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THE CHARTERED BANKS AND THE BANK ACT

ADDRESS BY S. T. PATON

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THE TORONTO-DOMINION BANK

TO

THE CANADIAN CLUB OF TORONTO

MONDAY, NOVEMBER 7, 1966.

It was with some trepidation that I accepted the invitation to speak to you today. Some of the reasons for this concern have now vanished; some still remain.

The primary problem was that the subject suggested was "The Bank Act". This was in the month of May and my immediate reaction was "which Bank Act" - the one which the Canadian banks have been operating under for the past 12 years, the revised one which was brought down in 1965, died on the vine but might have been resuscitated, or the one that was then imminent.

That problem no longer exists. A new Bank Act received first reading in the House of Commons in July, second reading early last month, and is now before the Finance, Trade and Economic Affairs Committee for detailed study. It still looks as if it will be early 1967 before we have a final Act, and presumably the banks will need a further extension of their present Charters due to expire December 1st.

Another of my reservations had to do with the timing of these remarks. Would it be politic for the President of The Canadian Bankers' Association to

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speak publicly when the Act was currently before the Committee for study, or should he wait until he appeared before the Committee. If he did speak, could he be forthright and factual; in short, would it be worthwhile having him as a speaker to compound any indigestion you may have suffered during the past hour?

A further problem, and one that has not been solved, is that the Canadian Club has a reputation of having speakers of high quality, and it seemed a shame to run the risk of diluting this. You will gather from that remark that I do not consider myself an orator; in fact, I doubt if any operating banker really could be these days. After all, particularly during the last 12 to 15 months, his conversation has largely been confined to a monosyllabic word beginning with "n".

However, weighing all considerations, I finally became convinced that I could be reasonably comfortable addressing you when I learned a Cabinet Minister would precede me by a month as a speaker and that a month later there would be another cabinet member. After the last three years, it would seem that there is no place a banker should feel more at home than sandwiched between two politicians.

Before getting into a discussion of the Bank Act itself I would like to make some general comments about banking and its contribution to the economic and social welfare of our great country.

Banking is one of Canada's largest and most important industries. The assets of the chartered banks exceed $26 billions - about double what they were 10 years ago and three times what they were at the close of World War 11. This growth has elevated some of our larger banks to leading positions in the world banking community. The largest Canadian bank ranks as the 12th largest in the world and our five largest banks are among the top 60.

The Canadian banking industry employs approximately 80,000 people and has an annual payroll of over $325 million. In terms of jobs provided in Canada it is more than half again as large as the Canadian automobile manufacturing industry - and considerably larger than the Canadian primary textile industry. Their $325 million payroll places the chartered banks as a group with the electric utilities and the primary wood products industry but it should be noted that the wide dispersion of the country's 5,700 bank branches makes the annual banking payroll much more significant to scores of smaller centres from Newfoundland to Vancouver Island.

In this day and age when there is so much talk about foreign control, perhaps I should emphasize that our banking industry is homebred and Canadian controlled. Nearly 90 per cent of the 118,000 shareholders of the chartered banks are domiciled in this country.

Capital spending is another measure by which banking can be compared to other sectors of the economy. Currently, the chartered banks are spending something in the order of $50 millions a year for the construction of new branches, the modernization and renovation of older premises and the installation of up-to-date equipment. Since the end of World War 11 they have spent

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about $700 millions for these purposes. One does not ordinarily think of banking being a significant factor in the capital investment programme and I think you will find these figures illuminating.

Additionally, the Canadian banks have grown into international organizations. From their early beginnings they have been active in financing Canada's foreign trade - imports and exports. Their know-how and service in this area have contributed materially to the growth of Canada's export trade, to the opening of new markets and to the expansion of Canadian firms abroad. Today, Canadian banks have offices in a number of countries and the fact that they hold more than $5 billions of deposits in currencies other than Canadian is a measure of their importance in the international banking field.

Canadian banks have grown into substantial institutions not only as a natural concomitant of the growth of the Canadian economy but also because they have played an important role in initiating and encouraging such growth. To put it in simple terms - the chartered banks have been providing the Canadian public with the services they require at a reasonable cost. Note that I mentioned "reasonable costs". The chartered banks <u>are</u> efficient institutions and Canadians pay less for their banking services than the people in many other countries of the world.

Earlier I mentioned the national character of the chartered banks and the fact that a branch of at least one of them will be found in every community of any size in Canada. This has been one of the strengths of the Canadian banking system and there is not a shred of evidence to support the contention, sometimes heard, that regional interests have not been given proper consideration. As the banks have grown, their operations have been decentralized and every bank has a number of geographic divisions which have a marked degree of autonomy in respect to the regions under their direction. Credit is equally available for credit-worthy borrowers in all sections of the country. Furthermore, the interest rate and the price of other bank services are uniform in all regions and this cannot be said for some of the other goods and services which you and I use.

As I indicated in my opening remarks a new Bank Act is more than two years overdue and some people wonder why we have to go through a major revision of the act every 10 years or so. The chartered banks are unlike most other corporate organizations in that their charters are for 10-year periods only and it will probably surprise you that this is by their own choice. Away back in 1900 they were offered permanent charters, but declined. At that time they preferred, and still do, the opportunity of taking a fresh look every decade provided such decades do not stretch out interminably.

Economic and social conditions change and it is most important that the chartered banks, as the keystone in the Canadian financial structure, be in a position to modify and adapt their operations and practices to the evolving economy in which you and I live. Only in this way can the banks make the kind of contribution to Canada's economic and social progress which Canadians have a right to expect.

The revised Bank Act now before parliament was preceded by a Royal

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Commission on Banking and Finance which studied Canada's financial system for a period of three years. It was specifically instructed to make recommendations in respect to the Bank Act and for this reason any discussion of my subject would be incomplete without some reference to its findings.

It would be an interesting and perhaps revealing exercise to have each of you write out your own definition of banking, or of a bank. As you know, exclusive jurisdiction over banking is vested in the Federal Government by the B.N.A. Act but unfortunately "banking" is not defined.

There are quite a number of institutions in this country, not called banks, that are engaged in a banking business and in recent years these institutions have come to be known as "near banks". The Royal Commission recommended that all institutions performing a banking function be brought under the Bank Act and that institutions not chartered or licensed under the Bank Act should not be permitted to engage in banking activities.

Specifically, the Commission would have included among banking liabilities "all term deposits, whatever their name, and other claims or liabilities maturing, or redeemable at a fixed price, within 100 days of the time of original issue or of the time at which notice of withdrawal is given by a customer".

Any attempt to define banking brings up constitutional questions as the majority of the near banks have provincial charters and no doubt this is one of the reasons for the non-inclusion of a definition in the new Act. My experience has been that such problems do not disappear of their own volition and sooner or later some solution, perhaps akin to that suggested by the Commission, must be found to ensure proper monetary and supervisory control over all institutions doing a banking business.

The commission's report recognized the importance of competition and recommended a more competitive financial system. Specifically, it favoured (and here I quote) "a more open and competitive banking system - carefully and equitably regulated under uniform legislation, but not bound by restrictions which impede response to new situations, enforce a particular type of narrow specialization or shelter some enterprises from competitive pressures" (end of quote). Such a framework, the commission felt, would encourage creativity and efficiency and would offer the public the widest possible choice of financial services while reducing the danger of unregulated institutions springing up to serve needs which the chartered banks are prevented from meeting.

The new Bank Act takes some important steps in this direction but falls

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short of the objectives laid down by the Royal Commission and this is unfortunate from the viewpoint of the Canadian economy. If the act is passed in its present form we will have a more open and competitive banking system, but not as open and competitive as was envisioned by the commission.

The most important provision of the new Bank Act from the point of view of the public and of the efficiency of the Canadian financial system is the one which relates to the restriction on the rate of interest the banks may charge on loans. Both the Royal Commission and the Economic Council have recommended complete removal of the 6% ceiling. In fact, the Commission recommended that the ceiling should be eliminated even if its other recommendations were rejected. It looked on this as the prime essential for improvement of Canada's financial structure.

The new Bank Act accepts a substantial part of the Commission's argument for removal but prefers a gradual process rather than immediate elimination of the ceiling. For the immediate future, at least, the ceiling is to be 1 3/4% above the average yield on Canada short-term bonds. This means that if the act was passed tomorrow the interest rate ceiling on bank loans would be 7%. However, the ceiling rate would be reviewed half yearly and adjusted, if necessary, in line with the movement of the average yield on short-term Canada bonds. If and when the average yield on such bonds falls below 4 1/2% for three consective months the ceiling would be eliminated entirely.

In our view, the transitional arrangement falls far short of what is necessary. Interest rates have been rising on a world-wide basis and there is a definite possibility that the pressure of credit demands will be sustained much longer than many observers expect, thereby delaying or preventing the removal of the ceiling for some years - even though its removal in the not too distant future is admitted to be desirable. As a palliative, and in the light of interest rate trends since the Bill received first reading, it would seem logical to change the 4 1/2% base to a higher percentage.

Ordinarily you might have expected me to enumerate the pros and cons and then to present you with a conclusion. I have chosen to offer you a conclusion and I now propose to buttress it with a number of sound reasons originating not with bankers, who might be biased, but with the Royal Commission.

First, and I quote - "the 6% ceiling impedes the flow of credit to some borrowers and - by driving them to higher-cost lenders - frequently harms the very people it is designed to help".

Second, - "the ceiling stands in the way of flexible lending by the banks in that it frequently prevents them from making loans on which higher rates must be charged to cover administrative costs and risks".

Third, - the ceiling "discriminates against borrowers such as small businesses which, if they are to obtain funds at all, must turn to other lenders which charge rates well above those the banks would ask if free to do so".

Fourth, - Because of the ceiling, "the chartered banks are unable to pay

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as high returns on their liabilities, - that is, deposits, - as they otherwise might. Some savers are accordingly penalized, although others are able to obtain higher returns on their funds from unrestricted institutions which are direct competitors of the banks".

Fifth, - "the distorting effects of the 6% ceiling have been most acute in periods of credit restraint ... At such times (the banks) cannot compete equally for funds and thus have no choice but to resort to arbitrary rationing procedures in their lending".

The ceiling places the banks at a competitive disadvantage in relation to the near banks and this has never been more evident than under current monetary conditions. Out of this situation evolves the important fact that the chartered banks are hindered in making their fullest contribution to the economic welfare of the country.

An illustration of what open competition will do is the personal loan field. Until a few years ago, the chartered banks were not active in what is popularly known as the consumer finance field. More recently, they have broadened their activities and any individual with a reasonable credit standing can now finance the purchase of an automobile or a number of household and other accessories through his or her bank. True, the total charge to the borrower on monthly instalment loans is greater than on ordinary loans and this arises from service charges to cover additional administrative expense and life insurance. The important fact is that the banks have improved the facilities available to the public and have appreciably lowered the average cost of personal loans.

There is every reason to believe that lifting the interest rate ceiling will result in similar benefits for many small businesses which now find it difficult to secure adequate bank credit. As mentioned earlier, the Royal Commission pointed out the ceiling discriminates against this type of borrower since the banks have not been in a position to charge a rate which would compensate them for the administrative costs and risks involved.

A maximum bank loan rate of 6% is unrealistic under present conditions and one need look no further than Government Bond yields to justify that statement. The disparity between market interest rates and the bank ceiling rate is an incongruity. The National Housing Act rate at the present time is 6 3/4%. New conventional mortgages in Toronto carry anywhere from 8% and upwards; bonds and debentures of the best Canadian corporations are priced to yield 6 1/2% to 7% in today's market. Another anomaly is the fact that while the chartered banks are limited to a 6% rate, the Industrial Development Bank is making loans to business concerns at 7 1/2%. Surely the chartered banks should have the right to become more fully responsive to the competitive factors which work in the capital market.

I am aware that the whole business of borrowing and lending and interest rates has always been a highly charged emotional issue. We should remember however, that the majority of people are typically lenders of money and recipients of interest through their life insurance policies, pension funds, savings deposits in banks and near banks and, in the past 20 years, through

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their Canada Savings Bonds. In fact, it seems to me that we should be thinking a little more of the saver, especially at a time when our domestic savings fall far short of what is required to finance the country's capital investment needs. Recently, we have heard a great deal about the importation of foreign capital but as yet we have devised very little in the way of savings incentives. One of the largest pools of savings in the country is the savings deposits of the chartered banks and in recent times the existence of the 6% interest rate ceiling on loans has been detrimental to the owners of these funds.

Everyone in this room is aware that the chartered banks occupy an important place in our financial system but for the last 20 years they have been losing ground to other financial institutions. The assets of the chartered banks now constitute a much smaller percentage of the total assets of all the principal financial institutions than they did in 1946. One factor in this has been the interest rate ceiling which I have just discussed at some length. Another is the primary cash and secondary reserve requirements for chartered banks.

At the present time the chartered banks are required to hold a cash reserve equal to at least 8 per cent of their Canadian dollar deposits and, by agreement with the Bank of Canada, a secondary reserve of treasury bills and day to day loans equal to 7 per cent of their Canadian dollar deposits. In other words, 8 per cent of their deposits must be held in a form that yields no revenue and an additional seven per cent has to be invested in low earning assets. This, of course, has meant that the chartered banks have been at a disadvantage in competing with the near banks for deposits since the latter have not been subject to any such requirements.

The new act contemplates some changes in these requirements. Over a period of time the cash reserve is to be reduced to 4% on notice deposits and increased to 12% on demand deposits. The secondary reserve is given legislative sanction by the Bank of Canada Act and can be varied over a period of months from zero to 12 per cent.

The change in the cash reserve on notice deposits should improve the capacity of the banks to compete for the increasingly important pools of term funds but the increase in the cash reserve on demand deposits to 12% seems excessive. The net effect of the proposed split reserve system is to lower slightly the total amount of cash reserves which the banks will be required to carry, but not to the level which would be needed solely for operational purposes.

Reserve requirements, in the interests of equity and efficacy of monetary policy, should be applicable to all institutions doing a banking business. The justification for legal reserve requirements lies in the role that they play in central bank monetary control and it seems axiomatic that full participation by all would make this task much simpler.

I see no need for a statutory secondary reserve, even on a standby basis, nor incidentally did the Porter Commission. This represents a continuing element of discriminatory treatment of banks in relation to competing

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institutions not subject to reserve requirements. The main point advanced in support of the secondary reserve is that it facilitates more direct response by the banks to changes in monetary policy but the Royal Commission examined this argument and found it wanting.

The Canadian public, as well as the banks, should welcome the proposed new freedom to take conventional as well as N.H.A. mortgages on real estate. The banks will be free to originate mortgages on industrial and commercial structures, on residential properties, and N.H.A. mortgages at the official rate on houses and apartments. They will be restricted only as to conventional residential mortgages, holdings of which are to be limited to 10 per cent of their Canadian liabilities attainable over a period of 8 years.

Extension of bank lending powers to include conventional mortgages should greatly improve the whole structure of mortgage lending facilities, but a word of caution is in order. It would be a mistake to look for a large new volume of mortgage funds becoming available immediately.

The extent of any bank's participation in the mortgage field will have to be determined in light of the total funds at its disposal and of the demands on its resources from established areas of lending. As you know, the latter are extremely heavy under present conditions.

One area where new benefits will flow from the new mortgage powers is in respect to commercial and industrial customers with medium and long-term financing requirements. Access to mortgage security should enable the banks to improve their service to these borrowers, particularly small enterprises and this is a worthwhile development.

A desirable innovation in the new act is the power given to banks to issue debentures subordinate to deposit liabilities. The issuance of debentures is a recognized means of corporate financing and has been used extensively in recent years by banks in other countries.

Early in my remarks I noted that the new Bank Act is a step forward toward the more open and competitive banking system envisioned by the Royal Commission. However, the section which provides that banks shall not own more than 10 per cent of the voting stock of other institutions is not in keeping with that approach. Furthermore, it has a very undesirable retroactive feature.

As the Royal Commission pointed out, some important gaps have developed in our capital markets from time to time. Efforts of the banks to bridge these gaps have resulted in their participation in other financial enterprises and there is no doubt that this has been beneficial to the Canadian economy. The financial system has become more competitive but now the banks are to be penalized for having shown enterprise and initiative in this regard.

The newer ventures through which the banks have taken an active or leading part in mortgage and real estate financing, in mortgage insurance, in term lending to business and in the provision of equity funds to new and small businesses have prospered only because they are rendering an essential service,

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many of which were not available before.

The banks feel strongly that the retroactive feature of this provision should be eliminated, or, at least, modified. The proposed legislation would have some meaning if these participations by the banks had resulted in a lessening of competition but this is not the case.

The question of the inner reserves of the banks has been a matter of discussion with some sections of the public. Professional analysts of the capital market claim that details of a bank's revenue and expenditure and knowledge of its so-called inner reserves (which are nothing more than provision for losses on lending and investing) are essential to a proper appraisal of the capital market. Critics of chartered banking sometimes see the inner reserves as a device for secreting profits from the public and even from the tax authorities. These criticisms are unfounded since the size of the tax-free reserve is determined by a formula established by the Minister of Finance, to whom, of course, the total reserves are disclosed. Then, again, these reserves cannot be paid out without attracting a tax payable by the bank itself and then another tax by the shareholder.

The new Act, if passed in its present form will require a bank to reveal not only its accumulated approprations for losses, but also its losses on lending and investing from year to year. This, I suggest, is not in the public interest. In support of this I would like to summarize for you the views expressed by the Minister of Finance and the Inspector General of Banks at the 1944 and 1954 revisions of the Bank Act. They strongly supported the non-publication of inner reserves as follows:

" ..... it is a responsibility of the shareholders' auditors and of the Inspector General of Banks to see not only that inner reserves are built up to the level of adequacy but also that they do not exceed this level."

"The ability and willingness of the banks to take risks on loans and investments are essential to economic growth, but enforced disclosure of losses may inhibit management from taking such risks."

"The stability of the banks, and the confidence of depositors and the public in that stability, are essential to the health of the whole economy."

Banks, more so than most businesses, depend on public confidence and I suggest to you that public confidence would be affected if in any year a bank had to report to the public substantial losses even though its reserves might be more than adequate. Unfortunately, also, the real danger would arise, not in good years, but in periods of economic decline, when publication of losses could not only impair the competitive position of a particular bank but also reflect on the stability of the whole banking system.

The final matter which I would like to mention does not concern a provision of the Bank Act but has a close association with it. The Minister of Finance, in speaking on the new Act in the House of Commons, indicated that it was the government's intention to inaugurate in the near future a system of deposit insurance

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in Canada.

The chartered banks do not need deposit insurance. They are already subject to close inspection and supervision and their ability to meet their deposit liabilities is undoubted. The most effective guarantee of the safety of deposits is sound financial management and in this connection I would remind you that for more than 40 years there has never been any serious concern about the safety of deposits in Canadian banks.

The real objective of the deposit insurance proposal seems to be the extension of better supervision and inspection to that segment of Canadian deposit-taking institutions that is not now adequately supervised but my understanding is that in the case of provincially incorporated institutions it would only apply "where this was desired by the institution and the provincial government concerned".

It seems rather strange that a system of deposit insurance, one of the main purposes of which is to achieve higher standards of inspection and supervision, should be made mandatory for banks and other federally incorporated institutions where the system of supervision has proved satisfactory and not obligatory for provincially incorporated institutions where higher supervisory standards are needed.

Frankly, I regard the deposit insurance proposed as an inequitable substitute for facing up to the issue of defining banking and bringing all competing institutions under similar legislative jurisdiction. Deposit insurance is not a panacea for the ills of inefficient management.

Some near banks will find deposit insurance attractive. For a fee plus acceptance of supervision they may be able to compete in terms of deposit security with the banks and the strong and well-established near banks. But there is also the risk that insurance will not be accepted by those who need supervision the most. What will happen in their case?

I have not attempted to deal with all the changes in the Bank Act. In summary, my main concern is that some of the provisions do not go far enough. You will have gathered that despite its shortcomings the new Act is much better than the existing one and I can only repeat that it takes important steps toward "a more open and competitive banking system but falls short of the objectives set out in the report and recommendations of the Royal Commission on Banking and Finance".