolio adjustment possible in an account is often severely limited by real conflicts in the interests of different beneficiaries. If one person receives the income from a trust during his lifetime (the "life tenant") while a "remainderman" subsequently inherits the principal, it is, in many cases, difficult to trade for the advantage of one without damaging the equal interests of the other. Moreover, it is a principle of trustee law, reinforced in the companies' minds by the experience of the 1930's, that capital must be preserved intact unless the trust instrument specifies otherwise; the trustee must be prepared to justify any impairment of capital to the courts in their periodic examinations of the account. For these reasons the companies do not trade most of their accounts actively, unless—as quite frequently happens—they have the voluntary consent of both interests. Instead, they concentrate their investment decisions on choices about the investment of new money and the reinvestment of maturing issues.[35] Investments are carefully considered by the officers responsible for each account and committees of senior management, and while quick action is always possible in unusual circumstances, there is not generally a sense of urgency or haste about buying and selling.[36]

It is therefore not surprising that the detailed reports of market purchases and sales in the sample during the six months prior to the survey date show that most accounts are not actively traded. Purchases and sales each averaged about 5% of assets in estates and in personal trusts[37] and considerably less in institutional trusts. Agency accounts, unaffected by the considerations mentioned above, are traded more actively, with purchases and sales averaging about 10% of assets during the six month period.[38] While there is a definite tendency for larger accounts and those having no investment restrictions to be traded more actively, the survey results do not show more active switching by trust companies in accounts which they alone administer compared to accounts in which others are involved in trading decisions. In each of the main types of account the survey shows considerably less trading of Government of Canada securities relative to the amounts held than was reported to us for the secondary market as a whole by the Investment Dealers' Association.[39] Other bonds also appear to be traded somewhat less actively in estate and trust accounts than by other holders, although this is not true of agency accounts which, according to the survey, were relatively active traders in the period concerned.

In view of the number and variety of accounts which they administer and the fact that each one is a separate entity with individual investment objectives, we cannot form any meaningful view of the investment skills of trust companies as trust administrators. It would certainly be wrong to take aggregate figures as an indication of the way in which individual accounts are or should be managed. The companies appear to manage their accounts carefully and conservatively: their view, with which we do not quarrel, is that the person setting up a trust can always take steps to see that more adventuresome policies are followed and, failing this sort of specific intent, a conscientious trustee must always be prudent in his administration. The companies are not, however, excessively conservative for the survey shows

[35] Transcript, pages 3322, 3331.

[36] Transcript, page 3317.

[37] Excluding one large and unusually actively traded personal trust. If this account is included, purchases and sales averaged 10% of personal trust assets.

[38] Transcript, page 3342.

[39] Submission of the I.D.A., Appendix F, page 4 and Chapter 16 of this report.

them investing large sums in equities: moreover, they are anxious to see broader trustee legislation adopted so that more common stocks can be placed in client accounts.

Some provincial laws allow a trust company to invest trust money in common funds, which are in effect mutual funds operated for the benefit of their administered accounts. These funds, which in some cases have separate mortgage, bond, and equity units, are intended to bring greater efficiency to the management of small estates. Although a few companies have successfully opened them up to public subscription, they have not grown as much as was hoped because changes in the per-share value of the fund raise conflicts between the life-tenant and the remainderman in the sharing of income and changes in capital values.[40]

In addition to taking custody of assets and administering them under trust and agency agreements, the trust companies do "corporate trustee" work which does not involve the management of assets. They are appointed as trustees for bond and debenture issues to hold the collateral and see that the borrower meets his obligations, as registry and transfer agents for equity issues, and to carry out a variety of other functions relating to the new issue market.[41] The companies able to attract such accounts, mainly larger companies which have chartered bank associations, find this the most profitable part of E.T. & A. business. The trust deeds set out the duties of the trustee but also carefully define the limits of his responsibility in order to protect the trustee from having to meet the obligations of a defaulting borrower regardless of his power to have prevented the trouble or forewarned the bondholders. While it is bound to be difficult to judge how far a corporate trustee can or should go, we have heard it argued that Canadian trust companies are perhaps over-careful about protecting themselves rather than guarding the interests of the security holders for whom they are trustees. In the United States an enquiry by the S.E.C. led to the passage of the Trust Indenture Act which sets out the duties of bond trustees. There is no similar law in Canada so that the duties vary from trust deed to trust deed, and the care with which they are executed may vary from company to company. While we have not heard of specific abuses, it is most desirable that the companies and the authorities ensure that trustees are in no sense lax. In this connection, we welcome the efforts of the Trust Companies' Association to improve the performance of the industry.

The trust companies inevitably encounter conflicts of interest in the course of their work. Some are conflicts between two accounts which they administer and can only be resolved by managing each account separately in its own best interests. In others, the companies' own investments in company and guaranteeed accounts or its interests as a corporate trustee may be involved, and again the company must scrupulously follow the best interests of its E.T. & A. customers and consider its own position second. For instance, it is clearly inadmissible for a company to buy bonds for estates or trusts simply in order to induce the issuer to give it the trustee and registrar business or to buy or sell securities for E.T. & A. customers other than through impersonal markets. It is difficult to see how such abuses are to be prevented absolutely because any trustee is in a position to use the funds he administers to his own advantage if he wishes. Examination by the courts and supervisory authorities is essential, but the strongest protection must be in the conscience of the trustee himself and his desire to preserve the reputation on which his business depends. We believe that the Canadian companies set themselves high standards. We therefore would not recommend that the trust and intermediary business be divorced, especially since such a step would probably reduce the availability and standards of trustee services to the public by leading many companies to devote their skills and experience to the more profitable intermediary business.

[40] See Trust Companies Submission para. 2.37 and Transcript, page 3351.

[41] See Trust Companies Submission, Section 4 and Winslow Benson, *Business Methods of Canadian Trust Companies*, Ryerson Press, 1962, pages 141-210.

Concern has been expressed at the concentration of equity holdings in the trust companies' own portfolios and in administered accounts. As already indicated, these appear to represent well under 20% of all Canadian common stocks and are spread between a fairly sizable number of companies, many of whose E.T. & A. clients vote their shares independently. Moreover, the trust companies' normal policy is to support existing management except in very unusual circumstances or unless they have very large stock holdings in one or a number of accounts, in which case they normally have an officer on the board to keep a watching brief in the interests of their clients.[42] Where conflicts arise, as between common and preferred shareholders, they must vote each account in its own interests, and have told us that they do so.[43] This essentially passive role as shareholders does not mean that they take no interest in how competently the companies in which they or their clients have invested are being managed. In fact, many trust companies follow the corporate affairs of such enterprises very closely, and if they do not like developments they sell out or take steps to intervene. As long as this continues to be the practice, we see no danger of shareholder control being abdicated. Nor do we foresee any possibility in the near future that trust company influence on corporate life will become so pervasive as to constitute a danger to the interests of the public.

RELATIONSHIPS BETWEEN BANKS AND TRUST COMPANIES

In any financial community close relationships are bound to develop among the participants since practically all institutions need the services of others in the course of their daily activities. It is not surprising that in the network of relationships among institutions and dealers some are closer than others; those involved are bound to find themselves working most closely and continuously with people whom they find congenial, best able to do the necessary job quickly, efficiently and economically, and familiar with their particular needs.

Many of these relationships go considerably further than a flexible working arrangement which may be readily changed or broken as circumstances alter. These permanent arrangements may involve stock-holdings in one financial institution by another, common directorships, or long-term fiscal agency or management contracts. We have enquired into such relationships to find out how they influence flows of funds in the market by their effect on competition. Information on common directorships, which is given in the appendix volume, and on stock ownership was supplemented by conversations with senior officers of the principal institutions concerned.

The most striking feature of these connections is the close link which has developed between chartered banks and trust companies. Close arrangements involving other financial institutions are by no means uncommon: insurance companies, sales finance companies, mutual funds and, to a limited degree, investment dealers, may be associated with each other or with banks or trust companies through common, but not mutually exclusive, directors. There are also instances where investment dealers, for example, either as individuals or as a firm, have substantial share interests in life insurance or sales finance companies. Similarly, at least one sales finance company has control of a life insurance company other than a captive company used to insure its own contracts, and has an interest in a corporation dealing in N.H.A. mortgages; another has a substantial investment in a trust company, while a third has recently taken an interest in an existing mortgage loan company.[44] One life company also has a significant holding in a trust company and others are shareholders of a company interested in developing new and smaller businesses. In these cases, there is a natural tendency for the partners to be favoured, particularly in the under-

[42] Trust companies submission, para. 2.39; Transcript pages 3357-8.

[43] Transcript, page 3362.

[44] In addition, many sales finance companies have established consumer loan company subsidiaries—see Chapter 11.

writing business, but we found no evidence that investment policies were unduly influenced or that competition was significantly impaired by such relationships; indeed, most such companies continued to run very much as independent enterprises.

A number of chartered banks have recently acquired interests in companies operating in the mortgage market as conventional lenders, sometimes in association with sales finance companies, investment dealers, trust companies or other institutions: in one case, a bank and associates have formed a company designed to insure conventional mortgage loans. In addition, a bank and associated dealers, institutions and individuals collectively have a major interest in a mutual fund. Two other banks and three trust companies have joined together to form a company engaged in making term loans to small and medium sized enterprises, while a further two banks have purchased interests in two separate companies making mortgage or longer-term loans to business.

Despite this recent tendency for banks to acquire interests in other financial concerns, however, it is in the relationships between banks and trust companies where the clearest pattern emerges. Moreover, these relationships are becoming both closer and more widespread. Each of the banks has a close association with at least one trust company, some of them loose working relations of long standing and others ownership affiliations of very recent origin. The form of these bank-trust company relations thus varies a good deal: in some cases there are as many as 15 common directors while in others there are few; five banks have an equity investment in at least one affiliate, varying from relatively small holdings to effective control, while the others have no equity investment.[45] Whatever the formal relationship, however, these bank-trust company links are firm enough that each institution is known to work more closely with its affiliate than with other trust companies or banks. Although the associations may not limit the independence of the trust companies or influence the allocation of business as much as is often thought, it is certainly true that the "independent" trust companies have a lively sense of the strength of these relationships.

The principal reason that banks have wished to be closely associated with trust companies is to provide a more complete financial service than they can do under their own act, although much of the recent impetus to closer ownership links has come from a desire either to prevent a trust company associate falling under the control of another trust company allied to a different bank, or to achieve added growth and standing. Another important factor has been the desire of the banks to have associates who are not restricted in their ability to offer competitive deposit rates, and some banks have been attracted by the possibility of participating in the growing profits of the trust companies. Since the legislation keeps the banks out of conventional mortgage lending and trustee business, they have found it advantageous (and profitable where there is ownership) to have a trust company "partner" who can conveniently look after their customer's needs in these areas. The oldest associations, which date from the nineteenth century, were established for just this reason—indeed in one case the trust company was founded by officers of the bank in order to bring better service to their customers even though no bank ownership was or is involved. Each of the partners of these unions can direct business to the other and does so, although no bank or trust company deals exclusively with its affiliate.[46]

While the influence exerted by the banks on the business of affiliated trust companies varies a good deal, it appears that they have not tried to influence the "banking" side of their business beyond assisting their affiliates to obtain good branch locations and, in some instances, urging the trust company to bid for deposits that are going to be lost to the parent bank in any event but which the trust company will at least tempo-

[45] Included in the five is one bank which has an equity in a trust company through its investment in the parent loan company and another whose associated trust company is owned by one of the bank's own parent companies.

[46] Transcript, pages 8227-29.

rarily re-deposit with the affiliate bank. There is no evidence that banks have tried to inhibit trust company growth by limiting their branch expansion or controlling this source of competition in other ways. Indeed, each bank's interest so far has been in seeing that its trust company does well in competition with other affiliated companies. Some of the affiliated companies have thus in fact been particularly aggressive in their deposit and certificate business. Similarly, the banks have not influenced the investment policies of trust companies to any marked degree, although we have heard of cases where the associate is urged to try to meet the needs of bank customers or where the customer himself is pressed to take his trust business to a particular company.

The banks make their presence felt most strongly in the E.T. & A. business, more than 80% of which is in the hands of trust companies affiliated to banks in one way or another. Their power to influence the disposition of corporate bond trustee and transfer business is particularly strong: personal trust business is not much affected, and it was, in fact, suggested that people often prefer to separate their banking and investment or estate management affairs entirely. The corporate E.T. & A. business may, of course, move to the affiliated trust company simply because management finds it convenient, but we were told that the banks often influence the choice in one way or another. While many corporations split this business as a matter of policy, a limited survey showed that anywhere from half to three-quarters of the trust business of larger corporations tends to go to the trust company affiliated with the corporation's principal banker.[47]

We see no reason for concern about the trend to bank-trust company affiliations because of any necessary incompatibility between trust and banking business. At the present time the trust companies do in fact carry on a large part of the business of banking without prejudicing the interests of their trustee customers, while in other countries banks do both kinds of business. If there is a danger, it is that continuation of the present trend might lead to undue concentration and thus to reduced competition in the financial system. The banks are already large and the trust companies collectively are the banks' most important single group of competitors. We shall have more to say about this matter in our recommendations for banking legislation in Chapter 18.

TRUST AND LOAN COMPANY EARNINGS

As already noted, one reason for bank purchases of trust and loan company stock has been the attractive returns available on their investments. The revenues of loan companies have been pretty well determined by the yield available on conventional first mortgages, which provided about 85% of gross revenue in 1961. Their revenues in relation to assets have thus risen steadily with mortgage rates and in 1961 were 6.79% of assets. Because of the relatively simple character of their business, administrative expenses, which have averaged around 1.25% of assets, are low in comparison with other institutions, and have in fact risen less rapidly than the volume of funds administered by loan companies in recent years. On the other hand, their borrowed funds, being predominantly long term, are relatively expensive. The tendency for the less expensive deposits to grow less rapidly than debentures, and some narrowing of debenture rates relative to mortgage yields, have led to a slightly more rapid rise in interest expenses than in revenues with the result that net earnings on each dollar of assets have declined a little. At 2.00% in 1961 they are still, however, high compared to those of the chartered banks (1.11% in 1961 and 1.00% in 1962) and the Quebec Savings Banks (.96% and .88%) and somewhat higher than the trust companies (1.63% in 1961). The return on share-

[47] It is sometimes alleged that the trust companies are in a position to control the banks through their E.T. & A. accounts. While in some cases E.T. & A. customers may hold as much as 10% to 15% of the outstanding capital of the affiliated bank, they also hold shares in other banks. Given the trust companies' present share-voting policies and the independence of many E.T. & A. accounts, these holdings of bank shares do not appear to be used as an active instrument in controlling bank policies.

holders' equity increased from around 5% in 1951 to 8½% in 1961, partly owing to the fact that the ratio of capital to other liabilities has steadily declined. Since 1955, net profit ratios have tended to remain stable although total profits grew by over 50% from 1955 to 1961.

It is more difficult to assess the position of trust companies because there is such variety in their character and because we are not able to separate the earnings from the two main types of business. Although we do have information on the fees and other income received from estate, trust and agency operations, the published statements do not attempt the difficult task of allocating expenses between this and the intermediary business. For this reason we have related all revenues and expenses to the funds employed in the intermediary business (i.e. consolidated company and guaranteed accounts). This amounts to treating E.T. & A. business as a service provided by a financial intermediary, in the same manner as we have treated the revenues and expenses relating to services provided by other institutions.

The common view in the industry is that the "banking" business is more profitable than the management of estate, trust and agency accounts. We were told that the companies try to develop the banking business rapidly in new branches in order "to cover the losses of other departments which take considerably longer to reach the break even point"[48] and that the fiduciary business is costly because of its personal nature, the expenses of developing new business, and the fact that each account must be separately managed. Salary and other administrative expenses are thus high for trust companies: they have run well over 4% of the funds in company and guaranteed accounts in recent years and even in 1961, when assets grew very rapidly and expenses rose less than proportionately, were about 3½%. However, it seems that some parts of the E.T. & A. business, particularly trustee and transfer work in connection with security issues, is very profitable to the companies able to obtain it. For the industry as a whole, moreover, the fees from E.T. & A. accounts have consistently covered a very substantial part of all salary and administrative expenses in spite of the fact that the companies have run into heavy costs from the rapid expansion of their intermediary business. While it

TABLE 10–7

REVENUES AND EXPENSES
(as a percentage of total assets)

—	Trust Companies[a]		Loan Companies	
	1955	1961	1955	1961
Revenue				
Fees etc. on ET&A	3.87	2.94	—	—
Interest, dividends and other income including trading profits and losses	4.25	5.58	5.94	6.79
TOTAL	8.12	8.52	5.94	6.79
Less:				
Administrative expenses	4.32	3.42	1.32	1.20
Revenue after administrative expenses	3.80	5.10	4.62	5.58
Less:				
Interest paid	2.12	3.48	2.45	3.58
Net earnings before tax and provisions	1.69	1.63	2.17	2.00
Net write-downs of assets	.02	.09	.04	.10
Taxes	.66	.67	.86	.76
Net profit	1.01	.87	1.27	1.14
Dividends	.51	.39	.73	.63
Retained for shareholders' equity and reserves	.50	.48	.54	.51
Memorandum:				
average rates				
earned—mortgages	5.80	6.79	6.27	7.32
—bonds and debentures	3.48	4.82	3.42	3.84
paid —deposits	2.10	2.89	2.18	2.72
—certificates and debentures	2.77	4.45	3.61	4.87
TOTAL	2.45	3.84	3.06	4.25

[a]Expressed as a percent of company and guaranteed funds.

[48] Trust Companies' Submission, para. 1.41. See also Transcript, page 3453: ". . . There is no question but that the estates and trust business, for the amount of work done, is not as profitable as the guaranteed accounts."

may take longer to become profitable, it appears that E.T. & A. business does in fact make a worthwhile contribution to the earnings of the companies, even though the amount per dollar of assets under administration is small.

Although E.T. & A. revenues and total administrative expenses have tended to grow less rapidly than total assets, income from the investment of company and guaranteed funds and the interest cost of funds borrowed have, like those of loan companies and other institutions, risen more rapidly. Because a substantial part of their funds are invested in bonds and other assets yielding less than mortgages, this part of revenue has been lower in relation to assets than for the loan companies, although higher than for the banks. The same is true of their rate of net earnings which, while declining somewhat, remains more than ½ of 1% above that of the chartered banks. The rate of return on equity has improved in recent years, rising from under 9% to about 10½% from 1955 to 1961 and again this has been associated with continuous reductions in the capital ratio. Total profits grew by no less than 89% from 1955 to 1961, reflecting the rapid growth of the companies' assets and E.T. & A. business. This trend appears to have accelerated in 1962 and 1963.

The loss ratios of both loan and trust companies have been very low in the post-war period, although during the depression they reached a level of 5% of mortgages, the great majority of them being incurred in connection with farm lending. Despite the low losses in recent years, the companies have urged that the Income Tax Act be amended to allow them more generous untaxed general reserves, although they have also made the somewhat conflicting request that permitted capital ratios be lowered. The Income Tax Act now allows them to allocate ¼ of 1% of the amount of their conventional mortgage holdings to a reserve each year up to a maximum amount of 3%, and the companies recommend raising these limits to ½ of 1% and 6% respectively. At the moment, the companies are not taking full advantage of the existing privilege and the reserves average only about 1¼% of the eligible assets. Since the subject of reserves, like that of capital ratios, has broader implications affecting all institutions, we defer consideration of it until Chapter 19.

Since both the trust and the loan companies have been able to obtain a higher return on their assets than the chartered banks, there seems to be no financial reason why they could not adjust to stiffer bank competition, particularly if they were to be permitted at the same time to move into the unsecured personal and business lending from which they have been precluded. While we will return to this question and to the related subject of bank ownership of trust and loan companies in Chapter 18, we hope that the increasing overlapping of the functions of banks and trust companies, which is bound to occur in any event, will strengthen the forces of competition rather than reduce them.

CONCLUSIONS

The vigorous post-war growth of the trust companies has been due in large measure to their willingness to compete aggressively with the banks in many fields. They have undertaken new activities, expanded their branch networks and offered savings customers attractive rates and convenient terms on their funds. Like the loan companies, they have also benefited from the strong demand for mortgages, a factor which might have led them to grow rapidly even if the banks had not been precluded from conventional mortgage lending. The nature of the banks' liabilities, lending skills, and basic attitudes might not have led them to enter this field on a major scale in the period under review. It will be recalled that they were faced with other pressing demands for much of this time and that although they in fact became heavy mortgage lenders for a while under N.H.A., their holdings of N.H.A. mortgages have not risen since 1959.

Since both the trust and loan companies are free of legal restrictions on the maximum rates of interest they may charge, they have been in a

better position than the banks to compete for funds and this factor has undoubtedly contributed to their high rates of growth, particularly in recent years when the general level of interest rates has also been high. They have been sensitive to restrictive monetary policy and credit conditions, although this has merely slowed their rapid rate of post-war growth.

These companies have also gained some advantage from their freedom from the law requiring chartered banks to hold non-earning cash equal to 8% of deposits and the agreement to hold an additional 7% in treasury bills and day loans. However, the earnings advantage has not been large—perhaps ¼ of 1% of total assets—and even if trust and loan companies had been required to meet similar cash and liquidity rules, their pre-tax earnings rates would still have exceeded the banks' by a comfortable margin.

In summary, then, the growth of the trust and loan companies must be imputed largely to their own efforts and ingenuity and to the underlying structure of the demand for funds, although the 6% ceiling on bank lending rates has also been an important factor in recent years and the conventional mortgage prohibition applying to them has also played a part: the difference in cash ratios, while certainly influencing profitability, cannot be said to have been a major factor. Although collectively the trust and loan companies are now 20% of the size of the banks' Canadian business, this is approximately the position they held at the end of the 1920's and cannot therefore be characterized as a major shift in the evolution of the financial system. What is new, however, is the increased competitiveness of these institutions and the growing similarity between many of their functions and those of the banks. The appropriateness of having completely separate legislation and supervision over two classes of institutions performing many similar functions is thus increasingly open to doubt and raises issues to which we shall return in Chapters 18 and 19.

CHAPTER 11

SALES FINANCE AND CONSUMER LOAN COMPANIES

The sales finance and consumer loan companies were pioneers in the specialized field of consumer credit. The former were established following the first world war to finance automobile sales, and branched out from that activity to the financing of other consumer durables. As new lenders ventured into the field, the companies began to finance purchases of equipment and machinery by businesses. The movement into other types of lending and new forms of activity has accelerated in recent years as a result of slower growth in consumer spending on durables and entry of the banks into the personal lending business. Nevertheless, instalment finance companies still concentrate on consumer credit, particularly automobile credit. The loan companies have dealt almost exclusively with consumers, making cash loans to people not able to obtain credit elsewhere. Their charges on loans under $1,500 are now regulated by the federal government under its jurisdiction over interest rates. Although money-lenders had been in existence since the nation's early years, the first federally-incorporated consumer loan company in Canada was founded only in 1928, and it and its successor company were instrumental in seeking to achieve higher standards and bring about orderly regulation of the business.

Although these companies compete with banks, credit unions and others for lending business, they do not compete as directly with them for the funds they borrow. The companies obtain their funds mainly by selling notes and debentures to other financial institutions and corporations and by borrowing from the chartered banks. Unlike other intermediaries, therefore, they borrow almost exclusively in the central financial markets and actually draw an important part of their funds from other financial institutions. Liability competition with such institutions as the chartered banks, trust and loan companies thus takes place principally in the money and securities markets where the instalment finance and consumer loan companies offer their short, medium and longer-term obligations as an alternative to bank deposits, trust company GIC's and loan company debentures. They do not compete as vigorously for funds from individuals and from smaller non-financial companies which are not active investors in the central markets. This is partly because the companies acts under which the finance companies are incorporated appear to prohibit, or at least do not clearly authorize, acceptance of deposits; the consumer loan companies are explicitly prohibited from taking deposits by the Small Loans Act. To the extent that they borrow from other institutions, finance and small loan companies are in effect a second intermediary standing between final lenders and the final borrowers to whom they extend credit. This is particularly true of the smaller companies which are not able to sell their notes in the market and must therefore rely heavily on bank loans.

Another unique feature of the instalment finance companies is that they are the only major financial institutions which are unregulated by any act other than normal company legislation.

This is partly related to the fact that they rarely obtain funds from the public other than through normal securities issues, but may also be due to the variety of business which they do and to the newness of many of the companies in the industry. Indeed, the sales finance "industry" can be only somewhat vaguely defined, although the Dominion Bureau of Statistics publishes statistics which now include about 150 companies and give quite comprehensive coverage of firms doing a general consumer instalment finance business. These statistics do not, however, encompass wholly-owned subsidiaries of merchandising and manufacturing companies which finance only parent company sales[1] or some of the smaller companies specializing in business loans, factoring, real estate finance, home improvement lending and similar activities which might be included in a more general definition of "finance" companies. Nor do the statistics include an indefinite but almost certainly large number of very small consumer instalment finance companies. A few of these fringe companies have started to deal with the public and this has given rise to regulatory and other problems to which we will return later.

The sales finance industry is highly concentrated: ten companies have about 90% of the business covered by DBS statistics and the four largest companies have some 80%. Most of the other companies are quite small, operating either locally or within one province, with the majority having only one office. However, with the entry of many new companies and rapid growth by smaller firms, the share of business held by large companies has been declining: 18 of the 27 larger companies included in a survey conducted for us by the Federated Council of Sales Finance Companies were founded since 1949.[2] Some of the large companies are controlled by foreign financial corporations but most companies in the industry are controlled by Canadian interests. The Federated Council, formed in 1957 to focus the views of the industry and further its interests, now has 42 members who account for about 70% of the consumer business and 90% of the commercial and industrial lending done by the industry.[3]

Unlike sales finance companies, the consumer loan companies operate under specific legislation. Any money-lender, other than a chartered bank or registered pawnbroker,[4] making personal loans of $1,500 or less and charging more than 1% per month on any loan must apply to the Minister of Finance for a license which is renewable annually under the federal Small Loans Act. The main purpose of this Act, first passed in 1939, is to control the total charges on small cash personal loans, as distinct from the instalment financing of merchandise. Since most of the borrowers who approach loan companies or money-lenders are in financial difficulties and in no position to bargain strongly because no other major lending institutions will normally accommodate them, it is considered necessary to "even out the bargaining power" by prescribing maximum lending rates.[5] The Act sets out a scale of such rates on loans up to $1,500—the limit was raised from $500 in 1957—and places the companies and money-lenders under supervision by the Superintendent of Insurance. Loans in excess of $1,500 are not regulated under the Act, and money-lenders operating entirely above this limit and the larger loans of licensed firms are thus exempt from its provisions.

At the end of 1961 there were 78 money-lenders and five small loan companies licensed under the Act, the only difference between them being the method of incorporation; small loan companies are federally-incorporated while the money-lenders are incorporated by the provinces. The consumer loan business is highly concentrated in the hands of a few firms. At the end of 1961 the 10 largest firms had close to 90% of the assets of all licensees (including their loans in excess of $1,500) and 940 out of a total of

[1] General Motors Acceptance Corporation is included in the D.B.S. statistics, but is not a member of the Federated Council of Sales Finance Companies.

[2] Submission, para. 14.

[3] As defined in the D.B.S. statistics. See also footnote [1].

[4] Pawnbrokers are limited to charging 15% per annum on amounts over $20 by the Pawnbrokers Act. The act also specifies maximum rates on smaller amounts.

[5] Transcript, pages 5558 and 5563.

1,148 branch offices. Three firms alone, one of them a money-lender, had two-thirds of assets and operated 620 branches across the country. At the other extreme, 48 lenders had assets of less than $500,000 each and the majority of these had only one office. Many of the companies are subsidiaries or affiliates of sales finance companies or of foreign-owned consumer loan companies. The largest of these subsidiary companies in fact dominate the field: at the end of 1961 five American-owned companies had 57% of all business and three subsidiaries of Canadian finance companies a further 28%.

Fifty-six of the companies having 99% of the business belong to the Canadian Consumer Loan Association, formed in 1944 to promote the interests of the industry. Since the members are all bound by the provisions of the Small Loans Act, they have a keen interest in seeing that no member or other company, whether or not it is licensed, breaks the law and gives the industry a bad name. The Association in fact actively co-operates with the Superintendent of Insurance in policing the small loans business generally.[6] Nonetheless the Small Loans Act only covers lending in amounts up to $1,500 and does not cover conditional sale contracts.[7] Moreover, a lender may purchase an existing contract, for instance a small mortgage initiated by another lender, yielding more than the regulated rates, although the Superintendent will then take action against the original lender if he has contravened the Act. Thus, in spite of the best efforts of the regulated companies and supervisory authorities there are still many small lenders who are not members of the Association charging higher, sometimes exorbitant, rates on various kinds of consumer lending. In addition, there is an unorganized fringe of similar private lending which would no doubt persist under any regulatory system. We shall have more to say later about steps which should be taken to improve the protection of small borrowers by extending the coverage of the legislation.

[6] Transcript, page 5539 and following.

[7] A conditional sale contract is taken to be a deferred sale of merchandise rather than a loan transaction.

LENDING ACTIVITIES

Although sales finance companies do not lend only to consumers, their growth has been largely determined by the demand for consumer credit and by the extent of competition in that market. In recent years, it has also been strongly influenced by their own willingness to venture into new fields as competition in their traditional areas of business became more intense. Prior to the war, they concentrated mainly on automobile finance and did not meet strong competition because the banks were reluctant to enter this new and specialized lending field. Needless to say, the depression and war years were not favourable to their growth because of widespread unemployment in the first period and shortages of consumer durable goods in the second. However, following 1945, rising levels of income and employment, low levels of personal debt, rising output of durable goods to replace and extend the aging stock of such assets in the hands of consumers, and the other factors affecting the willingness and ability of individuals to incur debt discussed in Chapter 2, led to strong consumer credit demand and rapid growth of the institutions prepared to meet it. As Table 11-1 shows, credit extended by finance and loan companies, by retail dealers either directly or through their affiliated finance companies, by chartered banks and credit unions and by insurance companies all rose sharply. Total consumer credit jumped from $388 million in 1945 to $1,231 million five years later and continued to grow rapidly through succeeding years.

The sales finance companies were the main beneficiaries during the first decade of this expansion, for the most rapid increase was in instalment credit for durable goods which the companies were willing to make available conveniently and easily through the automobile dealer or other retailer at the time of sale. Thus their share of consumer credit rose from 2% in 1945 to a peak of 27% in 1956. The consumer loan companies also expanded rapidly in this ten-year period but credit extended by retail dealers and banks grew more slowly. Table 11-1 also includes the relatively small amount of unsecured lending

TABLE 11-1

MAIN TYPES OF CONSUMER CREDIT OUTSTANDING

(December 31)

—	Sales Finance Companies	Consumer Loan Companies	Retail Dealers	Chartered Banks	Credit Unions & Caisses Populaires[a]	Other[b]	Total
				$ Millions			
1945	8	30[e]	100[e]	73	25	152	388
1950	202	93	454	224	76	182	1,231
1953	516	176	624	308	133	233	1,990
1956	756	356	798	435	209	281	2,835
1957	780	362	826	421	249	308	2,946
1958	768	401	861	553	294	317	3,194
1959	806	484	915	719	363	336	3,623
1960	828	549	960	857	417	358	3,969
1961	756	594	1,006	1,030	503	375	4,264
1962	771	689	1,039	1,183	560[e]	398	4,640
				Percent distribution			
1945	2.1	7.7[e]	25.8[e]	18.8	6.4	39.2	100.0
1950	16.4	7.6	36.9	18.2	6.2	14.8	100.0
1953	25.9	8.8	31.4	15.5	6.7	11.7	100.0
1956	26.7	12.6	28.1	15.3	7.4	9.9	100.0
1957	26.5	12.3	28.0	14.3	8.5	10.5	100.0
1958	24.0	12.6	26.9	17.3	9.2	9.9	100.0
1959	22.2	13.4	25.3	19.8	10.0	9.3	100.0
1960	20.9	13.8	24.2	21.6	10.5	9.0	100.0
1961	17.7	13.9	23.6	24.2	11.8	8.8	100.0
1962	16.6	14.8	22.4	25.5	12.1	8.6	100.0

[a]Includes small amounts of caisses populaires non-personal lending.
[b]Principally insurance company policy loans: also including Quebec Savings Banks.
[e]Estimated.

SOURCES: D.B.S., Bank of Canada and, for the credit unions and caisses populaires, the appendix volume to this report.

by the Quebec Savings Banks and the amount of life insurance policy loans, which accounted for 39% of the total in 1945 but have not grown rapidly since.[8]

Dramatic changes in the consumer credit market have recently resulted from the rapid expansion of chartered bank lending through their personal loan programs. The banks have, of course, lent to consumers for many years and one of them instituted a consumer loan plan during the 1930's, but they have stepped up their activities in recent years. Aided by the 1954 amendment of the Bank Act regarding chattel mortgages, from 1958 on they have moved actively into fields such as instalment financing of cars and other durables in which the sales finance companies had previously met little bank competition. At the same time, the credit unions have taken an increasing share of the market. This sharply increased competition from other lenders, coupled with the slow growth of consumer expenditure on durables, has caused the finance companies' consumer lending to grow very little since 1956 and induced them to move into other fields as well. Consumer loan companies have also been influenced by the changed competitive circumstances, but since their main market is still in cash lending to a class of people

[8] Policy loans did, however, account for about one-quarter of the increase in all consumer credit in 1957. Some of these loans are for business rather than consumer purposes but no classification is available.

who have not been greatly affected by the expanding consumer lending of the banks, these companies have not been exposed to the same pressures. They have experienced more severe competition from the credit unions, but their loans have continued to rise although at a reduced rate.

As the following table shows, consumer credit of all kinds now amounts to about 16% of personal disposable income, a figure which compares to 12-13% before the war. These trends were discussed in Chapter 2, but it is worth noting again that this higher level of debt reflects the cash savings and other conveniences available from many consumer goods, as well as the displacement of regular monthly commitments like laundry bills, transportation, and the like by regular debt repayments on the goods concerned. To the extent that the latter is a factor, the figures exaggerate the real rise that has occurred in the financial commitments of individuals in the postwar period; this is particularly true of the replacement of monthly rent by monthly mortgage payments as home ownership has risen. Despite the increased willingness of consumers to incur debts, however, these may have reached a level where they will expand only gradually in relation to income, and the industry may face an increasingly competitive market in the years ahead.

RATIO OF CONSUMER CREDIT TO PERSONAL DISPOSABLE INCOME

—	Consumer Credit	Personal Disposable Income	Ratio
Year-end	$ mn.	$ mn.	%
1945	388	8,617	4.5
1950	1,231	13,670	9.0
1953	1,990	16,848	11.8
1956	2,835	20,888	13.6
1958	3,194	23,362	13.7
1959	3,623	24,526	14.8
1960	3,969	25,486	15.6
1961	4,264	27,086	15.7
1962	4,640	28,646	16.2

NOTE: If estimated personal mortgage debt were included, the ratio of all consumer debt to personal disposable income would be approximately 50%.

(i) *Sales Finance Companies*

Sales finance companies differ from other financial institutions, including the small loan companies, in that they frequently do not lend directly to the purchasers of the goods being financed. Instead of applying to an institution for credit and receiving the funds in cash to make purchases or pay off bills, the borrower using finance credit rarely deals with the lending company or actually receives cash. The credit is made available by the auto dealer or other retailer at the time of sale in a single transaction with the customer, who signs a conditional sales contract or some other form of deferred payment agreement with the dealer. The dealer then sells the contract to a finance company, which will collect the payments on it, thus completing the transactions by which the company effectively extends credit to his customer. From the customer's point of view the result is the same as in other credit dealings—he has made his purchase and will pay for it over the following months—but the mechanics of doing business are entirely different.

Since finance companies "accept" credit contracts already written, competition among them focuses on their efforts to persuade dealers to bring them retail contracts rather than on direct efforts to attract borrowers, although the companies do a certain amount of advertising. The terms on which they buy the finance agreements from dealers are the most important part of this competition. The customer signs an agreement to pay a specified finance charge in addition to the balance due on his purchase, and the finance company taking over the contract credits part of this charge to the dealer as his payment or commission for having obtained the business for it. Rather than pay him immediately, the company normally credits the amount to a "reserve" account against which losses, or deductions resulting from rapid repayment, are charged. Obviously, dealers will be interested in doing business with the company which is prepared to pay them the best price, and—according to information filed with us—the dealers ordinarily receive 10% to 20% of the total finance charge, the remainder going to the

finance company.[9] Competition among the companies has raised the level of dealer reserves somewhat in recent years.

Another important part of the arrangements with dealers is the sharing of the risk of default. In most cases, the company accepts part of the risk by agreeing to find the goods if the buyer has "skipped", repossess them and deliver them to the dealer who then repurchases the contract, usually by a charge against his reserve with the company. A limited number of "full recourse" agreements leave the full liability with the dealer, while under "non-recourse" agreements, which may be offered as an inducement to dealers but are apparently not common, the finance company accepts all the risk. Finally, in order to protect their own investment and as a necessary service to help dealers close their sales without delay, the companies normally have credit investigation departments to check on prospective customers. They usually require insurance on major durables like automobiles, and many of them provide this automatically through subsidiary or affiliated companies when the contract is written.

In addition, the companies offer dealers a number of other services, the most important of which is the "wholesale" financing of their inventory. Competition for dealer accounts among the companies and with the banks is such that the charges for inventory finance are much lower than the retail rates; in 1961 they varied from 6% to 7% plus a small service charge compared to a range of 12½% to 19% on new car retail contracts and higher rates on used cars and other consumer goods.[10] Nearly all wholesale financing is for automobile inventories (retailers' inventories of other durable goods are often financed by the manufacturers), and large national companies have an advantage in this business for they all have offices close to the manufacturers through which the contracts can be processed. Because this helps them to attract dealer accounts, they thus have some competitive edge over smaller companies in automobile financing as a whole.

Finance companies are also prepared to make capital loans to dealers for the improvement of their facilities, and here as in the wholesale business competition among the companies has kept rates relatively low. However the amounts involved have been small, the ten largest companies reporting $14 million of such loans outstanding to 637 dealers in 1961.[11]

These various lending and other services form a package offered by the companies in order to obtain retail contracts, and although there are some instances where a dealer does business with more than one company, it is more common for him to assign all his retail paper to the company that provides his wholesale finance. Since earnings on these and capital loans are relatively low, a company is unlikely to handle them unless it obtains at least a significant part of the dealer's retail business. Moreover, his sales agreements are made out on forms provided by his company, the finance charges are taken from a rate chart it supplies, and the contracts are purchased at prices arranged with him in advance. No doubt the effective rate his customers must pay for financing has an effect on the dealer's ability to attract business—the success achieved by the banks, which lend at somewhat lower rates, and the fact that dealers are prepared to cut their price, and thus forego part of their reserve, attest to some sensitivity to interest rates. However, the other elements in his relationship with the finance company are of more immediate concern to him. Finance charge competition is, as it were, carried on at one remove, and the charges are less sensitive to changes in credit conditions than rates on wholesale financing which are settled in a more closely competitive market.

The character of the retail finance market is reflected in the wide variety of rates charged by the companies, although these are calculated and negotiated with customers in the form of the total dollar amount of the finance charge rather than a rate of interest. For instance, in 1961 the effective annual charges of 17 companies on a standard new car contract varied from 12.5% to

[9] Supplementary Submission of the Federated Council, pages 19-20.

[10] Based on data in submission of the Federated Council, Tables 4.1 and 4.4.

[11] Submission of the Federated Council, para. 58.

18.8%, with most companies reporting rates from 13.5% to 16%;[12] rates on a smaller consumer contract ranged from 16% to 23%. There is no uniform pattern in the timing, amount and on occasion even the direction of rate changes. Although the companies do not believe their retail customers to be highly sensitive to rates, they do not raise retail rates at all quickly when other rates are rising. Thus, each company sets its charges somewhat independently of others in the course of its competition for dealers and their contracts, although underlying market forces do shape their decisions.

There has been a tendency for the repayment periods on retail contracts to lengthen during the past decade as a result of competition, including that of the banks. The average repayment periods on new automobile contracts of four large companies submitting information rose from a range of 19 months to 21½ months in 1954 to a range of 26 to 30 months in 1961, and the somewhat shorter terms of other retail contracts have also lengthened.[13] One company told us of reducing its term and raising down payments as part of a restrictive policy in 1959,[14] but the available statistics do not show any consistent pattern of changes in response to general monetary conditions. Indeed, the averages for all four companies reported in the submission lengthened in 1959 and 1960, as did the average repayment terms of all finance companies as published by the Dominion Bureau of Statistics.

It is general practice, and required in some provinces, to disclose the dollar amount of finance charges to customers but the companies do not disclose the effective rate of interest. They have objected to doing so because different methods of calculation give different results and all require some arithmetic skill, because the charges include a necessary fee to cover the cost of servicing accounts and the total charges on small amounts thus work out to high rates of interest, and because they find that customers are more interested in the dollar amount to be paid than in the interest rate. In spite of these objections, we believe there is a strong case for disclosure in both forms so that customers may readily compare the cost of funds in contracts which are not identical as to terms and amount. All generally accepted methods of calculation give closely similar results. Moreover, dealers could be provided with rate as well as charge books and would not have to do the arithmetic themselves; and consumers could hardly suffer from having more information. Since this matter of disclosure applies generally, and not only to finance companies, we shall return to it later.

Consumer goods financing accounted for 64% of the finance company receivables included in Table 11-2 in 1955, but for the reasons suggested earlier these assets have not grown rapidly in recent years and by the end of 1962 were down to 54% of the receivables shown. Of this amount, 77% was for new and used automobiles, and 23% for other consumer durables. Commercial vehicle financing and the wholesale business associated with vehicle sales have also grown slowly, and in these circumstances sales finance companies have done much to diversify their business and find new lending markets, particularly by expanding their financing of industrial machinery, by other business lending and by investing in small loan and other subsidiaries.

Equipment financing has grown steadily and is now approaching $300 million, with most loans being for relatively small amounts. The typical contract runs for $5,000 to $15,000 and calls for repayment in two or three years, but some go as high as $500,000 and repayment may stretch over periods up to eight or ten years.[15] Rates of interest, which vary from one company to another and with the size of the loan, appear to range from 10%, and perhaps a little lower on large loans to good

[12] Applying the formula

$$\frac{2CP}{L(n+1)}$$

to finance charges shown in Table 4.1 of the Submission; C=the total finance charge; P=number of payments per year; L=principal amount borrowed; n=total number of monthly payments over the life of the contract.

[13] Federated Council Submission, Table 7.6 to 7.8. See also page 114 of the I.A.C. Submission.

[14] Transcript, page 1659.

[15] Submission of the Federated Council, para. 52-56, Transcript 5366-5370.

TABLE 11–2

SALES FINANCE COMPANIES: MAIN RECEIVABLES[a]

—	Consumer Goods			"Wholesale" Finance	Commercial & Industrial			Total
	Cars	Other	Total		Vehicles	Other	Total	
	$ millions							
1951	161	24	186	108	95	33	128	421
1953	411	105	516	115	123	61	184	816
1955	478	121	599	145	106	85	192	936
1957	636	144	780	202	135	153	288	1,269
1959	610	196	806	197	138	206	344	1,346
1961	569	187	756	184	138	257	395	1,335
1962	593	179	771	237	146	279	425	1,433
	Percent distribution							
1951	38.2	5.7	44.2	25.7	22.6	7.8	30.4	100.0
1953	50.4	12.9	63.2	14.1	15.1	7.5	22.5	100.0
1955	51.1	12.9	64.0	15.5	11.3	9.1	20.5	100.0
1957	50.1	11.3	61.5	16.0	10.6	12.1	22.7	100.0
1959	45.3	14.5	59.8	14.6	10.2	15.3	25.5	100.0
1961	42.6	14.0	56.6	13.8	10.3	19.2	29.6	100.0
1962	41.4	12.5	53.8	16.5	10.2	19.5	29.7	100.0

[a]This Table does not include some additional business receivables for which information is not available prior to 1960. A recently published DBS survey of financial institutions indicates that these receivables increased from $77 million at the end of 1960 to $259 million two years later. (See DBS publication No. 61,006.)

borrowers, up to 16% on loans of $5,000 or less.[16] Some companies specialize more than others in this business, either through their regular organizations or in separate business lending divisions. The financing of farm equipment and machinery has been a growing source of business for some companies, with lending particularly focussed on larger items. While the larger companies have not neglected the opportunities available to them, some smaller companies have been particularly successful in equipment financing, their aggressiveness in this direction reflecting to some extent the fact that larger companies have some advantage in automobile financing. A classification submitted to us shows the share of all kinds of financing held by the three largest companies declining, but falling particularly rapidly in commercial and industrial lending.[17]

In addition to this equipment financing, which some companies have done for years and is in many ways similar to consumer goods lending, sales finance companies are moving into many new types of medium-term business lending quite unlike their traditional instalment finance business. Some are doing mortgage lending, some provide interim financing on real estate and construction, and some have established subsidiary companies which will invest in residential and business mortgages up to 80% or more of property value. Finance companies are also engaged in property and equipment leasing, although with the exception of a growing automobile fleet management business which the companies and their dealers are well-equipped to service, equipment leasing is not as widespread as in the United States, partly owing to different taxation treatment.[18] Commercial financing and factoring—the financing of business receivables by lending against them or, in the case of factoring, by purchasing them outright—is also developing and some sales finance companies are competing with the twenty or so small companies which specialize in this type of lending. However, it is not as well-developed a

[16] Supplementary Submission of the Federated Council, pages 11-13.

[17] Tables 2.2 to 2.6, Submission of the Federated Council.

[18] Transcript, pages 5384-89.

business in Canada as in the United States, largely because the chartered banks normally handle such credit needs at rates well below those charged by factors: sales finance company activity is not yet large and the other companies probably do not have assets in excess of $30 or $40 million.

The available statistics on these and other new types of business lending do not give a complete picture of its growth. However, a new DBS publication[19] shows that at the end of 1962 the finance companies had business lending of $259 million (compared to $77 million in December 1960) in addition to the $425 million of commercial vehicle and equipment financing shown in Table 11-2. Growth of the magnitude indicated by these figures has brought the companies into competition with other established lenders. In their submission and at the hearings they expressed particular concern about the rapid expansion of the Industrial Development Bank which they feel to be in direct competition with them. They argue that the I.D.B. has made loans to many businesses which they were willing to finance, although at more than the I.D.B. rate, and cite evidence of I.D.B. funds being used in part to refinance loans they were already carrying.[20] This raises the important question of the proper role of the I.D.B. in relation to the private financial system, a subject which will be taken up in the next chapter.

Finance companies have also diversified their activities by investing in companies ranging from the steel to the trust industries, and by establishing or acquiring subsidiaries in other fields. A number of them have subsidiary insurance companies whose main business is the insuring of their instalment sales contracts but which also engage in a more general business, and one has acquired a substantial interest in an established life insurance company. Another company has diversified by acquiring instalment finance operations in the United States, the Caribbean area, and Western Europe. However the most common form of sales finance company expansion through subsidiaries is for them to move into the consumer loan business.[21] The continued expansion of the latter type of consumer credit and the high returns available in such lending have made diversification in this direction very attractive, and investment in the equity and debt of small loans subsidiaries by the ten largest companies rose from $17 million in 1954 to $141 million in 1961.[22]

(ii) *Consumer Loan Companies*

In contrast to the instalment finance companies, the consumer loan companies have pretty well remained in their traditional field of making cash loans, although some of them also do an instalment finance business. At the end of 1961, 71% of the companies' main assets were in loans under $1,500 which were subject to regulation, 22% in larger cash loans and 7% in conditional sale agreements. By contrast, before the level to which the Small Loans Act applies was raised from $500 to $1,500 in 1957 about three-quarters of the companies' cash lending was unregulated.

Within the regulated small loans category itself, there is a tendency for the average size of loan to rise—the average loan was for $429 in 1961 compared to $282 in 1957—but it is striking that a very low proportion of loans is made in the $1,000 to $1,500 range. This is not because there is little demand for loans over $1,000—about one-quarter all cash lending is in amounts over $1,500—but because the companies find the ½ of 1% a month maximum rate allowed on balances in the $1,000 to $1,500 range barely covers their cost of funds and in fact involves them in losses after administrative and bad debt expenses. On balances up to $300 they may charge a maximum of 2% per month, reflecting the higher relative costs of administering and initiating these loans, while on balances from $300 to $1,000 the maximum is 1% a

[19] Publication No. 61.006: *Business Financial Statistics, Selected Financial Institutions.*

[20] See the Supplementary Submission of the Federated Council, pages 30-41.

[21] For subsidiaries of the ten largest sales finance companies, see supplementary submission, pp. 2 and 3.

[22] *Ibid.*, pages 16-18.

TABLE 11-3

PRINCIPAL ASSETS OF CONSUMER LOAN COMPANIES

—	Small[a] Loans	Loans over $1,500	Sub-total	Conditional Sale Agreements	Total
	$ millions				
1951	—	—	114	—	114
1955	—	—	273	16	289
1958	316	66	382	31	413
1959	360	86	446	46	492
1960	392	112	504	52	556
1961	426	133	559	42	601
	percent distribution				
1951	—	—	100.0	—	100.0
1955	—	—	94.5	5.5	100.0
1958	76.5	16.0	92.5	7.5	100.0
1959	73.2	17.5	90.7	9.3	100.0
1960	70.5	20.1	90.6	9.4	100.0
1961	70.9	22.1	93.0	7.0	100.0

[a]That is loans up to $1,500. Data for earlier years not shown because the definition of small loans was raised from $500 in 1957.

SOURCE: Reports of the Superintendent of Insurance. Small amounts of conditional sales financing for business customers are included and the totals are therefore somewhat larger than the consumer credit figure shown in Table 11-1.

month.[23] On unregulated loans over $1,500 the companies' rates seem to average about 1½% monthly. Thus the scale of permitted rates distorts the availability of loans within the regulated field, while there is no regulation of the substantial amount of larger lending. It is most important to protect small borrowers but we think it desirable that a more realistic rate structure be adopted and that it apply not only to the consumer loan companies but also to other personal lenders, and will make recommendations to that effect in Chapter 19.

Most people who approach the loan companies are not in a position to borrow from another institutional lender because of their relatively low income levels and high debts. About 80% of loans are made to those with monthly incomes

[23] In their submission to us the Canadian Consumer Loan Association indicate for instance that the maximum charges on a $1,000 loan work out to an annual rate of 17.76% and those on a $1,500 loan are 15.24%. Some methods of calculation give slightly higher annual yields.

SIZE DISTRIBUTION OF NEW LOANS DURING 1961

—	Number of loans	Amount
Up to $300	33.2%	11.8%
$300 to $500	17.9%	12.9%
$500 to $1,000	46.9%	70.7%
$1,000 to $1,500	2.0%	4.5%

SOURCE: *Report of the Superintendent of Insurance, 1961.*

below $500, many of them clerical and relatively unskilled workers, while 75% of the amount lent in 1961 was to people who were already borrowing from consumer loan companies. The Act is designed to protect these unsophisticated borrowers by prohibiting the making of two loans to different members of one family in order to take advantage of the higher maximum rates on smaller loans. It also specifies that an increase in an original loan which brings the combined total over $1,500 shall continue to be regulated, but we were told by both the companies and the Superintendent of Insurance, who administers the Act, that it was considered perfectly legitimate to pay off an existing loan first and then replace it with an unregulated loan of more than $1,500. This seems to us illogical, and we recommend that future legislation be designed to prohibit the practice.

The companies interview applicants carefully and in practice accept only about one-half of them. In some cities they have set up information centres to insure that no one borrows from more than two companies but each company carries out its own investigation. Debt consolidation and payment for such essentials as clothing, medical care and household upkeep are common reasons for borrowing, but the companies also make substantial amounts of small loans for less pressing purposes—travel and holiday expenses and automobile purchases each accounted for 11% of loans in 1960 and the latter accounted for a considerably higher proportion of the dollar amounts lent.[24]

[24] See Table 6, submission of the Canadian Consumer Loan Association.

As a general rule, all loans under $1,500 are made at the maximum permitted rates, and are granted for the maximum term permitted by the Act. The companies may not charge more than 1% per month on loans of $500 or less made for a period longer than 20 months or on loans from $500 to $1,500 made for longer than 30 months, the idea being that these longer loans are cheaper to administer in relation to the balances outstanding. There is very little price or term competition in this rather special part of the financial system, although such competition does enter into the unregulated business. The companies therefore rely heavily on advertising, convenient location of well-marked offices in shopping districts, and rapid, efficient service to attract customers. In fact, the number of branches in the industry has risen almost as fast as the volume of business for just this reason, having almost doubled in the seven years ending in 1961 to the point where the industry now has a quarter as many offices as the chartered banks.

SOURCES OF FUNDS

In their early years, sales finance companies obtained most of their funds either from stock issues and retained earnings or by bank borrowing. Prior to World War II there were only a few public debt issues, some of which were retired during the war when the total business of the companies declined. However, their rapid post-war expansion led them to supplement equity and bank funds by the issue of a wide variety of notes, bonds and debentures, and about two-thirds of the liabilities of larger companies are now in this form. On the other hand, smaller companies with less ready access to the main financial markets continue to rely heavily on bank loans and equity.

The finance companies were the first substantial borrowers other than the federal government in the Canadian short-term market, and their efforts to develop and improve this source of funds have contributed much to its growth. Indeed, they are still the largest single group of

TABLE 11–4

LIABILITIES OF SALES FINANCE COMPANIES[a]

—	Bank Loans	Short Term Notes	Long Term Notes[b]	Bonds and Debentures	Other Liabilities[c]	Capital and Reserves	Total
			$ Millions				
1953, 10 largest companies	191	212	140	104	108	84	839
1957, 10 largest companies	156	409	227	193	158	143	1,286
1962, 10 largest companies	90	515	691		277	241	1,814
1962, all other companies	65	49	44		37	47	242
1962, TOTAL	155	564	735		314	288	2,056
			percent distribution				
1953, 10 largest companies	22.8	25.2	16.7	12.4	12.9	10.0	100.0
1957, 10 largest companies	12.1	31.8	17.7	15.0	12.3	11.1	100.0
1962, 10 largest companies	5.0	28.4	38.1		15.3	13.3	100.0
1962, all other companies	26.9	20.2	18.2		15.3	19.4	100.0
1962, TOTAL	7.5	27.4	35.7		15.3	14.0	100.0

[a]The 10 largest companies are those reported in the submission of the Federated Council of Sales Finance Companies. Data for 1953 and 1957 are from Table 6–1 of the submission and refer to fiscal year ends. Calendar year end data for 1962 are from the D.B.S. survey of sales finance companies.

[b]Two years and over.

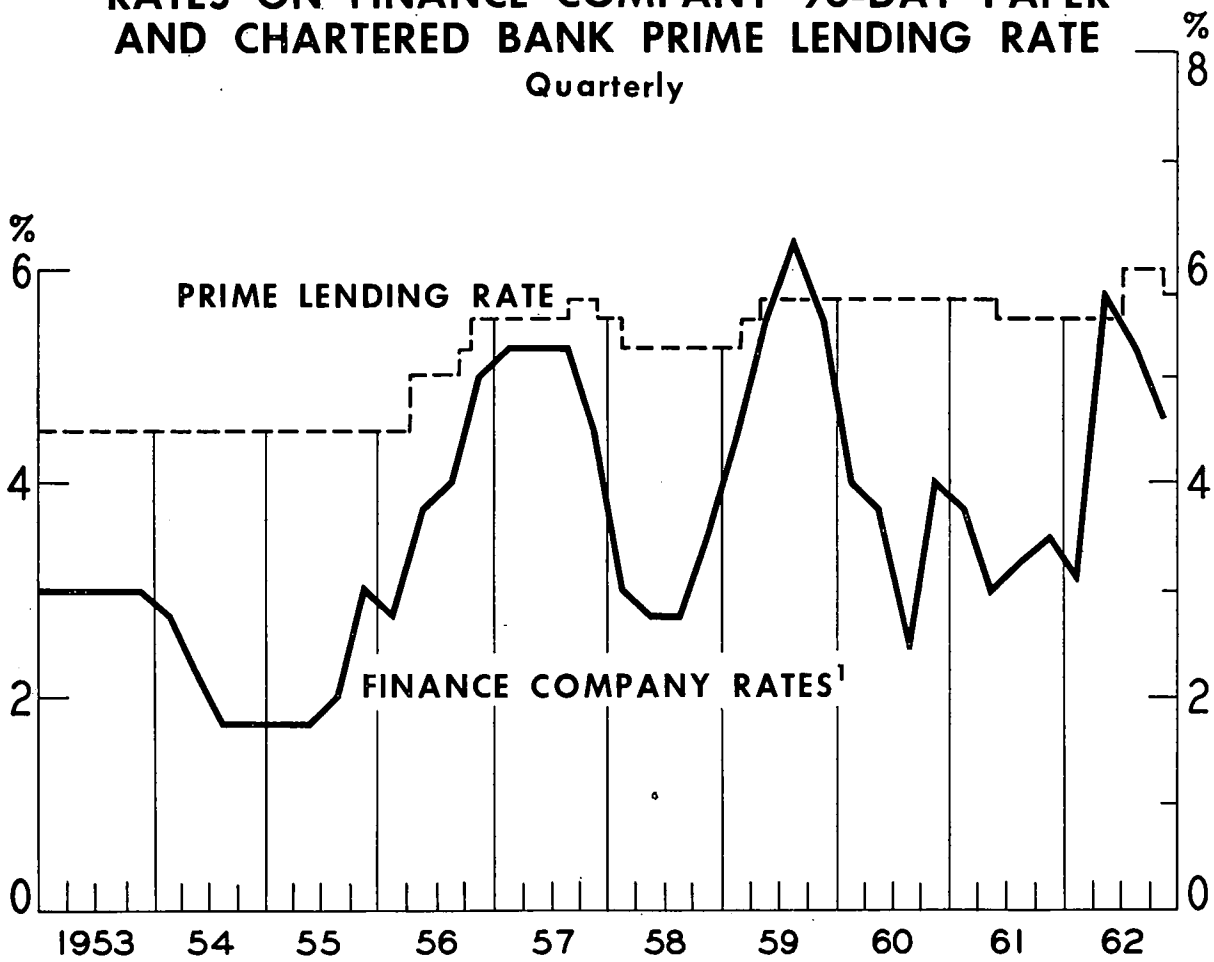
[c]Principally accounts payable, unearned service charges and dealer reserves.

borrowers in the money market despite the many others who have since entered it, and more than one-half of all outstanding short-term paper is normally issued by twenty sales finance companies who are regular borrowers, a high proportion being issued by a few large companies. As indicated in Chapter 7, the companies have developed this alternative to short-term bank accommodation both because the interest cost is usually lower and because their bank lines of credit were severely cut back in periods of credit restraint. As Chart 11-1 shows, the sensitive rates on their paper come down to levels well below the more inflexible chartered bank lending rate in periods of easy money, providing a strong incentive to borrow outside the banks. Moreover when bank funds were cheaper than market rates for fairly brief periods in episodes of tight credit conditions, the restrictions on bank lines prompted them to rely more heavily on non-bank sources.

Chart 11-1

RATES ON FINANCE COMPANY 90-DAY PAPER AND CHARTERED BANK PRIME LENDING RATE

Quarterly



1. This is an average quarter-end prime finance company rate: some companies were paying higher rates, particularly at peaks in the interest rate cycle.

Data supplied by the ten largest sales finance companies showed that their bank credit lines were cut by 21% in 1956-57 and by 50% from 1959 to early 1960, although outstanding amounts of loans actually rose in both periods and the share of lines in use rose from 52% to 81% in the first episode and from 26% to 91% in the second.[25] Similar information from the consumer loan companies revealed the same pattern: lines of the biggest companies were cut by more than 20% in the first period and by 10% in the second. For the smallest companies surveyed, however, there was actually an increase in 1956-57, although their credit lines were sharply curtailed in 1959-60; in contrast to the sales finance companies, use of these reduced borrowing rights showed a mixed pattern of increases and decreases.[26]

Most of the market paper issued by the companies is sold through investment dealers, although there has been a trend towards private placements and some companies now sell most or all of their paper in this way. The companies post rates at which they are prepared to borrow for the standard under one-year maturities; some also regularly take funds on terms up to six years while others will occasionally negotiate the size and terms for such medium-term borrowing to suit the lender. Because the market now includes a large number of Canadian and American investors who are accustomed to using finance company paper as a short-term investment, the finance companies find it a reliable source of short-term funds. They may at times have to pay high rates and do a more strenuous selling job to attract lenders, but only in rare instances has the market "dried up" for a particular company and even then not for more than a few days.[27]

In addition to their short-term paper, the finance companies issue secured notes and debentures for terms up to 20 years. The notes are sold primarily to insurance companies and other financial institutions, while the debentures, which are not specifically secured and normally yield slightly more, are acquired by individuals as well. This long-term debt is usually sold through underwriting syndicates managed by the companies' fiscal agents although direct placements have occurred. Part of the increase in long-term debt shown in Table 11-4 has resulted from efforts by the companies to anticipate future needs by borrowing long in years such as 1958 when interest rates are relatively low, but as a general rule they have not obtained their long-term funds at low rates. This is because it is during periods of easy money and slack demand in the economy that the volume of their lending business is least favourable and short-term debt is already being reduced by the proceeds of maturing sales finance contracts. The companies are unwilling to reduce their short debt too much for fear of losing their borrowing lines at the banks and weakening their short-term market contacts. Thus, more of their long-term issues were sold in periods like 1956-7 and 1959 when the demands on finance companies were strong, bank lines of credit were under restraint and the companies were anxious to assure themselves of adequate funds to meet the needs which they foresaw.

A number of companies have also issued long-term notes and debentures and invested the funds in readily marketable securities at lower yields in order to provide a cushion of liquidity to replace that formerly provided by bank lines. Since the companies do not feel they can rely on their bank lines of credit as they once did, their holdings of marketable securities rose from virtually nothing in 1957 to about $100 million, or 6% of assets, in 1959, and have fluctuated between $50 and $100 million since then.[28] The companies which have invested in marketable securities ap-

[25] Submission of Federated Council of Sales Finance Companies, Table 6:5. The reductions amounted to $69 million from the end of 1955 to March 1957 and to $194 million in the year ending March 1960.

[26] Submission of Canadian Consumer Loan Association, Table 24.

[27] Transcript pages 1630, 5437-39.

[28] Earlier figures relate to the ten largest companies only.

parently feel that the cost involved is reasonable, and did not generally accept a recent offer by the banks of firm lines of credit for six months in return for a fee. The companies hold this liquidity partly as a reserve to meet unexpected business demands and partly to guard against temporary difficulties in raising funds in the short-term market; it also serves as a reassurance to money-market lenders that they will be able to redeem their commercial paper at maturity even though bank lines may have been curtailed.

Whatever their own views about the form of their borrowing, the finance companies' freedom is restricted by the terms of trust deeds covering their notes, debentures and other debt. Although the companies are not subject to any legislative borrowing limits, apart from the implied or specific prohibition on taking deposits, the underwriters and the investors on whom they rely for funds in effect impose what they consider a sound capital structure. The terms of trust deeds are not uniform, but a common rule is that unsecured debt must not exceed shareholders' equity and that secured debt should not be more than four times the sum of equity and unsecured debt. Thus in the normal case a finance company is subject to an effective 10% minimum capital ratio, a figure higher than that of other financial intermediaries but less than that applying to non-financial borrowers, which of course do not have such a diversified portfolio of liquid receivables; the actual capital ratio for the industry as a whole at the end of 1962 was 14%.

These limits on capital structure, together with the lenders' scrutiny of the receivables put up as security for the notes and the normal examination of prospectuses by the securities commissions, provide the main protection to those lending to finance companies. So long as the companies draw their funds from well-informed investors able to judge their soundness, or even from the general public through the securities markets where a satisfactory prospectus is required, there does not appear to be any reason to impose inspection and supervision comparable to that applying to banks, trust and loan companies, credit unions and other institutions which borrow generally from the public by means of deposits. However, this freedom from government inspection cannot safely be extended to firms which do accept such funds or their practical equivalent from the public: in the life of this Commission we have had more than one instance of serious abuse and some provincial governments have taken steps to prevent recurrences. We do not conclude from these experiences that all finance companies—using the term very generally—should be precluded from taking deposits. Nevertheless, quite apart from fraudulent enterprises, there are many small and over-extended firms in the industry which got into the business in the days before competition stiffened. As long as these firms deal with the banks or other skilled lenders, or raise funds purely from friends and associates, no problem of the public interest is involved. If however, finance companies generally are to get into the taking of deposits, they clearly must be able to meet high and continuing standards of supervision and inspection in the same way as other institutions doing a similar business.

In contrast to the instalment finance companies, the small loans industry has not substantially changed its financing sources in recent years. Table 11-5 shows that its capital structure is relatively uncomplicated. Large companies obtain funds from their American parent or Canadian instalment finance company owner and small companies rely mainly on the chartered banks and their own shareholders. Some of the larger companies have sold short-term market paper but the amount is relatively small for the industry as a whole. The larger independent companies usually borrow short initially and then fund into long-term debt once they are reasonably certain that the higher volume of business will continue. Capital ratios are slightly below those in the sales finance industry, but since the distinction between shareholders' equity and long-term debt held by the parent is fairly artificial in the case of the wholly-owned subsidiaries which account for so

TABLE 11–5

LIABILITIES OF CONSUMER LOAN COMPANIES[a]

—	Owing to Parent and Associated Companies	Bank Loans	Short Term Notes	Other	Shareholders' Equity	Total
	$ millions					
Dec. 31st						
1960	333	72	31	35	54	526
1961	367	49	39	38	62	557
1962	404	51	59	46	74	633
	percent distribution					
1960	63.3	13.7	5.9	6.7	10.3	100.0
1961	65.9	8.8	7.0	6.8	11.1	100.0
1962	63.8	8.1	9.3	7.3	11.7	100.0

[a]DBS, *Business Financial Statistics, Balance Sheets,* publication No. 61,006. This new survey covers about 90% of the industry: we use it in this table because other sources do not break down borrowings into the main categories shown here.

much of the industry, this figure can only be regarded as approximate.

REVENUES AND EXPENSES

Because of the high expenses associated with numerous small branch offices and the initiation, processing and collection of small loans, the administrative expenses of the consumer loan companies are the highest of any class of financial institution. As a result of improving efficiency and some reduction in advertising outlays, these expenses have declined a little in relation to total assets during recent years, although they are still close to 7%. In addition, bad debt losses are high compared to those of other institutions, but appear to have stabilized at around 1% of assets, the level experienced by the more mature American industry. Gross revenues of the companies, meanwhile, have declined somewhat because of the higher ceiling on the size of regulated loans as well as the growth of large loan business and conditional sale agreements which yield less than the typical-sized small loan. Nevertheless, at 17.6% of assets in 1961 they are considerably higher than those of the sales finance companies, which were about 11% on a comparable basis,[29] and well over the gross revenues of the major financial institutions doing a lower-cost and lower-risk business. Reflecting the nature of the consumer loan companies' business and the long-term character of their liabilities, interest costs are also higher than those of other institutions, amounting to 4.7% of assets in 1961 compared to under half as much for the chartered and savings banks and about 3½% for trust and mortgage loan companies.

Nevertheless, net profits after taxes remain high compared to other major institutions and at

[29] Revenues reported to us by the sales finance companies are net of dealer reserves and other costs of acquisition of business which together probably amount to about 1½% of assets.

REVENUES AND EXPENSES

(percent of total assets)

—	Sales Finance Companies[b]			Consumer Loan Companies[c]	
	1954	1957	1961	1957	1961
Revenue[a]	10.1%	9.7%	9.7%	18.0%	17.6%
Less: administrative expenses	3.2	2.7	2.7	7.7	6.8
NET	6.9	7.0	6.9	10.3	10.8
Less: interest on borrowed funds	3.2	3.9	3.7	4.1	4.7
NET	3.7	3.1	3.2	6.2	6.1
Provision for losses and reserves, net	0.5	0.3	0.5	1.1	1.1
Taxes	1.6	1.3	1.4	2.3	2.6
Net Profit	1.6	1.5	1.4	2.9	2.4
Dividends	1.1	0.9	0.9	0.9	1.5
Retained Earnings	0.5	0.6	0.5	2.0	0.9

[a]See footnote 29.
[b]Ten large companies.
[c]Prior to 1957 the definition of small loans was different so that the revenues and expenses reported by the Superintendent of Insurance are not comparable with later years.

2.4% of assets are more than double those of the mortgage loan companies. Profits in relation to equity also appear to be more than double those of mortgage loan companies and the banks, the latter of which operate with much lower equity ratios. It is therefore not surprising that sales finance companies have been attracted into the personal loan business and that increasing competition has already started to bring about a noticeable decline in profit rates.

In spite of increased competition in the consumer field and the shift to business lending, on which rates are generally lower, the gross revenue of the sales finance companies has declined only marginally in relation to assets in recent years. The average rate earned on all wholesale financing has dropped by 1¼% to about 6½% since 1954, but retail rates have actually risen slightly to about 11¼%, net of dealer reserves, reflecting the somewhat higher rates charged on lower quality consumer business in which the banks are not active competitors. Administrative expenses have declined relatively as the companies have been under pressure to improve efficiency, and at 2.7% of assets are about ½ of 1% above those of the banks; they would be considerably higher if dealer reserves were included in the figures. Interest on borrowed funds, at 3¾% of assets, is 2% above that of the banks but not much higher than that paid by the trust and loan companies. The inability to borrow by deposits is a factor in these higher costs and explains why some companies are anxious to receive deposit-taking powers, although the greater share of longer-term debt with which the industry would almost certainly continue to operate in any event is also a factor.

Reflecting the riskier business which demand and competitive factors have led the companies to undertake, loss ratios appear to have risen very slightly on the average in recent years. While at ½ of 1% of assets these are considerably above those of the banks, they are less than half those of the consumer loan companies and have been kept manageable by the companies' efficient credit-rating and collection systems. Net profits per dollar of assets have been reduced in the last decade by the competition of new entrants and other institutions and by the shift towards business lending. The rate of return on equity has declined from 14.2% in 1954 to about 11% currently, at which level it is still above that of most intermediaries. Since the volume of business of the industry has, however, continued to grow, total profits of the ten leading companies have increased despite these lower margins, from just under $19 million in 1957 to $22¼ million in 1961. Margins may well fall somewhat further in future since it does not appear that the competitive adjustment of market shares with other institutions is yet complete, and the companies may lose further ground relatively.

FINANCE AND LOAN COMPANIES IN CREDIT CYCLES

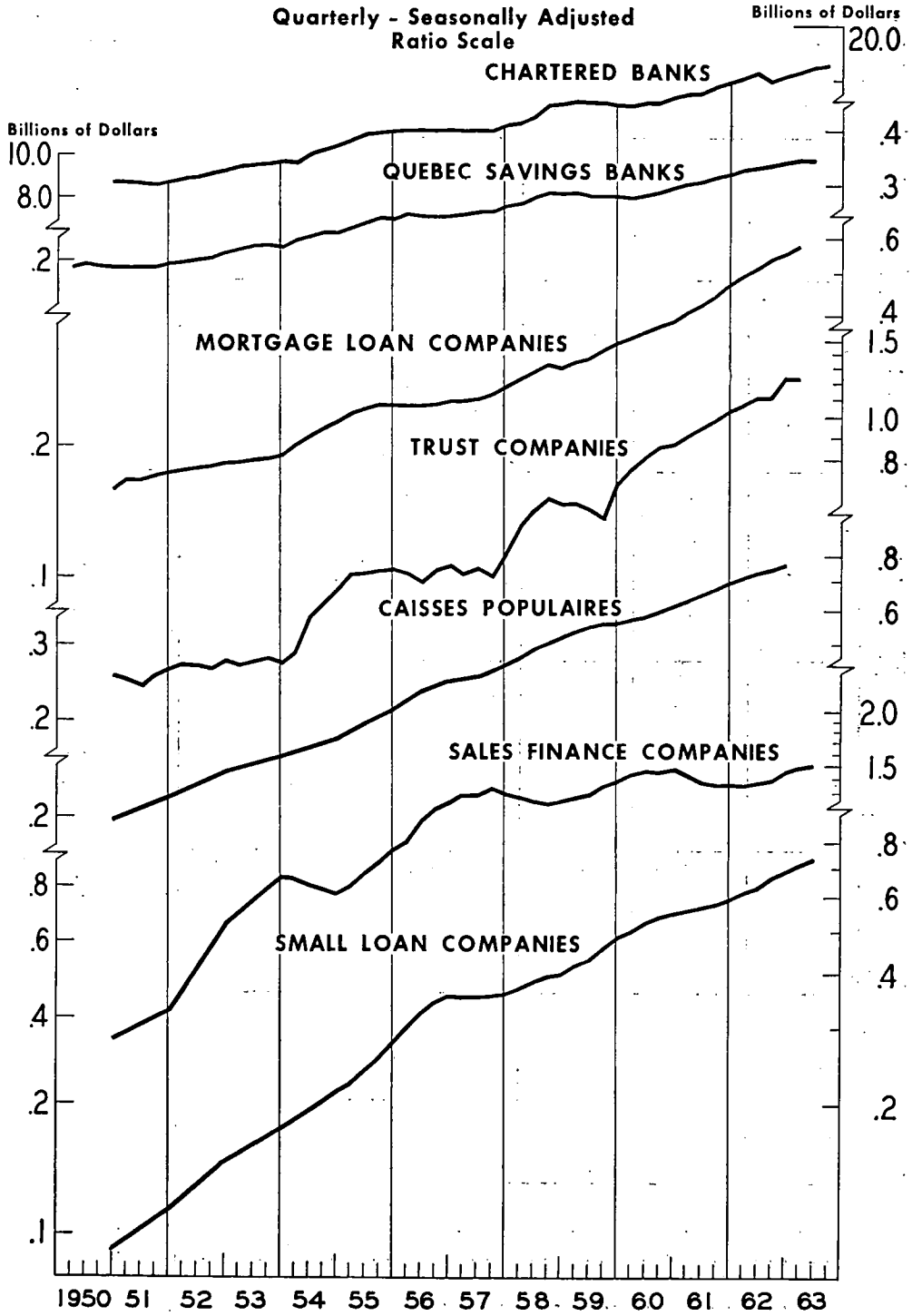
The cyclical behaviour of the sales finance and consumer loan companies has been strikingly different from that of the institutions discussed in previous chapters. Although the others do not all respond identically to changes in monetary policy, it has generally been true that high levels of interest rates have been associated with a slowing in their growth, or even an absolute decline in their assets, and with tighter restrictions on the terms and amounts of credit available to those who borrow from them. Indeed, the restriction of the institutions' growth and higher rates of interest are the two essential characteristics of periods of credit restraint. Chart 11-2 compares the growth rates of the main short-term financial institutions discussed in this and preceding chapters. In order to bring out the cyclical behaviour of each type of institution more clearly we have estimated the trend of each series and removed it by expressing each original observation as a percent of the trend value at the same date. We must emphasize that the long-run trends cannot be precisely and definitely calculated, but we believe that the estimates of cyclical fluctuation shown in Chart

Chart 11-2

THE GROWTH OF SELECTED FINANCIAL INSTITUTIONS

Quarterly - Seasonally Adjusted

Ratio Scale

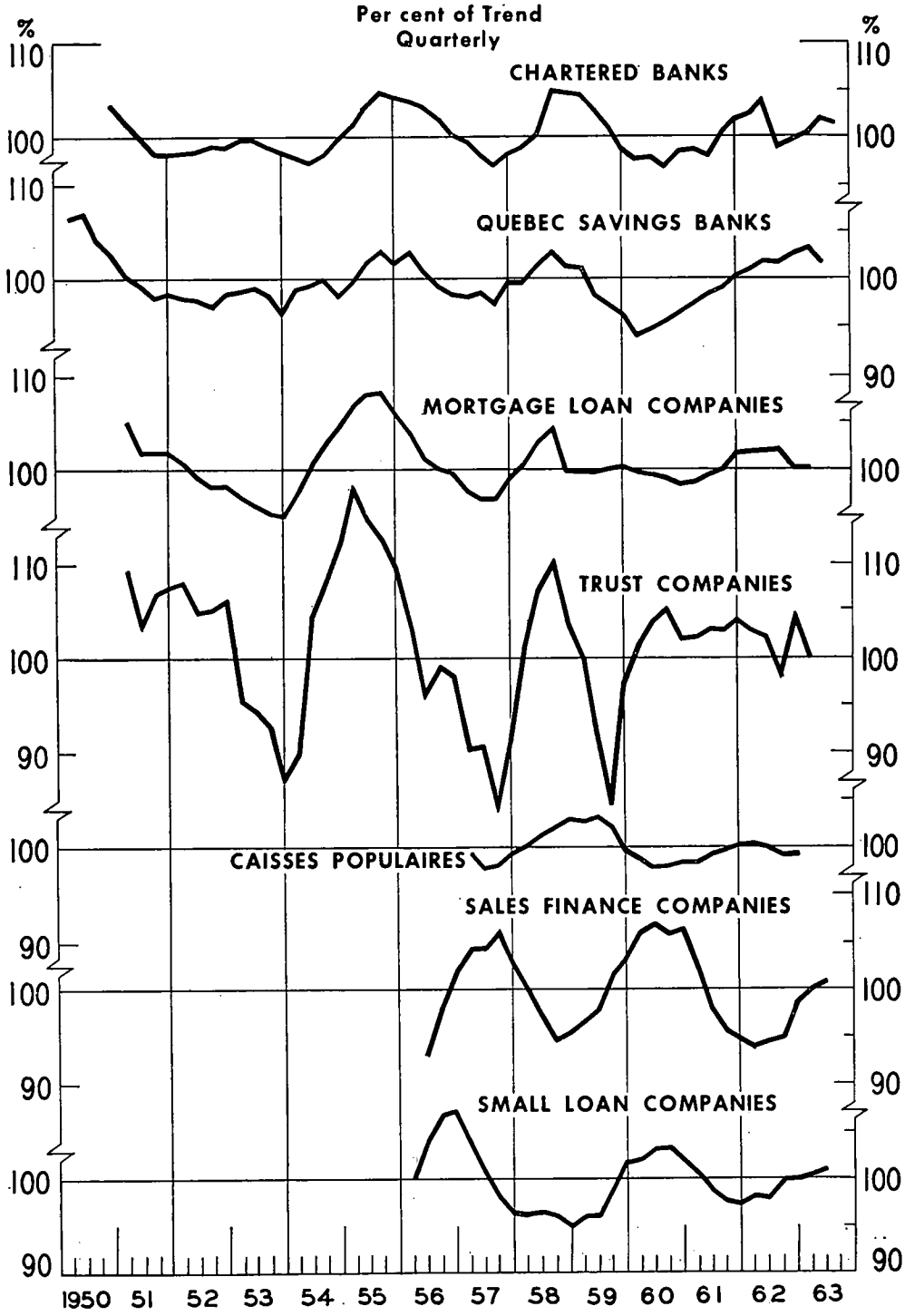


75319—15

Chart 11-3

FINANCIAL INSTITUTIONS : CYCLICAL FLUCTUATIONS

Per cent of Trend
Quarterly



11-3 fairly represent the behaviour of each institutional group.[30]

The cyclical behaviour of all institutions but the sales finance and small loan companies has been broadly similar. In periods of restraint such as 1955-57 and 1959 their rates of growth have fallen sharply when the central bank has brought pressure to bear on the system's cash reserves and interest rates have risen. Similarly, they all tend to expand rapidly at the same time, as in 1954-55 and 1958. On the other hand, the assets of sales finance and consumer loan companies have grown more rapidly than usual in years such as 1956 and 1959 when interest rates were high and the total resources of the other institutions were under pressure, and have grown less rapidly or declined in periods of easier money.

This is not because the companies' earnings and growth are unaffected by the higher cost of funds associated with monetary restraint. However, the business of sales finance and consumer loan companies has been much more influenced by the demand for funds from their customers than by the cost and availability of funds from holders of their liabilities. Consumer demands for credit—like those in all sectors—have been strongest in economic expansions when consumers are optimistic and have high demands for automobiles and other durable goods, and consumers seem more prepared than others to pay relatively high rates of interest for the credit needed to go ahead with their purchases. Thus, institutions specializing in lending to them are able to take on earning assets quickly and, because the yields on these assets are high, are able to pay the high rates necessary to attract funds even in periods of credit restraint. Moreover, finance companies are able to charge higher rates on their business lending than the banks are permitted. The process is made easier for them by the fact that they rely for funds mainly on a limited number of sophisticated lenders in the central financial markets; these lenders, being much more sensitive to rates than the general public from whom other institutions borrow relatively heavily, will make substantial amounts of additional funds available to the companies if attractive rates are offered.

This, of course, is how a price system should work. The cyclical behaviour of the liabilities of sales finance and consumer loan companies shows that funds do flow to the borrowers willing to pay most for them, particularly when rates are high and funds are limited. Thus, the fact that lending by sales finance and consumer loan companies rose in the tight credit conditions of 1956-57 and 1959 is not evidence of a failure in the workings of general monetary policy but of an appropriate response to market forces. It should also be recalled that bank lending was rising through much of this period in response to rising loan demand from both business and consumers, even though the total assets of the banks did not grow significantly. The banks were able to finance this increased lending by running down their holdings of more liquid assets in which, unlike the finance companies, they find it profitable to invest on a large scale when loan demand is weak. A comparison of the growth of the sales finance companies' receivables with that in bank general loans in the periods of most rapid cyclical increase, when total bank assets were under restraint, shows that from mid-1955 to

[30] The growth of sales finance companies in recent years is underestimated as the series used does not include the "other receivables" item for which information is not available prior to 1960. Cyclical indexes for the caisses populaires are not calculated prior to 1957 because quarterly data is not available although annual data is available for earlier years to aid in estimating the trend. Because of the pronounced change in the growth rates of sales finance and small loan companies in 1956-57 we have not been able to calculate trends for the entire period: despite the difficulty of estimating a trend for such a short period we believe that the cyclical fluctuations shown in Chart 11-3 are broadly accurate.

The following seasonally adjusted quarterly series are used in Charts 11-2 and 11-3:

Chartered Banks:	currency and total chartered bank deposits.
Quebec Savings Banks:	deposit liabilities.
Mortgage Loan Companies:	deposits and debentures of 4 companies; see the appendix volume.
Trust Companies:	deposits and certificates of 11 companies; see the appendix volume.
Caisses Populaires:	deposits of the Fédération de Québec des Caisses Populaires Desjardins.
Sales Finance Companies:	the receivables shown in Table 11-2 of this chapter.
Small Loan Companies:	total loans.

mid-1956 the increase in bank loans was $875 million, or about 27%, compared to an increase for the companies of $279 million, or 31%. In the year ending in September 1959, bank loans actually rose more rapidly, 23% against 9% for finance company receivables; the absolute increases were $950 million and $110 million respectively.

Thus, although the total assets of the companies and the banks behave differently during much of a period of restraint, their lending response has been much the same. In the latter stages of such periods, however, after the banks' lending has virtually ceased to grow, the finance companies have continued to increase their receivables, particularly from business, because of their continued ability to attract funds. For example, the banks' loans rose by 5% from mid-1956 to mid-1957 while the instalment finance companies increased their receivables 16%.[31] In the six months following September 1959 when the banks' general loans declined about 3% after allowance for seasonal variations, finance company receivables rose a further $85 million or 6%. It may be that in future the sales finance companies will be somewhat more sensitive to credit restraint in view of the increasingly close competition with the banks on both sides of their business, and in particular because their reduced margins make it more painful than formerly to absorb the increased cost of funds.

The assets of consumer loan companies have also increased more rapidly in periods of monetary restraint than in other years. They expanded by about $80 million in 1956 and 1959, the rates of increase being 28% and 21% respectively, compared to rates varying from 2% to 13% in the intervening years. The rates charged by consumer loan companies do not increase much in such periods, being at or near the maximum in any event for all regulated loans, but the lower per-unit administrative expenses of this increased business volume enable them to compete profitably for the extra funds they need, though in some cases with reduced profit margins.

Despite this growth, the record and their evidence before us make it clear that sales finance and consumer loan companies are still affected by changes in the financial climate. We have already referred to changes in the structure of sales finance company liabilities which have resulted from their ingenuity in developing cheaper sources of funds and from restriction of their bank loans in periods of tight money. Bank loans are the only main source of their funds which is not responsive to higher interest rates, partly because of the existence of the 6% ceiling. It will be recalled that bank borrowing actually increased despite the cuts in bank lines in periods of tight credit, but the companies able to do so turned to other sources, particularly the market for their short-term paper. The short-term notes of the ten instalment finance companies surveyed rose from $238 million at the end of 1955 to $331 million a year later and $444 million in mid-1957. However, even for these companies with ready access to the market, funds could only be obtained at rates running as high as 6¼% on 30-day paper and 7⅛% on one-year paper in mid-1957 and mid-1959.

For reasons suggested earlier, the companies also committed themselves to long-term borrowings at high rates, and in some cases borrowed abroad.[32] Smaller finance and loan companies not having the option of market financing even at these rates or having no access to funds through parent companies, were more severely affected by the reduced availability of bank loans, in spite of the fact that the banks did not cut back as sharply on them as on large companies and have in fact exempted small accounts from the cuts in credit lines. There is no evidence that, as between the larger companies, American-owned firms fare particularly well in times of tight credit conditions: larger Canadian firms, and even a few smaller ones, have easy access to the New York market and make use of this source of funds whenever they find it attractive to do so.

[31] Because of the latter's smaller absolute size, the dollar amounts of the two increases were not much different, about $200 million for the banks and $180 million for finance companies.

[32] *Ibid.*, Tables 6:8 to 6:10.

Since the cost of funds did not deter consumer lending as much as desired, the Bank of Canada called representatives of the industry together in 1956 to propose an agreement directly limiting the expansion of credit. Such "voluntary" consumer credit controls were not in fact imposed because agreement among all companies could not be reached, and the authorities apparently did not think the situation serious enough to warrant special legislation. Selective credit controls, whether imposed by law or by agreement, aim at limiting credit flows by interfering with market forces and are designed to extend the range and impact of changes in credit conditions without affecting interest rates significantly. The question of whether such controls would make a substantial contribution to reducing consumer spending in a boom and of whether they are desirable in a market economy will be dealt with in our comments on financial policy.

With pressures building up on the cost and availability of funds, and direct and indirect attempts being made by the authorities to restrict their lending, finance companies have not been able to carry on through periods of credit restraint without changing their lending policies. Some smaller companies have been faced with an urgent need to retrench, and have done so in spite of their desire to maintain their markets and continue to serve them. Larger companies, whose business dominates the industry, have been able to delay adjustments by turning to alternative sources of funds, but they too have altered their lending policies.

Wholesale lending policies appear to be altered first, both by raising the rates charged and by advising dealers to cut back on their inventories.[33] This is done either in circulars sent to them periodically or by direct contact from the company's regional superintendents or branch managers. However, the available data on wholesale lending indicate that these loans are not substantially affected by the changes in finance company policies. Their policy towards retail paper adjusts more slowly and with even less certainty. Thus the information supplied by the Federated Council shows the average of rates charged by the larger companies on a standard automobile contract rose from 16.2% in 1955 to 17.6% in 1956, but some companies apparently made no change in this period. In 1959, partly because of the competitive factors mentioned earlier, the average of reported rates rose only from 17.0% to 17.2% with 7 of 15 companies reporting no change.[34] While the companies tend to adjust both their wholesale and business lending rates to short-term changes in market rates, the consumer retail rates are less sensitive, moving more in line with longer-term changes in rate levels than with short-run developments.

In addition to adjusting their lending rates, the companies have taken such steps as sending circular letters to branches admonishing them to try and reduce dealer inventories and to tighten credit standards in retail lending. Circulars of this sort were sent out in 1956 and were strengthened during the year, including instructions to branches in some cases not to allow their outstandings to increase. The same approach was adopted in 1959, but as with the chartered banks it is difficult to judge the effect of such circulars. Outstanding amounts of credit continued to rise, although purchases of new consumer paper stopped increasing in mid-1956 and again towards the end of 1959, after allowance for seasonal movements. On the other hand, purchases of new commercial and industrial paper rose sharply in 1956 and again in 1959, and outstanding amounts continued to rise for longer than consumer credit.

Like the banks and other institutions, the companies are under competitive pressure to look after their dealers and other customers when business is good. Indeed, even if individual transactions are only marginally profitable, the companies must take a longer view. They cannot pull out of the business altogether, even for quite brief periods, and it is not surprising, therefore, that there are lags in their responsiveness to

[33] Submission of the Federated Council, Tables 4.4 and 4.5 as well as Transcript pages 1635-7, 1657.

[34] See submission of the Federated Council, Table 4.1. The rates quoted are a simple average of rates reported in the table and are not weighted by the amounts of business done at different rates.

changing credit conditions and that their business policy does not change completely when adjustments are made. Even more than the banks, whose reactions are also delayed and incomplete, the companies are affected by demand factors. Cyclical increases in their assets thus come to an end not primarily because of the state of financial markets and shortages of funds, although they have some influence, but because the demand for automobiles and the other goods they finance ultimately weakens. The situation of consumer loan companies is essentially similar, although they appear to make no major changes in their lending policies or in the freedom with which they grant credit, except for smaller companies which find themselves short of funds because of the reduced availability of bank credit. Subsidiary companies of Canadian and American firms are able to obtain all the funds they need from their parents and appear to be little affected by such difficulties.

CONCLUSION

The growth of personal demand for cash loans and credit to finance a variety of consumption needs, the willingness of the consumer loan and instalment finance companies to meet this demand in a convenient and easy way, and the diversification of the lending activities of the latter companies, have brought the two industries from small beginnings a generation ago to a position of prominence in the financial system. While competition from banks and credit unions in particular is continuing to have an effect on their profitability and growth, and may even lead to the winding-up or merger of some of the weaker units, the companies in general are in a strong position to continue to serve the needs of many borrowers. Moreover, many sales finance companies have carried on the pioneering tradition into which they were born and have moved actively into areas of farm, business and mortgage credit where there is a need for more aggressive and venturesome lending. They have also diversified their borrowing, and we will later have something to say about their deposit-taking powers.

The finance companies have said that they would welcome closer contacts than have so far been established with the Bank of Canada. Since such contacts would lead to a better understanding of the development of central bank policies and to improved co-operation when necessary in executing them, and since they would also improve the Bank's understanding of the industry's practices and problems, we believe they would be helpful to all concerned.

CHAPTER 12

SPECIAL CREDIT FACILITIES FOR SMALLER BUSINESS, AGRICULTURE AND EXPORTERS

The particular financial needs of small businesses, farmers and exporters have not always been completely met by the main security markets and the principal financial institutions already described. While these institutions supply the bulk of such borrowers' needs in the ordinary course of business, newer and more specialized private intermediaries have also developed to serve them. In addition governments have intervened to assist these borrowers either by insuring private loans or by direct lending.

SMALL BUSINESS FINANCE

In Chapter 3 we expressed the view that the substantial increase in the amounts and variety of finance available to small businesses has prevented the emergence of a serious gap in our financial system comparable to that found in the United Kingdom in the 1930's. However, evidence placed before us suggests that there is still room for improvement in the facilities serving the special needs of some of these borrowers.

In the area of short-term finance, the chartered banks are the main institutional source of funds for small as for larger businesses. We have already noted the tendency for banks to lend an increasing share of their resources to smaller borrowers, while many larger businesses have developed alternative sources of credit. Small businesses also obtain short-term accommodation from finance companies or such specialized enterprises as commercial financing and factoring companies. However, the quite modest growth and amount of these types of short-term credit (except in certain special areas such as automobile inventory financing) is evidence that most small businesses find the banks able to meet the bulk of their short-term requirements.

Bank term lending to smaller enterprises is, however, much more modest. On September 30, 1962, only $165 million of the $1,385 million of loans outstanding under lines of credit below $100,000 had been formally negotiated for repayment over periods longer than one year, although the share of funds lent on a term basis was slightly higher than in larger accounts and a sizable part of the remaining $1,220 million was undoubtedly used to help in financing capital expenditures stretching over a number of years. The banks have not expanded their formal term lending particularly rapidly because, as we indicated in Chapter 7, their traditional preferences incline them to direct their limited funds to short-term accommodation, while the 6% interest rate ceiling and mortgage prohibition have prevented them from levying the charges and obtaining the security appropriate to term lending to smaller borrowers. Medium and long-term lending by the chartered banks has thus fallen short of the needs of smaller businesses, and many other private and public sources of credit have consequently grown up to meet them.

In 1960, the Parliament of Canada enacted a Small Businesses Loans Act intended to increase the flow of bank term lending for plant and equip-

ment expenditures by providing a guarantee on loans with a maximum term of ten years. Firms with annual gross revenue of less than $250,000 may borrow up to $25,000 at an interest rate of 5½%, and in September 1963, $51 million of such loans were outstanding, principally to finance the improvement of premises. However, many of these loans would undoubtedly have been granted in the regular way in any event. There have been suggestions that the size limit should be raised and that eligibility should be based on total assets or a higher volume of sales. Any method of definition raises difficulties because of differences in the character of various types of business, but if the guarantee is to be maintained—a matter to which we return later—there might be advantage in a more flexible approach to eligibility.

"Small Business" is at best a vague term, but for present purposes it can be defined by reference to one of the financing problems such enterprises meet, namely that they are too small to sell equity and long-term debt issues in the capital markets where larger firms obtain a substantial part of their external financing requirements. As mentioned in Chapter 16, very few issues of less than $250,000 are sold, except to finance speculative oil and mining ventures. Some smaller industrial issues have been marketed (some of a speculative nature being sold at very high prices in relation to tangible assets or earnings) but in general this manner of financing is costly and unsuitable and is unlikely to become much more common for small companies than at present. For this reason the owners of new and established small firms must supplement bank borowings, their own funds and those of family and friends by turning to other institutional investors.

We have already noted in earlier chapters the growth of business lending by sales finance companies and the limited amount of such lending done by some credit unions.[1] The former lend both to their established customers, like automobile dealers, and to new clients wishing to invest in plant and equipment, although these borrowers are not all small businesses on any narrow definition of the term. Indeed, some finance companies regularly make loans of $250,000 to $500,000 but they deal mainly with businesses needing smaller amounts of medium and long-term credit. With almost $700 million of business lending outstanding at the end of 1962, equal to 27% of chartered bank business loans under lines of credit below $1 million and 52% of the amount lent under authorizations of less than $100,000, the finance companies have become a very important source of funds for smaller businesses.[2] The bulk of lending is either conditional sales financing of equipment purchases or the financing of plant acquisition and expansion, usually against mortgage security. Some finance company lending extends for 10 years or more, but most is intermediate-term credit to be paid off over five years or less. In shorter-term lending, finance companies and commercial financing firms now lend against receivables to various types of business, including small retail stores, which are thus better able to compete with larger stores having their own sales finance facilities for customers.

These institutions have not so far made equity investments other than in subsidiary financial concerns. Nor do they provide the management advice which a number of witnesses told us is frequently more important than additional financing to small businesses dependent on the abilities of one or at most a few people. They are thus straight lending institutions like the banks, although dealing with a somewhat different group of business customers. The sales finance companies and credit unions usually charge higher interest rates and are free to take all types of business mortgage security.[3] Some finance companies have set up separate divisions or subsidiary companies to handle particular

[1] Trust and loan companies also provide funds for businesses through investment in equity, bonds and mortgages.

[2] We have no size classification of finance company lending comparable to that available for the banks, but virtually all of it is in amounts of $1 million or less and a substantial part is known to be in loans of $100,000 or less.

[3] Some provincial legislation restricts the type and size of business loans which credit unions may extend. Much of their business lending is in the form of loans to co-operatives.

types of business lending for they find that the job of assessing the risks of advancing term funds to small firms requires special selectivity and skills.[4] The trust and life companies are also active suppliers of mortgage funds to smaller enterprises, but usually confine their operations to loans on factories and premises, some of which are of course leased rather than owned by small business. One life company, which has specialized in the field in the United States, purchases debt securities in amounts as small as $100,000 although it reports such business as slow in Canada. Most of the other companies believe that the volume of potential business is not high enough to offset the extra costs of acquiring special expertise in this field.

The need for specialized lending skills in dealing with small business financing was one of the reasons which led two chartered banks and three trust companies to join forces in 1962 to establish a subsidiary company, RoyNat Ltd., to provide "expanding and new Canadian businesses with financing beyond the normal scope of banking facilities". Through this company, the partners are able to combine the advantages of their extensive branch systems, the source of much of its business, with a specialized staff of bankers, accountants, engineers, lawyers and others in six offices across the country. The company is also free to take mortgage security—and normally does so—and to charge the rates above 6% which are appropriate to its business: its lending rates have so far ranged from 7¾% to 8½% and the average length of its loans, which are made for terms of from 3 to 10 years, has been 8½ years. As a matter of policy, it does not lend less than $25,000, and in its first year of business did not grant loans larger than $1 million, the average size being about $150,000. The company has some equity investments but participations are relatively small, control is avoided and directors are not appointed to borrowers' boards. At April 30, 1963, loans and accepted commitments of $15.9 million were outstanding and additional commitments of $5.4 million had been made to potential customers. Since its investments now exceed the original capitalization of $10 million, the company has started to borrow by issuing short-term market notes and longer-term obligations.

Another small business company recently founded by a group of 27 shareholders including insurance companies, banks and other financial and non-financial concerns, was also set up in the belief that specialists could better handle the risks and complexities of such financing than could any of its shareholders individually. Canadian Enterprise Development Corporation Limited (C.E.D.) operates in a manner similar to American Research and Development, one of its shareholders, and takes an equity position in each firm in which it invests, usually indirectly in the form of convertible debt. The Corporation has no objection to acquiring control of a company if the owners are willing to give it up, its main aims being to assist new Canadian firms or to help in establishing them when promising ideas come to its attention as well as to provide equity and long-term debt funds to established companies with particular growth potential. Although its interest centres on situations in which management is of better than average ability, the company is prepared to give technical and business advice to companies in which it invests—sometimes by using the facilities of the shareholders—and expects to have a voice in their affairs through its equity participation and appointed directors. It thus differs in concept from RoyNat, which is essentially a term-lending institution. In its first 10 months of operation, it made 4 investments totalling under $500,000, having chosen to move slowly until experience is gained.

A number of other development companies also seek equity investments in promising small companies, a notable example being the Canadian subsidiary of a British company, the Charterhouse Group Limited. Charterhouse, incorporated federally in 1953, has provided long-term debt as well as equity capital in amounts ranging up to $500,000. Unlike C.E.D., it is in-

[4] It will be recalled from Chapter 3 that the overall profitability of small business is slightly lower than larger businesses and that there are more loss companies; the job of selecting the good lending risks—which show above average profits—is therefore not an easy one, particularly in view of the personal nature of management.

terested only in established companies, but in common with C.E.D. its selection of investments depends very much on the quality of management and earnings prospects; the formal security offered for loans is a secondary consideration. At the time of its submission to us, it had accepted only 24 out of 1,100 formal applications and many more inquiries which did not reach the application stage. This acceptance rate is about the same as C.E.D. has experienced in its short life: the most common reason for refusing an application is a lack of competent management in the firm. There are a number of other private development companies active in Canada, many of them sponsored by foreign interests, and having varying investment policies[5] but they have not expanded rapidly. Among the reasons are the competition for such business from other less specialized lenders and the unwillingness of the owners of small enterprises to give up any equity to outside interests, even when a development company or other institution wishes to increase the firm's capital as a condition of granting long-term loans.

In addition to these and other private sources of funds, there are provincial and federal government agencies which lend to small businesses. The provincial development funds and similar facilities have been set up to assist local businesses unable to obtain funds from other sources, including the federal Industrial Development Bank. Some—as in New Brunswick, Newfoundland and Saskatchewan—may either lend directly or guarantee the repayment of funds to other lenders; in contrast, the Ontario Development Agency confines itself to guarantees, while still other provincial agencies make only direct loans. Their rates of interest are usually relatively low, indeed lower than the I.D.B. lending rate which is itself below those of competing private institutions. The term of loans is frequently limited by legislation to 10 years, but in at least one case may be for as long as 20 years.[6] The provinces' main aim is to assist small businesses, but some are prepared to guarantee quite substantial bond issues.

The General Investment Corporation recently established in Quebec jointly by the provincial government and private interests is intended to promote the expansion of manufacturing and other industrial development in the province. It stands prepared to provide equity funds or lend to applicants depending on the circumstances, being particularly interested in assisting medium-sized businesses which are expected to grow rapidly. Its first three transactions averaged about $700,000. Thus the Corporation's objectives differ substantially from those of the direct provincial agencies in other parts of the country, although it may well provide assistance to smaller enterprises as it develops.

Some of these agencies also go beyond lending or guarantee activities, the Alberta Provincial Marketing Board for example having a subsidiary which buys materials for small businesses, often at advantageous prices, and holds them until needed. By requiring only a partial cash deposit, this agency relieves smaller companies of part of the cost of carrying inventory. Moreover, the Alberta Treasury Branches also invest a substantial share of the funds collected in their deposit accounts in loans. In 1961, $23 million of the $38 million of Treasury Branch loans were to small businesses, and a further $7 million were to farmers' and feeders' associations. This was by a considerable margin the largest amount lent to businesses by any provincial agency. The government of Manitoba provides management advice as well as financial assistance to small enterprises through its Development Fund. Considerable emphasis is laid on attempts to foster balanced economic development in the province as a whole and on regional economic problems within the province. About two-thirds of the Development Fund's lending has been in small centres and rural areas where the government has also promoted Community Development Corporations to pool local resources for industrial invest-

[5] See submission of the Charterhouse Group Canada Limited for a partial list.

[6] The Industrial Establishments Promotion Act of Prince Edward Island.

ment.[7] In Nova Scotia, Industrial Estates Limited was set up in 1957 to promote secondary manufacturing and reduce the need for equity funds by building plants for lease and financing purchases of equipment. The new Ontario agency, in common with some others, is prepared to assist companies with technical and other advice. Thus the provinces provide help for small businesses in many ways, although the outstanding amount of advances or guarantees is not very large, probably not in excess of $50 million, and their policies have become more selective as the I.D.B. has broadened its activities.

The original federal legislation which established the Industrial Development Bank in 1944 generally confined its activities to lending to manufacturers. Subsequent amendments have broadened its field until in 1961 it was empowered to lend to virtually any business, although the act still requires that the applicant cannot obtain funds elsewhere "on reasonable terms and conditions". Similarly, the Bank's permitted business is broadly defined: it is able to take any class of security for its loans, may guarantee loans by others, invest in equities and participate in underwritings. In practice, the guarantee power has not been frequently used, I.D.B.'s equity investments have been quite limited for the reasons suggested earlier,[8] and its first and only underwriting occurred quite recently. There may well be occasion to use these powers more fully, particularly by participating in underwritings of issues even smaller than the $1 million offering in which it recently shared, but its main function will probably continue to be direct term lending.

During the nineteen years from its establishment until September 1963, the I.D.B. approved 10,131 loans (2,347 being additional credits to firms already borrowing from it) for a total of $542 million. In September 1963, there were $201 million of loans outstanding to 5,105 customers, and further commitments of $32 million had not yet been disbursed.[9] Most loans are for relatively small amounts—over the 19 years 49% were for $25,000 or less and 90% were for $100,000 or less. However, there is no limit on the size of individual loans, and loans over $100,000, including 24 in excess of $1 million, have accounted for almost one half of the dollar amount approved. There has been a tendency for the share of small loans to rise, partly as a result of increased lending to non-manufacturing firms whose capital requirements are smaller, but perhaps also because medium-sized firms are finding it somewhat easier to obtain term financing from private sources. The average term for which I.D.B. loans are granted has lengthened somewhat and in 1962 was about 7 years compared to 5½ years in 1950, with some loans being made for as long as 15 years.

SIZE DISTRIBUTION OF ALL I.D.B. LOAN APPROVALS

(to September 30, 1963)

—	Number of Loans		Amount	
		%	$'000	%
$ 5,000 or less	491	4.8	1,816	0.3
5,000 to 25,000	4,466	44.1	69,265	12.8
25,000 to 50,000	2,453	24.2	94,856	17.5
50,000 to 100,000	1,688	16.7	127,384	23.5
100,000 to 200,000	691	6.8	102,434	18.9
Over $200,000	342	3.4	146,404	27.0
TOTAL	10,131	100.0	542,159	100.0

The broadening of I.D.B.'s lending powers has contributed to a very rapid expansion since 1961, the amount of lending approved having jumped from $35.5 million in the 1960 fiscal year to $71.2 million in 1961 and $92.0 million in 1962. Part of this was a temporary surge as newly eligible borrowers came into the Bank, and at $80 million, the amount of approvals was lower in 1963 than in 1962. However, lending

[7] Submission of the Government of Manitoba, Chapter VI.

[8] The Bank had equity investments of $273,000 on September 30, 1962 and the largest holding reported at any fiscal year end was $308,000 in 1948.

[9] 1963 annual report of the Industrial Development Bank. The submission of I.D.B. to this commission contains comprehensive statistics on the Bank's operations up to September 30, 1962.

to new types of borrower does not fully account for the recent rapid growth: lending to others has also been expanded substantially with loan approvals to manufacturers—which averaged about $25 million a year from 1956 until 1960—being $48 million in 1961, $38 million in 1962 and $37 million in 1963. The Bank has increased its branch system and staff from 6 and 162 respectively in 1958 to 23 and 495 in 1963, has advertised its facilities more widely and has in general become a more aggressive institution. Although the I.D.B. is formally a subsidiary of the Bank of Canada, these and other changes have been matters of government policy; general management and credit approvals, are, however, carried out independently of the government by the I.D.B. board and staff.

Prior to the recent changes in policy, I.D.B. was frequently criticized for being too conservative, for having unnecessarily slow credit investigation procedures and for an inordinate appetite for tangible security. For instance, the Canadian Manufacturers' Association referred to complaints made by some of its members.[10] There are undoubtedly cases in which these criticisms are justified and the loss ratio of ½ of 1%, while not negligible, is moderate for an institution deemed to operate in areas beyond the risk-taking ability of conventional lenders. However, care is essential in all lending to smaller businesses. Moreover, the time taken for investigations reported to us by the I.D.B. does not seem excessive and has been shortened.[11]

Indeed, I.D.B. has now come under attack from the other side. Private lenders, particularly the sales finance companies, charge that the Bank has become too liberal in its lending and now offers unfair and unnecessary competition to private lenders. The heart of this criticism lies in the interpretation of Section 15 of its Act which states that the Bank may only lend if "credit or other financial resources would not be available on reasonable terms and conditions", a phrase which is nowhere defined in the legislation or the Bank's credit application forms. Those approaching I.D.B. for credit are nonetheless required to certify that credit cannot be obtained elsewhere on reasonable terms and conditions, which representatives of the Bank told us was interpreted to include an assessment of the reasonableness of the repayment period, amount, rate, and other characteristics of competing credit offers. They told us that the Bank will make loans if in its view private lenders are not willing to extend credit for as long as may be appropriate in particular cases or to lend as much as the applicant wants and can obtain from the I.D.B., and that their lending decisions very seldom turn solely on a view that private credit, when available, is too costly.[12]

On the other hand, the critics emphasize that the low cost of the funds obtained from the Bank of Canada and its freedom from taxation enable the I.D.B. to charge less than private lenders must obtain if they are to operate profitably. I.D.B. is financed by Bank of Canada investment in its equity and debentures, the latter in six-year serial form sold at a rate equal to the yield on comparable Government bonds plus a margin now set at .60%. The rate on debentures, which was 3½% below the I.D.B.'s average rate on new loans in 1955, has risen more rapidly than lending rates, and in the second half of 1962 was only about 1½% below the average rate of 6.54% earned on new loans. After realized losses, the return on capital and reserves (which were about 26% of all liabilities in September 1963) has consequently fallen to about 2½% in 1963, although this result stems in part from unusually heavy branch opening expenses. Clearly no comparable private taxpaying corporation, even with a smaller equity base and access to short-term funds, could operate profitably at I.D.B. lending rates.[13]

Critics of the I.D.B. argue that it is in an anomalous position as "lender of last resort" when its rates, which have varied from the low

[10] Submission of the C.M.A., paragraphs 72-76 and Appendix IV.

[11] Transcript, pages 8702-8703.

[12] Transcript 8679-80, and 8690.

[13] If I.D.B. were to earn about 8% on its capital after taxes, its total charges to borrowers would have to be in the range of 8% to 10%, depending on the assumptions made about capital structure and the amount allowed for the unusually heavy expenses in recent years.

of 5% maintained until February 1951 to the 7% now in force, give borrowers a strong incentive not to look for alternative sources. The problem, which is inherent in any government program specifically intended to aid particular borrowers who have difficulties in the private market, was less acute in earlier years. At that time there were few if any specialized small business lenders, finance companies were much less active in the field than now and the chartered banks were in practice the only alternative source of finance. In these circumstances a bank's refusal to lend could be taken as evidence that funds were not reasonably available, particularly as I.D.B. rates were then, as now, maintained above those charged by banks. The appearance of new private lenders making funds available at a variety of higher rates has greatly altered the situation. The I.D.B. must now take account of all these lenders and its decisions must reflect a continuing series of judgments about the level at which the cost and other terms of private funds justifies its intervening.

No matter where the I.D.B. rate is set, some lenders who would charge more are bound to be unhappy, as will some borrowers who would like to pay less. If there is to be an I.D.B. at all, it cannot avoid difficult decisions. For example, particular care must be taken to ensure that it does not subsidize some borrowers to the detriment of competing firms which are financed in the private market. More generally, if the aim of government policy is not to extend subsidies but to increase the flow of funds, private and public, into areas not adequately served by existing private lenders, I.D.B. must be wary of inhibiting developments in the private financial system. If it lends actively at relatively low rates, its operations may have this effect. Competition from I.D.B. has induced other lenders to lower their rates but it is very probable that the finance companies, development companies and others who now lend substantial amounts to small businesses at rates well below those charged in earlier years would not have developed their facilities as much if I.D.B. had always been seeking business aggressively for its own account.

In present circumstances, when comparable credit is available from private sources at rates ranging upwards from 7%, the I.D.B. rate of 7% is perhaps too low. Although there is no reason for its prime rate to be the highest in the market, it would be more appropriate for the Bank to be lending at rates ranging up to perhaps 2% over its prime rate and overlapping with the rates charged by other lenders. There are admittedly problems in charging different rates to different customers, but we nonetheless think it appropriate that I.D.B. should not restrict itself to a single rate regardless of the circumstances. No doubt many small I.D.B. loans must be made at rates too low to yield a profit in view of their higher unit costs of investigation, but rates should give some recognition to differing costs and risks. Moreover, we think it desirable that the I.D.B. prime rate should be varied more frequently with changes in comparable private rates than has been the case. We were told that there is no close connection between monetary policy and I.D.B. lending rates, although the general state of credit conditions is taken into account when setting them.[14] However, the announcement of a rate change may on occasion serve to confirm the authorities' general views about credit policy.

Thus, the I.D.B. rate should be set to enable the Bank to supplement private lending, but not to replace it or to inhibit desirable initiative in the private financial system. In line with this broad policy, the Bank should do its best to assist customers in meeting their needs from private lenders. Evidence put before us suggests that the Bank does less of this than it used to. Indeed, the finance companies cited a number of instances of I.D.B. taking over their accounts or granting loans of amounts and terms which they were quite prepared to meet, although at a higher rate. In a submission to us they cited 25 instances of their loans being paid out with I.D.B. funds, the

[14] Transcript, pp. 8689 ff.

total amount being $1.2 million,[15] and a further $2 million or so of business which they had solicited and in many cases approved but which subsequently was taken by I.D.B. Representatives of the Bank themselves told us that when established I.D.B. customers wish to obtain a new or larger loan they are not always asked to apply to other institutions first: the Bank in effect decides itself that reasonable terms and conditions are unlikely to be met outside.[16]

We believe that the Bank should be more insistent that its applicants make strenuous efforts to obtain funds elsewhere, being prepared if necessary to help them do so. In this connection, it should co-operate to the fullest extent with other agencies—insofar as it can without favouring particular institutions—in order to encourage the development of additional financing facilities for small businesses and to ensure that small businesses are in a position to make the fullest use of existing sources. Although it is important to ensure that smaller businesses are not unfairly affected by credit restraint, we believe that I.D.B. should be careful also to ensure that its lending activities in such periods do not lead it to expand its position at the expense of other institutions or to weaken the effectiveness of broader policies. In the past, its lending has not been closely related to national credit policy—rapid expansion taking place during the restraint in 1962 for example.[17]

We would not want these comments to be taken as a condemnation of the I.D.B. We believe it has performed a valuable role in our financial system and we agree with its President that it will continue to do so. Nevertheless, the private financial system in which it operates is also evolving and it is important that the Bank's policies take full account of these changes. Our recommendations are intended to suggest a useful direction for its own evolution, not only as a lender of last resort, but as an active agent in encouraging constructive private developments and in helping the managers of smaller enterprises to take advantage of them.

We favour the present arrangement under which I.D.B. is a subsidiary of the Bank of Canada, since this appears to shield it from interference with its exercise of sound business judgment. However, its activities are on the fringe of the areas of main concern for the money managers of the country, and we feel some changes could usefully be made to provide I.D.B. with its own full-time chief executive officer and to free the Governor of the Bank of Canada from direct responsibility in this connection. While the board and executive committee of the I.D.B. might include some Bank of Canada directors and would certainly include some central bank officers, they should be made up of directors suited to the I.D.B.'s quite different functions. The I.D.B. would continue to be financed through the Bank of Canada: we see no advantage at present in its obtaining all or part of its funds through public sale of debentures. It has been suggested that this would provide a "market test" of the cost of funds but in view of the government guarantee which I.D.B. issues would carry, at least implicitly, their rates would not reflect the borrowing costs of a comparable private institution. On the other hand, there is no strong reason to preclude I.D.B. from public borrowing if it is found convenient to do so for any reason.

It is clear that there is no general shortage of small business financing facilities in Canada, that many of the problems of modest-sized enterprises are managerial rather than financial, and that a part of such problem as does exist results from an unwillingness of the owners to sell any share of the business and its potential profits to those from whom long-term, high-risk funds are sought. Some witnesses indeed expressed the view that there is too much credit available to small businesses, particularly in construction and retail trade, and others claimed that funds were always available to deserving borrowers. Nonetheless, we believe that medium and long-term facilities could

[15] In some cases it may be good practice to consolidate a borrowers' financing by paying off existing debt out of an I.D.B. loan extended for a longer term than the private lender is prepared to grant.

[16] Transcript, page 8710-11.

[17] In part, this expansion was the result of the earlier branch openings and legislative changes mentioned previously.

be further improved. Government institutions can further this process by encouraging, or at least not inhibiting, constructive developments in the private sector. The aim of government institutions should not be to get the maximum number of loans on their books. Rather, it should be to ensure that businesses which can be competitive and profitable have access on a reasonable basis both to a variety of sources of funds and to guidance in planning their financial affairs.

FARM CREDIT AND THE USE OF GOVERNMENT GUARANTEES

In many countries there are private financial institutions which specialize in farm credit. In Canada, despite the importance of agriculture, there are no such institutions although many intermediaries allocate part of their resources to farm credit. Credit unions, insurance companies and trust and loan companies all invest in farm mortgages, although all but the first have reduced their farm lending since the 1930's. Credit unions, finance companies and the chartered banks extend medium and short-term credit. The banks are by a wide margin the largest institutional lenders to farmers, in part because government guarantees of medium-term loans have been available to them under the Farm Improvement Loans Act. In some provinces, notably Saskatchewan, credit unions devote a substantial part of their resources to farm lending. In addition, the feed, fertilizer, equipment manufacturing and other companies selling to farmers extend them credit either directly or through subsidiary finance companies, and private individuals are also an important source of farm credit.

Private lending, in addition to being encouraged by government guarantees, has been supplemented by direct federal and provincial lending through a variety of special agencies. As we noted in Chapter 3, the volume of long-term lending by governments, almost $500 million out of an estimated $825 million of long-term credit and $1,803 million of all types of farm credit outstanding in 1961, indicates that private lending has not been adequate.[18] At the same time, however, the availability of relatively inexpensive funds from governments has greatly reduced the opportunities for private lending, and institutions such as the loan companies which were substantial farm mortgage lenders in earlier years have made no attempt to re-establish themselves on a large scale in this rather specialized line of business.

The Canadian Farm Loan Board was established in 1929 to make mortgage loans to farmers. Except for a few years during the 1930's when it refinanced farmers' outstanding debts, the volume of lending was small and disbursements did not exceed $5 million between 1938 and 1952. Amendments to the legislation during the 1950's raised the limits on the size of loans and in 1959 the Board's functions were further expanded and taken over by a new Crown Corporation, the Farm Credit Corporation. This body paid out over $78 million on 6,453 loans in the year ending in March 1963, at which time it had loans of $278 million outstanding, nearly all secured by first mortgages on farm property. An increasing share of loans is made to finance purchases of farm land, smaller amounts being lent for the repayment of existing mortgage debts, for farm improvements and for purchases of livestock and equipment. The maximum loan is now $20,000 with special provision for supervised loans up to $27,500 for farmers between the ages of 21 and 45. Amendments to the Act passed in 1962 broadened the field of lending beyond mortgages on farm land by including some types of farming enterprises in which land is not the major capital investment, such as poultry and livestock operations, and by permitting chattel mortgages.

The federal government also lent substantial amounts to farmers for some years after the war under the Veterans' Land Administration, which from 1944 to 1951 was probably the most important single source of farm credit. Amendments to the Act raised the loan maximum in 1960 and

[18] Statistical information on farm credit is not comprehensive. The figures quoted are from tabulations by R. S. Rust in the *Economic Annalist* (Dept. of Agriculture, Ottawa) for February 1963, and include some estimates.

resulted in increased lending, but with the passage of time, lending under the V.L.A. will come to an end. A more recent intervention by the federal government came in 1961 when the I.D.B. was empowered to lend to farmers: by September 1963, 298 loans to farm enterprises and associated businesses totalling $9.3 million had been approved. The average size of loan was $31,000 and most of the lending to individual farmers was to finance major equipment purchases or farm improvements rather than land acquisition. The rapid growth of such I.D.B. lending suggests that the Bank is meeting a real need for this type of substantial farm finance.

The rate on Farm Credit Corporation first mortgages is 5%. The original 6½% charged by the Farm Loan Board in 1929 was reduced in steps to 4½% in 1945 and then raised to the present 5% in 1952. The earlier rate bore a reasonable relationship to comparable market yields—in 1945 and 1952 the rate was set about 1½% above the yield on long-term Government of Canada bonds—but the current charge is well below them and involves an undoubted element of subsidy which inhibits private long-term farm lending. We note that in 1962-63 the Corporation reported an operating loss of more than $1 million and that it is lending at rates below that paid by the federal government for long-term funds.[19] A comparable private corporation also paying income taxes and having an assumed equity equal to 10% of liabilities would have had to earn about $4 million more before taxes, or approximately 7% on its mortgages, to earn a profit of 8% on its equity. Even if the F.C.C. did not have to meet such stringent profitability tests, but were merely charged with earning 1% after taxes on government money invested in it, its lending rate would still need to be in excess of 6½%.

[19] In 1960 the Corporation earned a profit of $240,020, but since then increases in the cost of its funds and administrative expenses have led to operating losses of $202,798 in 1961, $776,117 in 1962 and $1,080,597 in 1963. The Corporation's borrowings from the government, usually in the form of 10 to 25 year maturities in annual instalments, carry rates ⅛ of 1% above those on comparable issues of direct government bonds and are determined quarterly by the Minister of Finance.

While there are admittedly farm needs for which the government wishes to provide special assistance, as a general rule we believe that efficiency in both agriculture and the financial system is fostered by the normal play of market forces. We recommend therefore that the present statutory method of setting the rate be changed and that the F.C.C.'s rates and charges be set automatically each year in somewhat closer relationship with market rates, perhaps 1¼% to 1½% above long-term Canada bond yields. In our view, any assistance to farm borrowers should be explicit and not the result of inadvertence, and should be given in ways which do not discourage reasonably efficient private lenders from broadening their credit services to meet changing farm requirements. If it is thought desirable to make farm mortgage credit available more cheaply than market forces dictate, the government should subsidize it openly.

The limits of $20,000 on ordinary F.C.C. mortgages or $27,500 to younger, experienced farmers are too low to enable the Corporation to meet the needs of many of the larger, efficient farm units which are playing an increasingly important role in Canadian agriculture. We therefore recommend that the limits be raised and maintained at a level more in line with the value of farm properties. At the present time a limit of $40,000 would be appropriate, and the government should be prepared to raise it further if circumstances warrant it, while maintaining the lending rate at levels which do not preclude the development of private mortgage lending to farms of all sizes. Representatives of the Canadian Federation of Agriculture suggested to us that farmers find it difficult to finance construction of additional housing, for instance as accommodation for hired help, because the F.C.C. normally takes a mortgage on the entire farm property and is often not prepared to finance such a building separately. N.H.A. loans on farm housing also call for a mortgage on the complete farm property and can therefore not be obtained in addition to F.C.C. credit. It is our understanding that the F.C.C. is in fact frequently willing to finance housing so long as its use is connected to the

operation of the farm, and we believe that the Corporation should continue to adopt a flexible approach in this regard. Given higher loan limits, it should be able to meet all reasonable demands for farm housing finance.

Most provincial governments also have agencies to assist farm financing. They usually are intended to supplement the F.C.C.'s facilities by concentrating on special financial needs. For instance, some provinces devote their resources to assisting young farmers to establish themselves, and British Columbia lends only for land clearing. The F.C.C. stated in its 1962 Report to the Minister of Agriculture that steps are being undertaken to provide closer co-ordination with provincial operations and eliminate duplication. Quebec has the most extensive loan service for farmers. Its rate, 2½%, has been very favourable, and until recently few Quebec farmers have sought term credit from other sources: at March 31, 1961 the Quebec government had loans of $118 million outstanding compared to only $7 million lent in the province by the F.C.C. However, in 1962 the Quebec government passed legislation under which farmers can obtain rebates of higher interest paid to certain other lenders, including the F.C.C., so that direct lending by Quebec has fallen and F.C.C.'s activities in that province have increased rapidly.

In addition to its direct lending activities, the federal government guarantees private lending to farmers. The Farm Improvement Loans Act was passed in 1944 to induce freer chartered bank farm lending on a term basis for the purchase of equipment and livestock and for the construction or repair of farm buildings. This Act, and the companion clauses of section 88 of the Bank Act, enable chartered banks to take the relevant equipment or other goods as security for the loan. Each bank's losses up to 10% of its total Farm Improvement Loans are guaranteed, subject to a maximum amount of $400 million outstanding for all banks at any one time.[20] (This procedure of guaranteeing part of each bank's loans subject to an overall limit had been introduced in the Home Improvement Loans Act in 1937, and has subsequently been used in other guarantee legislation.) The maximum loan, which was originally $3,000, has been raised in three steps to $7,500. Loans are made for terms of up to 10 years, (except that equipment loans must be repaid within 4 years) but shorter terms, varying upwards from 18 months for loans of $500 or less, are suggested in the Act's regulations for loans below the maximum. Most loans are made to finance purchases of equipment, with building construction or repair and livestock purchases ranking next.

In September 1963, the banks had $247 million of Farm Improvement Loans and $379 million of other loans to farmers on their books. Total farm lending represented 6.4% of all loans and investments (other than call and short loans and government of Canada securities) compared to 4.3% in 1945 and 6.4% in 1950.[21] The expansion of farm lending by the banks has varied with the demand for funds and has also been affected to a limited extent by changes in bank lending policy resulting from monetary policy. However, the banks have been careful to protect their farm customers along with other small borrowers in periods of tight money and we did not receive representations that agriculture suffers particularly under tight money. The same is true of lending by the F.C.C. which, for instance, expanded rapidly in 1956-57 and again in 1959.

The lending rate has remained at 5% since the Farm Improvement Loans Act was first put in operation eighteen years ago. The initial rate, although by no means high, was originally ½ of 1% above the chartered banks' prime lending rate. In the intervening years, prime rate has risen along with the whole structure of rates and the F.I.L.A. rate is now well below an appropriate level in relation to the cost of comparable credit to other borrowers. The same is true of lending rates under other guarantee programs, which have also been frozen while market rates

[20] The maximum amount of guaranteed loans has been raised from its original level of $250 million.

[21] Loans to grain dealers of $265 million are excluded from the farm lending totals. See Table 7-3.

have adjusted to changing circumstances.[22] At present levels they give no inducement for banks to lend freely to farmers and the other classes of borrower they are intended to favour.

It is our view that government guarantees need not become permanent features of the financial system. Their main purpose should be to introduce private lenders to types of business which they hesitate to enter without some such encouragement. Once the lenders become familiar with the new lending and its risks—which have not been large in the case of nearly all guaranteed lending—the guarantee has served its main purpose and might well be withdrawn.

We do not believe that the banks would reduce their lending to farmers, small businesses and others if guarantees were withdrawn from established classes of business, provided that the Bank Act were amended to permit them to take the mortgage security now available to them under the various guarantee laws. If the general mortgage prohibition were removed and the banks were permitted to lend at appropriate market rates of interest, which would at times exceed the present 6% limit, they might well be prepared to lend more freely than at the present uneconomic 5% rate. However, others may feel that at least for an interim period guarantees should be available to assist special classes of borrower. In that case the rates should be set at perhaps ½ of 1% above the banks' prime lending rate and vary with it. If experience under this system were to indicate that funds would be available without the guarantee, it might then be removed.

The maximum amount of a farm improvement loan was raised to $7,500 in 1959. In view of the increasing costs of equipment and improvements required by efficient farm units, this limit should be raised to $10,000 if the guarantee legislation remains in force. Some adjustment might also be made in the regulations covering down payments. For instance, down payments of 33⅓% and 40% are required on purchases of new and used trucks respectively and the borrower must put up 25% of the cost of permanent improvements such as electrical equipment. It might be advisable to lower some of these amounts, although down payments on loans for building construction and improvement could continue to be 10%. Bank managers might, of course, continue to call for higher down payments when in their judgment they are necessary. Finally, it should be possible to allow some flexibility in the repayment period for equipment loans, which is now limited to 4 years: the limit might be raised to 6 years, although once again individual managers would exercise their own judgment as to the useful life of each farmer's equipment and would frequently set shorter repayment schedules.

Under any approach to government guarantees, and particularly if government policy is directed to encouraging improved private lending facilities, it is clearly desirable that guaranteed loans be made available through as broad a group of institutions as possible. The guarantee of Fisheries Improvement Loans is available to credit unions, but other guarantees apply only to the chartered banks. We see no reason why other institutions with suitable facilities should not be able to apply for any guarantee extended by the government if it would enable them to serve their customers better. The government should not extend it to all institutions of a particular class but limit it to those having the staff, volume of business and experience to administer guaranteed lending soundly. Used in this way, government guarantees can assist in the development of the financial system and, for relatively short periods, can supplement the regular private sources of credit. However, the best way to ensure that gaps calling for such special measures do not persist is to see that private institutions are not discouraged by legislation or government lending activities from meeting new credit demands without recourse to guarantees.

EXPORT FINANCE

The financing of export sales raises some problems not encountered in domestic trade and Can-

[22] The rate on Fisheries Improvement Loans, for example, of which the total outstanding amount is under $500,000, is also 5%.

ada, like other countries, has facilities adapted to the special needs of exporters. Those who sell abroad on delayed payment terms incur not only ordinary commercial risks but also the hazard that buyers will fail to meet their obligations because of war, changes in foreign exchange regulations and import quotas, or other political events. Because of these "political" risks and because the buyer's trade credit is more difficult to assess when he is in another country, many firms would be hesitant to develop export business if they could not obtain protection against its added uncertainty. In Canada, the Export Credits Insurance Corporation (E.C.I.C.) was established in 1944 to fill this need by provision of federal guarantees.

E.C.I.C. sells insurance covering 85% of losses resulting from commercial or political risks—the two are not insured separately as in some other countries—while the exporter himself carries the remaining risk. Its policies cover insolvency of the buyer or his failure to pay within twelve months of the due date as well as the political risks, but not losses owing to such occurrences as a buyer's refusal to accept goods because he considers them unsatisfactory. The Corporation does not provide insurance on sales to the United States because it can be obtained from private sources.

Two main types of policy are available. Sales of consumer goods and other exports made on short-term credit may be insured under general commodities policies, which are annual policies setting a limit on the amount of insured sales. An exporter wishing insurance must obtain and pay for coverage of all sales to all countries to which he ships (other than the United States) and is not able to select particular sales or countries for insurance. This rule is imposed in order to spread the risks of insurance so that reasonable premiums may be charged on exports to any country, and also to avoid the political problem of disclosing higher rates for some countries than for others. Under the second type of policy, sales of capital goods or of engineering and other services on terms extending to a maximum of five years may be insured. Unlike the general commodities policies, these policies are written to cover individual transactions. Premiums on both types of policy are set at levels just sufficient to cover E.C.I.C.'s losses and other expenses, which include income tax.

We received suggestions that the E.C.I.C. should not be required to pay taxes, and the President of the Corporation supported them. At the same time he pointed out that the Government obtains no return on the capital and surplus, which amounted to $12.4 million in 1962, and that "the government can argue that the income tax which is levied against us is a small return on the capital made available for our backing".[23] We have no strong views on this matter, which is in any event part of the broader question of taxation of all Crown Corporations to which the Royal Commission on Taxation will no doubt address itself.

E.C.I.C. is authorized to accept insurance liabilities up to a maximum of $200 million on its own account, and at the end of 1962 had a liability of $71.8 million. It may also write a further $400 million of insurance for which the Government accepts the risk, covering transactions of a size or for a term which the Corporation would not normally underwrite but which the Minister of Trade and Commerce considers to be in the national interest.

A good deal of export trade is not insured with E.C.I.C. because it is going to the United States, because it is covered by irrevocable letters of credit which obviate the need for insurance or simply because the exporter does not think he needs insurance or his bank does not require it. The Corporation estimates that it now insures between 30% and 50% of eligible business, the $146 million of insurance written in 1962 representing about 2% of all exports.[24]

There are a number of detailed differences between the insurance coverage available to Canadian exporters and facilities in other countries, but the broad pattern is similar. "Insurance competition" among exporting countries is limited by the Berne Union of insurance agencies to

[23] Transcript, page 4594.
[24] Transcript, pages 4571-72.

which Canada and the other principal exporting nations belong. Minor modifications might be made with advantage: for instance the Canadian Exporters' Association recommended that the definition of capital goods eligible for insurance up to five years be broadened and that the Corporation should be more willing to write selective policies covering short-term credit to particular countries. These are technical matters on which we cannot make firm recommendations. More generally, we agree with the policy followed by E.C.I.C. of ensuring that Canadian exporters are not placed at a competitive disadvantage owing to inadequate insurance facilities rather than attempting to provide particular advantages for our exporters which would quickly lead to comparable action in other countries and thus produce no lasting advantage. The limits on the Corporation's insurance liabilities have been raised and, although lower in relation to our trade than in some other countries, seem adequate and can be raised again if necessary.

Short-term export credit is available without difficulty from the chartered banks, and they are also prepared to finance medium-term export payments over periods up to five years with the backing of E.C.I.C. insurance. It was thought that the banks were somewhat reluctant to lend as freely as they might for terms over one year, particularly in periods of credit restraint when they are concerned about the liquidity of their assets, and to meet this problem the Export Finance Corporation was set up in 1959 to rediscount medium-term export loans covered by E.C.I.C. insurance. The banks acquired its charter in 1961 following suggestions by the Government that additional facilities were necessary, but the demand for its rediscounting facilities has been limited. On April 30, 1963, the Corporation had advances of $93 million on its books, most of this to finance grain shipments to Europe for terms up to 3 years, with the remainder being largely capital goods sales to Latin American countries.[25] The relatively slow growth of business, despite the fact that its rates are competitive and its returns are intentionally modest—under 4% of captial and surplus in 1963—suggests that requirements for medium-term finance are being adequately met through the normal channels. The corporation obtains most of its funds by selling notes in the New York and—to a lesser extent—Canadian short-term markets.

Private lenders are less willing to give credit to exporters for periods longer than 5 years, and the government stepped into this gap in 1961 by authorizing E.C.I.C., on the approval of the Governor-in-Council, to provide long-term credit as well as insurance for capital goods sales up to a total of $300 million. After two years of operations, 8 loans with a total value of $57 million had been made. These facilities are designed to match those available to exporters in other countries through agencies such as the American Export-Import Bank so that Canadian firms will not be at a disadvantage in competing for large capital contracts in which extended credit terms are often essential to the buyer. E.C.I.C. stated that it does not intend to exceed credit terms elsewhere.[26] The lending program began too recently for its results to be evident, although it is already clear that there can be real problems in applying commercial lending principles in an area which must in the nature of the case involve foreign aid as well as foreign trade considerations.

Some exporters are bound to encounter financing difficulties, but we believe that the facilities available for commercial export insurance and finance in Canada are generally adequate, a view supported by the Exporters' Association whose main criticisms dealt with technical matters or questions involving government subsidization of long-term capital exports to less developed countries.

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[25] A number of major grain sales have been financed in other ways.

[26] Transcript, pages 4575-76.

CHAPTER 13

INSURANCE AND INVESTMENT COMPANIES AND PENSION FUNDS

Previous chapters have been mainly concerned with institutions which deal primarily in short and medium-term funds, although some of these institutions, notably the loan and trust companies, also issue long-term liabilities and invest a large part of their resources in long-term assets. Indeed, few institutions restrict themselves narrowly to assets and liabilities of a particular maturity any more than they deal exclusively with one type of customer, and classifications are therefore bound to be somewhat arbitrary. Nevertheless, the institutions which we will now discuss—insurance companies, pension funds and investment companies—are essentially long-term financial intermediaries in both their borrowing and their lending activities.

The manner in which these intermediaries collect most of their funds from savers is one factor which sets them apart. Other institutions sell most of their liabilities in exchange for single payments: for instance, the purchaser of a loan company debenture makes that one investment without committing himself to further investments in the loan company's liabilities. On the other hand, life insurance companies, pension administrators and, to a lesser extent, investment companies collect a large part of their funds on the basis of contracts involving a series of payments stretching into the future. People enter into such contracts in order to obtain the protection of life insurance or annuities and because they find it a convenient way of accumulating savings over the years. These particular financial assets are normally regarded by their holders as a final reserve to be liquidated for current spending only as a last resort: indeed many pension fund contributions cannot be withdrawn at all until retirement. Since these long-term savings are not generally subject to sudden withdrawal, the institutions administering them may safely invest a high proportion of their pools of funds in long-term assets and need retain only a modest liquidity position to meet claims, cancellations or withdrawal of funds. Mutual funds do not fit this pattern entirely; although much of their business involves contracts for payments into the fund over a number of years, the saver is free to redeem his shares at any time and may do so without sacrificing the protection which is the prime consideration in an insurance contract. However, redemption may be costly, and in any case people usually buy mutual fund shares with the intention of holding them as part of their long-term savings.

There has been an increasing amount of competition among insurance companies, pension administrators—including trust companies—and mutual funds as they have attempted to devise new contracts to attract long-term savings. Prior to the Second World War, the life insurance companies were virtually alone in the field except for the Annuities Branch of the federal Department of Labour. During the past fifteen years an increasing share of the population has entered pension plans and at the end of 1962 trusteed pension plans held assets of $4.6 billion: this compared to total assets—representing both life insurance and annuity funds—of almost $10 billion held in Canada by life insurance companies and fraternal societies. At the same time the establishment of

many investment companies has provided a third main institutional outlet for long-term savings. Both mutual funds and closed-end companies offer savers a share in a balanced portfolio of investments, and the former permit convenient investment by regular payments. The mutual funds which specialize in equity investments also offer the prospect of capital gains. The possibility of sharing in the growth of the economy and hedging against the danger of inflation has attracted many investors and contributed much to the funds' rapid growth. Buyers have not apparently been greatly deterred by the bigger risk of loss entailed in diverting funds from fixed-dollar claims to equities.

Savings through life insurance, pension contributions and investment companies are favoured by special tax arrangements. A 2% tax is collected on premiums, but life companies pay no tax on their income, except on the relatively small amounts allocated to shareholders. Pension contributions up to specified limits may be deducted from taxable income[1] and the investment income accruing to the pension fund is tax-free, although pension receipts are taxable. Finally, domestic investment companies are entitled to a special tax rate of 21% of taxable income if their investments and sources of revenue meet certain tests which will be described later in this chapter. Some are unincorporated and trusteed and pay no taxes themselves, the income passing directly to the participants.

The tax arrangements undoubtedly offer some inducement to invest through these institutions, particularly in the case of pensions. However, the funds they collect are the basic element in most people's savings and provide them in a convenient way with the protection which they feel they need. Since only a relatively small minority of people have the resources and skills to arrange for savings and protection in other ways, it is probable that these tax features have only a marginal effect on the amount and allocation of savings in the economy. Such effects, however, doubtless favour the institutions concerned at the expense of individual investment, and probably of some shorter-term institutions as well.

[1] Members of pension plans may deduct contributions to the plan and payments to other registered retirement savings plans amounting to the lesser of $1,500 or 10% of earned income. Their employers may contribute an additional $1,500. For those who are not members of company plans (and for whom contributions are not, therefore, being made by their employers) the limits are $2,500 or 10% of income.

—	Life insurance companies[a] (assets in Canada)	Trusteed pension Plans[b]	Canadian Mutual Funds[c]
Year end, book value of assets ($ millions)			
1945	3,125	n.a.	n.a.
1950	4,304	875	42
1955	6,043	1,835	191
1962	9,950	4,572	710
Annual rates of growth			
1945 to 1950	6.6%	n.a.	n.a.
1950 to 1955	7.0%	16.0%	35.4%
1955 to 1962	7.4%	13.9%	24.5%

[a] Assets held against life insurance and annuity contracts by insurance companies and societies.
[b] Method of estimating data for 1950 and 1955 is the same as that described later in the chapter.
[c] Mutual fund data are for 1951, 1956 and 1962, covering members of the Canadian Mutual Funds Association.

THE LIFE INSURANCE INDUSTRY

Canadians are in fact very well insured compared to people in other countries, with an average of over $11,000 in force per household. Total life insurance in force is about twice personal disposable income and annual premium payments absorb 3% of disposable income. Saving through life insurance companies on insurance and annuity business, which includes the companies' net investment earnings as well as premium receipts and is net of claims paid out by the companies, accounts for more than 25% of net personal saving.

The Canadian life insurance industry includes 105 federally registered companies[2] which in 1961 had 92.4% of the assets, 23 provincial companies with 3.3% and about 75 fraternal benefit societies with 4.3%. Although some of them are

[2] Six of these companies no longer write new business in Canada.

sizable institutions, the business done by provincial companies and fraternal benefit societies is thus small relative to the federal companies. The largest fraternal benefit society had assets of $113 million in 1962, while the largest provincial company had assets of about $100 million. These two institutions are larger than all but 16 of the federal companies, but most of the fraternal societies and provincial companies are small institutions doing a regional business. Apart from the fact that fraternal societies deal only with members of their own group, these institutions and the provincial companies conduct a business similar to federal companies and discussion in this chapter will concentrate on the latter group.

More than 90% of the assets of federal companies are held by 16 companies having assets of $100 million or more, 12 of them being Canadian, 2 British and 2 American.[3] The number of federal companies has risen from 65 in 1950 to 105 at present, all but 6 of the new companies being either British or foreign. As a result of the entry of these new companies and the rapid growth of some of them, the share of business held by the big companies has declined somewhat. Moreover, there have been marked differences in the growth rates of the larger companies, a number of which have a considerably smaller share of the business than they did a generation ago.

The Canadian insurance industry is more international than most sectors of our financial system. Many of the 36 Canadian federal companies, 13 of which are in fact now controlled outside Canada, do a substantial business abroad, particularly in the United States and the United Kingdom. At the end of 1962, the Canadian companies had total assets of $9.8 billion, of which about one-third related to their foreign business. At the same time, foreign companies operate in Canada: 16 British companies had assets of $624 million in Canada and 53 other foreign companies, most of them from the United States, had assets of $1,800 million here. Many of the foreign companies are small, some of them writing nominal amounts of Canadian insurance and being registered mainly for the investment of surplus funds arising from operations elsewhere.

Its international character brings increased competition and new techniques to the Canadian insurance market. In view of this competition, we are inclined to question the prohibition in the Canadian and British Insurance Companies Act against one life company investing in the shares of another. This prohibition, similar to that precluding banks from investing in other banks, was introduced in 1910 at the request of the insurance companies themselves.[4] However, no similar prohibition applies to foreign companies and control of a number of companies has been acquired by foreign interests in recent years. In order to protect Canadian companies

[3] These data refer to the domicile of the companies, not to their ownership.

[4] Transcript, page 6788.

TABLE 13–1

LIFE INSURANCE ASSETS IN CANADA[a]

($ millions)

—	1935	1945	1950	1955	1961	1962
Federal companies	1,828	2,886	3,997	5,599	8,574	9,183
Provincial companies	28	54	84	162	307 }	767[e]
Fraternal benefit societies	135	185	223	282	400 }	
TOTAL:	1,991	3,125	4,304	6,043	9,281	9,950[e]

[a]All federally-registered companies; provincial companies and fraternal benefit societies registered for business in Quebec or Ontario. A small amount of assets held by Companies and societies in other provinces is not included.
[e]Estimated.

against takeovers, the law was changed in 1957 to permit a joint-stock company to acquire its own shares and thus become a mutual company. There are now 11 federal mutual companies and 2 more are in the process of becoming mutual. The Superintendent of Insurance made the point that a Canadian company buying another would almost certainly merge the two operations and thus reduce the number of companies competing for insurance business, while foreign interests would continue to operate the original company in Canada.[5]

In view of the large number of companies operating in Canada and the fact that 13 of them having about 65% of the business are or will shortly be mutual companies, we see no reason why Canadian companies should not be free to acquire others, provided that the Minister of Finance approves of the purchase as being in the public interest, a procedure suggested by the life insurance companies.[6] It may well be true, as the Superintendent suggested,[7] that foreign interests will be willing to pay more for a company in order to acquire the established organization which another Canadian company would not need, but Canadian companies should not be precluded from bidding regardless of the circumstances. We do not agree with the Superintendent of Insurance that since policyholders have chosen to do business with a particular company its separate existence must necessarily be preserved.[8] If the new company is better managed than the old, they can expect to benefit from more efficient investment of the funds, and the efficiency of the life insurance industry as a whole will be raised. Removal of the prohibition would also enable the companies to form subsidiaries for their operations in foreign countries, and we see no reason why this should be prevented.

[5] Transcript, pages 6799-6800. A Canadian company may amalgamate with another by taking over its assets and liabilities, subject to Treasury Board approval; a Canadian stock company has taken over a mutual company in this way.

[6] Transcript, page 2381.

[7] Transcript, pages 6789-90.

[8] Transcript, pages 6801-2.

LIFE COMPANIES AS COLLECTORS OF SAVINGS

Life insurance companies offer protection and a means of accumulating savings. Whether it be life insurance or annuity coverage, the element of protection is the essential feature of every policy. The savings element, on the other hand, varies widely with the type of policy sold. The holder of a term policy buys protection only: if he dies, his beneficiaries obtain the insurance, but during his lifetime he does not accumulate any savings. In many other insurance policies, however, and in all annuity contracts, larger payments which are usually made over a number of years provide for the accumulation of substantial savings as well as covering the cost of protection itself. So long as premiums are set appropriately in relation to the life expectancy of policyholders and the companies' earnings, the companies will obtain premium and investment income in excess of current claims and will thus have substantial pools of long-term funds available for investment.

Since this type of savings is combined with the purchase of protection, the rate of return offered on savings need not be as high as would otherwise be needed to attract funds. The companies compete actively with each other in terms of all the features of their policies: the insurance benefits, which may include health coverage as well as any number of variations on the basic insurance or annuity provisions; the premiums charged, which can be reduced if earnings obtained on investments are increased; contractual rates of interest written into the policies and, in participating policies, the prospect of sharing in the companies' income. The rate of return on savings has its important place within the competitive package, but often does not have priority in the purchaser's thinking. Since the contracts are often complicated and each individual has particular requirements, the life companies obtain business through personal sales forces, normally paid on a commission system, rather than over the counter in branch offices.

Despite the unique characteristics of life insurance, the companies must compete actively for the public's savings. The spread of pension plans and government retirement assistance has meant that many people have less need to accumulate savings through life insurance. A growing interest in equity investments through mutual funds has also contributed to a rapid increase in sales of term insurance rather than policies with a savings element. A high proportion of term insurance is sold to groups, often in conjunction with pension plans. In 1961, 18% of the federal companies' insurance premiums came from group business, compared to 5% in 1945, and the share of group policies in total insurance in force had risen to 33% from 11%. The insurance companies have competed directly for the pension business through their annuity policies: these have grown from less than $100 million in force in 1945 to $866 million in 1962.[9] Thus the reduction in the flow of funds into the life insurance pool resulting from the slower growth of insurance policies with a high savings content has been in part offset by the growth of annuity business which produces a substantial flow of funds to the companies.

The pressure of competition within the industry and from other sources has also led to greater concentration on the rates of return paid on savings and to a variety of dividend arrangements, including policies in which future benefits vary with dividend rates. Competition from the mutual funds led—at the insurance companies' request—to a change in the law in 1961 to permit the writing of "variable annuity" policies in which benefits vary with earnings on a specific group of segregated assets. The industry has apparently not pressed the sale of these policies and at the end of 1962 the seven companies reporting them had segregated assets of $5 million of which only 19% was in corporate stocks. This competition for funds is bringing the insurance companies to lay more stress on the advantages they offer the individual as managers of funds, to devise new combinations of protection and savings features and to improve the calibre of their sales forces in order to attract business. It has also caused them to become increasingly alert to opportunities to increase their earnings and reduce costs in order to offer more attractive contracts to the public.

The result of this process has been to reduce the cost of insurance and to increase the rate of return on savings through life insurance companies. Also important have been the shift towards a higher proportion of term insurance, improved mortality experience, and higher investment earnings. In the event, premiums are now equal to 1.55% of insurance in force compared to 2.35% in 1950. Both the pool of life insurance assets and premium income have grown more slowly with the shift to term insurance, premium income remaining quite stable in relation to life company assets. On the other hand, investment income has risen with the general level of interest rates and at just over 5% of assets is close to that of the trust companies although more than 1% below that of the loan companies. Administrative expenses, which are relatively high owing to the costs of commission sales, were about 3½% of assets in 1961 and have risen a little over the years. Investment costs account for .34% of assets.[10]

Because of higher investment revenue, only a small part of which has been absorbed by higher administrative and investment costs, the return on life insurance savings has been increasing. Unfortunately the rate of return cannot be derived from the published statements but we know that premiums have been reduced and that dividends on participating policies, which were only 7% of the revenue of Canadian companies in 1950, are now 9%. Little of the increase in investment income has gone to shareholders' accounts. Because of the very limited share capital and conservative dividend policy, dividends to shareholders are equal to only .04% of assets and under ¼ of 1% of revenues, while surplus accu-

[9] These are the amounts of contractual annual commitments, a large part being payments to be made in the future under contracts which had not yet matured.

[10] These data relate to federally-registered Canadian companies. Investment costs are those for a smaller number of companies—see Table 5e of C.L.I.O.A. Submission.

mulation accounts for somewhat less than half as much as dividends actually paid out to policyholders. Despite these improvements, the return on savings in life insurance is still relatively low because, as representatives of the industry told us, the collection of savings through life insurance is an expensive business—although commission costs are lower in Canada than in the United States.[11] Nevertheless, savers are prepared to accept relatively low, although improving, returns because of their need for insurance protection.

INSURANCE COMPANY INVESTMENTS

The investment policies of life insurance companies are closely related to the character of their liabilities. Because of the contractual nature of their borrowing, they are able to predict reasonably accurately the flow of new funds which, together with the proceeds of maturing assets, will be available for investment. These forecasts cannot be precise; claims under insurance policies may differ from those expected on the basis of the mortality tables used; sales of new policies cannot be exactly predicted since they will depend on levels of personal income, on the efforts of the companies' agents and on competition with other forms of long-term savings; customers may surrender their policies or borrow against them; and losses may have to be absorbed on some investments. Even after taking account of these factors, an established life insurance company can foresee its position reasonably accurately and can count on a net cash inflow for some years ahead resulting from the business already on its books. Its position is thus quite different from that of an institution issuing "single-pay" liabilities, and particularly from one which borrows on a demand basis. An insurance company need not be concerned about the liquidity of its assets to nearly the same extent as an institution which cannot count on an inflow of funds from contracts already written and which may have to sell part of its portfolio at any time to meet unexpected demands from holders of its liabilities or borrowers. Life companies may therefore safely invest largely in long-term assets.

The many treatises written on the guiding principles of life insurance company investment also stress the need for maximum security. Although they are not usually subject to sudden unexpected calls on their funds, there must be no question of the companies' ability to meet their contractual obligations. The soundness of their investments is also an important factor in attracting new business.

(i) *Regulation*

Canadian insurance company legislation seeks to protect the policy holders by restricting investment to certain types of asset and by subjecting the companies to thorough government supervision. Federal companies may invest in Canadian federal and provincial government direct and guaranteed securities and similar issues of the United States, the United Kingdom and Commonwealth countries; they may also buy Canadian municipal securities, corporate bonds fully secured by mortgage and other bonds of corporations which have paid specified minimum dividends on their stock or have met minimum earnings requirements in relation to interest charges for at least five years. In addition, they may invest in real estate mortgages, (but may not lend more than two-thirds of the property value unless the excess is guaranteed by a government) and in specified income-producing real-estate or leaseholds up to 10% of assets. Preferred stock may be purchased if the company meets the 5-year dividend requirement applicable to investment in bonds. However, investment in common stock is subject to a 7-year dividend test, to not more than 30% of a company's stock being acquired, and to the total book value of common stock held not exceeding 15% of a life company's assets. The companies may also lend on the security of any of these assets or on the security of life insurance policies. Finally, they may invest 5% of their funds in assets not meeting the normal quality requirements although this "basket" provision may not be used to acquire mortgages over two-thirds of

[11] Transcript, pages 2444-5.

property value, to exceed the 30% rule regarding investment in any one company, to acquire stocks or income-producing real estate in excess of the 15% and 10% limits or to evade the prohibition against loans to directors and the companies of which they are directors.

These investment powers have been broadened somewhat in recent years—in 1961 the mortgage loan to value limit was increased from 60% to 66⅔%, the "basket" clause raised from 3% to 5% of assets and the restriction on income-producing real estate lifted from 5% to 10%. At the same time, provision was made for "segregated" investments not subject to the limitations on equity and real estate investment to be held against variable benefit annuity policies. These amendments gave the companies more freedom in their investment policies, but the acts are still intended to restrict the investment of insurance company funds, particularly with respect to common stock. It should be noted that the insurance company investment restrictions, which have been developed and amended over the years, contain some rather anomalous provisions. For instance, mortgage lending is restricted by the 66⅔% of value limit, but the companies are free to buy corporate mortgage bonds without limit. Similarly a sale and leaseback arrangement may be used instead of mortgage finance, without a limit as to the individual amounts advanced in this way.

The Superintendent of Insurance examines each company annually to see that its investments meet the requirements of the law and has the power to establish the value of all investments in their statements; the manner in which policy liabilities are to be computed is also subject to his approval. The legislation, and the Superintendent's authority under it, have undoubtedly contributed to the conservative investment policies—in many cases more conservative than the law actually requires —which are typical of the industry.

(ii) *Portfolio Composition and Changes*

At the end of the Second World War, 77% of the federal life companies' Canadian funds were invested in bonds, while only 10% were in mortgages.[12] Government of Canada securities alone accounted for about 60% of assets, but in succeeding years the companies liquidated a substantial part of these holdings and invested the proceeds, and new funds, in other assets offering higher returns, principally mortgages and corporate bonds. In 1962, almost 40% of their funds were in mortgages and 22% in corporate bonds; holdings of federal securities, although higher than the low point reached in 1957, accounted for only 7% of assets. Corporate stock holdings were $274 million or just 3% of assets, a proportion which has remained quite steady through the postwar period.

Because of their size, the insurance companies are a major factor in each of the markets in which they invest at all heavily. Although the trust and loan companies have gained on them in recent years, they are still by a considerable margin the principal buyers of mortgages: at the end of 1962 the federal companies' holdings of $3,639 million were 40% of all mortgages held by financial institutions, government agencies and corporate lenders. Similarly they are the largest group of investors in Canadian corporate bonds, of which they held 26% at the end of 1962, and are a powerful force in the municipal and provincial markets, having 16% and 13% respectively of the net amounts of these government debts outstanding. The reduction of their Government of Canada portfolios has brought their holdings down to 6% of market debt outside official accounts. Though more important than the chartered banks in the market for long bonds, of which they hold 13%, they are of much less importance in the short markets, their holdings being only 2% of outstanding Canada issues maturing within ten years.[13]

The investment policies of the individual companies vary a good deal, with the main decision relating to the share of funds invested in mortgages or in bonds. Mortgage portfolios of the

[12] The Canadian companies had additional assets of $3.2 billion in 1962 relating to their business in other countries, and some of these funds were also invested in Canadian securities. The distribution of assets is shown in Table 13-2.

[13] The maturity distribution of life company portfolios is shown in Table 13-3.

TABLE 13–2

FEDERAL COMPANIES: ASSETS IN CANADA[a]

—	1945[a]		1950[a]		1957		1962	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Cash	28	1.0	50	1.3	47	0.7	45	0.5
Bonds:								
Govt. of Canada	—	—	—	—	538	8.3	677	7.4
Provincial	—	—	—	—	415	6.4	917	10.0
Municipal	—	—	—	—	427	6.5	651	6.7
Corporate	—	—	—	—	1,749	26.9	2,005	21.8
Foreign	—	—	—	—	128	2.0	131	1.4
TOTAL BONDS	2,222	77.0	2,710	67.8	3,257	50.0	4,345	47.3
Stocks:								
Canadian	101	3.5	131	3.3	139	2.1	220	2.4
Foreign					76	1.2	54	0.6
Mortgages	280	9.7	769	19.3	2,367	36.4	3,639	39.6
Real Estate	36	1.2	58	1.5	223	3.4	311	3.4
Policy Loans	152	5.3	178	4.5	295	4.5	372	4.1
Other Assets[b]	67	2.3	101	2.5	106	1.6	197	2.1
TOTAL	2,886	100.0	3,997	100.0	6,511	100.0	9,183	100.0

[a]Details of the securities portfolio of the industry are not available on a comparable basis prior to 1954. For twelve large companies having about 75% of the business, 59% of assets in 1946 were Government of Canada securities, 6% provincial, 4% municipal and 9% corporate issues.

[b]Includes the unamortized portion of life companies' own stock purchased under mutualization plans.

SOURCE: Superintendent of Insurance for Canada, Bank of Canada and Submission of the C.L.I.O.A.

larger companies vary from 12% to 66% of assets, while their bond holdings range from 80% to 25%. Although most companies have shared in the post-war shift towards mortgages, each one tends to maintain its broad preference for mortgages or bonds through the years, largely because the two types of investment call for different internal organizations and investment skills. Mortgage investing requires a branch organization which takes time to develop and can pay its way only through a relatively steady flow of investment. Securities investment needs a less extensive organization—a small sample of companies reported 1960 investment costs of .09% for funds invested in securities compared to .42% for mortgages[14]—but special skills are still required. The companies which have developed the necessary personnel thus find bonds more attractive in spite of their lower gross yields, especially the smaller companies, which find the costs of establishing a mortgage department prohibitive.

Given their broad investment preferences and organizations, the companies adjust the flow of their investments to the structure of yields available on different classes of mortgages and bonds. Some companies invest very little in N.H.A. mortgages, but the industry as a whole varies its purchases of guaranteed and conventional mortgages with changes in the difference in yields between them. Similarly, the shift out of Government securities and into corporate bonds has resulted from the attraction of higher yields and greater availability of the latter, especially in years of high business investment. Such changes in life company investments are not as dramatic as are, for instance, the portfolio changes which banks undergo, being largely a matter of redirecting the investment of new funds and the proceeds of maturing assets. The amounts in-

[14] Submission of the Canadian Life Insurance Officers' Association, (C.L.I.O.A.) Table 5e.

volved are nevertheless very large, even though they do not bring about sudden changes in the structure of the companies' portfolios.

It is frequently asserted that the life insurance industry's investment policies are not flexible enough, and that some companies rely on rules of thumb and quotas covering different types of asset rather than comparisons of their yields. Industry representatives told us that it is indeed common practice to establish the broad lines of future investment policy in relation to expected cash flows, and even to assign quotas to the main types of investment.[15] It would be extraordinary if this were not done in that the mortgage and security departments can function best if they have at least a general idea of the amounts they can expect to have available. This is particularly true of the former because the companies do not like to disrupt the builders and others who bring them mortgages by following too changeable a policy within a short time. Similar guide lines are frequently applied to the main classes of bonds, and once again they assist in the daily job of managing the entire portfolio.

Where such limits are set down by the directors and senior investment committees, they are not rigid and can readily be changed when attractive investment opportunities arise, but they are not always adjusted promptly to changing circumstances. On occasion, an institution will not make an investment because that quota is filled, even if comparable issues are yielding less. Sometimes this may be no more than a polite way of refusing an issue unwanted for other reasons. Nevertheless, if inflexible or artificial quotas not needed to maintain diversification of risks were to distort the investment pattern, they would be harmful to the company's and policyholders' best interests as well as thwarting the market allocation of funds to the most pressing needs. No doubt this does sometimes happen, and some companies are not always as sensitive as they might be to prices and yields. However, their administrative arrangements, including the use of quotas, do not on balance appear to inhibit their investment freedom excessively.

In this connection, we were told that local representatives of the companies anxious to see that money is invested in their areas for sales reasons encourage the investment departments to take up local municipal and other issues.[16] This sort of pressure helps to ensure that such borrowers are not excluded owing to head office rules of thumb or unfamiliarity with the issues. Indeed, evidence was submitted indicating that the companies do spread their investments across the country rather than favouring borrowers who happen to be near their head offices. The calculation provided by the industry, which necessarily involves some estimation, shows differences among provinces in the relationship of investments to policyholder liabilities but does not suggest that there is any discrimination in favour of the central parts of the country.[17]

Changes in financial policy and interest rate levels do not significantly affect the rate of growth of their assets, and the companies therefore do not find themselves in the situation faced by banking institutions when a restrictive policy sharply reduces the flow of funds available for investment. Life companies may have to meet a slightly increased demand for policy loans from borrowers unable to obtain funds elsewhere, and may find that amounts left on deposit by policyholders decline or that surrenders of policies increase, but the effect of these changes on their cash flow is small.

The response of life insurance companies to changes in credit conditions is similar to their response to changes in the relative yields on different assets in that it is largely a matter of adjusting the direction of current investment flows. Given the quite steady growth in their assets through periods of tight and easy money, the companies respond by reaching out for long-term investments when rates are high. Conversely, they allow their portfolios to shorten somewhat, and hold new funds in short-term investments when rates are low and expected to

[15] Transcript, page 2478 ff.

[16] Transcript, page 2556.

[17] Submission of the C.L.I.O.A., Table 5a.

rise. Thus, when rates are high and strong demands make attractive mortgages available, they tend to raise their rates and extend mortgage commitments freely so that the cash flowing out in succeeding months will go into high-yielding assets even if market rates have begun to soften. If, as usually has happened, conventional mortgage rates rise more rapidly than the N.H.A. rate, the flow of funds into guaranteed mortgages will fall relatively. However, some companies doing a substantial N.H.A. business may continue to lend, although in reduced amount, to builders who rely heavily on them and bring them a steady supply of investments.[18]

Given their future commitments, the companies vary their holdings of cash, treasury bills and other short-term assets in the light of their expectations about interest rate levels. Information prepared for us by twelve large companies, however, shows that the amounts involved are not large relative to their cash flows or to the operations of the chartered banks; the sum of their net cash, treasury bill and commercial paper holdings for example, rose only from $21 million in mid-1957 to $67 million a year later when interest rates had declined substantially.[19] Security portfolios are of course heavily concentrated in long-term issues, about three-quarters of the holdings of federal, provincial and corporate bonds now being in issues of 10 years or longer. The only substantial change shown by available statistics in recent years was the move into longer-term Canadian government issues at the time of the Conversion Loan in 1958: since then about 80% of the government portfolio has been in issues of over 10 years. The share of government bonds in under two year maturities has also increased, principally because of the concentration of recent federal financing in this part of the market.

Most of the companies do not carry their response to changes in the level and structure of rates to the point of trading out of lower-yielding into higher-yielding securities. There are a few companies which do trade actively, but the general pattern of industry behaviour is to hold investments until they mature

[18] The mortgage market is more fully discussed in the following chapter.

[19] There is a substantial seasonal swing in these liquid assets associated with the pattern of mortgage lending. See the appendix volume for details.

TABLE 13–3

MATURITY DISTRIBUTION OF SECURITIES[a]

Year-end	2 years and under	Over 2 years to 5 years	Over 5 years to 10 years	Over 10 years	Total
	percent				$ millions
1951—Federal	0.5	2.6	43.0	53.8	893
Provincial	1.1	5.6	25.0	68.3	202
Corporate	1.5	3.2	13.0	82.3	928
1955—Federal	5.4	20.3	39.7	34.6	607
Provincial	3.2	14.2	14.7	67.8	239
Corporate	2.1	4.4	11.7	81.8	1,250
1958—Federal	8.6	3.4	6.4	81.6	454
Provincial	6.3	5.1	23.2	65.4	263
Corporate	2.8	4.6	18.4	74.2	1,506
1961—Federal	11.8	7.0	1.3	79.9	522
Provincial	1.3	4.5	17.5	76.7	572
Corporate	3.0	6.8	22.9	67.3	1,486

[a] Based on a survey of 12 companies (with 75% of net premium income in 1961) carried out by the Canadian Life Insurance Officers Association. Full details will be found in the appendix volume.

or have only a short while to run. The companies which do not trade their portfolios have often not developed the experienced personnel necessary for successful secondary-market operations and would find it difficult to alter their policy. Some believe, moreover, that the potential returns from more active portfolio management do not justify the expense, or that their holdings are too large and contain too many illiquid issues for any substantial part to be turned over advantageously in the market. These are valid and understandable reasons, and we do not wish to suggest that all life companies would necessarily serve their policyholders and the capital market as a whole better by adopting the policy of the few with active trading programs. Nonetheless many companies could usefully trade more actively and we have enquired whether, as has been suggested, the present valuation rules inhibit them from doing so.

(iii) *Valuation and Investment Policies*

Life insurance companies are bound by quite rigid regulations covering the valuation of their liabilities. A fixed present value is set on each policy—or batch of similar policies—by discounting at a particular rate of interest the future premiums and probable future claims as given by mortality tables. This present value is known as the actuarial reserve and must be matched by an equivalent amount of assets to meet the solvency requirements of the insurance legislation which are designed to ensure that the company will be able to meet its obligations. These are highly technical actuarial calculations which we do not need to examine in detail; the important point for the present is that in Canada not only the premiums, but also the mortality table and rate of discount to be used in calculating reserves, are fixed when the policy is sold—the latter two being subject to approval by the Superintendent—so that its value for statement purposes is inflexible.[20] This enables the companies to guarantee specific cash surrender values throughout the life of a policy; it also means, however, that the rate of discount used, which reflects a view of the rate of future earnings on assets which will be available to assist in meeting the liability, may not be altered with the general level of rates.

Since the companies are bound by rigid liability values, any change in the value of their assets arising from changes in market prices and yields will affect the companies' surplus positions. No company wants to report a drop in its surplus—its competitors may point to it as a sign of mismanagement or weakness.[21] Moreover, the complete disappearance of surplus would indicate technical insolvency (although not necessarily meaning that the assets will not recover their value and enable the company to meet all its obligations). Thus, most of the industry has favoured protecting the stability of reported surplus by valuing assets as rigidly as liabilities, that is by extending the use of amortized cost rather than market values. On the other hand, the authorities favour market values, and the present rules applying to Canadian companies are a compromise.

The total value of securities shown in a Canadian company's annual report may not exceed the sum of amortized values of Canadian federal and provincial securities and issues of the U.S. and U.K. governments, plus the market values of other securities. Lower values may be shown, and most companies do in fact carry equities at well below market values, either by retaining the original purchase price if the stock has appreciated, or by writing it down to the degree permitted by the Department of Insurance. Oddly enough, the authorities, who favour the use of market values as being the most realistic measure of assets available to meet obligations, discourage the companies from writing up the values of individual assets whose price has risen. The companies are thus in fact obliged to show unrealistic values for many issues. The compromise rules are, moreover, rather inconsistent: the assets which are most likely to be sold in the market—government securities—are amortized, while

[20] The "segregated fund" policies permitted by the 1961 change in the law referred to earlier are an exception in that the value of these reserves may vary with changes in the value of the assets concerned.

[21] Transcript, page 2462.

others which are seldom if ever sold—and indeed could not be disposed of in any quantities without seriously affecting the market—are shown at quoted market values. British and foreign companies are required to show all assets at market values, writing them up or down as need be, on the grounds that if they were to stop doing business in Canada another company would only take over their assets at the market price. Moreover, the Canadian authorities have no control over the disposition of a British or foreign company's surplus.

These valuation rules may influence investment policies and the companies' willingness to trade securities in the market. Given the rigidity of their liabilities, many companies are less willing than they might be to invest in assets which may not be shown at above market values, since falls in the price of such assets would expose them to the danger of sharp declines in surplus. This has been advanced as one reason why they prefer assets which can be amortized[22] and why they shy away from equities. In this connection, it might be noted that the legislation authorizes the Minister of Finance to establish higher values in order to preserve technical solvency if an otherwise sound company is hard hit by a market drop. Such special values were used during the 1930's but would not be applicable to the more moderate changes in surplus which also concern the companies.

Although this valuation and surplus problem does no doubt act to deter some stock investment, it is hard to believe that it is in itself the explanation of the industry's low equity holdings. Most companies could increase their stock holdings substantially before they reached a size which might seriously endanger the stability of surplus. In any case they may be carried at less than market value by Canadian companies so that a swing in the stock market need not force reported values down unless it is of major proportions. Moreover, some of the companies which do approach the 15% common stock limit are in fact British companies which are required to show both increases and declines in the market values. Company policies may thus be strongly influenced by the rules but need not be determined by them.

So far as trading activity is concerned, some companies appear unwilling to sell an amortized security at less than its value on their books in order to switch into a higher-yielding investment. This is because the book loss must be shown, and will reduce reported surplus unless it can be offset by profits on other transactions. If the security were subject to market valuation, the decline in its price would reduce surplus whether or not a trade actually took place, and it is argued therefore that the companies would feel freer to trade. Indeed, one company which does trade actively favours the use of market values to clear away the book loss problem, which is simply an accounting rigidity, and to focus attention on the real alternative yields open to it at any point in time.

This company and a few others do trade their portfolios as much as the secondary markets permit, in spite of the amortization rules, partly because they have been able to protect their surplus positions by realizing capital gains on some investments while accepting trading losses on others. As with the matter of equity investment, the rules do not prevent a company from trading, although they are undoubtedly an inhibiting factor. Changes will thus not lead to an immediate or drastic alteration of long-standing company policies, but some useful improvements might nevertheless be made.

The principal objective should be to introduce greater flexibility into the methods of valuing liabilities so that they may be adjusted in some degree to the same market forces as affect asset values. Unnecessarily rigid liability valuations should not be allowed to stand in the way of a sound allocation of capital in financial markets. It is undoubtedly true that for the present the popularity of cash surrender value policies prevents any sudden development of the freedom enjoyed by insurance companies in the United

[22] The higher yields available on corporate bonds have been sufficient in most of the post-war period, however, to attract heavy life company investment in spite of the companies' inability to carry them at amortized values.

Kingdom in choosing valuation rates of interest. We do not pretend to have expert knowledge, but we nonetheless think it desirable and possible for the authorities to permit greater flexibility over time in liability valuation and to join with actuaries in the industry in developing new approaches to the task. We have been assured by actuaries with whom we have discussed the problem that while there are difficulties to be overcome they are by no means insuperable. The introduction of flexible reserve rules for the variable annuity business was a useful departure: it should prove possible to develop comparable flexibility in both the design of life insurance policies themselves and methods of valuing them. If it were possible to devise methods which would allow the actuarial value of policies to reflect market forces, the companies could carry their assets at market values, thus applying consistent assumptions to both sides of their balance sheets. Any valuation rules necessarily involve a somewhat arbitrary set of calculations, but such an approach would be more realistic than most, and would not expose the companies to those fluctuations in surplus which appear to be such an embarrassment. There would then be nothing in their bookkeeping to inhibit the Canadian companies from adjusting their investments to market prices and yields; it would also place these companies in the same position as their British and foreign competitors in Canada.

However, progress in developing more flexible liability valuation may well be slow, and in the interim rigidity on that side should be matched by some stability of asset values from year to year in order to preserve the stability of surplus accounts.[23] It would be appropriate, therefore, to continue for the time being to value all government securities other than municipals at or below amortized cost, but we see no need to adopt the industry's suggestion of extending this method of valuation to municipal securities. Nor do we believe it desirable to move towards rigidity in the valuation of stocks by using the three-year averaging method recommended by the industry. However, the companies should be permitted to write up as well as write down asset values within the maximum levels set by the legislation: discouragement of write-ups justified by market developments serves no useful purpose and may at times inhibit desirable portfolio adjustments.

It is worth emphasizing that the soundness of the Canadian insurance industry is based not only on the figures which appear in annual statements but on careful management by the companies and supervision by the Superintendent's Department, both of which enjoy the highest reputation in Canada and abroad. All valuation procedures are arbitrary, but within a reasonable and meaningful framework, the details need not intrude unnecessarily on intelligent asset management by the companies or impede the free flow of savings and capital.

(iv) *Equities*

As we have mentioned, only a few companies have approached the 15% of assets they are permitted to invest in common stock, although some have been restricted by the rule.[24] Some of the British companies, which in the absence of restriction are accustomed to investing heavily in stocks in the United Kingdom,[25] are well above the Canadian industry's average of 3% to 4%. On the other hand, legislation in some states restricts some American companies narrowly at home and only one of them held any equities at all in Canada at the end of 1962.

Life insurance companies might be expected to find increased equity holdings an attractive investment for the long-term funds which they manage. However, the valuation difficulties already referred to, and a deeply ingrained conservatism stemming largely from the experience of some companies in the 1930's when only the use of specially authorized values enabled them to avoid technical

[23] The Superintendent apparently believes that a surplus of at least 6% of liabilities should be maintained.

[24] For example a company with stocks having a book value of 10% and a market value of 20% cannot trade any substantial part of these holdings against more attractive shares without breaking the rule because the Superintendent will not allow the new investments to be written-down substantially below market.

[25] 45 major U.K. life offices had 26% of their assets in equities in 1962, and some were considerably higher.

insolvency,[26] have contributed to a cautious policy. The philosophy of the legislation, and in some cases the 15% limit itself, also has a restricting influence. Finally, some companies have felt that fixed-income investments have been more attractive on balance, preferring to forego the higher returns expected from equities over the long run for the greater certainty of bond and mortgage returns, especially in view of the fixed-dollar nature of their liabilities.

In our view, there is little need for restriction on equity investments, since sound management and competent supervision of the industry could be relied on to ensure that no company built up too unbalanced a portfolio. However, it is true that because of the long-term nature of a life company's liabilities, today's investment errors may only lead to troubles many years hence. With this in mind some may wish to proceed slowly and maintain a limit on equity investments. We therefore recommend that the limit be raised to 25% of assets, as suggested by the C.L.I.O.A., and that the basket clause be raised to allow the companies to invest 10% of their funds in assets not otherwise eligible. We also recommend that the companies be permitted to hold equities and income-producing real estate in their basket clause investments in excess of the 25% and 10% limits.

If this greater freedom to invest in equities is used, there is perhaps some risk of a concentration of corporate control in the hands of life companies. There has been no evidence of such a tendency in the past because such holdings are small. If a tendency toward the concentration of share ownership were to develop it might be desirable to reduce the limit on individual investments from 30% of the shares of a corporation—perhaps to the 10% which applies to investment companies under the Income Tax Act.

These changes should free all companies to invest as fully in equities as they may wish, at least for some years to come. As with the changes in valuation rules, we would not expect dramatic changes to follow, but it might induce some companies to place more of their funds in the equity of Canadian enterprises.[27] We believe that a move in this direction, either by direct investment or through participation in development companies such as that mentioned in the previous chapter, would well serve both the policyholders and the economy as a whole. Increased purchases of equities would of course reduce the amounts which life companies would have available for other investments. While we believe that some re-direction of their funds would be useful, there is no reason for it to go beyond the point which the companies themselves find to be in the best interests of their policyholders. Compulsory purchases, which have been suggested to us, would be undesirable because they could seriously undermine the companies' sense of financial responsibility, harm the interests of the policyholders whose funds they manage, and would be an unwarranted infringement of the market system which would impair efficient economic development and innovation.

OTHER INSURANCE COMPANIES

The general insurance companies, including those life companies which sell insurance against sickness and accident and—in a few cases—against other risks, also obtain their funds largely on a contractual basis. In that they only provide protection against the specified risks and do not include any savings feature, the policies are akin to pure life insurance policies. The purchaser of general insurance does not accumulate financial assets in this way, he simply buys a service; these companies are thus not financial intermediaries in the full sense. However, they do accumulate pools of funds from premium and investment income out of which to meet claims under their policies, and thus they do manage portfolios of assets like other financial institutions.

[26] Although the declining value of large stock portfolios threatened technical insolvency, the companies would have been able to meet all their obligations without difficulty both at the time and thereafter; indeed, hindsight shows that if such holdings had been maintained, they would have been far more profitable than fixed-income securities.

[27] It should be noted that since they pay no tax on interest or dividends as such, the life companies do not have the same inducement as tax-paying investors to buy equities at reduced gross yields.

At the end of 1961, assets of $1,528 million were held by institutions doing a general insurance business, compared to $929 million in 1955 and $563 million in 1950. $1,408 million, or 92%, was in the hands of the 376 federally-registered companies subject to supervision by the Department of Insurance and the remaining 8% was held by some 90 provincial companies and more than 350 local insurance mutuals as well as members of the Lloyd's group. 108 of the federal companies are Canadian, 84 are British and 184 foreign, with the Canadian companies having 43% of the business and assets.

A high proportion of general insurance is written under short-term contracts, frequently covering three-year periods. For this reason, and because there can be much wider and more unpredictable swings in the claims against them than in the life insurance and annuity business, the net flow of funds to them is not so stable. Because of these factors, and the higher turnover of their funds generally, their cash holdings—5% of assets in 1962 for federal companies—are higher than for life companies. They also invest very little in mortgages, carrying more than 70% of their funds in bonds, a high proportion of them being Government of Canada and provincial issues which can readily be liquidated if need arises. The general insurance companies are a significant factor in the short-term market and some of them, particularly the Canadian ones, are also relatively large holders of preferred and common stocks in the less liquid part of their portfolios, although the total for all federal companies is only $113 million at book value, equal to 8% of assets.

INVESTMENT COMPANIES

The rapid growth of investment companies, which are intermediaries selling securities to the public and investing the proceeds in diversified investment portfolios, has brought them into increasing competition for long-term savings with other institutions and with the portfolio management services of trust companies and others. Closed-end investment companies in Canada, of which there are now some 23 with assets of more than $525 million,[28] sell debt and equity from time to time in the same way as industrial companies; their securities trade in the normal way on securities markets, although a number of them are closely held. They provide the investor with the advantages of professional management and diversification. Open-end companies or "mutual funds" also offer these benefits, but their only liabilities to the public are "special" or "Class A" shares which they stand prepared to sell and redeem at all times at prices based on the current value of their assets.[29] They thus facilitate regular purchases by small savers wishing to build up their investment gradually. There are some 65 mutual funds in Canada with investments of $1,200 million in 1962, including a number of recently established funds managed by trust companies.[30]

Like mutual funds in other respects, but without their professional management, are the investment clubs. Started in Canada in the late 1920's, it has only been within the past decade that they have experienced a rapid increase in numbers. To meet the needs of these clubs and to assist new clubs in forming, the Canadian Association of Investment Clubs was founded in 1955. It has been estimated[31] that approximately 1,000 such clubs are now in existence in Montreal and Toronto alone. The typical club has about 17 members with an average age of 41 years and making monthly contributions of approximately $11.00 each.[32] It has a net asset value of $9,400, an average rate of appreciation of 4.3% and holds 11 securities. The functions of these clubs are to enable the members to learn about investing and to put their savings to work

[28] *Financial Post 1963 Survey of Investment Funds*, page 28.

[29] The founders normally subscribe nominal amounts of common or "deferred" shares in order to comply with the requirements of companies legislation, although some funds are established under a trust indenture and sell units rather than shares.

[30] A number of mutual funds are associated with one another.

[31] Submission of Investment Dealers Association of Canada, Appendix J, page 45.

[32] C.A.I.C. *Newsletter*, July 1962.

in equities. A large proportion of these funds probably would not otherwise have found their way into the equity market.

The oldest of the present Canadian closed-end companies was formed early in this century and the majority date from the 1920's, only six having been established since 1940. Although one of the younger companies is now the largest, and although all companies' assets have expanded significantly—largely because their stock investments have appreciated—they have not grown as rapidly as the mutual funds in recent years. In the 1920's, many promoters and investors found closed-end companies a convenient way of extending their control of companies or improving the leverage on a given amount of equity investment. They would invest, say, $100,000 in the shares of a company, obtain $900,000 more by issuing debt securities and then buy $1 million of equities with the proceeds. If the underlying shares appreciated by 10%, they had doubled their investment, although if the shares fell by a similar amount they were wiped out. The unfortunate experience of some companies in the 1929 stock market crash destroyed public enthusiasm for this form of financing and there has been a tendency for the closed-end companies to rely less on debt and more on equity funds and to become less interested in speculation.

At the same time, investors have been attracted to the mutual fund form of diversified stock investment in which the value of each share is directly related to the current value of asset holdings. These funds are a relatively new phenomenon in the Canadian capital market. All but a few formed in the 1930's have been established in the past 15 years or so, a high proportion in the middle years of the 1950's when rapid economic development, price inflation and rising stock markets attracted attention to the advantages of equity investment. Among the other reasons for their rapid expansion have been the diversification of holdings they offer the small investor who would not otherwise have the resources to buy a wide range of equities; their professional management which relieves the buyer of the difficult and time-consuming task of choosing and managing a stock portfolio; their relative liquidity arising out of their redemption feature; and the convenience of long-term saving through their contract plans.

Not all the companies raise their funds in Canada. In 1954, the U.S. tax law was altered so that the returns to American investors from foreign investment companies would be taxed as capital gains rather than at higher income tax rates, provided all dividends were reinvested in additional shares. These non-resident owned (N.R.O.) funds grew rapidly until 1958 when their investments of $400 million were almost one-half of total Canadian mutual fund assets. The subsequent change in our economic circumstances and growing opportunities abroad lowered American enthusiasm for Canadian equity investment. More recently, U.S. tax laws have been amended to remove the advantage which had existed, and by 1962 the market value of N.R.O. fund assets had declined to $255 million. A few funds established to sell shares in foreign countries other than the United States have also failed to grow rapidly in recent years; at the end of 1962 two such funds had assets valued at $39 million compared to $38 million 4 years earlier.

The remaining mutual funds, most of which sell their shares principally to Canadians, have continued to expand at a very rapid rate. The market value of the assets of members of the recently formed Canadian Mutual Funds Association has risen from $57 million in 1951 and $252 million in 1956 to $834 million in 1962.[33] These funds had 282,000 shareholders at the end of 1962, compared to 22,000 in 1951, and the number is still growing quickly. The share of assets invested in equities by the industry as a whole has fluctuated within a narrow range around 80%, but there is considerable variety in the policies of individual funds. Most of the

[33] Membership in the Association is restricted to open-end funds organized and primarily owned in Canada, and the 27 members held 92% of the assets of such funds at the end of 1962. The new funds offered by trust companies had assets of $20 million; in addition trust companies operate many pooled funds with assets of more than $150 million for the investment of their small E.T. & A. accounts.

TABLE 13–4

ASSETS OF CANADIAN MUTUAL FUNDS[a]
(December 31)

—	1951		1956		1962	
	$ mn	%	$ mn	%	$ mn	%
Net cash and receivables	—	—	—	—	26.9	3.2
Bonds and debentures	—	—	—	—	111.5	13.4
Preferred Stock	—	—	—	—	46.3	5.5
SUB-TOTAL	10.5	18.5	59.4	23.5	184.7	22.1
Common Stock	46.2	81.5	193.1	76.5	649.5	77.9
NET ASSETS at market value	56.7	100.0	252.4	100.0	834.2	100.0
(Net Assets at cost)	(42.2)		(191.1)		(710.0)	
Number of shareholders	22,276		58,318		282,209	

[a]This table and the following one include only members of the Canadian Mutual Funds Association.

TABLE 13–5

MAIN TYPES OF CANADIAN MUTUAL FUNDS
DISTRIBUTION OF ASSETS, 1962

—	"Balanced" Funds		"Fully Managed" Funds		Bond Funds		Stock Funds		Specialty Funds		Total	
	$ mn	%	$ mn	%	$ mn	%	$ mn	%	$ mn	%	$ mn	%
Net cash and receivables	13.5	3.2	10.3	3.0	0.1	1.9	0.1	1.0	2.9	5.2	26.9	3.2
Bonds and debentures	73.4	17.4	33.0	9.6	3.5	97.0	—	—	1.6	2.7	111.5	13.4
Preferred stock	38.0	9.0	7.2	2.1	0.1	1.1	0.6	7.0	0.5	0.9	46.3	5.5
Common stock	297.1	70.4	292.8	85.3	—	—	7.6	92.0	51.8	91.2	649.5	77.9
TOTAL NET ASSETS	422.0	100.0	343.4	100.0	3.7	100.0	8.4	100.0	56.8	100.0	834.2	100.0
Number of Funds included	10		8		3		2		4		27	

large funds carry some bonds and short-term securities to limit the effect of swings in stock prices and dividends on their assets and earnings and to provide for unexpected redemption requirements.

Classifications of the funds according to their investment policies are somewhat arbitrary. In the United States, the funds' charters filed with the S.E.C. set out investment policies in some detail, specifying in the case of a "balanced" fund for instance that certain proportions of the portfolio will consist of bonds, preferred stock and common stock. In Canada, on the other hand, investment policies are stated more generally in

charters and prospectuses, relatively few funds having detailed investment restrictions. However, some funds tend to carry fairly substantial portfolios of bonds and preferred stock at most times and the term "balanced" fund is commonly applied to them. Others, known as "fully managed", are more inclined to shift their portfolios between these investments and common stocks depending on the state of markets and yields. Policies may change from time to time, but at the end of 1962, for instance, the group of so-called balanced funds included in Table 13-5 had an average of 70% of assets in common stock while the fully managed group had 85%. A small share of mutual fund assets is held by institutions with more restricted investment policies—bond funds, stock funds and funds which specialize in securities of particular industries or invest only in foreign securities.

Investment policies are influenced by the provisions of the Income Tax Act permitting an investment company a tax rate of 21% if it meets certain conditions. To qualify for the lower rate, 80% of its funds must be invested in stocks, bonds or other financial assets and they must provide 95% of its income; 85% of gross revenue must be from Canadian sources, not more than 25% from interest; and at least 85% of income after taxes must be distributed to shareholders. Not more than 10% of assets may be invested in securities of any one issuer, except securities of Canadian governments. Finally, there must be at least 50 shareholders, none of whom holds more than 25% of the funds' outstanding shares.

Between three-quarters and four-fifths of mutual fund investments are common stocks, principally issues of well-established companies, with all branches of industry represented. The bond holdings shown in Table 13-4, amounting to only $112 million in 1962, are nearly all federal and corporate issues, and the funds cannot be considered a significant factor in either market. On the other hand, their stock acquisitions and trading activity have undoubtedly influenced the behaviour of equities markets.

While it is difficult to assess the impact of mutual funds on the stock market, their purchases, which were equivalent to about 10% of net new stock issues in the decade ending in 1961, have almost certainly tended to raise equity prices. Some part of the funds flowing into mutual funds from their shareholders in the post-war period might have gone into stocks in any case, but much would probably not have. Indeed, representatives of the securities industry told us that favourable experience with mutual funds had led many investors who had not formerly bought common stocks to make direct share purchases themselves. In any event, the careful management of mutual fund portfolios has injected more professional judgment into the market which should serve to improve its allocation of funds.

We have studied the transactions of a number of funds closely in order to form a view of the industry's short-run impact on the market. The results, which are by no means conclusive, suggest that mutual funds tend to be stabilizing in a market decline and somewhat de-stabilizing in a market rise, although they do seem to have a moderating effect on the rise as the market nears its peak, often diverting more funds into the bond market to take advantage of the attractive yields usually prevailing at such times. There seems to be a fairly continuous flow of net new funds from contractual and other investors in mutual funds[34] which, while moderating market declines and intensifying upswings, is less volatile than individual investments in the stock market. Moreover, the mutual funds appear to be fairly selective in their buying and selling, thus often alleviating pressures that may exist on certain stocks. Finally, mutual funds and their shareholders are outright long-term owners not exposed to margin calls, and this imparts additional stability to their operations. At times, of course, they can be highly de-stabilizing, as the activities of the N.R.O. funds since 1954 attest. Nor is there any doubt that if Canadian mutual

[34] In this regard it is interesting to note that no major net redemptions have occurred in the industry and that even from September 1929 to December 1932 the U.S. mutual fund industry, then very small, experienced an increase in the number of shares outstanding. The same was true of mid-1962, when stock prices fell sharply. See the Submission of the Canadian Mutual Funds Association to the Royal Commission on Taxation, paragraph 21.

funds were ever to be liquidated on a substantial scale, the process would be both prolonged and painful in view of the size of their holdings, both absolutely and in relation to trading volume. However, such a development is unlikely, and less probable than mass selling by individual stock owners.

Both new money received and the appreciation of investments already made contribute to the growth of the funds. The experience of 11 funds which we studied varies quite substantially, but for the group as a whole about 65% of the increase in net asset values in the decade ending in 1961 resulted from the inflow of new funds and 35% from capital appreciation. Since the purpose of mutual fund investment is to buy a diversified group of securities, the stock portfolio of most funds tends to move in value with the main stock price indexes. While much depends on the skill and luck of individual investment managers, the funds' performance on average in years of rising stock prices is not quite as good as the D.B.S. Industrial Common Stock Index, while the reverse is true when markets fall. This results partly from the fact that debt holdings automatically restrain increases in the net asset value of each share when the stock portfolio is appreciating and cushion declines in less happy times.

The average value of the 300,000 mutual fund shareholders' investments is about $3,000 and an increasing proportion of them have invested by making regular payments rather than lump sum purchases. Under some instalment plans, the investor pays an acquisition fee averaging about 8% with each payment, and may stop his purchases and redeem shares at any time. The effect is thus not very different from a lump sum purchase, on which an 8% fee is also typically charged.[35] However, under many contractual plans stipulating for a series of payments over a number of years, the acquisition fee for the entire investment is frequently levied against the early payments. As a result of this "front-end loading", considerably less than 92% of early payments is credited to the investor, and if he wishes to redeem his shares early in the life of the contract he may suffer substantial loss. This is not peculiar to mutual fund investment—life insurance savings normally involve a similar loading of the selling charges on the early premiums[36]—but the consequences of the practice have not always been made clear to investors. A similar problem arises in investment plans under which the individual may withdraw stated amounts in regular payments: it is not always clearly explained that the withdrawals may exhaust his savings sooner than expected if the value of the fund portfolio does not continue to appreciate significantly.

It is important that these and other features of mutual funds be adeqately disclosed to the purchasers, many of whom are relatively unsophisticated. Disclosure is especially vital because the portfolio managers of the fund are often the same people as the distributors, and both groups may also be represented on the board of directors of the fund itself. As a recent United States study shows,[37] this situation can lead to undesirable conflicts of interest. Whatever the arrangements, the portfolio management organization typically receives an annual fee of about ½ of 1% of the fund's average net assets. Other expenses, such as fees for directors, custodian and legal services are relatively small for the large funds, in some cases as low as 3% of the portfolio management fee. In smaller funds, however, these other costs, which do not vary proportionately with the size of the portfolio, are sometimes as large as the management fee. Thus total expenses vary from about ½ of 1% to 1% of net assets. While these costs are not unreasonable, the investor should be clearly aware of them as well as of the acquisition charge and any "front-end load" arrangements.

In our view, there should also be full disclosure of the fund's investment policy, particularly as

[35] The fees are usually lower on larger single purchases.

[36] However, the buyer of life insurance is at least sure of insurance protection during the life of the policy, even though he will have paid a high price for it if he decides to let it lapse.

[37] *A Study of Mutual Funds,* prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce—U.S. Govt. Printing Office, Washington, 1962.

to whether speculative purchases are made, of the extent of brokerage transactions with those who have any interest—direct or indirect—in the fund's affairs, and of any purchases or sales of securities of companies in which the fund's directors and managers are in any way involved. The present securities acts do not regulate mutual funds as such—no Canadian legislation does—but they do regulate mutual fund sales to the public. Investment companies are required to file a prospectus and financial statement making "full, true and plain disclosure" of all material facts, and usually do so annually. Prospectuses do not always meet the disclosure standards we have just suggested. Moreover, until recently regulation of mutual fund selling has not been stringent enough. In 1961, about one-third of the 10,800 securities salesmen registered in Canada were mutual fund salesmen, many of them untrained, and to whose qualifications the inadequately-staffed securities commissions gave only the most perfunctory attention.

Because of the rapid growth of the industry, the more frequent use of "hard sell" techniques and the occasional failure to inform investors of the risks of equity investment, and because of abuses by fringe operators which came to light in the United States, the securities administrators recently asked the industry to undertake some regulatory responsibility for itself. The industry, recognizing the need both for greater protection of the purchaser and for maintaining its own good reputation, subsequently held a series of meetings and in October 1962 formed the Canadian Mutual Funds Association, to which 27 funds and their sales agencies and management companies now belong.

In consultation with the securities administrations, the Association drafted a code of ethics and regulations which among other things prohibits funds buying on margin, selling short, or failing to disclose investment restrictions. It also limits investment to 10% of any issuer's securities except for government securities and shares of other mutual funds or investment subsidiaries. Moreover, to prevent conflicts of interest, it prohibits investment in a fund's management company, underwriter or a firm distributing its shares. It also strikes at a number of potential selling abuses, providing the buyer of a contractual plan involving a front-end load with 30 days to withdraw the funds invested without financial sacrifice if he changes his mind. It further requires distributors of fund shares to ensure that their sales representatives are properly qualified and trained before being allowed to solicit business. The industry is to be commended for these moves and should be able, if properly supported by securities administrators and legislation, to prevent the development of the abuses which have occurred in the United States.

The problem is not the same for closed-end investment companies, their shares being traded in the securities markets in the normal way. Some of them have no investment restrictions, while others specify in their by-laws or charters the amounts that may be invested in any one type or group of securities; sometimes these restrictions also limit part or all their purchases to dividend-paying securities traded on stock exchanges or to securities eligible for investment by insurance companies.

While greater competition for savings and less rapid rises in stock markets may well slow down the rate of growth of mutual funds, there has been no sign of this happening in recent years. On balance, they play a constructive role in mobilizing savings for equity purchases, particularly from smaller investors. They have also improved the workings of markets and can play a useful role in increasing Canadian ownership of domestic industry. Recent moves to increased self-regulation should help to insure that these constructive functions are not accompanied by practices detrimental to the Canadian investor whose interests it is their primary function to serve.

PENSION PLANS

The rapid spread of pension planning has been perhaps the most important change in the financial system since 1945. It has already had important effects on patterns of saving and invest-

ment—at the present time more than 30% of personal savings is made through the accumulation of pensions.[38] The assets held in trusteed pension funds have grown from an estimated $1,180 million in 1952[39] to $4,074 million in 1961 and $4,572 million in 1962, the annual growth rate having declined from about 16% to 13% during the decade. This growth has reflected—with some delay—the transition to an industrialized, wage-earning society in which an individual's own business and family can no longer be counted on to support him in retirement. Pressure from labour unions in their negotiations with employers has hastened the process, which has also been favoured by tax regulations permitting employers and individuals to deduct their contributions to pension plans from taxable income.

The pension and annuity business is not entirely new, the insurance companies having always sold annuities and the federal government since 1908 having made annuities of limited size available to the public. Individuals may purchase government annuities for up to $1,200, either separately or as members of a group annuity plan. In the year ending March 31, 1963, the Annuities Branch of the Department of Labour received contributions of some $37.5 million and paid benefits of $55.4 million on a total of 381,737 policies in force.[40] The premium income is used for the government's current needs—the plan is "unfunded" although separate accounts are kept—and since premiums have not been set at adequate levels, administrative expenses and a substantial part of annuity payments have been met out of the government's general revenues. The institution of Old Age Security payments and the proliferation of other pension and annuity arrangements have completely altered the situation for which government annuities were designed and have removed the need for this form of subsidy. We therefore support the recommendation of the Royal Commission on Government Organization that the sale of Government annuities be discontinued.

The main alternatives to Government annuities for pension plan administration, apart from similar schemes set up on a "pay-as-you-go" or unfunded basis, are insured administration with the life companies, savings through mutual fund retirement plans and trusteeship with a trust company or a group of individuals responsible for seeing that the terms of the plan are met. The pension agreement may involve only one "underwriter"—an insurance company, trust company or committee representing the group concerned—or some combination of two or more of them. For instance, government annuities may cover the first $1,200 of pension with additional benefits covered under an insurance company plan.[41] There is an even greater variety as to eligibility for membership, the rates of contribution by employees and employers, the way in which pension benefits are calculated and circumstances in which they may be drawn, and the conditions under which an employee may transfer pension rights from one plan to another ("portability"). In most Canadian plans the employee is required to make contributions at rates set out in the plan; the employer may also contribute at set rates or, in many cases, may vary his contribution with earnings, drop-out and mortality experience, being obligated to see that sufficient funds are available to meet the actuarial liabilities of the plans.

Sixty per cent of plans covered by the D.B.S. survey (which did not cover "pay-as-you-go" plans) are of the "money purchase" type—contributions are a stated amount or specified share of earnings, but the pension benefits depend on the amounts accumulated, and on investment earnings at the time of retirement. However, these

[38] If pension saving through life insurance companies—already discussed above—is excluded, the figure is just under 25%.

[39] The D.B.S. survey for 1952 reported $717 million of assets in industrial pension plans. No statistics on other trusteed plans are available earlier than 1957, at which time their assets of $838 million were two-thirds as large as those in the industrial plans. The estimate of $1,180 million for 1952 was made by applying this ratio, which has been fairly stable since 1957, to the figure for industrial plans.

[40] Since the business in force is continuing to increase—a situation which normally would lead to a surplus of receipts over benefits—a substantial element of subsidy was involved.

[41] The variety of arrangements is indicated in Table 29 of *Pension Plans, Non-Financial Statistics 1960,* a comprehensive survey of 8,920 plans recently published by the D.B.S.

plans tend to be small and include only 13% of members, while 75% of pension fund members are in plans which relate benefits to earnings in some way. Depending on rates of contribution, sufficient assets may be acquired year by year to meet a plan's present and future liabilities as calculated by actuaries or the contributions may fall short of this. In some cases the employer contracts to provide the funds necessary to meet the terms of pensions at the time when employees retire: this is known as terminal funding and since it is a liability accepted by the employer should be shown in the published financial statements. In plans which are not fully funded, the deficiencies may relate only to "past service liabilities" arising when the fund was started. Quite frequently, the plan calls for these deficiencies to be made up over a period of years by stipulated payments.

An important feature of pension plans is the "vesting" provision, that is to say the employee's right to contributions made on his behalf by his employer in the event that he changes jobs, retires or dies before the retirement age specified in the plan. In a fully vested plan, he is entitled to the benefits from all contributions as they are made. Shading down from the 29% of plans covering 5% of the members which are fully vested, there are a great variety of vesting provisions depending on years of service or length of membership in the plan, ending with the 3% of plans covering 31% of all pension plan members in which there is no vesting until the moment of retirement. Thus a plan may be fully funded in that adequate contributions have been made, and yet the employees are bound to the plan by the fact that they are not entitled to carry the full value of their own and their employer's contributions with them. This is the "portability" problem. On the other hand, a plan may be fully vested although inadequately funded or not funded at all—the employer is simply bound to make up the necessary amount on termination of an employee's service.

Smaller pension plans tend to be in the hands of insurance companies or to be administered by trust companies. The rapid growth of the insurance industry's annuity business, mentioned earlier in this chapter, has raised the amount of the future contractual annual payments involved in the federal companies' policies in force from $192 million in 1950 to $866 million in 1962. In the same period, annuity premium income has risen by about 275% from $59 million a year to $221 million, while insurance premiums increased just over 200% from $261 million to $807 million. Individual policies—some of them being part of a pension plan—have grown steadily but most of the expansion has been in group contracts which the companies offer in competition with other pension administrators and which now account for about 80% of the 724,196 annuity policies in force.

Insurance company plans offer advantages to individuals and small groups wishing to avoid inconvenience and expense in making their pension arrangements. Moreover, these insured pension funds are invested within the limits of insurance company legislation and the solvency of the plan is assured by the usual careful inspection by the federal Department of Insurance or provincial authorities. This close regulation has been one factor inhibiting the companies from devising new plans and tailoring them to the requirements of individual employers. In consequence of this and the vigorous competition from trust companies, they have found it difficult to attract large accounts. Although the introduction of their segregated funds may alleviate part of the difficulty, and although insurance companies have responded to the competition and are uniquely placed to underwrite pension liabilities, it remains true that in 1961 the average insurance company group had 69 employees while trusteed pension plans averaged 796: 160 of the latter had more than 1,000 employed members.

Trusteed plans and the way in which they are administered vary widely. Many of the large ones are trusteed with individuals, typically a group including officers of the employer concerned or others connected with the plan's members. A pension fund society is a similar form of trusteeship in the hands of a committee representing the employer and members of the plan; it is common

for large funds. Some smaller funds are also administered in one of these ways, but the great majority are under "corporate trusteeship"—i.e. administered by a trust company. They may be individually managed—investment responsibility often being shared with representatives of the group concerned—or as is commonly the case with small plans, the funds may be combined for investment with other funds under common trust arrangements.

TABLE 13–6

TRUSTEED PENSION PLANS—1961

—	Number of Funds with assets of:			All plans		
	Less than $5 mn.	$5 mn. to $25 mn.	$25 mn. and over	Number	Total Assets	Average Assets
					$ mn.	$ mn.
Trust companies:						
Individually managed	357	32	4	393	938.3	2.4
Other	718	4	1	723	181.5	0.3
TOTAL	1,075	36	5	1,116	1,119.8	1.0
Individual trustees	165	26	20	211	2,485.0	11.8
Pension fund societies	19	9	8	36	469.3	13.0
TOTAL	1,259	71	33	1,363	4,074.1	3.0

TABLE 13–7

ASSETS OF TRUSTEED PENSION PLANS, 1961

—	Trust Companies		Pension Fund Societies	Individual Trustees	Total	
	Individually Managed Funds	Pooled Funds				
	percent				$ millions	percent
Bonds—Govt. of Canada	9.2	2.9	9.5	18.8	602.4	14.8
Provincial	18.7	4.4	16.1	42.3	1,309.9	32.2
Municipal	12.1	1.8	26.9	7.9	439.9	10.8
Other[a]	31.9	14.3	21.1	10.6	688.4	16.9
TOTAL	71.9	23.4	73.6	79.6	3,040.6	74.7
Stocks—common	17.1	3.9	7.9	6.9	374.8	9.2
preferred	0.6	0.5	1.1	0.3	18.4	0.4
TOTAL	17.7	4.4	9.0	7.2	393.2	9.6
Mortgages and real estate	7.4	2.6	14.4	9.3	374.3	9.2
Pooled and mutual investments[b]	—	66.7	0.3	1.6	161.5	4.0
Other assets	3.0	2.9	2.7	2.3	104.6	2.5
TOTAL	100.0	100.0	100.0	100.0	—	100.0
TOTAL AMOUNTS	$938.3 mn	$181.5 mn	$469.3 mn	$2,485.0 mn	$4,074.1 mn	

[a]Canadian corporate and a small amount of foreign bonds.
[b]These funds are invested largely through the trust companies' own pooling arrangements in a variety of assets.

SOURCE: *Trusteed Pension Plans 1961, Table II.* D.B.S. publication no. 74-201.

Just as there is great variety in the forms of trusteeship and administration, so the investment policies of pension funds may differ substantially from the aggregate statistics shown in Table 13-7. One common feature is that a high proportion of funds in government plans tends to be invested in issues of the employer or of similar borrowers. Thus the high proportion of municipal securities held by pension fund societies reflects the fact that 10 of the 36 societies are for municipal employees. Similarly the large provincial funds are heavily represented among plans with individual trustees, and it will be noticed that 42% of these funds are invested in provincial securities. Clearly pension fund investment decisions—particularly in plans at each level of government—are not made exclusively in terms of yields available on different assets. At the extreme, some funded plans administered by provincial governments hold only non-marketable long-term obligations of the government concerned—which is virtually equivalent to operating an unfunded plan. Given the size of the flows involved, this tendency to disregard market considerations on the part of many funds, particularly some of the large ones, can lower both the returns to members on their pension savings and the efficiency of capital allocation in the market.

About 10% of the market value of trusteed plan assets is invested in corporate stock. In view of both the assured growth and term nature of pension fund liabilities, this is surprisingly low. In many cases, the explanation lies in the bias towards investment of public pension funds in government securities, but it is also true that the administration of many funds has tended to be conservative to a degree perhaps not justified by the need for protecting the pensioners' interests.

On the other hand, the trust companies, which compete actively for pension accounts on the basis of their ability to perform well as investment managers, have tended to invest a considerable share of their pension funds in equities. In 1961, 18% of the assets of funds managed individually by the companies were in stocks and the ratio for pooled funds was about 25%.[42] Moreover, the share of equity investment is rising: more than 30% of the reported increase in assets of individually managed trust company accounts during 1961 was in corporate stocks. For all trusteed plans covered by the D.B.S. survey, stock holdings increased by about $120 million in 1961, which was 27% of the increase in book value of trusteed pension assets. Canadian stocks accounted for $95 million of the increase; while most of the purchases were not of newly-issued stock, their acquisitions may be compared with net new stock issues of $250 million in that year. Thus although many pension fund administrators still shy away from stock investments, those that have found them attractive now play a major role in the equity market. Many of them also trade their portfolios actively as they try to improve their funds' performance, and they switch their holdings as market yields and prices dictate. The investment income of funds with more equity investment has been about the same as that for all trusteed plans, which rose from 3¾% to about 4½% of year-end assets from 1957 to 1961, but they have benefited from the appreciation of stock portfolios as well.

One would not wish industrial plans to invest in the employer's own stock, for this raises serious conflict of interest problems, may have undesirable effects in helping management to put itself above the interests of the shareholders, and also exposes the employee to the risk of losing both job and pension if the company should run into difficulties.[43] On the other hand, careful and diversified stock investment seems a reasonable and obvious use for a somewhat higher share of pension funds.

Although the investment of annuity and pension funds in the hands of life companies and the solvency of these plans is governed by the insurance legislation, there is no regulation of other pension funds and no restriction on their investments beyond what may appear in the individual agreement or by-laws. This is an anomalous situa-

[42] This includes part of the 66.7% of funds shown in Table 13-7 as being invested in "pooled and mutual investments".

[43] The by-laws of most industrial pension plans in fact prohibit such investments.

tion; the protection of the individual's savings is every bit as important in trusteed as in insured pension plans or life insurance and is perhaps more logical in that he frequently has no option but to invest a substantial share of his savings in this way as a condition of employment. It is also more necessary in that the competence of pension fund administration varies greatly—from the plans managed by skilled financial experts to those which are in the hands of less qualified administrators. There has been no evidence of abuse in Canada as yet, but it hardly seems wise to wait until misfortune brings a cry for excessively restrictive legislation.

We therefore think it desirable that the provincial and federal authorities co-operate in establishing broad investment rules, the first of which should prohibit investment in the employers' own securities or other investments raising the possibility of conflict between the pensioners' interests and those of the fund managers. An exception could be made for plans administered by the federal or provincial governments: municipalities should adhere to the general rules although exceptions might be made subject to provincial approval. In order to ensure appropriate diversification of assets, all funds should be prohibited from investing more than 10% of their funds in securities of any one issuer with the exception of federal or provincial issues.

In addition to these prohibitions, a pension plan should be limited to investing in assets eligible under the federal insurance legislation, including a 10% "basket" clause for assets not meeting the quality requirements. We understand that virtually all trusteed plans do now invest within these limits. However, many plans hold more equities than the 15% now allowed to life companies and some exceed even the higher insurance company limits we have recommended. Plans in which all or part of the benefits depend on the performance of the fund (money purchase plans) are similar to the life companies' variable annuities and can like them appropriately be free of any quantitative restriction on stock holdings. Indeed, there is good reason to invest them in equities if there are good prospects of increased earnings and dividends. On the other hand, it is reasonable that plans in which the fund is committed to meeting fixed-amount benefits should invest more heavily in fixed-value assets and avoid the risk of over-investment in equities. Between these extremes, investment policy must be attuned to the type of benefit written into the plan as well as to market prospects. In view of the great variety of plans, we hesitate to recommend that specific quantitative rules be imposed.

Even if funds are wisely invested, it is important to see that they are adequate to meet the terms of the pension plan. There must be enough assets to meet actuarial liabilities, or formal arrangements must be made to ensure that funds will unquestionably be available. We believe that the authorities, whether provincial or federal, should require annual reporting on all funds, including periodic reports by an independent actuary, to see that these standards are met. Indeed, we wish to emphasize that such regular examination is more important than the imposition of arbitrary investment restrictions. The Ontario "Portable Pensions" legislation sets out such rules for private pension plans in all establishments of 15 employees or more, however they may be administered.[44] A period of years will be given to make up any actuarial deficiencies arising out of past service benefits. In addition, it will require that all contributions made on behalf of an employee be fully vested in him as they are made.

If full funding is to be required of all the private plans now in existence as is proposed in Ontario for the minimum benefit requirements of the Act the many plans with actuarial deficits will have to acquire substantial additional assets over a period of years. This increase in the pools invested by pension administrators, financed out of employees' and employers' current incomes, could conceivably result in substantial extra saving in the economy and have a material effect on financial markets and incomes. While other forms of saving would almost certainly be reduced, the net effect would very probably be

[44] The full title is "An Act to provide for the Extension, Improvement and Solvency of Pension Plans and Portability of Pension Benefits".

to increase the amount of capital available in Canada to finance governments and industry.

We do not have the data on individual plans necessary to make actuarial calculations, but discussions with pension actuaries suggest that the $4.6 billion of assets now held by trusteed plans may be $2 billion or more below the amount required for full funding. Taking this estimate for illustrative purposes and assuming that funding were to be carried out over a 25 year period, the extra annual payments would be about $125 million at 4% interest. This would represent an increase of about 20% over the rate of contribution to pension funds and other retirement plans in 1961; the ratio would be considerably lower for the period as a whole since normal contributions will grow substantially.

If one goes on to consider the problem of financing universal government pensions with generous levels of benefits, the magnitudes involved become much larger. Indeed, they raise serious questions about the ability of the economy to support such pension benefits and about the consequences for financial markets of different contribution arrangements. In addition, sizable public pensions would almost certainly involve a considerable expansion of the role of government in the economy.[45]

Though the Commission has made no thorough study of the proposed Canada Pension Plan, we venture to call attention to some considerations which are relevant to our terms of reference. This federal plan would provide those over 70 with pensions building up to a maximum of $75 a month 10 years after it is initiated; these benefits would be additional to Old Age Security benefits of $75 a month.[46] Some classes of workers, such as farm labourers, domestic servants and the self-employed, will not be required to participate, but may do so if they choose. According to the Government's calculations, the cost may rise to between 3% and 3.4% of contributory earnings—that is, earning up to $4,500—by the year 2000. On the assumption that Old Age Security benefits are adjusted in step with changes in average earnings, their financing is expected to cost at least an additional 5½% of contributory earnings. While all such estimates of future costs are bound to be uncertain,[47] it is clear that the plan involves drawing off substantial amounts of personal savings for distribution to pensioners. Even though our national income per capita is about 30% lower than in the United States and welfare payments already account for a larger share of our national production, the Old Age Security and pension plan benefits to be paid to a retired couple who have had earnings of $400 a month will exceed those in the United States by 17%, and by higher amounts at lower income levels.

The Quebec government plans to introduce legislation to establish a plan which will involve the accumulation of a fund for investment. No details are available at present, but the government apparently intends to use the funds received in excess of benefit payments to assist in financing its own requirements and possibly to invest in industry.

Whether or not a plan is funded, the financing of universal pension benefits and the increased payments made to pensioners are certain to affect spending and savings habits in the community and the workings of the financial system. An ambitious plan can be expected to have particularly important consequences, especially if the financing of a high level of benefits in relation to personal income and saving strains the economy's real resources and dislocates saving and investment. There is a limit to the amount of goods and services which the working population will be willing to produce for consumption by retired people. There is also a limit to the amount of supplementary private saving one can

[45] In the following comments on government pension plans we have left aside such important matters as the fairness of contribution and benefit rates to individuals or to groups of members since these matters are not within our terms of reference.

[46] Under certain conditions, participants in the plan would be entitled to begin drawing pensions at age 65.

[47] The U.S. Social Security system was originally established with contributions of 2% on earnings up to $4,800. Since 1937, the rate has risen to about 7% and will rise to 9.25% in 1968, a result in part of the extension of coverage and benefits. It is only reasonable, however, to assume that benefits will move continuously upwards over the years.

expect if contributions to a national scheme, whatever form it takes, absorb a substantial part of the current income people are willing or able to devote to providing for their future: in such circumstances there is every reason to expect a sharp decline in other forms of saving.

There will be differences in the impact of a comprehensive government plan depending on whether or not it is funded. To the extent that the plan is funded a pool of funds will be made available for investment by the government's pension fund administrators. The consequences of this change for economic and financial conditions will depend on how much the savings which had previously flowed into investment through the hands of private pension administrators are reduced and redirected, and on the use to which the new government funds are put. If as proposed,[48] the latter are used to finance government spending, there will be a reduction in the need to sell government securities to other holders, including the long-term financial institutions. Governments, having a captive source of finance, possibly at favourable rates, might well be inclined to spend more freely than they otherwise would. Alternatively, the funds might be invested in a broad range of public and private securities to replace the investments which private institutions and savers would have undertaken. At the very least there will be a shifting of functions from the private to the government sector, which will be in a position to exercise a direct influence on the allocation of a large share of the community's savings and might indeed come to dominate a large part of the financial system. Professor Lundberg discussed with us some of the difficulties encountered in Sweden where the administrators of the national pension scheme, which is partially funded, have become not only important arbiters of capital and resource allocation, but also a centre of financial power whose decisions can influence the government's financial and monetary policies.[49] Arrangements of this sort would be a substantial departure from the accepted roles of the private and public sectors in the Canadian economy.

Since there is normally no question of the central government's ability to meet pension obligations and it is therefore unnecessary for it to ensure solvency by accumulating a fund of investments, it is often thought best for the government to avoid the problems of managing a potentially massive portfolio. If the government therefore finances its pensions entirely on a "pay-as-you-go" or unfunded basis, it channels funds from the working population directly to those who are retired and who are unlikely to save or invest any significant part of them. Under these arrangements, there are no savings accumulated in the hands of government pension administrators which could substitute for the private accumulation of savings through funded retirement plans, and the supply of investible funds may well be reduced. With a growing population, a given level of benefits can be financed through an unfunded plan with lower contributions than would be called for in a funded scheme; alternatively, benefits may be increased earlier than would otherwise be the case so that the working population is required to set aside just as much of its current income for the pensioners as under a funded plan.

The end result of such changes from present methods of financing pensions through private funds cannot be foreseen with any certainty. It will depend on the levels of contributions and benefits and the impact they have on saving by the working population and on spending by retired people. It is possible that in circumstances of less than full employment the stimulus to spending may initially generate higher income levels out of which new savings will flow into investment through the established channels.

[48] The federal government's proposal of January 1964 is for a partially-funded Canada Pension Plan; after 10 years, a fund of $2½ billion (excluding interest) would be accumulated, at which time the fund would still be growing. One-half of the funds would be invested in provincial debt in proportion to the provincial distribution of contributions, and the remainder in federal government securities.

[49] Submission of Professor Erik Lundberg and transcript, pages 4349 ff. Professor Lundberg explained that the level of funding chosen was that considered sufficient to offset the potential decline in other forms of saving: even with partial funding, Professor Lundberg estimates that the fund is now equivalent to one of $15 billion in Canada.

However, the government can work towards full employment in other ways; the stimulus from this source would not be continuing and could better be achieved in other ways which less seriously impair the government's ability to pursue stabilisation policies.

It is in fact all but certain that the financing of a national pension scheme with relatively high benefit levels would result in a substantial reduction in the funds available for investment in the mortgages, bonds and equities which the savings institutions acquire. A change of this type in resource allocation in the economy and our financial arrangements might well take us into a new situation in which the experience of past market developments would have only limited relevance. A serious reduction in domestic private financial investment would fall most heavily on municipal and provincial governments and on business, agriculture and housing. It might well lead to increased reliance on investment by non-residents and necessitate steps by the federal government to see that adequate levels of capital formation are financed in one way or another. Given the higher levels of consumption which could be expected to follow from the transfer of income to retired people, an adequate level of investment might place too heavy a demand on the economy's physical resources and intensify the difficulties of combating inflation. No method of financing enables one to escape the fact of a limit on the economy's ability to provide goods and services for those who are no longer working.

We emphasize that in stating these problems we are not arguing against the desirability of seeing that Canadians provide themselves with adequate retirement income. We are simply stressing the necessity of considering each step along the way with the greatest care, particularly where the vital savings and investment process is involved. We have no panacea to put forward, although we do urge that any proposed pension legislation take account of the price that will have to be paid in terms of the financing of our national development. The magnitudes involved are potentially so great, especially if contributions were to rise over the years, that in our view a cautious, gradual approach should be taken to ensure that achievement of the immediate objective does not bring with it undesirable consequences. In a world of scarce resources it makes sense to consider carefully before making irrevocable decisions affecting the economic welfare of all Canadians.

CONCLUSION

The growth of long-term savings institutions, some of them very large, has not led to the concentration of economic power which some had feared, partly because the business is shared by many insurance companies, mutual funds and pension plans and partly because most of them like to obtain regional and industrial diversification in their portfolios. Nor does the growth of contractual saving appear to have affected the level of personal saving, which has remained a remarkably steady proportion of personal income over the years. This so-called "institutionalization of savings" seems, if anything, to have enlarged equity purchases on balance. This is because the institutions themselves, especially mutual and private pension funds, invest more in equities than many of their individual contributors could or would do on their own. Moreover, those with surplus savings appear to be willing to invest heavily in equities after having met their primary requirements through the institutions: it will be recalled from Chapter 10 that over half the funds in estates managed by trust companies are invested in Canadian equities. While the long-term institutions cannot supply large amounts of high-risk venture capital directly, they can supply it indirectly through participation in development companies, and should step up this activity. As we mentioned, the life companies could appropriately expand their direct purchases of equities as well.

Unless developments are affected in a major way by the nature of government pension legislation, it seems likely that all three major classes

of intermediaries described in this chapter will come into increasing competition with each other: life insurance companies, in addition to their normal functions, will become increasingly like investment trusts competing for the management of investors' funds; pension funds may well add more of the protective feature of life insurance to their benefits as well as becoming increasingly sophisticated in their investment programs; and finally, the mutual funds will probably come to depend more and more on retirement-savings plans as a major source of their growth. It is with such factors in mind that we have suggested a framework of regulation which will allow this competition to be effective over a wide area while still protecting the interests of the small investor who is the ultimate source of much of the funds of these major institutions.

CHAPTER 14

THE RESIDENTIAL MORTGAGE MARKET

Although the annual volume of secondary trading in mortgages is small, the amount of net new residential mortgages marketed in the post-war period has exceeded that of any other type of financial asset. This big and important part of the financial system has grown rapidly in response to vigorous demand generated by an expanding population, rising income levels and a backlog of housing needs accumulated during the years of depression and war. These high requirements for funds to finance new housing construction, repairs and renovation, and sales of existing housing have powerfully influenced the growth of both new and established financial institutions; their response to these continuing needs has in turn led to many improvements in the facilities offered to those seeking mortgage money. Nevertheless, the federal government has played a major role in the mortgage market as a direct lender and insurer of private loans in addition to unifying and improving the standards of mortgage financing and residential construction.

At the end of World War II, Canada's housing stock was low relative to the needs of the population and much accommodation was in need of repair. In succeeding years, growth of the population increased the demand for new housing, as did the movement of people from one part of the country to another. Changes in the structure of the population also added greatly to the demand—family formation rates were high until 1957, and many families moved out of homes which they had shared with others into homes of their own. Given the high and rapidly rising levels of personal income, these underlying demand factors led to high rates of residential construction expenditures, which rose from $700 million right after the war to a peak of $1,722 million in 1958 (both measured in 1957 dollars). These outlays have accounted for 24% of all private fixed investment expenditure in the postwar period as a whole.

In more recent years, the supply of dwellings has been brought into better balance with the demand. This has been one of the factors contributing to some reduction in the rate of new construction, which in the three years 1960-62, averaged $1,349 million (measured in 1957 dollars) compared to $1,722 million in 1958 and $1,633 million in 1959. Other important factors in this development have been the slower growth of real personal incomes and a marked decline in the rate of new family formation and immigration.

These post-war developments in the housing market have had major consequences for the financial system. As pointed out in earlier chapters, many of the institutions willing and able to invest in mortgages have enjoyed rapid growth rates and good profits. In addition to the established mortgage lenders such as life insurance, trust and loan companies, new mortgage lenders have emerged. In 1948, the savings banks were first allowed to invest in conventional mortgages and in 1954 both they and the chartered banks were permitted to acquire N.H.A. mortgages. More recently, other institutions such as sales finance companies have begun to move into the field. Throughout the period, however, the federal

government has, in varying degree, assisted the financing of residential construction for reasons of economic and social policy.

From 1945 to 1962, the estimated total amount of mortgage debt outstanding rose from about $1.3 billion to some $14.2 billion, or from 5% to about 20% of all forms of primary debt outstanding. These figures include estimates of the amounts of mortgage debt held by individuals as well as the reported amounts held by the financial institutions, by governments and their agencies, and by non-financial corporations. The increase of $13 billion in mortgage debt may be compared to a net increase of $2 billion in federal government debt outstanding over the 17 years, and to increases of $7 billion, $3 billion and $6 billion in outstanding provincial, municipal and corporate securities respectively.

These mortgage figures include substantial amounts of business and farm debt. Although we unfortunately do not have full information on all such mortgage lending, particularly that granted by non-financial corporations and individuals, we have estimated that some $6½ billion of the $8½ billion in mortgages held at the end of 1961 by financial institutions and governments, or 77%, was secured by residential property. Assuming a comparable proportion in the holdings of other lenders,[1] the total amount of residential mortgages outstanding would be of the order of $10 billion in 1961. At that time, there were 4½ million dwelling units in the country having an estimated value of between $40 and $45 billion—including land—so that mortgage indebtedness represented approximately 25% of property values. This rough relationship is borne out by our own consumer survey in which mortgage debt was reported at about 30% of the value of dwellings.

Loans secured by residential property are used to finance the construction of new housing, for repairs, renovation and transfer of existing properties, and for a variety of other purposes not directly related to housing finance. There has been some evidence in recent years that borrowers are making increasing use of mortgages on their homes to obtain funds to meet other needs such as education costs or major durable purchases, but the largest source of demand—and the most important in its effects on employment and economic activity—remains that for new construction. Since the end of the war, 75% of the amount of residential lending approved by the main financial institutions has been for new construction, while government residential mortgage lending is almost exclusively for this purpose. Individual lenders also supply mortgage funds for new construction but a much higher share of their lending is secured by existing properties.

Thus, the relatively small share of the housing stock built each year provides the main source of demand for mortgage funds. Moreover, such new construction depends heavily on borrowed funds compared, for instance, to the relatively low use of external finance by businesses referred to in Chapter 3. As shown in Table 14-1, the owners'

[1] This assumption is supported by a survey of mortgage registrations by individual lenders in Ontario in 1958, in which 77% of the total amount was secured by residential property.

TABLE 14–1

SOURCES OF FUNDS FOR EXPENDITURE ON NEW HOUSING
(annual averages)

—	1954–1957		1958–1962	
	$ mn	%	$ mn	%
Owners' equity	269.7	18.7	291.0	17.8
Federal Government				
—CMHC	46.4	3.2	276.5	16.9
—other[a]	37.8	2.6	36.6	2.2
Lending Institutions				
—N.H.A.	406.9	28.2	357.0	21.8
—Conventional	194.1	13.5	308.2	18.8
Other Financing[b]	487.4	33.8	367.7	22.5
TOTAL EXPENDITURES	1,442.3	100.0	1,636.8	100.0

[a] Includes public housing such as armed forces dwellings and joint Federal-Provincial housing.

[b] Mortgage lending by caisses populaires and credit unions, which are not approved lenders under The National Housing Act, is included with credit extended by individuals and non-financial lenders in this "other financing" total.

SOURCE: *Canadian Housing Statistics.*

equity in new housing has provided only 18% of the funds needed for construction since 1954, with 82% coming from financial institutions, government agencies and other outside sources. Borrowed funds are the principal source of finance for all but a relatively small number of houses and apartments built: in 1962, institutional and government funds were the main source of finance for 106,995 of the 130,095 dwelling units started, and money borrowed from other lenders undoubtedly provided the principal financing for most of the remaining 23,100. The market for new housing can thus be powerfully affected by the way in which the mortgage market is organized and allocates funds among competing needs and by changes in the availability of mortgage funds.

CHARACTERISTICS OF THE RESIDENTIAL MORTGAGE MARKET

The basic characteristics of the residential mortgage lending process, and of the mortgage instrument itself, do much to determine the nature of the mortgage market. Residential mortgages are long-term loans secured by individual pieces of real estate with widely varying characteristics as to location, type and age of building and quality of construction. Such loans are normally supported by the borrower's personal covenant to repay, but the amounts involved are normally so large in relation to the borrower's income that—apart from ensuring as far as possible that the borrower is not over-extended or unwilling to honour his commitments—the lenders must look primarily to the property itself as the ultimate security for their funds[2] and must therefore be skilled in appraising property values and building standards. Moreover, unlike corporate or government securities, most mortgages—except those on large apartment buildings—must be issued in relatively small amounts; the average loan on new single family houses was about $13,400 in 1962, while loans on existing houses averaged $8,310.

Individuals can and do lend substantial amounts on mortgages but mainly in circumstances where they know the situation or where their occupation gives them special skills in the field. A considerable amount of such lending also arises from the sale of housing, the vendor taking back a mortgage to complete the transaction or realize a higher price. However, institutional lenders with the organization and skills necessary to appraise properties and administer portfolios of mortgages at reasonable cost provide a larger share of the funds. Because of the individual nature of each mortgage and the resulting decentralized character of the market there is little trade in outstanding mortgages compared to the secondary market turnover in stocks and in many types of bonds. Institutional and other lenders tend to originate their own loans and keep them until final repayment, and the dominance of these long-term lenders in the market tends further to reduce turnover and marketability. This in turn tends to limit the supply of funds from investors with significant liquidity needs. Flexibility in the market is further reduced by the elaborate legal arrangements and consequent costs of real estate and mortgage transactions and by the variety of prohibitions and restrictions applying to mortgage investment by financial intermediaries referred to in earlier chapters.

(i) *The National Housing Act*

The structure of the market for new housing finance is in large part determined by the terms of the National Housing Act and the operations of Central Mortgage and Housing Corporation under it. Since passage of the Dominion Housing Act in 1935, the federal government has played an increasingly important role in the housing market. This piece of legislation, and the first National Housing Act which replaced it in 1938, were designed to increase spending on new housing with the twin purposes of increasing the housing stock and stimulating economic activity, while the companion Home Improvement Loans Guarantee Act of 1937 was intended to promote

[2] Because of the character of the security, the lender is often willing to allow a subsequent purchaser to assume the liability for an existing mortgage (or to arrange modification of its terms). While such transactions give rise to substantial gross flows of credit to purchasers from vendors, the net flows of mortgage credit are not changed.

spending on housing repair. The principal technique introduced in 1935 was the joint mortgage loan under which the government put up 20% of the property value at 3% interest and private institutions obtained a higher rate, 5.66%, on their share, which could vary from 50% to 60% of property value and was covered by partial insurance. The result was to make mortgage funds available more cheaply than otherwise. Moreover, the amortization period of 20 years was longer, and the maximum loan of 80% was larger, than was available in normal mortgage lending. Relatively low rates, long amortization periods providing for regular monthly repayment of principal, a high ratio of loan to property value and the insurance of private institutional lending are still the most important elements in the financial side of the government's housing policy.

In addition, the 1935 legislation established minimum construction standards for building financed under its provisions, and the government has continued to work for improvement in the quality of housing by insisting that the security for mortgage loans it grants or guarantees meet high construction standards. The early housing legislation had a number of other features designed to stimulate construction activity, such as special terms favouring borrowers with low incomes and those living in small and remote communities; there was also provision for loans to corporations paying limited dividends which undertook to build low-rental housing projects. However, residential construction remained at low levels during the late 1930's and was, of course, severely restricted during the war. The total amount advanced from 1935 to 1944 under all parts of the housing legislation was only $87 million.

In order to assist in meeting the housing shortage resulting from these years, a new National Housing Act (N.H.A.) was passed in 1944. In the following year, the Central Mortgage and Housing Corporation (CMHC) was set up to administer this Act, which now included the Home Improvement Loans guarantee legislation, and to be the government's agent and advisor in matters of housing policy. The policies laid down in previous legislation were maintained, and the Act was extended to provide for federal loans covering 50% of the cost of municipal slum clearance projects. Despite amendments in succeeding years which broadened CMHC's direct lending powers—particularly the 1947 amendment enabling the Corporation to make loans in small or remote communities where private lending institutions were not providing joint loans—the joint loan remained until 1954 the principal type of lending under the N.H.A. Eighty-six percent of the $1,351 million of loans approved under the Act from 1946 to 1954 were of this type.

In 1954, a revised National Housing Act replaced the joint lending arrangement with a system of insuring loans made entirely by approved private lending institutions; provisions for direct lending by CMHC, loans to limited dividend companies, rental guarantees and home improvement loans were, however, retained. The Corporation was also empowered to buy and sell insured mortgages. The main purpose of the changes was to increase the flow of new housing mortgage funds from private institutions, and to this end the chartered banks and Quebec savings banks were also permitted to make N.H.A. mortgage loans by amendment of their own legislation. Whereas insurance of joint lending applied to the institutions' business as a whole, it applies to each individual loan under the present scheme and may therefore be transferred with the loan. This is essential if the mortgages are to be sold by the first lender to other investors and if a range of private N.H.A. lenders without the facilities and skills to initiate loans is to be attracted into the market. The insurance, which the borrower pays for[3] and which the lender may

[3] The fee is 2% for home ownership property and 2½% for rental property. Fees go into a reserve fund, amounting to $102 million at the end of 1962. The fund is about 2% of outstanding N.H.A. mortgages and has certainly been adequate for the claims made on it to date; these have amounted to about $12 million from 1954 to 1962. The present level of fees appears adequate for all normal circumstances, although a major depression might deplete the fund. If that were to happen the claims would fall directly on the government, which stands behind the insurance fund.

claim if he chooses not to retain the property mortgaged by a defaulting borrower, covers the full amount of principal outstanding, as well as interest for a number of months, taxes due and some of the lender's costs.

The terms of N.H.A. loans have changed considerably over the years; there have been a number of increases in the size of loan permitted and the amortization period as well as changes in the maximum rate of interest allowed.[4] At present, loans to home owners may be made for 95% of the first $13,000 of property value (as determined by CMHC) and 70% of the remainder up to a total loan of $15,600 on houses with four or more bedrooms and $14,900 on smaller houses. The maximum term is 35 years, and lenders may not require repayment in less than 25 years, although the borrower may not want such long amortization and some loans are written for periods as short as 15 years. In lending to home owners the lender must try to ensure that annual payments on the mortgage and property taxes are not more than 27% of the borrower's income.

Loans on apartments and other rental property may not exceed 85% of property value. Until 1963, the maximum loans allowed on rental property were considerably below those on individually owned homes, but at present they are the same—$14,900 or $15,600—for all types of rental property other than apartment buildings for which a maximum of $12,000 for each unit is imposed. The maximum term of 35 years is the same as for home owners. Thus the previous policy of favouring home ownership over rental accommodation has been pretty well abandoned. In view of the population's changing housing needs and the advantages of renting for those obliged to move frequently, we take this to be an appropriate change.

A maximum rate of 6¼% now applies to all N.H.A. loans other than CMHC's special lending to limited dividend companies, to universities for student housing and for slum clearance and joint low-rental housing projects undertaken with the provinces; the rate on such loans is 5⅛%. Virtually all mortgages are written at the maximum rate. Since 1954, the rate has been changed only 7 times, varying from a low of 5¼% set in February 1955 to the level of 6¾% which prevailed from late 1959 until November 1961.

(ii) *The Conventional Mortgage Market*

N.H.A. residential loans are available only for new housing, and their terms are considerably more favourable to the borrower than those on conventional mortgages on new or existing property. Although the repayment period on conventional lending has lengthened considerably owing to successful experience with N.H.A. lending, to the general acceptance of regular amortization schedules and to competition among lenders, the term of much conventional lending—particularly mortgages on existing properties—is still shorter than the 26 year average for N.H.A. loans. In the case of life insurance company lending on new property, there is probably not much difference: amortization periods of 20 or 25 years are common and some mortgages are now written for 30 years. Moreover, a good deal of lending on recently-built houses is written on the same basis as that applying to new properties. On most existing housing, however, the average amortization of loans is closer to 15 to 20 years, reflecting its greater obsolescence or the prospects of older neighbourhoods declining in value.

Trust and loan companies, which are more exposed to changes in the cost of their own borrowed funds and which often hesitate to commit their E.T. & A. accounts for long periods, generally prefer shorter terms on new and used housing. An average amortization period of 15 to 20 years is common on new property, and some of these companies do not write mortgages on existing homes for longer than 15 years. The life companies' mortgage loans normally have the same term as their amortization period. However, trust and loan companies prefer to commit themselves to lend at a stated rate for only 5 years, although setting repayment schedules to amortize the loans over longer periods. They do this in

[4] For full details from 1935 to 1961 see CMHC Submission, pages 63-64.

order to obtain the right to re-negotiate the rate of interest if the cost of their funds rises sharply. In practice they are almost always prepared to renew the loan at the end of its original term and do not always call for a higher rate even if interest rates have risen in the interim. Competition has recently obliged them to offer terms longer than 5 years.

(iii) *Mortgage Prepayment Privileges*

The lending institutions stated that the borrowers' legal right to prepay mortgage loans raises difficulties for them. At present, N.H.A. loans to individuals may be repaid in full at any time after three years,[5] while under the terms of the federal Interest Act, individual conventional borrowers may repay in whole—but not in part—after five years,[6] subject in both cases to a charge of three months' interest on the amount repaid. The three year provision in the N.H.A. was a compromise struck between the government, which would have preferred complete freedom to repay, and the lending institutions, which wanted to apply the same five year rule as for conventional loans. The actual term of mortgage investments is consequently less certain than it is for bonds with prohibitions against refunding at lower rates of interest or other no-call features, and this makes them less attractive than bonds when interest rates are high. Since lenders do not have the same absolute right of calling for repayment or renegotiating the loan at a higher rate of interest, institutions such as trust and loan companies, which may have to borrow their funds at higher rates if interest rates rise, are not anxious to commit themselves to long-term mortgage loans at low yields. Thus, they have not been significant N.H.A. lenders when there has been a strong demand for conventional mortgage loans of shorter term.

The prepayment privilege given to individual mortgage borrowers—and not usually available to other long-term borrowers—may raise problems for investors. However, the principle of protecting individuals against entering into unalterable long-term commitments, or against being forced to carry mortgage loans which they may no longer need, has merit. Moreover, the difficulties for institutional investors should not be exaggerated. The institutions' concern is not so much with individual prepayments as with the average experience in their portfolios. In practice, N.H.A. loans written for 25 years have an average life of 12 to 14 years and 20 year conventional loans average 7 to 9 years. The charge levied for prepayment—which with accompanying legal fees amounts to about 3% of the sum to be repaid—and the inertia of borrowers serve to limit the amount of prepayments. Admittedly, the upward drift of mortgage rates has made refinancing unattractive at most times in recent years and substantial declines might lead to considerable refinancing. While recognizing the difficulty this might present for mortgage investors, we think it best on balance to retain the prepayment privilege. On the other hand, there seems no strong reason to maintain differing repayment rules for N.H.A. and conventional loans. If N.H.A. loans were also not repayable for five years, it would remove the slight deterrent to N.H.A. investment which the present three-year rule may impose.

Quite apart from the problems raised for lenders by changes in the cost of funds needed to finance long-term commitments, many of them are not anxious to grant loans with such long amortizations that principal repayments are extremely low in the early years. For instance on a loan yielding 6¼%, 23% of principal is repaid within 10 years if amortization is complete in 25 years: the share drops to 16% for a 30 year loan and 11% for one amortized over 35 years. Private lenders are granting some N.H.A. loans for 30 years but very few private loans have been written for the maximum 35 years permitted by the Act. The introduction of so-called "5 and 25" apartment loans is further evidence of their concern. These are 30 year loans but amortization in the first five years is at a 25 year

[5] Individual N.H.A. borrowers may prepay up to 10% of the loan at the end of the first and second years and any amount from the end of third year on. Corporate or rental borrowers may prepay the whole amount at the end of 5 years, or 10 years if the lender requires.

[6] The Interest Act does not apply to corporate borrowers.

rate, followed by 25 years at lower payments. We believe that the institutions are wise to show some resistance to the lengthening of term and that the maximum N.H.A. term should not be raised above the present 35 years.

(iv) *The Financing of New and Existing Property*

Despite the fact that competition continues to oblige the lenders to offer longer terms, a significant margin persists between the term available to N.H.A. borrowers and those who must turn to the conventional market. This margin is, however, less of a factor than the differences between N.H.A. and conventional loans in the ratio of loan to value of the property and—at times—in rates of interest. Although there is no absolute limit on the size of conventional loan most institutions can grant, they may only make first mortgage loans, and even then may not lend more than two-thirds of the appraised property value. In the case of Quebec savings banks the ratio is 60%, the law not having been changed when the ratio applying to the life insurance, trust and loan companies was raised. These ratios compare to the N.H.A. limits of 95% on the first $13,000 of value and 70% on the remainder up to the maximum loan of $14,900 or $15,600.

Thus borrowers who must obtain funds in the conventional market, whether for new or existing housing, have until recently been required to make substantially higher down payments either out of their own funds or by borrowing in the second mortgage market at higher rates of interest. In addition, the conventional rate of interest is normally higher than the N.H.A. rate. Prime conventional mortgages have at times cost borrowers virtually the same as N.H.A. funds (including the insurance fee), but the differential has been as high as 1¼%; lenders naturally charge more than the prime rate if the condition of the property, its location or the borrower's financial position justify it.

THE SUPPLY OF MORTGAGE FUNDS

The residential mortgage market centres in the lending institutions—principally life insurance, trust and loan companies, the chartered banks (when they have been active lenders) and the credit unions and savings banks. Other lenders, notably private individuals and the federal government through CMHC, are very important suppliers of mortgage funds, but their role has been to a considerable extent that of supplementary or residual lender, meeting excess demands for funds or investing in types of mortgages which the institutions are unwilling or unable to acquire.

The life insurance companies have long been the most important institutional source of residential mortgage money. As we noted in the previous chapter, there has been a continual growth in the share of life company funds invested in mortgages since the war. However, the trust and loan companies, particularly the former, have grown more rapidly—partly because their ability to bid for short and medium-term funds has been enhanced by the relatively high yields earned on their growing mortgage investments. This growth has raised their participation in the market, so that in 1960-62 they accounted for about 41% of institutional approvals compared to only 24% in the early 1950's. Yet Table 14-2 shows that in spite of the slower growth of their resources, the life companies still accounted for 56% of all residential mortgage approvals by the major institutions in 1960-62. The chartered banks became very important N.H.A. mortgage lenders in the years following the 1954 legislative amendments, but since 1959 they have originated very few mortgage loans. During the six years in which they were active, the banks approved one quarter of all residential mortgage loans by the institutions covered in the table.

As noted in earlier chapters, the mortgage policies of individual companies within each group of institutions differ widely, with some life and trust companies having large mortgage portfolios and others concentrating more of their resources on bond investments. However, there are important common features about the position of each type of institution in the mortgage market. The life insurance companies, because of the long-term and relatively low-cost funds at their dis-

TABLE 14–2

GROSS RESIDENTIAL MORTGAGE LOANS APPROVED BY LENDING INSTITUTIONS

—	1951–1953		1954–1959		1960–1962	
	$ mn.	%	$ mn.	%	$ mn.	%
Life insurance companies	943.3	74.7	2,638.1	50.2	1,706.6	55.5
Trust companies	88.5	7.1	546.7	10.4	726.8	23.6
Loan companies	208.5	16.5	661.6	12.6	530.2	17.2
Chartered banks	—	—	1,292.2	24.6	1.3	—
Other[a]	22.8	1.8	114.9	2.2	111.7	3.6
TOTAL	1,263.2	100.0	5,235.5	100.0	3,076.6	100.0

CLASSIFICATION OF RESIDENTIAL MORTGAGE APPROVALS BY TYPE OF PROPERTY
1960–1962

—	New Construction				Existing Property		Total	
	N.H.A.		Conventional					
	$ mn.	%	$ mn.	%	$ mn.	%	$ mn.	%
Life insurance companies	669.0	60.5	737.0	67.6	300.6	34.2	1,706.6	55.5
Trust companies	379.6	34.3	97.4	8.9	249.8	28.4	726.8	23.6
Loan companies	54.6	4.9	208.2	19.1	267.4	30.4	530.2	17.2
Chartered banks	1.3	0.1	—	—	—	—	1.3	—
Other[a]	2.1	0.2	47.7	4.4	61.8	7.0	111.7	3.6
TOTAL	1,106.6	100.0	1,090.4	100.0	879.5	100.0	3,076.6	100.0

[a]Includes Quebec Savings Banks and mutual benefit societies. Caisses populaires and credit unions are not included; in 1961 the former approved all mortgages of some $80 million and the latter not more than $15 or $20 million.

posal, have traditionally invested more freely than the trust and loan companies in new construction loans. In the years 1960-1962, 82% of the amount of life company approvals was for new construction compared to 66% for trust companies and 49% for loan companies, and the insurance companies provided 64% of all institutional funds for new residential construction. However, as already noted, the trust and loan companies have had to modify their natural preference for shorter maturities, and have offered longer terms and begun to invest more in N.H.A. mortgages. This has been particularly true of trust companies: during 1960-1962, 52% of their residential mortgage approvals were for N.H.A. loans compared to 17% in the preceding three years. A narrowing of the yield advantage in favour of conventional loans in 1960 and 1961, reflecting the greater competition in conventional lending, has contributed to this shift in the investment preferences of many trust and loan companies.

The caisses populaires are important mortgage lenders in Quebec, although they are not approved N.H.A. lenders. Because of their favourable lending rates and large membership, they account for perhaps one-third of conventional lending by financial institutions in the province. At the end of 1961 they held $348 million of mortgages, most of them secured by residential property. On the other hand, the credit unions, with their emphasis on personal loans, had only about $25 million of residential mortgages—excluding those taken as security for personal loans—with most holdings being in British Columbia, Saskatchewan and Manitoba.

Despite the greater interest in residential mortgages recently shown by some institutional lenders, and despite the appearance of new lenders in the market, the government has also been a large-scale mortgage lender. There are a number of reasons for this situation. Part of the imbalance in the private market results from the fact that the lending institutions do not have facilities in every community to make funds available on regular N.H.A. terms. It is probable that under any arrangements there would be some mortgage demand of this sort which the government would wish to meet. However, present arrangements have inflated the call on government funds well beyond such special situations. In fact, CMHC has for some years provided funds throughout the country, not because private lenders lack the facilities, but because they are either prevented from N.H.A. lending or have inadequate incentive to do so at going rates on such mortgages.

For some years after the amendment to their legislation in 1954, the chartered banks were substantial suppliers of mortgage funds. Through their extensive branch systems, they were able to lend in smaller communities not fully served by other lenders and to supplement the flow of funds from other institutions in all parts of the country. In those years, private lending handled all but a small part of the mortgage demand. Since mid-1959 however, the banks have all but withdrawn from N.HA. lending—partly because of other demands upon them and partly because of doubts about the propriety of making direct mortgage loans above 6%. In addition, there have been occasions when the N.H.A. rate was fixed at levels which were unattractive to lenders, given alternative rates on conventional loans and on securities. Thus the government's policies have resulted in a gap in the availability of funds which it felt obliged to fill with direct CMHC lending. From 1957 to 1962, CMHC approved loans of $1.6 billion and at the end of 1962 its portfolio was almost $1.3 billion.[7] In the same years, the private institutions approved $2.6 billion of N.H.A. loans, bringing their combined portfolios at the end of 1962 to $3 billion.

The market in mortgages on existing properties is much more complex and fragmented than that on new housing: the quality of security is less uniform, the terms and conditions of borrowing vary more widely and there are a great many more lenders. In the new housing market, there are some 65 institutions approved to lend under the N.H.A. Although the number making conventional mortgages on new houses is considerably larger—including as it does the caisses populaires, some credit unions and other financial institutions not entitled to originate N.H.A. mortgages—the participants are still relatively few, the lenders are mainly institutional and the terms of lending remain relatively uniform. In the financing of existing properties, in contrast, individual lenders play a major role and terms vary widely. Moreover, because of the limits under which the main institutional lenders operate, other institutions not subject to the same restrictions have emerged to develop what amounts to a supplementary mortgage business. The need for such additional supply is increased by the fact that neither the chartered banks nor CMHC is empowered to lend in this part of the market. Some banks are, however, entering the field indirectly through associated companies.

Even when one of the major institutions is prepared to take a first mortgage, the buyer is faced with putting up cash for at least one-third of the appraised value of the property out of his own funds or with financing obtained from some other source. When additional financing of some sort is required, the most common solution is for the seller to accept part payment in the form of a second mortgage, and much residential mortgage investment by individuals arises in this way. However, many sellers of houses and other individuals do acquire first or second mortgages as the result of a conscious investment decision. Mortgages are convenient, high-yielding investments for many people, particularly in small communities where both the property and borrower are known to the lender and where alterna-

[7] Joint loans and insured loans to builders and home owners only. Uninsured loans accounted for a further $300 million.

tive investment opportunities are not as great as in larger centres.

Statistical information is sketchy, but estimates prepared by CMHC show total mortgage holdings of individuals, unincorporated businesses and charitable institutions amounting to about $3.5 billion in 1961, and personal holdings would account for a large part of this total. In our own survey of consumer finances, about 6% of households reported holding mortgage and miscellaneous loans; the average amount for all households in the survey was just over $600. Assuming that most of these loans were mortgages, and that our survey is representative, the national total would be of the order of $2¼ billion. The average amount held per household rises with the age of the head of the household, being largest where the head was over 65 and was more likely to have taken back a mortgage on a previous sale of a house. Mortgage and other loans accounted for about 15% of the average holdings of financial assets of all households in the survey, compared to about 12% for marketable bonds and close to 25% for shares. It would be helpful if the authorities could obtain further data on the amounts, terms and costs of mortgages held outside the main financial institutions, since knowledge of this important sector of the mortgage market is now very limited.

In addition to mortgage lending by individuals, a great variety of businesses large and small invest in first mortgages of up to 80% or more of residential property values. These lenders also make second mortgage loans, either to facilitate the sale of houses by reducing the gap between the property value and the 66⅔% which the major lenders are permitted to advance, or to provide homeowners with funds for other purposes. The 80%-85% mortgages are a recent development in mortgage finance, and a number of companies have been set up in the last decade, and particularly in more recent years, to specialize in this business. Some of them raise funds directly in the securities markets by means of a variety of short and long-term debt issues as well as equity issues, while others are subsidiaries or affiliates of the larger finance companies; the latter reflect the pattern of investment diversification which has marked that industry during the past decade and which was discussed in Chapter 11.

In some cases these companies put up all the funds themselves, while in others arrangements have been made for joint lending with the regulated institutions. For example, a trust company will take a first mortgage equal to 66⅔% of the value, leaving the supplementary mortgage company a second mortgage on a further 16⅔% on which a higher return is obtained. Such arrangements are simply a technique for blending two mortgages in a single loan covering a high proportion of the property value. The combined rate of interest varied from 8% to 10% when conventional first mortgage rates were 7% to 7¼%, but with increased competition this rate is now commonly lower.[8] Separate second mortgages are usually written by the specialized lenders for five, ten or 15 years, whereas under the blended loan technique the full 80% may be amortized over periods of as long as 25 years.

The introduction of high-ratio lending by substantial institutions, some of them having facilities to operate in a number of provinces, has tended both to lengthen the term and reduce the rate of second mortgage lending. A second mortgage of longer than five years is no longer a rarity, and rates in urban centres are typically around 12% compared to the 20% or more which was common a few years ago. However, there is still a certain amount of high-rate lending by some fringe institutions and by individuals or groups of investors familiar with real estate. This remains an area of the financial system in which unscrupulous operators are able to exact usurious terms from some borrowers—frequently from people newly arrived in the country. We are pleased that steps have been taken by provincial governments to ensure that fraudulent or unconscionable transactions are controlled, but the best

[8] For instance, a 7½% combined rate on an 80% mortgage when the first mortgage is written at 7% implies a rate of about 9½% on the top portion of the loan.

support possible for such efforts is to have full disclosure of effective rates of interest and to make funds available through legitimate lending institutions at economic rates of interest.

REGIONAL DIFFERENCES IN THE MARKET

Despite the lengthening term of conventional loans and the appearance of new lenders making high-ratio loans, there remain significant differences in the financing of new and existing housing. There are also important regional differences in the structure of the market. For instance, conditions vary substantially with the age of the housing and thus, typically, its location. In his evidence before us, Mr. Mansur generalized the situation in the cities by referring to three types of housing; that in the post-war sub-divisions, a second band built in the interwar years in residential areas and varying considerably in its current quality and state of repair, and a third category of older housing situated in the centre of the cities.[9] The established mortgage institutions will lend freely in the first area at their prime rates, are prepared to lend on much of the second type of housing, although at rates which may be as much as 1% higher, but are not interested in acquiring mortgages on the older run-down urban properties in areas which may be due to undergo considerable change. Such loans are typically made by private or other investors at rates in the range of 10% for first mortgages and considerably more for second mortgages. Although there are undoubtedly occasions when an institution's own guide lines lead it to reject quite sound mortgage propositions, some broad policy decisions are essential in their business and those described by Mr. Mansur are neither surprising nor unreasonable. However, these preferences on the part of the principal institutions do mean that the problem of financing housing sales is more acute in some parts of our cities than in others.

There are also important regional differences in the character of the mortgage market. The main lending institutions acquire mortgages in most parts of the country, either directly through their own branch organizations or from agents operating in centres where they do not have facilities. However, a high proportion of their mortgage funds is placed in the larger cities and towns while they play a relatively less active role in smaller communities. Thus, while the institutions financed 69% of all N.H.A. housing starts in 1962, their share was 77% in metropolitan areas, 60% in major urban areas and only 44% in all other parts of the country.[10] Some of these differences may stem from the relatively greater willingness of individuals in smaller centres to invest in mortgages, and indeed some institutional lenders told us their agents had difficulty in locating good mortgages in such centres. However, the fact that CMHC was called upon to lend much more heavily in the areas outside main cities suggests that this is not the complete explanation. It is interesting to note that in 1958, when the chartered banks were active in N.H.A. lending, the discrepancies in institutional lending by size of centre were less marked: private institutions financed 57% of N.H.A. housing starts in metropolitan areas, 50% in major urban areas and a slightly higher share, 53%, in other areas.

Smaller regional differences are found in the conventional mortgage market, but here they are reflected in differences in the cost as well as the availability of funds. Thus in 1962 the average yield on all mortgages registered varied from 6.93% in Quebec to 7.74% in Prince Edward Island, with rates tending to be higher in the Atlantic Provinces than in other parts of the country.[11] Borrowers in Quebec enjoy low rates largely because of the activity of the caisses populaires: since they lend in all parts of the province, they reduce the regional differences within Quebec as well as keeping rates low relative to other parts of the country. In Ontario, the loan and trust companies have a similar impact although their branches are not as numerous or widely dispersed as are the caisses populaires.

[9] See evidence of Mr. D. B. Mansur, Transcript pages 6128 ff. These categories apply particularly to larger cities.

[10] *Canadian Housing Statistics, 1962,* Table 32.

[11] *Canadian Housing Statistics, 1962,* Table 50.

MORTGAGE INSURANCE FOR EXISTING PROPERTIES

The difference between the terms on which new and existing housing may be financed results both from the availability of a government guarantee on mortgages for new housing, which is not applicable to those on existing property, and from the limitations imposed on the loan to value ratios of the major lending institutions. Moreover, the main object of government housing policy has been to increase new residential construction. This element of discrimination has served its purpose well, for those with limited savings have found it easier to build or buy new properties than to buy existing housing.[12]

More equal financing terms in the two parts of the housing market would all but certainly contribute to a more balanced and rational use of the housing stock and more economic rates of increase, transfer and improvement. However, it would be foolish to assume that such improvements would necessarily check the flight to the suburbs or lead to the restoration of urban slum areas, which owe their existence to deep-seated social and economic factors. Experience in the United States, where government guarantees extend to existing houses, indicates that better financing terms on older housing may have little effect on urban development and that as long as people wish to buy their own separate housing, sheer space considerations will force an outward move from the centre of the city.

It has been suggested that government guarantees be extended to mortgages on existing housing to reduce the disparities between the financing of such property and new construction. Assuming that the technical difficulties of providing guarantees for loans secured by the great variety of existing houses could be overcome, (lending ratios, amortization periods, and other terms would clearly have to vary with the state of repair and prospective market values of individual properties) the results of such a change cannot be foreseen. It would almost certainly increase demand and prices for existing housing, both absolutely and relative to new housing. These price increases might offset some of the initial decline in new housing demand which could result from a re-shuffling of the ownership of the housing stock. How extensive this re-shuffling would be is impossible to guess—many families prefer to live in downtown areas for economic and social reasons, and changed financing terms would not affect their decisions. Similarly, many older people living in houses now bigger than their family needs require would not necessarily move just because improved financing enabled them to realize more for their house, especially if the surplus space is rented to others as is frequently the case.

Nevertheless, there would undoubtedly be important changes in the lenders' willingness to finance used properties—depending on the rates and other lending terms relative to those available on new construction. The effects of this increased lending on the financing of new housing and on the funds available elsewhere in the capital market would, of course, depend on what the recipients of the extra financing—and former mortgage lenders displaced by the institutions—do with their surplus funds. Because of these various unknown factors it is not possible to form a clear view of the results of extending government guarantees to existing housing.[13]

The evidence placed before us, including that from CMHC[14] and our own studies, does not argue the need for so radical and difficult an innovation, although improvements in the conventional mortgage market can and should be made by bringing in new lenders—notably the chartered banks—and expanding the permitted terms of conventional lending by the financial institutions. If such important changes were made, we would expect a closer and more desirable balancing of

[12] It can be argued that the steady increases in the prices of much existing housing do not suggest that mortgage arrangements have made it excessively difficult to find buyers. However, the rising values often result in part from the demand for land for alternative uses as the cities expand and develop.

[13] We would not be concerned over the supposed danger of "monetizing the housing stock" by improving its marketability. There is no reason to believe that the community would begin liquidating its holdings to spend on other goods and services —a "flight from housing" seems highly improbable.

[14] Transcript, page 6084.

new and used residential financing terms to come about without the need for direct government intervention. Another innovation which might carry the evolution of the market forward would be the provision of private mortgage insurance on conventional loans. Such insurance is available in the United States and one company has recently been established to do a similar business in this country.[15]

THE SECONDARY MARKET

In recent years, both the government and private interests have attempted to broaden the mortgage market by attracting new private lenders. CMHC has attempted to promote the development of a secondary market for the trading of N.H.A. mortgages so that investors who do not have the facilities to originate mortgages or to service them, as well as those needing some means of liquidating assets from time to time, may be induced to invest in them. Private N.H.A. lenders have not bought and sold outstanding mortgages on any substantial scale under the provisions of the 1954 Act permitting approved lenders to sell loans provided they continue to service them. From 1954 to 1962, the institutions sold $318 million of mortgages from their portfolios, with the chartered banks accounting for $164 million. In 1962, institutional sales, which include substantial transactions between originating lenders and affiliated pension funds rather than being true secondary market sales, were about 2% of the institutions' mortgage holdings. Thus the 'turnover' of N.H.A. mortgages is well below that of alternative investments such as bonds[16] and stocks.

The main buyers of existing N.H.A. mortgages—other than those sold by CMHC—have been those life insurance companies which do not originate loans themselves and pension funds, particularly those of the federal crown corporations and those for employees of the selling institutions.[17] Some other corporations, and even individuals, were also brought into mortgage investment in this way. Further steps to broaden the secondary market were taken in 1961 by CMHC, which began the practice of selling mortgages out of its own portfolio at auctions open to approved N.H.A. lenders and members of the Investment Dealers' Association. To the end of 1963, $209.5 million of mortgages had been offered in seven auctions and $148 million were sold.[18] The main buyers have been banks and trust companies, which purchased $70 million and $48 million respectively, although not principally for their own accounts; investment dealers purchased $15 million, life companies $8½ million and others $6½ million.

Investors wishing to participate in these auctions bid for parcels of mortgages prepared by the Corporation, which does not bind itself to accept bids on all the parcels offered. The auctions are a useful initiative, but experience with them has been limited and they have not yet attracted many new mortgage investors. The Corporation is considering the possibility of continually standing prepared to sell mortgages at posted prices, a technique which would more easily enable it to give buyers options for a period of time so that they may examine the mortgages and the properties concerned.

Among the ultimate buyers of mortgages sold at these auctions have been recently-established financial institutions set up to specialize in N.H.A. mortgages. These institutions finance their portfolios by bank borrowings and sales of short-term paper and debentures in the securities markets. Many people familiar with the mortgage market have felt that such corporations, which are simply specialized loan companies, afford the best means of attracting additional investment funds for mort-

[15] In general terms, such companies insure mortgages in return for a fee. In Canada, the portion of high-ratio loans above the presently-permitted 66⅔% of property value would have to be assumed by investors not regulated by the legislation relating to life, trust and loan companies.

[16] See Chapter 16.

[17] $137 million of the $229 million of N.H.A. mortgages held by trusteed pension funds in 1961 were in the funds of government agencies and federal crown corporations.

[18] One offer was withdrawn because a sudden change in monetary policy drastically altered the state of markets at the time of the auction.

gages from individual investors.[19] These companies may ultimately extend their operations into the field of conventional mortgages, in which the lack of uniformity and insurance pose even more difficult problems of trading the underlying instruments themselves. Somewhat similar in nature are the mortgage funds of a number of trust companies in which the holder may buy units of participation. The American technique of selling participation units in individual apartment or other buildings is not frequently seen in Canada.

Even if some of the legal and technical difficulties of investing in and transferring mortgages could be overcome,[20] mortgages will doubtless remain less attractive than alternative long-term investments for most individuals' portfolios, and various institutional lenders will thus continue to constitute the market for these obligations. However, means of improving the secondary market should not be neglected. For example, we see much merit in the suggestion put to us that CMHC improve the appeal of its auctions by making more information available on the mortgages included in its parcels.[21]

In addition, we have had representations that the Corporation could increase the willingness of financial institutions to hold N.H.A. loans by standing prepared to discount them—presumably at a penalty rate—in order to provide temporary access to cash for dealers and institutional holders of mortgages. Legal provision for such operations now exists, and we believe that the government should not wait for some difficulty to arise before making arrangements for the Corporation to use these powers if they should become necessary.[22] This facility should only be available on a temporary basis and at penalty rates to tide an institution over a short-term liquidity difficulty and might, indeed, be used little if at all. At the same time, care must be taken to ensure that monetary policy considerations are given due weight in formulating CMHC policy; this should not be difficult as the Department of Finance and the Bank of Canada do in fact participate in discussions about the secondary market.[23]

[19] See Transcript page 6106 for views of the President of CMHC.

[20] See submission of John R. Campbell, which refers to legal difficulties in connection with the acceptability of titles, foreclosure proceedings and some features of the insurance provisions.

[21] Transcript, page 6202 (evidence of Mr. Mansur).

[22] See Transcript pages 6110-6112 for a discussion of this matter with CMHC.

MORTGAGE RATES AND STABILIZATION POLICY

The demand for housing is affected by changes in interest rates and other loan terms in the mortgage market. However, spending on housing is perhaps more importantly influenced by the availability of mortgage funds from private lenders. In addition to these reactions in the private financial market to changes in credit conditions, including changes in the administered N.H.A. rate, house building has been strongly influenced on occasion by direct government action to vary the flow of mortgage funds supplied by CMHC. Although many other factors influence housing demand, significant patterns linking financial developments with housing expenditure can be traced. This is not surprising in view of the heavy dependence of house building on borrowed funds.

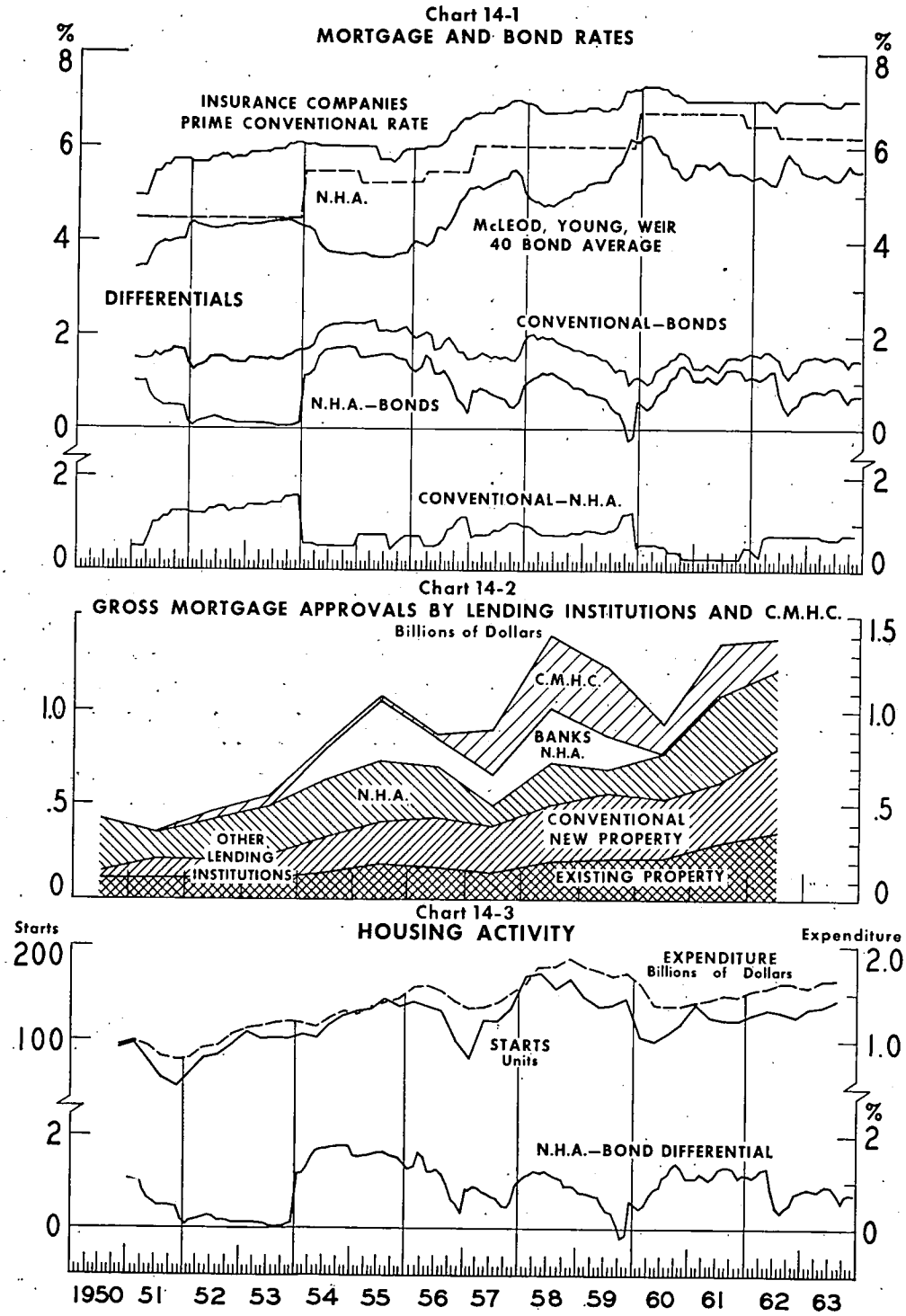
The evidence of the effects of changes in mortgage borrowing terms on the demand for housing finance is not easy to interpret because of the major changes which have occurred simultaneously on the supply side of the mortgage market. Our consumer survey included some hypothetical questions bearing on the point, and the results indicate that a significant share of spending on housing would be reduced or deferred by substantially tighter mortgage terms. On the other hand, the survey suggests that the decisions of potential home buyers are less likely to be influenced towards larger expenditures by easier mortgage terms.[24]

The changes in mortgage terms assumed in the questions in our survey are substantial, although comparable changes did occur in the prime conventional lending rate between 1955 and 1957. As shown in Chart 14-1, however, conventional

[23] Transcript, pages 6100-01.

[24] See Chapter 21 for a further discussion.

THE MORTGAGE MARKET



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mortgage rates have generally been considerably less flexible than the yield on market bonds, while N.H.A. rates have varied even less. So far as conventional loans are concerned, it is undoubtedly true that other features of loan terms have also varied. Moreover, the willingness of institutions to lend at the prime rate shown in the chart, rather than at higher rates, has altered over credit cycles; the prime rate series thus understates the effective changes in mortgage credit conditions. In their evidence before us, spokesmen for the trust and loan companies said that when money is tight they tend to cut back on the size of loans relative to property value and that at such times the size of loan can be a more important factor in competition than the rate.[25]

There is no question that substantial changes in these other mortgage terms can significantly affect the demand for funds and new housing. For instance, the increases in down payments required under the N.H.A. in February 1951 were a major factor in the decline in institutional approvals of new construction loans from $310 million to $237 million and the reduction in housing starts from 92,531 in 1950 to 68,579 in the following year. Similarly, the increases in loan to value ratios made in 1954, 1957 and 1960 have stimulated the demand for housing. The evidence put before us suggests that such changes affecting down payments and the amounts of monthly payments have a greater impact on borrowing and house building decisions than interest rate changes. For instance our survey of consumers—on which we would not place too much reliance—indicates that borrowers appear to be more sharply affected by interest rate increases when they are reflected in higher monthly payments than when the term of the loan is lengthened sufficiently to keep monthly payments unchanged. The survey does not give good evidence on the effect of changing down payments but it is clear from the fact that borrowers are unwilling to shift to conventional loans with higher down payments when N.H.A. funds are unavailable that this factor is of major importance.

[25] Transcript, page 5852.

Finally, we may note that our own econometric results—while admittedly not exhaustive—failed to find a relationship between interest rates and the demand for new housing. On the other hand, one reason that the institutions give for rationing funds in periods of strong demand rather than raising lending rates more sharply than they do is a fear that too many potential mortgage borrowers would be deterred by higher rates.[26]

The relative stickiness of mortgage interest rates undoubtedly reduces and delays the effect of a change in general credit conditions on housing demand. It reflects basic differences between the residential mortgage market and the bond market. The fact that loan commitments on new housing—whether the original borrower is a builder or the home owner—are entered into some months before funds are actually disbursed leads to stability of rates, particularly when market rates are rising. Frequent adjustments of their rates would annoy home owners and, even more importantly, the house builders on whom lending institutions rely for a good deal of their business. Moreover, very frequent changes in rates and lending policy would tend to disrupt the whole lending organization. Like those of the chartered banks, the loans of these institutions originate mainly at the local level, and a continuing stream of differing head office directives is not consistent with maintaining an effective and competitive branch system.

Another factor which explains the comparative slowness to change of mortgage rates is that the vast majority of mortgages are bought to be held to maturity by the original lenders. Since there is very little trade in outstanding mortgages, the mortgage market—unlike that in bonds and stocks—does not have a forum in which prices are continually adjusted to shifting demand and supply pressures from buyers or sellers anxious to take advantage of very small yield differentials. Finally, one vitally important mortgage rate, that on N.H.A. loans, is set by the government and has not been adjusted sensitively to changes

[26] See for instance Transcript pages 5876, 5882, 5886.

in market rates, so that relatively rigid rates have been imposed on a crucial part of the market. Although there is evidence of some shortening in the lag between changes in bond yields and mortgage rates, the market is still not immediately sensitive to changes in the financial climate.[27]

Whatever may be the influence of changing loan terms on people's willingness to incur mortgage debt, there is no doubt that changes in the supply of mortgage credit have had an important impact on residential construction. These have not resulted primarily from changes in the availability of funds to mortgage institutions, but from artificial rigidities in the interest rate structure. We have seen in earlier chapters how the growth of life companies' funds is not greatly affected by changing credit conditions. This is not true of the trust and loan companies, but they have chosen to run off part of their security holdings in order to acquire mortgages when their total funds have failed to grow or declined. Moreover, when there is upward pressure on interest rates, as in 1956-57 and in 1959, conventional mortgage rates tend to rise, although less abruptly than some other long-term rates, and the volume of such lending increases.

On the other hand, the government has frequently chosen not to allow the full upward movement in interest rates to be reflected in the maximum rate on N.H.A. mortgages, and insured mortgages on new buildings thus tend to lose their attractiveness as investments to the lending institutions. For example, from late 1955 to late 1956 the N.H.A. rate rose by only .25% while yields on prime conventional mortgages rose .7% and bond yields rose about 1¼%. Similarly, in the year ending in November 1959 the N.H.A. rate was unchanged while conventional rates rose about half of one percent towards the end of the period and average bond yields rose a full percent. Not surprisingly, the lending institutions find N.H.A. mortgages unattractive in these circumstances. The close relationship between these interest rate changes and fluctuations in the flow of N.H.A. funds from the institutions is shown in the charts. From 1955 to 1957, N.H.A. approvals by the life companies fell from $227 million to $96 million, while those of loan and trust companies dropped from $42 million to $9 million. In 1959, life company N.H.A. approvals of $113 million were $58 million below the previous year, and there was again a sharp drop in N.H.A. lending by the trust and loan companies.

Not all of the funds diverted from investment in N.H.A. loans are lost to the new housing market, because the lending institutions are able to raise rates on new conventional loans and are thus willing to increase their investments in such mortgages. For example, their new residential conventional loans were $20 million higher in 1956 than in 1955, and rose $52 million from 1958 to 1959. However, increased conventional lending, which has been more regular year by year than the flow of money into N.H.A. mortgages, has not been sufficient to offset the drying up of private N.H.A. funds. Borrowers are unwilling or unable to meet the higher down payments and monthly payments of conventional loans. Thus, the demand for, and rates on, such loans are not sufficiently high to prevent the total amount of new residential lending by the institutions from dropping sharply when the N.H.A. rate becomes unattractive.

In late 1959, the supply of funds was further cut by the change in the chartered banks' position. An N.H.A. rate of 6.75%, which was not high enough to draw funds from other institutions in competition with other calls on their resources, was nonetheless too high for the banks since it exceeded the 6% ceiling on their lending rates. Although views on the legal position differ, and although the banks may buy outstanding N.H.A. mortgages and other investments yielding more than 6%, it was indicated to them that it would be undesirable if they acquired new N.H.A. mortgages at more than 6%. In these circumstances, it would have proved impossible to ration the flood of applications at more than ¾ of 1% below the true market rate, and indeed would have

[27] See Chart 14-1.

made little sense to do so in view of the lower servicing costs of commercial loans at the same rate. This situation, combined with strong pressure on their liquidity, led to the banks' virtually complete withdrawal from N.H.A. lending. Their approvals fell precipitously from $300 million in 1958 to $175 million in 1959 and to only $1 million in the following year.

Against the background of these violent fluctuations in the private supply of new housing finance shown in Chart 14-2, the government itself has played a changeable role. In 1957, the drop of $147 million in private N.H.A. approvals from the 1956 level was more than offset by an increase of $215 million in direct CMHC lending. In 1959, CMHC lending was maintained close to the 1958 level, but in the following year, when private lending again fell as a result of the change in the chartered banks' position, CMHC was instructed by the government to cut back its lending by $150 million because of concern over the government's cash position and belated—and as it turned out, misplaced—concern over inflationary pressures. In fact, the Corporation's approvals declined from $367 million in 1959 to $168 million in 1960. Housing starts fell from 141,345 to 108,858, most of the decline being accounted for by reduced CMHC lending. The policy was carried out by a process of rationing and a decision not to lend to home owners with incomes over $5,000.[28]

By manipulating the N.H.A. rate and altering CMHC lending, the government can clearly exert a powerful influence on the supply of mortgage funds and, with some delay, on spending on new housing. (The cyclical behaviour of housing starts and new housing expenditures are shown in Chart 14-3.) Because of the heavy use of labour in the construction industry, measures to affect house building can be an important component in stabilization policy. Whether or not the N.H.A. rate has been deliberately used for stabilization purposes—and it has been suggested to us that developments in 1956-57 and 1959 were not always consciously sought[29]—the mechanism did at times operate to assist in the task of stabilizing the economy. At other times, however, direct government lending policy was destabilizing; for example, its curtailment in 1960 was hardly appropriate to the weakening economic circumstances of that time.

It should also be stressed that the circumstances of the 1950's particularly favoured this instrument of policy. In the face of strong demand for housing, it was possible to restrain activity in some years in confidence that when funds were made available again house building would rebound quickly. Now that the most pressing demands for housing have been met, at least temporarily, it is uncertain that the tap can still be turned on and off quite as decisively.[30] This is particularly true because the series of reductions in down payments has brought them close to the practical minimum, and there is thus little room for stimulating demand in this way. Moreover, some disadvantages follow from the irregular flow of N.H.A. funds, for the periodic disruption of the residential construction industry makes it difficult to increase efficiency and reduce costs through the establishment of large and relatively stable enterprises.

While we do not believe that housebuilding should be shielded from the effects of government policy, we think it unnecessary and undesirable to concentrate too much of the impact of counter-cyclical measures on this one sector of the economy. If other instruments of policy are used appropriately, it should not prove necessary to do so, although we would not wish to preclude the government from taking strong action in this or any other part of the economy in emergency circumstances.

RECOMMENDATIONS FOR THE MORTGAGE MARKET

Our review of the mortgage market has persuaded us that changes should be made in the

[28] For detailed changes in CMHC's lending policy, see its Submission, paragraphs 3-11 and 3-12.

[29] See Transcript, pages 6078, 6088.

[30] See Transcript, pages 6059-60 for the views of CMHC on this question.

present arrangements under which government policy and legislation lead to substantial limitations in the supply of private mortgage funds and which contribute to the extra difficulties of mortgaging existing properties.

In our view, much of the imbalance in the mortgage market for new housing would be overcome if the N.H.A. rate were free to move with market forces and allowed in normal circumstances to find its own place in the broad pattern of interest rates. This rate is presently set by the Cabinet, which is often slow to alter it in times of rising general interest rates, and has an understandable reluctance to make the full adjustments necessary. When general credit conditions are easing, on the other hand, there is a temptation to move the N.H.A. rate down faster and further than circumstances justify. In either event, as we have seen, the inadequate return on N.H.A. lending forces the government to be a heavy direct lender or means that many borrowers either are unable to obtain funds or are driven into the higher-cost conventional or supplementary mortgage markets. If the N.H.A. rate were freed, in contrast, it would tend to move up and down with other long-term interest rates, and be a more accurate reflection of the price at which mortgage business on new housing was actually being done.

The best approach would be for the maximum on N.H.A. rates to home owners to be set automatically at a margin, say, 1½% above average rates on long-term Government of Canada bonds.[31] The maximum would provide a limit on the yield at which the Government was prepared to guarantee private mortgage lending, but we would expect N.H.A. rates to be set by the market below the maximum. (Indeed if market forces were to drive rates to the maximum this would mean that the system we envisage was not working and that the maximum was too low.) An alternative approach would be for the Government to vary the maximum rate administratively in line with changes in other rates, but to alter the rate regularly, perhaps once every quarter if market changes call for an adjustment. It would perhaps be easier under this system to use N.H.A. rate adjustments for purposes of economic stabilization, but it has the disadvantage of the present system that the rate may remain at inappropriate levels because of the Government's failure to act. Either method would be preferable to the present situation but we think the first approach has more to commend it.

Since a free rate would be competitive with other rates at which private lenders could invest their funds, it would avoid the sudden gyrations in the availability of private N.H.A. mortgages which have characterized the market since the mid-1950's. Since it thus would not necessitate massive CMHC lending, it would also avoid some of the instability connected with changes in government direct lending policy. Finally, a rate free to move up and down more flexibly would have an increased, although still moderate, dampening or stimulating effect on the demand for mortgage finance. It would thus make some contribution to stabilization policy as a partial offset to the reduced impact of changes in the supply of N.H.A. funds.

Under a free rate, some slight regional differences in N.H.A. mortgage costs might develop, reflecting the stronger demand for housing in some areas of the country than in others. We would not expect this to be significant since most lending is done by national organizations which find it easier to lend at uniform rates across the country. If, however, large or undesirable differentials should develop because of the unwillingness or inability of lenders to service certain outlying communities, we see no reason why CMHC should not step into such markets as a lender of last resort—the role originally intended for CMHC residual lending to home owners.[32]

If the objectives of general economic policy were to call for the restraint or stimulation of house building beyond that which could be

[31] Rates on other types of CMHC lending—e.g. for slum clearance—could continue to be set administratively.

[32] Regardless of the extent of regional differentials permitted, lenders should be allowed to originate N.H.A. mortgage loans at small discounts or premiums under a free rate system. This would permit them to vary effective rates closely while maintaining convenient coupon intervals of, say ¼ of 1%. Large discounts, however, should not be allowed because they can seriously affect the borrower's down payment.

achieved through changes in market rates of interest, the government could always achieve its purposes by varying the other terms of N.H.A. loans from time to time. As already noted, although down payment ratios are now at very low levels, there is no reason why these ratios should not be raised if demand pressures again become excessive. We would prefer to see major changes of this kind reserved for fairly extreme circumstances since it is our view that house building should not be made subject to major variations each time there is a modest change in the general economic environment.

Regardless of how variations in the terms of N.H.A. lending are used, however, stabilizing policy should be operated explicitly rather than relying on the adventitious effects of an inflexible rate on the supply of funds. As we have seen, these effects are in fact frequently destabilizing. Although unpopular decisions will at times be necessary, the government should be prepared to make them openly and deliberately. The government should take whatever steps it considers necessary in emergency conditions, including the deliberate fixing of the N.H.A. rate at a level which dries up the supply of funds. Stabilization policy could also be supported by appropriate timing of expenditure on public housing, for there are substantial needs for slum clearance, subsidized housing and similar projects which private interests cannot be expected to meet. In the 1952-61 period, just over 2% of all new housing expenditure was accounted for by joint federal-provincial housing projects and limited-dividend housing corporations, the two main forms of housing for low-income groups. CMHC also told us that only 8,000 of the 1½ million housing units built since the war have been subsidized for low-income housing groups.[33] While such groups have benefited to some extent from the "filtering down" of housing from those who obtained new N.H.A. loans, there seems to be considerable scope for further outlays, which could to some extent be tied into stabilization policy.

[33] Transcript, page 6045.

In addition to freeing the N.H.A. rate, the private supply of N.H.A. funds for unsubsidized housing could be increased by bringing more lenders into the market. It is most unfortunate that the interest rate ceiling and other factors have obliged the chartered banks to withdraw from lending since 1959. From 1954 to 1959, the banks showed themselves able to operate effectively in this market, both in the large cities and in smaller communities where many other lenders are not active. In those years, they provided a flow of funds roughly equal to that which CMHC has advanced in direct loans since the banks withdrew from the field. Although the banks, like other lenders, would vary the flow of investment in mortgages depending on rates of return and their available resources, we would not expect them to enter the market and withdraw suddenly, provided that they are free to move their rates. Having established themselves in the mortgage market they will not wish to disrupt their relationships with builders and borrowers by following excessively variable lending policies. Our recommendations about the interest rate ceiling will be fully discussed in Chapter 18, but an important consideration in the matter is to ensure that the advantages of the banks' large branch system to the mortgage market should not be needlessly lost.

It would also be desirable to increase the number of approved N.H.A. lenders by admitting those caisses populaires and credit unions which wish to participate, and have the facilities to do so efficiently. While they have not so far expressed any great interest in moving into this field, they might well do so if the rate were set by the market in appropriate relationship to conventional rates. Whatever success can be achieved in developing the secondary market in mortgages will also serve to increase the supply of funds, and we therefore urge CMHC to continue to improve and extend its auctions, to assist private institutions in every way possible to develop sound new mortgage facilities and to establish discount privileges at penalty rates for approved private lenders.

Judging by our earlier experience and by that in the United States—where the effective Federal

Housing Administration rate fluctuates with other market rates and the Administration does not need to be a net lender to the mortgage market over time—these changes should enable CMHC to withdraw from the massive residual lending operations it has undertaken in recent years. The Corporation could then concentrate on specialized lending operations for purposes which cannot be expected to attract private funds, on acting as a genuine lender of last resort to the market and on the tasks of working for continued improvements throughout the mortgage market and of advising the government on housing policy. Such a transition would involve a substantial reduction in the government's need for funds which would release savings flows for the purchase of assets other than government securities. One means by which government might smooth this transition would be to press the sale of Canada Savings Bonds less vigorously. The latter probably compete more closely than marketable securities for the funds which might otherwise flow to trust and loan companies, banks, life companies and other mortgage institutions. To the extent that competition from C.S.B.'s has this effect, it can be argued that it has diverted funds from private mortgage lending and increased the need for direct lending by CMHC.[84]

The changes suggested for the N.H.A. market should go some way toward solving the problem of the financing of existing housing since they will prevent the emergence of wide differentials between the interest costs of financing new construction and existing properties. The N.H.A. rate would presumably settle below the prime conventional rate by a margin representing the value of insurance, perhaps ½% to ¾% depending on market factors, and we would not again have situations in which the conventional rate is as much as 1½% higher. However, we feel more direct measures are necessary to eliminate undesirable deficiencies which might still remain in the amount and terms of funds available for financing existing housing.

Having considered the matter carefully, we believe that the chartered banks, like other institutions doing essentially a banking business, should be permitted to invest in conventional as well as insured mortgages. The present anachronistic prohibition impedes the flow of long-term savings into the mortgage market to the detriment of both mortgage borrowers and the banks' deposit customers and shareholders. In view of the substantial changes which have occurred in the mortgage market in the last generation —in particular the general acceptance of regular amortization schedules—this prohibition no longer seems necessary for the protection of bank funds and should be removed. The broader implications of this proposal will be discussed in Chapters 18 and 19, but if it were carried out the Home Improvement Loans guarantee could also be removed. This legislation, which was introduced to enable banks to take mortgage security on loans for property improvement (up to a maximum which is now $4,000) despite the existing prohibition in the Bank Act, would then become redundant since the banks would be free to make such loans without special authorization. The guarantee itself is no longer important: losses have been small and the banks are now thoroughly familiar with the business.

Lending terms in the two parts of the mortgage market could also be brought closer together by raising the maximum loan to value ratios imposed on some of the major lending institutions. These ratios do not now apply to lenders such as the caisses populaires, the credit unions and the finance companies which have recently entered the mortgage market. Some of these, as we have mentioned, are now making first mortgages up to 80% or more of property values for fairly extended terms. We do not think it necessary to restrict loan values for those companies which raise funds for investment in high-value mortgages (presumably carrying higher risk) through the sale of securities covered by prospectuses. If investors are aware of the companies' investment

[84] We do not wish to suggest that there is a necessary relationship between C.S.B. sales and CMHC direct lending. However, it is interesting to note that from the end of 1956 to the end of 1962 the increases in CMHC's portfolio of insured loans to builders and home-owners of $1.1 billion was equal to roughly half of the increase in outstanding C.S.B.'s.

policies and choose to make this sort of investment, there is no reason to prevent them from doing so. On the other hand, there is a case for restricting the banking institutions and life companies, which accept funds generally from the public, as well as the pension funds which accumulate the savings of members who frequently have no choice about their contributions.

The case for putting some maximum on loan to value ratios does not rest on liquidity grounds. A balanced portfolio of regularly amortizing mortgages—whatever the relationship of individual loans to property values—can be just as liquid as a portfolio of loans or certain types of securities. Rather, it rests on the desirability of offering some guide-lines to institutions dealing with unskilled investors to ensure that those institutions do not make unsound loans and jeopardize the public's savings. We wish to stress that by themselves such ratios cannot guarantee solvency and that a 60% loan on one building may go bad more readily than a 70% loan on another; much depends on the income or integrity of the borrower, the institution's skills in appraising present and prospective property values and the occurrence of unforeseen developments. Similarly, the life of the loan relative to the status of the property is very important; a 20 year mortgage on an old property may prove sounder than a 15 year loan on a somewhat newer residence because of factors such as the condition of the buildings or trends in land values in the two locations concerned. There is no way to determine these factors by formula—it is a matter which requires business skills on the part of the institutions and wisdom on the part of the regulatory authorities.

Nevertheless, such guide-lines have their merits, and we therefore recommend that a maximum loan to value ratio be maintained in the relevant federal and provincial legislation for the life insurance, trust and loan companies and that it also be applied to pension funds and all institutions deemed to be doing a banking function. However, we believe that the experience of the institutions and the development of the mortgage market justify an increase in this ratio to 75%, as suggested by the life companies. An increased limit would not only permit the institutions to finance existing houses on terms closer to those now available under N.H.A., but would help to reduce the borrowers' reliance on high-cost supplementary mortgage financing which—because of the high monthly payments involved—often weakens the position of the first mortgage lender.

This limit would apply as at present to first mortgage loans. Institutions such as the banks which have the power to make unsecured loans without limit can, and quite often do, make what are in effect second mortgage loans without the security of a mortgage. It would be undesirable to prevent them from taking good security on such desirable lending, and the banking institutions should therefore be free to take second mortgages. The 75% limit on first mortgages would thus not prevent them absolutely from advancing a larger amount to a borrower but would forcefully remind them of the need to pay careful attention to all aspects of the borrower's credit standing rather than relying too heavily on the mortgage security itself. Such arrangements will, we hope, inhibit the growth of second-mortgage lenders which make excessive charges while still providing protection for the institutions and their creditors and shareholders against anything but a drastic collapse of property values, from which no reasonable loan to value ratio could protect them.[35]

The residential mortgage market's facilities have greatly improved, especially in recent years, and a number of the remaining shortcomings which we have noted have resulted directly or indirectly from legal or other rigidities which are capable of correction. The relative growth of residential mortgage debt may be slower than it has been during much of the post-war period, and this factor—together with the emergence of new lenders and financing techniques and the increase in competition between established insti-

[35] The various provincial trustee laws contain loan to value ratios which now range from 50% in Manitoba to 75% in Nova Scotia, and the provinces might well want to bring these into line at 75%.

tutions—should lead to further improvements in the services offered borrowers in the future. However, we expect that the mortgage market will continue to be one of the largest users of funds in the economy, and though by its very nature it will never be as sensitive to fractional changes in prices and yields as the securities and foreign exchange markets to which we now turn, it must nevertheless work under arrangements which enable it to respond effectively and quickly to the needs for housing finance. Introducing more flexibility into the N.H.A. rate, bringing new lenders into the market, improving CMHC auction procedures, introducing discount procedures, and increasing permitted loan to value ratios on existing properties should help to achieve this objective and further enhance the usefulness and responsiveness of this market.

CHAPTER 15

THE FOREIGN EXCHANGE MARKET

The foreign exchange market, in which Canadian dollars and foreign currency claims are traded, is the link between the Canadian financial system and those of other countries. Just as settlement of domestic payments requires an efficient apparatus for transferring money claims from one person to another, so the payments arising out of the flow of international transactions in goods, services and financial claims must be quickly and conveniently settled. This usually involves the purchase of one currency with another in the exchange market. In Canada, the chartered banks are the main financial institutions in this market; at its outer rim are their branches serving the exchange needs of their customers, and at its core is the highly centralized interbank market where the banks meet their own exchange needs in dealings with each other and with the authorities.[1]

THE BANKS' DEALINGS WITH CUSTOMERS

Bank branches are prepared at all times to buy and sell foreign exchange to accommodate the demand and supply pressures which result from their customers' international trade, investment, speculative and other transactions. Some other institutions and companies also provide foreign exchange services for their customers, but all fill their requirements through the banks. The banks, and some other intermediaries, keep a limited supply of U.S. cash and, to a lesser extent, other main foreign currencies and travellers' cheques at their branches to look after demands for foreign cash or its equivalent. However, as in the domestic payments system most transactions, and virtually all large ones, involve transfers of bank balances rather than of notes and coin. Customers needing foreign exchange to make international payments buy claims on balances maintained at the banks' agencies abroad or with their foreign correspondent banks, while those selling exchange obtain Canadian dollars in return for giving their bank title to their claims on foreign banks. Most such transactions are completed by "telegraphic transfers" which are simply instructions to the foreign agent or bank to carry out the appropriate transfers of bank balances, although in some cases customers may wish to buy or sell foreign currency bank drafts. To take a simple example, a Canadian importer will pay his supplier in New Orleans by buying U.S. dollars from his bank branch and asking the branch to instruct its correspondent to credit them to the supplier's own account. If the bank has a New Orleans correspondent it will simply instruct it to make the payment: if not, it will ask its correspondent in, say, New York to transfer funds to the appropriate New Orleans bank. In either case the Canadian bank must carefully manage its correspondent balances to ensure that funds are available to meet its obligation, if necessary by purchasing the required U.S. dollars itself.

[1] We wish to acknowledge our indebtedness to Mr. S. Turk for his paper on *The Foreign Exchange Market in Canada* which contains a fuller description of the market's operations.

Some large branches have their own foreign currency accounts with correspondent banks in cities where their customers do a substantial amount of business—for instance the main Vancouver branches might well have accounts with Seattle and San Francisco banks—but most branches buy and sell as agents for the head office "foreign exchange" or "trading" departments which hold and manage the main correspondent balances. Since the branches having separate accounts also obtain additional foreign exchange as needed from the trading department and transfer any excess accumulation of foreign funds when their accounts build up, each bank's entire foreign exchange business is funnelled into the head office department. Moreover, all branches buy and sell exchange at prices set by head office: small transactions are completed at buying and selling prices listed in bulletins sent out either daily or as frequently as is justified by changes in exchange rates while larger transactions are settled at current market rates obtained from the department by telephone or telegraph.

In addition to dealing with their customers in foreign exchange for immediate delivery, or "spot" exchange, the banks buy and sell for future delivery in the "forward" market.[2] A bank selling forward exchange to a customer binds itself to deliver the agreed amount at a certain date in the future for a price in Canadian dollars which is fixed at the time of the original contract. No exchange of funds with the customer occurs until the specified date, at which time it will be identical in form to a spot transaction except that the price set initially may well differ from the then current spot exchange rate. Thus an importer who is committed to making a payment in a foreign currency three months hence is able to know the price he will have to pay for his funds when payment is due and an exporter due to be paid in foreign funds can establish the amount of Canadian dollars he will receive. By such "hedging", firms can avoid uncertainty about the rate at which they will buy or sell foreign exchange: moreover, the importer can protect himself against the possibility of having to pay more Canadian currency than that specified in his forward contract, even if our dollar depreciates drastically in the interim, while the exporter is assured of a given return in domestic currency even if the Canadian dollar appreciates. Of course, at the same time, they forego the possibility of an extra profit if the value of the Canadian dollar should move the other way. Some of those having foreign currency receipts or commitments may cover all their expected transactions in the forward market in order to avoid exchange rate risks, while others may never cover forward, preferring to fill their needs in the spot market as and when they arise. A third group may use the forward market at some times and not at others depending on the direction in which they expect exchange rates to move and on the cost of hedging. We have brought together a limited amount of information on the pattern of commercial activity in the spot and forward markets and will review it in the latter part of this chapter.

The forward market is also used in conjunction with international investment transactions. Some of these arise out of commercial receipts and payments, as when an exporter decides to take advantage of attractive interest rates in New York and invest his foreign currency earnings there for, say, 90 days. To avoid the exchange risk on the subsequent conversion of his funds into Canadian dollars, he can buy the latter for delivery in 90 days. If the rate on a 90 day U.S. investment is 4% while the forward Canadian dollar is selling for ¼% below its spot rate, the investment yields a return in Canadian dollars of about 5% per annum.[3] The exporter will be attracted by this "hedged" investment if the overall rate is higher than the yield on a comparable

[2] Spot transactions in the Canadian market are normally completed on the day following their negotiation, but outright transactions for delivery in two or three days are usually done at the spot rate. Commitments further in the future are done at the appropriate forward rate.

[3] It is normal to refer to the forward discount or premium on the foreign currency: in the case cited the foreign currency is said to be at a ¼% premium over its spot rate.

Canadian investment which could be made by selling U.S. dollars at once and investing in the Canadian market for 90 days. The same "covered interest arbitrage" principle applies to short-term international investment transactions having no direct connection with commercial receipts and payments. Those having funds available for short-term investment will transfer them from one market to another by buying the foreign exchange and selling it forward if the covered yield makes such switches attractive. Similarly, short-term borrowers such as sales finance companies will be tempted to obtain funds abroad when the covered interest cost is lower than in Canada. Foreign exchange deals of this sort which involve a simultaneous spot and forward transaction in opposite directions are known as "swaps", to distinguish them from "outright" forward transactions in which no spot exchange is traded. The essence of a swap is that spot and forward exchange are traded at the same time, markets being made in terms of the difference between the two exchange prices. The transactions are completed in the usual way, the spot being delivered promptly and the forward contract maturing on the agreed date.

THE INTERBANK MARKET

In the course of its business with customers, each bank is continually buying and selling spot and forward exchange in outright and swap transactions. Much of this activity is offset within the bank; some branches are buying foreign exchange while others are selling, and it is only the net purchases or sales which affect the position of the bank as a whole. Each trading department tries to avoid the exchange risk inherent in carrying an uncovered position and therefore offsets any fluctuations in its position generated by its branch business as quickly as possible. This is done either in the central foreign exchange market made up of the trading departments of all the Canadian banks and the authorities—the "interbank" market—or by dealing with banks in exchange markets abroad. It is in these markets that exchange rates are determined, both by residual supply and demand flowing in from the banks and by the actions of the authorities—that is the Bank of Canada acting for the Exchange Fund Account, for foreign central banks and international institutions, or on its own account.

Since 1939 the Government has had direct responsibility for foreign exchange policy and the Bank acts as its agent in operating the Exchange Fund Account. This Account is used to influence conditions in the foreign exchange market in ways consistent with government policy. If more foreign exchange is offered than private buyers are willing to take up at existing exchange rates, this excess supply will cause the value of the Canadian dollar to rise unless the Exchange Fund steps in to buy exchange. When the Bank of Canada buys (or sells) for the Exchange Fund in the interbank market, the payment made to (or received from) the chartered bank on the other side of the transaction is debited (or credited) to the federal government's Canadian dollar balances. Thus, while these transactions affect the balance of supply and demand and the level of foreign exchange rates—indeed can be of paramount importance in the market—they do not by themselves affect the aggregate level of chartered bank cash reserves as long as payment is made from or credited to government deposits with the banks. Instead, bank deposits shift among banks and their ownership shifts between the government and others, the effect being analogous to purchases and sales of government securities by the government's domestic securities accounts. Aggregate cash reserves are not changed unless either the Bank of Canada chooses to alter its own foreign currency position or the effect of government financing of the Canadian currency counterpart of Exchange Fund transactions induces the authorities to change the banking system's cash base. It has not been the Bank's normal practice to deal in foreign exchange for its own account with the aim of affecting bank cash, although there is no reason why it, like many other central banks, should not do so if it is found convenient and if it accords with government exchange policy.

Since the adoption of the fixed rate system, the authorities have perforce played a more active role in the market in order to ensure that the rate on the Canadian dollar stayed within 1% of the established parity, currently equivalent to 92.5¢ (U.S.). Put in another way, it requires $1.081 to buy $1 (U.S.) and adherence to the International Monetary Fund agreement specifies that the rate should be maintained between $1.070 and $1.092. The authorities, of course, do not normally wait until our dollar is against these limits before taking action since to do so would be to encourage speculative pressures and reduce their own freedom to manoeuvre. Their more active role in the market contrasts sharply with the position between 1950 and 1960 when, under our floating exchange system, official intervention was normally confined to evening out erratic or excessive short-run movements and was not aimed at establishing or maintaining any particular value for the currency.

Access to the interbank market is restricted in Canada, as in other countries, to the domestic banks and the central bank.[4] The banks never deal directly with each other but buy and sell exchange through brokers in Montreal and Toronto who, since the dismantling of foreign exchange control in 1950, have been salaried employees of the Canadian Bankers' Association. This brokerage system is peculiar to the Canadian market. Prior to World War II, private brokers earned a commission, which was 1/64 of 1% in 1939, on each deal they arranged between banks. They were in business for themselves, but then as now the brokers did not operate for their own account and accepted orders only from Canadian banks. Under the present system, a broker receiving an order from a bank's trading department immediately calls the other banks in sequence, using some discretion based on his knowledge of which bank is likely to be on the other side of the market. If the transaction is for a large amount it may be split among a number of banks. When a deal has been negotiated, all banks—including the Bank of Canada—are notified of the amount, price and settlement date but only the banks involved are told the name of the bank on the other side of the transaction. The market is thus completely impersonal with all banks fully informed of current developments. In this respect it is a more perfect market than the securities market in which trading is less centralized and, even among the large active dealers, knowledge of transactions cannot be as complete. It appears to us that the present arrangements provide an efficient, sensitive interbank market and we see no reason to change them.

[4] The Montreal City and District Savings Bank has access to the market by a special arrangement which recognizes its long connection with the foreign exchange business.

THE STRUCTURE AND GROWTH OF THE MARKET

The U.S. dollar is the most commonly traded foreign currency in the Canadian exchange market, with the pound sterling coming second and other currencies trading in limited amounts. This reflects the close trading and financial connections between Canada and the United States, and, to a lesser degree the United Kingdom, as well as the wide use of the American dollar and sterling for the settlement of international debts. The chartered banks thus carry their main correspondent balances in U.S. dollars and sterling, maintaining small working balances in other currencies and obtaining any sizable amounts for customers by purchasing the required funds with one of the major currencies or by crediting the Canadian dollar account of the correspondent bank concerned. The spreads between the rates at which branches buy and sell U.S. dollars in amounts up to the branch limit—normally $10,000—are in most cases ¼% for transfers and 1% for notes and coin. These spreads are maintained to cover costs, to provide some protection against very recent rate changes of which all branches will not have been informed and to provide a margin of profit. Spreads are narrower on large transactions on which current rates are obtained from head office. Less active currencies trade at wider spreads, although large sterling transactions are done at spreads close to those for U.S. dollars.

Swaps and outright forward transactions, on which narrow spreads are maintained, can now be negotiated readily with banks for periods up to six months, with most being for three months or less. Arrangements can be made for periods over six months but they are comparatively rare. Most forward contracts mature on a particular day, but some allow for completion within a specified period at the option of a customer if he is not certain of the exact date of delivery: the banks charge slightly more for such optional contracts in order to cover the additional risk and inconvenience. In all of a bank's forward dealings with customers there is a possibility that the customer will be unable to complete transactions when they fall due. Since the bank will normally have committed itself to offsetting forward transactions in the course of managing its foreign exchange position, it may incur a loss in such circumstances because of having, for example, committed itself to pay more than the current spot rate for funds in order to meet the needs of a customer who subsequently defaulted on his forward contract. For this reason, banks normally enter into forward contracts only with customers having established lines of credit (indeed a limit on their forward contracts is often a part of the line of credit arrangements) or require that a customer put up some cash at the time the contract is entered into.

Just as currencies other than the U.S. dollar and sterling do not trade at all actively in the Canadian exchange market, so the market in Canadian dollars is much more active in Canada than elsewhere. Most of our external trade is invoiced in U.S. dollars or sterling and not in Canadian dollars, with the result that the exchange conversion problem is usually left to the Canadian firm rather than its foreign customer or supplier. Canadians having business abroad must usually deal in foreign exchange whereas residents of other countries may carry on their business with Canadians without dealing in Canadian dollars. Thus the principal market is in Canada where the Canadian firms doing an international business have their main banking connections. Similarly, the principal market to which the chartered banks turn in order to manage their own trading and investment positions is the Canadian interbank market.

These markets are, however, fully integrated with those in other countries. In addition to checking the prices quoted by one or more Canadian banks, a firm having exchange business may well contact banks abroad, particularly in New York, Detroit and other American cities where banks make markets in Canadian dollars, but also in London. Because of the activity of subsidiaries whose parent companies have their main banking connections in their own country, particularly the United States, and because some foreign banks devote considerable attention to Canadian exchange business, direct dealings between Canadian firms and foreign banks have increased in importance in recent years. Whereas Canadian banks quote Canadian exchange to the nearest 1/32nd, New York banks have commonly quoted in 1/64ths and some of them, as well as banks in active centres such as Detroit, quote to the nearest 1/100th, or even 1/1000th, of a cent.

Similarly, the Canadian banks deal with banks abroad as well as in the domestic interbank market, buying and selling exchange wherever they can obtain the best price. In earlier years, when the domestic market in short-term investments had not been developed, it was customary for Canadian banks to carry out most of their exchange transactions in New York since it was the main market in which the banks bought and sold the short-term claims used to adjust their cash and liquid positions. The growth of the domestic market in liquid assets, the increased role of the authorities and the effect of exchange control, which broke established links with New York, have contributed to the replacement of New York by the domestic interbank market as the main centre for the banks' exchange transactions. Indeed, New York banks now bring much of their Canadian exchange business to our interbank market. In 1961 $1.8 billion of outright transactions went through the interbank market, compared to $1.2 billion in 1953, while

a much larger volume was done with customers but netted out within individual banks. The market in swaps between banks has expanded much more rapidly, from a volume of $.3 billion in 1953 to $1.7 billion in 1961. The salaried broker system adopted in 1950 has also been an undoubted factor in the growth of an active domestic interbank market, for the banks no longer need pay brokers' commissions in Canada as they do in other markets. Moreover, it has led them to deal in the market more frequently than they used to since there is no extra cost in turning to the market to cover spot and forward positions as they occur; formerly, they would tend to carry a position longer in the hope that further trade with customers would provide the necessary offset and save the cost of commissions.

The growth of the Canadian exchange market in the post-war period also reflects the expanding volume of Canada's international financial transactions. However, balance of payments statistics cannot be related directly to activity in the foreign exchange market, partly because of the difficulty of tracing and recording complex international transactions included as a residual item with short-term capital flows in order to balance the accounts. But quite apart from this difficulty, which is common to all countries, balance of payments statistics are intended to record changes in the balance of claims between Canadian residents and foreigners rather than gross transactions in the exchange market. For instance, a province selling a bond issue in New York might temporarily hold the proceeds in a bank account or in some other U.S. dollar short-term asset which would be reflected in the balance of payments statistics as a long-term capital inflow matched by a short-term outflow even though no transactions have gone through the exchange market. In other cases the borrower will use the proceeds of foreign issues to purchase foreign goods or an exporter will use his own foreign currency earnings to pay for imports. In both cases there will be entries in our international accounts,[5] but neither involves conversion of exchange. Finally, there is very limited information available in the balance of payments statistics and elsewhere about activity in the forward market, which plays a crucial role in the exchange market's overall volume. Nevertheless, there has been a broad tendency for market activity to reflect the growth of Canada's foreign financial dealings as well as the improvement in its own facilities.

[5] The first will be reflected in a capital inflow with matching imports, the second in matching exports and imports.

SPECIALIZED TRANSACTIONS IN THE MARKET

The foreign exchange market is a sophisticated one in which an increasing number of participants are keenly aware of the opportunities for profit and the danger of losses from changes in exchange rates. Moreover, there is a growing sensitivity to the possibilities of moving funds from one country to another in response to interest rate differences. We have already discussed briefly in Chapter 5 the ways in which these considerations, in conjunction with many others, bear on Canada's international financial position. To round out the present discussion of the exchange market, we will comment on the principal market transactions through which the effects of speculative pressures and interest rate differentials work themselves out, leaving for Chapter 23 an assessment of their implications for financial policy.

(i) *The Banks*

The policies and practices of the chartered banks are of course of great importance to the working of the market. The banks as a matter of policy do not speculate on the exchange rate in the majority of their dealings, preferring to forego the potential profits of successful speculation in order to avoid the possibility of equally large losses on uncovered foreign exchange positions. Each trading department's first concern, apart from the mechanics of seeing that transactions are duly completed for its customers, is therefore to ensure that commitments to customers are covered against the risk of losses from adverse changes in the level of rates, or in the case of forward commitments, in the spread between spot

and forward rates. Changes in their spot obligations to customers are normally offset by immediate offsetting purchases or sales of spot exchange in the interbank market. The major risks associated with changes in a bank's forward position can also be much reduced by offsetting transactions in the spot market[6] since parallel movements of spot and forward rates are in practice larger and more frequent than changes in the forward differential. A further reason for using the spot market to match forward as well as spot commitments is that it is often difficult and time-consuming to find another bank wishing to do a corresponding outright forward transaction, and delay brings serious risk of loss. Having covered the most serious risk in the spot market and preserved a balanced "overall" position, a bank may find itself with a short forward position (i.e. it is committed under forward contracts to sell more foreign exchange than it has undertaken to buy) matched by a long spot position, or vice versa. It will then bring the two into line as soon as possible by entering into swaps with its own customers or other banks to cover the secondary risk that the forward differential will alter. Subsequent swaps may be necessary to cover the time differences between the maturities of different forward contracts. In this manner each bank is continually taking on its customers' exchange business and then sorting out its own trading position in the interbank market with a series of spot and swap transactions. Since the banks usually attempt to offset changes in their own positions arising from customer transactions, their trading behaviour merely reflects underlying supply and demand from those customers and does not have an independent effect on market behaviour except over the very short periods when they are balancing their spot and forward commitments.

[6] Thus a bank commitment to sell a customer U.S. dollars in 30 days will normally be accompanied by an immediate purchase of U.S. currency in the interbank market. This assumes, of course, that the bank was in a balanced position prior to the forward sale and that other transactions for customers do not immediately provide the necessary offset. It also assumes that the bank's policy about covering its trading position does not alter.

In addition to handling customers' business, the international departments also co-ordinate the banks' own foreign currency business, and operate in the market for the banks' own accounts. It was noted in Chapter 7 that the net foreign currency position of a bank—as distinct from the operating position of its trading department—may fluctuate considerably from time to time in line with the bank's investment policy. A bank which draws on its foreign position as part of the liquid asset adjustment to domestic monetary pressure sells foreign assets, obtaining Canadian dollars. (If the exchange is sold to another Canadian bank or to one of its customers, resident or non-resident, the selling bank receives a claim on another bank which when cleared and settled will increase its cash reserves at the Bank of Canada at the expense of that bank. The process is exactly the same as if the bank had obtained cash by realizing on its domestic liquid assets. In either case, banks can draw cash from each other—and if sales are made to bank customers can reduce Canadian dollar deposits—but their transactions do not increase aggregate cash reserves unless the Bank of Canada acts on its own account.) When the banks vary their net foreign asset positions in this way, they normally do so as a temporary expedient and cover the spot sales of foreign exchange with forward purchases, hedging these fluctuations just as they cover swings in their trading positions. When the domestic monetary situation eases they tend to rebuild their net foreign positions by completing the forward purchases. However, the banks may on occasion take a view of the future course of exchange rates by altering their uncovered foreign position, although such actions are not usual and do not involve large amounts in relation to the volume of business done.

(ii) *Speculative Transactions*

Many other participants in the market are more willing to take speculative positions. Those who expect the Canadian dollar to depreciate can and do speculate in the spot market by buying foreign exchange in the hope of reselling it at a profit if their judgment proves correct. Such

speculation brings pressure to bear directly on the spot rate or exchange reserves, or both. They may also speculate by buying foreign exchange forward in anticipation of a profitable sale if the expected movement occurs by the time the contract matures. Forward speculation is less costly than spot purchases in that funds do not have to be committed as they do when the speculator buys spot exchange and holds it—perhaps invested in highly liquid form in foreign markets—for later sale. The effects of forward speculation will be felt in the spot market as well since it will tend to induce capital flows which will bring immediate pressure on the dollar. By initially depressing the Canadian dollar in the forward market, they make it more profitable than formerly to buy foreign exchange spot and sell it forward in order to make short-term investments abroad.[7] In practice the manner in which the chartered banks manage their foreign positions tends to transfer pressure immediately to the spot market because they cover their forward sales of exchange by buying spot exchange at once. As they subsequently balance out the resulting short forward and long spot positions they will sell the spot exchange to others. The result is that someone outside the banks will have been induced by the increase in the covered interest return available on foreign investments to sell Canadian dollars spot. Speculative pressure in the forward market, unless it induces counterspeculation or new commercial offerings of forward exchange,[8] is thus transferred to the spot market through short-term capital outflows which tend to lower the value of the Canadian dollar or drain official foreign currency reserves.

The transactions discussed so far are "pure" speculation in the sense that they are not related to the normal flow of international trade and investment. Our enquiries suggest that such speculation is much less important than that carried on by firms and individuals whose regular business brings them into the exchange market. Commercial firms expecting the Canadian dollar to depreciate may speculate in the spot market by delaying conversion of their foreign currency receipts and hastening the payment of foreign currency indebtedness. This "leads and lags" process can bring immediate pressure to bear on exchange rates and official reserves, with much of it taking the form of changes in the indebtedness between Canadian subsidiaries and their foreign parent companies. Research carried out for us, however, indicates that a high proportion of speculation in the market is done through forward contracts, with business and other users of foreign exchange altering their policy of covering future requirements as they change their view of the exchange rate.

Many commercial firms have a set policy of using only the spot market and never cover forward receipts and payments. In this connection, the Canadian Manufacturers' Association asked its members dealing in the exchange market what their policy was, and 77% indicated that they never used the forward market, or did so only infrequently, only 11% replied that they usually hedged their transactions in the forward market and the remaining 12% reported that they frequently used the forward market, particularly when it appeared advantageous in view of their expectations about exchange rates.[9] While our own survey of corporate financial policies did not enquire closely into exchange practices, the information we did obtain—which is summarized in the following table—indicated that rather fewer of the firms in our sample invariably dealt in the spot market and somewhat more always cover their commitments forward.

Differences in the replies to these two surveys probably result in large part from the fact that our survey covered substantially more large firms. It will be noted that the distribution of replies from firms with assets of less than $10 million is quite similar to that reported by the C.M.A. These smaller firms probably make relatively little use of the forward market because they are not familiar with it and because their transactions

[7] The effects are, of course, reversed if the speculator is looking for an appreciation of the Canadian dollar and sells forward exchange.

[8] Or induces the authorities to offer forward exchange—see Chapter 23.

[9] See Table 8 of the Submission of the C.M.A.

FOREIGN EXCHANGE PRACTICES
PERCENTAGE DISTRIBUTION OF REPLIES

Assets of Firm	Always use the Spot Market	Occasional or Frequent Forward Transactions	Always use the Forward Market	Total
Under $10 million	76%	6%	18%	100%
$10 million and over	51%	10%	39%	100%

are not large or regular enough to justify the costs of devoting time and resources to decisions about their exchange business. Considerably fewer large firms invariably meet their needs as required in the spot market and more of them cover all anticipated purchases and sales of foreign exchange in the forward market as soon as trade or other commitments are entered into. Relatively small proportions of small and large companies, but more of the latter, make selective use of the forward market. This group includes firms which tend to obtain forward cover for unusually large transactions and those which speculate by covering when they expect the exchange rate to move against them, and not doing so when they expect a favourable change in the rate. We found evidence of large purchases of forward U.S. dollars by such companies in the spring of 1962 and their activities appear to be a major element in exchange speculation at all times. In addition, our survey shows that some firms speculate by altering the timing of their spot transactions or by taking forward or spot exchange positions unconnected with their ordinary business. In total some 8% of firms speculate in one way or another.[10]

These remarks on exchange speculation are based largely, although by no means entirely, on experience under the floating exchange rate system. There has been foreign exchange speculation in Canada since the fixed rate was established just as there is in other currencies under fixed rate conditions. Indeed some respondents to the survey indicated that their policies about the use of the forward market have not altered. However, early indications are that participation in the forward market generally will be reduced for commercial transactions in ordinary circumstances, although short-term investment flows will continue to be hedged. Speculation in all forms may, of course, become extremely heavy if doubts develop about the maintenance of the existing rate.

(iii) *Short-term Capital Flows*

While speculative forces can give rise to large short-term capital flows which at times dominate the behaviour of the foreign exchange market, such flows also result from changes in the cost and availability of funds in Canada relative to other countries, particularly the United States. We have already indicated in Chapter 5 how changing interest costs between the two countries influence long-term capital flows. Some types of short capital movement also respond to such changes, particularly when availability as well as cost is involved, the most important of these being international trade credit. This particular type of short capital flow cannot be analysed very rigorously because it is not shown separately in the balance of payments statistics and because —as already indicated—it also responds to speculative forces. However, the heavy inflow of funds in periods of credit restraint such as 1956-57 and 1959, and the much reduced inflow in years of domestic monetary ease like 1958 suggest strongly that Canadian firms do draw on foreign funds in this way when credit is relatively costly and difficult to obtain in Canada. This is particularly true of Canadian subsidiaries of foreign companies which naturally look to their parent firms for a substantial part of any marginal financing requirements.

While absolute interest rate differentials do set off short as well as long-term capital flows, there is always the possibility that even a small adverse movement in the exchange rate may wipe out the profit obtained by moving short-term funds to take advantage of higher interest rates. Thus,

[10] Further discussion of practices in the foreign exchange market will be found in the appendix volume.

if the U.S. yield on three month treasury bills is 4% compared to a 5% yield in Canada, the advantage of moving funds into Canada would be eliminated if the U.S. dollar appreciates by about ¼ of 1% in Canadian funds over the three month period. In contrast, it would take an appreciation over the entire life of the borrowing of over 14% to offset a 1% yield advantage on a 20-year foreign currency bond issue.[11]

In order to obtain protection against the risks involved, many short-term international investment and borrowing transactions are hedged in the forward market and respond, therefore, not to absolute interest rate differentials but to the differential as adjusted for the cost or profit of forward cover. Unlike long-term flows and the uncovered short-term movements mentioned above, these covered flows thus tend to produce rather small net flows of funds. For example, if Canadian short-term interest rates rise relative to those in New York, foreign investors will be tempted to move funds to Canada and Canadian borrowers will seek short-term funds in New York. Both will wish to cover their future exchange requirements since the lender will be anxious not to earn a lower return than he could obtain by investing in his own currency and the borrower will not wish to incur higher costs than he would pay in the Canadian market. The forward U.S. dollar will thus appreciate very quickly and check the outward flow by reducing the lender's return and raising the borrower's costs. Large amounts can and do move in both directions in such circumstances but the net flows will be smaller than in the case of uncovered movements which will only be checked, other things being equal, when they have led to a restoration of the original interest rate differential. When transactions are covered, and there is no offsetting speculation or commercial buying of forward exchange, the forward rate will adjust rapidly to changes in the interest rate differential so that no advantage in moving funds on a covered basis remains.

In recent years there has been a rapid development of the instruments and techniques of interest arbitrage—indeed, this is perhaps the most notable development in the structure of the exchange market. Corporate treasurers have become increasingly sensitive to the returns available on short-term investments while banks and investment dealers in Canada and abroad have evolved a variety of channels for facilitating arbitrage transactions and have induced investors and borrowers to make use of them to tap the international capital market. The main types of transaction involved are covered investments in commercial and finance company paper, and to a lesser extent in treasury bills, and the "swap deposits" offered by chartered banks which were described in Chapter 7. The implications of these developments for policy will be discussed more fully in Chapter 23. Our present purpose has simply been to draw attention to the increasingly close links which the development of the Canadian foreign exchange market has forged between the capital markets of the world and the Canadian money and financial markets.

[11] See Chapter 4.

CHAPTER 16

INVESTMENT DEALERS AND THE BOND AND MONEY MARKETS

The function of the bond and money markets is to facilitate the issue of new securities by those with borrowing needs and to encourage the holding of debt obligations by those with available funds. Serving the financial institutions as well as the general public, these markets act as a convenient and readily accessible guide to the values of debt instruments and as a central meeting place where the orders of buyers and sellers can be quickly and efficiently brought together. They thus add to the ease with which obligations can be bought or sold if the need arises and make lenders and borrowers more aware of the terms on which business may be done between them. The investment dealers play an important part in this process by bringing buyers and sellers into the market, by matching and executing their orders, and by providing related financial services and advice. The dealers also contribute significantly to the working of the markets by participating in trading for their own account and by adjusting the level of their holdings to meet the needs of their customers.

If these markets are functioning well, borrowers and lenders will be brought together at minimum cost and changing investor preferences and shifts in the demand for funds will be quickly and accurately reflected in prices and yields. Broad, deep, sensitive and adaptable markets thus play an important role in allocating the nation's real resources and in determining the efficiency with which they are used, both by reducing the cost and increasing the availability of funds in general and by channeling funds to developing industries. As indicated earlier, these markets are also the primary vehicles through which the authorities influence credit conditions and through which much of their impact is transmitted to the rest of the economy.

The bond and money markets have broadened and grown significantly in recent years and, although still suffering from imperfections, have shown themselves remarkably adaptable to changing conditions. The dealers have been at the heart of this process and it is not surprising that a feeling of importance, a lively sense of innovation, and an atmosphere of brisk activity are to be found in the industry. Yet the industry is also a study in contrasts: pioneering in some areas is accompanied by traditionalism and caution in others; an attitude of constructive enterprise designed to serve the real needs of the economy exists side by side with excessive anxiety to avoid risks and—at the fringes—with an exclusive preoccupation on making a quick profit from transactions of a more dubious value; finally, the hard work and dynamic spirit of most individuals in the industry may be set against the comfortable willingness of some of its participants to rest on the fruits of past luck or resourcefulness.

Basic forces are, however, exerting an inexorable impact on the industry and forcing it to become more professional and competitive. The increasing institutionalization of savings has put enormous amounts of investment funds in the hands of skilled professionals who expect com-

petent and experienced service and who set high standards in the purchase of securities, particularly new issues. The growing importance of these customers and the spectacular development of the money market—whose participants are mainly corporate treasurers and others skilled in the financial business—have forced the industry to recruit and train more professional personnel and to break with its traditional belief that university education was less appropriate than routine on-the-job training. Moreover, the growing size of the markets has made them more impersonal, and this has also contributed to the fact that clients of all kinds have become less satisfied with the cheerful order-taker who can provide price quotations and uninformed gossip but who knows nothing about the underlying economic and business developments which ultimately influence market behaviour.

The growing professionalism of its clients has also forced the industry to adopt more competitive attitudes and led to a paring of its trading margins on both new issues and outstanding securities. Nowhere is this more true than in the money market which, because of its recent development and skilled and impersonal nature, has been largely free of traditional ties and relationships and has thus been open to vigorous innovation and price-cutting. Nevertheless, the same trend is noticeable in the bond markets, particularly for larger sales, and in underwriting, where new issues are increasingly being placed with large buyers at a much reduced fee. In addition, abnormally high demands for capital from corporations have receded, and such clients are no longer willing to pay the same substantial underwriting commissions. Government issues have been large, but margins on these are smaller so that competition for corporate business has become more intense. We would not want to exaggerate the importance of these developments or to suggest that the character of the industry will be altered over-night, but the main trends are clearly visible and are reflected in industry mergers and pressures to attain a new level of efficiency and skills.

Although there are some 400 securities firms in Canada, those which do an investment dealer business number slightly more than 200, almost 190 of which are members of the Investment Dealers' Association of Canada (the I.D.A.). More than 60% of the latter are also members of a recognized stock exchange in Canada or have stock exchange affiliates, usually operating from the same premises and having much the same management and officers. These activities and those of broker-dealers, which account for the balance of the securities industry, will be discussed in the next chapter. The number of firms in the investment dealer industry has declined by about 10% over the past decade, although the number of branches has continued to expand, reflecting the pressures referred to earlier as well as the attempt of some firms to spread their costs and make full use of skilled head office departments by providing a national service. About two-thirds of the 340 branch offices of I.D.A. members are located in the provinces of Ontario and Quebec, mainly in Toronto and Montreal where much of the country's financial activity is centred. There is also a tendency to serve smaller communities through agents or salesmen rather than branch offices. The industry, which is predominantly Canadian-owned, also has almost 40 branch offices or affiliated companies operating outside Canada, mainly in the United States and the United Kingdom.

One of the distinguishing features of the Canadian industry is its relative lack of specialization. The largest and most profitable firms are fully integrated; they underwrite and distribute new issues, position and trade debt and other securities, sell wholesale and retail, operate in the money market, have memberships in one or more stock exchanges, manage portfolios, and in general perform the whole range of functions common to the industry. The growing houses gradually take on these functions and offer a more complete service to their clients while the many firms that remain small and local also tend to be very general and unspecialized. Only a few firms have concentrated their efforts on the

wholesale or institutional market or on municipal and local issues. This contrasts sharply with the United States industry in which firms have specialized in a wide variety of ways, a development which may occur here as well when Canadian markets have grown further. A typical Canadian firm now has about one-quarter of its personnel engaged in sales, a further 10–12% in trading, up to 5% in underwriting and security analysis, 10% in senior administration, and the balance in routine accounting, delivery and clerical functions.

Another striking characteristic of the investment dealer industry is the dominant position of a few houses. Eight of the 124 firms reporting to a 1961 I.D.A. financial survey undertaken for us (the others reported through similar stock exchange surveys) had no less than 46% of the total capital and earned 51% of the net income; in 1962 the figures were 47% and 45% respectively. These firms are all national in scope, two of them operating in all but Newfoundland and the remainder in at least six provinces. In the earlier year, six of these firms, acting alone or as syndicate managers, underwrote approximately 90% of the dollar amount of all public utility issues, 60% by value of industrial bond issues, 65% of the sums raised through stock issues and also dominated the provincial and large municipal underwritings. Although these firms have attained their position because of their placing power and experience, their dominant influence in underwriting contributes to the existence of some of the rigidities and imperfections we will be discussing later. A further 24 houses that carried security inventories in excess of $1 million accounted for an additional 30% of the industry's capital and 28% of its profits in 1961 (29% and 30% in 1962) and have tended to improve their share of earnings at the expense of the largest firms.

Trading and underwriting have accounted for between 81% and 85% of investment dealers' earnings in recent years, with underwritings alone accounting for between 50% and 60% of income. Stock market commissions account for most of the remaining income and tend to fluctuate in significance directly with the behaviour of stock market prices. In the six years reported in the I.D.A. survey, the aggregate net income as a proportion of capital and surplus of its members fluctuated between a low of just over 9% and a high of 17% as is shown in the following table:

NET INCOME AS A PERCENTAGE OF TOTAL CAPITAL
(Excluding Loans)

—	1951	1956	1959	1960	1961	1962
Reporting Members I.D.A.	14.5	17.0	10.7	10.2	11.4	9.2
Eight National Houses	17.1	18.5	10.7	12.0	12.7	8.6

SOURCE: Submission of Investment Dealers' Association of Canada.

The profit experience of the industry has been healthy, comparing favourably with most other industries and with the returns or other financial businesses already described. Moreover, the true level and trend of earnings may be more favourable than indicated above since an increasing proportion of revenue after all expenses but taxes and remuneration to partners and shareholders has been paid to the owners in the form of salaries and bonuses. The increase in this ratio may reflect nothing other than the need to pay more competitive salaries and the increasing tendency to offer shares in the firm to a greater proportion of employees (about 20% of all employees are now shareholders), but the fact remains that salaries and bonuses had risen by 1962 to more than three times their 1951 level. As the owners and managers of the businesses are the same group, it is a matter of convenience whether the returns from the operation are distributed in the form of salaries or dividends, and it is not known to what extent, if any, such payments are out of line with comparable salaries elsewhere for personnel with similar skills. If anything, they may slightly depress reported profits for the industry as a whole, although there is great variation between individual firms. Net

profits as reported, and averaged for the years shown in the table above, are just slightly below those for American federal government securities dealers in the period 1948-58 but are well above the average pre-tax return of only 6.4% earned by all incorporated U.S. security dealers, including stock brokers, in the same period.

The following table gives an analysis of the allocation of revenues in the industry in the years 1951 and 1962:

TABLE 16–1

DISTRIBUTION OF INVESTMENT DEALER REVENUE

—	1951			1962		
	Categories			Categories		
	A	B	C	A	B	C
Revenues ($ millions)	13,895	4,160	6,934	29,879	17,150	13,995
Expenses:						
Employee compensation	30.3%	36.3%	39.1%	37.9%	35.6%	39.8%
Communications	9.1	10.0	8.8	10.5	10.1	8.1
Occupancy and equipment	4.7	5.5	5.3	6.5	6.0	6.3
Promotional	3.8	2.9	4.7	4.7	3.9	3.9
Other	6.1	6.5	8.3	6.3	7.1	7.8
Income before remuneration to shareholders or partners and income taxes	46.1	38.8	33.7	34.1	37.3	34.1
Deduct:						
Shareholder salaries, bonuses, and other compensation	13.1	13.8	16.3	19.2	20.6	20.3
Income taxes	15.9	11.9	5.5	6.7	7.2	4.5
Net Income	17.1	13.2	12.0	8.1	9.4	9.4

NOTE: Category A = 8 national houses; Category B = 24 major positioning houses; Category C = all other reporting members.

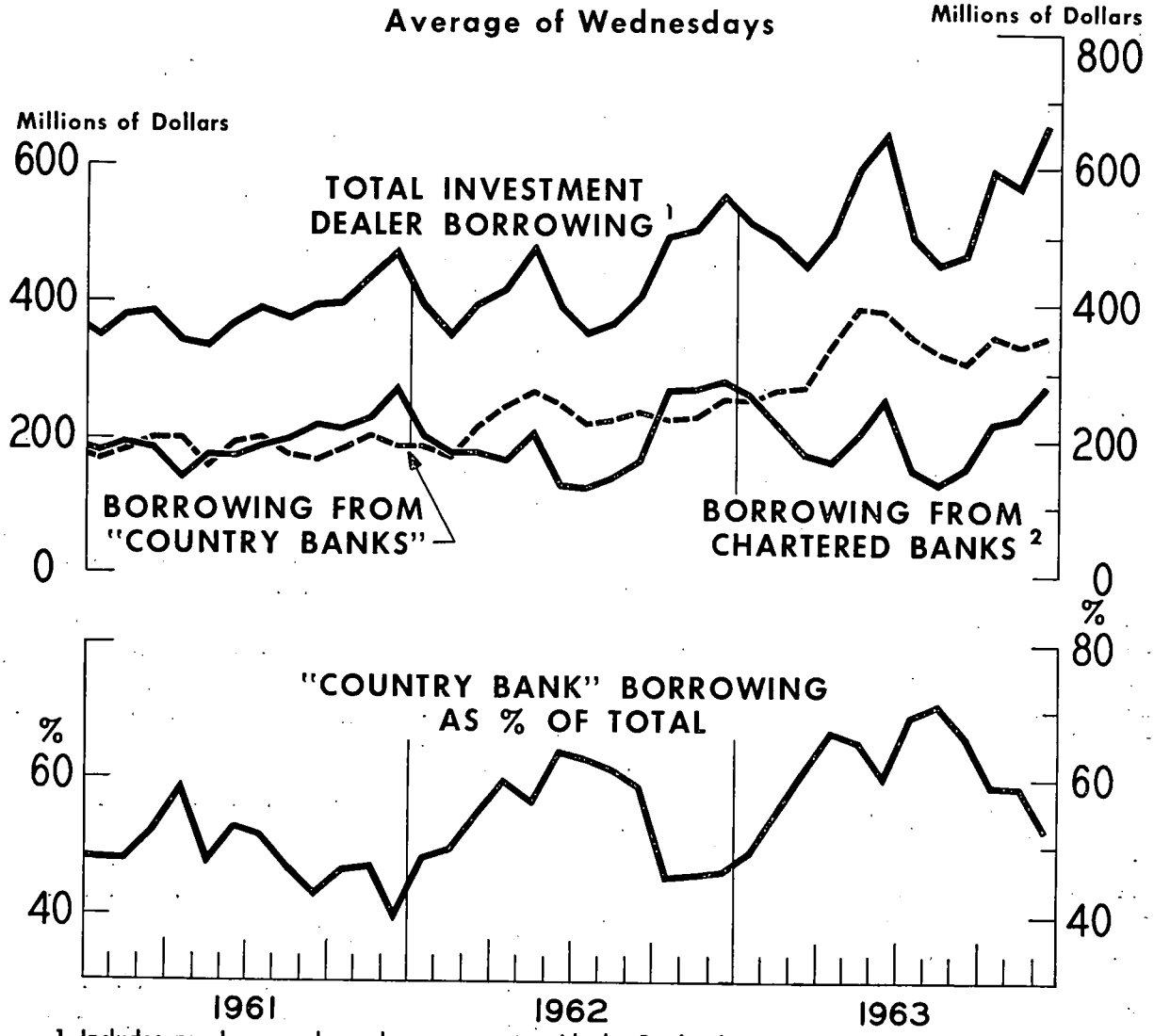
As a service industry, the proportion of revenues allocated to wages and salaries is necessarily high. Yet the dealers also require substantial amounts of equity capital and borrowed funds to carry inventory, to cover underwriting liabilities, to service margin accounts and to cover short-term liabilities in connection with current transactions. The foundation of their enterprises is the amount of capital and undivided profits in the business, the minimum amounts of which are regulated by the Association under a formula which relates them to the volume of liabilities. In 1961 the capital of the I.D.A. members reporting in the survey was $61 million (almost $66 million if subordinated loans from shareholders and borrowings from affiliated companies are included). This sum, which represents an investment of about $12,000 for each of the industry's 5,400 employees and which compares with $26 million a decade earlier, supported total borrowings of over $447 million, a ratio of 6.8 to 1. Bank and non-bank borrowing by the dealers is shown in Chart 16-1 and reveals the growing share of the latter, particularly in tight money periods.[1] Such "country bank" borrowing first became significant in response to the monetary tightness of late 1958 and 1959 and grew in importance when bank call loan rates remained high and out of touch with the market in 1960. In the restraint associated with the 1962 exchange crisis in May and June, country banks were supplying up to 70% of the funds borrowed by

[1] Figures for non-bank, or country bank, borrowing are not available prior to November 30, 1960.

Chart 16-1

FINANCING OF INVESTMENT DEALER INVENTORIES

Average of Wednesdays



1. Includes purchase and resale agreements with the Bank of Canada as well as chartered and "country" bank borrowing.
2. Day-to-day loans plus call loans to investment dealers.

dealers and the absolute amount had grown to almost $300 million (it has since exceeded $400 million on occasion).

The industry's capital appears to be adequate to permit it to perform efficiently its role in the economy. Its willingness to hold inventories of money market securities has increased substantially as market experience has been gained and we have found no evidence that shortages of capital have been a limiting factor to this expansion. Total inventories have grown from $46 million in 1951 and $212 million in 1956 to $485

million in 1962, a factor which has contributed no little to broadening the market even though the industry may be still somewhat conservative in some aspects of its inventory policy. A comparison of the ratio of inventory holdings to net worth of the eight Canadian national houses with that of the United States government securities dealers shows that the Canadian firms operate with relatively more capital. While their inventories in relation to capital increased steadily from 1951 to 1961, the ratio on a gross basis was only 9 to 1 in the latter year, compared to an average ratio for the United States firms in the period 1948-58 of 15 to 1. Within the periods studied there were of course substantial fluctuations, the lowest ratio for Canadian and American firms being 2.4/1 and 9.1/1 respectively and the highs being 9/1 and 26/1. Some allowance must be made for the differences in the Canadian and United States dealers' portfolios, but these figures do not support the contention that our industry is relatively under-capitalized. The U.S. dealers, with federal government securities making up about 90% of their portfolios, had only about 10% more of their holdings in these relatively riskless issues than the Canadian dealers, who had a correspondingly higher proportion of other government and corporate bonds (as well as a small amount of stocks) which required higher margins.

Nor can we ascribe such weaknesses as exist in the underwriting field, including the at times almost unseemly haste with which new issues are sold, to a shortage of industry capital. We could find no evidence that firms refused underwritings because of inadequacies of their own capital, and indeed received complaints that there was not sufficient new issue business in relation to the industry's capacity. Any firm that does find its capital strained can bring additional firms, and banks, into its underwriting syndicate to share the liability. Alternatively, it may have access to subordinated loans or other funds from shareholders or associated companies.

This is not to argue that more capital in the industry would not be desirable or helpful, but simply to state that we find no persuasive evidence that shortages of such equity limited the effectiveness of the dealers as a whole. Moreover, we found the industry's capital adequate on the whole to protect the public from any default due to unfavourable market or other developments. The I.D.A. standards seem reasonable in this connection, although we suggest that the minimum requirement of $25,000 should be raised again. Capital requirements are enforced by annual and sample interim audits, close checks on new members, and a willingness to take quick disciplinary action. However, only the Ontario and Pacific districts require a regular filing of financial information from all members in addition to the annual audit. This does not seem to provide an adequate check on members and the I.D.A. might well adopt a system of employing outside examiners. The provincial securities administrations have responsibilities in connection with the adequacy of capital and can make periodic checks although for the most part they are satisfied to leave the task to the self-regulatory associations. In our view, the authorities ought to take a more active interest to ensure that the associations continue to perform their functions well. Moreover, the industry ought to improve the protection of the public from the risk of such losses as fire, theft, forgery and unexplained disappearance. The I.D.A. has recently raised the required minimum insurance coverage for such risks to $100,000 from $30,000, but the minimum requirements would be more appropriately related to the size of business transacted—a practice followed by many members in any event.

These safeguards for the clients of the industry are the more essential because of the lack of information about the industry. All the Canadian firms are partnerships or private corporations and consequently not required to disclose information about themselves. Persons doing business with them must, therefore, rely upon the firm's reputation and the regulation and supervision of the authorities and the industry itself. In our view, steps should be taken to remedy this lack of information, particularly since some dealers are financial intermediaries in the sense that they

accept short-term deposits from corporations, and solicit funds from others, and since all dealers are similar to the institutions in having on hand substantial customer credit balances. The protection of the public is also involved because the dealers hold clients' instruments in safe-keeping, sometimes in unregistered form or registered in the dealer's own name,[2] and undertake large underwriting liabilities. Finally, the dealer's own inventory activities, another intermediary function, can have important effects on the money and bond markets, and more should be known about these activities.

Information is now available at least quarterly on the major assets and liabilities of the most important financial intermediaries and we consider it desirable that similar aggregate data,[3] including a combined annual earnings statement, be published regularly for the investment industry. A first partial step in this direction would be for the I.D.A. to release publicly its country bank borrowing statistics now collected weekly for the use of the industry.[4] Moreover, firms issuing promissory notes or accepting deposits in other forms, including credit balances of clients, should also be required to make individual financial statements available on request —as some now do—to the owners of these liabilities. The authorities, borrowing and investing public and, perhaps most of all, the securities industry itself would benefit from the results of this fuller disclosure. Indeed, many investment firms in the United States, including affiliates of Canadian firms, now publish at least their individual net worth figures and we hope the Canadian industry might find it a useful practice to do the same. The I.D.A. and the stock exchanges were most co-operative in collecting and collating data for us on their sections of the industry and are now in a good position to continue such collections on a regular basis.

[2] These must, however, be segregated in their accounts and held separately.

[3] D.B.S. is now collecting quarterly balance sheet information.

[4] These should be improved by the inclusion of short positions.

In making these recommendations, we do not wish to under emphasize the substantial role played by the I.D.A. in protecting the public and improving industry standards. Founded in 1916, representing dealers across Canada and divided into six administrative districts, its principal function is to encourage sound financial practice and high ethical standards. In these activities the understaffed securities administrations have given it substantial scope and responsibility and only the occasional prodding. Despite the inherent difficulties of self-regulation and the particular problems entailed by the concentration of power in the industry, the Association has made a valuable contribution in this field and is seeking to raise standards still further. The I.D.A. has also undertaken an active educational program for its members' employees and for the investing public and has recently imposed minimum qualifications on sales staff. In addition, the Association represents the dealers in discussions with public and other bodies, prepares and distributes a variety of publications, and provides a limited although increasing amount of statistical data. The basic ground rules for trading and for carrying out securities transactions generally, except for stock exchange transactions, are also set by the Association.

UNDERWRITING

In no activity do the dealers influence the allocation of real resources and the level of economic activity more than through the underwriting and distributing of new issues. Substantial amounts of funds are raised each year by the investment community, which in 1962 underwrote or helped to place most of the $2.7 billion of gross new provincial, municipal and corporate issues shown in the following table; in addition it helped to distribute the $3.4 billion of Government of Canada direct and guaranteed securities issued in that year.

The table shows the growth in the amount of security issues in the post-war period, the shift away from corporate issues in recent years as business investment has declined and internal

TABLE 16–2

GROSS AND NET NEW ISSUES—SELECTED YEARS[a]
(Par value in millions of Canadian dollars)

	1946		1951		1956		1962	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Canadas and Guarantees	984	137	578	−458	1,527	−616	3,442	521
Provincials and Guarantees	133	−2	419	250	635	540	1,088	661
Municipals and Guarantees	150[e]	−5	250[e]	176	355	224	509	215
Corporate Bonds	581	−8	438	293	1,042	792	765	315
Other Bonds	n.a.	n.a.	n.a.	n.a.	15	6	12	−2
Preferred Stock[b]	89[e]	−14	29	−15	190	175	87	65
Common Stock[b]	83[e]	81	208	207	514	514	251	250
	2,020	189	1,922	453	4,278	1,635	6,154	2,025
Total Less Canada and Guarantees	1,036	52	1,344	911	2,751	2,251	2,712	1,504

[a]Excludes treasury bills, treasury notes, deposit certificates and commercial paper.
[b]At offering prices.
[e]Estimated.
SOURCE: *Bank of Canada Statistical Summary.*

resources have grown, and the expansion of government issues as deficits have increased and government enterprises have become more significant. It also shows the relatively small share of equity issues in the total, reflecting the fundamental preference of corporations for debt financing when their position will allow it, the tax factors related to the non-deductibility of dividends referred to earlier, and the increasing dependence on retained earnings as a source of equity capital.

The investment dealers are normally more than conduit pipes through which paper moves from borrower to lender and money flows back. The extent of their participation can vary enormously, being comparatively small in the preparation of a routine rights issue and relatively large when a small company is coming to the market for the first time. In the latter case, the underwriter may provide very extensive advice about the financial structure and affairs of the company, the type, timing and size of issue, and its yield, terms and the class of buyers to whom it should be sold. Not surprisingly, the cost of this service is commensurate with the effort and risk and may even run as high as 10% to 20% of the gross value of a small issue. However, the most common role of the dealer in public underwritings and private placements is that of providing advice on the price, terms, and other conditions of the issue.

The most prevalent type of underwriting on this continent is a firm commitment underwriting in which the underwriter buys the whole issue, takes the risk of selling it and obtains his compensation from the difference between the price paid to the borrower and that at which it is sold to the public. The issue may be negotiated or won at an auction. The option underwriting, under which the issuer grants the underwriter a series of options on blocks of unissued stock in exchange for a firm commitment on one block, is used mainly in mining finance and will be discussed in the next chapter. However, on smaller municipal issues particularly, the dealer may take an option on the whole issue good for a limited period; if he finds interested buyers he will then purchase the securities. The dealer may also act purely as an agent, using his best efforts to sell an issue in return for a commission on sales actually made or helping the borrower to find a source of funds and to negotiate reasonable terms with the purchaser, usually one or a few large

financial corporations. By using these direct placements, costs are minimized—the issue usually being exempted from registration and prospectus requirements under the securities acts —and terms can be specifically tailored to the borrower's requirements. In certain circumstances the covenants may also be easier to renegotiate although the lender is often in a good position to drive a hard initial bargain on rates and terms. While in the United States about 50% of all corporate issues are privately placed, half of them without dealer assistance, this form of raising funds is less common in Canada and the advice of a dealer is usually sought.

Virtually all corporate issues and an increasing number of provincial and large municipal issues are marketed by firm commitment underwritings negotiated with a fiscal agent. The usual procedure is that the borrower first contacts the dealer or dealers with whom it has a continuing relationship or agreement and discusses the nature, timing and terms of the issue and whether it will be a market issue or a direct placement. If the issue is not exempted under the securities acts, the necessary prospectus, trust indenture, balance sheet and other documents will be prepared and the registration procedure initiated. When the issue is almost ready for market the banking group, which is almost always the same group of dealers for every similar issue of that borrower, will be notified and its participants asked to accept their traditional portion of the liability. The firm agreement setting out the terms of the underwriting will subsequently be signed and in a day or two, or even on the same day in some instances, approaches to customers will begin; payment and actual delivery of the securities will be made two to three weeks later. Particularly if the issue is large, a selling group might also be formed, the dealers in which enter firm orders as principals, subject to allotment, on which they receive a commission or discount. In fact, then, the full liability for the issue is taken by the syndicate manager who in effect simultaneously spreads it to the banking and selling groups. For a non-exempt issue the whole process might take anywhere from three weeks to several months, while for exempt securities like government issues the elapsed time may be 10 days for a small municipal offering and as little as three days for large provincial issues. The typical procedure in the latter instances is for the syndicate manager, on first hearing of the intention of the government to raise money, to consult immediately with the steering committee of the syndicate before the final price is set and the agreements are signed. If an issue is being offered by tender, as most municipals are, the syndicate as a whole, or its leading members, will meet to discuss the bid that is to be submitted.

While this system is effective in spreading risks and distributing issues, it has problems associated with it. Perhaps the greatest of these is the rigidity it introduces into the industry. Syndicates once formed tend to ossify: the new firm finds it almost impossible to obtain participations, while the aggressive and growing members of the syndicate experience equal difficulty in expanding theirs. Participants in syndicates, particularly of corporate issues, also complain that they are seldom seriously consulted, often being given less than 24 hours to decide whether or not they will participate. Given the lack of flexibility in syndicates, they usually must go along whether or not they believe the issue is attractive, since rejection means they will not be invited to distribute subsequent issues. It is also traditional in Canadian underwritings for the syndicate manager to set aside from 40% to 60% of the issue for sale on behalf of the syndicate to the selling group and large institutions. These institutions make up what is known in the business as the "exempt list" and can only be approached by the syndicate manager or dealers authorized by him. This further strengthens the position of the managers with the institutional buyers and other syndicate members, although it helps to prevent the institutions from being inundated with selling offers during the issue's distribution period. It is also designed to prevent powerful buyers from playing the sellers off against one another in an attempt to break the minimum issue price specified in the banking and selling group agreements.

Syndicates in the United States are much more flexible, although they were not always so. This is partly because adherence to the Securities and Exchange Commission's net capital requirements occasionally makes it necessary for a heavily committed firm to decline invitations. Issues are also much more frequent and the number of syndicate managers much larger so that rejection of a participation does not have the consequences for a firm's present and future revenues that it does in Canada. More important, however, the size and impersonality of the American market tend to make price factors more important and to lead to less emphasis on reciprocal business. Houses with a good record of placing their participations will thus be invited to participate in subsequent issues even if they declined the last time, margins are slim enough to discourage some of the inefficient firms, and the managers deal comparatively ruthlessly with poor performers. We hope that a similar flexibility will develop in Canada, particularly since the industry is now large enough to allow more impersonal and competitive forces to work without impairing the service provided to the borrower.

The present Canadian system puts enormous power in the hands of the relatively few main syndicate managers. Since these firms participate in one another's syndicates and since other firms are reluctant to compete with them for a large issue because of fear of losing their participations in all the syndicates managed by them, competition for corporate, large municipal, and provincial underwritings has been modest and the constant lobbying of the better syndicate members for increased participations has been relatively ineffective. Some "sniping" does indeed go on, but competition has tended to take other forms, such as the provision of money market services and information and advice about securities and commodities markets. Part of the responsibility for this state of affairs must lie with the issuers, who are reluctant to switch fiscal agents on price or service grounds. Indeed, in some instances the issuer insists that the participations of existing syndicate members be left unchanged even though they do not properly place their allotments. The recent moves by some members of the industry to make room for expanding and more effective firms by cutting back on the syndicate allotments to poor performers are to be commended. The issuers themselves can assist in this development by taking a closer interest in the record of distribution of the individual members of the syndicate.

The advantages and disadvantages of having the chartered banks in syndicates were discussed by the I.D.A. in their brief to us. By supplementing the capital and retail distributing power of competing groups of dealers, such bank participation —which is mainly confined to municipal and provincial issues—can play a useful role. The investment industry does not seem to have been weakened by this practice and so long as the dealers remain alert and aggressive, there is no reason why it should be. However, if the banks remain in this field they should do so as open partners sharing full responsibility with the other underwriters to the investing public. At present the banks are shielded from this responsibility by the Bank Act, Section 157(2) which prohibits the appearance of a bank's name in a prospectus or advertisement for the sale of securities other than those issued by the Government of Canada. We believe this provision should be amended so that the banks can be required to comply with the disclosure requirements imposed on other underwriters by the securities legislation. In order to prevent unscrupulous use of a bank's name to sell securities, the original reason for the section's adoption in 1944, the section might continue to prohibit the use of a bank's name in a prospectus or advertisement when it is not an underwriter, except when the bank gives its express consent. Although removal of the present restriction might increase the participation of the banks in the distribution of securities, the dealers will continue to be in a better position to advise both borrowing and investing clients. Moreover, bank managers, with their many other responsibilities, are not likely to try to become experts on security sales which reduce their own deposits.

The reasonableness of underwriting costs must be considered in any assessment of whether the new issue market serves borrowers well. The cost of registration with the various securities commissions averages about $200 including the fee for the legal opinion on the validity of the issue. More significant are other legal fees, which for some complex debt issues might run as high as $30,000, the trustee's fee, the cost of an audit if one is required, printing costs for the certificates, and possibly engineering and other costs for technical advice and services. The total cost, excluding the payment to the underwriter, is likely to fall between $15,000 and $50,000 and most offerings cost between $25,000 and $30,000. Current data are not available for the United States but a Securities and Exchange Commission study published in 1957 estimated that an industrial debt issue of $15 million would cost about $100,000, excluding the underwriters' charges, or about twice the maximum Canadian cost today. The costs for government issues are, of course, very much lower and are not significant in total.

The largest single cost in floating an issue is the compensation to the investment dealer. This cost sometimes includes payment for continuing advisory and market services not directly related to a specific underwriting, although a separate charge is occasionally made for such services. The underwriter's internal costs are to a large extent fixed regardless of the size of the issue and may even be higher for preparing a complex small issue of a company new to the market than for floating a routine large issue of an established company. Moreover, the market risk is often related to the size and newness of the company. Until recent years the underwriter paid for his own legal advice but the issuer now usually pays this cost, partly because a 1955 amendment to the Income Tax Act, (Section 11(1)(cb)) allowed expenses incurred for the issue and sale of securities to be deducted from corporate income for tax purposes. The amount paid to the underwriter is, however, not deductible, a subject on which we received representations but which we believe is better dealt with by the Royal Commission on Taxation.

Comparisons of the results of an American study of 1951-55 underwriting costs[5] with Canadian data for the same period indicate that Canadian spreads were generally wider for large issues, but were typically lower on smaller issues. Spreads in Canada do not appear to have altered significantly since that time and usually range between 2% and 3% on good corporate issues, between 3% and 5% on sound but less well-known companies, and between 5% and 10% or higher for unproven companies. In the United States on the other hand, spreads have narrowed perceptibly. Although spreads on U.S. public utility issues remained consistently below 1% and averaged about .8 percent in 1961, the underwriting costs of industrial issues had declined to under 1% in the same year. Canadian spreads for good corporate debt issues, therefore, now appear to be between 2 and 3 times those in the United States. The underwriting costs of Canadian equity capital when issued through rights to shareholders appears to compare favourably with those in the United States, averaging between .5% and 1.0%; any unsubscribed shares are either underwritten for a slightly higher fee or sold by auction. Underwriting spreads for most provincial issues are normally in the range of ¾% to 1¼%. For the larger municipalities they range from 1% to 1½% moving upward to as much as 4% for issues of poorer quality on which bidding is not intense. While difficult to compare with American spreads, the underwriting costs of provincial issues seem to be about the same as comparable American issues, although higher than some big American issues sold by competitive tender, while many municipal spreads in Canada compare favourably with those in the United States.

These generally higher underwriting margins in Canada, especially on corporate issues, are explained in part by the relatively greater importance of the retail market in Canada. It has been estimated by the industry that between

[5] S.E.C. Study, *Cost of Flotations of Corporate Securities, 1951-55.*

40% and 60% of many Canadian issues might be marketed to individual clients who are more costly to service.[6] The other major reasons for our higher spreads are undoubtedly the high degree of concentration of underwriting power in Canada, the comparative lack of competitive bidding for new issues (except for municipals where Canadian spreads, significantly, are usually lower), and the general failure of the industry to engage seriously in competition for underwritings.

It is not possible or desirable for every borrower to offer his new issues by competitive auction. For example, the advantages of continuing professional advice and of building up client interest in the securities concerned are obvious in the case of a small company coming to market for the first time or when the requirements of a corporation are complex. The advantages are less clear when a large company with experienced financial officers comes regularly to market with issues of a routine nature, especially since market consultants can be hired separately. As we indicated in Chapter 4, we believe that the benefits of having a permanent fiscal agent and underwriter can be over-emphasized and that the dealers' willingness to make secondary markets is not purely a function of permanent fiscal agency relationships. Most corporate debt issues carry sinking funds which serve to provide market support and which would still be available if there were no permanent fiscal agency arrangements. We thus find it surprising that corporations and utilities virtually never use tendered underwritings in Canada, particularly when this method, which is obligatory for most American public utilities, seems to be so effective in reducing underwriting margins in the United States. If auctions were held even occasionally, it would make for better prices and reduced costs, serve as a benchmark for companies that might prefer to negotiate their issues, and provide more opportunity for the newer and smaller investment houses to expand and develop—provided that they were sufficiently strong and competitive to win and distribute these issues successfully.

As an alternative to competitive auctions, borrowers have sought to reduce underwriting costs by other means. For example, two provinces have underwritten their own issues, paying the dealers only a selling commission for distributing their bonds. In the corporate field particularly, direct placements with financial institutions have become more significant, partly as a means of reducing the payment to the dealer although also to avoid registration and prospectus expenses. Moreover, rights issues, which also substantially reduce payments to dealers, and in certain circumstances are exempt under the securities acts, have become a much more common method of obtaining new equity funds. On the other hand, there has been a movement away from tendered underwritings by the provinces and the larger municipalities. There may be some justification for this when issues are unusually large, but we think the Canadian industry is sufficiently large to support at least the occasional auction of such issues, if only to ensure that underwriting spreads do not get out of line. We recognize the danger that over-enthusiastic bidding by weak syndicates may lead to an unsuccessful issue and consequent repercussions on the borrower's credit standing. However, this can be guarded against to some extent by requiring proof from bidding syndicates that their capital is adequate or by requiring a reasonable deposit when a bid is submitted.

In general, we conclude that the nation would benefit from more competition in the underwriting field and that—judging from the anxiety with which dealers try to increase their participation in syndicates and by the level of profits in the industry generally—underwriting spreads could be reduced somewhat without fundamental damage to the industry. However, we would not want to leave the impression that underwriting costs are so excessive as to impair the basic workings of markets: a reduction in margins,

[6] Based on Bank of Canada figures for distribution of non-federal bond holdings, however, the average of all issues held by Canadians other than the main financial institutions is closer to 30%; the comparable federal figure is a little higher.

while representing a very worthwhile cash saving to the issuer, would have only a minimal effect on the annual yield cost of a 20 year issue.

There are three further areas of the Canadian underwriting business where some change could improve resource allocation and the functioning of the markets. First, there appears to be a tendency for the large well-capitalized firms to avoid sponsoring riskier enterprises. While most companies of this type do succeed in finding a sponsor, particularly among the smaller and more aggressive houses, the capital available for this kind of underwriting is relatively small and the costs of issue are probably higher than they would be if the large firms participated actively in the business. The large houses apparently feel that having established their reputation as high grade bond houses dealing only in investment-type securities, their business would be harmed if they dealt in riskier issues. They also feel that their high overhead costs effectively prohibit them from undertaking small underwritings on reasonable terms, and are reluctant to charge high percentage fees. This reason may be relevant at times when an additional underwriting will tax the underwriter's physical or financial resources, but does not hold true on those frequent occasions when a firm's underwriting resources are not being fully utilized in the preparation of higher-quality issues and when the costs of employing them in other directions are consequently low. The first objection is perhaps more understandable, although it is not uncommon for clients of even the most conservative houses to want to include some speculative issues in their portfolios.

Fortunately, there are a number of small firms which are not so concerned about their corporate image and have less compunction about charging what they think their services are worth. However, because of the high costs of preparing an issue for market, even these firms rarely take industrial underwritings of less than $250,000 and their spreads can climb as high as 20%. Indeed, very small corporate issues are not appropriate for market distribution, and their needs can be better met by term loans from banks or other financial institutions or by specialized development companies. We believe, however, that the larger underwriting firms might usefully play a more active role in seeking to obtain capital for firms with issues in the $250,000-$1,000,000 range. Some in fact are now doing so on a private placement basis and we hope that this trend will be carried further.

The second weakness of the industry is its reluctance to take on true underwriting liabilities for any extended period of time. Agreement between the underwriter and the issuer on the pricing of the issue is normally only reached at the last possible moment, although the general range will have been established earlier. Moreover, the firm underwriting agreement, which is not signed until the price is fixed, also contains an escape clause which, though seldom invoked, allows the dealer to refuse the issue if the market moves seriously off the agreed price. Finally, institutional and other purchase commitments are often obtained before the underwriting agreement is signed so that the real liability of the underwriter and banking group is frequently negligible. This obsession to dispose of its liabilities quickly, despite the way risks are spread by the syndicate system, sometimes leads the industry to price issues too conservatively at the expense of the issuer or to reduce the size of the issues it will handle. However, the latter problem—which may formerly have contributed to some borrowers making use of the American market—is now less common, and the industry has recently shown its willingness and ability to handle very sizable issues. We hope that in future the industry will gradually develop a longer view towards its underwriting liabilities.

The speed with which issues are disposed of gives rise to a third problem, the lack of time available to the investor to decide whether he will purchase a new issue. Given that the sales force of the industry is mobilized to clear the liability in a matter of days, or even hours, after the issue officially comes to market and that informal purchase commitments may have been entered into ahead of time, some purchasers never hear about such issues or are given only a matter of hours to make their decisions; sometimes,

indeed, a prospectus is not even available to them. These difficulties could be overcome by the circulation of draft prospectuses, known as "red herrings" in the United States, and containing all details but price and yield, well in advance of the official offering date. This procedure assists the American underwriter to judge the demand for an issue and price it more closely to the market as well as enabling the potential purchaser to study the issue carefully. At present, this route is effectively closed in Canada by the way in which "trading" is defined and by the provisions of Section 39(1) of the Ontario Securities Act, although—as we have indicated—some market testing goes on with the bigger institutions.

The risk involved in the use of the "red herring" prospectus is that it might contain incomplete or misleading information. Although such defects would almost certainly be remedied in the subsequent registered prospectus and reputable firms would be sure to draw attention to them, fringe operators might not be so ready to do so. However, such abuses could be controlled by giving the securities commissions the power to take "stop order proceedings" similar to those in the United States whenever any material deficiency is discovered either in the draft or the final prospectus. Where such an order is issued, the offering cannot lawfully be made or continued until the registration statement has been amended to cure the deficiencies and the S.E.C. has lifted the stop order.[7] In addition to the embarrassment of having a stop order issued, the company's prospectus moves to the bottom of the queue of applications for registration. The effectiveness of the procedure is demonstrated by the fact that only 6 of 1,830 registration statements filed with the S.E.C. in the fiscal year ending in June 1961 were placed under stop orders.

All these factors considered, the case for the use of red herring prospectuses in Canada is a strong one. We therefore recommend that the necessary amendments and additions to the legislation be made. Such changes would also help to co-ordinate the timing of new issues in an informal way, a function that is now performed by the major underwriting houses which, by consultation, can usually avoid having two large issues come onto the market at about the same time. The Bank of Canada does have a system whereby it will indicate to a province upon request whether or not a particular date in the future appears to be available for a new issue, but some people urged us to consider a more formal and public method of co-ordination of new issues. However, such measures would only be feasible if the co-operation of all the major borrowers were received or if some central authority were to be given powers to defer issues and assign priorities. It is doubtful whether control to this extent is either possible or desirable. Nor does the problem seem likely to be a serious one, although it might be helpful to all borrowers if the federal, provincial and large municipal governments were to announce the general nature and timing of their borrowing programs in advance.

We have not discussed the subject of new issues floated in the American market in this chapter since the matter is dealt with elsewhere. The dealers play an important role in advising borrowers whether to resort to such external financing and, given the close links between the Canadian and American markets, are very sensitive to differentials in interest costs and in the availability of funds. New issues in foreign markets are underwritten in much the same way as domestic issues, with the exception that private placements are more common and that syndicate participations are usually divided between Canadian underwriting houses with American operations and United States firms with experience and placing power, particularly in the institutional market.

Finally, we wish to deal with the representations we received that undesirable conflicts of interest arise between the underwriting and other activities of dealers. The investment dealer by becoming a director of a firm with which he has a fiscal agency agreement or understanding places himself in a position to use insider knowledge for his own benefit and perhaps contrary to the interests of the other shareholders. The advantage

[7] Section 8 (d) of the United States Securities Act of 1933.

to this arrangement is that the dealer can seek to influence the management of the company in ways which help to protect his clients' investment. However, he can always obtain information by contractual arrangement with the issuer in any event and would have to be kept informed if he were engaged as a market consultant. While there are thus some advantages to shareholders not being represented by directors who have fiscal agency ties with the company concerned, there are also disadvantages, and we do not feel that there is a need for legislation prohibiting investment dealers from acting as directors of any company of which they are fiscal agents. Any abuses arising out of such relationships can be dealt with under existing laws or through the legislative powers we will propose in the next chapter.

We have also considered the potential conflict of interest resulting when the dealer acts both as an agent and a principal, that is, when he may be merely bringing together buyers and sellers and dispensing objective market advice to clients at some times, while at other times he may be making sales to clients out of his own holdings. The securities administrators and industry associations have taken action to require their members to indicate to the customer whether they are acting as principal or agent so that he may be aware whether or not the advice he receives is fully impartial. Obviously, it is not in all cases—if only because a firm tends to become enthusiastic about the issues it knows best—but we could find no indication of abuses so prevalent and substantial as to warrant the major disruption of the securities business that would result from the enforced separation of jobbing and underwriting on the one hand and brokerage functions on the other.

SECONDARY BOND MARKET

Securities, once underwritten and distributed, trade in the ordinary way through the secondary market. The existence of this market, by enhancing the transferability of securities and serving as a guide to values, makes the primary new issue market a larger and lower-cost market than it would be in the absence of such after-trading. Trading in the secondary bond market is informal, the main dealers in each major city being linked for the most part by direct telephone communications and, quite frequently, by direct lines to their own head offices. While geographically dispersed in the sense that trading is carried out in all the main population centres, the main trading, residual demand and supply, and virtually all dealer inventories are concentrated in Montreal and Toronto.

Statistical information about the secondary market, other than comprehensive data on prices and yields, is practically non-existent. However, the I.D.A. compiled some special sales and inventory information for us from a survey of its members, some of which is set out in Table 16-3. While these data lack precision and the figures should only be taken as representing orders of magnitude, they clearly indicate the preponderant role played by Government of Canada securities in the dealers' secondary market sales: 80% of total transactions were in Canada's, almost 70% in money market issues alone. Treasury bills accounted for much of this volume, with dealer sales being equal to about three times the amount outstanding. Dealer turnover of Canada bonds beyond the money market range drops substantially, with some of the sales representing sales to government accounts like the Securities Investment Account and the Purchase Fund. Dealer secondary market activity in provincial and municipal direct and guaranteed bonds and in corporate bonds was equivalent to an even smaller proportion of total bonds outstanding, with sinking fund activity perhaps accounting for between 10% and 15% of total trading of the provincials and corporates.

A wide variety of factors determine whether or not an issue trades actively in the secondary market and thus whether it is a relatively liquid or shiftable instrument in the hands of its holders. Other things being equal, large issues with a widespread distribution are more likely to have a good and continuing market than smaller issues: the existence of substantial numbers of potential buyers and sellers means that the bigger issue

TABLE 16–3

SECONDARY MARKET SALES[a]

—	Amount Outstanding[b]	Secondary Market Sales	Relationship of Market Sales to Bonds Outstanding	Distribution of Secondary Market Sales	Distribution of Investment Dealer Inventory[c]
	$ millions	$ millions	%	%	%
Government of Canada:					
Treasury Bills	2,165	6,507	301	37.4	28.6
3 years and under	4,176	5,532	132	31.8	34.4
3 years to 10 years	3,249	742	23	4.3	2.3
Over 10 years	4,856	1,212	25	7.0	4.6
Provincial Bonds	7,156	1,225	17	7.0	9.5
Municipal Bonds	3,090	388	13	2.2	3.1
Corporate and other Bonds	5,958	1,163	20	6.7	9.8
Finance Company and Commercial Paper	n.a.	654	n.a.	3.8	7.7
		17,421		100.0	100.0

[a]Table based on secondary market sales made only by members of I.D.A. during their 1962 fiscal years.
[b]Gross amounts outstanding as at December 31, 1962—direct and guaranteed market issues payable in Canadian dollars.
[c]1962 fiscal year-ends—excludes stocks.

SOURCE: Submission of the I.D.A. and *Bank of Canada Statistical Summary*.

can be traded in large volume without moving the price unduly. Trading spreads are thus narrower than for a smaller issue, a factor which in itself encourages trading; for example, the spreads on the large Canada Conversion Loan issues of 1972 and 1983 are typically ¼ of 1% to ½ of 1% narrower than on many of the smaller and more closely held surrounding maturities.[8] The existence of a sinking fund also adds to the marketability of an issue, not only through its own operations but because its existence makes others more willing to trade in the belief that there will always be some support for the issue. However, the existence of such funds does not by itself make an issue trade actively, as the turnover figures on corporate and provincial bonds attest. The original method of distribution also plays a role—bonds privately placed with institutions rarely trade, while those available only in large denominations never attract a widespread retail following. On the other hand, issues convertible into common stock may be very active traders, particularly in a period of rapidly changing equity markets, while bonds selling at a substantial discount may have an active market among those in high tax-brackets.

Perhaps most important are the attitudes and motives of the holders. Thus we find many short-term bonds trading actively as much because the holders regard them as liquid as because of their comparatively low risk of capital loss. Conversely, municipal issues, and many corporate and provincial issues as well, are illiquid mainly because they are bought by long-term holders not interested in short-term trading; in the case of municipals, the serial feature, odd denominations, and small amounts often involved add to this lack of liquidity. With the exception of the securities of the larger provinces and their hydro-electric commissions, a few of the larger municipalities and some of the bigger corporate issues, therefore, virtually no secondary market exists for this type of obligation. Spreads might be as wide as one or two points for well-regarded provincial issues and two to four points for comparable corporate securities, while the market will be confined to a comparatively few dealers.

[8]The bid and asked spreads used here are retail or publicly quoted spreads. Spreads for "inside" trading are much narrower but the same relative differentials appear.

Another important determinant of the closeness of market spreads and trading activity is the willingness of dealers to carry inventories and establish short positions from which they can meet client orders when there is a temporary imbalance of supply and demand in the rest of the market. Dealer inventories have grown substantially in the last decade and this has contributed greatly to the improved functioning of the market. At the end of their 1962 fiscal years, members reporting to the I.D.A special survey had total long positions of $485 million compared to only $46 million eleven years earlier, while short positions had grown to $35 million from $9½ million. This growth has been due to a number of factors, among them the development of the money market, the growth of dealer capital and skills, a more enterprising attitude in the investment community, and the maturing of the market generally. This is a welcome trend which we hope will continue. As the earlier table shows, the distribution of inventory tended to be broadly similar to that of secondary market sales.

Better markets are made if dealers are also willing to take short positions, either to service customers or to speculate on future market developments. Dealers are still comparatively reluctant to take such positions despite the trend of recent years, and almost half of such short positions are in fact in treasury bills and other money market securities. If an issue is not liquid, some dealers are unwilling to sell short because of the difficulty they might have in buying the bonds later, a factor which itself contributes to the issue's lack of liquidity. Moreover, the cost of borrowing issues appears to be a factor inhibiting short sales, although more financial institutions are now willing to earn a return by lending dealers bonds against appropriate collateral. We expect to see short positions gradually built up as the market develops and becomes more experienced.

In general, we have no reason to believe that the secondary bond market fails to allocate resources well or that it puts yields on issues which are fundamentally out of line with the risks and costs involved. In earlier chapters we noted that this might not be so true of some of the smaller and less well-known municipalities (although part of the responsibility for this state of affairs lay on provincial governments failing to make more information available about such localities). We also pointed out that some smaller enterprises might find the terms of issue too expensive although this is not a general problem. The market has also shown itself to be sensitive to changing demand and supply conditions, and yield differentials on the various types of securities seem to reflect these conditions; for example, the differential between government and corporate bonds has narrowed substantially in recent years as the government demand for funds has risen and corporate demand has fallen substantially from its peak in 1956-57. Moreover, markets seem to have adapted well to changing conditions, with new types of securities being designed to take advantage of changing investor demand—for example bonds with warrants to purchase common shares and convertible securities. New covenants have also been devised to meet the requirements of institutions and the public: examples include the assignments of production contracts incorporated in the securities which financed the development of the uranium mines and some of the oil and gas enterprises in Western Canada, and the clauses which protect the investor against refunding issues at lower rates of interest.

The market has also become better informed and made more information available to the public. Although there is no single trading board where current prices are posted and available to the public, any dealer stands ready to provide his quotations for the most commonly traded issues at any time: most bank branches also provide this service to their customers. The dealers, through their association, also publish daily press quotations, although they seem somewhat wider than many dealers actually quote; they may thus provide some shelter to the least efficient members.

There is inadequate statistical evidence to analyse the market effects of dealer inventory speculation. There is some tendency for dealers' inventory to reach peaks just before the treasury

bill rate begins to move upward and to decline during periods of rising rates; inventory peaked, for example, in the early part of 1962, while by the time the rate had reached its peak in mid-July dealer inventory had been reduced from approximately $519 million to $342 million. In this period, dealer speculation reinforced the trend of rates and had the effect of assisting the monetary authorities to bring about the desired change in credit conditions relatively rapidly. Dealer holdings of longer term bonds, although a small proportion of the total, dropped particularly rapidly, and—as is typical in such periods—dealers quoted wider spreads in an effort to protect themselves against acquiring unwanted inventory.

At other times, however, dealer speculation can play a less constructive role: with ready access to bank and non-bank funds, some dealers—including dealers and brokers who do not normally carry large inventories—are tempted to over-extend themselves in periods of monetary ease or of apparently successful new Government of Canada issues. This happened in early 1958, and contributed to the subsequent sharp drop in bond prices in that year, and again in late October 1962 when anticipation of a decline in the bank rate drove dealer inventory to what was then an all-time peak of over $540 million. The Cuban crisis intervened before the bank rate was reduced and, on the theory that in troubled times one ought to be in cash, the dealers panicked and dumped bonds worth over $100 million into the Bank of Canada. A similar situation developed in July 1963 when uncertainty developed over the impact of proposed U.S. taxation on new issues sold in the New York market and trading in the Canadian market came to a virtual standstill until the central bank's reaction was known.

While the secondary market is not yet fully matured, is still at times excessively dependent on support from the Bank of Canada, and occasionally displays signs of unthinking conformity to prevailing sentiment, these characteristics are to be found in varying degrees in financial markets everywhere. When formulating their own policies, dealers should, of course, take into account economic and financial developments and the central bank's probable reaction to them. In a maturing market, the participants become increasingly able to "see through" short-term factors and willing to act on the basis of their own judgments. Significant progress in this direction has already been made and the markets have become sturdier and more independent of the need for continuing official intervention. The dealers and markets have also shown themselves able to withstand falls of about 15% in the value of long bonds within a year, although understandably not without some effects on trading volume and profits. We are confident that the markets will become more highly developed in the years ahead.

SHORT-TERM MONEY MARKET

The Canadian short-term money market is a relatively new development which, under the encouragement of the Bank of Canada, has grown and diversified enormously in the last decade and has now become a mature and reliable component of the broader capital market. There are currently 15 money market dealers, of which between 4 and 6 do the bulk of the business. The Bank of Canada grants a line of credit to these dealers, after establishing that their capital is adequate to the volume of business done and that they are capable of making continuous and broad two-way markets in money market securities. These lines, which amount to some $300 million in total, enable them to borrow from the Bank of Canada against eligible Government of Canada securities at a penalty rate (currently Bank Rate or ¼ of 1% above the yield of the latest average tender for 91 day treasury bills, whichever is less) and thus encourage them to carry substantial inventories in the knowledge that financing will always be available. More important, however, these credit lines entitle them to obtain day loans from the banks, callable before noon on any day by either party; rates on these loans are low because of their liquidity, because they are included

in the banks' secondary reserves, and because the banks know that dealers can always resort to central bank accommodation if necessary. The money market dealers, with these primary sources of funds, have played a significant role in developing other sources of funds, as we have already noted. They have also brought other borrowers into the market and educated a wide range of governments, financial and non-financial corporations, and charitable and other institutions in the use of its facilities. Thus the alert treasurer may use the market to borrow or lend for any period from one day to three years and has a wide range of alternative outlets in which he can keep temporarily surplus funds invested at a worthwhile return.

Since the market is highly competitive and relatively impersonal, it has tended to keep dealers' commissions to a minimum and force both them and the banks to devise new methods of attracting deposits. The relatively inexpensive funds provided by the banks and country banks, by encouraging dealers to carry larger inventories, have led to more active markets in federal treasury bills and short-term bonds, to a reduction in dealer spreads, and thus to an increase in the liquidity of these and similar instruments. In addition, the development of a series of short-term instruments of other borrowers with competitive rates has broadened the range of instruments which are sensitive to general credit conditions. An important section of the business and investing community has thus been made more aware of general monetary conditions and day to day changes in interest rates. Some treasurers have used this knowledge to introduce more flexibility into the timing of their approach to the market for long-term capital, adjusting their short-term lending and borrowing in the meantime.

The development of the money market has provided the Bank of Canada with a notably improved vehicle for its own operations. Prior to 1954, the Bank's activity in the treasury bill market was severely restricted; the market was thin and most of the bills were held by the chartered banks and were only traded directly with the central bank. Today this market has all the advantages resulting from the existence of substantial dealer inventories and a large and diversified group of buyers and sellers, and the Bank can now carry out sizable open market operations by acting through the 15 jobbers as well as the banks. Moreover, the effect of these transactions is more widespread and more speedily transmitted than could have been the case prior to 1954 since previously compartmentalized pools of funds have now tended to flow into the central reservoir of the money market.

The history of this market, has been well described elsewhere[9] and we shall accordingly restrict our discussion to the more recent development. By 1958, the initiative of the Bank of Canada and the active co-operation of the jobbers and banks had developed a broad market in federal government treasury bills and short-term bonds. Dealers had also become active in marketing the short-term promissory notes of instalment finance companies which turned increasingly to this market because of the uncertainty of chartered bank lines of credit and the rigid and relatively higher cost of bank lending rates. Finance company paper outstanding rose from $16 million at the end of 1949 to $118 million at the end of 1951, which was the year of the first post-war freezing of their bank lines, and continued to expand until by mid-1962 approximately $500 million was outstanding. Most of this paper has been placed through dealers.

Particularly since 1957, a market has developed for the short-term promissory notes of prime non-financial corporate borrowers, and by 1961 this market grew to over $200 million. Currently, the amount outstanding may run up to $450 million; our survey (which excluded governments) showed non-financial corporate borrowing of over $300 million in mid-1963. At that time, there were 51 corporate borrowers including large retailers, grain dealers and a wide

[9] See J. A. G. Wilson, *The Canadian Money Market Experiment*, Banca Nazionale del Lavoro Quarterly Review, March 1958; Bank of Canada Annual Reports; and the Submission of the Investment Dealers' Association of Canada.

range of manufacturing corporations. Virtually all these companies have important seasonal variations in their cash flows and many of them are issuers of notes at one time during the year and purchasers at others. The rate structure for prime corporate paper is comparable to that of finance company paper but is normally about ⅛ of 1% above it, partly because their notes are unsecured. Dealers at first acted strictly as agents in placing this paper, taking a small commission averaging about ⅛ of 1% per annum for bringing together borrower and lender. However, severe competition forced dealers to take the paper into inventory and use it, along with treasury bills, for buy-back arrangements with short-term lenders. The clients for this paper include trust companies who take it into their own portfolios and issue their own liabilities to investors who may only purchase trustee securities. Some of the trust companies also use the dealers to place guaranteed investment certificates on a commission basis but these instruments do not trade subsequently.

Two factors, in addition to the expertise and selling efforts of the money market dealers, have contributed to the development of this corporate paper market. The first has been the relatively high cost of borrowing from the banks at times when credit conditions are easy and the second has been the increased attractiveness of this market to lenders when short-term rates are above 2%. Once accustomed to this market, both borrowers and lenders tend to remain with it as long as there is any net advantage in doing so, even though the original wide differential has disappeared. Moreover, bank pressure on their larger borrowing customers in times of monetary stringency has reinforced this movement, as has the borrowers' experience that funds are virtually always available if the rate offered is appropriate.

Chartered bank competition for short-term funds has been described in Chapter 7. In June 1962, the banks contributed another instrument to the money market, the banker's acceptance, whereby a customer wishing to use market facilities sells a short-term instrument guaranteed by a chartered bank. The minimum denomination for such acceptances is $100,000[10] and the rate is between the treasury bill rate and the rate on prime finance company paper, although the borrower pays the banks a minimum fee at a rate equivalent to 1¼% per annum for guaranteeing the draft. Acceptances were introduced just before the treasury bill rate reached its peak of over 5½% and borrowing by this means would have thus cost considerably more than direct bank borrowing. Although the treasury bill rate has since declined, the development of the market has been miniscule; the differential between the cost of borrowing by acceptance and the bank's prime borrowing rate is still rather narrow, most of the chartered banks lack enthusiasm for this instrument, and larger corporations already have access to the market at rates which are between ½ of 1% and 1% cheaper. However, if interest rates fall still further, the chartered banks' prime lending rate remains insensitive, and a foreign demand for this paper springs up, the acceptance market might yet develop in Canada. Lowering the minimum denomination further, as was suggested to us by a number of witnesses, would entail considerable extra difficulties and costs for the banks owing to the closer supervision which small borrowing accounts require, and to the loss of compensating loan revenue which would be involved. However, if the market expands and more experience is gained, such a development might occur.

Other recent entrants into the money market include the provinces, provincial agencies, and the municipalities. Although provincial government treasury bills have been outstanding for many years, these bills were held almost entirely within the banking system and it is only within the past three or four years that the provinces and their agencies have sold short-term paper in the market. A large amount of this paper has been placed privately and little information is available about it. Some provinces have, however, called for tenders on particular blocks and dealers have participated in the tenders. In early

[10] Until January 14, 1963, it was $200,000. Acceptances are eligible for rediscount at the Bank of Canada, as security for day loans and for inclusion under the 15% liquid asset agreement.

1962, the provinces of Manitoba and Saskatchewan each began to hold regular weekly tenders for $1 million of three-month treasury bills. They were issued in each case to a total amount of $13 million and have been maintained at that level since. While there have been a few cases in which the bid was not accepted by one of the provinces, the experiment seems to have been successful on the whole. A number of the larger municipalities have also entered the money market with tax-anticipation or treasury bills from time to time, and both tendered and negotiated underwritings of these bills have taken place. It has been estimated that approximately $60 million of short-term municipal paper was outstanding in mid-1962, about half of which was issued by Metropolitan Toronto. A number of municipalities entered the market for the first time in that year and the city of Montreal began in September to accept bids on a series of weekly treasury bill issues.

Foreign investment in the money market, particularly by U.S. residents, has been substantial and has contributed significantly to its recent development. Prior to the introduction of the 15% withholding tax in December 1960, most of the interest was in federal government treasury bills. As the calculation of the 15% tax on these bills proved to have a strong nuisance value, foreign interest in them has tended to diminish and more attention has been given to better-yielding finance company and corporate paper where the withholding tax poses fewer problems. Foreign holdings of all short-term money market instruments are estimated to vary between $300 and $500 million in normal circumstances. Four to six dealers in Canada handle most of the foreign money market transactions and a large proportion of their business is channelled through a single bank in the United States which places the paper and hedges the transaction. Indeed, almost all non-resident transactions in this market are fully hedged against the exchange risk.

Ordinarily a hedged spread of about ½ of 1% is required to set in motion international flows of short-term capital. We have noted in the previous chapter that the factors taken into account by the foreign investor include the interest rate differential between domestic and foreign paper, the differential between the spot and forward exchange rates—the cost of hedging—and the trend of interest rates in his own country. Despite the diminution of risk which results from both the short-term nature of the paper and hedging against exchange loss, considerations other than those just mentioned can be important. In the first half of 1962, for example, despite attractive net yields, the flow of U.S. funds was discouraged by the psychological effect of the withholding tax combined with an unsettled federal political situation and fears about our external financial policies. These fears were intensified by the earlier expropriation of a privately-owned power company in British Columbia and the threatened nationalization of similar companies in Quebec. Moral suasion by the U.S. administration against investing abroad also played a part in damping down short-term capital inflows at that time.

Apart from its rapid growth and development, perhaps the only discernible trend in the money market is the diminishing use of dealers in commercial paper transactions. In the United States in the 1920's virtually all commercial paper was placed by dealers, but by 1935 companies had begun to place this paper directly among themselves. Although halted by the war, the trend has resumed since, and directly placed paper now amounts to more than three times that placed through dealers. A similar trend seems to be starting in Canada as borrowers and lenders become more experienced and more familiar with one another, although in view of the newness of the market it will probably be some years before the American situation is reached.

The short-term money market has had a remarkably trouble-free development and has evolved into a smooth mechanism for transferring short-term funds from lenders to borrowers. It has increased the number of participants in such flows and allowed the banks to

transfer cash among themselves quickly and easily, albeit indirectly. Rates in the money market seem to be highly flexible, and although not all banks seem to take full advantage of it at the margin, it has enabled them to run very close to the minimum cash requirement and thus greatly simplified the task of the monetary authorities.

One source of potential difficulties has, however, arisen in the commercial paper market, partly because borrowing for terms of less than one year is exempt from the disclosure requirements of securities laws. The available information about corporations entering this market is therefore sometimes restricted to that contained in their annual reports, or, in the case of private companies, to virtually no financial data at all. Since there is no official rating service to evaluate the credit worthiness of borrowers, the burden of responsibility for insisting on the provision of adequate data and its evaluation must be borne by the dealer and purchaser. In some instances, a proper evaluation may not have been undertaken, although this can be easily and cheaply done, while in others dealers have found it difficult to refuse to market paper offered by a client whose financial position might lead to difficulties in adverse circumstances.

While the potential risks in the unregulated growth of this market must be recognized, the participants in the market are likely to continue to be sufficiently sophisticated to protect themselves. However, we believe that the Bank of Canada ought to interest itself in a general way in the quality of paper being handled by the money market dealers and ought to feel free to draw attention to any serious weaknesses if these should ever develop. While we are not recommending central bank intervention in the dealers' affairs, and indeed have found no evidence of such intervention, we think it only reasonable that the central bank should continue to ensure that those to whom it extends borrowing privileges remain financially sound and otherwise qualified to remain useful and reputable money market participants.

THE CENTRAL BANK AND THE MARKETS

The Bank of Canada in its brief to us stated that one of the objectives that affects its choice of techniques for implementing monetary policy is its "desire to encourage the development of broad, self-reliant markets for Government securities".[11] Such markets serve as reliable guides to credit conditions and help to transmit the effect of policies smoothly and quickly to all sectors of the economy. They are usually characterized by active trading, close spreads between bids and offers, active arbitrage which transmits changes in one maturity range quickly along the whole yield curve, and by the absence of erratic changes in the direction of market yields. The Bank of Canada has tried to encourage such developments, not only through its facilities for the money market dealers, but in facilitating the movement of securities across the country and by making more market information and statistics available so that informed and intelligent trading and speculation can take place. It has also, as the federal government's fiscal agent, attempted to increase the number of debt-holders and thus the breadth of buying and selling interest in the market. Finally, it has privately encouraged the industry to build up its capital which, as we have seen, is now relatively above that of the United States government bond dealers.

While the central bank has in general played a useful and constructive role in this connection, it has not always succeeded in developing effective markets and has sometimes engendered strong distrust by the dealers, particularly by those less familiar than some with the requirements and repercussions of an active monetary policy. In any event, these two inter-related features of reliance upon the Bank and distrust of its operations were clearly reflected in the industry's submission to us and in its evidence at the public hearings. In part, this has been the result of a breakdown of communications at both the trading and policy levels. Until very recently, senior personnel of the Bank have made only infrequent visits to the financial centres of

[11] Submission III—paragraph 23.

Toronto and Montreal and, while dealers have always been welcomed in Ottawa, their visits are often with some specific purpose or complaint in mind and do not provide the closeness or frequency of contacts needed. Moreover, the Bank's market activities have not always been well explained, and from time to time dealers have felt they were capricious.

Some part of the explanation can be found in the central bank's trading practices. The trader in a bond house can, with the flick of a switch talk to his opposites in any one of 30 or 40 other houses and banks with whom his firm has direct telephone connections. Moreover, given his firm's inventory policy, he is usually willing to respond instantly to bids or offers and expects others to do the same. However, his trading relationships with the Bank are quite different. No dealer has direct telephone lines to the Bank, apparently because of the Bank's fears of charges of favouritism, but must instead dial the Bank's switchboard and wait for the trader to return his call in the order in which it was received. Although approximately 80% of the Bank's trading contacts are with the 15 money market jobbers, there are times—particularly in unsettled markets—when 30 or 40 dealers may telephone the Bank and when the delays which result are both long and annoying. Moreover, the Bank's trading operation is dispersed—although linked together by a direct communications system—and the four traders in Ottawa, two in Montreal, and three in Toronto have very limited discretion in responding to bids and offers. Finally, when trading on directions from Ottawa, they are apparently not normally informed about the purpose of the transactions and are thus not in a position to explain the Bank's policy and aims. Since their discretion is limited, and since the Bank has not posted prices since January 1948, preferring for the most part to operate more generally on the level of rates and to let the market sort out individual security prices, the dealer's proposal might well have to be relayed to Ottawa. Although as high a proportion as 87% of dealers' firm propositions are dealt with immediately, the other 13% involved delays averaging 20 minutes and ranging up to more than two hours on occasion. In an industry used to practically instantaneous communications and quick decisions, such delays can prove very upsetting and on occasion are reflected in unnecessary market disturbances.

Trading arrangements are rather different in the United States, where the Federal Reserve System's trading is carried out by the Federal Reserve Bank of New York and centralized in that city. Instructions are handed down by the Federal Reserve Open Market Committee but the Account Manager, a Vice-President of the New York Bank, is given wide discretion within these instructions. Market contacts and information are excellent, and dealers doing business with the Bank may attend 15 minute weekly or bi-weekly conferences with its officers to discuss general conditions and any technical or other aspect of the market related to the firm's operations; most of the active dealers send senior members of the firm to these meetings. The Bank trades only with a select group of 17 banks and dealers (some of them with head offices outside New York) which specialize in government securities; in other respects the position of these dealers is similar to that of the 15 Canadian money market jobbers. The trading techniques of the Federal Reserve are streamlined and efficient, and direct lines to the dealers are maintained to enable it to contact the dealers and receive bids or offers from them in a matter of minutes. If a large purchase or sale is to be made, all dealers are contacted virtually simultaneously by a procedure known as a "go around" which allows the dealers making the most attractive bids or offers to do the business. In Canada, by contrast, the dealer who just happens to be on the line often makes the purchase or sale, although the Bank sometimes solicits bids or offers from a few dealers or limits transactions with any one dealer if it is engaged in a large buying or selling program. The American system, of course, involves a problem of communications within the Federal Reserve and delays are not unknown, but we received the impression that on balance it led to a highly efficient trading operation.

As early as 1900, a limited number of dealers in the United States had specialized in government securities and in 1920 the New York Federal Reserve Bank began extending repurchase agreements to them. The Bank since that time has found it convenient and efficient to restrict its trading to a limited number of highly-qualified specialists. Since some Canadian dealers are already becoming specialized in positioning and trading Government of Canada issues, the Bank of Canada ought in due course to consider whether its own operations would be made more efficient and the market more self-reliant by confining its trading to a limited, but not unchanging, number of dealers. A first and useful step in this direction might be to give direct lines to houses engaging in a certain minimum of market trading: others would continue to call in as at present. A second constructive measure would be the raising of the minimum size of transaction which the Bank is prepared to undertake (currently this is $250,000 for money market securities and $100,000 for other maturities). When this minimum size was last increased, the number of dealers with whom the Bank did regular business was cut from 110 to 40, and we were informed that doubling the minimum size of transaction would now cut the latter by about half. This would have the advantages of encouraging the market to be more independent in its judgments and of facilitating the Bank's trading operations without in any way interfering with such other market contacts as the Bank wished to maintain, particularly in centres outside Toronto and Montreal. Nor do we believe it would penalize smaller or growing firms since their livelihood and expansion does not depend on trading in relatively small amounts with the Bank of Canada.

Some frustration is inevitable in any relationship between the central bank and securities markets, especially since the monetary authorities cannot always disclose their hand, even when they are certain of their future policy. In fact, central banks are often not exactly certain about underlying economic forces or what state of credit conditions is appropriate to them. Moreover, they must frequently use trial and error methods—known in central banking as "successive approximation"—until financial markets give them more guidance or the results of their previous policies become somewhat clearer. However, we believe that secrecy can be overdone, and that the benefits of frank and full information about monetary and debt management activities are sometimes not fully appreciated by the Canadian authorities. While we realize—as should any informed and sensible participant in the market—that there will be times when major policy decisions or switches require careful consideration and consultations among the Bank's senior officials in Ottawa which necessarily involve secrecy and delays, we are still of the opinion that the Bank's working relationship with the markets can be improved. We will return to this question in Chapter 26 after we have dealt more fully with the operation and effectiveness of monetary and debt management policies. In the meantime, we wish to note and welcome the recent efforts that have been made to improve trading practices and communications with the investment community.

The problem of reconciling the goal of broad, self-reliant markets with the need to establish precise levels of interest rates or to curb excessive market swings from time to time is not an easy one. It is particularly difficult for the Bank to "disengage" after being an active buyer of numerous issues, and to prevent such disengagement being misconstrued by the market. However, a franker discussion of the Bank's aims on such occasions would be helpful, as it would when the Bank is undertaking operations related only to the more mechanical aspects of handling the government's debt. At present, Bank traders tell the market that transactions for the government accounts or foreign clients are "for an account" and the dealers appear to endow this phrase with particular significance. We do not believe the Bank ought to be bound by such rules, nor are they particularly revealing when one considers the close relationship between monetary policy and some aspects of debt management—

a subject we will discuss in later chapters. However, there are undoubtedly frequent occasions when the Bank could be more forthcoming about such matters and could even help to achieve its broader aims by doing so. Given the importance of the Bank's direct and indirect impact on security markets and credit conditions, it is to be expected that the dealers should be strongly influenced by the Bank's view of the economic outlook and the probable response of the monetary and debt authorities to it. However, this does not mean that they should always share the authorities' views, await their moves, or show no independence of judgment. The more information that markets can be given and the more they can be left to work out the pattern of interest rates without undue dependence on the authorities when broader considerations allow, the more useful and effective they are likely to become.

The techniques used to distribute new Government of Canada issues no longer appear to be a source of friction between Bank and dealers. Successive experiments have resulted in practices that seem well suited to the current Canadian market, although we do not suggest that they remain fixed for all time. Indeed, as we shall argue more fully in later chapters, the authorities must be flexible in their debt management techniques no less than in their other operations.

For both political and economic reasons it is desirable for the debt managers to tap as wide a range of buyers as possible. A broadly held public debt contributes to greater public consciousness of government policies and activities and also encourages the development of a broader and more liquid market which may help to minimize interest costs. Finally, wide-spread debt holdings may facilitate the transmission of financial policies throughout the economy. These considerations are reinforced in Canada by the lack of an institutional market as highly developed as in the United States; retail sales to individuals must therefore be relied upon to supply a significant proportion of government funds. In fact, it appears that the proportion of Government of Canada marketable debt held by individuals is almost twice that in the United States.[12] Before mobilizing their extensive branch networks and sales forces which service this retail market, the dealers like to have some indication about the number of bonds they will receive and the timing and main characteristics of the new issue. Reducing the uncertainty surrounding such issues is therefore a particularly important consideration in Canada if full advantage is to be taken of the industry's distribution facilities.

While the Bank of Canada and government accounts effectively underwrite government issues and may subscribe to a portion of them initially, the main distribution is made by about 270 investment dealers and brokers, the eight chartered banks and the two Quebec savings banks—collectively known as the primary distributors. The Bank states that dealer participants are selected only after careful investigation has proven financial responsibility and a record of active and continuous distribution of high-grade securities; geographic distribution is assured by the use of the chartered banks and by the selection of dealers with head offices across Canada.

In most recent issues the Bank has adopted a procedure of offering a portion of the new issue "firm" to each dealer, thus assuring them of a minimum amount of bonds if they accept this allotment in whole or in part. Subscriptions are then invited for the remainder of the issue, but individual dealers and banks may not enter subscriptions for more than twice the amount of firm bonds accepted by them. This is to prevent excessive "padding" of orders which may result in a dealer getting more bonds than he can handle if he has misjudged the percentage of his subscription that will be accepted. When the book is closed, these non-firm bonds are allotted pro rata along with any firm bonds not accepted. Actual delivery and payment are usually made two weeks later.

[12] We considered the possibility of encouraging the dealers to cultivate this higher-cost market through a two-price system for new issues or a two-tiered commission structure. However, quite apart from the question of whether such methods would be justified or effective, they would lead to abuses which would be difficult and costly to contain.

Prior to any offering, meetings will have been held between the Minister of Finance and his Bank of Canada and departmental advisors at which decisions about the rate, term, method of distribution, commission, etc. are made. Within a week an announcement will have been made by the Finance Department giving some of the general characteristics of the new financing and its offering date, usually two to four days later. This enables dealers to start planning their sales campaign, although the exact size, term, call characteristics, price and yield of the new issues are contained only in the telegrams sent to dealers across Canada before the opening of trading on the offering date itself. These telegrams also describe the commission, which ranges from .10% to .25% on short-term issues to as much as .75% on long-term issues, the dates of interest payments, and the available denominations. In addition, they set out the number of bonds offered firm to all primary distributors as well as to the recipient of the telegram and contain delivery and subscription instructions. Finally, they set out the issue price—the minimum price at which the securities may be offered or sold to investors; this price restriction is usually removed on or before delivery date. In subscribing, the primary distributor also agrees to conform to a series of regulations relating to sales through sub-agents and other matters, and to submit to the Bank a record of all sales of the issue over a period of about a month.

Among the problems associated with this method of distribution are those of pricing the issue correctly, of setting commissions and of choosing the primary distributors and ensuring that the allotment of each fairly reflects his placing power. The role played by the Bank in these matters is formally that of agent for the Minister of Finance. One possible alternative method of issue is sale by auction, which has been used successfully for treasury bills since 1934 but was tried for bonds only on two occasions in the first half of 1960. This system removes the problems of setting prices, allotments, and commissions, and provides the government with the best possible price for that issue. However, it also creates its own problems: for example, the only complete issue offered for tender—the 4¼'s of December 1, 1962—was not well placed. Individual dealers have to guess what the other 269 bidders will do, and the price may be bid up to unrealistic levels as a result, only to fall again later. The dealer is also uncertain about his own price and allotment and reluctant therefore to make a sales effort until after the auction, by which time the initial momentum may have been lost.

These problems would be less intense if the bonds were offered for tender to two or more strong syndicates of dealers who could sound out the market in an organized way ahead of time and would not have to worry about irrational bidding from smaller dealers and brokers. Towards the end of 1962, the United States Treasury successfully marketed a $250 million long-term bond issue in this way, but despite its small size in relation to that market a later issue failed to attract buyers and the syndicate was left with a large unsold position.[13] The Canadian industry is not yet large enough to handle Government of Canada issues by auction to competing syndicates, even allowing for the fact that the Bank of Canada and the government accounts would presumably take substantial amounts of the issue at the average tender price. In any event, we see no need to experiment with such a system at the moment, although we certainly would not wish to rule out its use at a later date.

We also received suggestions from some I.D.A. members that the federal government negotiate underwritings with a single syndicate. This ignores the fact that the Bank of Canada is the fiscal agent for the federal government and that basic debt management policy must be tied in with other government policies. The government would have to set the terms and amount of the issue if it were not to conflict unnecessarily with monetary policies, while the Bank would have to continue to operate in the securities markets for policy reasons; we fail to see, therefore, the

[13] The United States Treasury normally markets bonds directly and the banks and dealers receive no commission on orders handled by them.

desirability or feasibility of establishing a single underwriting syndicate. It would surely raise the costs of distribution and place the Bank in a position in which, instead of being able to tap the experience and judgment of a number of individual dealers, it would have to negotiate with a monolithic organization interested primarily in its own profit margins. Given the rigidity of other underwriting syndicates, existence of a single group of private underwriters would doubtless lead also to difficulties and discrimination in the composition of its membership.

The final way in which the present system of distribution of new Canada issues could be altered is to adopt a "tap system" under which the central bank and/or government accounts purchase the issue, or a significant part of it, from the Treasury and distribute it over a period of time as the market demands it. In the United Kingdom, securities not subscribed for by the public are taken up by the Issue Department of the Bank of England and are marketed through the Government Broker over the following weeks and months at a price which is usually a little below the current price of comparable government issues. The few issues on tap are closely watched by the financial community and regarded as the bellwethers of the gilt-edged market. The main advantage is that it avoids the lumpiness of the existing technique with its pricing and distribution problems. On the other hand, the market will be thin and the issue will lack liquidity if a substantial proportion is not distributed initially, while dealers will be reluctant to carry inventories and make markets if the authorities in fact completely dominate the issue. Clearly, this technique makes no contribution to the development of self-reliant and resilient markets. There may be times when the monetary authorities wish to supply bonds to the public in substantial amounts or to establish precise levels of rates on certain securities, but this can be done without changing the method of distributing new issues.

In recent years, the Bank of Canada has occasionally taken the whole and frequently taken a part of a new issue but its intentions about resale have not always been clear. Dealers have thus not known whether the bonds would be offered to the market, and if so on what terms, until the Bank subsequently indicated a willingness to accept bids. Since some of these Bank offerings were subsequently withdrawn in a few days, this method of operating cannot be considered a true tap system. It does, however, have merit as a method of curbing excessive speculation in new issues. When such securities are acquired by the Bank and government accounts in exchange for shorter-term bonds and with the intention of subsequently distributing them in the market, moreover, this technique can make a useful contribution to refunding the publicly-held debt in advance of maturity.

The present system of nation-wide distribution of new federal issues by a large network of primary distributors selected by the Bank works effectively on the whole. Pricing problems have not proved too serious in the recent past, and improved contacts and communications with the investment community should minimize them in the future. However, the number of primary distributors seems unnecessarily large, and allotments do not always appear to reflect their true placing power. There is evidence that some of the dealers involved, including some who are primarily brokers, make virtually no contribution, merely selling their allotments directly or indirectly to the larger dealers and banks. While we recognize that there are geographical and other considerations which prevent the Bank from adjusting participations as rapidly as it might desire, we believe that the industry would be healthier, and distribution more effective, if such weak firms were eliminated from the list and their bonds reallotted to the growing houses. While over 85% of commissions on new federal issues are paid to banks and the 32 investment firms which carry large positions in government bonds, we would not want to see the group automatically closed to smaller and growing members of the industry as long as their placing power makes a significant or increasing contribution.

We also considered a number of other changes in marketing techniques in our search for ways to improve the market for Canada bonds, including the possibility that the government go to market at fixed or known intervals or give more advance warning of a new issue. The former might facilitate the scheduling of new issues by other borrowers, and both would give potential investors more time to review their portfolios. However, they would reduce the flexibility of the debt managers and probably also lead to stagnation of the markets while dealers and investors awaited the terms of the new issue. While commending the practice of giving the market a few days notice of a new issue and while urging that the government keep the market informed of its probable cash needs we do not believe that regular issues or extended notice would on balance be an improvement.

The Canada market might, however, benefit significantly from a reduction in the number of issues outstanding and an increase in their size. Although fewer and larger borrowings at one time might cause major digestive problems for the market, we see no reason why new borrowings should not add whenever possible to outstanding issues, gradually building them up to a size that will make for more active secondary markets and a higher degree of liquidity while simultaneously eliminating smaller issues for which no real market exists. It would not be possible, of course, to add to issues selling at deep discounts, especially in view of the action taken in December 1960 to stem the practice then springing up among junior governments of offering low-coupon, deep-discount bonds to maximize the tax-free return to investors and reduce their own borrowing costs. The withholding tax also makes it technically awkward to add to issues released prior to that time which are exempt from withholding tax.

Finally, we wish to express our agreement with the Bank of Canada about the unsettling effects on the market of the practice of "riding" new issues. If a new issue is rising in price, a rider places an order to buy with the intention of selling before the delivery date, thus taking a profit without having to put up any capital. This inflated but short-lived demand may cause an unrealistic price increase followed by a rapid price drop to the disillusionment of true investors. A second abuse, "withholding", occurs when a dealer withholds a new issue from his customers in a rising market and subsequently takes the capital gain for himself. Both these practices have harmful effects on markets and on the reputation of the securities industry. As the Bank of Canada reminded us, "orderly marketing of an offering of new bonds is important not only for the particular issue concerned but also for the reception which will be accorded future issues. Primary distributors and investors who have been involved in unfortunate developments with one issue are apt to demand greater price concessions on, and may take a more speculative view of, the next issue".[14] The National Association of Securities Dealers in the United States specifically makes free riding and withholding violations of their Rules of Fair Practice, but nothing is said about them in the by-laws and regulations of the Investment Dealers' Association. In our view, the Canadian industry should take a stronger stand on these two matters. Some of the riders are institutional traders well-known to dealers who could be stopped if dealers acted in concert and with the cooperation of the senior management of the financial institutions. Apart from self-regulation, riding would be diminished were the subscriber required to put up a cash deposit upon placing his order or, in the case of refunding, to deposit some proportion of his holdings of the maturing issue.

We will be dealing in a later chapter with the question of Canada Savings Bonds and the issues they raise, but we might note that the dealers play an active role in their distribution along with banks and trust companies, caisses populaires, Quebec savings banks and the provincial savings offices. The growing proportion of the federal debt represented by these bonds is one of the factors leading to the relative shrinkage of the retail market for other securities and has thus contributed to the increased orientation of the

[14] Submission IV, paragraph 34.

industry towards institutional and more skilled investors noted earlier. Despite this trend, however, the absolute size of the industry's placing power continues to grow, and it has shown itself capable of handling government issues running into many hundred millions of dollars. While money market issues may be sold to not much over a thousand customers, the industry has obtained as many as 20,000 orders for a single issue designed for the retail market.

The bond and money markets and the dealer industry which is at the heart of them have all grown, diversified and matured in the post-war period. These expanded activities have resulted in increased placing power and broader trading markets and have played an important role in financing the country's development. The industry, with some exceptions, has become more professional, competitive and enterprising while standards of business conduct have been significantly raised. True secondary markets have been developed where none existed before, and this has made it relatively easier and cheaper to raise capital and has provided the central bank with an improved vehicle for its own operations. The Bank of Canada has encouraged much of this market evolution—both publicly and privately—and, although its relations with the industry are less good than they should be, must share much of the credit for these developments. The industry performs its function at reasonable cost, with the notable exception of some underwriting activities on which margins seem to us unduly high for the true liability assumed and the few losses actually incurred. The issuers, however, must share the blame for this lack of competition as there often are other houses willing to undertake the business at more competitive rates. One other area of weakness is the reluctance on the part of the bigger established firms to underwrite smaller or less seasoned enterprises, a factor which may contribute to the higher costs of these issuers in other sectors of the industry. With these exceptions, the industry has performed its job of raising and allocating capital with vigour, imagination, and efficiency.