Efficiency and Regulation

A Study of Deposit Institutions

Economic Council of Canada

1976

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This Report has been signed by the members of the Economic Council of Canada with the exception of Claude Edwards, W.C.Y. McGregor, Joseph Morris, Miss Huguette Plamondon, and Donald H. Taylor, who have not participated in the work of the Council since March 1976.

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1 INTRODUCTION

More than a decade ago, the Royal Commission on Banking and Finance – the Porter Commission – appraised the workings of the Canadian financial system, to determine its ability to serve the needs of the economy. Published in 1964 as the outcome of the first official inquiry into financial markets since that of the Macmillan Commission in 1933, the Porter Commission Report set out the most comprehensive proposals for the reform of financial markets since Confederation. In addition to a concern about aggregate economic goals, the Porter Commission focused attention on the structure and regulation of financial markets served by banks and near banks. The Report contained a comprehensive program for increasing efficiency, flexibility, and innovation in the industry.

Substantial changes have taken place in financial markets since the publication of the Porter Commission Report. Many of the Commission's proposals were implemented in the 1967 revisions to the Bank Act, and the laws governing near banks – trust and mortgage loan companies, credit unions, and caisses populaires – have also been reviewed and revised. Other changes are a result of the fact that banking has increasingly become an international activity. Numerous foreign banks have established operations in Canada, while Canadian banks have increased their international commitments. New activities such as leasing and factoring have emerged, while institutions such as credit unions and caisses populaires have altered their traditional functions to become major sources of financial services for households. The growing use of transaction cards and the advent of the computer have led to the prospect of a technological revolution of the payment system.

In response to these developments, there has been increasing recognition that some of the regulations governing the deposit-taking sector may be outmoded and inappropriate. Concern has been expressed by the financial institutions themselves. Chartered banks have called for an expansion of their own powers and, at the same time, have urged a revision of the status of foreign bank subsidiaries in Canada. Many of the near banks have indicated a desire to gain direct access to the clearing system. Governments and their agencies have also expressed concern. As early as 1971, the Prices and Incomes Commission questioned the effectiveness of competition in banking. Subsequently, the federal government, after discussions at the Western

Economic Opportunities Conference in 1973, introduced legislation to ease entry into banking through letters patent and to permit provincial ownership of chartered banks.[1] Several provinces have now expressed interest in entering the financial industry directly. Finally, the expanding use of computers in financial activities has led the federal government to issue two policy statements – one suggesting an approach to a future electronic payment system, and the other aimed at setting guidelines for the supply of computer services by banks.

All these developments indicate that the task of reappraising the financial system and its operations has become imperative. The efficiency of deposit institutions and of the markets in which they operate depends on two key factors – the degree of competition that exists among the institutions, and the nature of the regulations to which they are subject. Our major objective in this study is to suggest ways to increase efficiency through competition and a more flexible regulatory framework.

While we recognize that a competitive financial system is not an end in itself, we also believe that increased competition will result in greater technical efficiency within deposit institutions, lower interest rates for borrowers, higher interest rates for depositors, and a greater variety of services – all of which will be of direct benefit to the users of the banking and financial system.

More than in most other sectors of the economy, regulation shapes the nature of deposit-taking activity. The existing system of regulation governs deposit institutions on the basis of their incorporation. As a result, institutions performing similar activities can be governed by substantially different rules if they fall under different jurisdictions. Conversely, institutions carrying on dissimilar business can be subject to the same rules. As an alternative to this institutional approach, we believe that the rules governing any institution should be established on the basis of the activities it undertakes. As the institution moves into new activities, the rules governing its conduct should be altered accordingly. The central theme of our report is that this "functional" approach to regulation would best fulfil the needs of the Canadian economy for intermediary services. In our view, the competition, flexibility, and innovation necessary for a smooth financial system can be assured only under such an approach.

Objectives other than efficiency also play an important role in designing a better financial system. Some, such as depositor protection and monetary control, are essential and, indeed, can be viewed as inherent to efficiency in this industry. Others must be viewed as separate objectives and may have to be traded for efficiency in any policy choice. Incorporated in existing legislation governing deposit institutions are three principles that reflect such objectives and that we believe should be maintained in any reform. The first principle – the need to avoid undue concentration of economic power – is reflected in the current prohibitions on concentrated ownership of established banks and in the limitations on bank ownership of nonfinancial enterprises. The second principle states that conflicts of interest should be avoided.

1 This principle was incorporated in Bill C7, which was introduced at the first session of the 30th Parliament on October 3, 1974. This legislation has not yet been passed.

The third principle – that major financial institutions should be owned by Canadians – was first established in the Bank Act revisions of 1967 and has subsequently been incorporated into other federal and provincial legislation. Thus, while we emphasize efficiency, we fully recognize that it plays only a part in the overall contribution of the financial system to the welfare of consumers and the economy at large.

Our report can be divided into three major topics. First, we examine the environment in which deposit institutions operate and analyse their performance, in order to assess the nature and extent of the obstacles that hinder the efficiency of financial markets. Based on the conclusions of this analysis, we then state the central theme of the report: in order to increase the efficiency of deposit institutions, the regulations governing them must be more flexible, and the scope for competition must be widened. The practical implications of this principle are then developed, both for Canadian institutions and for Canadian subsidiaries of foreign-owned banks. Finally, we examine the evolution of the payment system, particularly with regard to payments by cheque, bank credit cards, and the electronic payment system.

2

DEPOSIT INSTITUTIONS AS INTERMEDIARIES

Deposit institutions – chartered banks, trust companies, mortgage loan companies, caisses populaires, and credit unions – are distinguished from other financial intermediaries in that the claims they offer to the public have a fixed money value, and the majority can be withdrawn on demand or on short notice or can be transferred to third parties by payment order. In this chapter, the intermediary role of the major deposit institutions in Canada is reviewed, and the size and activities of these institutions are examined in relation to other financial institutions and to each other. The activities of Canadian subsidiaries of foreign banks are also reviewed briefly.

The Role of Deposit Institutions

The primary function of financial markets in an economy is to transmit funds from lenders to borrowers. The simplest transactions take place between the borrower and the lender, who negotiate the amount and term of the loan. In more complex arrangements, an agent or broker matches borrowers' requirements with the financial resources made available by a number of lenders. These transactions are carried out in direct markets, where the only financial instruments are the securities issued by ultimate borrowers. In indirect markets, the third party plays a more active role, borrowing from lenders and lending to borrowers. In this process, new securities are created in the form of claims on the third party, who is referred to as a "financial intermediary." The main contribution of this additional type of security to financial markets is that borrowers' requirements for funds can be met by a number of lenders with different preferences as to risk and maturity.

Financial intermediaries, of which deposit institutions are a major group, contribute to expanding opportunities to borrowers and lenders by tailoring their liabilities to meet the investment requirements of lenders while providing loans that meet the needs of borrowers. To perform such a complex function, these institutions engage simultaneously in many types of intermediation.

Through "denomination intermediation" they accept deposits in denominations that differ from those of the loans they make or the securities they purchase. While both borrowers and lenders could match their requirements in direct markets, they turn to deposit institutions for denomination intermediation when they perceive that, by doing so, their needs will be met more effectively and cheaply.

Financial intermediaries can also engage in "default risk intermediation" by offering claims to savers that are insulated, to various degrees, from losses. In most institutions, the saver holds a claim on a pooled portfolio. To the extent that the probabilities of default by these borrowers are independent of each other, the risk of realizing large proportionate losses through default on a pooled portfolio is less than on the components of the portfolio. For their part, deposit institutions also offer claims of fixed value. In this case, the remaining risk is shifted from the depositor to the shareholders.

In much the same way, financial intermediaries also provide "maturity risk intermediation," through which they undertake to supply or borrow funds when neither the period in question nor the interest rate is matched. As part of this undertaking, "term risk intermediation" commits institutions to supply funds to borrowers for periods differing from those on commitments received from lenders. In conjunction, institutions may undertake "interest rate intermediation," fixing the interest rate over a given term for either the lender or borrower, without a similar rate on the other side of the transaction. Financial intermediaries also perform "capital value intermediation" by holding securities whose capital value fluctuates with the market rate, while issuing liabilities that can be redeemed at a fixed money value. Through these types of intermediation, lenders may avoid uncertainties about the term of the transaction, the interest rates that may prevail when funds are needed in the future, and the consequent effect on capital values.

Our examination of their intermediary role suggests that, in addition to channeling funds from lenders to borrowers, deposit institutions can both reduce overall risk in the economy and transfer risk from lenders to their own shareholders. Any assessment of the performance of deposit institutions must take into account the changes that may occur over time in the relative importance of their roles as simple channels for funds and as bearers of risk. In competitive markets, the revenues of deposit institutions should reflect the relative significance of these roles for each institution. An institution serving only as a channel between lender and borrower would be expected to have a lower return than one accepting substantial risk. Thus differences, over time or across institutions, in the spread between interest rates paid and received by financial intermediaries must be interpreted in relation to differences in intermediation services provided.

An Overview of Deposit Institutions

While there are several ways of measuring the importance of financial institutions, information on assets and liabilities provided in their balance sheets reflects one dimension of their relative size and the significance of certain of their activities. In order to obtain an overview of the intermediary activities of deposit institutions, their assets are compared with those of other financial institutions, both public and private (Table 2-1). In 1974, deposit institutions held the largest share of the assets of all financial institutions. Among the various financial institutions, chartered banks were the largest, followed by life insurance companies, which were far smaller.

Table 2-1

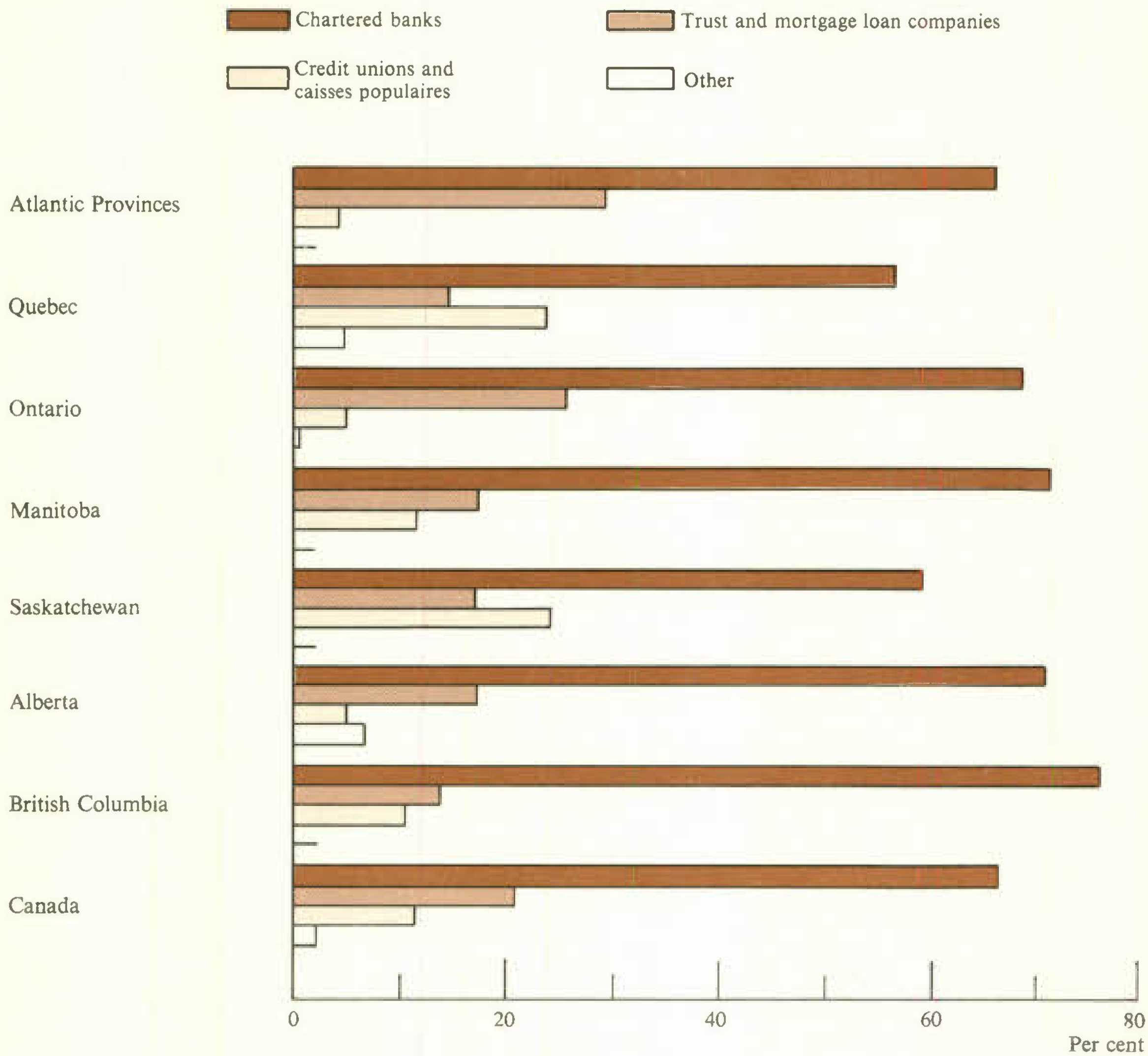
Assets of Financial Institutions Issuing Claims to the General Public, Selected Years, 1963-74[1]

	1963			1967			1971			1974		
	Millions of dollars	Percentage of: Private	Total	Millions of dollars	Percentage of: Private	Total	Millions of dollars	Percentage of: Private	Total	Millions of dollars	Percentage of: Private	Total
Private institutions												
Deposit												
Banks[2]	15,741	40.2	34.4	22,889	38.0	33.0	34,764	40.5	35.4	56,034	43.2	38.1
Trust and mortgage loan companies	3,464	8.8	7.6	6,733	11.2	9.7	10,728	12.5	10.9	17,350	13.4	11.8
Credit unions and caisses populaires[3]	1,760	4.5	3.8	3,113	5.2	4.5	4,908	5.7	5.0	9,551	7.3	6.5
Quebec savings banks	362	0.9	0.8	458	0.8	0.7	591	0.7	0.6	849	0.7	0.6
Subtotal[4]	21,327	54.5	46.5	33,193	55.1	47.8	50,991	59.5	51.9	83,784	64.6	57.0
Other												
Life insurance companies	9,390	24.0	20.5	12,323	20.5	17.7	15,218	17.7	15.5	19,492	15.0	13.3
Consumer loan and sales finance companies	2,849	7.3	6.2	4,437	7.4	6.4	5,552	6.5	5.7	7,234	5.6	4.9
Mutual funds[5]	863	2.2	1.9	1,993	3.3	2.9	2,723	3.2	2.8	3,007	2.3	2.0
Pension funds	4,724	12.0	10.3	8,273	13.7	11.9	11,286	13.2	11.5	16,219	12.5	11.0
Subtotal[4]	17,826	45.5	38.9	27,026	44.7	38.9	34,779	40.5	35.4	45,952	35.4	31.3
Assets of all private institutions[4]	39,153	100.0	85.5	60,219	100.0	86.7	85,770	100.0	87.3	129,736	100.0	88.2
Government institutions												
Bank of Canada[6]	1,842		4.0	2,292		3.3	2,985		3.0	4,612		3.1
Federal annuities	1,264		2.8	1,324		1.9	1,314		1.3	1,284		0.9
Government savings institutions	193		0.4	254		0.4	363		0.4	568		0.4
Public pension funds	3,367		7.3	5,352		7.7	7,760		7.9	10,830		7.4
Assets of all government institutions[4]	6,666		14.5	9,222		13.3	12,422		12.7	17,294		11.8
Total assets of private and government institutions[4]	45,819		100.0	69,441		100.0	98,192		100.0	147,030		100.0

1 As of March 31.
2 The bank asset figures in this table differ from those in Table 2-2 in that they include *all* Canadian and net foreign-currency assets (see footnote 2, Table 2-2). They also differ from the asset figures in Table C-1 in that they include only *net* foreign-currency assets (see footnote 3, Table C-1).
3 Consolidation of centrals and locals.
4 Details may not add up to totals because of rounding.
5 As of June 30.
6 Figures cover only notes held by other than chartered banks.
SOURCE Based on data from the Bank of Canada, and Statistics Canada; and estimates by the Economic Council of Canada.

Chart 2-1

Share of Deposits, Canada, by Province, 1972[1]



1 As of December 31.

SOURCE Based on data from the Bank of Canada, Statistics Canada, and the Canadian Bankers' Association; and estimates by the Economic Council of Canada.

During the 1963-74 period, diverse growth patterns emerged among the different institutions. The proportion of assets held by deposit institutions increased relative to that of all financial institutions and that of private institutions. The share of government institutions was thus reduced from 14.5 per cent of the total in 1963 to 11.8 per cent in 1974. In the private sector, the life insurance companies lost ground.

Among deposit institutions, the assets of trust and mortgage loan companies grew relative to those of all financial institutions throughout the period, as did those of credit unions and caisses populaires. Chartered banks experienced a slight decrease in their share of the assets of all financial institutions between 1963 and 1967 but managed to reverse this trend during the rest of the period. This change in the relative movement of the chartered banks' share can likely be attributed to the 1967 revisions of the Bank Act, which, among other things, removed the ceiling on interest rates charged by banks, permitted lower average reserve holdings, and allowed banks to hold conventional mortgages. Nevertheless, the 15 per cent growth in the chartered banks' share of total assets of financial institutions from 1967 to 1974 fell short of that of trust and mortgage loan companies, credit unions, and caisses populaires over the same period. This indicates that near banks became more competitive with both the banks and other institutions, such as life insurance and sales finance companies.

The relative importance of the different deposit institutions also varies across the country. Estimates of the shares of outstanding deposits held by the various deposit institutions in 1972 indicate that the most notable deviations from the national pattern exist in Quebec, Saskatchewan, and British Columbia (Chart 2-1). The strength of the co-operative credit institutions in the first two provinces has led to a much smaller share for chartered banks and for trust and mortgage loan companies than elsewhere. In British Columbia, the chartered banks' share is greater than elsewhere, which is reflected mainly in a substantially smaller share for the trust and mortgage loan companies than in other provinces.

Chartered Banks

The term "bank" can only be used by those institutions that are chartered under the Bank Act, and chartered banks are the only deposit institutions that are governed solely by federal legislation and that are required to hold cash reserves at the Bank of Canada. By sheer virtue of their size, they dominate the deposit-taking sector. Not only are they collectively very large, with their assets amounting to more than twice the aggregate assets of other deposit-institutions, but they are also individually very large. Each of the three largest chartered banks holds Canadian-currency assets amounting to more than two-thirds of the total assets of the trust and mortgage loan companies and slightly more than the total assets of caisses populaires and credit unions. Chartered banks also have far more extensive networks of branch offices than their competitors. In 1974, for example, they operated more than 6,700 branches in Canada and over 260 branches abroad. In contrast, trust and mortgage loan companies had fewer than 700 branches; credit unions and caisses populaires only rarely had any branches at all. In addition, the investment powers of chartered banks considerably exceed those of any other deposit institution. Neither trust and mortgage loan companies nor credit unions and caisses populaires can undertake commercial lending as a normal part of their business; moreover, the consumer lending activities of trust and mortgage loan companies are strictly limited.

While chartered banks share many characteristics and are relatively few in number, there is much diversity among them. There are obvious differences in size between the largest banks and the newer ones – Bank of British Columbia and Unity Bank of Canada – whose asset holdings are relatively small. These small banks also have few branches. Indeed, only the five largest banks – the Royal Bank of Canada, Canadian Imperial Bank of Commerce, Bank of Montreal, the Toronto-Dominion Bank, and the Bank of Nova Scotia – have branches across the country. The Provincial Bank of Canada and Bank Canadian National are concentrated primarily in the province of Quebec; Bank of British Columbia and Unity Bank of Canada are centred in British Columbia and Ontario, respectively. The Mercantile Bank of Canada, on the other hand, has chosen to specialize in business finance in major financial centres.[1] The banks' commitment to foreign business also varies substantially, as does their emphasis on consumer loans and mortgages.

Table 2-2

Major Canadian Assets and Liabilities of Chartered Banks, Selected Years, 1963-74[1]

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Assets[2]								
Cash	1,000	6.8	1,459	6.9	1,762	5.5	2,687	5.1
Government of Canada securities	3,599	24.4	4,299	20.2	7,014	21.8	7,545	14.2
Other securities	1,125	7.6	1,216	5.7	1,701	5.3	2,604	4.9
Mortgages	923	6.3	774	3.6	1,551	4.8	4,836	9.1
Personal loans	1,625	11.0	3,077	14.5	5,448	16.9	10,204	19.2
Business loans	4,120	27.9	6,295	29.6	9,340	29.0	18,226	34.3
Other loans	1,975	13.4	3,673	17.3	4,280	13.3	5,902	11.1
Other assets	378	2.6	489	2.3	1,123	3.5	1,166	2.2
Total[3]	14,745	100.0	21,282	100.0	32,219	100.0	53,170	100.0
Liabilities								
Demand deposits	4,035	26.4	5,564	25.3	6,797	20.5	9,644	18.3
Personal savings deposits	8,234	53.8	10,701	48.6	17,231	51.9	26,398	50.1
Nonpersonal term and notice deposits	1,524	10.0	3,237	14.7	5,576	16.8	11,622	22.1
Government of Canada deposits	320	2.1	806	3.7	1,181	3.6	794	1.5
Debentures outstanding	—	—	—	—	40	0.1	657	1.2
Shareholders' equity	1,114	7.3	1,652	7.5	2,200	6.6	3,031	5.8
Other liabilities	78	0.5	68	0.3	203	0.6	494	0.9
Total[3]	15,305	100.0	22,028	100.0	33,228	100.0	52,640	100.0

1 As of March 31.
2 The bank asset figures in this table differ from those in Table 2-1 in that major Canadian assets exclude net foreign-currency assets, net Canadian-dollar items in transit, and customers' liability under acceptances, guarantees, and letters of credit (see footnote 2, Table 2-1). The data also differ from those in Table C-1 in that they include only Canadian-dollar assets and liabilities, and major Canadian liabilities exclude acceptances, guarantees, and letters of credit (see footnote 3, Table C-1).
3 Details may not add up to totals because of rounding.
SOURCE Based on data from the Bank of Canada.

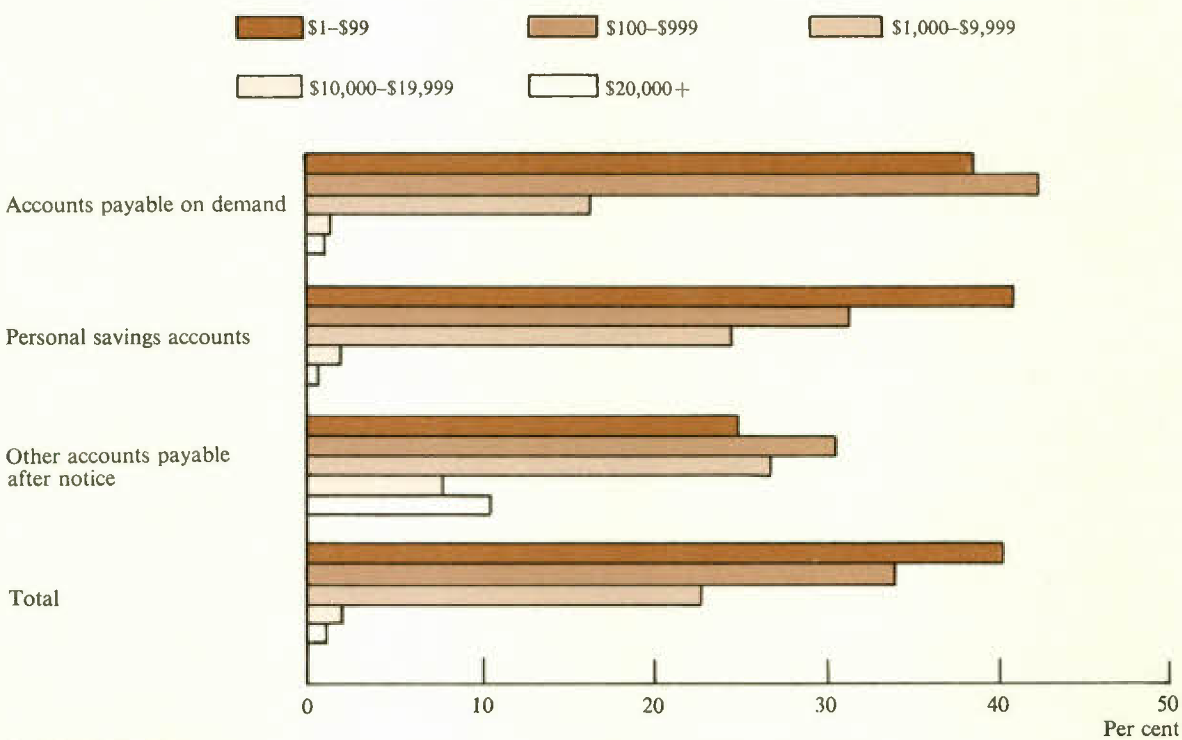
1 The Northland Bank and the Canadian Commercial and Industrial Bank – two newly chartered banks – apparently intend to follow this same specialization.

The Activities of Chartered Banks

The scope of chartered bank activities can be seen in their consolidated balance sheets (Table 2-2). Some notable changes in the relative importance of the various items shown have occurred in recent years. On the asset side, mortgages, personal loans, and business loans have all increased as a proportion of the assets of chartered banks, whereas Government of Canada securities, other securities, and other loans have decreased relatively. While some of these changes can be attributed to the 1967 amendments to the Bank Act, others – particularly the movement into personal loans – had started earlier as a result of a more aggressive approach to personal loans. On the liability side, the proportion of demand deposits decreased steadily throughout the period. While personal savings deposits represented a slightly smaller share of liabilities in 1974 than in 1963, this proportion fluctuated on a yearly basis. The most significant changes have occurred in nonpersonal term and notice deposits, which have more than doubled as a proportion of bank liabilities

Chart 2-2

Classification of Canadian-Dollar Deposits at Chartered Banks, 1974



1 As of April 30.

SOURCE Based on data from *The Canada Gazette*, July 1974.

since 1963. This probably reflects the higher interest rates that banks could pay on term deposits after the removal of the 6 per cent limit on loan rates in 1967 and the greater attention to cash management by businesses.

An indication of the characteristics of the various types of deposits can be gained from the data on their size distribution in 1974 (Chart 2-2). The average balance in demand accounts was just under $2,000, while in personal savings accounts it was even lower, at just slightly below $1,400. In fact, over 80 per cent of the demand accounts and over 72 per cent of the personal savings accounts had balances of less than $1,000. In contrast, only 55 per cent of other notice deposits had balances of less than $1,000; 18 per cent had balances in excess of $10,000, with the average balance being in excess of $16,900. This suggests that demand deposits and personal savings deposits largely reflect the business of numerous household accounts, even though demand deposits also reflect the transaction balances held by businesses, while other notice deposits represent the larger deposits of individuals and corporations.

The Role of the Branch System

One of the most distinctive features of Canadian chartered banks is their extensive branch system. In order to determine the role of these branches, we obtained, through the co-operation of individual banks, 1974 balance sheet data for a sample of 10 per cent of chartered bank branches.[2] The distribution of deposits indicates that the role of branches differs according to the size of the branch (Table 2-3). Whereas 1 per cent of the branches in the sample – the six branches with deposits of at least $100 million – accounted for 24 per cent of all deposits, branches with deposits of less than $20 million – approximately 95 per cent of the sample – held only 60 per cent of all deposits. The same pattern of concentration can be observed in demand deposits and is even more pronounced in other term deposits. A different pattern can be seen in savings deposits, where the larger branches held less than 7 per cent of the total.

The concentration of loans among the largest branches is even more pronounced than that of deposits (Table 2-4). The 1 per cent of branches with more than $100 million in deposits held almost 31 per cent of the outstanding loans – a proportion much larger than their share of deposits. These largest branches accounted for as much as 41 per cent of other loans and almost 37 per cent of industrial loans, but only 9 per cent of personal loans. Branches with deposits of less than $20 million held only 46 per cent of all outstanding loans, though their share of all deposits was 60 per cent. However, they accounted for almost 79 per cent of outstanding personal loans.

From these data, it is evident that the business of chartered banks is divided into wholesale and retail markets. In the retail market, the network of small branches generates business primarily through the collection of personal savings deposits and

2 The data appear biased towards the larger branches. For the whole banking system, loans and deposits per branch totalled $5 million and $7 million, respectively; for the sample, they amounted to $8.2 million and $9.6 million, respectively.

Table 2-3

Sample Distribution of Bank Deposits, by Branch Size, 1974

			Personal savings deposits		Other term deposits		Demand deposits		All deposits	
	Number of branches	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Branch deposits ($ Million)										
100 and over	6	1.0	188.8	6.5	946.9	57.6	329.5	22.1	1,465.3	24.2
50-99.9	7	1.1	97.3	3.3	212.9	13.0	120.7	8.1	430.9	7.1
40-49.9	2	0.3	46.6	1.6	15.6	0.9	25.9	1.7	88.1	1.5
30-39.9	2	0.3	13.6	0.5	12.5	0.8	39.8	2.7	65.9	1.1
20-29.9	16	2.5	182.7	6.3	84.7	5.2	108.5	7.3	375.8	6.2
15-19.9	40	6.4	356.0	12.2	117.6	7.2	158.7	10.7	632.3	10.5
10-14.9	60	9.5	476.1	16.3	79.1	4.8	175.5	11.8	730.6	12.1
5- 9.9	192	30.5	924.1	31.7	108.4	6.6	301.7	20.3	1,334.2	22.1
Less than 5	304	48.3	626.7	21.5	65.3	4.0	227.8	15.3	919.7	15.2
Total[1]	629	100.0	2,911.9	100.0	1,642.9	100.0	1,488.1	100.0	6,042.9	100.0

1 Details may not add up to totals because of rounding.
SOURCE Sample survey of bank branch data from individual banks.

Table 2-4

Sample Distribution of Bank Loans, by Branch Size, 1974

			Industrial loans		Personal loans		Other loans, excluding agricultural and government		All Loans[1]	
	Number of branches	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Branch deposits ($ Million)										
100 and over	6	1.0	507.4	36.6	113.3	9.4	802.1	41.0	1,585.2	30.9
50-99.9	7	1.1	356.4	25.7	52.4	4.4	373.6	19.1	797.2	15.5
40-49.9	2	0.3	51.8	3.7	10.1	0.8	25.3	1.3	88.4	1.7
30-39.9	2	0.3	9.4	0.7	7.8	0.7	5.1	0.3	22.3	0.4
20-29.9	16	2.5	38.3	2.8	71.5	5.9	62.7	3.2	258.0	5.0
15-19.9	40	6.4	138.1	10.0	122.9	10.2	168.7	8.6	469.1	9.1
10-14.9	60	9.5	97.4	7.0	156.7	13.0	202.8	10.4	531.2	10.3
5- 9.9	192	30.5	106.2	7.7	326.9	27.2	171.7	8.8	729.9	14.2
Less than 5	304	48.3	81.5	5.9	341.8	28.4	144.5	7.4	656.6	12.8
Total[2]	629	100.0	1,386.3	100.0	1,203.5	100.0	1,956.5	100.0	5,138.0	100.0

1 Includes industrial, personal, agricultural, government, and other loans.
2 Details may not add up to totals because of rounding.
SOURCE Sample survey of bank branch data from individual banks.

the extension of consumer loans. In contrast, in the wholesale market, large branches, presumably in major financial and industrial centres throughout the country, generate a substantial proportion of bank activity. However, this division, by type of business, is not completely rigid. Large branches collect personal savings deposits and make personal loans; smaller branches grant industrial loans, although these are likely to be made to businesses of small and medium size and can be most appropriately regarded as a form of retail banking.

The Foreign Operations of Canadian Banks

Canadian chartered banks have been involved in international operations for over a hundred years, accepting deposits and extending loans denominated in foreign currencies, primarily U.S. dollars. Until the mid-1960s, however, their activities were confined mainly to New York and London. In New York, bank agencies accepted

Chart 2-3

Foreign-Currency Liabilities as a Percentage of Total Liabilities, Chartered Banks, 1963-74[1]

[1] As of June 30.

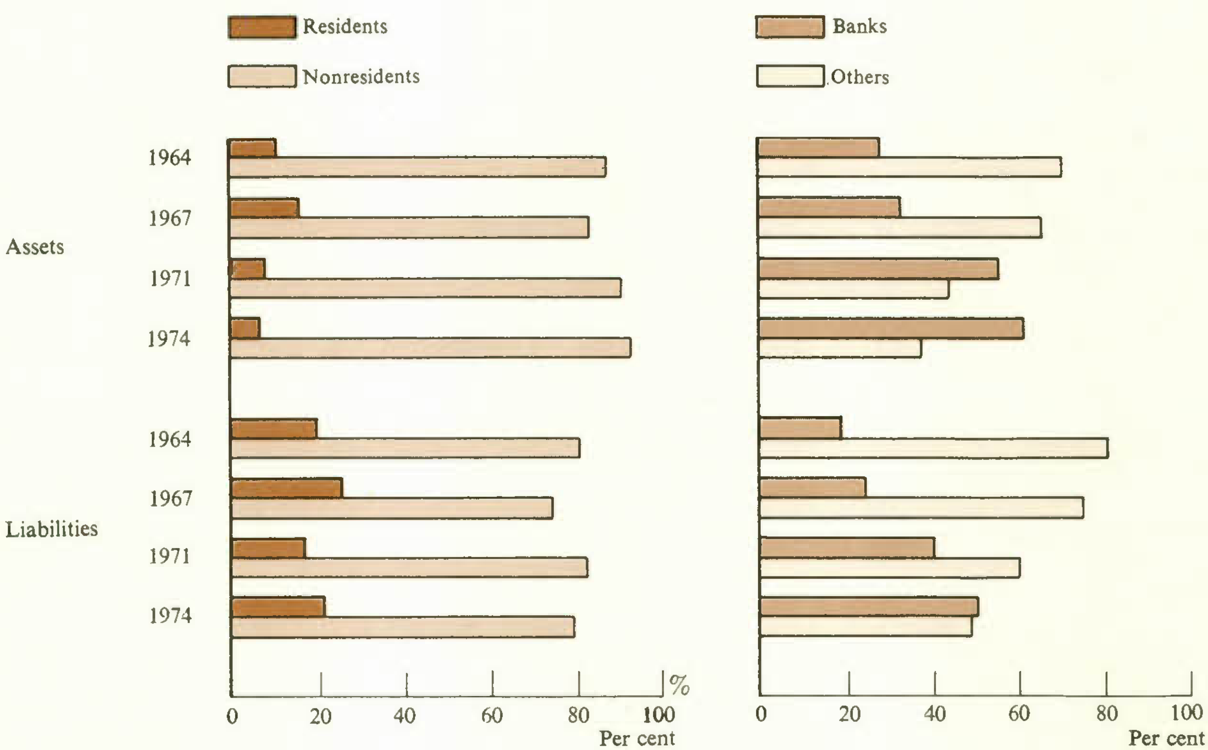
SOURCE Based on data from the Bank of Canada.

deposits from, and loaned funds to, U.S. residents, mainly in the broker call loan market, but these operations were little more than an appendage to the U.S. money market. Other international operations were mainly concerned with financing international trade with Canada's major trading partners – the United Kingdom and the United States.

During the past decade, the international operations of Canadian banks have changed and expanded dramatically, spreading to virtually all areas of the world. In effect, Canadian banks have been transformed from primarily domestic to large and diversified transnational institutions, competing with other banks on a worldwide scale. Undoubtedly, a primary factor in this rapid expansion has been the enormous growth of the Euro-currency market, outside the restrictions and controls encountered by banks in their own national financial systems. The banks also increased their lending to both Canadian and foreign transnational corporations and their financing of Canadian foreign trade and entered a number of domestic financial markets in other countries through foreign branches, subsidiaries, and affiliates.

Chart 2-4

Foreign-Currency Assets and Liabilities of Chartered Banks, Selected Years, 1967-74[1]



1 As of June 30.

SOURCE Based on data from the Bank of Canada.

These developments are reflected in the growth of foreign-currency liabilities relative to that of the total liabilities of chartered banks (Chart 2-3). Between 1967 and 1970, the share of foreign-currency liabilities increased from 19 per cent to 28 per cent of total liabilities. By 1974, their share had risen to one-third of the total liabilities of Canadian banks – an increase of over twelve percentage points since 1963.[3]

During the 1967-74 period, the composition of the foreign-currency business of chartered banks changed with regard to residency and type of holder (Chart 2-4). The largest shift in the holdings of foreign-currency assets and liabilities was from other customers to banks. Foreign-currency liabilities to other banks increased from 19 per cent of total foreign-currency liabilities in June 1964 to 50 per cent in June 1974; foreign-currency assets held with other banks rose from 29 per cent in 1964 to 62 per cent in 1974. This interbank activity increased relatively evenly during the period, but it was particularly evident after 1968. In terms of residency, foreign-currency liabilities payable to residents were approximately 20 per cent of total foreign-currency liabilities in both 1964 and 1974. There was, however, considerable volatility in those percentages during that period. The composition of foreign-currency assets shifted modestly, with assets against residents declining from 11 per cent to 7 per cent of total foreign-currency assets.

Trust and Mortgage Loan Companies

Trust companies and mortgage loan companies are considered here, because their powers as deposit institutions are roughly similar. In addition, close ownership ties exist between a number of the largest trust companies and mortgage loan companies, essentially linking their businesses into a single unit. For example, among the larger units in this group, Canada Permanent Mortgage Corporation controls Canada Permanent Trust Company, and the Huron & Erie Mortgage Corporation controls the Canada Trust Company.

The mortgage loan companies serve as intermediaries specializing in mortgage lending, financed by borrowing over a term of one to five years; the trust companies perform two interrelated functions – that of trustee and that of intermediary. In their trustee function, trust companies serve as administrators of estates, trusts, and agencies. In the role of administrator, trust companies do not obtain ownership of the assets under their administration; rather, they act with varying degrees of authority as the trustee of a property. As intermediaries, they accept funds from the public and, in turn, lend or invest them. The funds placed with trust companies in their intermediary business are designated as "guaranteed funds" and, by law, specific counterpart assets must be segregated from their other funds. While this legal distinction makes little practical difference, it does reflect the development of the intermediary business of trust companies as an outgrowth of their fiduciary or trust function.

3 E. Wayne Clendenning, *The Euro-Currency Markets and the International Activities of Canadian Banks*, a background study prepared for the Economic Council of Canada (forthcoming).

Unlike chartered banks, both trust companies and mortgage loan companies can be incorporated under either federal or provincial statutes. But, regardless of the jurisdiction under which they are incorporated, many of their activities fall under provincial authority. Though several provinces have subrogated their authority to the federal government, trust companies and mortgage loan companies accepting deposits within many provinces are required to obtain licences from provincial authorities. Moreover, the estate, trust, and agency activities of trust companies, because they pertain to property, are matters of provincial responsibility under the British North America Act.

Intermediary Activities

At the end of 1974, approximately ninety trust and mortgage loan companies, with assets of $17 billion, accepted funds from the general public. The concentration of these institutions on mortgage lending is illustrated in Table 2-5, which shows that 72 per cent of the assets of these companies were held in mortgages. On the liability

Table 2-5

Major Assets and Liabilities of Trust and Mortgage Loan Companies, Selected Years, 1967-74[1]

	1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Assets						
Cash	100	1.5	343	3.2	109	0.6
Term and notice deposits	106	1.6	267	2.5	1,258	7.3
Government of Canada securities	518	7.7	645	6.0	472	2.7
Other securities	1,235	18.3	1,737	16.2	1,800	10.4
Mortgages	4,161	61.8	6,813	63.5	12,500	72.0
Personal loans and other loans[2]	155	2.3	200	1.9	338	1.9
Other assets	459	6.8	722	6.7	874	5.0
Total[3]	6,734	100.0	10,725	100.0	17,351	100.0
Liabilities						
Chequable savings and demand deposits	741	11.0	559	5.2	721	4.2
Nonchequable savings and demand deposits	758	11.3	1,457	13.6	2,097	12.1
Term deposits and debentures[4]	4,089	60.7	7,059	65.8	12,238	70.5
Shareholders' equity	640	9.5	917	8.6	1,147	6.6
Other liabilities	506	7.5	733	6.8	1,148	6.6
Total[3]	6,734	100.0	10,725	100.0	17,351	100.0

1 As of March 31.
2 In 1974, personal loans amounted to $105 million or 0.6 per cent of total assets; other loans, $233 million or 1.3 per cent of total assets.
3 Details may not add up to totals because of rounding.
4 In 1974, term deposits amounted to $11,747 million or 67.7 per cent of total liabilities; debentures, $491 million or 2.8 per cent of total liabilities.
SOURCE Based on data from the Bank of Canada.

side, these institutions offer the same range of claims as chartered banks. In contrast, however, term deposits and debentures comprised over 70 per cent of the liabilities of these companies, compared with 23 per cent in the case of banks (see Table 2-2).

As with chartered banks, aggregate data for all trust and mortgage loan companies can obscure important differences among the institutions. Although they operate under the same legislation, a number of different types of institutions can be identified among the trust companies. From a policy perspective, it is useful to classify the trust companies into two categories to emphasize that the problems facing different companies are diverse and that the approach taken for one group of these companies could be inappropriate for another.

The first group consists of trust companies that are long-established, having both an extensive estate, trust, and agency business and a highly developed intermediary business based on a network of branches. Five trust companies – the Canada Trust Company, Canada Permanent Trust Company, Montreal Trust Company, National Trust Company, Limited, and the Royal Trust Company – hold at least $500 million in assets in intermediary business and $2 billion in assets in estate, trust, and agency accounts. Furthermore, all but one have at least forty branches throughout the country. In 1973, these companies held 53 per cent of the intermediary assets and 79 per cent of the estate, trust, and agency assets of trust companies (Table 2-6). Marked differences exist among these companies in their intermediary business, especially in terms of mortgages as a proportion of assets, and term deposits as a proportion of liabilities. Two of these companies, together with

Table 2-6

Activities of Selected Trust Companies, 1973[1]

	Estate, trust, and agency funds	Company funds[2]	Guaranteed funds	Total assets[3]
		($ Million)		
Five largest companies				
The Royal Trust Company	10,936.5	113.4	2,070.6	13,120.6
Montreal Trust Company	5,279.8	36.9	578.2	5,895.0
The Canada Trust Company	2,375.2	54.1	941.2	3,370.6
National Trust Company, Limited	2,442.0	57.1	838.6	3,337.7
Canada Permanent Trust Company	2,318.1	67.4	870.8	3,256.3
Subtotal	23,351.7	329.0	5,299.5	28,980.2
Other companies	6,088.8	353.6	4,566.4	11,008.8
Total	29,440.5	682.6	9,865.9	39,989.0

1 As of December 31.
2 Company funds consist of shareholders' equity. Trust companies must have separate accounting for these funds, as well as separate financial statements, distinct from intermediary and fiduciary funds.
3 Details may not add up to totals because of rounding.
SOURCE *Report of the Ontario Registrar*, 1973, and *Report of the Superintendent of Insurance for Canada*, 1973.

their associated mortgage loan companies, held over 75 per cent of their assets in mortgages but obtained only 60 per cent of their funds through term deposits in 1973. By contrast, another two in this group held slightly more than 60 per cent of their assets in mortgages but obtained over 70 per cent of their funds through term deposits. While this comparison does not take account of maturity differences in mortgages and term deposits, it suggests that the liquidity requirements and the impact of interest rate changes on earnings differ among these companies.

A second distinguishable group in the trust industry consists of intermediary companies with total assets of between $10 million and $120 million. Many of them have been incorporated as trust companies during the past fifteen years, and examination of their 1973 balance sheets suggests that many operate mainly as intermediaries, with a minority having more assets in their estate, trust, and agency accounts than in their intermediary accounts. Most operate a number of branch offices, but they are usually concentrated in one region. Half the companies in this group hold a higher proportion of their assets in mortgages than do trust companies as a whole. There are also differences in their borrowing patterns. While most obtain a larger proportion of their funds through term deposits than the industry as a whole, some rely heavily on demand deposits. Indeed, one of the most notable differences between the two groups of trust companies has been the growth in their intermediary activities over recent years. The rate of growth of the newer companies' intermediary business has been almost double that of the large established companies, indicating that incorporation as a trust company has provided an avenue of entry into retail intermediation.

As with trust companies, substantial differences exist among mortgage loan companies, the foremost being their affiliation with other financial institutions. At the end of 1972, mortgage loan companies associated with trust companies held 46 per cent of the outstanding deposits and debentures of all mortgage loan companies. The two largest in this group – Canada Permanent Mortgage Corporation and the Huron & Erie Mortgage Corporation – each held over $800 million in deposits. The mortgage loan companies affiliated with chartered banks are smaller than those associated with trust companies; they accounted for almost $900 million in deposits and debentures – or over 19 per cent of the aggregate. Both groups of companies are virtually integrated with their parents to the degree that, in most cases, the deposits or debentures of the affiliated mortgage loan company can be obtained through the facilities of the trust company or chartered bank.

Fiduciary Operations

The trust management activities of a trust company, as opposed to its role as financial intermediary, do not involve a combination of borrowing and lending money, but rather the management of portfolios on behalf of clients. Moreover, trust accounts, unlike intermediary assets, are held separately for each portfolio, even though relatively small accounts may be pooled to facilitate diversification and possible economies of scale in operating costs. Mechanisms used to generate income also differ in that the financial intermediary draws its income from the differential between the yield of its portfolio and its operating and borrowing costs; the trust manager obtains his income from the margin between fees and commissions earned and his operating costs. Trust activities also involve a great variety of relationships between the trust manager and his client. Each trust deed determines the trust manager's latitude in administering his client's assets – a latitude that may be very wide or very limited. The legal provisions of a trust deed define the client's rights to income generated by the assets legally transferred to the trust company. On the other hand, with an agency contract, which does not involve a transfer of ownership, the owner retains the right to supervise the management of his assets.

Few statistical data are available on the fiduciary operations of trust companies. Publicly available information is essentially limited to official reports to the regulatory and supervisory authorities for the trust companies. From these reports, we know that trust companies administered more than $29 billion in 1973, whereas their resources as intermediaries totalled approximately $10.5 billion. But, under present arrangements, deposit-taking and trust operations are so closely integrated that it is difficult to assess their respective contributions to profits – and thus their relative importance – from published data. We can, however, estimate the contribution of trust activities to total revenue. In 1973, revenue derived from fees and commissions earned on estate, trust, and agency business represented 21 per cent of the total gross revenue of the trust companies registered in Ontario. Unfortunately, since many of the trust companies are involved in extensive real estate sales operations, these data include revenue from other than pure fiduciary activities. For companies registered in the province of Quebec, real estate sales contributed almost 42 per cent, and fiduciary operations 58 per cent, to the revenue from trustee activities. Thus fiduciary operations would appear to account for no more than 12 per cent of trust company revenues (.58 x .21 = .12).

Credit Unions and Caisses Populaires

Credit unions and caisses populaires differ significantly from other deposit institutions in a number of important respects. First, the credit unions and caisses populaires are co-operatively owned by their customers, or members. Membership can be based on residential, occupational, or associational ties. In Quebec, the majority of the caisses populaires are organized on a geographic basis; in 1973, over 60 per cent of the local credit unions in Ontario were based on an occupational bond, whereas in Saskatchewan over 85 per cent of them were founded along residential lines. Second, the co-operative credit movement consists of independent local units that form centrals for common purposes. Generally, credit unions and caisses populaires operate only one office, though in recent years multiple branches have become more common among the larger locals. The activities of the centrals vary from province to province but can include computerized bookkeeping, clearing through chartered banks, advertising and other promotions, and supplying investment outlets for local units. Finally, unlike any of the other deposit institutions, the credit unions and caisses populaires fall solely under provincial jurisdiction.

In 1974, there were almost 4,200 local caisses populaires and credit unions and 18 centrals in Canada. The lending activities of the locals were directed almost exclusively towards households, mainly through mortgages and personal loans (Table 2-7). Caisses populaires and credit unions issue a variety of claims that range from demand deposits, some of which are chequable, to term deposits. In addition, as a result of their co-operative nature, they also raise funds by issuing shares, which are usually regarded as identical to notice deposits by their holders.

Table 2-7

Major Assets and Liabilities of Credit Unions and Caisses Populaires, Selected Years, 1963-74[1]

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Assets								
Cash	77	4.4	165	5.3	266	5.4	268	2.8
Investments	445	25.3	789	25.3	1,306	26.6	2,485	26.0
Loans	622	35.3	1,161	37.3	1,727	35.2	2,824	29.6
Mortgages	502	28.5	876	28.1	1,400	28.5	3,606	37.8
Other assets	114	6.5	122	3.9	209	4.3	368	3.9
Total[2]	1,760	100.0	3,113	100.0	4,908	100.0	9,551	100.0
Liabilities								
Savings deposits	843	47.9	1,482	47.6	2,186	44.5	3,965	41.5
Term deposits	97	5.5	171	5.5	880	17.9	2,651	27.8
Share capital	638	36.3	1,177	37.8	1,399	28.5	1,949	20.4
Other members' equity	114	6.5	186	6.0	287	5.8	386	4.0
Other liabilities	68	3.9	97	3.1	156	3.2	579	6.3
Total[2]	1,760	100.0	3,113	100.0	4,908	100.0	9,551	100.0

1 As of March 31.
2 Details may not add up to totals because of rounding.
SOURCE Based on data from the Department of Agriculture, and Statistics Canada; and estimates by the Economic Council of Canada.

Probably more diversity exists among the caisses populaires and credit unions than among any other type of deposit institution. For example, in 1973 over 700 locals had less than $100 thousand in assets; over 400 had at least $5 million; and some had as much as $200 million in deposits. As many as 27 per cent of the locals in Ontario held less than $100 thousand in assets in 1973, whereas fewer than 10 per cent of the locals in either Quebec or Saskatchewan had assets of less than $100 thousand. Differences in the strength of credit unions are also reflected in the data on credit union assets, by province (Table 2-8). Assuming that the 1973 data are representative, assets per capita at credit unions are highest in Saskatchewan and Quebec, with the latter having the highest proportion of credit union members in its population. Assets per member are highest in Saskatchewan. The most notable differences in the distribution of assets are the heavy concentration in mortgage lending in British Columbia and the large amount in personal loans in all provinces except Quebec, Saskatchewan, and British Columbia.

Table 2-8

Selected Characteristics of Credit Unions and Caisses Populaires, by Province, 1973

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Canada
Number of members	6,378	16,044	120,523	130,514	3,464,139	1,230,418	251,463	377,077	231,860	553,638	6,382,054
Number of locals	51	14	132	146	1,651	1,386	194	254	227	199	4,256
Average membership per local	125	1,146	913	894	2,098	888	1,296	1,485	1,021	2,782	1,499
					(Percentage of population)						
Ratio of members to population	1.2	14.0	15.0	20.0	57.0	15.5	25.2	41.5	13.8	23.9	28.9
					(Millions of dollars)						
Total assets	4.6	12.4	90.2	83.7	4,143.3	1,591.7	402.2	823.6	321.3	992.6	8,465.8
					(Dollars)						
Assets per member	722	773	748	642	1,196	1,294	1,599	2,184	1,385	1,793	1,326
Assets per capita	9	108	112	128	681	200	403	907	191	429	383
					(Percentage of assets)						
Personal loans	86.7	89.5	76.7	51.5	20.7	53.9	38.2	22.5	54.9	18.3	30.0
Investments	3.2	3.9	7.9	12.6	23.3	11.9	15.4	36.1	13.3	9.2	19.7
Mortgage loans	4.7	—	8.3	26.6	35.3	27.6	37.8	33.6	23.5	66.0	36.5
Deposits	14.9	30.6	34.4	21.2	84.0	44.1	91.3	57.5	57.1	69.9	70.3
Members' equity	71.2	39.3	60.9	73.4	13.4	49.1	2.2	38.3	36.5	23.8	25.4

SOURCE Based on data from Statistics Canada.

Foreign Bank Activities in Canada

Various estimates have been produced regarding the extent of foreign bank activity in Canada. One of these estimates indicates that there are over one hundred foreign banks operating in Canada. Others claim a more modest figure of about fifty that carry out any substantial banking activity. The changing role of U.S. banks in Canada is of particular interest to Canadians. The Bank of Canada, recognizing the increasing role of foreign-owned subsidiaries, now publishes balance sheet data for forty-five of these firms – most of them U.S. banks. Because the Bank began collecting these data so recently, we have only limited information on the growth of these institutions. Despite problems with data, however, all estimates agree that the growth of foreign bank activity has been rapid over the past few years, even though foreign banks were prohibited from operating as banks in Canada by the 1967 revisions to the Bank Act.

The major difficulty in trying to estimate the extent of foreign bank activity in this country is to establish the criteria that define foreign bank presence. At one end of the spectrum, a foreign bank may have a wholly owned Canadian subsidiary, such as a trust or sales finance company, while, at the other end, the Canadian operation may be simply a representative office, doing little or nothing in the way of either accepting deposits or making loans. In fact, representative offices of foreign banks do not keep their own balance sheets but, instead, solicit deposits and make loans on behalf of their head office. Some subsidiaries obtain their funds as loans from parent and affiliated companies, chartered banks, and other financial institutions; others frequently deal in the money market in direct competition with Canadian chartered banks.

It has been estimated that, at the end of 1974, Canadians held just over $1 billion in deposits that were booked at the U.S. offices of U.S. banks, and held a further $1.1 billion in deposits and notes with the subsidiaries of foreign banks operating in Canada. The total of these deposits was equivalent to nearly 4 per cent of the Canadian-dollar deposit liabilities of Canadian banks.

On the lending side, many foreign-owned subsidiaries undertake business loans, mortgages, and contractual or conditional sales agreements. In addition, some engage in leasing and factoring – two activities prohibited to domestic banks. The data that are available indicate that the recent growth of foreign bank loans to Canadians was mainly attributable to the increased use of subsidiaries in Canada. U.S. bank loans to Canadians booked at U.S. offices were equivalent to 11.4 per cent of the business loans outstanding from Canadian banks in December 1974. Adding to this the loans outstanding at forty-five subsidiaries of foreign banks operating in Canada, we find that the total loans of foreign banks to Canadians were equivalent to 19 per cent of Canadian bank commercial loans. These data have led us to conclude that, whatever the intent of Parliament during the last Bank Act revision, foreign banking firms have expanded their role in Canada, largely beyond regulatory control.

Conclusion

From our analysis of deposit institutions, it is apparent that chartered banks, both individually and as a group, are the dominant financial institutions in Canada. Each of the five largest banks has more than $10 billion in assets. In addition, chartered banks have large branch networks and wide investment powers, and they operate exclusively within the federal regulatory framework. Trust and mortgage loan companies are the next most important group of deposit institutions, followed by co-operative credit institutions. Our analysis of balance sheets indicates that the liability holdings of the major deposit institutions are relatively similar, but the structure of their assets varies considerably, reflecting the different investment powers of each type of deposit institution. As a result, the various types of deposit institutions compete in essentially the same deposit markets but are prevented, to a large degree, from participating in the same lending markets. Foreign bank subsidiaries, which have expanded rapidly in the past few years, also compete in the deposit market and have unregulated access to lending markets.

3

A FUNCTIONAL ANALYSIS OF DEPOSIT INSTITUTION ACTIVITIES

Our analysis of data from the balance sheets of banks, trust and mortgage loan companies, credit unions, and caisses populaires enabled us to determine the composition of the activities of each of these groups as well as the changes that have occurred in recent years. However, this institutional analysis obscured certain links among deposit institutions and also between deposit institutions and other segments of financial markets. For example, in some of their activities, such as the issue of savings deposits, banks must compete with other deposit institutions; in their consumer and commercial lending activities, much competition comes from outside the deposit-taking sector – from direct markets, sales finance companies, and the internal financing capacity of corporations. An analysis of deposit institutions in terms of their activities, or functions, thus constitutes an important, if not essential, background for judging their efficiency. From such a functional analysis, we can discern the origin, the nature, and the intensity of the competition they engage in.

In this chapter, the participation of a deposit institution in any activity is measured by the corresponding asset or liability item on its balance sheet. Balance sheet data can only be used to measure the relative importance of various institutions in activities in which their operations are similar. Consumer lending is an example of such an activity. While banks, credit unions, and sales finance companies may differ in some details with respect to their consumer credit activities, this form of credit is characterized by relatively short maturity and high ratios of new lending and repayment to the corresponding outstanding balances.

The choice of boundaries among functions must necessarily involve some arbitrary judgment. Households using consumer credit, for example, need not be rigidly confined to this market alone. As an alternative, they can choose to increase their mortgage borrowing if the terms are more favourable than those for consumer loans. Still, the characteristics of consumer credit relative to those of mortgage financing are generally more suitable for financing certain types of expenditures. As a result, institutions granting consumer credit can be considered as participating in an activity distinct from mortgage lending. A similar problem arises in the analysis of deposit institution liabilities. Deposit institutions issue deposits that have a definite set of characteristics, and some approximate boundaries can be drawn around these various types of claims; but households and corporations can hold their wealth in a wide range of assets. While some competition can, and does, exist beyond these boundaries, their usefulness depends on the degree to which they delineate major areas of competition.

Assets

The lending activities of deposit institutions are divided, for our purposes, into consumer, mortgage, and commercial lending. This division allows us to examine the activities of different deposit institutions in terms of their relative importance in the different markets.

Consumer Credit

Chartered banks are by far the most important suppliers of consumer credit, having accounted for over $9.2 billion, or 52 per cent, of credit extended to consumers in 1974 (Table 3-1). Among deposit institutions, credit unions and caisses populaires had the next largest share, with outstanding balances of $2.5 billion, or 14 per cent of the total, in the same year. Consumer lending by trust and mortgage loan companies amounted to only $105 million, reflecting the presence of some continuing constraints on their degree of participation.

Table 3-1

Sources of Consumer Credit, Selected Years, 1963-74[1]

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Chartered banks	1,206	26.0	2,443	32.8	4,790	43.3	9,264	52.1
Trust and mortgage loan companies	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	105	0.6
Credit unions and caisses populaires	515	11.1	967	13.0	1,487	13.5	2,462	13.9
Quebec savings banks	14	0.3	16	0.2	22	0.2	37	0.2
Sales finance and consumer loan companies	1,524	32.9	2,338	31.4	2,359	21.3	2,909	16.4
Retail dealers	1,000	21.6	1,241	16.6	1,627	14.7	2,090	11.8
Life insurance companies	375	8.1	452	6.1	767	6.9	908	5.1
Total[2]	4,634	100.0	7,457	100.0	11,052	100.0	17,774	100.0

n.a. — not available.
1 As of March 31.
2 Details may not add up to totals because of rounding.
SOURCE Based on data from the Bank of Canada, the Department of Agriculture, and Statistics Canada.

The most significant feature of the consumer credit market in recent years has been the shift in the relative shares of chartered banks and sales finance companies. While in 1963 the share of sales finance companies exceeded that of banks, by 1974 the share of chartered banks more than tripled that of the sales finance companies. One of the reasons for this change was the removal of the 6 per cent ceiling on bank interest charges in 1967. As a result, chartered banks became much more aggressive in the consumer lending field, using extensive advertising and other marketing techniques to increase their share of the market. In addition, they were prepared to offer competitive rates to consumers with good credit ratings and with whom they had extensive contacts through their deposit activities. In this case, greater competition in the consumer credit market was of direct benefit to many consumers, increasing the availability of lower-cost funds.

The consumer credit market exhibits all the characteristics of a retail business: transactions are numerous, and their average value is low; and it is probable that both the number and the location of points of sale play a predominant role in determining market shares. Given their number of branches and their freedom to compete since 1967, it is not surprising that chartered banks have taken a large share of the market. If legislation governing trust companies were to allow them freer access to consumer lending, they would probably be in a position also to increase their share of this market significantly and provide better services to users of consumer credit.

Mortgage Lending

Mortgages can be grouped into three categories, covering existing residential units, new residential construction, and nonresidential construction. Of these three, the market for mortgage loans on existing residential units most closely resembles a retail lending operation. These loans are generally granted to individuals on the guarantee of a single property. In contrast, loans for new residential construction are made to builders as well as to individuals acquiring property. Loans for nonresidential properties involve business and industry, and the average transaction is large.

The stock of debt secured by mortgages totalled over $53 billion at the end of 1974 – an increase of 290 per cent from 1963 (Table 3-2). The distribution of holdings also changed significantly. Between 1963 and 1974, the share of deposit institutions rose almost entirely at the expense of life insurance companies, with trust and mortgage loan companies showing the most dramatic advance. One of the main reasons for the shift from life insurance companies to deposit institutions was the adoption of the five-year-term residential mortgage, which was much better suited to the liability structure of deposit institutions than that of life insurance companies. The relatively small share of the market held by chartered banks reflects the restrictions on their conventional mortgage holdings, in particular the limit on their conventional mortgage holdings, which is set at 10 per cent of their deposits and outstanding debentures.

Table 3-2

Mortgage Holdings, by Institution, Selected Years, 1963-74

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Chartered banks	885	6.5	840	3.7	2,338	7.0	6,025	11.3
Trust and mortgage loan companies	2,291	16.8	4,487	19.9	7,632	22.7	14,825	27.9
Credit unions and caisses populaires	549	4.0	1,060	4.7	1,660	4.9	4,100	7.7
Life insurance companies	4,560	33.4	6,636	29.4	7,880	23.5	9,500	17.9
Government and government agencies	2,531	18.6	5,006	22.2	8,183	24.4	10,300	19.4
Other institutions and corporate lenders[1]	2,824	20.7	4,544	20.1	5,865	17.5	8,450	15.9
Total[2]	13,640	100.0	22,573	100.0	33,558	100.0	53,200	100.0

1 Includes Quebec savings banks; mutual benefit and fraternal societies; pension funds; estate, trust, and agency funds of trust companies; and corporate lenders.
2 Details may not add up to totals because of rounding.
SOURCE Based on data from Central Mortgage and Housing Corporation.

Deposit institutions are the main lenders in the mortgage market for existing residential units, largely because they have a large number of branches that provide many points of contact with potential customers (Chart 3-1). The deposit institutions also have a large share of the market for loans on new residential construction, but this is slightly less pronounced. Life insurance companies concentrate on loans on nonresidential properties, mainly because these mortgages are longer-term instruments and are better suited to their liability structure.

Commercial Lending

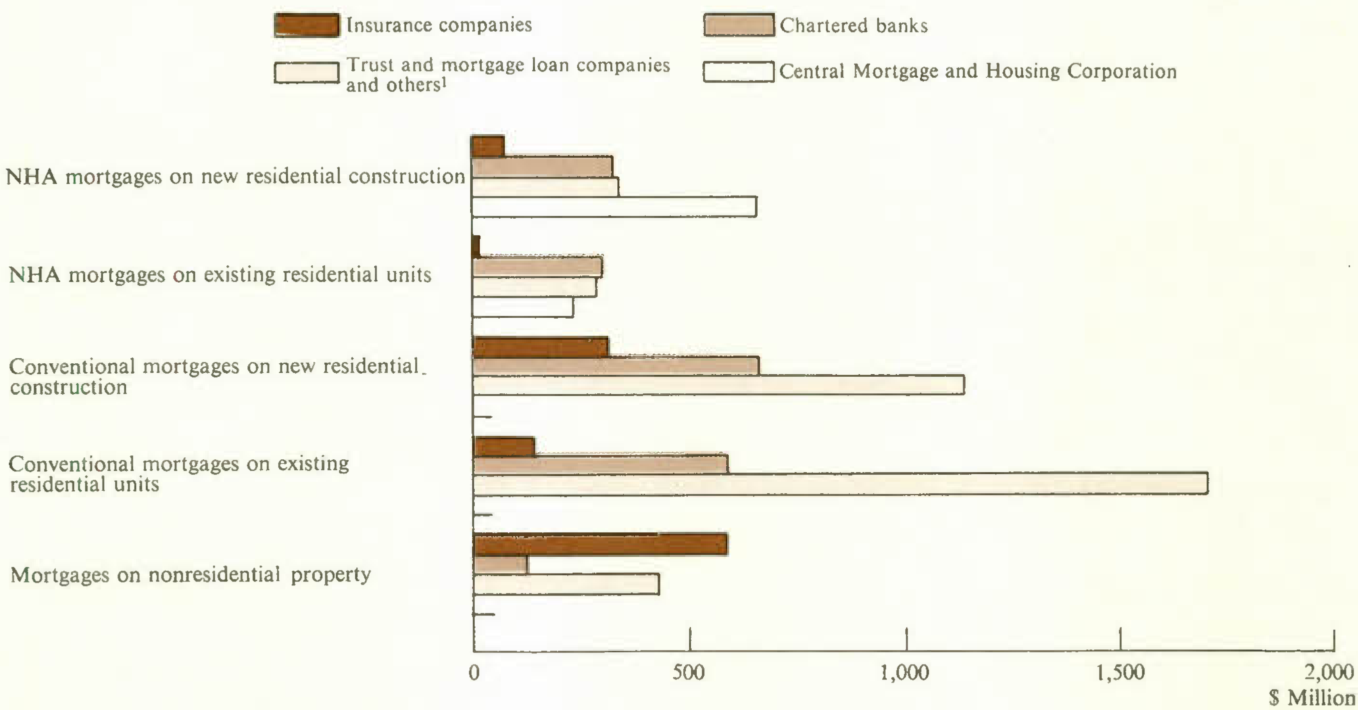
The commercial lending market differs from other lending markets in that, among the deposit institutions, only chartered banks play a significant role. This market is also distinctive because the alternative sources of funds for businesses are numerous and varied – including the issue of short-term paper, bonds, and equities; the use of accounts payable and government assistance; and reliance on internal funds. The range of alternatives varies substantially, however, by size of firm. Larger firms have access to direct, as well as international, markets; smaller firms depend more on accounts payable and on chartered banks for their external funds.

The commercial loan market is extensive. Outstanding business loans of Canadian chartered banks amounted to $18.2 billion at the end of March 1974 – an amount nearly equivalent to total consumer credit outstanding. Thus business loans represented 53 per cent of all Canadian-dollar loans made by chartered banks. The share of business loans as a proportion of bank assets rose steadily from 25.1 per cent in 1961 to 34.3 per cent in 1974.

While the availability of internal funds may be an important determinant in the investment decisions of firms, in our view the performance of the commercial lending market is also a significant factor. For many small and medium-sized firms, bank credit is a major source of finance. In fact, these firms account for a large proportion of bank credit. In 1973, for example, loans to firms with lines of credit of less than $1 million accounted for about 40 per cent of the value of all chartered bank business loans. In addition, even though internal funds may be the most important source of funds in the nonfinancial sector, their importance has varied substantially from industry to industry over time (Chart 3-2). For the nonfinancial sector as a whole, the ratio of internal funds to all sources of funds declined by ten percentage points during the sixties.

Chart 3-1

Mortgage Approvals, by Type of Institution, 1974

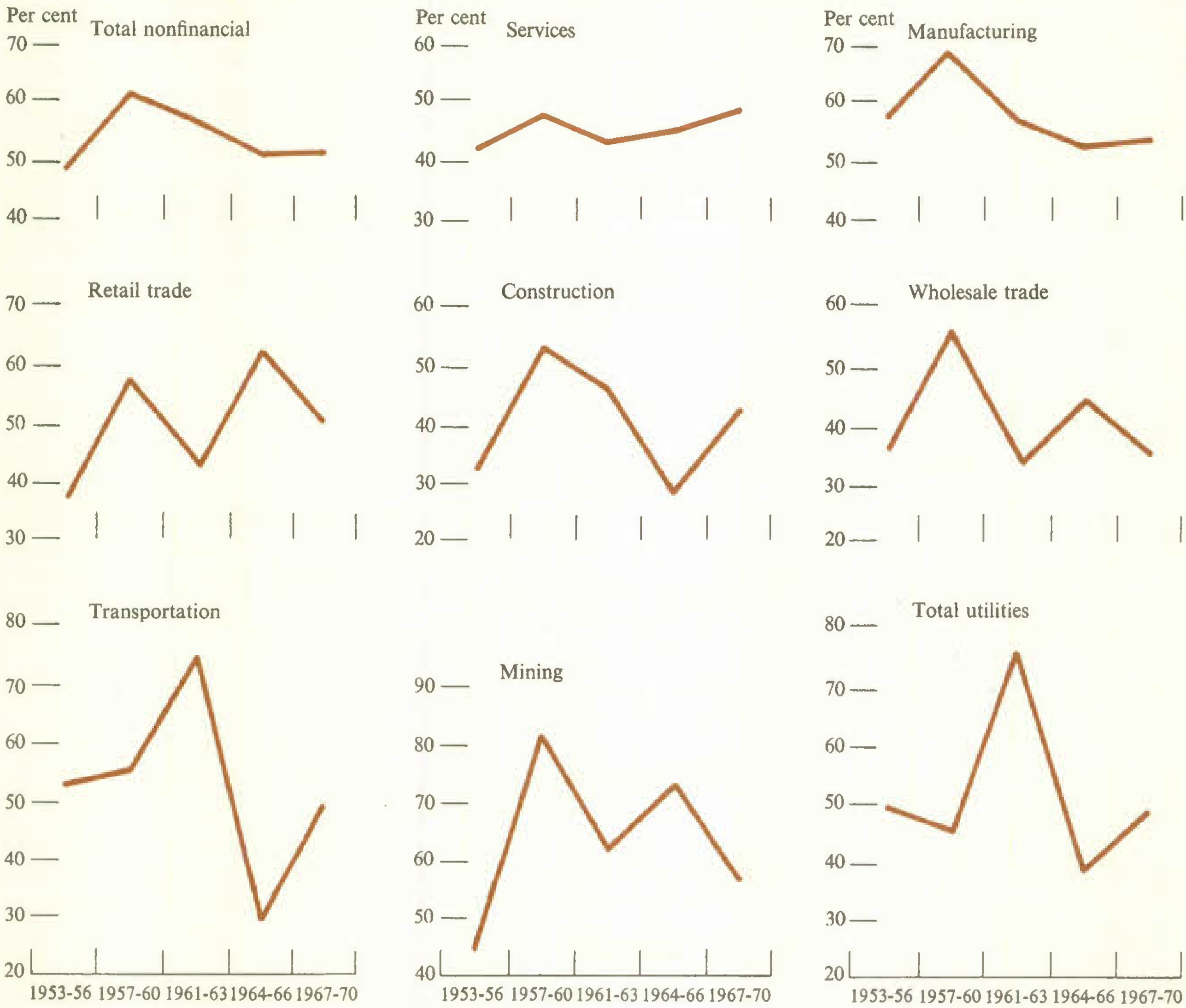


1 Others include caisses populaires, credit unions, fraternal societies, mutual benefit societies, and Quebec savings banks.

SOURCE Based on data from Central Mortgage and Housing Corporation.

Chart 3-2

Ratio of Internal Funds to Total Sources of Funds, 1953-70



SOURCE Based on data from Statistics Canada and estimates by the Economic Council of Canada.

Since a significant share of commercial lending is to small firms, the banks' network of branches places them in a favourable position to service this market. The growth of bank business loans is not, however, just a result of the increasing dominance by banks on the supply side of the market; it also reflects important changes on the demand side.

Among the liabilities of nonfinancial corporations, their bank and short-term loans had an average annual growth rate of 10.1 per cent between 1953 and 1970 – considerably higher than their accounts payable, long-term loans, and equity financing. Thus, from 1953 to 1970, there was a major change of emphasis in corporate financing, from equity to debt, as well as from long-term to shorter-term debt. The banks met part of this increased demand for short-term credit.

Nevertheless, bank financing still plays a relatively minor role in corporate borrowing. For example, in the first quarter of 1974, bank loans financed no more than 9 per cent of the stock of total assets of nonfinancial corporations. This indicates that there is still considerable scope for the expansion of indirect financing to business firms and for the entry into commercial lending of other deposit institutions, especially the trust and loan companies, whose extensive branch systems would allow them to serve the small-firm sector of this market. Increased competition in this market would provide significant benefit to commercial borrowers.

Liabilities

A functional division of the liabilities issued by deposit institutions is difficult because of the deficiencies in available data. The problem arises because different classifications are used in the statistics relating to the activities of each type of deposit institution. For our purposes, the liabilities of deposit institutions are grouped into chequable deposits, savings accounts of households, and liquid balances held by corporations.

Chequable Deposits

Chequable deposits include demand and chequable savings deposits at chartered banks, together with all chequable deposits at other deposit institutions. These accounts provide the bulk of the payment mechanism for the economy. Chequable deposits at banks vary widely, from the small chequing accounts held by households to those of large corporations. The banks, in their traditional role as provider of the payment mechanism, accounted for more than three-quarters of all chequable accounts in 1974 (Table 3-3). But the share of the caisses populaires and the credit unions expanded substantially; in fact, it almost doubled from 1967 to 1974. During the 1967-71 period, the absolute value of chequable deposits at chartered banks and at trust and mortgage loan companies fell; in the case of the former, this was undoubtedly a reflection of the 1967 revision of the Bank Act, which changed the cash reserve requirements from 8 per cent on all deposits to 12 per cent on demand deposits and 4 per cent on other deposits. The incentive arising from this lower reserve requirement, together with the increased consciousness of liability management in banking about that time, resulted in a more rapid growth of savings deposits relative to demand deposits. While the value of chequing deposits at both the banks and the trust

Table 3-3

Chequable Deposits, by Issuing Institution, Selected Years, 1963-74[1]

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Chartered banks[2]	9,881	87.9	13,162	85.6	12,154	81.6	16,296	77.7
Trust and mortgage loan companies	512	4.6	741	4.8	559	3.8	722	3.4
Credit unions and caisses populaires	843	7.5	1,482	9.6	2,186	14.7	3,965	18.9
Total[3]	11,236	100.0	15,385	100.0	14,899	100.0	20,983	100.0

1 As of March 31.
2 Includes demand deposits and chequable personal savings deposits.
3 Details may not add up to totals because of rounding.
SOURCE Based on data from the Bank of Canada, the Department of Agriculture, and Statistics Canada.

and mortgage loan companies resumed growth between 1971 and 1974, these institutions continued to lose some of their share, particularly of small household accounts, to the caisses populaires and credit unions.

Liquid Balances Held by Households

Deposit institutions issue various types of deposits that households can hold as liquid balances. This is very much a retail activity, carried out mainly through local branches. The distinguishing characteristics of such liability instruments are that they are primarily held by individuals, have a fixed money value, and are nonchequable. They are thus differentiated from instruments such as shares of mutual funds and real estate investment trusts whose unit value is determined by the value of the portfolio. This category of financial instruments is defined to include Canada Savings Bonds, which have virtually the same characteristics as savings deposits and compete closely with them for household balances.

Between 1963 and 1974, liquid balances held by households increased fivefold, and the distribution of these balances underwent some important modifications. Trust and mortgage loan companies significantly increased their share of this market between 1963 and 1967 at the expense of the banks and Canada Savings Bonds (Table 3-4). However, after 1967, the share of trust and mortgage loan companies remained stable, and the banks increased their relative share at the expense of Canada Savings Bonds. The 1967 revision of the Bank Act played an important role in this evolution, by removing the ceiling on bank interest rates and introducing different reserve requirements according to the term of deposits. This prompted the banks to issue nonchequable savings deposits similar to those offered by the trust companies.

Table 3-4

Household Nonchequable Balances, by Issuing Institution, Selected Years, 1963-74[1]

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Chartered banks[2]	2,388	24.7	3,103	20.7	11,874	39.9	19,830	41.2
Trust and mortgage loan companies	1,441	14.9	3,852	25.7	6,879	23.1	11,748	24.4
Credit unions and caisses populaires	735	7.6	1,348	9.0	2,247	7.6	4,632	9.6
Quebec savings banks	341	3.5	432	2.9	559	1.9	797	1.7
Government savings institutions	179	1.9	241	1.6	341	1.1	672	1.4
Canada Savings Bonds	4,588	47.4	6,026	40.2	7,830	26.3	10,421	21.7
Total[3]	9,672	100.0	15,002	100.0	29,730	100.0	48,100	100.0

1 As of March 31.
2 Data exclude chequable savings deposits.
3 Details may not add up to totals because of rounding.
SOURCE Based on data from the Bank of Canada, the Department of Agriculture, the Canada Deposit Insurance Corporation, and Statistics Canada; and estimates by the Economic Council of Canada.

Liquid Balances Held by Corporations

Liquid balances held by corporations include "nonpersonal term and notice deposits" held at both the chartered banks and at the trust and mortgage loan companies. In addition to the domestic instruments of the deposit institutions, this market includes the foreign-currency deposits of residents with the chartered banks and also the wide variety of money market instruments issued by other borrowers, such as sales finance companies, foreign bank subsidiaries, provincial and municipal governments, and nonfinancial corporations.

In contrast to the market for household balances, the market for corporate balances is very much a wholesale market, where the average size of balances is many times that of household accounts and where the means of attracting funds are entirely different. Many of the nonpersonal term and notice deposits of deposit institutions are "money market" deposits in which the investor places his funds where he can obtain the highest return, regardless of his normal banking relations. In contrast to household savings deposits, large corporate deposits are usually placed with head offices or main branches in financial centres, or they may even be traded through investment dealers.

The aggregate value of liquid instruments held by corporations more than tripled between 1967 and 1974 – a growth rate far higher than that in any other deposit market (Table 3-5). Among the factors contributing to this growth were the high interest rates over the period, which increased the incentives for more-intensive corporate cash management, and the increased interest in liability management in financial institutions. Along with this rapid growth, there was some change in the market shares of different instruments and institutions. Over the 1963-74 period, chartered banks increased their share of this activity from approximately 50 to 65 per cent, with most of the increase occurring prior to 1968. The share of commercial paper held by nonfinancial corporations declined from 8 per cent in 1963 to 5 per cent in 1967, but then rose to 11 per cent in 1974. Among the institutions whose shares declined were the trust and mortgage loan companies and the sales finance companies. In the case of the latter, this was a reflection of their declining share of the consumer credit market; for the former, it was a result of the entry of chartered banks into nonchequable deposit markets after the 1967 revision of the Bank Act.

Table 3-5

Corporate Nonchequable Balances, by Issuing Institution, Selected Years, 1963-74[1]

	1963		1967		1971		1974	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Chartered banks								
Nonpersonal term and notice deposits	1,171	29.5	2,492	38.5	4,776	39.3	10,175	44.6
Debentures issued and outstanding	n.a.	n.a.	n.a.	n.a.	40	0.3	657	2.9
Foreign-currency liabilities held by residents of Canada	791	20.0	1,440	22.2	2,513	20.7	3,895	17.1
Subtotal	1,962	49.5	3,932	60.7	7,329	60.3	14,727	64.6
Trust and mortgage loan companies								
Estimated nonpersonal term and notice deposits	909	22.9	994	15.4	1,638	13.5	2,096	9.2
Sales finance and consumer loan companies								
Paper outstanding	772	19.5	1,035	16.0	1,250	10.3	2,530	11.1
Nonfinancial corporations								
Commercial paper outstanding	323	8.1	335	5.2	1,159	9.5	2,468	10.8
Canadian-dollar bankers' acceptances	n.a.	n.a.	176	2.7	337	2.8	493	2.2
Provincial and municipal treasury bills and other short-term paper outstanding	n.a.	n.a.	n.a.	n.a.	446	3.7	501	2.2
Total	3,966	100.0	6,472	100.0	12,159	100.0	22,815	100.0

n.a. — not available.

1 As of March 31. Ideally, the data in this table would have been liquid-asset figures taken from consolidated balance sheets for the nonfinancial corporate sector. However, a breakdown, by issuing institution and type of instrument, was not available from this source. Therefore, our data were taken from the liability side of balance sheets for financial institutions. We have assumed that all of these instruments were held by nonfinancial corporations, except in the case of trust and mortgage loan companies where the nature of available data necessitated estimation of these balances.

2 Details may not add up to totals because of rounding.

SOURCE Based on data from the Bank of Canada, the Canada Deposit Insurance Corporation, and Statistics Canada; and estimates by the Economic Council of Canada.

Conclusion

The traditional approach to the regulation of deposit institutions requires only limited information regarding the activities of different institutions. Such information can be provided through an institution-by-institution review, as presented in Chapter 2. In contrast, regulation by function requires a perspective on each activity separately, to determine the range of institutions participating and their relative importance. Such an analysis can also show when impediments exist to the entry of institutions into particular activities. The analysis of the lending and borrowing activities of deposit institutions undertaken in this chapter suggests that all deposit institutions compete in the collection of funds but do not have equal access to investment or lending activities. Existing legislation limits, or forbids, the participation of trust and mortgage loan companies in the personal and commercial credit market, while chartered banks are subjected to restrictions with respect to mortgage lending.

4

ASSESSMENT OF THE PERFORMANCE OF CANADIAN BANKING

The conditions of entry into an industry are an important determinant of the degree of competition in that industry. If entry is easy, new firms will undertake activities in competition with existing firms whenever an opportunity arises to better serve the customer and take away a share of the profit. Ideally then, the lowest costs and prices would prevail. The purpose of this chapter is to assess the nature and significance of both economic and regulatory entry barriers to banking activities and the degree of competition among Canadian banks. It is impossible to measure directly the extent of competition or market power in an industry, but it can be determined indirectly by comparing the rate of profit in banking with that of other industries. With free entry, other things being equal, the rate of profit would be expected to be the same across industries. Less than full competition in an industry, however, may result in higher production costs or wasteful practices for all the firms in the industry without creating excess profits in comparison to other industries. The performance of Canadian banks is therefore compared with that of U.S. banks.

Entry Barriers in Banking

There are two types of entry barriers: regulatory and economic. Regulation imposes costs on a potential entrant by requiring him to obtain a licence, which involves waiting periods; by restricting the scope of his activities; or by simply barring him altogether. Economic obstacles to entry exist when, for reasons other than regulation, a new entrant must bear, either temporarily or permanently, higher operating costs than existing firms. Such obstacles give existing firms some leeway in maintaining higher prices than would exist if they had to face new competitors.

Regulatory Barriers to Entry

Regulatory barriers to entry can serve to discourage both the firms intending to enter banking directly by obtaining a bank charter and those planning to enter only certain banking activities. Among the regulatory provisions that limit direct entry into banking are the need to obtain a charter, the limitation on the ownership of nonbank corporations by banks, the ownership requirements limiting equity holdings of any one interest to 10 per cent, and restrictions on interlocking directorates between banks and trust and mortgage loan companies.[1] The charter requirement enables Parliament to screen applicants, especially other financial firms and those from the real sector. To obtain a charter, a group of at least ten individuals must be willing to provide capital of $1 million or more. The ceiling on individual ownership can be expected to reduce the number of prospective entrants, and the 10 per cent ceiling is low enough to have a strong dampening effect. The 10 per cent ownership limitation forces the entrant to consider the problem of maintaining control of the firm. Even if the 10 per cent limitation were waived in the initial period, the principals would still face the risk of being forced to divest in future. Entry for another group of potential entrants – the foreign entrants – is further restricted, as aggregate foreign ownership is limited to no more than 25 per cent.

The regulatory constraints limiting the entry of institutions as chartered banks do not, however, limit their entry into various banking activities. Consequently, they could enter as near banks. The degree of competition from this source would, however, be limited, as no single type of near bank has the breadth of powers of chartered banks. In addition, some near banks, especially the trust and mortgage loan companies, operate under constraints, such as maximum borrowing limits, that restrict their ability to compete on an equal footing with chartered banks.

Economic Barriers to Entry

Among the potential economic barriers, the first is the need to gain the confidence of customers. Any difficulties that new banks have in establishing a sound reputation equivalent to that of established institutions constitute obstacles to entry. The second barrier derives from a basic characteristic of the Canadian system; namely, the established branch network with which new entrants must compete.

One of the requisites for establishing the confidence of customers, to enable successful entry into banking, is that senior personnel with experience in the industry be attracted to the enterprise. This need not pose any obstacle in terms of additional costs if employees can be drawn from existing institutions at equivalent salaries. An entrant's ability to maintain parity in executive salaries depends on the prospect of success, which, in turn, is tied to the level of capitalization. Even then, the difficulty of competing for employees would be relatively transitory and would diminish in importance once a new institution's prospect of survival appeared good.

1 A number of these provisions were waived temporarily for the most recent charter applications. Nevertheless, an ad hoc approach leaves uncertainties about the provisions that will apply in any particular case.

New institutions must also convince depositors that their money is safe. The longer they take to do this, the greater their entry costs. The weight of this factor has, however, been greatly reduced by the introduction of deposit insurance, which places new institutions on an equal footing with established firms in the retail deposit market. The question of confidence undoubtedly remains crucial for money market borrowings, which are not protected by deposit insurance. Lenders can be expected to evaluate the quality of management and to monitor closely the financial position of borrowing firms. A new institution must either pay a premium or limit its money market borrowing until it is well established. The same kind of scrutiny also faces the entrant seeking additional equity investment. Confidence is also likely to be an issue with certain borrowers. Small and medium-sized firms that deal with a single bank are likely to weigh carefully the prospects of a new institution in case they are forced at an inopportune time to seek funds elsewhere.

The branch banking system affects entry in several ways. A critical aspect in the retail banking market is the convenience of branch office locations. A problem facing new entrants is the availability of appropriate branch sites. For instance, in suburban locations, once shopping centre sites become occupied, zoning restrictions may effectively block any additional branches. Although a number of shopping centres have branches of more than one deposit institution, the policy of many centres is to enter into restrictive agreements that prevent the opening of competing outlets. In addition, in rural areas and small towns that cannot afford more than their existing number of branches, potential entrants may be shut out. Still open to entrants are downtown locations and sites that become available in new suburban areas.

Branching is also an entry issue if a bank with few branches is at a disadvantage in relation to an institution with numerous branches. Such a disadvantage arises when a customer prefers to deal with a large multibranch bank or when the unit costs of certain operations decrease as the size of a bank increases. A widespread branch system also offers some advantage to mobile customers. When they move, they are able to maintain their banking connections; when they travel, they can obtain funds through a courtesy or international card. While these advantages influence some customers, they are unlikely to be of general significance. The marketing advantages of a branch system may, however, extend beyond these benefits to its customers. Every branch office of a bank increases its visibility to the public – an especially important factor for a bank that is not well known.

The geographic concentration of branches is another important dimension of size, because the length of the lines of communication, and hence the unit costs, decline with increased concentration. To reduce the unit costs arising from the control and support of its branch system, any new bank must concentrate its branches within a limited geographical area; yet, a lack of appropriate branch sites may make this difficult.

Entrants can overcome marketing disadvantages, and the higher unit costs they impose, by spending more on advertising and other promotional techniques. They can also attract customers by offering lower prices. In this regard, the position of entrants into banking is somewhat better than that of entrants into other industries with numerous marketing outlets – for example, retail food and gasoline distribution – since rates are set by each bank at the national level. Thus, if an entrant chooses to use rate differentials to attract customers in a given area, it can do so without established competitors dropping their national rates. This protection does not, however, extend to the market for business loans, where new firms possibly face a struggle, customer by customer.

We cannot at present provide data on the cumulative costs of economic obstacles to entry. However, in comparison with other industries, the conditions of entry into banking are relatively attractive, and the economic barriers can be overcome. The initial costs of a major entry into banking are lower for groups that have management expertise and a good reputation in a financial activity. The most likely potential entrants into banking are therefore existing financial institutions that compete with banks in some, but not all, of their activities. It appears that the main reason for the development of near banks as a substitute for direct entry into banking is the regulatory framework. Since profit rates in banking are relatively high, as will be noted in the following sections, the removal of regulatory barriers would likely result in greater direct entry into banking.

Rates of Return in Banking and Industry

To get some indication of the effective ease of entry into an industry, the rate of return to its shareholders' equity can be compared with rates of other industries over a period of time. If the rate of return in banking were higher than in other industries, there would be an incentive for firms to enter. In the absence of regulatory barriers, the extent of entry would depend upon the expected duration and size of profits relative to the initial costs associated with entry.

Table 4-1

Before- and After-Tax Average Rates of Return to Shareholders' Equity, Selected Sectors, 1963-67 and 1968-73

	Before tax		After tax	
	1963-67	1968-73	1963-67	1968-73
Chartered banks[1]	14.2	24.4	8.1	12.9
Trust and loan companies	15.4	18.9	9.5	10.9
All manufacturing	17.8	17.4	10.9	10.6
Food and beverages	19.4	20.3	11.4	11.9
Textiles	16.4	12.5	10.9	7.9
Transportation	12.9	12.9	8.5	8.4
Wholesale trade	18.2	18.2	11.9	11.6
Retail trade	16.6	15.0	10.5	9.3

1 Seven largest banks.
SOURCE Appendix C.

Since effective rates of taxation are not the same across industries, the relevant measure of profits must be taken after tax. It may also be convenient to look at before-tax profit rates in cases where specific activities are considered and compared. Table 4-1 provides data on the rates of return to equity on both before-tax and after-tax bases.

Prior to 1967, the after-tax profit rates of chartered banks were lower than those in most industries, and little incentive existed for entry into banking. During the 1963-67 period, the banks' share of the deposit-taking sector eroded considerably, falling from 74 per cent of assets in 1963 to 69 per cent in 1967 (see Table 2-1). This decline was a manifestation of the effect of the 6 per cent interest ceiling, which lowered chartered bank profit rates below competitive levels.

The 1967 revision of the Bank Act removed the ceiling, and the profit performance of chartered banks changed significantly. Over the period 1968-73, Canadian banks enjoyed the highest after-tax rate of return of all the industries recorded in Table C-4. This result, coupled with the lack of any substantial direct entry into banking, indicates the presence of barriers to entry that serve to protect existing firms from the full force of competition. Before-tax profit rates in banking have also been far higher than in manufacturing or in trust companies every year since 1967 and, on average, over the period 1968-73. The difference between profits in banking and other industries is greater on a before-tax basis than on an after-tax basis because of the higher effective tax rates paid by chartered banks. This difference is further magnified when the losses of revenue from required primary and secondary reserves are added to before-tax revenues.

A comparison of profitability across industries cannot, by itself, serve as a reliable indicator of market power. Profit differences can also be the result of factors specific to the industries being compared. In Appendix A, we consider the possibility that the higher profits in banking have been the result of such factors as greater risk since the last Bank Act revision, the contribution of foreign business to the profits of the Canadian banks, and the transitory forces in banking markets. These factors do not, in our opinion, explain satisfactorily the profit performance of the Canadian banks since 1967. The data have led us to the tentative conclusion that chartered banks have sufficient market power not only to maintain high profit rates before taxes but also to have higher profit rates after taxes than most other industries.

Rates of Return in Canadian and U.S. Banking

Even though banks' profits are higher than those in the rest of the economy, the possibility remains that banking is inherently more profitable than other activities. A second method of assessing the profitability of the Canadian banking system is to compare profit rates with those in the U.S. banking system. Two sets of U.S. banks have been used as standards of comparison to reflect differences in the importance of retail and wholesale banking between the two countries. The first group consists of the eight New York City banks that manage 20 per cent of the assets of all insured banks in the United States. These banks do a very large wholesale business and, as a consequence, have low operating costs per dollar of assets. The second group consists of all insured banks in the United States, including the eight New York City banks, and covers numerous smaller institutions whose loan and deposit rates undoubtedly reflect the profit margins that are characteristic of retail banking activities. The New York City banks probably do less retail business than the Canadian banks, whereas the group of all U.S. insured banks are probably involved in more retail activities than their Canadian counterparts.

From 1968 to 1973, the after-tax rate of profit of the seven largest Canadian chartered banks was, on average, 1.9 percentage points higher than that of all U.S. insured banks and 3.8 percentage points higher than that of the New York City banks (Table 4-2). The lower profits in U.S. banking support the view that banking does not inherently require as high a rate of return as that realized by the Canadian banks. The profit comparison of New York City banks and all insured banks in the United States indicates, as expected, greater competitiveness in wholesale than in retail banking. Nevertheless, the return to all U.S. insured banks still falls short of that realized by Canadian banks.

Table 4-2

After-Tax Rate of Return to Equity for Canadian and U.S. Banks,[1] 1963-73

	Seven Canadian banks	All U.S. insured banks	Eight New York City banks	Difference between Canadian and all U.S. insured banks	Difference between Canadian and eight New York City banks
			(Per cent)		
1963	6.3	9.9	10.1	-3.6	-3.8
1964	7.4	10.4	10.2	-3.0	-2.8
1965	6.5	10.5	10.8	-4.0	-4.3
1966	9.5	9.8	8.6	-0.3	0.9
1967	10.6	11.1	10.6	-0.5	0.0
1968	14.2	11.3	10.1	2.9	4.1
1969	11.9	12.0	8.0	-0.2	3.8
1970	10.4	10.0	7.6	0.4	2.8
1971	11.4	10.3	8.4	1.1	3.0
1972	14.1	10.9	9.9	3.2	4.2
1973	15.1	11.2	10.2	3.9	4.9
Average, 1963-67	8.1	10.3	10.1	-2.2	-2.0
Average, 1968-73	12.9	11.0	9.0	1.9	3.8

1 Shareholders' equity includes capital, surplus, and reserves for losses.

SOURCE Based on data from *The Canada Gazette*, the Board of Governors of the Federal Reserve System of the United States, *Moody's Bank and Finance Manual*, and the annual reports of the seven largest Canadian banks.

The Efficiency of Canadian Banking

Our profit rate comparisons indicate that Canadian banks possess a significant degree of market power relative to other sectors and to banks in the United States. But higher rates of return are not incompatible with lower costs and prices and therefore do not, by themselves, measure the efficiency with which banking services are provided in Canada. Any assessment of the efficiency levels of banking institutions requires an examination of the differences between the rates received by the institutions on their assets and the rates paid on their liabilities. In this section various measures are introduced and compared with similar measures in the U.S. banking system. To the extent that the U.S. banking system is less than fully competitive, its use as a standard will understate inefficiencies in the Canadian system.

Comparisons of Net Interest Revenue

Net interest revenue (NIR) is the difference between the revenues earned on all domestic assets and the interest paid on all liabilities. This differential includes income taxes where applicable, profits, and all operating expenses except interest. If the assets and liabilities of the Canadian and U.S. banks being compared were identical, then, other things being equal, the same net interest revenue per dollar of assets would imply equal efficiency in supplying intermediary services. If, after accounting for differences in taxes and profits, the net interest revenue per dollar of assets were larger in one group of intermediaries than in another, then the higher operating cost per dollar of assets would indicate lower efficiency.

During the 1968-73 period, NIR per dollar of assets was, on average, .60 percentage point higher in Canada than in the United States, or 17 per cent of the Canadian base (Table 4-3). On an after-tax basis, the difference between NIR in Canada and the United States was much smaller, averaging only .14 percentage point from 1968 to 1973, or 5 per cent of the Canadian base. In other words, in providing their services, the Canadian banks would be 17 per cent less efficient than U.S. banks before tax and 5 per cent after tax. The difference between the before- and after-tax comparisons reflects the fact that U.S. banks pay lower taxes, in particular because the income they receive from their holdings of state and local government securities is tax-exempt. The lower NIR in the United States is offset partly by their lower taxes. Conversely, the higher NIR in Canada makes up in part for the higher taxes.

Comparisons of net interest revenue per dollar of assets do not take into account any of the differences between the Canadian and U.S. banking systems. Nevertheless, the differential in NIR is consistent with the previous comparisons of after-tax profit rates, with Canadian banks earning more than their U.S. counterparts. If other things were equal, NIR comparisons, together with profit comparisons, would lead to the conclusion that banking services were provided less efficiently in Canada than in the United States between 1968 and 1973. However, substantial differences exist between the two banking systems with respect to their activities, operating costs, noninterest income, debt/equity ratios, and foreign banking operations. A more thorough examination reveals that the similarities between the profit rate and NIR comparisons can be attributed in large degree to the offsetting influences of these differences between the systems.

Table 4-3

Net Interest per Dollar of Assets, Canadian Chartered Banks and All U.S. Insured Banks, 1964-73

	Before tax			After tax		
	Canadian banks[1]	All U.S. insured banks[2]	Difference	Canadian banks[1]	All U.S. insured banks[2]	Difference
	(Per cent)		(Percentage points)	(Per cent)		(Percentage points)
1964	2.89	2.72	.17	2.36	2.37	-.01
1965	2.83	2.64	.19	2.35	2.35	.00
1966	2.78	2.61	.17	2.28	2.34	-.06
1967	3.00	2.67	.33	2.51	2.39	.12
1968	3.27	2.73	.54	2.76	2.46	.30
1969	3.59	3.02	.57	2.73	2.60	.13
1970	3.75	3.32	.43	2.83	2.92	-.09
1971	3.51	3.03	.48	2.70	2.75	-.05
1972	3.53	2.88	.65	2.74	2.62	.12
1973	3.80	2.91	.89	3.04	2.63	.41
Average, 1968-73	3.58	2.98	.60	2.80	2.66	.14

1 Canadian figures are for Canadian-dollar assets and liabilities and are averages for October of two consecutive years. Total assets exclude customers' liability under acceptances, guarantees, and letters of credit.

2 U.S. figures are December, June, December averages. Net revenue is net of gains and losses on securities and includes interest paid and income from reserve transactions (federal funds).

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, and the Board of Governors of the Federal Reserve System of the United States; and estimates by the Economic Council of Canada.

Comparisons of Loan-Yield Spread

As an alternative approach to assessing differences between the Canadian and U.S. banking systems, we have compared margins as measured by the difference between the average yield received on loans and the average interest paid on deposits. This approach avoids many of the problems associated with NIR comparisons, which implicitly include the yields on all balance sheet items. Even though bank activities may differ in each country, making loans and taking deposits are the major functions of both systems. The net yield spread measures the net revenue from simultaneously carrying out these two activities. Assuming similar deposit and loan activities, a higher net spread in one country relative to the other would reflect a higher cost in performing banking activities.

Here again, the deposit and lending business differs in a number of respects between the Canadian and U.S. banking systems. The most critical for this analysis is the larger proportion of demand deposits in U.S. banks. To allow for this, alternative measures of spreads have been calculated. In one estimate, it is assumed that demand deposits are attracted without cost; in a second estimate, that they are attracted at the same cost as other deposits. Our third and best estimate is an intermediate one based on the assumption that costs are proportional to the payment services provided to depositors.[2]

If the Canadian and U.S. banking systems were equally efficient, the net yield spreads of the Canadian banks would be expected to lie between those of the New York City banks and all insured banks in the United States. That is, the Canadian spreads should be lower than the U.S. average and higher than those of the New York City banks. In fact, our intermediate measure indicates that, over the period 1969 to 1973, the yield spreads for the Canadian banks exceeded the margins for the New York City banks by 1.74 percentage points and for all insured banks by .74 percentage point (Table B-1). If these excess margins are multiplied by the average stock of Canadian-dollar loans outstanding in chartered banks over the period 1969 to 1973, one finds that Canadian bank customers paid $172 million more for a given volume of banking services than if the spreads of all U.S. insured banks had prevailed, and $403 million more than with the spreads of the New York City banks (Table B-2). Based on this particular record, there seems to be little doubt, therefore, that Canadian banks are less efficient than U.S. banks. These excess interest payments by Canadian customers represent 8.7 per cent of all interest paid on loans annually over the period 1969-73, using all U.S. insured banks as the standard, and 20.4 per cent using the New York City banks.

These results do not take into account the different environments in which the banks operate. U.S. banks generally have higher reserve requirements and lower debt/equity ratios than Canadian banks, which would be expected to result in wider spreads for U.S. banks. On the other hand, the higher effective tax rates for Canadian banks would make for wider spreads as well. In Table B-3, the Canadian-U.S. differences in spreads incorporate the effects of the differences in operating costs in the two banking systems. The U.S. yield spreads used for that table are those that would maintain the rate of return for U.S. banks if their reserves, debt/equity ratios, and effective rates of taxation were adjusted to reflect Canadian conditions. On the whole, these adjustments do little to alter the unadjusted margins. To the extent that there are differences between adjusted and unadjusted spreads, they tend to reinforce the conclusions drawn from our estimates – namely, that the yield spreads and the resulting costs to bank customers are considerably higher in Canada.

The Sources of Higher Bank Costs in Canada

The wider spreads between loan yields and deposit rates in Canada relative to the United States could result from higher bank profits as we have just seen, tax liability differentials, or higher resource costs in performing banking services in Canada – or any combination of these factors. Because of their policy implications, it is necessary to examine the relative contribution of each potential source.

2 Details on these three estimates are provided in Appendix B.

If comparisons of the effective tax rates paid on profits by Canadian and U.S. banks are straightforward in this particular case, the impact of the tax burden on yield spreads cannot be estimated directly, because the latter cover only part of the overall business of the banks. Whatever the exact contribution of taxes to the spreads between the two countries, one point is clear: effective tax rates for banks are substantially higher in Canada than in the United States (Table 4-4). It can thus be calculated that chartered banks paid, on average over the period 1969-73, $134 million more than they would have at the U.S. rate. This amount is equal to 78 per cent of the excess costs ($172 million) to Canadian bank customers, associated with the wider margins.

Table 4-4

Effective Realized Tax Rates for Canadian and U.S. Banks, 1969-73

	Canadian banks	All U.S. insured banks
	(Per cent)	
1969	51.4	33.2
1970	56.2	32.4
1971	51.2	25.3
1972	46.3	23.0
1973	45.3	24.2

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, and the Board of Governors of the Federal Reserve System of the United States; and estimates by the Economic Council of Canada.

Table 4-5

Excess Charges, Taxes, Profits, and Costs in Canadian Banking, 1969-73

	Charges[1]	Taxes[2]	Profits[2]	Resource costs
		(Millions of dollars)		
1969	101	30.6	29.9	40.6
1970	42	78.0	62.4	98.1
1971	144	39.7	37.1	67.1
1972	282	66.3	76.6	139.5
1973	369	11.8	14.3	342.6
Average, 1969-73	172	45.3	44.1	82.1

1 Figures are the excess costs based on our intermediate measure for all U.S. insured banks. They represent our estimate of the drop in bank revenues if the loan-yield margins for all U.S. insured banks applied to Canadian banks.

2 Excess profits are based on the differences in rates of return for the seven largest banks and the manufacturing industry, as shown in Appendix C. Excess taxes are the taxes that banks would have paid on these profits.

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, and the Board of Governors of the Federal Reserve System of the United States; and estimates by the Economic Council of Canada.

Under this approach, where taxes paid account for most of the Canadian excess cost of banking services, there is little room left for other potential sources of higher costs such as profits or resource use. These calculations would thus suggest that the Canadian government has been the major beneficiary of the high yield spreads in this country.

An alternative way to allocate the excess cost of banking services between taxes, profits, and resource use is to assume that profits and taxes beyond the rates applying to Canadian manufacturing belong to business covered by loan-yield spreads. The balance is imputed to higher resource costs (Table 4-5). These data would suggest that, although Canadian banks have generally earned higher profits than other industries in the economy, profits contribute about 25 per cent to the yield-spread differences between Canada and the United States.

The largest component of the excess Canadian spreads is by far the residual item representing noninterest expenditures for loan and deposit services supplied to bank customers. It is also the most difficult to interpret. While these higher resource costs could merely reflect the influence of such factors as population distribution, the structure of industry, or other institutional factors, they are also consistent with less than full competition as a source of efficiency in the provision of banking services. This interpretation is reinforced by the presence of high profits.

Conclusion

In this chapter we have made quantitative estimations of the costs to the Canadian public of barriers to entry into banking. The evidence points in the direction of a significant amount of market power in this sector. However, the major beneficiary is not so much the bank shareholders as the Government of Canada through its taxes.

There is little doubt that present bank legislation gives rise to costs to Canadian customers. While these costs are in part a transfer from users of bank services to government and bank shareholders, the waste component of the costs may not be negligible. The higher prices charged for financial services will necessarily cause households and firms to fill their needs for these services by inferior methods. Thus there is a case for increasing the incentives to greater efficiency and for reducing operating costs and prices in Canadian banking.

5

EXISTING REGULATIONS AND THE FUNCTIONAL APPROACH

In Canada, as in most market economies, deposit institutions are among the more highly regulated business enterprises. As a result, their performance is influenced substantially by the form of regulation they face. Our evaluation of the goals of the system of regulation and our examination of the existing regulatory structure have led us to the conclusion that a new approach to regulation on a function-by-function basis would enable deposit institutions to operate more efficiently.

For our purposes, the term "regulation" refers to a variety of measures undertaken by government authorities to alter the behaviour of privately owned deposit institutions. Most directly, regulation can take the form of legislation that establishes and limits the powers of deposit institutions. This type of regulation extends beyond legislation, such as the Bank Act and trust companies' acts, that establishes specific powers, to more general legislation, such as the Interest Act, that governs institutions to the extent that they participate in specific transactions. The term also covers the regulations that often accompany legislation as well as the broad range of initiatives, generally described as moral suasion, by which either the Minister of Finance or the Governor of the Bank of Canada issues informal requests to financial institutions.

The Goals of Regulation

The existing regulations governing deposit institutions in Canada have been justified on the grounds that they protect depositors, assist in the working of monetary policy, encourage competition and efficiency in financial markets, influence the composition of economic activity, preserve the separation of financial and non-financial activities, and foster Canadian ownership of the financial sector. While all of these goals were considered important by the regulators, the difficulties involved in achieving all of them simultaneously meant that certain priorities had to be established. Our analysis of these goals indicates that, in the past, depositor protection, monetary policy objectives, and the separation of financial and non-financial activities were given priority in the regulatory system; however, since the 1967 revision of the Bank Act, the goals of greater competition and efficiency, together with Canadian ownership, have assumed added importance.

Depositor Protection

In assessing the depositor protection argument for regulation, it is useful to ask why, and to what degree, the public should be protected. One argument in support of consumer protection is that the cost of obtaining information about various institutions can be reduced by the collective gathering of information or, alternatively, through disclosure requirements. Consumer protection laws in a number of other areas are based on this presumption. However, deposit institutions, compared with other issuers in the financial sector, are subject to a vast array of regulations that extend far beyond the mere provision of information about their activities. Special characteristics of the activities of deposit institutions must be examined to determine the rationale for their extensive and distinctive regulation.

First, time plays an essential role in the intermediation undertaken by deposit institutions, whereby they issue short-term liabilities with a fixed money value against holdings of assets, some of which have variable money values. This intermediation depends on the expectation that only a portion of these liabilities will be withdrawn in any future period. An important determinant of the ability of a financial institution to retain its deposit is the maintenance of the depositors' confidence that claims will be met when desired. In turn, the value of a deposit, and hence depositor confidence, depends largely on the future actions of the issuer. Depositors could ensure that a deposit institution would not jeopardize the value of their deposits by insisting on a contract that would bind the future actions of the deposit institution, but this would be expensive for individuals. Government regulation could be viewed as a substitute for private contracts, providing the depositor with some indication of the range of future actions permissible to a deposit institution.

A second characteristic of deposit institutions frequently cited in support of their regulation is that the confidence of depositors in any institution depends not only on that institution's actions but also on those of similar institutions. Thus a financial institution acting in its own interests could undermine trust in other institutions. For example, when some deposit institutions are unable to meet depositors' needs for repayment, doubt is cast on the ability of other institutions to meet their claims. In other areas, the problem posed by the effects of an individual's actions on others is often dealt with by taxing him so that he has to bear the full costs of his actions and adjust his plans accordingly. This approach has not usually been adopted for financial institutions. Rather, some form of portfolio regulation has been enforced to maintain acceptable combinations of assets and liabilities.

It has been argued that the need to ensure the acceptability of the means of payment requires regulation of any deposit institution whose liabilities serve this role. Some deposit institutions do provide a major part of the means of payment for the economy and should therefore be regulated.

Monetary Policy

The role of deposit institutions in the conduct of monetary policy is critical. At present, however, considerable controversy exists over what objectives the central bank should pursue, as well as how monetary policy affects the economy. The traditional Keynesian approach emphasizes the role of interest rates and the amount of credit made available to various sectors of the economy, while the monetarist approach stresses the importance of the money stock, a substantial proportion of which is made up of chartered bank liabilities. Whichever view is taken, the central bank must exert prior influence on the behaviour of deposit institutions to influence either interest rates or the money supply. If it is to manage the money supply, the central bank must have the power to vary either the amount of cash available or the reserve requirements that must be met by the banks. If the Bank of Canada is to control the cost and availability of credit, then it needs certain other powers that will enable it to influence lending by deposit institutions.

In Canada, the practice of monetary policy is based mainly on the control of broad monetary aggregates. While the central bank has intervened to alter credit flows on specific occasions, less emphasis has been placed on such intervention in recent years. This view of monetary policy was recently reaffirmed by the current Governor of the Bank of Canada, who stated that

> ...the indirect influence of cash management to regulate the pace of monetary and credit expansion in terms of broad aggregates, leaving it mainly to the workings of private financial institutions and market to sort out the specific impacts on the cost and availability of credit to particular classes of borrower and lender... is the basic approach followed in Canada.[1]

To follow this indirect approach, there must be a clear and stable relationship between reserve holdings and the money supply. Provided the central bank controls the monetary base, defined as notes and coins plus chartered bank deposits at the Bank of Canada, the money supply can then be controlled. Although the money supply could also vary with changes in public demand for notes and coins relative to other assets and with the banks' holding of reserves relative to deposits, experience in other countries suggests that, even in the absence of reserve requirements, changes in these factors are of little significance compared with those in the monetary base. In other words, it is unduly pessimistic to believe that if banks were free to choose their own level of reserves relative to deposits, the resulting reserve ratios would fluctuate widely from month to month, making control of the money supply next to impossible. As a result, we are rather sceptical of the argument that the present high levels of imposed cash ratios are indispensable to the control of the money supply.

Competition and Efficiency

One of the aims of regulation that has become particularly important in recent years is to ensure that the financial system is protected against monopolistic practices that would be harmful to the public interest. Tangible benefits can be

1 Speech delivered by Mr. Gerald K. Bouey at the Canadian Conference on Banking, September 16, 1974. Reprinted in the *Bank of Canada Review*, September 1974, p. 18.

expected from competition among deposit institutions. For example, they will function in a technically efficient manner and at the lowest cost in terms of resources; the interest rate spread between the rate earned on assets and that paid on deposits will be at a minimum, which implies that the cost of credit to borrowers will be as low as possible and the interest paid on deposits as high as possible. Moreover, competition will help to ensure that bank services will not be produced in "bundles" but will be individually priced in relation to costs. Thus consumers will be free to pick and choose the particular bank services they wish to buy.

Until the Bank Act revision of 1967, the main aspect of banking legislation relating to competition was the requirement of ministerial assent for any merger among chartered banks. With the revision, provisions limiting chartered bank ownership of trust companies and mortgage loan companies and prohibiting agreements with respect to interest rates paid on deposits or charged on loans were added to encourage competition. These provisions aside, deposit institutions have, on the whole, remained outside the scope of competition legislation.

The Council, in a report on competition policy published in 1969, went on record as favouring extension of competition policy to services, including those provided by financial institutions. It stated then that

> ... while there are important differences in the nature of the products supplied by goods and service industries respectively, these differences are not such as to render an efficiency-oriented competition policy less relevant for service industries. On the contrary, it may in some ways be more relevant.[2]

Referring specifically to the financial sector, the Council argued that

> ... the present Bank Act therefore reflects two different aspects of policy, both of which are designed to protect the public interest in the activities of the banking system. The primary focus of the legislation is on the need to ensure the stability and solvency of the chartered banks. But as the ban on rate agreements indicates, once this basic requirement is met, then the public is deemed to have a right also to the benefits of effective competition and efficient resource use in the financial system. Nor does there appear to be any reason why the extension of competition policy to all financial institutions cannot be a major factor making for efficiency in this area. Indeed, it is our view that the application of competition policy is as relevant to the provision of financial services as it is to other fields.[3]

These views are reflected in the recent revision of the Combines Investigation Act.[4] With the exception of certain agreements and mergers among banks, to which amendments to the Bank Act apply, this new legislation places financial services under the coverage of competition legislation in the same way as any other industry. While we believe that this is a desirable step, it is also our view that the revised Bank

2 Economic Council of Canada, *Interim Report on Competition Policy* (Ottawa: Queen's Printer, 1969), p. 146.

3 *Ibid.*, pp. 154-55.

4 The provisions of the Act relating to the service sector came into effect July 1, 1976.

Act and other related legislation should complement competition policy by incorporating changes that will encourage competition among financial institutions.

Selective Credit Policies

Regulation of financial institutions can influence the composition, as well as the level, of output of an economy by restricting the choice of assets these institutions may hold. Policies directed towards this goal typically include restrictions on portfolio behaviour, as well as moral suasion. Such initiatives have been frequently suggested with respect to preferential financing for housing, small businesses, or enterprises in lagging regions.

The effectiveness of such regulation depends on the alternative sources of financing available to households and businesses. When close ties exist between certain kinds of expenditures and specific financial instruments, regulation can help to attain such goals; when these ties are loose, regulation can contribute little. For example, if minimum mortgage/asset ratios were imposed on financial institutions so that terms for mortgage credit were more favourable, households would obviously be inclined to do more borrowing through mortgages. Undoubtedly this cheaper credit would induce them, to some degree, to spend more on housing; but they might also finance automobile purchases and other expenditures by increasing mortgages on their houses. In circumstances where such flexibility exists in finance alternatives, the use of compulsory mortgage ratios may not be effective in promoting additional expenditure on housing. Any increased demand for mortgages by financial institutions to meet this requirement would be nullified quickly by shifts of credit needs from other markets, with little effect on the terms of mortgages.

The difficulties of using regulation to influence the composition of lending carry over into the business sector. The encouragement of investment in depressed regions or the granting of credit for exports can also lead to increased use of instruments related to these activities without any corresponding increase in the activities they were meant to encourage.

To the degree that portfolio regulation is effective in directing funds to particular uses, it operates like a control or a tax incentive on the financial institutions to which it applies. If the regulations apply to only one set of institutions, their portfolio choice, and consequently their subsequent growth, will be limited relative to institutions unaffected by the regulations. This reduced growth, together with regulations separating markets, could even have the perverse effect of reducing the flow of credit to the desired type of activity.

Where portfolio regulations are similar for all intermediaries, the relative effects on the various intermediaries will be small. Instead, the use of intermediaries will be slowed relative to the use of direct markets – a substitution that will not be costless. As seen earlier, indirect financial markets, in addition to transmitting funds from lenders to borrowers, provide intermediary services that transform the characteristics of liabilities issued by ultimate borrowers so that they are more acceptable to lenders.

Where the payment mechanism is closely tied to the process of intermediation, as in Canada, portfolio ceilings impose additional costs on consumers. Thus, while it may appear to cost nothing, the use of portfolio regulation to alter the composition of credit is costly to society in terms of the reduced degree of intermediation, which results in corresponding losses to households and businesses.

Separation of Financial and Nonfinancial Activities

Separation of the financial from the nonfinancial sector of the economy can be justified on the grounds that it is necessary to regulate the types of assets that can be combined with the liabilities that serve as a medium for payment or are readily convertible on demand. If deposit institutions were permitted to operate without constraint in the real sector of the economy, their portfolio risk would be substantially altered. For example, a deposit institution would be more likely to continue lending to a corporation in financial difficulty if it had an equity interest in that corporation. It would thus be accepting higher risk in the hope of saving the corporation from bankruptcy and protecting its own shareholders against eventual reduction in their equity position.

Many view the concern about the sheer size of the larger banks as a more important reason for the separation of financial and nonfinancial sectors. While the activities of deposit institutions in any specific market are now subject to competition legislation, the overall accumulation of power across many markets is a separate question. The separation of financial and nonfinancial sectors is, at best, an indirect means of dealing with this issue, but it should at least limit the size of these institutions and their pervasiveness throughout the economy. The main means of achieving this objective has been to restrict bank ownership of nonfinancial corporations in Canada.

Canadian Ownership

Until 1967, foreign ownership of Canadian chartered banks was unrestricted. In fact, two fully foreign-owned banks operated in Canada at various times during the postwar period. Moreover, in 1965, nonresidents held more than a 24 per cent interest in at least two of the largest Canadian banks, and more than a 20 per cent interest in another.[5] The Porter Commission, addressing the issue of foreign control of banks, noted a number of possible dangers, including the allocation of banking business for noneconomic reasons and a lack of sympathy towards the goals of the Canadian monetary authority. The Commission concluded that "a high degree of Canadian

5 G. R. Conway, *The Supply of and Demand for Canadian Equities* (Toronto Stock Exchange, 1968). The proportion of shares held by nonresidents must be differentiated from the proportion of shareholders who are nonresidents. The Canadian Bankers' Association reports that, in 1974, residents owned 89 per cent of all bank shares, up from 77 per cent ten years earlier. In contrast, 94 per cent of all shareholders in 1974 were residents.

ownership of financial institutions is in itself healthy and desirable, and that the balance of advantage is against foreign control of Canadian banks."[6]

At present, in order to limit foreign ownership, a ceiling is placed on the proportion of bank shares that nonresidents may hold. Similar provisions apply to federally incorporated trust and mortgage loan companies and also to those incorporated in some provinces, though the provision is not general.

The Regulatory Structure

Canada has a complex institution-by-institution regulatory structure that is administered by both the federal and provincial levels of government. Banking was established as a federal responsibility in the BNA Act. As a result, banks have to be federally chartered, and the formulation and application of the Bank Act remain a federal prerogative. Nevertheless, certain of their functions – for example, as agent, issuer, and purchaser in direct markets – fall under provincial jurisdiction. And, although the activities of chartered banks, trust and mortgage loan companies, and co-operative deposit institutions overlap considerably, existing regulations confine these institutions to specialized market areas.

Much of the complexity of the regulations governing deposit institutions is the result of this divided jurisdiction. Trust and mortgage loan companies can be incorporated under federal and provincial jurisdiction and are restricted in their consumer and commercial lending activities by both federal and provincial legislation. In addition, any federally incorporated trust or mortgage loan company must receive a licence from provincial authorities in order to operate in most provinces. Moreover, the trustee activities of trust companies – a matter of property and civil rights under subsection 13 of Section 92 of the BNA Act – are governed by provincial legislation regardless of where they are incorporated. Conversely, provincially incorporated trust and mortgage loan companies proposing to do business in many provinces are required to qualify for deposit insurance under the Canada Deposit Insurance Corporation (CDIC). A similar division of responsibility occurs with respect to co-operative institutions. Credit union centrals, which are incorporated solely by provincial governments, have access to a lender of last resort through CDIC, though only if they have met specific conditions under the Co-Operative Credit Associations Act. Finally, foreign banks, although prohibited from calling themselves banks by the Bank Act, have entered a number of areas of activity through provincial incorporation.

Under federal jurisdiction, the number of authorities having responsibility for different institutions results in considerable complexity of regulatory responsibility. As can be seen from Table 5-1, each federally incorporated institution is subject to the authority of at least three federal agencies. Some degree of co-operation is ensured as members of certain regulatory authorities hold ex officio positions in other agencies.

6 *Report of the Royal Commission on Banking and Finance* (Ottawa: Queen's Printer, 1964), p. 374.

Table 5-1

Functions and Responsibilities of the Regulators of Deposit Institutions, 1975

	Federally incorporated		Provincially incorporated		
	Chartered banks	Trust & mortgage loan companies	Trust & mortgage loan companies	Credit unions	Caisses populaires
Federal					
Bank of Canada	Lender of last resort; regulator of liquidity				
Inspector General of Banks	Inspector; administrator of Bank Act				
Canada Deposit Insurance Corporation (CDIC)	Insurer of deposits; lender of last resort	Insurer of deposits; lender of last resort	Insurer of deposits (outside Quebec); lender of last resort	Lender of last resort	
Superintendent of Insurance		Inspector; administrator of Trust & Loan Act, administrator of Small Loans Act	Administrator of Small Loans Act	Administrator of Small Loans Act	Administrator of Small Loans Act
Minister of Consumer & Corporate Affairs	Administrator of Interest Act	Administrator of Interest Act	Administrator of Interest Act	Administrator of Interest Act	Administrator of Interest Act
Provincial					
Quebec Deposit Insurance Board (QDIB)			Insurer of deposits (in Quebec); lender of last resort		Insurer of deposits; lender of last resort
Registrar of Trust and Loan Companies		Licenser of business in provinces	Inspector; administrator of Trust & Loan Act; licenser of business in province		
Ministry of Financial Institutions (Quebec)					Inspector (delegated to centrals); administrator of Caisses Populaires Act
Supervisor of Credit Unions				Inspector; administrator of Credit Union Act	
Credit Union Reserve Board (some provinces only)				Insurer of deposits; lender of last resort	

The Deputy Minister of Finance is a director of the Bank of Canada and the CDIC. The CDIC board also includes the Inspector General of Banks, the Superintendent of Insurance, and the Governor of the Bank of Canada. To our knowledge, the division of responsibility among federal regulators does not result in any major problems in the implementation of regulation at present.

The divided jurisdiction between the federal and provincial governments has not precluded close co-operation between them. Indeed, many provinces have modeled their trust company legislation on federal acts. Some have followed the federal government's modifications of legislation; some have even entrusted the administration of their legislation to federal authorities.

Co-operation between the two levels of government has also been evident in the area of deposit insurance. Prior to passage of federal legislation in 1967, two provinces – Ontario and Quebec – passed legislation requiring that deposit institutions under their jurisdiction be covered by deposit insurance. But, once the federal government passed its own legislation, Ontario deferred to the federal government, and Quebec worked out an agreement on the division of responsibility for insuring the deposits of different types of institutions. Under this agreement, the Quebec Deposit Insurance Board (QDIB) undertook the insurance of deposits accepted in Quebec by all provincially incorporated institutions, regardless of province of incorporation. Part of the agreement between the federal government and the province of Quebec makes provision for short-term loans to be granted to the Quebec Deposit Insurance Board by CDIC in order to enable it to meet emergency liquidity needs in connection with its insurance operations. More recently, the federal government, under the Co-Operative Credit Associations Act, permitted CDIC to make loans for liquidity purposes on a short-term basis to co-operative credit societies and to provincially created corporations that provide, or administer, stabilization or liquidity funds for the benefit of credit unions. By this Act, the federal government undertook some responsibility towards provincially incorporated institutions that operate solely within the confines of the province of their incorporation.

Present arrangements lead to a diffusion of responsibility for inspection of the diverse set of institutions currently covered by deposit insurance. This structure of supervision and inspection is recognized in the organization of CDIC. The Inspector General of Banks examines, on behalf of the Corporation, the affairs of each bank; the Superintendent of Insurance examines, on behalf of the Corporation, the affairs of each federally incorporated trust company and loan company; and, where the Corporation enters into a contract of deposit insurance with a provincial institution, a person designated by the Corporation is permitted to examine the affairs of the company.

Although the present system of dividing responsibility for regulation and inspection between federal and provincial governments and among the various federal agencies has resulted in a lack of uniformity in the application and enforcement of regulation, this system, together with the considerable co-operation that has been evident between the two levels of government, has worked reasonably well over recent years.

Nevertheless, the adoption of the functional approach to regulation would necessitate some modifications to ensure uniform treatment of institutions undertaking similar activities.

The Effectiveness of Regulation

Many legislative bodies, as well as the officials who administer legislation, tend to assume that the existence of formal regulation is a guarantee of its effectiveness. If, for example, a statute requires that certain financial institutions refrain from undertaking certain kinds of business, then the presence of the statute is taken to be evidence that the corporations will refrain from engaging in such activities. For a number of reasons, however, the effectiveness of such regulation may, in practice, be limited.

Regulation may be badly designed, containing a number of loopholes that allow institutions to carry out activities in a form slightly different from that envisaged by the initiators of the regulation. Although such activities are in direct contravention of the spirit of the regulation, they are not, as a matter of law, an infringement of it. Ineffectiveness of regulation can also occur from the failure to anticipate new financial needs by businesses and households or new activities by the regulated institutions. In the latter case, ineffectiveness may be condoned by the regulators, in the knowledge that strict adherence to existing regulations can create substantial costs in the face of changing conditions. But the existence of ineffectual regulation raises a number of policy questions.

An immediate issue is whether ineffectiveness must be remedied through revision of the legislation or whether recognition of market reality should lead to legitimization of activities or actions. To answer this question, it is essential to determine whether the rationale of the regulation continues to be sound. If so, a further question is whether the commitment of resources required for effective enforcement would be appropriate. Given the resolution of these issues, the choice then involves either enforcement, though possibly in modified form, or acceptance of the ineffectiveness if the costs of enforcement are not justified by the rationale. A further important issue resulting from ineffective regulation concerns the approach to legislation. Ineffective regulation exposes the problem that present Canadian banking legislation is designed to last ten years without revision. Given the pace of change in financial markets, the inevitable failure of regulation to anticipate such changes correctly must lead either to some ineffectiveness or to the continued enforcement of provisions that are no longer appropriate.

This also raises the issue of choosing between a rigid legislative form of regulation and a more flexible approach that allows regulators to operate with discretion within a relatively broad legislative framework. With the latter, regulations could be altered by order in council at the discretion of the regulators in light of changing conditions and requirements. Such an approach is now used for trust and mortgage loan companies and parallels the procedures used in the United States for determining the range of activities that deposit institutions are permitted in that country.

An Evaluation of Existing Regulations

At present, deposit institutions are governed by a regulatory framework that depends on their basis of incorporation. As a consequence, institutions incorporated under the same legislation are governed by the same rules despite, in some cases, considerable differences in their activities. Similarly, institutions undertaking the same functions can be subject to different rules. With the exception of banking legislation, most of the regulations confine deposit institutions to a limited range of activities. Such a framework tends to foster specialization. There are two major arguments in favour of this approach to regulation. First, if institutions are concentrated in a narrow range of activities, their staff can be expected to develop a comprehensive knowledge and expertise. Second, by establishing the type of liabilities permissible for any type of lending business, the term structure of assets can be matched with that of liabilities; as a result, the risks to the institution will be reduced and the safety of deposits increased.

These advantages are not, however, without cost. Attaining depositor protection by requiring the close matching of the terms to maturity of an institution's assets and liabilities restricts it to performing only part of the intermediation process; thus the institution is constrained in its possibilities of reducing risk for others by diversification and transfer of risk. In addition, while this approach may be adequate to satisfy the current demand for financial services, it fails to satisfy new and unanticipated demands. Regulations that confine each type of deposit institution to specific activities will almost invariably create unsatisfied demands, which, in turn, will require either new financial institutions or the circumvention of regulations by existing institutions.

It has also frequently been argued that limiting the number of institutions conducting each specialized financial activity can ease the task of the monetary authority to the degree that it wishes to direct its policy towards specific types of activities and not to others. By contrast, the greater the variety of institutions performing any function and the larger the number of activities performed by some institutions, the more difficult it becomes for the monetary authority to direct credit towards, or away from, specific uses. Diversified institutions could offer households and businesses a variety of ways to finance any expenditure. Similarly, if the directives were applied to one type of institution but not to others, the wider the range of institutions providing a given type of finance, the easier it would be for borrowers to avoid the impact of the directives.

The advantages, however, of directing monetary policy towards a few selected sectors can be seriously questioned. The cost of responding to monetary policy would be greater, not just to the affected sector but to the overall economy, than that of a more diffuse response over a broader range of activities. We believe that, for reasons of efficiency, the impact of a restrictive monetary policy should be spread among competing borrowers. By removing obstacles separating the sources of finance for different activities, the costs to the economy of adjusting to changes in monetary policy will be reduced.

The Functional Approach

While the present regulatory structure allows the achievement of many objectives, it may inhibit the efficiency of deposit institutions and the markets in which they operate. Our overall concern about efficiency has led us to favour a functional approach to regulation of deposit institutions. The functional approach involves the regulation of activities of deposit institutions on a function-by-function basis. Instead of restricting particular institutions to particular functions, all deposit institutions would be allowed to undertake similar functions, provided they met the regulatory requirements established for each function. New institutions would be able to choose the combination of functions that they could perform most efficiently and competitively with existing institutions. Foreign institutions could also be accommodated within a functional regulatory framework, albeit in accordance with the ongoing concern about foreign control in the financial sector.

The purpose of this approach would be to stimulate efficiency in intermediary and other activities undertaken by deposit institutions by encouraging competition among existing suppliers of those services, by reducing the cost of entry into these activities for existing institutions serving related markets, and by encouraging the entry of new firms into these areas of activity. Many of the markets served by deposit institutions in Canada are oligopolistic in nature, particularly those involving commercial, mortgage, and consumer lending. This market structure is, to a large extent, the result of the institutional approach to regulation, which tends to compartmentalize the various deposit institutions in particular areas of activity. The degree of oligopoly in these markets could be reduced most effectively by allowing and encouraging greater entry into these financial activities by existing institutions, new institutions, and foreign institutions. With easier entry into an oligopoly, existing market participants, as well as new entrants, would be more concerned about the cost of producing services, more innovative in their approach to those services and, generally, more dynamic in their operations. In addition, by fostering greater competition and innovation, these production costs should be lower than they were when there was less possibility of entry.

Regulation by function is superior in terms of meeting new and unanticipated demands for financial services, providing for the transfer and reduction of risk, and minimizing the costs of monetary policy adjustments. As a result, we believe that this approach to the regulation of deposit institutions would more effectively fulfil the needs of the Canadian economy for intermediary services. Therefore,

Recommendation 1

We recommend that the federal and provincial governments adopt an approach to the regulation of deposit institutions whereby the rules governing any such institution shall relate to the activities or functions undertaken by that institution. Deposit institutions would include all financial institutions offering liabilities of fixed money value that can be cashed on demand or on short notice, or that can be transferred to other parties by payment order. Any institution performing this function should be regulated by either federal or provincial authorities.

The functional approach, although desirable from the point of view of efficiency, creates a number of problems within the Canadian jurisdictional context. In addition to cutting across institutional lines, this approach also cuts across constitutional jurisdictions. Under the present federal-provincial division of powers in the financial sector, it is difficult to achieve uniformity of regulation. In order to institute an effective functional approach to regulation, a choice between either dominance by the federal government or a high degree of co-operation and co-ordination between the two levels of government will have to be made, depending on the case.

If sole responsibility for deposit institutions were assumed by the federal government, federal control would have to be extended to institutions currently under provincial jurisdiction. We see a number of disadvantages to such a transfer of responsibilities, even if it involved only deposit institutions doing business in more than one province. This solution would impose costs on institutions that are currently provincially incorporated by forcing them to qualify for, and obtain, federal incorporation.

Some would argue that this transfer of responsibilities to the federal government is possible under subsection 15 of Section 91 of the British North America Act, which grants exclusive powers over banking to the federal government. But this approach is certain to be strenuously opposed by provinces that already incorporate, supervise, and regulate some major deposit institutions. If this approach were used and the anticipated conflict occurred, it might be some time before a settlement could be reached and only after affected institutions had faced prolonged uncertainty and attendant costs. Thus it can be said that the extension of federal jurisdiction over the activities of all deposit institutions is not only unnecessary in terms of their efficiency, but it may also create a major obstacle to the desired end – the productive reform of the deposit-taking sector.

Indeed, we believe that the present division of regulatory responsibility between the two levels of government is not an obstacle to achieving effective co-operation in the administration of regulations. The major problem would be for them to adopt compatible rules. In this regard, many of our recommendations are clearly directed to the federal government, whereas others are aimed at provincial governments. Implementation of these proposals will thus require further co-operation among governments.

We are concerned that division of regulatory authority at the federal level could pose difficulties for the implementation of policy. To reduce this possibility, we conclude that the present office of the Inspector General of Banks and those sections of the office of the Superintendent of Insurance dealing with trust and mortgage loan companies, together with the administration of the Canada Deposit Insurance Corporation, should be integrated. A Supervisor of Deposit Institutions should be given responsibility for the implementation of all federal legislation governing deposit institutions and should have an audit and analysis capacity for monitoring the activities and performance of deposit institutions. We also believe that the supervisor should have responsibility for reviewing the continuing appropriateness of legislation and initiating proposals for revision. Therefore,

Recommendation 2

We recommend that federal and provincial governments each take steps, where necessary, to establish a single authority for the regulation of deposit institutions within their jurisdiction. At the federal level, a new position of Supervisor of Deposit Institutions should be created to incorporate the present responsibilities of the Inspector General of Banks and those of the Superintendent of Insurance dealing with trust and mortgage loan companies. In addition, the Supervisor of Deposit Institutions should have responsibility for the administration of the Canada Deposit Insurance Corporation.

Conclusion

Our analysis of the existing regulations governing deposit institutions in Canada has shown that, because of the institutional orientation of these regulations, they have been unable to achieve fully the goals set out for them. At the same time, there is a complex division of responsibility between the federal and provincial governments for the enforcement of regulation and the inspection of deposit institutions.

Our concern about the efficiency of deposit institutions has led us to recommend the adoption of a functional approach to the regulation of their activities. While the adoption of this approach is likely to raise a number of jurisdictional problems, the development of close co-operation between the federal and provincial governments should contribute to the required uniformity and consistency in the regulation of deposit institutions.

6

SOME IMPLICATIONS OF THE FUNCTIONAL APPROACH

In the preceding chapter, we recommended steps designed to promote competition and efficiency in the deposit-taking sector within the framework of a function-by-function approach to regulation. We are also concerned with other aspects of regulation, which, though not directly related to the efficiency objective, require consideration in light of the functional approach. This has led us to examine the rationale for deposit insurance, reserve and liquidity requirements, and borrowing limits (debt/equity ratios) and to propose certain changes in present arrangements.

Deposit Insurance

Deposit insurance is directed primarily towards the protection of depositors, but it can achieve other objectives as well. For example, the response of financial institutions to changes in their cash reserves is likely to be more predictable when the prospect of changes in public confidence is ruled out. Similarly, the protection of depositors against loss permits smaller and newer deposit institutions to compete more effectively against larger and longer-established institutions.

Not all deposit institutions are covered by deposit insurance. Outside Quebec, no coverage is provided for co-operative credit institutions. Reserve funds have been established, either voluntarily or by government requirement, that provide some protection for depositors, but these funds fall considerably short of full deposit insurance. In British Columbia, for example, the Credit Union Reserve Board maintains approximately 1 per cent of the credit unions' liabilities in a guarantee fund. While this amount has proved adequate for any contingencies until now, without any explicit commitment of support from government it cannot offer full protection in the event of a severe financial crisis. And the way these funds are invested at present – some are even invested back into credit union centrals – only a portion could be mobilized quickly to meet any problems that might arise. With this large volume of claims on credit unions lying outside the scope of deposit insurance, and as part of our functional approach to regulation, it is our view that provincial governments should take steps to ensure that all depositors at provincially incorporated institutions, including credit unions, be protected by deposit insurance. While provinces may wish to make their own arrangements, the facilities of the Canada Deposit Insurance Corporation should be made available to credit unions under an arrangement similar to that currently being used for provincially incorporated trust and mortgage loan companies. Therefore,

Recommendation 3

We recommend that provincial governments take steps to ensure that depositors at all provincially incorporated deposit institutions, including credit unions, be protected by deposit insurance.

Deposit insurance is currently provided for all Canadian-currency deposits under $20 thousand held at insured deposit institutions. Institutions insured under CDIC are required to pay a premium of one-thirtieth of 1 per cent of their insured deposits per year. At the end of 1974, CDIC had approximately $70 million available to meet claims on insured deposits. In case of a failure beyond the value of the accumulated fund, CDIC is empowered to borrow up to $500 million from the Consolidated Revenue Fund. The Quebec Deposit Insurance Board, in contrast, does not charge any premium and lacks any accumulated fund. By agreement between Quebec and the federal government, QDIB can borrow from CDIC to meet any settlement.

Although the possibility is slight that more support than the CDIC can provide would ever be required, and even though legislators might be expected to extend the limit in the event of a catastrophe, there is good reason to avoid complacency about the present arrangements. CDIC has guaranteed over $40 billion in deposits. While eventual losses from the failure of an institution are likely to be small relative to its total deposits, such assets as loans and mortgages would be repaid only over a fairly long period of time. The amounts needed to deal with the interim problem of meeting depositors' immediate claims could be much larger than the ultimate losses to be met by CDIC. In addition, given the circumstances under which CDIC would require assistance, it is uncertain whether legislative action could be taken quickly enough to forestall problems that would arise if CDIC reached its borrowing limit. Because of the very high costs to the financial system in the unlikely event of CDIC being temporarily unable to meet its commitments, we believe that the borrowing powers of the corporation should be expanded to correspond more closely to the current level of contingent liabilities.

One problem with specifying a limit to the borrowing power of CDIC is that growth in insured deposits will eventually make any figure obsolete. Therefore, we believe that the borrowing power should be set at a proportion of the deposits protected by the corporation. Moreover, the limit of the latter should be substantially increased, if only to compensate for the growth of deposits since 1967. Therefore,

Recommendation 4

We recommend that the borrowing power of the Canada Deposit Insurance Corporation, through the Consolidated Revenue Fund, be set at a proportion of at least 5 per cent of deposits protected by the Corporation.

With respect to depositor protection, deposit insurance is subject to problems because, as with other types of insurance, it could influence the behaviour of the insured and thus alter the probability of the insured event. Depositors will be less concerned with the characteristics of the institutions when their deposits are insured. If institutions pay different rates on deposits, with deposit insurance the depositors will tend to shift their funds from institutions with low risk and low return to those with higher risk and higher return. In addition, deposit institutions themselves will be less reluctant to take risks. In the absence of deposit insurance, a deposit institution could choose between a portfolio with a low risk and a low return, the advantage of which is the assurance that depositors' claims will be met, and a portfolio with a higher risk and greater return, for which the main attraction is the higher returns. When the presence of deposit insurance eliminates doubts about the safety of deposits, deposit institutions may be forced to hold assets with higher risk and higher return in order to compete for deposits by paying higher interest rates.

As with other types of insurance, the deposit insurer must know, and be able to limit, the risk against which he is providing insurance. He can limit his risk by charging variable premium rates for deposit insurance, based on the type of assets held by the insured corporation. With variable premium rates, movement to a portfolio with higher risk would subject an institution to higher insurance premiums. Similarly, if depositors were to move to institutions with higher risk, they would also, indirectly, pay higher premiums. Alternatively, as is presently the case, the deposit insurer can define the risks he insures by establishing eligibility requirements for deposit insurance.

One dimension shaping the diversity of risks is the volume of uninsured business carried on by an insured institution. While deposit insurance on any of the liabilities of an institution reduces the risk for other liability holders, uninsured depositors increase the risk of the deposit insurer. In the absence of deposit insurance, any sign of difficulty for a deposit institution will lead depositors to withdraw their funds to ensure their safety. With deposit insurance, holders of insured balances will have less incentive to withdraw their funds; as a result, competition for conversion will be limited to foreign-currency balances and Canadian-currency deposits exceeding $20 thousand. In effect, deposit insurance increases the safety of these uninsured deposits, despite their exclusion from coverage. Given the added safety provided by deposit insurance, Canadian institutions can compete effectively for these deposits at lower interest rates than otherwise. The existence of these deposits and the potential drain on the assets they represent increase the probability that the deposit insurance agency will be required to pay considerably higher amounts in case of failure.

The CDIC could restrict the degree of risk it has to bear by establishing a set of rules determining acceptable assets and liabilities, and the various limits affecting them. But strict regulation in terms of prohibition and limits to ensure low risk can impose substantial costs in terms of the ability of financial institutions to meet the needs of savers and borrowers. In more practical terms, the range of institutional activities presently covered by deposit insurance renders it very difficult to prescribe permitted activities to any degree without substantially limiting the activities of one institution or another. This would also inhibit the adoption of a functional regulatory approach.

At present, all deposit institutions pay the same insurance premium rate. As an alternative to detailed regulation, this rate could vary according to factors such as the volume of uninsured liabilities and their maturity relative to insured liabilities, the maturity structure of assets relative to liabilities, past loss experience, and the size and diversification of the institution. Therefore,

Recommendation 5

We recommend that the Supervisor of Deposit Institutions implement a system of variable premium rates for deposit insurance, according to established criteria reflecting the differences among institutions with regard to potential claims on the insurer.

Initially, the determination of appropriate rates for deposit insurance may pose some difficulty for administrators. But it is easy to exaggerate the problems of formulating a system of variable premiums for deposit insurance. Judgments about risks are made implicitly, at present, to determine eligible assets and their maximum proportion in the portfolios of financial institutions. Similar decisions are made continually by financial institutions in their lending decisions, by bond-rating companies in their assessment decisions, and by bank regulators in other countries, especially the United States, in their judgment of the adequacy of bank capital. Thus we believe that any difficulty could be readily overcome so that a system of variable premium rates could be established.

Reserve and Liquidity Requirements

The reserve requirements that apply to deposit institutions vary considerably. Among them, only chartered banks are required to hold primary reserves that do not yield any return. In addition, chartered banks can, at the discretion of the Bank of Canada, be required to hold secondary reserves in the form of cash in excess of the required primary reserves, treasury bills, or day loans to investment dealers with whom the Bank of Canada is prepared to enter into purchase and resale agreements. The reserve requirements for other deposit institutions resemble the secondary reserve requirements for chartered banks. Federally incorporated trust and mortgage loan companies are permitted to hold their reserves as cash, as deposits with other institutions, or as bonds of, or guaranteed by, the federal government or any province. The requirements for provincially incorporated trust and mortgage loan companies are similar, whereas those for credit unions vary by province.

A major justification for primary reserve requirements stems from the role of deposit institutions in the transmission of monetary policy. Whether the target of monetary policy is some monetary aggregate, the level of interest rates, or credit conditions in general, the key to the central bank's policy is its ability to influence the liabilities of deposit institutions. These institutions supply the public with the means of payment and its close substitutes, which are prime targets of monetary policy. The central bank's control over these monetary aggregates is exercised through its ability to manage the amount of cash available to deposit institutions to meet their cash reserve ratio, whether chosen voluntarily or imposed by legal requirement.

In certain circumstances, a minimum reserve requirement might contribute to the central bank's ability to maintain close control of the money supply. In the absence of legal reserve requirements, the desired relationship between the liabilities of deposit institutions and their cash reserves might tend to fluctuate in response to changes in their taste for risk or in the technology of cash management. The central bank could increase the predictability of the response of deposit institutions by imposing a reserve requirement higher than the level the banks would be expected to hold voluntarily. However, we have argued in the preceding chapter that the regulation of primary reserve requirements is not essential for the central bank to exercise effective monetary control because, as long as the relationship between the cash reserves and deposit liabilities of the institutions remains stable, the monetary authority's controls could work, as they do now, with specific reserve requirements. Even if the relationship between reserves and deposits shifts over time, the central bank can exercise effective monetary control by altering the volume of cash reserves available to the banking system in response to the shift in desired reserves.

Secondary reserve requirements are also justified in terms of their contribution to monetary policy, in that they can affect the composition of credit flows. These requirements act to direct credit towards eligible uses – day loans and treasury bills – but do not alter the overall volume of credit that can be extended by the banks. The effects of secondary reserve requirements on interest rates are less clear. For example, if government demand for finance is unresponsive to the rate of interest, the same composition of credit can be obtained whatever the interest rate may be. In such a case, the secondary reserve requirement merely shelters government finance from higher interest rates, while the interest rate in the unsheltered sector remains as high as it would have been otherwise. The secondary reserve requirement is, then, a cost to bank depositors and shareholders. Alternatively, if government finance is responsive to interest rates, secondary reserve requirements will direct credit towards the government and lead to higher interest rates in the unsheltered sector. The secondary reserve requirement then becomes not only a charge on the bank but on other borrowers as well. Either way, the total volume of credit extended by the banking sector remains unchanged by the use of secondary reserve ratios.

Several other arguments might be put forward for the use of secondary reserve requirements in the implementation of monetary policy. First, it might be judged desirable to insulate government expenditures from the effects of monetary restraint because of the inherent desirability of these expenditures. As we have seen, such an argument requires that government finance be responsive to interest rates so that the imposition of liquidity ratios would alter the distribution of credit in favour of the government sector. We find it difficult to see any grounds for advocating a specific charge on bank depositors and shareholders as an approach to reducing the cost of such finance. Second, these reserve requirements might provide increased scope for monetary policy by insulating the Canadian economy from international capital flows. Since interest rates in the sheltered market are lower than they would be in the absence of this protection, foreign capital will be less likely to move into this market. Secondary reserve requirements could contribute to an autonomous monetary policy to the extent that, given constant interest rates, capital flows were less mobile in the unsheltered market than in the sheltered market. The validity of this argument could be determined by examining empirically the responsiveness of capital flows in the various markets. In Canada, as we have indicated earlier, the sheltered market is composed of day loans and treasury bills. Since the early 1960s, this market has been confined almost exclusively to the central bank and to chartered banks. As a consequence, determination of interest elasticity is impossible. On the other hand, the unsheltered market includes government securities close to maturity and borrowing by large corporations – areas in which the interest sensitivity of capital flows is likely to be high.

The composition of required reserves differs according to their purpose. If the reserve requirement exists for monetary policy purposes, eligible assets include those subject to effective control by the central bank. On the other hand, if the reserve requirement is meant to subsidize borrowing costs on certain types of debt, eligible assets include those issued by groups for which a subsidy was intended.

Reserve requirements, as well as many other regulations, can be viewed as a form of tax on deposit institutions. The cost to institutions consists of revenues forgone by holding specified assets rather than those which might have been held in the absence of the requirements. Revenues from the tax accrue to the issuers of assets held as reserves by the deposit institutions, and they consist of the difference between the interest on their debt in the absence of requirements and the interest expenses actually incurred.

The impact of reserve requirements on the profit rate of banks can be estimated under various assumptions about rates of return on alternatives to reserve holdings. On the assumption that the return forgone on reserves had been the same as that realized on loans, the average before-tax profit rate of banks would have been 31.5 per cent rather than 23.1 per cent for the 1967-73 period. This estimate, however, is excessive since, even in the absence of legal requirements, banks would still hold some reserves. To take this into account, we present a second estimate in which the forgone return is assumed to be equal to half the yield on loans (Table 6-1). This is the same as assuming, for example, that banks would invest half the resources they formerly held as reserves in assets on which the yield is equal to the average yield on their loans and put the other half in liquid assets with no return. According to this estimate, which we consider to be more realistic, the cost of reserve requirements in terms of the average bank profit rate would have been 4.3 percentage points over the 1967-73 period.

At present, the Bank Act requires that 12 per cent of demand deposits and 4 per cent of notice deposits be held as primary reserves. It is very difficult, however, to justify these levels for purposes of monetary policy. To the extent that reserve requirements contribute to the workings of monetary policy, this contribution could be offset by the present difference between reserve ratios levied against demand deposits and term

Table 6-1

Effect of Reserve Requirements on the Before-Tax Rate of Profit of Chartered Banks, 1967-73

		Profits as a percentage of equity			
		Based on average yield on loans		Based on half the average yield on loans	
	Actual	Without primary reserves	Without primary and secondary reserves	Without primary reserves	Without primary and secondary reserves
		(Per cent)			
1967	16.6	22.2	22.6	19.3	19.5
1968	21.3	27.0	27.6	23.9	24.2
1969	22.3	31.2	31.7	27.8	28.0
1970	22.1	31.7	32.0	28.1	28.3
1971	26.3	30.8	31.9	27.4	27.9
1972	26.5	33.2	36.2	29.7	31.2
1973	26.3	35.0	38.4	31.2	32.8
Average, 1967-73	23.1	30.2	31.5	26.8	27.4

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, and *The Canada Gazette.*

deposits, because any change in the composition of deposits alters the required reserve holdings. In addition, the difference between these types of deposits is, in many cases, more apparent than real; cheques can be issued against notice deposits and, to our knowledge, notice is seldom required for withdrawal. Therefore,

Recommendation 6

We recommend that cash reserve requirements be applied to all deposit institutions on an equal basis according to the nature of their liabilities. Reserve requirements should only be levied against demand deposits, notice deposits, and term deposits with an earliest maturity of less than 100 days and should be set at a level of no more than 4 per cent of the relevant deposit liabilities. The holding of such reserves should be made a condition for direct access to the clearing system and for coverage under deposit insurance. Depending on the institution, these reserves could be held at either the Bank of Canada or an approved depository.

Since we recommend that all deposit institutions be allowed to undertake the same activities, they must be equally subject to the same obligations, particularly where reserve requirements are concerned. Some people have advocated that interest be paid on the reserve holdings of deposit institutions. While we do not make any recommendation to this effect, we do believe that, to maintain equality of treatment for the various institutions, reserves should bear interest for all or none of them.

The extension of primary reserve requirements to credit unions poses some practical problems. The nature and number of local credit unions make the application of mandatory reserve holdings for locals at the Bank of Canada or at an approved depository difficult. On the other hand, credit union centrals should be obliged to comply with the requirements as a condition for direct membership in the clearing system. Moreover, recent liquidity crises in the credit union movements in some provinces lead us to believe that the liquidity management practices of credit unions could be improved. Accordingly, we suggest that provincial authorities review the appropriateness of the liquidity requirements that are applied to local credit unions.

In addition to the primary reserve ratios imposed on chartered banks, differing minimum liquidity requirements exist for some deposit institutions. Whereas chartered banks must comply with secondary reserve requirements, other deposit institutions must satisfy liquidity ratios. The secondary reserve requirements, directed more towards debt management, are met to a major degree by securities of the federal government. In contrast, the liquidity ratios, directed towards ensuring sound management, can be met by a range of securities that fulfil maturity, and other, criteria. We see some merit in retaining the type of liquid asset reserve requirements that currently governs trust companies, mortgage loan companies, and credit unions. The advantage of such liquidity requirements depends on the breadth of the market for assets that meet the requirement. We do not subscribe to the principle that any one type of security should be subsidized by being the major component of required liquid reserves; nor can we find any principle for determining the assets to be subsidized. We therefore conclude that, although secondary reserve requirements should be retained to ensure sound portfolio practices, the range of assets eligible for such requirements should be determined mainly with reference to their marketability. Therefore,

Recommendation 7

We recommend that the principle of liquidity ratios be maintained and applied to deposit institutions according to the nature of their liabilities. The range of assets eligible for such requirements should, however, be broad and should be determined with reference to the marketability of such assets.

Debt/Equity Ratios

Regulations imposing a maximum on the debt/equity ratio of deposit institutions limit the expansion of their deposit business to some multiple of the excess of their assets over their liabilities. These regulations are aimed at ensuring the solvency of an institution by requiring that the value of its assets exceed the value of its deposit liabilities by some margin. Once an institution reaches its limit, it must either expand its equity accounts by the issue of additional shares or the accumulation of retained earnings or cease to expand its deposit liabilities.

Such a borrowing limit is presently imposed on trust and mortgage loan companies and is set out in the legislation of the jurisdiction in which the companies are incorporated. A company generally does not have the right to borrow up to the maximum ratio allowed by law; rather, its specific limit is determined by the supervisory agent.

The use of borrowing limits to protect depositors is subject to a number of practical limitations. First, there may be other than depositors' liabilities against the assets held by the institution. For example, an institution's equity might be impaired by commitments arising from leases or guarantees to subsidiaries or affiliated companies. Second, and probably more important, the effectiveness of borrowing limits depends on the accounting procedures used in evaluating an institution's assets. At present, government bonds and mortgages are carried at book, rather than market, value. In times of high interest rates, when bond and mortgage values fall below their book values, the realizable excess of assets over liabilities of a trust or mortgage loan company could fall substantially below its book value. In other words, the unimpaired equity does not provide the degree of depositor protection implied by the borrowing limit. On the other hand, when the market value of an institution's security holdings exceeds the book value, the depositor has more than the intended degree of protection.

Some indication of the significance of these considerations can be seen by comparing the market valuation of a company's equity – that is, the price per share times the number of outstanding shares – with the value appearing in its books. Given an adequate flow of information to the participants, the market value of the firm's outstanding shares should reflect the value of the excess of assets over deposit liabilities. Our examination of book and market valuations of equity for different trust companies reveals substantial differences. At times, the market value of equity for some trust companies was more than double its book value whereas, at the same time, the market value of equity fell short of the book value for other companies. Yet both groups of companies were governed by the book value in relation to their borrowing limits. When the book value of equity is lower than its market value, depositors enjoy greater protection, but the institution's borrowing capacity is restricted. Conversely, if the book value of equity exceeds its market value, depositor protection is lower and the institution's borrowing limit is higher.

The borrowing limits for trust and mortgage loan companies can affect the evolution of financial markets by inhibiting the growth and ability of these companies to compete relative to other institutions. Table 6-2 shows the debt/equity ratios for selected trust and mortgage loan companies and for chartered banks. Banks, on the whole, have had appreciably higher ratios than trust and mortgage loan companies. As a result, the growth of trust and loan companies, compared with that of chartered banks, could have been inhibited by these limits.

The limits also affect the relative size of different trust and mortgage loan companies. In cases where the market valuation of shareholders' equity greatly exceeds the book value of the difference between assets and liabilities, a firm's ability to expand, based on the book value of debt/equity ratios, is limited, even though, as we have mentioned earlier, depositor protection, as valued by the market, exceeds the statutory minimum; in cases where the market valuation falls short of book value, a firm may expand beyond the point where there is effective depositor protection. To a

Table 6-2

Debt/Equity Ratio of Major Deposit Institutions, 1973[1]

Chartered banks[2]	
Bank of Montreal	28.5
The Bank of Nova Scotia	23.9
The Toronto-Dominion Bank	24.4
The Provincial Bank of Canada	26.4
Canadian Imperial Bank of Commerce	22.5
The Royal Bank of Canada	24.8
Bank Canadian National	24.5
The Mercantile Bank of Canada	14.4
Bank of British Columbia	21.7
Trust companies[3]	
Canada Permanent Trust Company	12.5
The Canada Trust Company	17.3
Guaranty Trust Company of Canada	20.2
Montreal Trust Company	16.4
National Trust Company, Limited	16.3
The Royal Trust Company	23.3
United Trust Company	14.7
Victoria and Grey Trust Company	21.9
Loan companies[4]	
Canada Permanent Mortgage Corporation	10.7
Crédit Foncier Franco-Canadien	7.3
The Huron & Erie Mortgage Corporation	12.0

1 As of December 31.
2 Bank debt includes total deposits and outstanding debentures; bank equity includes equity paid up, rest account, accumulated appropriations for losses, and undivided profits.
3 Trust company debt includes demand and term deposits, and certificates; their equity includes equity paid up, general reserve, investment reserves, and retained earnings.
4 Loan company debt includes demand and term deposits, and outstanding debentures; their equity includes equity paid up, general reserve, investment reserves, and retained earnings.
SOURCE Based on data from *The Canada Gazette*, 1973; and *Report of the Registrar of Loan and Trust Corporations for the Province of Ontario*, 1973.

degree, the selection process implied by the present type of limits on debt/equity ratios is perverse; institutions that have managed to increase the market value of their portfolios beyond their book value are penalized relative to those that are suffering losses.

The federal government has recently taken steps to revise the borrowing limits applied to trust and mortgage loan companies. These companies will soon be permitted to pass by-laws that will extend their borrowing beyond the limit of twenty times the excess of a company's assets over its liabilities, subject to ministerial approval. Among the conditions for such approval is the requirement that a company must issue subordinated notes to some proportion of the borrowing in excess of the present limit.[1] Trust companies will also be able to exceed the limit to the extent that

1 Subordinated notes give their holder a claim subordinate to that of all creditors of the company, but with priority over the shareholders.

cash held by the company and the market value of federal and provincial government securities exceed 20 per cent of the aggregate of a number of categories of liabilities potentially payable in 100 days. The wisdom of the effort to revise the legislation in this way is questionable; it appears to be so complicated as to require excessive resources for its enforcement. Even more questionable is the amendment of a regulation that is now so ineffective in attaining its purpose.

We conclude that borrowing limits in their present form are ineffectual instruments for achieving depositor protection, because they may have perverse effects in terms of their incidence across institutions. Therefore,

Recommendation 8

We recommend that federal and provincial legislation governing trust and mortgage loan companies be amended to remove the borrowing limits of these companies.

The debt/equity ratios of deposit institutions could, however, still be monitored and used in calculating the variable deposit insurance rates proposed elsewhere in this report. In this way, the relevant information could be integrated into the major regulatory process that now ensures depositor protection in Canada.

7 THE ENTRY OF CANADIAN-OWNED INSTITUTIONS INTO NEW FINANCIAL ACTIVITIES

In the preceding chapters, we emphasized the need for greater competition and efficiency in the Canadian deposit-taking sector. By encouraging nonbank deposit institutions to enter additional lending fields and by permitting existing banks to undertake additional financial activities, substantial progress towards achieving these goals would be made.

Banking and Competition

Canadian banks have a very strong position in the retail banking field, although competition has increased because of the entry of credit unions, caisses populaires, and trust companies into deposit-taking activities and lending to households. These nonbank institutions have not, however, been able to compete with chartered banks in the field of commercial lending because of regulatory restraints on their activities. Their absence in commercial lending has likely affected small business borrowers, who have often expressed dissatisfaction with the banking services available to them.

This situation has also meant that banks have maintained a considerably higher rate of profit than industry in general. We have also found that the difference between the rates paid on deposits and the business loan rates of banks has increased since 1968; that is, the profit opportunities in one of their major markets has increased. Several explanations for this situation were presented in Chapter 4. The explanation that we have retained, however, is that the Bank Act revision of 1967, by not adequately encouraging further competition among financial institutions, enabled chartered banks to increase their importance as a group in retail markets, most noticeably in the retail commercial loan market.

Thus consumers of banking services have a major interest in regulations fostering greater entry into retail banking. Increased competition would tend to make the banking industry more cost-conscious in its operations. This, in turn, would encourage the pricing of services in relation to their production costs. It could also lead to a more rapid development and diffusion of banking innovations, such as online banking services, automated tellers, and other related technical services, which would further reduce the costs of banking operations and of making payments. As a result, there would be improvement in the terms at which loans were made available, particularly to small businesses, and in the amount of interest paid to depositors.

The Porter Report recognized the benefits of increasing competition in financial markets and, in order to accomplish this, recommended that trust and mortgage loan companies, as well as all other deposit institutions, be brought under federal jurisdiction and chartered as banks. Under the Commission's scheme, nonbank deposit institutions, while retaining their existing powers, would have acquired other banking privileges, particularly in commercial lending. The proposals allowed credit union locals to remain under provincial jurisdiction but suggested that their centrals be federally regulated and hold deposits at the Bank of Canada. Later, banks would be allowed near bank privileges, including trust powers, thus enlarging the range of activities for all deposit institutions.

Our concern about a number of the basic issues involved in the entry question is slightly different. We are not, for example, convinced of the necessity for extending federal control to all deposit institutions. Under our functional approach to regulation, it is only necessary to achieve regulatory consistency for each function, which, with sufficient federal-provincial co-operation, could be accomplished without federal dominance. At the same time, we are uneasy about the conflicts of interest that might occur in institutions operating estate, trust, and agency business while carrying out intermediary functions. Finally, we accept the ownership rules established for chartered banks as an important means of limiting the concentration of power in Canada.

There are three main reasons for the difference between our proposals and those of the Porter Commission. First, the Commission was more concerned than we are about monetary policy and the power of the Bank of Canada. We are confident that monetary policy can be sufficiently flexible without extensive or rigid primary and secondary reserve requirements. Second, we think that the advantages of foreign entry merit the integration of foreign subsidiaries into the Canadian regulatory structure. We believe the Canadian market can be adequately safeguarded from domination by large foreign banks through existing ownership rules that limit the concentration of shareholdings in large deposit institutions and through the additional measures that we propose in the following chapter. Finally, since the Porter Report of 1964, deposit insurance has become a part of the financial system, so that the central authority can now have sufficient control over financial institutions operating under provincial jurisdiction to make federal charters for these institutions unnecessary.

There are several methods that Canadian-owned nonbank deposit institutions could employ to enter banking markets. The institutions could become banks under federal jurisdiction, provided they satisfied certain criteria that would be somewhat less restrictive than those currently in existence. Alternatively, they could establish banking subsidiaries, which would be subject to the Bank Act. Finally, near banks could remain under provincial jurisdiction, but their powers should be extended to include commercial lending, provided a number of clauses similar to those in federal legislation governing deposit institutions were incorporated into provincial legislation. In this latter case, the provinces should adopt the principle that a firm in the nonfinancial sector should not control a bank or a near bank; that federal requirements concerning the concentration of ownership should also be applied in provincial jurisdictions; and that commercial lending powers should not be granted to firms maintaining estate, trust, and agency business without provision for separation of these activities.

We believe that these principles will be acceptable to most provincial authorities. If not, then we are confident that the federal government can take the steps necessary to ensure that a province wishing to extend commercial and consumer lending power to institutions under its jurisdiction meets its criteria. For example, institutional access to the clearing system could be made conditional upon provincial regulation matching federal requirements. Deposit insurance coverage is another example. At present, the Canada Deposit Insurance Corporation can require institutions to be in substantial conformity with federal legislation. Any institution failing to conform could be excluded from deposit insurance – a factor that, under present conditions where competitors are covered, would be a major deterrent to growth. Finally, if the provinces were unwilling to impose equivalent provisions, the federal government could, under the terms of the British North America Act, challenge any legislation extending banking powers to provincially incorporated institutions.

For federal institutions, we support a far more rapid incorporation process, through the use of letters patent, rather than the existing system that requires passage of an Act of Parliament. This method should not lead to any change in the requirements for a charter, but it would reduce the waiting period new entrants now face. Any Canadian institution currently carrying on deposit activities should be eligible to receive a bank charter, either in its own name or on behalf of a subsidiary company. This recommendation is intended expressly to include trust and mortgage loan companies, credit unions, and caisses populaires. In addition, other individuals or institutions, such as sales finance companies, would be eligible to apply for a bank charter.

Under this scheme, there would be no ownership restrictions for new Canadian-owned banks during an initial transition period unless they became larger than a designated size. The legislation should state explicitly the latitude of the Supervisor of Deposit Institutions in determining the size limitation and the length of the transition period. After the transition period, a bank could remain wholly owned by any Canadian, or eligible group of Canadians, on condition that the number of branches and the size of the bank, measured by the current value of assets, be limited to that allowed during the transition period. If a bank wanted to expand beyond this designated size after the transition period, the major founding interest could retain more than 10 per cent (possibly 25 per cent) of the shares, the maximum presently allowed for shareholders of banks. If an institution became sufficiently large, however, the 10 per cent maximum should apply to all shareholders, after a designated divestiture period. Therefore,

Recommendation 9

We recommend that the Bank Act be amended to make provision for 1/ closely held banks, with no limit to the shares held by one interest, such entrants being subject to restrictions on activities in terms of the number of branches and asset size; and 2/ controlled banks, with a maximum of 25 per cent of outstanding shares held by one interest, such entrants being subject to a maximum size limitation. Each of these institutions shall be subject to conditions similar to those that will apply to widely held banks with respect to separation of financial and nonfinancial activities.

These proposals are designed to attract new entrants into banking by permitting the major interest in a near bank, or those undertaking *de novo* entry, to maintain ownership control for a considerable period of time. Without such a stipulation, major shareholders might be dissuaded from entering the business because of the uncertainty about their share of future profits. On the other hand, if they wished to diversify risk, they would be free, under the proposed legislation, to reduce their shareholding. Therefore, even after the transition period, the major initial shareholder would be permitted to retain a larger proportion of outstanding shares than any other single shareholder. Only if an institution became large in relation to other Canadian institutions would the 10 per cent ceiling on shareholdings apply.

Our proposals would also allow institutions under provincial jurisdiction to acquire banking powers. Of course, they could establish bank subsidiaries under federal jurisdiction. Some of these institutions, especially credit unions and caisses populaires, might, however, prefer to maintain their provincial incorporation. In this case, a third method is available to acquire banking powers: provincial authorities would extend commercial and personal lending powers to these institutions under their jurisdiction similar to those conferred by the proposed revision to the Bank Act. A precondition to such an extension, however, would be the acceptance by provinces of federal requirements concerning ownership, conflict of interest, and reserves. Under this approach, such an institution would be required to hold reserves at the Bank of Canada or at an approved depository.

Clearly, we would not force deposit institutions to expand their activities. Thus it would not be contrary to our recommendations if provincial authorities gave existing financial institutions the choice of keeping their limited personal and commercial lending powers without forcing them to hold reserves, adjust to the ownership regulations, or eventually divest their estate, trust, and agency business. Their activities should, however, be restricted. For example, trust companies adopting this method – which is really the status quo – would be required to conform to the limits contained in a basket clause that permits them to hold otherwise ineligible assets up to a proportion of 7 per cent of their guaranteed funds.

Trust Companies and Potential Conflicts of Interest

The regulations governing the portfolios of trust and mortgage loan companies, unlike those governing the portfolios of banks, list the assets that these companies are permitted to hold, rather than set out prohibitions. The present list of eligible assets for trust and mortgage loan companies covers a fairly broad range – from government securities, through securities issued by corporations meeting certain earnings and dividend criteria, to mortgages. In general, the list of eligible assets at present tends to inhibit the trust and mortgage loan companies from commercial or consumer lending, and any loans in these categories must be held under the basket clause.

The portfolios of both the trust companies and the mortgage loan companies are concentrated in mortgages; these account for more than two-thirds of the total assets of the industry. The anticipated relative decline in the mortgage market will make it more difficult for the institutions tied to this market to compete for deposits. Our approach to regulation would enable such companies to adjust by supplying more funds to households and businesses. In addition, flexibility to move into new markets would facilitate productive utilization of their expertise and entrepreneurial skills. Companies would be permitted to shift their activities in response to changes in demand for financial services. Specifically, we propose that federal and provincial authorities revise the legislation governing the eligible investments of trust and mortgage loan companies, to permit them to participate in commercial lending and consumer credit as a normal part of their business.

Our concern about the considerable cost of establishing new firms has led us to propose that trust companies be given the right to organize bank subsidiaries. However, the extension of commercial lending powers to trust companies raises the question of a possible conflict of interest with their estate, trust, and agency, or fiduciary, business. It is frequently argued, both outside and within the trust industry, that inherent conflicts of interest are inevitable when commercial lending and fiduciary business are combined in one institution. As financial intermediaries, the management of trust companies must guard the interests of their depositors and shareholders; as trustees, they must act in the best interests of their trust beneficiaries. A conflict of interest would arise if they managed funds in a way that benefited one group and harmed the other. In some circumstances, management may find it impossible to avoid such a conflict.

The prospect of a conflict of interest has a direct bearing on any proposal to alter the power of trust companies or to permit new entry into trustee activity. The Porter Commission, seeking to minimize the differences in regulatory provisions governing deposit institutions, proposed eventual bank entry into estate, trust, and agency activities. Our wish to avoid any greater scope for conflict between intermediary and fiduciary activities has led us to refrain from such a suggestion and to propose the extension of commercial lending powers only to trust companies that agree to comply with provisions for the separation of intermediary and fiduciary activities over time. At this time, however, the broader question must be raised of the compatibility of fiduciary activity with any intermediary activity at all.

In estate, trust, and agency activities, there is a potential conflict of interest when trust funds are used to increase the financial resources, and thus the revenues, of the financial intermediary. An example is the investment of a portion of a trust fund in guaranteed deposits of the same financial intermediary that administers the trust.

Conflict would then arise if an excessive proportion of trust funds were to be placed in liquid assets, such as guaranteed demand deposits, thus earning a lower return than otherwise, or if the guaranteed term deposits of the intermediary in question featured less attractive terms than available alternatives. In practice, the trust departments abstain from placing trust funds in guaranteed deposits of the intermediary administering the trust. Nevertheless, the estate, trust, and agency statements of trust companies indicate that trust funds are deposited with financial institutions associated with the institution administering the trust funds. In these circumstances, the possibility of conflict of interest cannot be ruled out.

Many trust companies currently place some of their trust funds in deposits of other trust companies and chartered banks. Even in these circumstances, absence of any conflict cannot be guaranteed. Much concern has been expressed in the United States about the existence of reciprocity agreements between different institutions. Such agreements may encourage trustees either to opt for a very liquid portfolio or to choose the deposits of another institution not on their merit alone but as a function of the indirect advantages to be drawn from the relationship with that institution. For example, the liquid assets of trust accounts could be held at a chartered bank in exchange for the clearing of cheques drawn on the guaranteed funds or intermediary side of the trust company's business. In this case, the interests of the beneficiaries would be better served if the trust company paid directly for its clearing services.

The second type of potential conflict is more subtle, involving not only the choice of assets for the estate, trust, and agency funds but also the timing of their acquisition and disposal. A conflict of interest would result when either of these aspects of the administration of estate, trust, and agency funds was influenced by the management requirements of the trust company's own resources. Situations where such conflicts might occur are common. For example, estate, trust, and agency funds may be used to artificially raise the price of a new capital issue or to acquire debt instruments of a company in difficulty, in order to safeguard the value of the financial intermediary's investments in that company. In the same way, if a debtor is in difficulty, putting him into bankruptcy may be detrimental to the interests of the trust beneficiaries but beneficial to those of the financial intermediary. This type of conflict is possible when the securities of a given borrower are held simultaneously by a financial intermediary and the associated trust department – a situation that could occur in Canada. In 1973, trust departments held more than $11 billion in shares; and approximately $830 million in shares and nongovernment bonds were held by the trust companies on their own account. The possibility of duplication is thus considerable.

Our work suggests that the extent of the potential for conflict of interest to arise is underestimated when consideration is limited solely to problems arising from the combination of commercial lending and trust activities in the same institution. In fact, even under present arrangements, trust companies have substantial opportunity to act to the benefit of shareholders and depositors and to the detriment of trust beneficiaries or vice versa. We are sufficiently mindful of the danger of adding to the possibility of conflict to require that any trust company taking advantage of commercial lending powers should take steps to insulate its commercial lending activities from its trustee functions. Therefore,

Recommendation 10

We recommend that, where necessary, the legislation governing trust and mortgage loan companies, credit unions, and caisses populaires be amended to permit commercial and consumer lending as a normal part of their business. Such extended powers should be conferred only on those institutions that meet the ownership requirements applying to entrants into chartered banking. In the case of any trust company exercising commercial lending powers, a further requirement must be met. The company must maintain separation between its commercial lending and trustee activities.

In our research on deposit institutions, examination of estate, trust, and agency activities of trust companies has been only incidental. Nevertheless, it is apparent that the need exists for careful examination of the fiduciary activities of trust companies, with particular attention to the problem of conflict of interest. The results of the investigation might reveal that the conflict between commercial lending and trustee activity is negligible. If such were the case, the eventual entry of chartered banks into trustee activities could be considered. Even then, we would insist that all institutions involved in both commercial lending and fiduciary activities maintain separation of these functions. However, such a study might reveal unacceptable degrees of conflict in present arrangements that combine fiduciary and intermediary activities within the same trust company. In this case, steps would have to be taken to require existing trust companies to concentrate on either intermediary or fiduciary activity and to divest their interest in the other. Therefore,

Recommendation 11

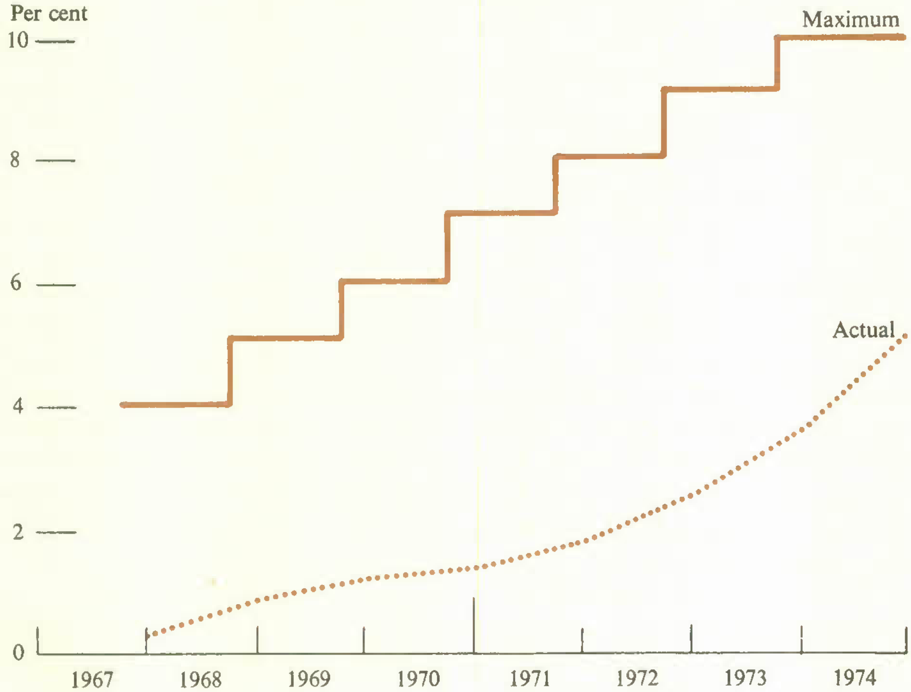
We recommend to the appropriate provincial authorities that a careful examination of the fiduciary activities of trust companies be carried out immediately, particularly with regard to the conflict of interest between intermediary and fiduciary activities.

Bank Mortgage Ceilings

Chartered banks are subject to the limitation that their conventional residential mortgage holdings are no more than 10 per cent of the sum of deposit liabilities payable in Canadian currency and outstanding debentures. This portfolio ceiling is an example of a regulation whose rationale has altered over the years. Originally, self-liquidating loans were considered to be the appropriate business for chartered banks. They were expected to lend only when repayment would be forthcoming over a short period of time, so as to maintain a balance between the maturity of bank assets and liabilities. The first movement away from this principle, with respect to mortgages, occurred with the Bank Act revision of 1954, which permitted chartered banks to hold mortgages issued under the National Housing Act. These loans were insured by Central Mortgage and Housing Corporation. In 1967, the remaining restrictions on

Chart 7-1

Actual and Maximum Ratios of Conventional Mortgage Loans to Canadian-Dollar Deposits and Debentures of Chartered Banks, 1967-74[1]



1 As of December 31.

Source Based on data from the Inspector General of Banks, January 1975.

residential mortgage lending were eased further. The banks were then permitted to hold up to 4 per cent of their total deposits in conventional mortgages, with the ceiling rising at 1 per cent per year until it reached 10 per cent at the end of 1973. As Chart 7-1 indicates, chartered bank mortgages have been well below the ceiling. At the end of 1974, the banks as a group had used half the capacity permitted them under the constraint. Individual banks have used these mortgage lending powers in different ways and to different degrees. Some have channeled their mortgage lending through subsidiary mortgage loan companies, so that only a fraction of their mortgage holdings show up on their balance sheets. Others are considerably closer to the mortgage ceiling than the banking system as a whole. At the end of 1974, three banks were within two percentage points of their current mortgage ceilings. Thus, while a fairly large unused capacity for mortgage lending exists among banks as a whole, the present ceiling may force certain banks to curtail the rate at which they acquire mortgages and may soon restrict them from further mortgage lending, unless they are prepared to establish a mortgage-holding company.

The rationale for adopting the present ceiling on mortgage holdings was that it would ease the impact on competitors of bank entry into the mortgage market. But one might ask whether the entry of chartered banks created substantial problems for the institutions tied to the mortgage market, particularly the trust and the mortgage loan companies. The volume of mortgages held by deposit institutions more than doubled over the period from 1967 to the end of 1974. While the chartered banks' share of the mortgage market rose from 3.7 to 11.3 per cent over this period, the combined share of the trust and loan companies and of the credit unions also rose – from 24.6 per cent in 1967 to 35.6 per cent by the end of 1974. Data on the rates of return earned by major trust and loan companies during this time suggest that, while the average margin between the return earned on assets and the interest paid on borrowing narrowed over the period, the rate of return on the equity of trust and mortgage loan companies increased as the result of increased debt/equity ratios. From this evidence, we do not believe that the entry of chartered banks jeopardized the viability of other institutions in the mortgage market. On the contrary, entry of the banks eased the problem of financing the unprecedented growth in demand for mortgage credit.

Such rapid growth in demand cannot be forecast for the next ten to fifteen years in the mortgage market, given the expected slowdown in population growth, especially among the age groups that buy houses. However, we do not regard this slackening growth of the mortgage market as sufficient grounds for continuing to restrict bank participation in the finance of conventional mortgages. Therefore,

Recommendation 12

We recommend that present limitations on holdings of conventional mortgages by chartered banks be removed.

Leasing

There are two types of leasing, conventional and financial. In conventional leasing, the lessor holds an inventory of capital goods, which are leased to customers according to their needs. The term of this type of lease may be for only a fraction of the expected life of the equipment. The lessor, in effect, purchases assets in anticipation of customers' needs; he not only supplies the asset, but finances its use by the customer. In financial leasing, the lessee determines his specific needs for capital goods and only goes to the lessor to obtain the equivalent of financing. The lessor does not hold inventory and is not the effective supplier of the assets. In general, the lease agreement is for a major proportion of an asset's expected usefulness. Financial leasing, as distinct from conventional leasing, can be regarded as the equivalent of a financial transaction.

The growth of financial leasing as an alternative to traditional modes of financing has been a phenomenon of recent years. There are several advantages to these arrangements for the lessee, compared with borrowing and purchasing. As many leasing firms point out, the lessee retains his financial resources and his line of bank credit for high-return opportunities, such as obtaining discounts for early payment. Possibly more important, with certain combinations of lessor and lessee, income tax advantages may permit a lower cost for the lessee. In the conventional transactions, the owner of the capital good receives the depreciation allowance permitted for the investment. If the owner has either a low taxable income or a low tax rate, the benefits of the depreciation allowance could be small or even unused entirely. In contrast, in a lease transaction, the owner of the capital good is the lessor, who may be able to gain a greater tax benefit from the depreciation allowance. If these benefits are reflected in the lease agreement, the lessee will have acquired the use of the capital good more cheaply than he could have under a borrowing and purchasing arrangement.

At present, financial leasing is not within the range of activities permitted the banks, and this affects certain types of firms to varying degrees. If a tax advantage is one of the major advantages of financial leasing, the firms with low income or low tax rates – relatively new and smaller firms – will suffer from impediments to bank entry. Greater entry into leasing would probably be most constructive in increasing competition among lenders of funds to small businesses. Therefore,

Recommendation 13

We recommend that deposit institutions be permitted to engage in financial leasing.

We suggest that leasing be regarded as the equivalent of a financial transaction and be ruled to be within the scope permitted for deposit institutions. Among the criteria to be used by the Supervisor of Deposit Institutions in determining whether a given leasing activity is a genuine financial transaction would be the absence of inventories of assets held by the lessor; the scope of the lessee's choice of assets, subject to normal credit limit considerations; and the term of the lease in relation to the expected useful life of the asset.

In implementing the appropriate changes in the legislation governing deposit institutions, concern should be given to aspects whereby tax liabilities become, in effect, marketable and are likely to be transferred from enterprises with low marginal tax rates to others with high marginal tax rates. The possibility of an overall reduction in tax liabilities through the transfer of depreciation allowances has been the main reason for the emergence of leasing; this problem is, however, a major concern of the tax authority and not of the regulators of deposit institutions.

Factoring

Factoring is a specialized financial service that involves either the purchase, or discounting, of business accounts receivable or lending against receivables with an undertaking to collect them. While it has a long history in the Canadian textile industry, only within the last decade has factoring been extended to include manufacturers and wholesalers engaged in the production and sale of other goods, such as various manufactured articles and even certain types of raw materials.

However, compared with the United States and other countries, factoring is still in its infancy in Canada and is still generally regarded as financing of last resort. U.S. commercial banks, looking for further services to tempt and hold their customers, moved into factoring in the late 1950s. After absorbing a large share of their home market, they extended their factoring operations overseas and into Canada, as did factoring institutions sponsored by nonbanks. Only recently have Canadian banks begun to move into factoring through subsidiaries.

Unlike their predecessors, who concentrated their activities on the purchase and discounting of business accounts receivable, factoring firms now consider cash flow management an important aspect of the financial services offered to businesses. It is believed that an efficient factoring firm can reduce a company's average collection time by 15 per cent or more. By guaranteeing a firm a regular cash flow at predetermined dates, the factoring institution mobilizes what would otherwise remain a nonliquid asset.

In "maturity factoring," which is not yet common in Canada, the factoring firm assumes the total credit risk of the client and pays on a prearranged schedule based on the due dates of the client's invoices. In addition, the factor conducts credit checks of the client's customers, as necessary; mails statements; makes collections; and keeps sales and receivables records. In this way, the work of the credit, collection, and bookkeeping departments is turned over to specialized financial administrators. For these services, the factoring firm receives a commission on sales that depends upon the type of business, number of customers, and volume.

When businesses do not want to wait to be paid by the factoring firm on prearranged due dates, they may receive an advance of up to 90 per cent of their approved receivables immediately, with the balance to be paid according to a due date schedule. In addition to the normal commission derived from maturity factoring, the factoring firm receives an interest payment on outstanding balances. Interest charged is normally 2½ per cent over the chartered banks' prime rate.

Some firms offer recourse factoring with advances, which is the same as maturity factoring with advances, except that the factor does not assume the credit risk. However, the factor offers credit guidance, keeps all receivables records, and makes collections. The larger factors usually also offer related financial services such as inventory loans, letter-of-credit facilities, letters of guarantee, and term loans. If they are engaged in commercial financing, which involves a direct lending relationship with clients, factors usually do not provide factoring services, and the borrower continues to administer his own credit, collections, and receivables.

From a banker's point of view, factoring, as practised today, complements rather than competes with the lending operations of chartered banks. In the same way that retailers can turn a large proportion of their receivables over to charge card programs operated by banks, manufacturers and distributors can turn their receivables over to factors.

Factoring is a financial innovation that should be encouraged, insofar as it offers greater financing flexibility and cash flow management to small businesses. Moreover, potential exporters who are unfamiliar with the credit ratings of foreign importers will be encouraged to seek out foreign sales if factoring services are readily available. Permitting deposit institutions to enter into factoring would be an appropriate extension of the commercial lending business. At present, a large proportion of factoring in Canada is carried out by foreign-owned institutions. Preventing Canadian deposit institutions from entering into factoring would invite foreign domination of this financial service in Canada. Therefore,

Recommendation 14

We recommend that deposit institutions be permitted to engage in factoring in conjunction with their commercial lending activity.

Subsidiaries and Joint Ventures

Chartered banks and many trust companies participate in a broad range of activities through their ownership of subsidiaries whose activities extend beyond the scope of intermediation. Such activities are a source of contention between deposit institutions and their regulators. While the institutions view subsidiaries as vehicles for expanding their activities into areas complementary to intermediary activities, the regulators may regard them more as a potential means of avoiding the regulation intended in the legislation.

Section 76 of the Bank Act, which governs the ownership of subsidiaries by chartered banks, stipulates that a chartered bank shall own no more than 50 per cent of the voting shares of Canadian corporations when the amount paid for shares is less than $5 million; no more than 10 per cent of the voting shares in other cases; and no more than 10 per cent of the voting shares of a trust or loan corporation accepting deposits from the public. In addition, banks are permitted to own, without the ownership restrictions on other subsidiaries, bank service corporations that either provide services to banks or hold property for them.

The provisions governing the subsidiaries of trust and mortgage loan companies are similar but not identical. A trust or mortgage loan company can own no more than 30 per cent of the shares of any other corporation. As in the case of banks, special arrangements exist for subsidiaries whose activities are auxiliary to those of the parent, so that a trust or mortgage loan company can own more than 30 per cent of certain types of companies it controls. Among the companies permitted are a foreign company in the same activity; a real estate company; and a company offering public participation in a portfolio and in related advisory, management, or sales distribution companies.

The most important reason for regulating these subsidiaries is to preserve the separation of the nonfinancial from the financial sector. This, in turn, minimizes the problems related to the risk of involvement in nonfinancial activity, the conflict of interest inherent in transactions that are not at arm's length, and the excessive accumulation of economic power. In addition, the limits on the ownership of trust and loan companies by chartered banks are aimed at ensuring competition among deposit institutions and avoiding undue concentration in the sector.

Under existing regulations, it is in the interest of banks to establish subsidiaries through which they may undertake, on a limited scale, new activities that were unanticipated when the existing bank powers were framed, gaining expertise in certain areas before banking legislation is revised to extend entry provisions. And certain markets may benefit from a limited infusion of bank participation. For example, the existing ceilings on bank equity holdings allow banks the opportunity to enter into venture financing, either through a subsidiary specializing in the supply of venture capital or through specific ventures undertaken jointly with nonfinancial corporations. Thus the use of subsidiaries encourages deposit institutions to innovate within the current relatively rigid regulatory structure.

The fear that subsidiaries have been used to avoid regulatory controls, however, is justified. For example, banks have undertaken leasing activities, despite the objections to direct entry by the Minister of Finance; and banks own mortgage loan companies that accept deposits from the public. The fact is that subsidiary mortgage loan companies and real estate investment trusts provide an opportunity to avoid the 10 per cent mortgage ceiling, and the "equity maintenance clause" in a subsidiary leasing company allows equity investment of over $5 million.

The lack of any overall ceiling on bank support to subsidiaries has enabled banks to use subsidiaries to avoid the apparent intent of regulation. The legislation refers only to the extent of equity participation. A number of the mortgage loan companies in which banks have equity interests have, at various times, had outstanding bank loans, presumably from the participating banks, that were many times the limit of the bank's equity participation. In our view, the limitations on bank subsidiaries are inadequate to ensure effective control of their activities. We believe that any limitations on bank participation in subsidiaries should be framed in terms of total bank commitment, including loans and guarantees, rather than equity commitment alone.

Many deposit institutions have reacted to these limitations on subsidiary ownership by participating in joint ventures with other enterprises. While their partners are frequently nonfinancial corporations, foreign financial institutions, and nondeposit institutions, many deposit institutions have also participated in joint ventures with other deposit institutions.

A number of economic arguments have been advanced to justify joint ventures. First, a venture may be beyond the scope of one institution, and a joint venture would be justified by the scale of the undertaking. Second, because the size of the venture may involve high risk, a joint venture would allow risk-sharing. Third, where an activity requires a range of expertise, a joint venture could provide the means by which expertise from a number of areas could be brought together. Despite the economic arguments in favour of joint ventures, there is reason for concern about this form of enterprise. Concern about their possible impact on competition among financial institutions led to the 1967 changes in the Bank Act that prohibit interlocking directorates among financial institutions. Joint ventures permit officers of major financial institutions to serve on the same boards; thus competition among them may be limited. Also, when major financial institutions join together in new activities, the number of potential entrants into these activities is then reduced, as each institution might have entered independently or in joint venture with nonfinancial firms.

Any attempt to establish policies towards domestic joint ventures is complicated by their variety. Given the existing limits on bank investments in subsidiaries, most joint ventures with nonfinancial firms should not raise any problems; however, joint ventures among deposit institutions are a different matter. We do not wish to limit their ability to participate in temporary consortia or other arrangements formed for the purpose of financing large individual projects. Such arrangements are already dealt with in the legislation on competition. We believe, however, that joint ventures among deposit institutions should require the approval of the Supervisor of Deposit Institutions, acting within a framework of specific criteria. These criteria should take into consideration the relationship of the activity of the joint venture to that of its parent companies, the characteristics of the services offered and the market served, and the potential entrants to the market. Where joint ventures appear to be in conflict with these criteria, a procedure for divestment of one party or another should be arranged. Therefore,

Recommendation 15

We recommend that advance approval of the Supervisor of Deposit Institutions be required for investment by deposit institutions in Canadian subsidiaries that involve either 1/ a financial commitment on behalf of the parent in any form, including guarantees in excess of the existing limits to equity investment, or 2/ a joint venture among deposit institutions.

Conclusion

Our proposals in this chapter are designed to widen the scope of activities of Canadian financial institutions by allowing them to enter new areas. Thus we would permit existing nonbank deposit institutions to enter the commercial and personal loan markets on terms equivalent to those for banks. Our aim is not only to allow *de novo* entry, which will no doubt be difficult for institutions with no experience in branch banking, but also to facilitate the transition of established near banks into the banking market. At the same time, we encourage the participation of banks in such activities as leasing and factoring, and we would remove the ceilings on mortgage loans by banks.

8 FOREIGN BANK ENTRY

Our objective in this chapter is to define a framework for foreign banks in Canada to ensure, on the one hand, that Canadians have access to up-to-date financial services at the lowest cost and, on the other hand, that the banking system is kept firmly under domestic control. We hope that deposit institutions will respond to foreign bank competition by becoming more dynamic, innovative, and conscious of costs. At the same time, our proposals are also designed to give fair treatment to the shareholders of existing Canadian financial institutions.

The 1967 revisions of the Bank Act sought to maintain Canadian ownership of the financial sector by restricting foreign ownership of any chartered bank to a maximum of 25 per cent, and no provision was made for foreign banks to operate either agencies or branch offices in Canada. The same ownership limitations were also applied to federally and, in some provinces, provincially incorporated trust and mortgage loan companies. No restrictions, however, were placed on the establishment of subsidiaries by foreign banks as long as they were not called banks.

In fact, over the last few years, foreign banks have expanded their activities in Canada substantially through financial subsidiaries that undertake many banking operations but yet do not use the term "bank" in their corporate name. Many of these subsidiaries are involved in activities, such as financial leasing and factoring, from which Canadian chartered banks are excluded under the Bank Act. Understandably, their presence is a source of concern to the domestic banking industry and the Canadian regulators of deposit institutions.

The Basic Issues

We believe that the issues raised by the entry of foreign banks into Canada are complex and difficult to deal with, mainly because of the unavoidable conflict between two of the basic principles that underlie government policy on trade and foreign investment in general. On the one hand, the government recognizes that the economy benefits from foreign trade and foreign investment; on the other hand, it wishes to encourage domestic ownership and control of Canadian industry. This same conflict is apparent in the field of banking. Over the last decade, world capital markets have become increasingly integrated, and banking has become an international activity – a process in which Canadian chartered banks have participated actively, bringing tangible benefits to Canada. However, there is some uneasiness that the deposit-taking industry in Canada may be dominated by foreign, and especially U.S., banks.

In our approach to this problem, we have sought to give equal weight to the twin principles of efficient international specialization and adequate domestic control. If a policy designed to maintain significant Canadian control in domestic financial markets is to be effective, policy-makers must take into account certain considerations with respect to these markets.

First, many foreign financial institutions already have subsidiaries in Canada. While the Foreign Investment Review Agency was created in 1973 to screen direct foreign investment in Canada, it does not have authority to prevent the extension of financial services by foreign banks, since expansion in an existing line of business is permitted. Second, Canadian financial institutions have a vested interest in maintaining an open international financial system because they participate actively in international operations and earn substantial profits from them. At present, 30 per cent of the business of Canadian chartered banks is denominated in foreign currencies, and it is estimated that Canadian banks have about five hundred foreign branches, agencies, and affiliates in no less than forty countries. They wish to continue their activities in these countries and thus have an interest in reciprocal arrangements to ensure that foreign banks are permitted to enter Canada. Third, it is important to emphasize that retail customers of financial institutions must not be disadvantaged relative to larger depositors and borrowers who have access to alternative sources of funds and investment opportunities. If restrictions were placed on, or developed in, the Canadian capital market, large corporations, public utilities, and governments could then easily turn to the international capital market. Restrictions on foreign bank activities in Canada would thus result in poorer service and higher costs, mainly to Canadian consumers and small privately owned businesses. Larger firms, particularly foreign subsidiaries operating in Canada, would find such legislation to their advantage, because their ability to finance internationally would offer them a competitive edge over their smaller rivals. We consider such a development wholly detrimental to the interests of this country.

The Reasons for Foreign Bank Growth

The entry of foreign banks into Canada through subsidiaries is undoubtedly a part of their overall international expansion and diversification plan. While there are many reasons for undertaking such expansion, the growth in the number of subsidiaries is not the result of an attempt on the part of transnationals to gain control of the Canadian banking industry.

There are several reasons why a foreign financial firm may consider entry into Canada profitable. Some institutions may have underutilized managerial capacity.

Such firms could offset the capital costs of entry into the retail and/or wholesale markets with more effective use of their head office management personnel, investment analysts, and computer technicians, as well as both their software and hardware computer technology. They may also believe that their managerial methods are superior to those employed by Canadian institutions and should be extended successfully into Canadian retail or wholesale markets. Further, an insufficient degree of competition in Canadian markets may be apparent in some activities. Even though a foreign bank could expect a greater degree of competition in the future, in the meantime the costs of entry would be covered by the higher short-term profits that could be made in its Canadian operations.

Considerations based on utilization of technology and management capabilities are most likely to influence a foreign institution's decision to enter the retail banking market. A foreign firm would, however, only be willing to pay the high cost of entering that market in a widely branched banking system if it were confident it could introduce a package of knowledge, technology, and organization that would capture a substantial volume of business by reducing costs to consumers.

Some observers assume that the only reason foreign banks enter is to extend banking services to subsidiaries of corporations that are bank customers at home. The basis of such an argument is that banks develop a relationship with their clients in the wholesale market that they can exploit more fully by "full-line forcing" – or packaging of services. Typically, it is alleged, foreign banks having a banking relationship with a corporation in their own country could also capture the business of the Canadian subsidiary of this corporation. Because of such a relationship, it is argued, Canadian banks would be excluded from their business. Full-line forcing is thus analogous to an entry barrier that would discriminate against Canadian banks; even though they might be able to offer competitively priced services, they would be excluded from the most profitable banking activities because of the national ties of subsidiary corporations.

It it unlikely that full-line forcing would be a sufficient reason for foreign bank entry into Canada, because large corporations usually have the option not only of dealing with many banks but also of employing direct methods of raising funds in the financial markets. This choice of alternative sources of capital allows them to minimize their financing costs. In these circumstances, it would be difficult for a foreign bank to achieve an exclusive arrangement with its domestic customers, and it would thus be reluctant to invest in Canada with only a possibility of developing and maintaining such an arrangement with its customers' subsidiaries in this country. In fact, we think that the expertise of the Canadian banks in understanding Canadian institutions and markets, the conduct of government policy, and Canadian foreign exchange markets would enable them to maintain a strong position in the wholesale sector of the Canadian market, even with substantial foreign bank entry.

The Effects of Foreign Bank Activity

Some allege that entry into Canada by foreign banks has eroded Canadian control over the key financial sector of the economy; others claim that it has decreased the effectiveness of monetary policy, that it has led to inequitable treatment of Canadian chartered banks, and that, because of foreign bank activity in the short-term paper market, Canadian corporations are being discriminated against. Indeed, there are some disadvantages, as well as advantages, to foreign bank entry for consumers, corporations, chartered banks, near banks, and regulatory authorities.

Competition in Wholesale Banking Services

While foreign banks have already entered the Canadian wholesale banking market to a substantial degree, their inability to participate directly as banks has left them at a disadvantage relative to Canadian-owned firms. Already, they have probably lessened the transaction, search, and credit rating costs of doing business in this country. Foreign banks raising funds in Canada have also been able to avoid both primary and secondary reserve requirements in both countries, and this has proved to be an advantage when competing with Canadian banks for Canadian business.

The Canadian banking community has long argued that foreign banks operating in Canada should be brought under Canadian regulation. Costs for foreign banks would then rise, but their existence would also be legitimized. From the point of view of the foreign banks, Canadian regulation of their activities would reduce the risk of Canadian authorities arbitrarily limiting their ability to profit from their existing investment in expertise and facilities in Canada. Since the wholesale market has already been entered on a substantial scale by foreign banks, any formalization of entry would have only minor effects on this market. At best, Canadian banks might encounter slightly stiffer competition for commercial lending and large deposits and in their foreign exchange business.

Equity among Competitors

In addition to the overall competitive situation, Canadian chartered banks have a number of other, and sometimes conflicting, interests with respect to the presence of foreign banks in Canada. First, there is the question of equity. Should subsidiaries of foreign banks be allowed to undertake activities that are prohibited to Canadian banks? Second, is the treatment of Canadian banks abroad a factor in considering the entry of foreign banks into Canada?

In our view, an argument can be made that, in certain activities, Canadian chartered banks are being discriminated against, relative to subsidiaries of foreign banks operating in Canada. Under Section 75 of the Bank Act, banks are not, for example, permitted to deal in goods, wares, and merchandise, or to engage in any trade or business. This provision has been interpreted by the Minister of Finance to prevent banks from engaging directly in leasing. No such restriction, however, is placed on certain subsidiaries of foreign banks operating in this country, depending upon where they are incorporated.

Investment opportunities are another area in which banks are treated differently. Under Section 76 of the Act, banks cannot own more than 10 per cent of the voting shares of a Canadian trust or loan company that takes deposits from the public, or of Canadian companies where investment by the bank is in excess of $5 million. Many foreign bank subsidiaries face no such restrictions on their investment opportunities.

Although we agree that there is considerable variation in the treatment of Canadian chartered banks relative to that of foreign banks operating in Canada through provincially incorporated subsidiaries, we feel that this should be corrected by broadening the powers of the chartered banks in some areas of banking activity, such as leasing and factoring, while at the same time restricting foreign banking institutions to the same responsibilities and privileges given the domestic deposit institutions. In this way, equity between Canadian and foreign deposit institutions could be restored within the framework of the overall legislation governing deposit institutions in Canada.

Reciprocity and the Foreign Business of Canadian Banks

The main advantage of the international role of banks for most Canadians rests upon the competitive pressure on Canadian banks, particularly in the retail market, to make their international expertise available to their customers at competitive prices. If domestic competition is insufficient, part of this advantage may result in higher profits for bank shareholders, who may or may not be Canadian residents. The benefit of higher profits may be shared with the Canadian taxpayer in the form of tax revenues generated by the additional bank earnings from international operations. This benefit can, however, be limited by the foreign tax credits provided to offset the foreign taxes paid by the banks on profits generated abroad. With the combination of Canadian withholding tax laws and the foreign tax credit system, a substantial portion of the profits earned could become a source of revenue for foreign governments.

The foreign activities of Canadian banks provide other advantages. Canadian banks may supplement the information foreigners receive through official diplomatic and trade representatives. Canadian banks can merchandise their extensive knowledge of Canadian commercial conditions to potential foreign investors through their foreign offices. Similarly, Canadians looking for commercial opportunities abroad may find that banks with which they already have ties are in a position to supply them with legal and commercial information about foreign markets; they can also arrange contacts and act as credit guarantors. It is therefore in the interest of Canadians for the government to maintain conditions permitting Canadian banks and other financial corporations to compete successfully abroad.

The relationship between Canadian access to banking markets abroad and the entry of foreign banks into Canada has become an increasingly important issue, similar to that raised by international trade barriers. Canada is committed to removing tariff and nontariff barriers through multilateral negotiations with its trading partners. Under the pressure of foreign competition, industry is expected to rationalize its production and find markets for its more efficiently produced goods and services. The same result is anticipated in the financial sector. Reciprocity in banking markets is equivalent to bilateral trade agreements in the real sector. The advantages to users of bank services of foreign entry into Canadian banking are, at least in theory, independent of the access of Canadian banks to markets abroad. This is parallel to the accepted proposition that Canadian consumers benefit from domestic tariff reductions, regardless of the level of foreign tariffs. Nevertheless, the Canadian government represents Canadian shareholders and producers, as well as consumers, and should do everything in its power to maintain access to foreign markets.

Canadian banking business abroad has been growing, and the industry is confident of its ability to compete in world markets, as well as at home; it will be careful not to endanger its access to foreign markets. Thus the Canadian government and banking industry must decide to what extent Canadian concessions are necessary to maintain those profitable activities of Canadian banks abroad.

As a basis for this decision, the current proposals for conditions under which foreign bank entities will be allowed to operate in the United States are significant. U.S. officials appear to favour integration of foreign banking into the existing regulatory structure. The principle is that reciprocity requires only that foreign banks be placed on a par with domestic banks. This would allow a great deal of variation in banking regulation from country to country but would not permit any country to discriminate against foreign banks. This principle of nondiscrimination is a constructive and attractive proposal that should be endorsed by Canadian authorities. It would allow preservation of much of our domestic regulatory structure and still permit sufficient room for foreign bank entry to satisfy foreign authorities. This is the general approach adopted in our entry proposals for foreign banks.

Near Banks and Competition

Nonbank deposit institutions, which have grown to meet market opportunities at the retail level, would also be affected by foreign entry. These market opportunities were created directly by regulation or indirectly by its impact on the structure of chartered banking. Trust companies have expanded, partly because of the restrictions on mortgage lending by chartered banks; credit unions have grown by catering to small local markets that larger banks found costly to reach.

Because of the unique situation of near banks and the regulatory prohibitions that have prevented them from fully entering banking markets, it seems to us that equity, together with the infant industry argument that domestic firms should be protected for an interim period until maturity is achieved, would warrant allowing them an opportunity to develop a presence in the retail lending market before it is opened to foreign competition. This could probably best be accomplished through a phased entry of foreign banks into the retail banking market.

Regulatory Authorities and Monetary Control

One indictment of foreign bank activities in Canada is that they render monetary policy ineffective since they can offset the effects of monetary restriction by drawing on external resources. One characteristic of Canadian financial markets has been their openness to international capital flows. Many large borrowers, both corporate and government, have been able to obtain funds from foreign sources. In addition, the Canadian banks have foreign operations comparable to those of any foreign banks likely to enter Canada. In these circumstances, when funds already move easily in and out of Canada, the presence of foreign banks is unlikely to make a substantial difference.

A Staged Approach

We have seen that purchasers of bank services have a major interest in ensuring competition at the retail level. We support these interests but, in an attempt to balance both producer and consumer interests, we suggest a procedure for staging foreign bank entry into retail banking. Such an approach would enable Canadian chartered banks and other deposit institutions to adjust to the new environment and would allow sufficient time for the revamping of the Canadian regulatory structure implied in other sections of this report.

In line with this approach, we propose that a Foreign-Owned Banks Act be passed at the same time as the revised Bank Act. This new Act would require all foreign-owned institutions accepting deposits in Canada to meet certain conditions set out in the Act. Some foreign-owned firms are already established as near banks under provincial jurisdiction. Although they would be permitted to continue their operations as such, they would be encouraged to conform to the terms of the Act after a transition period. If some chose not to operate under this federal Act, they would remain subject to provincial legislation provided that legislation was in harmony with federal legislation.

During the initial stage after passage of the Act, possibly a ten-year period, a foreign bank entering the Canadian banking field would have its power to branch and expand restricted. Each foreign institution would be permitted to control only one Canadian banking operation, with the type of activities that it could undertake limited to those allowed Canadian institutions under the Bank Act. The purpose of this initial stage is to permit existing Canadian near banks to respond to their expanded powers. If, in the interim, the retail field is well served by Canadian institutions, foreign institutions may not find it so attractive to enter; however, if market opportunities still exist, the threat of foreign entry would spur Canadian industry on to greater efficiency.

In the second stage, a foreign-owned bank could continue, or begin, to operate on the same basis as in the initial stage, or it could obtain the same branching powers as domestic banking institutions, subject to the sale of a substantial number of its shares to Canadians and an overall size limitation. The parent bank would be allowed to retain a designated maximum proportion of shares in its Canadian subsidiary, possibly 25 per cent; other shareholders would be restricted to 10 per cent shareholdings. A stipulated minimum proportion of Canadian-owned shares (perhaps 50 per cent) would also be required. During this period, a foreign bank would also be permitted to enter the Canadian market by buying into an existing Canadian institution, subject to regulatory approval. If an institution operating under this option exceeded its designated size limit, the parent would be required to reduce its shareholdings in order to comply with the fundamental principle of Canadian banking legislation, that ownership of a bank must be widely dispersed. The new institution would thus be under the same ownership constraints that presently apply to existing chartered banks. Therefore,

Recommendation 16

We recommend that a Foreign-Owned Banks Act be passed at the same time as the Bank Act is revised, which would bring under federal control foreign-owned institutions accepting deposits in Canada. This Act should include a staging procedure providing limited entry during an initial transition period and the option thereafter of either a closely held bank or a controlled bank, each subject to all the conditions applicable to Canadian-owned institutions of the same nature.

Regulatory Considerations

In order to conduct deposit-taking operations in Canada, any foreign-owned corporate entity would be required to obtain a licence from the Supervisor of Deposit Institutions, or the appropriate provincial authorities. The terms of reference of the federal regulatory authority should be broadly defined. Because of the principle of separation of financial and nonfinancial activities, the licence should be granted only if the parent firm is itself a bona fide financial institution, subject to public scrutiny in its home country, and if the regulatory authorities of that country are willing to exchange information and transmit the results of public inspection of the parent. This precautionary measure would not only help to minimize the risk of fraud, but it would also ensure that profits are recorded in the jurisdiction in which they are earned; consequently, subsidiaries would pay their fair share of Canadian taxes. In order to implement this policy, Canadian regulatory authorities would need to develop contacts, information exchanges, and other co-operative arrangements with foreign regulators.

Implementation of these proposals requires co-operation between the various federal and provincial authorities responsible for deposit institutions. At present, most of the subsidiaries of foreign institutions are provincially incorporated and thus are not subject to the federal legislation that applies to deposit institutions. It would be contrary to the spirit of our proposals if, because of their provincial incorporation, foreign-owned institutions were not subject to the same requirements.

If co-operation were not forthcoming, the federal government would have a number of options. It could take advantage of its jurisdiction over banking under the British North America Act, to ensure compliance with the Bank Act provisions. However, while the federal government has exclusive power under subsection 15 of Section 91 with respect to banking, it may be difficult to use this power to regulate some activities of foreign banks in Canada. In the face of the restrictions in the Bank Act, foreign institutions have been forced to enter areas that are not strictly banking. Many domestic firms operate in the same markets, carrying out business similar to that of subsidiaries of foreign banks. Any attempt to bring the activities of foreign bank subsidiaries under the provisions of the Bank Act would necessarily involve the status of these domestic institutions.

An alternative would be for the federal government to invoke subsection 25 of Section 91 of the BNA Act, which gives the federal government exclusive jurisdiction over all matters related to aliens. A precedent for federal control of foreign-owned financial institutions exists in the Foreign Insurance Companies Act, under which such companies must be registered with the federal government, which has exclusive jurisdiction over them.

The federal authority administering the entry of foreign banks will have to face the jurisdictional question of whether a firm falls under its aegis. The authorities should, in our view, be free to apply a rule of reason when distinguishing between near banks and nonbank financial institutions.

Conclusion

Although foreign banks have no official position in the Canadian regulatory structure, they have entered the Canadian banking market on an appreciable scale through nonbank financial subsidiaries, which, in effect, conduct many aspects of banking operations. To date, this entry by foreign banks has been almost entirely in the wholesale banking market. On the basis of our analysis, we have concluded that the prospect of foreign bank entry into both the wholesale and retail banking markets would be beneficial to Canadian consumers of banking services.

We believe that our proposed changes in the regulations governing entry of domestic and foreign institutions into banking activities are necessary for the achievement of a competitive and responsive financial sector. We also think that our proposals treat existing deposit institutions in an equitable manner. In our view, foreign banks will not find it easy to enter the Canadian market, even if they are allowed to do so. Therefore, in stating the case for entry of foreign financial institutions into the Canadian retail financial market, we would not expect immense expansion. If, however, foreign firms do have an advantage in efficiency, they can only share the benefit of this advantage with Canadian consumers and put pressure on domestic firms by entering the market. Entry would not only create the condition for reducing profit margins, but Canadian financial institutions would also have incentive to meet the standards of performance demonstrated by the foreign competitors. We believe that most domestic institutions will succeed in meeting this competition in all areas, while some might specialize in market areas in which they have the greatest experience. In fact, entry of domestic and foreign institutions does not need to take place on a large scale for the benefits of greater competition to filter through to consumers. We are confident that if these entry proposals were adopted, along with our other suggestions, the efficiency of financial markets would continue to improve, and Canadian firms and households would be better served.

9 THE CHEQUE PAYMENT SYSTEM

The payment system plays a vital role in the functioning of any complex industrial economy such as Canada's. While, in the past, payments were made primarily with notes or coins, today cheques drawn on deposit institutions are the most important element in the Canadian payment system. We estimate that, during 1973, the use of cheques accounted for approximately 74 per cent of the total value of transactions.

The Role of Chartered Banks in the Clearing System

A unique characteristic of chartered banks is the nature of their involvement in the cheque payment system. The issuing of cheques by customers of deposit institutions necessitates some arrangement between institutions to exchange these cheques and to settle with each other any resulting indebtedness. Chartered banks are the only direct participants in the final stage of the cheque payment system when settlement between the institutions holding the payer's and payee's funds occurs.

The clearing system is used primarily to settle cheque transactions between payees and payers whose accounts are held at branches of different banks. In addition, a number of other items including money orders, travellers' cheques, and Government of Canada savings bond redemptions are processed through the clearing system.

In 1973, 15 per cent of cheque transactions involved deposits within the same branch. The other transactions – one billion in total – were effected between creditors and debtors holding deposits in different branches. A distinction can be made between internal clearings, involving accounts at different branches of the same bank, and clearings involving accounts at different banks. While data are not publicly available on the relative importance of these processes, our estimations suggest that clearings involving different banks account for 80 per cent of all cheque transactions between deposits held at different branches.

For present purposes, attention is directed solely to clearings involving deposits held at different banks, which requires co-operation between institutions. The procedures for external clearing depend on the location of both the payer's and payee's accounts. If both accounts are at the same banking point,[1] clearings take place locally. Cheques are exchanged between banks through their designated clearing branches. At present, there are 133 of these local banking points, with 475 participating branches. The method of settlement for local cheques depends on the number of banks participating at the banking point. Where there are only two banks, each opens an account with the other, and net balances are settled either at fixed intervals or when they exceed $10 thousand. Where more than two banks participate at a clearing point, one of the banks, designated as the settling bank, pays, or is paid by, the other banks according to daily imbalances. These payments, in the form of drafts on the banks' accounts with the Bank of Canada, are transmitted to the nearest bank agency.

The clearing process is more complicated when, as is most often the case, the payer's and payee's accounts are at branches located at different banking points. These "out of town" items are routed from the payee's branch to the clearing branch of its bank at the nearest regional clearing centre, where cheques are exchanged regularly among the banks. Net balances are settled once a day, and the resulting transfer is then transmitted to the Bank of Canada by its local agent for changes in the banks' deposits with the Bank. Statements of the value and number of such clearings for each of the chartered banks at the ten regional clearing centres during 1974 are presented in Tables 9-1 and 9-2.

Table 9-1

Value of Interbank Clearings,[1] by Regional Clearing Centre, 1974

	Halifax	Saint John	Quebec City	Montreal	Ottawa	Toronto	Winnipeg	Regina	Calgary	Vancouver	Total
					(Millions of dollars)						
Bank of Montreal	2,757	2,322	2,099	85,744	1,540	111,201	11,064	4,624	10,349	7,156	238,858
The Bank of Nova Scotia	2,928	2,053	556	23,191	902	60,358	2,787	2,648	5,425	2,095	102,943
The Royal Bank of Canada	4,212	2,170	2,322	91,246	1,202	133,234	11,075	5,337	14,370	8,214	273,382
The Toronto-Dominion Bank	685	420	326	31,432	986	77,710	3,897	1,430	8,121	2,863	127,870
The Mercantile Bank of Canada	41	31	53	16,746	8	21,809	268	–	1,204	1,304	41,464
Bank Canadian National	–	79	2,083	28,707	279	10,909	237	–	29	111	42,434
The Provincial Bank of Canada	–	538	2,246	32,091	287	10,428	39	–	–	70	45,699
Canadian Imperial Bank of Commerce	1,775	1,157	993	45,023	1,209	118,435	9,390	4,664	15,213	19,528	217,388
Bank of British Columbia	–	–	–	–	6	–	30	–	1,112	6,884	8,031
The Montreal City and District Savings Bank	–	–	–	1,601	–	–	–	–	–	–	1,601
Bank of Canada	370	1,031	–	–	4,274	–	–	–	–	–	5,675
Unity Bank of Canada	–	–	–	–	47	3,086	219	–	17	161	3,530
Total	12,768	9,801	10,679	355,782	10,739	547,170	39,007	18,703	55,840	48,385	1,108,874

1 Summarized by each bank in terms of its receipts.
SOURCE Based on data from the Canadian Bankers' Association.

1 A banking point refers to any location at which two or more banks have agreed to exchange cheques drawn on one another.

Table 9-2

Number of Interbank Clearings,[1] by Regional Clearing Centre, 1974

	Halifax	Saint John	Quebec City	Montreal	Ottawa	Toronto	Winnipeg	Regina	Calgary	Vancouver	Total
						(Thousands)					
Bank of Montreal	3,766	2,885	3,661	39,927	3,823	59,734	7,234	3,967	12,265	8,100	145,364
The Bank of Nova Scotia	5,080	2,893	1,464	18,974	1,656	43,786	3,840	6,832	8,894	3,276	96,695
The Royal Bank of Canada	6,469	3,719	4,676	42,283	2,534	72,755	12,210	5,404	15,545	13,176	178,771
The Toronto-Dominion Bank	100	821	693	17,327	1,841	57,001	4,856	2,364	8,795	3,274	97,073
The Mercantile Bank of Canada	15	14	42	362	18	427	251	–	227	259	1,615
Bank Canadian National	–	134	5,725	35,801	575	3,727	386	–	62	97	46,505
The Provincial Bank of Canada	–	1,361	4,306	44,149	893	5,221	71	–	–	90	56,091
Canadian Imperial Bank of Commerce	1,223	2,295	1,463	30,715	2,844	82,467	8,433	4,954	21,529	21,563	177,485
Bank of British Columbia	–	–	–	–	10	–	38	–	147	4,396	4,591
The Montreal City and District Savings Bank	–	–	–	5,344	–	–	–	–	–	–	5,344
Bank of Canada	47	7	–	–	30	–	–	–	–	–	84
Unity Bank of Canada	–	–	–	–	35	1,267	39	–	21	54	1,416
Total	16,699	14,129	22,030	234,882	14,259	326,386	37,359	23,522	67,484	54,284	811,035

1 Summarized by each bank in terms of its receipts.

SOURCE Based on data from the Canadian Bankers' Association.

Chartered banks are the only institutions participating at the final settlement stage. By its act of incorporation, the Canadian Bankers' Association (CBA) has the authority to operate a clearing system. In practice, and because of the dominance of banks in supplying payment services, the bank clearing system is the sole clearing system in Canada. The CBA determines the rules of operation and the basis of access to the system. Its direct role in the process is minimal, being mainly confined to supervising the daily settlement process at each of the ten regional clearing centres. Most clearing takes place through direct exchanges of cheques among banks. Each bank makes its own arrangements for delivery and acceptance of cheques; however, in a number of centres, a common messenger service is used.

Clearing arrangements, of necessity, create an interdependence among otherwise competing institutions. A bank's approach to clearing determines the costs for institutions with which it co-operates as well as its own. To prevent any institution from imposing costs on others, for example, by refusing cheques for payment at cities other than Vancouver or Halifax, all banks are required to be represented at each regional clearing centre. However, not all banks are direct participants at every centre; some of the smaller ones have arranged for other banks to serve as their agents at various centres.

In contrast to regional clearing centres, participation in clearing arrangements is optional at any banking point. Any bank located at that banking point is free not to participate. And if two banks represented at any place perceive some mutual benefit from establishing their own clearing arrangements, they are free to proceed with such arrangements, subject to the approval of the CBA. A bank can also withdraw from any local clearing arrangements, other than the regional clearing centres, by giving six months' advance notice to fellow participants. Present arrangements are, therefore, flexible enough to permit banks the freedom to establish a wide variety of clearing procedures.

Near Banks and the Clearing System

The role of other deposit institutions in the clearing system differs substantially from that of chartered banks. A near bank gains access to the clearing system by arranging for a chartered bank to serve as its agent. Until 1971, agreements between near banks and their agents were dictated by rules set by the CBA[2] and were subject also to the approval of the local clearing house, if any. These rules were then changed to permit near banks and their clearing agents to negotiate their own arrangements. At the same time, a further change considerably altered the relationship between near banks and their agents. Previously, payment orders issued by near bank depositors identified the branch of the chartered bank through which these orders were to be processed, so that the ability of these nonbank deposit institutions to transfer from one clearing agent to another was circumscribed by the trouble and expense of changing the transit number on their payment orders. Since 1972, a near bank can qualify for its own institutional transit number, provided it meets certain standards. It is required to have more than one branch and a monthly clearing volume of at least 50 thousand items; twenty-two institutions have now met these standards and are able to retain their transit number even when changing their clearing agent. Relieved of the necessity of altering clearing instructions on all their outstanding cheque forms, near banks gained greater flexibility to negotiate the terms of their access to the clearing system with potential clearing agents.

The question of the ease of access of nonbank deposit institutions is of continuing concern to the near banks. The Porter Commission, reporting over a decade ago, recommended that

> the clauses of the Canadian Bankers' Association Act which give the Association the right of operating the clearing system should be repealed, and an association of all clearing institutions formed to manage the system and allocate costs equitably among all members in relation to the work done by each.

A corollary of this recommendation was that all banking institutions be required to hold reserve balances at the Bank of Canada. The advantage of this arrangement, the Commission observed, would be that "all banking institutions will be able to settle their clearings at the Bank of Canada rather than being required to make arrangements with one of the present chartered banks." Moreover, the Commission argued,

2 These rules can be found in the Appendix to the *Submission to the Royal Commission on Banking and Finance* by the Canadian Bankers' Association, Spring 1963.

the Bank would thus have to equip itself to act as clearing agent for institutions at the centres where they are not represented, but there would be no need for it to take over the rest of the normal work of routing cheques and other payment items within the private financial system.[3]

At present, a broad range of views exists among near banks about their terms of access to the clearing system. Discussions with some trust companies revealed that they were satisfied with current arrangements – an attitude engendered, to a large extent, by the increased scope for bargaining made possible by greater flexibility in the regulations of the CBA. By contrast, other trust companies and credit unions had some misgivings about current clearing arrangements. Certain of the institutions complained about float charges, by which near banks pay their clearing agent an additional fee for making settlement for them before it is reimbursed at an interbank settlement; others complained about the apparent unwillingness of chartered banks to compete with each other to become clearing agents for near banks. In view of their dissatisfaction with the present system, a number of near banks expressed considerable anxiety about their future involvement in the payment system, especially in light of current developments in computer technology.

The existence of a clearing system in which direct access is confined to one set of institutions is contrary to our view that additional flexibility and competition are essential in the deposit-taking sector. At present, an anomalous situation exists, where some institutions outside the interbank clearing system generate larger volumes of transactions at regional clearing centres than many participating banks. The B.C. Credit Union Central, for example, has an annual volume of ten million items – one-fifth the volume of the Vancouver clearing centre and a greater volume than that of all but two of the banks participating at the centre. The Central's incoming clearings are valued at approximately $3.7 billion per year – 7 per cent of the total annual value at the Vancouver centre and more than that of all but three banks.

The policy issue raised by the present operation of the clearing system is whether it is feasible to have more than one clearing system. If not, what should be the basis for entry into the existing system? A clearing system can be viewed as a type of network utility in which the benefits to a customer depend on the number and identity of the other customers. A prime example of a network utility is a telephone system. Separate telephone systems would make it difficult for people on one system to communicate with the customers of other systems, and there would be little reason for belonging to a system other than that with which one most frequently communicated. Near banks derive their deposit business mainly from households, but relatively few transactions between households would involve two customers' accounts at near banks. Moreover, most transactions are between households and businesses, either for consumer purchases of goods and services or business purchases of productive services from households. Thus, for a majority of payments from deposits at near banks, some form of interchange between banks and near banks is required. Existence of two clearing systems – one for banks and one for other deposit institutions – would involve the extra complication of interchange between the two systems as well as clearing within

3 *Report of the Royal Commission on Banking and Finance* (Ottawa: Queen's Printer, 1964), p. 393.

each system. Thus the creation of a separate clearing system for near banks would be an inefficient alternative to the extension of the existing system.

We propose, therefore, that near banks be permitted direct access to the clearing system on the same basis as chartered banks. This proposal follows our functional approach to regulation, in that not only would institutions exercising the same activities be subject to the same constraints but also that the same opportunities would be available to them. Direct access to the clearing system would enable near banks to participate more fully in the evolution of the payment system.

Such a proposal, however, necessitates consideration of criteria for eligibility – particularly for participation at regional clearing centres. Should any deposit institutions be eligible, by right, to participate in any regional clearing centre, or should some qualifying standards be met first? To evaluate this issue, it is necessary to examine the nature of the regional clearing centres. In larger centres, cheques are exchanged continuously throughout the day, so that the volume of daily transactions required to make direct participation in this clearing process worthwhile for any institution will likely limit the number of potential near bank entrants. There is also the problem that additional costs may be imposed on other participants. Under present arrangements, any chartered bank receiving a payment order drawn on a near bank can include the item with all the other items to be presented to the near bank's agent for clearing. If a near bank were a direct participant, the bank receiving its payment order would have to transmit the order directly to it, possibly at considerably greater expense. Thus, by admitting numerous smaller institutions into regional clearing centres, the unit costs for all others may rise. Some criteria for eligibility and rules for the operation of regional clearing centres would be justified to minimize the possibility of new entrants imposing excessive costs on existing participants. Such criteria should, however, be independent of the basis of incorporation of the institution and should reflect factors such as the volume of its payment transactions.

A second question about the participation of near banks in regional clearing centres concerns the responsibilities of participants, particularly at regional centres. At present, even though some banks do not participate directly at all centres, each bank makes provision, either directly or through an agent, for its cheques to be received and settled at each of the regional clearing centres. If this regulation were retained and near banks gained direct access to regional clearing centres, all but the largest would probably have to employ agents at some clearing centres. This proposal could have the effect of increasing the number of agents beyond the five or six possible at some centres. By contrast, co-operation on a national scale might lead to reciprocal arrangements for mutual representation among credit unions and other institutions. Therefore,

Recommendation 17

We recommend that direct access to the clearing system and participation in its management, on a basis equal to that of the chartered banks, be extended to suitably qualified near banks willing to accept the responsibilities implied by such participation.

A further responsibility of participants in the clearing system arises from the need for rapid settlement of clearing balances. At present, imbalances among chartered banks are covered by transfers among their deposit accounts at the Bank of Canada. In contrast, with near banks holding deposit balances with their clearing agents and not with the Bank of Canada, imbalances between their incoming and outgoing clearings are met by changes in their deposits with their clearing agents. This difference in settlement procedures has been cited as an obstacle to including near banks in the final settlement stage of the clearing process. But the importance of this objection can be questioned. Even now, some chartered banks not directly represented at regional clearing centres have made arrangements with other banks to settle clearing balances. As long as near banks committed themselves to some arrangement by which they could settle clearing balances as rapidly as chartered banks, it would not be necessary for them to hold deposit balances at the Bank of Canada. Nevertheless, inasmuch as transactions on deposit balances at the Bank of Canada may be the most convenient method by which near banks can settle, they should be permitted to hold such balances.

Conclusion

Any proposals relating to the clearing system require the reconciliation of two strands of analysis: one arising from the costs of new entrants to the clearing system; and the other from the overriding philosophy of this report, which argues that constraints on the activities of deposit institutions should be removed when they cannot be justified on economic grounds. In our view, the overall thrust of our approach would be thwarted if participation in the final stages of clearing were limited to one type of deposit institution. Accordingly, we propose that the provisions of the Canadian Bankers' Association Act governing the operations of the clearing system be changed to permit direct access to other suitably qualified deposit institutions on a basis equal to that of chartered banks. The expanded clearing system would be managed jointly by all participating institutions. It is our view that, to become qualified, any deposit institution must maintain adequate deposit balances at the Bank of Canada, or at an approved depository, so as to ensure rapid settlement of clearing balances; generate a volume of clearing transactions in at least one regional clearing centre equal to the standards approved by the Supervisor of Deposit Institutions, with standards determined independently of the basis of the institution's incorporation; and adhere to other requirements for membership in the clearing system, as approved by the Supervisor of Deposit Institutions.

10 TRANSACTION CARDS

The technology of making payments has, in the past, progressed from barter, through commodity money and paper money, to the cheque payment system. A striking development in recent years has been the emergence of a further stage in the evolution – the use of transaction cards for making payments. One type of transaction card, the credit card issued by department stores and oil companies, is most often restricted to purchases from the issuer. Travel and entertainment card systems, such as American Express, Carte Blanche, and Diners Club, use special-purpose cards, and their use is generally directed towards higher-income groups and retailers who typically sell higher-priced goods and services. Over the past decade, general-purpose transaction cards that can be used for a wide variety of transactions, such as Chargex and Master Charge, have gained wider currency.

In examining transaction card systems, it is important to distinguish between the payment feature, which is common to all transaction cards, and the credit feature, which is not. With a card having only the payment feature – the "cash card" – the holder would have to maintain a deposit on account with the issuer of the card, who would not provide credit. With a credit card, payments are made against a prearranged line of credit. Credit cards can, but need not, have a deferred payment feature, through which the holder can elect to pay his outstanding balance by instalments, with interest levied on the outstanding deferred balance.

Use of cards is a convenient way for many consumers to make transactions. The customer can avoid numerous trips to the bank and need not carry sums of cash – an especially important advantage when travelling or shopping in establishments where a personal cheque would not be accepted. Unlike cash, transaction cards provide consumers with a record of expenditures. Those that offer the consumer access to credit under a revolving credit arrangement provide added convenience in that the holder need not go through the procedures required to obtain a specific loan. Moreover, interest is charged on the revolving credit, only for the period for which it is used, unlike some other forms of consumer credit; and often no interest is charged for at least thirty days after purchase.

For participating retailers, transaction card systems provide an efficient means of receiving payments. Payment is guaranteed by the issuer of the card; risk of cash losses is reduced; and the proceeds of sales can be easily monitored. In addition, once card systems have a substantial number of consumers, the retailer's market may be extended to card holders who might not buy if they were required to use cash. Furthermore, the credit card permits the retailer, indirectly, to offer credit to his customers without bearing any credit risk and without tying up his own resources.

The advantages to the institution issuing the cards are varied. Evidence from the operations of existing card systems indicates that they can be a source of profit. The competitiveness of the service offered by an institution is also important. Any institution not offering this service will almost certainly lose some of its customers to competing institutions that do, if only for this service. Finally, the general-purpose card can be viewed as a stepping stone to the payment system of the future. Whatever that system may be – and we catch glimpses of it here and there – some means will be required to identify the customer, verify his ability to pay, and transfer the required balance from buyer to seller. There is evidence that the bank credit card system will evolve to fill this role. Canadian banks now participate in such systems; deposit institutions not taking part in any card system are likely to be at a disadvantage in the payment system of the future.

Bank Credit Cards

In 1967, four Canadian banks – the Royal Bank of Canada, Canadian Imperial Bank of Commerce, the Toronto-Dominion Bank, and Bank Canadian National – acquired Canadian rights to BankAmericard, one of the two major bank cards in the United States, and marketed it under the name of Chargex. The Bank of Nova Scotia was subsequently admitted to this system on payment of compensation to the original members. In 1973, Bank of Montreal and the Provincial Bank of Canada became members of Master Charge, the other major bank card in the United States, with exclusive rights until 1978 and diminishing degrees of exclusivity until 1985. Neither of the systems issues a strictly general-purpose card. Each operates solely with the group of affiliated retailers who have entered into agreements with the card issuer, although many retailers participate in both systems.

Fees for the services of the bank credit card are now paid entirely by the retailer who is charged from 1½ per cent to 5¾ per cent of the value of each transaction, depending on the volume and average amount of his transactions. Where the retailer's and the customer's banks are different, this fee is split between them. Master Charge assigns 1 per cent of the gross sale per draft to the customer's bank, whereas Chargex assigns it the average rate of discount applied to the transaction by the retailer's bank, less 25 cents per draft.

Since the introduction of credit cards in Canada, their use has become widespread (Table 10-1). In 1974, over two million bank credit cards were in active use, while 196 thousand agreements existed between the card systems and their retail outlets. During the year, a sales volume of $1.4 billion was processed through bank credit cards and, at the end of the year, $500 million in balances remained outstanding. This

Table 10-1

The Use of Bank Credit Cards in Canada,[1] Selected Years, 1968-74

	1968	1971	1974
		(Thousands)	
Number of retail outlets	11,593	52,391	196,366
Total cards outstanding	975,936	2,153,895	3,825,265
Active cards[2]	98,562	623,259	2,033,786
		(Millions of dollars)	
Annual sales volume	9.4	267.9	1,427.6
Total balance outstanding	10.2	117.1	544.8
		(Dollars)	
Sales volume per retail outlet	810	5,114	7,270
Sales volume per active card[2]	95	430	702
Balance outstanding per active card[2]	104	188	268

1 Statistics include data from seven banks; two of these commenced credit card operations in 1973, and another in 1974.
2 Active cards are those that have been used at least once during the year.
SOURCE Based on data from the Canadian Bankers' Association.

chart shows that the increase in the number of active cards outstanding has been the most important source of growth in overall bank card transactions.

Efficiency and the Pricing of Bank Card Services

The importance of bank cards in the payment system raises two important issues. First, the present pricing mechanism for bank card services does not reflect the costs of providing them; therefore, it is not as efficient as it might be. Second, chartered banks are the exclusive issuers of general-purpose cards – a feature we would be reluctant to accept over the long term.

Transaction cards are only one means of paying for goods and services; purchasers can also use cash or payments by cheque. Ideally, the costs of each of these methods would be distributed among consumers, retailers, and the institutions supplying the payment services. In an efficient pricing system, the price for services would reflect the value of the resources used to provide them. Technically, this requires that the prices of services be related to their marginal cost.

The present pricing system for transaction card services departs significantly from the ideal. The consumer does not bear directly the expense of using the transaction card. The revenues of chartered banks from the operation of the system come from the discount charged to retailers on every transaction. The retailers must bear the discount paid for the use of the transaction card as a general business expense and are prohibited from recouping this discount by charging different prices for cash and card transactions. In effect, all consumers may bear the cost to retailers who accept cards, whether or not they use them. This is one of the major inefficiencies of the present pricing system.

Another is that credit is extended without formal interest for various periods of time to all users of transaction cards. From the retailer's discount schedules for Chargex and Master Charge, we estimate that the implicit interest paid is between 2 and 3 per cent. While consumers can earn interest on their balances during the period between purchase and date of payment, the return on these balances is unlikely to offset fully the implicit interest expense. Many consumers could pay on the spot and would likely do so if confronted directly with the costs of using credit.

One alternative to the present pricing system would be to ensure that the customer bears part of the transaction charge. Such direct charging for the use of transaction cards could be expected to accelerate the development of the cash card, through which a household's asset account would be reduced as purchases were made. A cash card would require some procedure to permit the continual monitoring of the amounts that could be transferred by the card. This system would allow households to avoid implicit credit charges related to the mandatory provision of credit under present credit card arrangements. Some institutions might even offer interest on balances held against debit cards. A cash card would also provide access to card-related payment technology for households with low income as well as those now deemed to be unacceptable credit risks.

Another benefit of a direct levy on customers for the use of transaction cards is that card issuers would have some incentive to become more competitive. Currently they compete mainly on the size of their lines of credit, the package of services offered, and their promotional efforts. The major price competition among card issuers is directed solely towards participating retailers but, even here, adherence to published price schedules is the norm. Moreover, differences in published discounts appear unrelated to the costs of performing transaction services. For example, for retailers with the largest dollar volume, the fees are unconnected to the number of separate transactions handled. In future, if the card holder bore some of the cost of using the transaction card, price competition for household business would be possible. The prospect of such competition might be further increased if an institution issuing transaction cards were prohibited from entering an agreement, whether formal or informal, with any other institution on the prices charged retailers or consumers for transaction card services.

Another way to alleviate the inefficiencies of the present pricing system in card transactions would be to allow retail discounts for cash in order to encourage card holders to make payment decisions on the basis of economic costs. This alternative would, however, be less satisfactory than that of charging customers, partly because the latter is more likely to produce price competition among issuers. Charging the card user rather than the retailer would also allow differentiation of charges according to transaction costs and degree of credit use. For example, higher charges could be levied on international transactions, where the costs of authorization, handling, and credit rating are higher than on domestic transactions.

Our conclusion about present pricing procedures for transaction cards is that they lead to inefficiencies, as customers are not facing the consequences or the cost of their decisions. If the charge presently levied on the retailer were divided between the customer and the retailer, relative to the services provided to both by the card, the customer's share should cover some portion of the handling charges and also the implicit interest; the retailer's share should cover the remainder of the handling charges, the guarantee function, and any auxiliary services provided to him. Among the auxiliary services provided by card issuers at present is the analysis of the composition, volume, and other characteristics of their card transactions. This service clearly benefits the retailer directly, and any attempt to make customers pay for these services would lead to the same inefficiencies as exist under the present arrangement. It is appropriate that costs for services that benefit the retailer be borne by him directly, subject only to the provision that such services be optional, relative to his participation in the transaction card system. This division of charges should eliminate any illusions on the part of card holders that the use of the card or the credit provided prior to payment are "free." They would then be confronted with the costs of alternative methods of payment, and their choice would more nearly reflect the economic costs involved.

The Bank Card and Competition among Deposit Institutions

An important issue for public policy is the present control of chartered banks over the issuance of general-purpose transaction cards. We argue throughout this report that any obstacles that limit the ability of deposit institutions to operate in financial markets should be questioned carefully in relation to the economic justification for them. In line with this approach, we view the present exclusivity of bank cards as one of the more serious impediments to competition among deposit institutions. As long as near banks cannot offer a general-purpose credit card to their customers, they will be confined to a limited range of deposit-related business with their customers. Just as important in the future, the exclusivity of the transaction card may pose even greater problems for competition if, as expected, the card evolves into the building block of an electronic payment system. Our examination of the problems of undertaking such an activity has led us to consider several alternative ways that near banks could enter the card system.

In setting up a card system, a broad base of retailers adequate to attract customers to use the card must be established; a national authorization system to make the card usable throughout Canada must be developed; and arrangements must be made among participating institutions to exchange sales drafts. By entering into agreements with one of the two major transaction card systems in the United States, the banks learned about the introduction of transaction cards from the experience of the affiliated system; obtained developed authorization systems; gained access to international interchanges; and benefited from promotional spillovers – though, in the case of Chargex, this advantage was reduced by the change of name. The chartered banks also had a number of other advantages in that they already had working relationships with retailers, and only minor adjustments were required to process card vouchers. In addition, the national branch systems of major chartered banks enabled them to enter into arrangements with retailers across the country, providing customers with a transaction card that was acceptable throughout Canada. Moreover, this national coverage allowed some economies in promotional activities.

Any near bank, or group of near banks, attempting to establish a new card system to compete with the present bank card systems would face a number of difficulties that the banks did not encounter. Many retailers who already handle two bank cards and possibly a variety of travel and entertainment cards might be reluctant to accept another one. Besides, they do not usually maintain banking relationships with near banks and would incur additional expenses in doing so. Master Charge and BankAmericard are the dominant bank card systems throughout the world, and they provide chartered banks with both international customers for their retailers and international use of cards for their customers. Any near bank developing a transaction card system would be unable to offer either its retailers or its customers the same services. In addition, regional or local near banks would have difficulty offering a transaction card that would be usable throughout the country. Any such card system would have to have a national authorization system. In addition, retailers accepting the card anywhere in the country would need a local means of reimbursement for vouchers they accept. Even if a group of near banks across the country developed a co-operative transaction card system, they would have to develop some system for the interchange of vouchers.

In the face of such difficulties, near banks are unlikely to establish an independent card system in the near future. Their participation in a transaction card system could be achieved through compulsory licensing of existing systems, an "umbrella" card providing for interchange among systems, or a single universal card issued by all deposit institutions. There are certain advantages and disadvantages to each of these methods.

Under compulsory licensing, the existing card systems would be required to license deposit institutions wishing to enter the credit card field. By paying a reasonable fee, new entrants could participate in the system on the same basis as present members. A major problem with this approach would be to determine the appropriate entry price. The chartered banks spent large sums to set up card systems in Canada, and it would be very difficult to determine the degree to which the benefits of these expenditures will accrue to the banks and the new entrants to the system. Some expenditures, such as those for signing up retailers and developing international interchange arrangements, will benefit all participants; and any tariff ought to be designed to compensate for this share of the expense. In contrast, other expenses, such as those for attracting additional card holders, will mainly benefit existing institutions. Finally, the share of the benefits from some expenditures is hard to allocate. For example, bad debts might be regarded purely as an internal expense of the existing institutions; it might, however, be argued that initially this expense was a direct consequence of the number of card holders required to attract retailers into the system and that the expense should therefore be shared by new entrants.

Licensing would also raise the question of what form near bank participation should take. In the United States, some institutions participate only to the degree that they act as sales agents for the bank issuing the card; others obtain cards for their customers and bill them but do not carry credit; still others provide full services for their household customers but do not have any retail connections of their own. Different degrees of participation are appropriate for different types of institutions; however, if access to the full range of retail activities of deposit institutions is to be encouraged, near banks must have the option of entering as full members.

A disadvantage of the licensing approach would be the tendency over the longer run towards homogeneity of the services offered by participating institutions. However, this need not cut across all services; member institutions could vary their charges or offer the transaction card as part of different service packages. Indeed, some variation in services and charges would remain under compulsory licensing inasmuch as two distinct bank card systems would continue to exist. Moreover, there would still be the possibility that either some national competitor to the present systems or a number of regional, or otherwise specialized, card systems would emerge.

An alternative to the licensing of existing card systems would be the adoption of an "umbrella" card usable by otherwise independent card systems. The main requisite of an umbrella card system would be that retailers who accept any card affiliated with the system honour all general-purpose cards accredited to the overall system. An umbrella card would allow the customers of financial institutions to gain access to full credit card privileges throughout Canada. An umbrella card system could take any number of forms. Affiliated institutions might only be required to agree to extend reciprocal privileges to retailers who are signed with one of the institutions; such a provision already exists among participating institutions in each of the Chargex and Master Charge systems. Or the umbrella card could provide common authorization and international clearing facilities to all participating financial institutions. Some standardization would be required, but individual systems could still have separate identities.

The umbrella card approach could be used to ensure the participation of near banks by making membership in a national umbrella card system compulsory for any general-purpose card system operating in Canada. Retailers would then be required to keep an account at a deposit institution and could present vouchers for all card systems at that institution. Alternatively, an umbrella card could be established in which membership would be optional for the existing systems. In this case, some form of government assistance would undoubtedly be necessary to foster new systems to compete with existing ones.

Finally, another alternative to the present systems would be the adoption of a universal credit card that would replace all existing credit cards. Consumers could obtain this single card through any participating deposit institution, and it would be accepted by all participating retailers. In addition, all promotion, service, and clearing arrangements would be common for all participating card issuers. As with compulsory licensing, all member institutions would have interchange arrangements with card systems abroad. In the case of the universal card, such agreements would, however, be negotiated by the central organization.

Experience with some umbrella card systems in the United States suggests that a universal card is more likely to be readily accepted by retailers than would a variety of cards under an umbrella system. However, a universal card would preclude the possibility of the growth of regional or other specialized systems and could eliminate any incentive for participating institutions to develop the transaction card system further.

After reviewing the relative advantages of these alternatives for providing entry into the transaction card business, we propose that steps be taken to implement compulsory licensing in the two existing bank card systems. Therefore,

Recommendation 18

We recommend that all deposit institutions be assured access to existing bank card systems through compulsory licensing, on terms that are nondiscriminatory to both the existing card issuers and the entering institutions. If agreement cannot be reached between the banks and other institutions, the Supervisor of Deposit Institutions should have the power to appoint an arbitrator to determine the conditions for access.

In choosing this alternative, we were influenced by the scope it provides for the development of new card systems on regional or other specialized grounds. Moreover, compulsory licensing would encourage rival systems to innovate and experiment. It is thus possible that, over time, other card systems would develop to a stage where compulsory licensing of present systems could be dropped. And, while we considered the necessity of government participation in the establishment of authorization and interchange arrangements in the other approaches, we think that the private sector of the economy would make efficient arrangements under compulsory licensing; thus we do not believe that direct government involvement is either called for or appropriate.

11

THE EVOLUTION OF ELECTRONIC PAYMENTS

In addition to cash transactions, two payment systems – one based on the cheque, the other on transaction cards – exist side by side in the Canadian economy. Visible on the horizon is a system in which payments will be transferred directly through an electronic network from a buyer's to a seller's account. When this electronic payment system arrives, in whatever form, it will be a further step in the continuing process of applying computer technology to deposit institutions. These institutions already rely heavily on computers, which, more than in most other areas, are shaping the nature of the services provided. The impact of computers on deposit institutions, and on the markets in which they operate, raises many new policy issues for financial institutions.[1]

Computers and Deposit Institutions

During the past two decades, retail banking activities grew rapidly, and consumer use of bank facilities became more widespread. Accompanying this growth was a substantial increase in paperwork and processing time, with a concomitant rise in costs. Beginning in the late 1950s, computer technology was introduced into the accounting activities of deposit institutions to help overcome these problems. Computerization centred around the use of electronic "batch processing" to ease the handling of paper both within and between institutions. The greatest single result was the reduction in time required for a cheque to be cleared, from three or four days to overnight.

Additional activities are now being computerized. In some parts of the country, direct and indirect electronic connections between the branches, computer centres, and head offices of individual banks and other deposit institutions are proliferating. Some of these systems involve the "batch processing" of data. These systems are either "offline," in that tapes or other materials must at some stage be physically transported

1 Concern about these issues was expressed by the federal government in Government of Canada, *Towards an Electronic Payments System* (Ottawa: Information Canada, 1975).

from one place to another, or "online," in the sense that all basic data are transmitted electronically from one input and/or output device to another. Some online systems are either "real-time" or "time-sharing" systems, and both result in virtually instantaneous two-way communication between the branch terminal and a computer centre. Most institutions now have online savings accounts, although not in most cases from all branches. In addition, 24-hour cash dispensers, as well as more sophisticated automated tellers, have been installed in some metropolitan branches of certain institutions. As a result of these developments, substantial improvements are being made in the range and quality of customer service and marketing, and institutional rivalry for shares of total business is increasing.

The verdict on the effects of computerization on resource savings, especially from online banking, is less clear, largely because present developments are only the beginning of a continuing process. Some experts within financial institutions doubt that there has been much cost saving to date but claim that services have improved; passbooks are cleaner and more legible, and errors have been reduced. Many believe that the benefits of online banking, in terms of both cost control and ability to develop new and improved lines of services, will accrue only gradually over time.

Forecasts of future developments typically envisage the spread of terminals and attendant communications networks beyond the premises of financial institutions to retail stores, hotels, and even private homes. Through point-of-sale terminals and other devices, members of the public will be able to do an increasing proportion of their business with banks, credit unions, caisses populaires, and trust companies without actually visiting their business premises. Computerized banking will, no doubt, become much more extensive and pervasive as the use of automated tellers becomes more widespread and as more sophisticated card payment systems incorporate memories capable of indicating unused balances.

Towards an Electronic Payment System

How and when these developments will lead to a more sophisticated payment system are matters of speculation. Despite these uncertainties, however, it is now possible to identify some of the problems likely to be encountered in the evolution of the payment system. Any system must involve the interchange of information between the payer's and the recipient's institutions. At least in the short run, problems of co-ordinating this process could intensify with the spread of computer technology, especially to the degree that some financial institutions compete for market shares by using computers more effectively than their competitors. However, despite their desire to capture larger markets, rivals will have to communicate efficiently with each other to transfer funds and conduct clearings.

The co-ordination required for moving towards an electronic payment system raises the issue of the competitive position of near banks. The choice of technologies and institutional arrangements for the electronic payment system may substantially alter the ability of near banks to serve their customers' needs. For example, if point-of-sale terminals through which a store customer could pay by transferring funds from his account to the retailer's were adopted, retailers would want to be serviced by only one terminal system linked to a variety of institutions. But, if such a system developed from the existing clearing system or from bank credit cards, nonbank deposit institutions would be unable to offer this service to their customers. Not only would such a development severely limit competition in the provision of payment services, but it might well be accompanied by reduced competitiveness in other related consumer financial services.

The federal government, in considering these issues, has proposed an approach to the development of electronic payments whose essential features would be a common-user network for all communications connected with payment transactions and an implementation committee to ensure the development and adoption of appropriate standards in the payment system. A "common-user network" is defined as "a shared service which would be openly accessible to all qualified users on a fee-for-use basis."[2] While not explicitly stated, the government's intention appears to be to institute a monopoly network, absolutely protected from competitive entry by parties wishing to establish other networks, either nationally, regionally, or for special purposes. The payment system envisaged would undoubtedly be brought under direct public regulation comparable to that presently governing the telecommunications industry in Canada. Technological compatibility would be ensured by adoption of a single system with negotiated standards of interchange with participating institutions; qualified deposit institutions would be ensured access through the common-user network.

While the government's proposal deals with questions of access and technological compatibility, questions must be raised about the extent to which it would create other kinds of problems. For instance, a danger in the government's proposal is that it may lead to a premature commitment to only one of many potential technologies. In effect, it rules out the existence of competing communications networks for servicing the payment system. Deposit institutions would only be able to use "private communications systems for purposes that are entirely internal to the institution and are unrelated to payments transactions."[3] Such a situation would not be without cost. The major advantage of competing systems is the scope they provide for potential innovation. Local experiments could provide knowledge and information that would contribute to a more effective payment system. Under the government's proposal, institutions would have little incentive to pursue such experiments or even new developments in specialized activities that might well lead to substantial improvements in efficiency. For example, in future, a group of financial institutions might wish to establish a highly specialized computer/communications network for some purpose, such as foreign exchange trading. While this specialized network would conflict, as a matter of principle, with the proposed common-user system, careful investigation might confirm that it would represent an appropriate use of the nation's resources.

The impact on innovation is only one aspect of the difficulties created by the implementation of a single communications network and the high degree of

2 *Ibid.*, p. 7.

3 *Ibid.*, p. 19.

standardization required. Since differentiated products are generally required to serve the different needs of various groups of customers, implementation of the government's proposal could unduly limit the range of alternatives available to users of the future payment system and seriously conflict with other important objectives if pursued too far.

One of our criticisms of the government's proposal is that it insists on the development of a national electronic payment network. In the initial stages of development, such a system would be viable only in certain regions of the country where the number of affiliated establishments would be sufficiently high. While we might favour the extension of basic utilities to a wider area than would be viable from the point of view of profitability, at some point the social benefits of extending the service still further would cease to justify the use of additional productive resources. One of the dangers in developing a national system would be that cross-subsidization might be necessary. As a result, some users would subsidize the others. To the extent that they used the service, they would pay an excessive price; if they did not use the service, they would have to turn to other less efficient means of fulfilling their needs.

The government's policy statement also places much emphasis on the necessity for Canadian ownership of the computer industry in any electronic payment system. But, if the output of the protected domestic computer industry were more expensive than that of its competitors, the use of the electronic payment system would be more costly. Potential users, facing these higher costs, would continue to use other forms of payment, even though the technology of electronic payments would be potentially more efficient. The proposal attempts to promote the Canadian computer industry, seemingly without any regard for its efficiency relative to that of other countries. Such an objective may be thoroughly legitimate for a government to pursue, though misguided economically. But the use of the payment system to attain this goal is highly questionable, and the costs should not be imposed on the payment system alone. If the government is concerned about fostering domestic competition among transnational computer producers, such a policy should be promoted openly and directly – for example, through the energetic application of competition policy, where appropriate, or through the use of direct subsidies for domestic producers.

A Policy Position on the Electronic Payment System

Our approach to the evolution of electronic payments would lead to a less centralized and more flexible system than would the government's initial proposal. Many uncertainties surround the innovative process, and there is a need for competition and adaptability in order that the system will be responsive to unexpected developments in technological innovation. Under our approach, there would be less necessity to anticipate future problems. Whenever specific issues such as increasing industrial concentration and market power in the financial sector arose, we would seek specific cures for them – preferably those that would not enhance or entrench market power in other industrial sectors. The eventual creation of a large common-user payment network to serve the financial sector of the Canadian economy would not necessarily be ruled out. If a network emerged, however, it would be extremely important that it not have a high degree of exclusivity in its field through the control of entry and the creation of monopolies in related activities. This more open and flexible approach is consistent with that taken by the Council to other policy issues in the past and that taken elsewhere in this document for other aspects of the deposit-taking sector.

Our views are derived, first, from considerations about the different possibilities for competition in various components of an overall payment network. In a study of the regulation of telecommunications, Beigie defined four basic components of supporting network systems: transmission trunks, switching equipment, local gathering and distribution loops, and terminal devices.[4] The prospects of competition in the supply of each of these parts vary substantially. Largely because of economies of scale, trunk transmission equipment and, to a lesser degree, local loops are likely to be regulated monopolies, as at present. The potential for competition in both switching and terminal equipment is much greater. Switching, which consists of the processing and the modification of messages at some stage in the communications network, can be carried out by both communications carriers and data processing firms. Similarly, there is nothing in the technology of terminal equipment that would prevent competition among a number of suppliers. Thus, while a single network may be an appropriate means of supplying trunk transmission and even local loops in an eventual electronic payment network, there is little convincing evidence that a unique monopoly network is the best solution for these functions at this time. Given past experience with direct regulation and the performance of regulated industries, we do not believe that government policy should extend, or entrench, areas of regulated monopoly without very good reason.

The uncertainties about future technology become especially important in discussions about the possibilities for competition in any future payment network. If massive movement towards an electronic payment system were imminent, policy decisions would have to be made on the basis of the existing state of technical development. But, even now, evidence on scale economies and other arguments that would naturally lead to adoption of a single monopoly payment network have yet to emerge. Moreover, there is mounting evidence that significant movements towards an electronic payment network are still considerably far off. To commit the Canadian public to the establishment of a monopoly payment network at this time would unnecessarily limit the choice among competing technologies and alternative institutional arrangements.

We must take into account that certain patterns of development could serve to restrict competition among deposit institutions. The creation of obstacles to flexibility and competition would be contrary to the philosophy of this report. To prevent such obstacles, it is necessary to anticipate the development of electronic payments to some degree, and we support the government position on the need for forward planning of

4 Carl E. Beigie, "An Economic Framework for Policy Action in Canadian Telecommunications," in H. Edward English, ed., *Telecommunications for Canada: An Interface of Business and Government* (Toronto: Methuen, 1973), pp. 48-54.

interchange standards, so that all deposit institutions can work towards them in their internal planning and development. The proposed implementation committee, composed of representatives from deposit institutions, common carriers, computer manufacturers, and others as required, including retailers, would provide some leadership in this area. However, we think that a single committee would be cumbersome and unsuitable for responding to rapid technological change. Instead, we suggest that a number of smaller, more specialized, committees be created as the need arises. Banks and near banks could, for example, be brought together in one committee to plan the technological standards for an electronic payment system and other matters of common interest. For other purposes, an appropriate forum might be a joint technical and planning committee of users, including the Canadian Bankers' Association, the Trust Companies Association of Canada, and the federations of credit unions and caisses populaires.

The danger that obstacles to flexibility and competition in financial markets will be created with the advent of an electronic payment system should not be minimized, even if the precaution of planning interchange standards in advance has been taken. The causes of these obstacles, or the forms they may take, cannot be accurately foretold at this time. Nevertheless, the government's proposals in attempting to forestall the development of such obstacles have the disadvantage of imposing a strait jacket on the development of electronic payments. Our approach is less comprehensive. We do not ignore the possibility of such obstacles being created; rather, we believe these obstacles must be dealt with by the federal government as they arise. Therefore,

Recommendation 19

We recommend that the federal government not commit itself at this time to a single common-user network for the electronic payment system; that a committee of users, including representatives of chartered banks, trust and mortgage loan companies, caisses populaires, and credit unions, be established to reach agreement on basic technological standards for an electronic payment system; and that the government commit itself to ensuring that no steps in the development of an electronic payment system shall foreclose access to this system by smaller deposit institutions.

The Consumer and the Changing Payment System

The growth in the use of transaction cards, together with their probable integration into an electronic payment system in future, will alter substantially the method of making payments for goods and services. The cheque has many desirable features that have led to its widespread use. Over time, the respective rights of the issuer, the recipient, and the institution on which a cheque is drawn have become codified and are broadly familiar to the general public. The deposit holder is protected from loss by fraud through procedures that require the recipient and deposit institutions to identify the issuer as a legitimate owner of the deposit account on which the cheque is drawn.

Cheque issuers are permitted to issue stop-payment orders for a certain period of time, providing limited protection against another party's failure to fulfil the terms of a transaction. Finally, the cheque serves as a record that an obligation has been discharged, and it is generally accepted as evidence in case of dispute.

When the cards were first introduced, they incorporated one of the most desirable features of the cheque. Card holders received duplicate copies of transaction vouchers with their monthly statement, which enabled them to verify entries. Recently, a simple descriptive statement has been widely adopted because of obvious cost considerations. While customers still receive a copy of the voucher with their purchases, they are no longer sent a duplicate with their statement. This change in procedure will make it even more necessary to define the respective rights and responsibilities of card issuers and holders in disagreements and disputes over charges.

In the United States, legislation establishing guidelines in cases of dispute has been adopted. Among the provisions is the requirement that the creditor acknowledge within thirty days any question raised by the holder and either correct, or provide an explanation for, the charge in question within a further specified period. During this time, the creditor is prohibited from attempting to collect the disputed amount or from reporting it as overdue to any third party such as a credit bureau. The legislation also requires card issuers to provide notice of these conditions periodically to their customers. Failure to comply with these conditions results in loss of the right to collect the disputed amounts.

The legislation proposed in the United States embodies a number of principles that should be carried over to any Canadian legislation. While not advocating the adoption of the exact provisions of this legislation, we believe such a codification of rights and responsibilities is desirable and will become especially critical under an electronic payment system, where payment documentation will undoubtedly differ from that of present systems. A need exists to create incentives for quick resolution of disputes, especially where disputed items are large. In addition, consumers' credit ratings should not be affected by the existence of outstanding disputed items. However, card holders as a group must bear the costs of nuisance disputes, and the card issuer should be protected. Some form of nominal fee for unsuccessful challenges, reflecting the costs of undertaking the verification, might be an appropriate protective measure.

With its identification and guarantee features, the card has gained wider acceptability than the cheque, but at the risk of greater financial loss through unauthorized use. At present, the holder's liability is customarily limited to a maximum amount of $50. Similarly, if retailers follow procedures established by the card issuer, they are protected against unauthorized use. The present safeguards for the holder have been criticized because of a lack of standard procedures for notifying issuers in case of loss. Protection for issuers is also inadequate. While the retailer can seize stolen cards on behalf of the issuer, the rights of the issuer and his agents with respect to repossession of the cards from holders with delinquent accounts are less clear.

Transaction cards and probable electronic payment systems do not provide the advantage, as do cheques, for a purchaser to stop payment when the terms of a transaction are not fulfilled. Such a feature is possible with chequing arrangements because payment is not guaranteed, and there is a delay between the exchange of the cheque and the ensuing transfer from the issuer's account. Transaction cards guarantee payment to the retailer, in effect ruling out the possibility of stopping payment. In an electronic payment system, stopping payment would also be impossible because transactions would be performed instantaneously. Elimination of the possibility of stopping payment would alter the relationship between the customer and the supplier in the case of disagreement over terms of transactions. The possible displacement of the cheque means that consideration should be given to alternatives to the stop-payment order. Means of recourse could be embodied in consumer legislation. Moreover, the resulting rights should be identical for all consumers, regardless of the method of payment used.

While progress towards an electronic payment system is being achieved, payment options for some groups in society may become unduly restricted. At present, any individual who fails to obtain a transaction card may still make payments in cash or by cheque. However, the wider the use, and the greater the acceptance, of transaction cards, the more inconvenient will be the use of these alternatives. For example, even now some U.S. car rental firms do not accept cash, and it is conceivable that many bank branches will be replaced by automatic tellers, activated only by transaction cards. These concerns could be eliminated with the adoption of a cash card, which would reduce the importance of credit worthiness to the card issuer. Thus, while the development of an electronic payment system need not foreclose alternative means of payment to some groups in society, some vigilance will be required to ensure that it does not. Therefore,

Recommendation 20

We recommend that the federal government give priority to formulating guidelines that will establish the rights and responsibilities of all parties participating in payment systems based on transaction cards and electronic transfers of funds. These guidelines should set minimum standards with respect to such matters as protection from fraud, disagreement over charges, and conditions allowing individual access to transaction cards.

One final aspect of the changing payment system relates to the conflict between the individual's right to privacy and the credit grantor's reasonable demand for information. The advent of large computer systems has created the potential for comprehensive data banks, increasing public concern about the invasion of individual privacy and the use of information in data banks against an individual's interests without his or her knowledge. Nevertheless, access to a range of varied information regarding payment habits, assets and liabilities, and other factors related to credit worthiness is an important input to the granting of credit. We believe, however, that the flow of information generated by, and required for, the granting of credit, and its use, should be under the control of the individual. Therefore,

Recommendation 21

We recommend that legislation be implemented that will embody the following principles of consumer privacy: every person has the right to know what information pertaining to his assets and liabilities is being kept on file by any financial institution; anyone who has reason to believe that such information is inaccurate has the right to have this information reviewed and, if necessary, corrected; and anyone who furnishes such information about himself to any financial institution has the right to be assured that this information will not be passed on to any other financial institution without his express permission.

12 CONCLUSIONS

The principal theme underlying this report has been a concern about the efficiency of deposit institutions in meeting the financial needs of the Canadian economy. Efficiency, in our view, is most readily attainable in a competitive environment, where institutions can move freely into new activities in response to changing technology and shifting demands, and where households and businesses have access to a variety of institutions offering them financial services. Efficiency among deposit institutions can be impeded by an inappropriate structure of regulations and by corporate arrangements that restrict participation in certain activities. Throughout our study, where obstacles to greater efficiency have been encountered, especially in the area of legislation, we have endeavoured to appraise their possible rationale in terms of other goals such as depositor protection, the effectiveness of monetary policy, the avoidance of concentrated power, and the maintenance of domestic control of financial markets. Thus our recommendations have been directed towards increasing the efficiency of the deposit institutions, while recognizing that certain other objectives must also be safeguarded.

At present, Canadian deposit institutions are governed by a legislative framework that consists of separate sets of rules defining the range of permissible activities and requirements that apply to each type of institution. Our analysis indicates that the evolution of the legislative framework has failed to keep in step with the changing nature of the institutions and their activities. Consequently, institutions involved in substantially different activities are governed by the same rules and regulations, purely because of incorporation under the same legislation. Similarly, other institutions carrying on substantially the same business are governed by entirely different rules, or no rules at all, depending on the basis of their original incorporation. The alternative approach to regulation that we recommend is one that relates to the functions performed by any institution. Regulation by function will permit greater opportunity for institutions to move into new activities as changing credit needs emerge, and thus help to ensure that financial services are supplied as cheaply as possible. This approach permits specialization but does not require it; thus an institution can elect to specialize if it so desires.

Under the proposed functional approach to regulation, changes in incorporation are not required; rather, any institution will be able to perform activities open to deposit institutions if it meets the qualifications and abides by the rules governing those activities. In contrast to other approaches towards revising the framework governing deposit institutions, our functional approach permits reform without requiring changes in the division of powers between federal and provincial authorities, provided agreement is reached on the development of regulations relating to each function.

Our examination of deposit institutions and their markets supports the view that regulation by function is beneficial. Where legislation has permitted the entry of new institutions, the movement of existing institutions into different activities, or direct competition among a variety of institutions within the same market, there has usually been a competitive response in terms of prices or services offered. Moreover, a number of the innovations and beneficial changes in financial markets have resulted from new entrants into these markets.

Concomitant with the variety of legislation governing deposit institutions is a variety of regulators charged with responsibility for different institutions. Not only does this multiplicity of authorities reflect the division of responsibility for deposit institutions between federal and provincial jurisdictions; it also reflects a division of responsibility at the federal level and in some provinces – a division that limits the scope for uniformity of regulation required by our functional approach. We have concluded that regulation by function can be more readily achieved with a single authority for the regulation of deposit institutions within each jurisdiction. These authorities should administer and enforce the legislation governing the institutions and take responsibility for collecting data, auditing institutions' accounts, and monitoring their activities. They should also review the continuing appropriateness of legislation, initiate proposals for revision, and maintain liaison with the officials in other jurisdictions. We expect that the existence of a single authority in each jurisdiction will ease the task of gaining the co-operation required among both levels of government for the effective regulation of deposit institutions.

In addition to our concern about efficiency, we have also focused our attention on other goals of the regulatory system, such as depositor protection, innovation, and effective monetary control. This analysis has dealt specifically with the deposit insurance system, the reserve requirements imposed on deposit institutions, and certain borrowing limits applied to deposit institutions. Our review of the deposit insurance system has led us to conclude that depositors at all provincially incorporated deposit institutions should be protected by deposit insurance, that the borrowing power of the Canada Deposit Insurance Corporation should be increased and set as a proportion of the deposits protected, and that a system of variable premium rates should be established reflecting the difference among institutions with regard to potential claims on the insurer. In the case of cash reserve requirements, we recommend that they be applied to all deposit institutions on an equal basis at a uniform level of no more than 4 per cent of all relevant deposit liabilities. These reserves, according to the type of institution, could be held at either the Bank of

Canada or an approved depository. Secondary liquidity reserves should also be applied to all deposit institutions according to the nature of their liabilities but with the range of assets eligible for such requirements broadened on the basis of the marketability of such assets. The borrowing limits applied to trust and mortgage loan companies no longer effectively serve the intended depositor protection role; therefore, we recommend their removal.

The easing of entry by new institutions into various financial activities is an important aspect of fostering increased efficiency in the deposit-taking sector under a functional approach to regulation. We believe that several provisions in the existing legislation have served to inhibit entry into banking activities, and they contribute to reducing efficiency unduly. Therefore, we recommend easier entry by both Canadian and foreign-owned financial institutions into all areas of financial activities open to Canadian banks.

Some deposit institutions are now limited in their commercial and consumer lending by the legislation governing their activities. The trust and mortgage loan companies, for example, are restricted in these activities to the limited provisions of their basket clause. Similarly, membership provisions tend to constrain commercial lending by credit unions. Such restrictions on a group of institutions, offering a range of deposit liabilities similar to those of other institutions, conflict with the functional approach advocated in this report. We therefore recommend that all deposit institutions be permitted commercial and consumer lending as a normal part of their business. A complicating factor, however, is that some trust companies carry on estate, trust, and agency business, which we feel may lead to conflict of interest when combined with commercial lending. To safeguard against broadening the range of potential conflict, we recommend that trust companies seeking commercial lending powers separate their commercial lending from their trust activity. In addition, we propose that the entire estate, trust, and agency business be the object of a comprehensive review, especially in relation to conflict of interest.

Portfolio ceilings that prohibit deposit institutions from holding specific assets beyond certain proportions of their portfolios, and the complete prohibition against certain types of financial activities that can be viewed as complementary to their normal business, have also served to reduce competition among deposit institutions. All deposit institutions are subject to portfolio ceilings in one form or another. The purpose of such regulations apparently varies substantially from regulation to regulation. Through time, our examination shows that a number of these portfolio ceilings have outlived their original purpose. In addition, the prohibitions against financial leasing and factoring activities on the part of deposit institutions have become outdated with the widespread acceptance of these forms of financing in the business community, both within Canada and internationally.

The main portfolio ceiling, which applies exclusively to chartered banks, limits their holdings of conventional mortgages to no more than 10 per cent of their outstanding deposits and debentures. When the former prohibition on conventional mortgages was eased in 1967, fear concerning bank domination of the mortgage market led to the imposition of the 10 per cent ceiling. The ability of the other deposit institutions to adjust to bank entry into mortgage lending suggests that this ceiling is no longer necessary. It is also our view that financial leasing, as distinct from conventional leasing, can be regarded as the equivalent of a financial transaction as long as certain criteria are satisfied. These criteria include the absence of inventories of assets held by the lessor, the scope of the lessee's choice of assets subject to normal credit limits, and the term of the lease in relation to the expected useful life of the asset. In addition, we believe that factoring can be regarded as complementary to the existing commercial lending of deposit institutions.

In examining the effectiveness of regulation, we found many instances where the apparent intent of legislation had been avoided through the use of subsidiaries by deposit institutions. Under existing provisions, the equity interest of chartered banks in subsidiaries other than bank service corporations is restricted to no more than 50 per cent of the outstanding shares of the subsidiary when the investment is less than \$5 million, and no more than 10 per cent in other cases. Such an outlet may be beneficial in that it provides limited opportunities for chartered banks to engage in new areas complementary to banking for which explicit provision is lacking. Nevertheless, it must be noted that the absence of any limit to the supply of finance to these subsidiaries by any means other than equity weakens the effectiveness of the ceiling. In our view, such a ceiling on investment by deposit institutions in subsidiaries is required to ensure the continuing separation of financial and nonfinancial activities.

Since foreign banks in Canada are largely outside the scope of existing regulations, steps must be taken to establish the terms under which they should operate. The regulated entry of foreign institutions could contribute to Canadian access to financial services at the lowest possible cost. Such steps can also be justified in terms of fairness to domestic institutions already subject to regulation and in terms of the maintenance of Canadian control of the banking system. We recommend the passage of a Foreign-Owned Banks Act at the same time as the revised Bank Act that would place all foreign institutions accepting deposits in Canada under federal control. This act would allow the staged entry of foreign banks into Canadian banking activities. In the initial stage, its powers to branch and expand would be restricted but, at a subsequent stage, full branching powers could be obtained, subject to the sale of a substantial portion of its shares to Canadians and an overall size limitation. Finally, the size limitation would be removed if the foreign parent reduced its shareholdings to comply with the fundamental principle of Canadian banking legislation – that ownership of a bank must be widely dispersed among Canadian shareholders. Foreign-owned financial institutions operating under provincial jurisdiction would be regulated by provincial authorities on a functional basis similar to Canadian institutions undertaking similar activities under provincial jurisdiction, provided that the provincial regulations meet the conditions of the Foreign-Owned Banks Act.

With regard to the payment system, our research has indicated a number of continuing problems in the existing cheque-clearing system and a substantial range of regulatory issues surrounding the use of transaction cards and the computerization of banking activities. These must be dealt with in order to facilitate and regulate the approaching technological revolution of the payment system. Currently, banks and near banks differ with respect to their role in the cheque-clearing system, with only chartered banks holding deposits at the Bank of Canada and participating in the final settlement stage. The conditions of access for other institutions are determined through bargaining with present members to serve as the near bank's clearing agent. We view the present clearing arrangements as a potential obstacle to the type of competition desired in financial markets. As a result, we recommend that access to the clearing system, and participation in its management, be extended to other suitably qualified deposit institutions willing to accept the responsibilities implied by such participation.

The importance of the transaction card in the development of an electronic transfer system for funds leads us to the view that wider access to the provision of this service is essential to the healthy development of the Canadian financial system. As payment transactions become automated, the risk will arise that, unless all deposit institutions can offer transaction card services to their customers, competition among these institutions will be weakened, to the detriment of the public. After examining a number of approaches to ensure the near bank's ability to issue transaction cards, we believe that compulsory licensing is the best alternative. Under a system of compulsory licensing, existing card issuers would be required to make their card systems accessible to other deposit institutions upon acceptance of certain responsibilities such as the payment of royalties and the assumption of liability for transactions carried out by cards that they have issued. If agreement over terms of access cannot be reached between the banks and other deposit institutions, we suggest that an arbitrator determine terms that are nondiscriminatory to either party. To meet this criterion, royalty payments must not only reflect the substantial development costs incurred by the banks to date, but must also provide fair terms of access to near banks.

The application of computer technology to banking will continue to lead to profound changes. Not only are new ways of performing old activities being introduced, but new services are being offered and the nature of older services is being transformed. Encouraging the timely and orderly development of computerization in the deposit-taking sector is one of the most important challenges facing policy-makers. Recently, the government issued a statement on electronic payments that proposed the development of a common-user communications network for all deposit institutions and the formation of an implementation committee to plan the network. We view the government statement as the beginning and not the end of this discussion. We advocate a less centralized and more gradual approach than that proposed by the initial policy statement. While we do not rule out the eventual creation of a large common-user payment network, we believe an important first step must be to reach agreement on technological standards. Consequently, we recommend that the government not commit itself at this time to a single common-user network, that a committee of users be established to reach agreement on basic technological standards, and that the government ensure access to the electronic payment system by smaller deposit institutions.

With new payment techniques, the use of cheques will decrease relative to other means of payment. In contrast to the cheque, the alternatives lack the legal codification of the respective rights of payers, recipients, and institutions whose instruments are used for payments. Reliance on the use of the card as a means of identification also requires definition of the responsibilities of the participating parties for loss in case of fraud. Similarly, the increasing use of summary statements of accounts necessitates the adoption of official procedures for treating disagreements over charges. Finally, to the extent that the transaction card becomes the dominant means of payment for some transactions, conditions must be determined under which individuals may be granted the use of transaction cards. In this regard, we recommend that the government give priority to formulating guidelines that will establish the rights and responsibilities of all parties participating in a payment system based on transaction cards and electronic fund transfers.

The advent of large-scale computer systems increases the capacity to create large data banks; consequently, there is public concern over their use. Moreover, developments pertaining to credit cards may lead to an increasing interchange of credit information among institutions. To ensure the maintenance of privacy, we believe certain consumer rights must be upheld. In accordance with this, we recommend that legislation be implemented, giving every person access to information pertaining to his financial activities on file at any financial institution, the right to have this information reviewed and corrected, and the assurance that this information will not be passed to other financial institutions without his express permission.

We feel that, if the comprehensive recommendations presented in this report were implemented by the federal and provincial governments in a co-operative and co-ordinated manner, there would be a more competitive, innovative, and flexible financial system in Canada. This system would serve Canadians better, through lower costs and a greater variety of services. It would also result in greater equity among deposit institutions. The recommendations do not cause jurisdictional problems between the federal and provincial governments but, instead, attempt to expand upon the existing degree of co-operation between the two levels of government. The attainment of more competitive and efficient deposit institutions will be particularly important with the advent of the electronic payment system based on transaction cards and computer technology. If a more competitive deposit-taking sector is not achieved prior to this development, inefficiencies could become more difficult to eliminate and could reduce the benefits to be obtained from the electronic payment system. Finally, considerable flexibility in the financial system will be required with the approach of the electronic payment system. A functional regulatory approach for deposit institutions could contribute significantly to the achievement of this greater flexibility.

RECOMMENDATIONS

1 We recommend that the federal and provincial governments adopt an approach to the regulation of deposit institutions whereby the rules governing any such institution shall relate to the activities or functions undertaken by that institution. Deposit institutions would include all financial institutions offering liabilities of fixed money value that can be cashed on demand or on short notice, or that can be transferred to other parties by payment order. Any institution performing this function should be regulated by either federal or provincial authorities.

2 We recommend that federal and provincial governments each take steps, where necessary, to establish a single authority for the regulation of deposit institutions within their jurisdiction. At the federal level, a new position of Supervisor of Deposit Institutions should be created to incorporate the present responsibilities of the Inspector General of Banks and those of the Superintendent of Insurance dealing with trust and mortgage loan companies. In addition, the Supervisor of Deposit Institutions should have responsibility for the administration of the Canada Deposit Insurance Corporation.

3 We recommend that provincial governments take steps to ensure that depositors at all provincially incorporated deposit institutions, including credit unions, be protected by deposit insurance.

4 We recommend that the borrowing power of the Canada Deposit Insurance Corporation, through the Consolidated Revenue Fund, be set at a proportion of at least 5 per cent of deposits protected by the Corporation.

5 We recommend that the Supervisor of Deposit Institutions implement a system of variable premium rates for deposit insurance, according to established criteria reflecting the differences among institutions with regard to potential claims on the insurer.

6 We recommend that cash reserve requirements be applied to all deposit institutions on an equal basis according to the nature of their liabilities. Reserve requirements should only be levied against demand deposits, notice deposits, and term deposits with an earliest maturity of less than 100 days and should be set at a level of no more than 4 per cent of the relevant deposit liabilities. The holding of such reserves should be made a condition for direct access to the clearing system and for coverage under deposit insurance. Depending on the institution, these reserves could be held at either the Bank of Canada or an approved depository.

7 We recommend that the principle of liquidity ratios be maintained and applied to deposit institutions according to the nature of their liabilities. The range of assets eligible for such requirements should, however, be broad and should be determined with reference to the marketability of such assets.

8 We recommend that federal and provincial legislation governing trust and mortgage loan companies be amended to remove the borrowing limits of these companies.

9 We recommend that the Bank Act be amended to make provision for 1/ closely held banks, with no limit to the shares held by one interest, such entrants being subject to restrictions on activities in terms of the number of branches and asset size; and 2/ controlled banks, with a maximum of 25 per cent of outstanding shares held by one interest, such entrants being subject to a maximum size limitation. Each of these institutions shall be subject to conditions similar to those that will apply to widely held banks with respect to separation of financial and nonfinancial activities.

10 We recommend that, where necessary, the legislation governing trust and mortgage loan companies, credit unions, and caisses populaires be amended to permit commercial and consumer lending as a normal part of their business. Such extended powers should be conferred only on those institutions that meet the ownership requirements applying to entrants into chartered banking. In the case of any trust company exercising commercial lending powers, a further requirement must be met. The company must maintain separation between its commercial lending and trustee activities.

11 We recommend to the appropriate provincial authorities that a careful examination of the fiduciary activities of trust companies be carried out immediately, particularly with regard to the conflict of interest between intermediary and fiduciary activities.

12 We recommend that present limitations on holdings of conventional mortgages by chartered banks be removed.

13 We recommend that deposit institutions be permitted to engage in financial leasing.

14 We recommend that deposit institutions be permitted to engage in factoring in conjunction with their commercial lending activity.

15 We recommend that advance approval of the Supervisor of Deposit Institutions be required for investment by deposit institutions in Canadian subsidiaries that involve either 1/ a financial commitment on behalf of the parent in any form, including guarantees in excess of the existing limits to equity investment, or 2/ a joint venture among deposit institutions.

16 We recommend that a Foreign-Owned Banks Act be passed at the same time as the Bank Act is revised, which would bring under federal control foreign-owned institutions accepting deposits in Canada. This Act should include a staging procedure providing limited entry during an initial transition period and the option thereafter of either a closely held bank or a controlled bank, each subject to all the conditions applicable to Canadian-owned institutions of the same nature.

17 We recommend that direct access to the clearing system and participation in its management, on a basis equal to that of the chartered banks, be extended to suitably qualified near banks willing to accept the responsibilities implied by such participation.

18 We recommend that all deposit institutions be assured access to existing bank card systems through compulsory licensing, on terms that are nondiscriminatory to both the existing card issuers and the entering institutions. If agreement cannot be reached between the banks and other institutions, the Supervisor of Deposit Institutions should have the power to appoint an arbitrator to determine the conditions for access.

19 We recommend that the federal government not commit itself at this time to a single common-user network for the electronic payment system; that a committee of users, including representatives of chartered banks, trust and mortgage loan companies, caisses populaires, and credit unions, be established to reach agreement on basic technological standards for an electronic payment system; and that the government commit itself to ensuring that no steps in the development of an electronic payment system shall foreclose access to this system by smaller deposit institutions.

20 We recommend that the federal government give priority to formulating guidelines that will establish the rights and responsibilities of all parties participating in payment systems based on transaction cards and electronic transfers of funds. These guidelines should set minimum standards with respect to such matters as protection from fraud, disagreement over charges, and conditions allowing individual access to transaction cards.

21 We recommend that legislation be implemented that will embody the following principles of consumer privacy: every person has the right to know what information pertaining to his assets and liabilities is being kept on file by any financial institution; anyone who has reason to believe that such information is inaccurate has the right to have this information reviewed and, if necessary, corrected; and anyone who furnishes such information about himself to any financial institution has the right to be assured that this information will not be passed on to any other financial institution without his express permission.

APPENDIXES

A POSSIBLE SOURCES OF INCREASED PROFITS IN CANADIAN BANKING

The high profit rates for chartered banks since 1968, as noted in Chapter 4, have been attributed to the presence of barriers to entry into Canadian banking. These higher profit rates might be explained, however, by other factors. Higher profits from 1968 onwards could be a reward for the increasing riskiness of bank operations that occurred at that time. Alternatively, high profits for the banks may be attributed to their foreign business. Finally, they may be temporary rather than permanent. To the extent that these alternative explanations account for the level of bank profits, the size of these profits need not reflect the presence of market power.

Risk

High accounting profits and returns to shareholders in a given industry may not serve to motivate entry if the extra profit just compensates existing shareholders for the risk borne. In this case, the higher observed rates of profit would be a necessary cost to the industry's customers. Part of the service the financial industry sells is the transferral of risk from customers to shareholders. For this reason, one might argue that the higher profits now being earned by banks may be the result of the greater risks in banking, compared with other industries, since the Bank Act revision.

For the purpose of determining the relative riskiness of bank shares, movements in the bank share price index prepared by Statistics Canada have been compared with movements in the Toronto Stock Exchange (TSE) index of industrials. Table A-1 shows the reaction of bank share prices to a change in the TSE index. The measures used represent the systematic risk on bank shares. Systematic risk refers to the movement of a security's return relative to the movement of returns on all share prices. Theory predicts that the return on any security will vary directly with its systematic risk. On average over the period 1956 through 1966, when the TSE return changed by 100 basis points,[1] the Statistics Canada bank index changed by 82 basis points. These results support the position that banks were no riskier than the market.

1 One hundred basis points equal one percentage point.

Table A-1

Estimated Reaction of the Bank Share Price Index to a Change of 100 Basis Points in the Toronto Stock Exchange Index of Industrials, Selected Periods, 1956-73[1]

	Reaction coefficients[2]
Before Bank Act	
1956-66	82.4 (8.25)
1961-66	88.3 (9.63)
After Bank Act	
1968-73	94.7 (5.40)
1969-73	69.4 (4.30)

1 Based on the equation:
Bank index = a + b (Toronto Stock Exchange index of industrials), estimated with quarterly data.
2 t values are in parentheses.
SOURCE Based on data from Statistics Canada.

The choice among the alternative measures of risk, presented in Table A-1 for the years after the Bank Act revision, is complicated because the period was dominated by the large increase in bank shares in 1968 – a movement due in our interpretation to a re-evaluation of bank shares by the market to reflect the Bank Act revisions. To the degree that this rise was associated with new information, it is independent of the movement of the market and should not be used to assess the relative riskiness of the banks. On this reasoning, the preferred measure of bank riskiness after 1967 is that for the years 1969 to 1973. By this measure, banks do not appear to have become any riskier, compared with the market, than before. For the period 1969 to 1973, the estimated reaction coefficient indicates that bank shares were significantly less risky than the shares included in the TSE index. Therefore, a change in the level of risk after the Bank Act revision appears not to explain the high profit rates found in banking in recent years.

Foreign Operations

Another explanation for the high profit rates earned by Canadian banks may be the contribution of their foreign activities. The importance of this factor can be assessed by examining the profit data reported by banks.

One problem in determining the contribution of foreign business to the overall profits of Canadian banks is to find an appropriate measure of profit on foreign business. The reports of revenues and expenses (Schedule Q) made to the Inspector General of Banks provide two bases for reporting foreign business: the operating results for foreign branches, and the operating results for all foreign-currency business. For present purposes, the important distinction is between business in Canadian dollars and business in foreign currency, on the grounds that this is a better reflection of the transnational activities of Canadian banks than the level of earnings at foreign branches. Therefore, the division of revenues and costs by currency has been used for one set of the comparisons that follow.[2] An alternative estimate of the balance of revenue from foreign operations has been calculated for the five largest banks by the Canadian Bankers' Association in its submission to the Royal Commission on Corporate Concentration (the Bryce Commission). We present, in the tables that follow, calculations based on these alternative revenue estimates for five banks.

A further problem in distinguishing domestic from foreign profit rates is that some criterion is required for the allocation of bank equity capital between domestic and foreign business. Since our aim is to estimate the rate of return earned in the domestic market, our estimate of purely domestic earnings must be related to an appropriate estimate of equity capital employed. The association of bank equity with one sort of business or another is necessarily arbitrary. Equity stands as security for all depositors. Moreover, the role of deposit insurance makes the assessment of equity requirements still more difficult, since insured depositors are much less concerned about the level of capitalization of the bank.

For present purposes, the contribution of foreign business to the banks' overall rate of return is estimated on a variety of assumptions concerning the allocation of capital

Table A-2

Before-Tax Rate of Return to Equity of Canadian Banks and Manufacturing Corporations, 1968-73[1]

	Percentage of total shareholders' equity[2]					
	Total bank profits		Bank profits on Canadian-dollar business		Profits of Canadian manufacturing corporations	
	Schedule Q	CBA	Schedule Q	CBA	Schedule Q	CBA
1968	21.3		18.4		16.7	
1969	22.3		19.6		17.4	
1970	22.1	24.8	19.8	20.9	12.6	12.6
1971	26.3	24.2	21.8	19.6	16.0	16.0
1972	26.5	26.7	22.4	22.0	18.1	18.1
1973	26.3	27.6	24.4	22.8	23.7	23.7
Average, 1968-73	24.0		21.1		17.4	
Average, 1970-73	25.3	25.8	22.1	21.3	17.6	17.6

1 Data restrictions necessitated the use of different data for foreign and domestic revenues and expenses than were used in Table C-5; this accounts for the minor discrepancies in profit rates between the two tables.

2 Profit on Canadian-dollar business is derived from Canadian-currency profit divided by total equity. It is implicitly assumed that no equity is required for foreign business.

SOURCE Based on data from Inspector General of Banks, the Canadian Bankers' Association, and Statistics Canada; and estimates by the Economic Council of Canada.

2 Foreign-currency data include a small amount of Canadian-dollar transactions. Thus the impact of foreign business may be overstated. Profit figures used are on an accrued basis.

between foreign and domestic business. One unrealistic extreme would be to assume that all equity is required for domestic business (Table A-2). While use of this assumption lowers the estimated "domestic" rate of return for the banks, their profit rate remains, nevertheless, substantially above the rate for all manufacturing. In only one year, and only with the Canadian Bankers' Association profit data, did the profit rate for banks fall below that for manufacturing.

If, as has been suggested, Canadian banks have been forced to raise equity to maintain favourable terms on interbank loans in the Euro-currency market, the assumption that no equity need be allocated to foreign business cannot be accepted. A second, more reasonable, assumption is that Canadian banks earn the same rate of return to equity on their foreign business as New York City banks, using these banks as a standard of profitability in international wholesale banking. With an estimate of foreign net revenue, we can use the rate of return to New York City banks to estimate a division of equity capital between foreign and domestic business. Under this assumption, the rates of return on domestic business are considerably higher than on foreign business (Table A-3).

Table A-3

Before-Tax Rate of Return to Domestic Equity, Assuming the Same Rate of Return on Foreign Business as Accrues to New York City Banks, 1971, 1972, and 1973

	Rate of return for New York City banks	Equity assigned to foreign business[1]		Equity remaining for domestic business		Implied rate of return for domestic business[2]	
		Schedule Q	CBA	Schedule Q	CBA	Schedule Q	CBA
	(Per cent)	(Millions of dollars)				(Per cent)	
1971	14.7	714.4	612.7	1,602.0	1,519.8	31.5	27.5
1972	15.1	690.9	666.4	1,863.6	1,676.4	30.8	30.7
1973	16.2	340.8	697.6	2,515.8	1,896.8	27.7	31.2

1 Equity assigned to foreign business is calculated as the value for equity that would, given the net revenue from foreign business, result in a yield for this business equal to the yield earned by the New York City banks.

2 Implied rate of return for domestic business is the ratio of net revenue from domestic business to equity assigned to domestic business for all banks, using Schedule Q earnings, and for five banks, using the CBA earnings.

SOURCE Based on data from Inspector General of Banks, the Canadian Bankers' Association, the Board of Governors of the Federal Reserve System of the United States, and *The Canada Gazette*, and estimates by the Economic Council of Canada.

A final approach to determining the contribution of foreign business to bank profitability is to assume that the asset/equity ratio for foreign business is a given fraction of the ratio for domestic business. Rates of return are calculated for two assumed values for this ratio – one-quarter and three-quarters (Table A-4). When the fraction is one-quarter, implied domestic rates of return are higher than the overall rate of return in Canadian industry. When the asset/equity ratio for foreign business is assumed to be three-quarters that for domestic business, then the rate of return on foreign business is in the same range as the profit rate of New York City banks. With this assumption, the domestic profit rates of Canadian banks are considerably higher than total profit rates.

Table A-4

Before-Tax Rate of Return to Domestic Equity for Chartered Banks, under Alternative Assumptions for Equity Requirements,[1] 1968-73

	Rate of return									
			$\alpha = 0.25$				$\alpha = 0.75$			
	Actual		Domestic		Foreign		Domestic		Foreign	
	Schedule Q	CBA	Schedule Q	CBA	Schedule Q	CBA	Schedule Q	CBA	Schedule Q	CBA
	(Per cent)									
1968	21.3		19.7		43.4		22.4		16.4	
1969	22.3		21.3		33.9		24.7		13.1	
1970	22.1	24.8	21.9	23.1	24.4	41.0	26.0	27.5	9.7	16.3
1971	26.3	24.2	24.0	21.6	48.6	49.2	28.5	25.7	19.2	19.4
1972	26.5	26.7	24.5	24.1	47.8	54.9	28.7	28.1	18.7	21.4
1973	26.3	27.6	26.8	25.1	21.3	52.9	31.7	29.6	8.4	20.8

1 $\alpha = \frac{A_D K_F}{A_F K_D}$, where A_F = foreign assets;

A_D = domestic assets;

K_F = equity assigned to foreign assets; and

K_D = equity assigned to domestic assets.

SOURCE Based on data from Inspector General of Banks, the Canadian Bankers' Association, and *The Canada Gazette*; and estimates by the Economic Council of Canada.

Each of the alternative sets of calculations casts doubt on the proposition that profit on foreign business is a sufficient explanation for the high level of the banks' rates of return. It is impossible to be certain of the rate of return to equity from different types of business without a full theory of capital requirements. Nevertheless, even if no equity were assigned to foreign uses, the rates of return, measured as the ratio of domestic net revenues to total equity, remain higher than those in other industries.

Long-Term Profit Expectations

Book profits would not be an appropriate indicator of market power if high profits were a reflection of transitory forces. Even though profits may have been high in the years following the Bank Act revision of 1967, entry would only be expected to follow if these high rates of profit could be extrapolated into the future.

Investors' expectations of the permanence of high profits in banking should be revealed by the market behaviour of bank stock prices. If the higher profits of banks are expected to last for only a short time, then the increase in bank stock prices will be minor, because the capitalized value of a short-term flow of revenue is small. If the stock market prices of bank shares rise significantly relative to stock prices overall, this reveals an optimistic market expectation that banks will be able to maintain the higher level of profits. In Canada, bank shares are in the portfolios of many institutions that administer their investments in an informed and professional manner. The record of bank share prices, therefore, provides us with a valuable source of information regarding professional opinion about bank profitability.

Industry market power, whatever its source, would affect the behaviour of share prices in several ways. First, share prices can be expected to increase when something happens to increase potential earnings reflecting the higher expected profits. In contrast, a constant level of market power should have no effect on the expectations or returns of shareholders. Second, the degree of market power will determine the response of share prices to any changes that expand the market for bank services. Indeed, if banks have no market power, then a rise in demand for bank services will cause only a temporary rise in book profits. Investors will recognize that it will become more profitable for new entrants to expand the supply of banking services, causing lower profit margins to be re-established. Thus large upward movements in the prices of bank shares, relative to market shares in a given period, provide evidence that banks are expected to maintain their higher profit position for a long time into the future. Share prices, therefore, provide evidence on long-term expected profitability rather than short-term swings in profitability. Long-term expected profitability is the basis for assessing barriers to entry.

Table A-5 shows that, while shares in chartered banks fell relative to the market over the 1961-66 period, a recovery in bank share prices began in 1967 and took a dramatic step upward in 1968. Apparently, investors did not quite appreciate the effect of the 1967 Bank Act revision until 1968. Bank shares also outperformed the market in general in 1971. Overall, from 1967 to 1973, the price increases of chartered bank shares were substantially greater than for the market as a whole. It is difficult to explain the continued, almost permanent, increases that bank shareholders have realized. The differential risk of bank shares has been ruled out above as a source of this higher return to investors in bank shares.

Table A-5

Average Annual Share Price Increases, 1956-73[1]

	Toronto Stock Exchange index of industrials	Statistics Canada index of bank stocks
	(Per cent)	
1956-60	4.1	6.9
1961-66	6.0	0.8
1967	10.2	14.6
1968	16.9	53.8
1969-73	3.4	6.1

1 Average quarterly returns at annual rates, excluding dividends.
SOURCE Based on data from Statistics Canada.

One other interpretation of the 1968 appreciation in bank shares is possible. It may be argued that the rise in bank shares reflected not so much an expectation of higher profits but rather a return of profits to competitive levels. If, before 1967, shareholders had expected profits in banking to remain permanently below competitive levels, then share prices would have fallen quite considerably. With normal profits expected again, share prices would rise. The 1968 rise in bank share prices has been compared to the rise necessary to leave the shareholder in the same position at the end of 1968, whether he had held bank shares over the previous decade or shares represented by the TSE index. Under these conditions, the 1968 increase in bank share prices should have been 30.1 per cent, had 1956 been the beginning of the holding period, and 43.7 per cent, had 1961 been used. Comparison of these calculations with the actual bank share price increase of 53.8 per cent establishes that the rise in 1968 was significantly higher than the increase needed to re-establish those earlier relationships between bank share values and other stock price levels.

The before- and after-tax rates of return to equity in banking have been reviewed and found higher than the rates elsewhere in the economy. Examination of the main arguments about the use of rates of return as an indication of market power has led to the following conclusions: 1/ higher profits in banking have not been a reward for greater relative risk; 2/ higher profits in foreign business do not explain the high profit rates of Canadian banks; and 3/ the higher profits of banks have been judged by investors to be of long-term rather than temporary duration.

B COMPARISONS OF LOAN-YIELD SPREADS

The first estimate of loan-yield spreads (D_T) used to compare the efficiency of the Canadian and U.S. banking systems is based on the assumption that neither banking system incurs costs in attracting demand deposits. Under this assumption, interest paid on nondemand deposits is averaged over all deposits, demand and nondemand together, to give a total deposit rate. At the other extreme, the assumption is that the costs of attracting demand deposits equal the rate of interest paid on nondemand deposits (D_N). Because U.S. banks have a much higher proportion of demand deposits than Canadian banks, their loan spreads are narrowed by more than those of Canadian banks through adjustment from D_T to D_N. In effect, D_T provides an upward limit to the relative efficiency of Canadian banks. Similarly, the measure D_N may overstate the efficiency of U.S. banks by imputing services valued at the rate paid on nondemand deposits to all their demand deposits.

The use of an alternative measure of the spread (D_X) avoids the extreme assumption of either D_N or D_T. D_X is based on the alternative assumption that the services provided without charge are reflected in the amount of payments handled for the holders of demand deposits. Demand deposits at U.S. banks are assumed to be attracted at the same expense as nondemand deposits. The value of services provided to holders of demand deposits in Canada is assumed to equal the imputed interest that would have been earned on nondemand deposits, and is adjusted to reflect both the differences between the two countries in the number of payments per demand deposit and in the service charges levied for the provision of these services. This measure then reflects both the higher proportion of demand deposits held at U.S. banks and the greater turnover in payments of the demand deposits held at Canadian banks.

Results of the comparison of rates earned on loans and those paid on deposits between Canadian and U.S. banks are presented in Table B-1. With D_T, the measure biased to overstating the efficiency of Canadian banks, the latter appear to have operated with lower spreads than the U.S. banks – on average, 0.41 percentage point lower than the New York City banks and 0.28 percentage point lower than all insured banks in the United States. In contrast, the use of D_N, with the opposite bias, shows that Canadian banks have loan-yield spreads that are 1.07 percentage points higher than all U.S. insured banks and as much as 2.08 percentage points higher than the New

York City banks. The intermediate measure, D_X, suggests that, over the period 1969 to 1973, the loan-yield spreads for Canadian banks exceeded the margins for the New York City banks by 1.74 percentage points and for all insured banks by 0.74 percentage point.

Table B-1

Loan-Yield Spreads of Canadian Banks Minus Those of U.S. Banks, 1969-73

	All U.S. insured banks			Eight New York City banks		
	D_T	D_N	D_X	D_T	D_N	D_X
	(Percentage points)					
1969	-.32	1.06	.57	-.89	1.82	1.33
1970	-.46	.84	.22	-.98	1.82	1.20
1971	-.37	.96	.68	-.11	2.03	1.75
1972	-.01	1.24	1.10	.36	2.22	2.08
1973	-.24	1.27	1.15	-.44	2.51	2.35
Average, 1969-73	-.28	1.07	.74	-.41	2.08	1.74

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, the Board of Governors of the Federal Reserve System of the United States, and *Moody's Bank and Finance Manual*; and estimates by the Economic Council of Canada.

Table B-2

Estimates of Excess Costs to Canadian, Compared with U.S., Bank Customers, 1969-73

	Canadian-dollar loans by chartered banks	All U.S. insured banks			Eight New York City banks		
		D_T	D_N	D_X	D_T	D_N	D_X
	(Millions of dollars)						
1969	17,742	-57	188	101	-158	323	236
1970	19,248	-89	162	42	-189	350	231
1971	21,169	-78	203	144	-23	430	371
1972	25,676	-3	318	282	92	570	534
1973	32,058	-77	407	369	-141	805	753
Average, 1969-73	23,178	-65	248	172	-95	482	403

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, the Board of Governors of the Federal Reserve System of the United States, and *Moody's Bank and Finance Manual*; and estimates by the Economic Council of Canada.

The implications of these differences in spreads can be assessed by considering the differences in costs to the purchasers of a given volume of bank services as a result of the differences in these spreads, as shown in Table B-2. Using D_T – the upper-bound estimate of the efficiency of Canadian banks – as a measure of the spread differences, Canadian bank customers would appear to have paid $65 million less for this volume of banking services than if the spread for all U.S. insured banks prevailed and \$95 million less than if the spread for the New York City banks prevailed. On the other hand, the D_N estimates – the lower-bound measure of the efficiency of Canadian banks – suggest that Canadians would have paid \$482 million more than if New York City bank spreads prevailed and \$248 million more than if all U.S. insured bank spreads prevailed. The intermediate, and probably more realistic, estimates, D_X, suggest that the cost would have been \$172 million higher than with the spreads of all U.S. insured banks and \$403 million higher than with the spreads of the New York City estimates.

In Table B-3, the spreads given in Table B-2 are adjusted to take into account Canadian/U.S. differences in reserves, asset/equity ratios, and income taxes.

Table B-3

Loan-Yield Spreads of Canadian Banks Minus Those of U.S. Banks, Adjusted to Reflect Some Characteristics of Canadian Banks, 1969-73

	All U.S. insured banks			Eight New York City banks		
	D_T	D_N	D_X	D_T	D_N	D_X
	(Percentage points)					
1969	-.20	1.24	.75	-.51	2.51	2.02
1970	-.22	1.17	.55	-.92	1.79	1.17
1971	-.25	1.05	.77	-.05	2.09	1.81
1972	.04	1.23	1.09	.31	2.11	1.97
1973	-.01	1.57	1.45	-.56	2.41	2.29
Average, 1969-73	-.13	1.25	.92	-.35	2.18	1.85

SOURCE Based on data from the Bank of Canada, the Inspector General of Banks, the Board of Governors of the Federal Reserve System of the United States, and *Moody's Bank and Finance Manual*; and estimates by the Economic Council of Canada.

C STATISTICAL TABLES

Table C-1

Assets and Liabilities of Chartered Banks, 1974[1]

	Assets						
	Coin, cash reserves, and deposits with other banks[2]	Treasury bills	Securities	Mortgage loans	Other loans	Other assets	Total[3]
	(Millions of dollars)						
Bank of Montreal	3,331.8	707.4	1,499.2	543.1	10,661.9	1,658.5	18,401.9
The Bank of Nova Scotia	3,607.3	398.3	935.0	372.7	7,936.7	1,016.1	14,266.2
The Toronto-Dominion Bank	2,991.4	453.8	962.8	365.2	7,076.2	931.0	12,780.3
The Provincial Bank of Canada	535.1	116.9	234.3	124.1	1,568.1	160.2	2,738.6
Canadian Imperial Bank of Commerce	3,917.1	884.3	1,781.9	854.4	10,933.9	1,878.8	20,250.4
The Royal Bank of Canada	4,324.8	878.9	1,922.2	741.0	12,882.5	2,149.2	22,898.5
Bank Canadian National	436.4	210.8	571.8	292.3	2,560.0	349.1	4,420.5
The Mercantile Bank of Canada	20.3	34.0	79.8	7.2	505.0	53.0	699.3
Bank of British Columbia	88.5	18.5	28.4	11.7	332.6	23.5	503.4
Unity Bank of Canada	12.5	–	25.4	4.3	94.3	6.3	142.8
Total	19,265.2	3,702.8	8,040.9	3,316.0	54,551.2	8,225.6	97,101.8

	Liabilities						
	Demand deposits	Personal savings deposits	Nonpersonal term and notice deposits	Other deposits[4]	Other liabilities	Shareholders' equity	Total[3]
	(Millions of dollars)						
Bank of Montreal	6,734.2	6,020.4	1,736.9	2,258.0	953.8	689.6	18,401.9
The Bank of Nova Scotia	7,001.1	3,482.7	1,054.0	1,294.8	814.0	619.8	14,266.2
The Toronto-Dominion Bank	5,150.7	3,414.6	1,565.8	1,447.6	623.3	578.4	12,780.3
The Provincial Bank of Canada	828.9	998.8	510.5	275.8	31.4	93.1	2,738.6
Canadian Imperial Bank of Commerce	6,082.4	7,309.2	2,536.1	2,662.5	829.0	831.2	20,250.4
The Royal Bank of Canada	8,521.0	6,693.3	2,321.3	3,013.7	1,385.9	963.4	22,898.5
Bank Canadian National	1,021.8	1,734.7	832.1	496.5	155.7	179.6	4,420.5
The Mercantile Bank of Canada	116.1	7.3	436.1	54.4	41.0	44.5	699.3
Bank of British Columbia	142.1	116.5	152.3	55.9	15.5	21.0	503.4
Unity Bank of Canada	30.1	12.0	64.9	10.9	0.6	24.7	142.8
Total	35,628.6	29,789.4	11,209.9	11,569.6	4,850.0	4,054.4	97,101.8

1 As of December 31. Details may not add up to totals because of rounding.
2 Includes gold coin and bullion, other coin, notes and deposits with Bank of Canada, government and bank notes other than Canadian, and deposits with banks.
3 The asset and liability figures in this table differ from those in Tables 2-1 and 2-2 in that they include all Canadian-dollar and foreign-currency assets and liabilities (see footnote 2, Tables 2-1 and 2-2).
4 Includes deposits by banks and governments (federal and provincial), and foreign-currency deposits.

SOURCE Based on data from *The Canada Gazette*.

Table C-2

Assets and Liabilities of Canadian Financial Institutions Affiliated with Foreign Banks, 1974[1]

	Millions of dollars
Assets	
Currency and demand deposits	16
Short-term paper, term deposits, and other investments	145
Loans to, and investments in, parent, affiliated, and subsidiary companies	70
Business loans and receivables	1,552
Other assets	36
Total	1,819
Liabilities and shareholders' equity	
Loans	479
Notes payable with an original maturity of less than one year	1,108
Notes payable with an original maturity of one year or more	41
Other liabilities	50
Shareholders' equity	141
Total	1,819

1 As of December 31.
SOURCE Based on data from the Bank of Canada.

Table C-3

Assets and Liabilities of Nonfinancial Corporations, 1974[1]

	Millions of dollars
Assets	
Cash and demand deposits	2,286
Short-term loans and advances to affiliated companies	1,852
Investments	16,769
Accounts receivable	25,927
Inventories	28,862
Fixed assets	58,317
Other assets	4,219
Total	138,232
Liabilities and shareholders' equity	
Short-term loans	
Bank loans	9,204
Affiliated companies, directors, and shareholders	2,112
Short-term commercial paper	1,707
Other short-term loans	1,607
Accounts payable	24,416
Long-term debt	
Bank loans	2,966
Other long-term debt	23,979
Other liabilities	8,923
Shareholders' equity	63,318
Total	138,232

1 As at the end of fourth quarter. The nonfinancial sector excludes the following: agriculture, fishing, forestry, trapping, construction, all financial institutions, investment holding corporations, government business enterprises, personal corporations, nonprofit corporations, most co-operatives, and subsidiaries or branches of Canadian corporations operating outside Canada.

SOURCE Based on data from Statistics Canada.

Table C-4

After-Tax Realized Rates of Return to Average Shareholders' Equity, Selected Sectors, 1963-73

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
						(Per cent)					
Chartered banks	6.3	7.4	6.5	9.5	10.6	14.2	11.9	10.4	11.4	14.1	15.1
Trust and loan companies	8.2	9.7	9.7	10.0	10.1	9.6	8.0	7.6	12.4	14.1	13.6
All manufacturing	10.4	11.3	11.3	12.3	9.4	10.1	10.4	7.5	9.8	11.1	14.6
Food and beverages	10.5	11.6	12.2	11.7	11.0	11.2	12.5	10.8	11.2	11.8	14.0
Textiles	12.8	12.6	12.0	9.7	7.4	7.6	8.3	4.7	7.9	6.8	12.1
Transportation	6.9	9.0	10.6	8.7	7.2	7.4	6.9	7.0	8.5	9.7	10.8
Wholesale trade	8.7	11.2	14.6	13.5	11.5	11.8	10.7	8.7	9.6	13.6	15.2
Retail trade	10.2	9.8	11.4	10.6	10.5	10.3	8.4	7.2	9.2	10.2	10.2

SOURCE Based on data from the annual reports of the seven largest banks; *Report of the Registrar of Loan and Trust Corporations for the Province of Ontario*; and Statistics Canada.

Table C-5

Before-Tax Realized Rates of Return to Average Shareholders' Equity, Selected Sectors, 1963-73

	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
						(Per cent)					
Chartered banks	12.1	13.4	12.2	15.9	17.2	21.4	24.1	23.4	23.6	26.3	27.6
Trust and loan companies	14.3	16.5	15.5	15.3	15.6	15.3	13.7	12.9	22.5	24.7	24.5
All manufacturing	17.2	18.5	18.7	19.3	15.5	16.7	17.4	12.6	16.0	18.1	23.7
Food and beverages	18.2	19.5	20.7	19.5	19.0	19.7	21.6	19.0	18.8	19.2	23.5
Textiles	20.6	19.6	17.7	13.8	10.1	11.9	12.4	7.9	12.3	11.7	18.8
Transportation	10.8	13.6	15.4	13.4	11.4	11.8	10.8	11.5	12.9	14.3	16.2
Wholesale trade	14.0	17.4	21.3	20.4	17.8	17.9	16.7	14.5	15.5	21.0	23.8
Retail trade	16.4	16.0	18.0	16.3	16.4	16.0	14.2	12.3	14.7	16.5	16.4

SOURCE Based on data from the annual reports of the seven largest banks; *Report of the Registrar of Loan and Trust Corporations for the Province of Ontario*; and Statistics Canada.

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