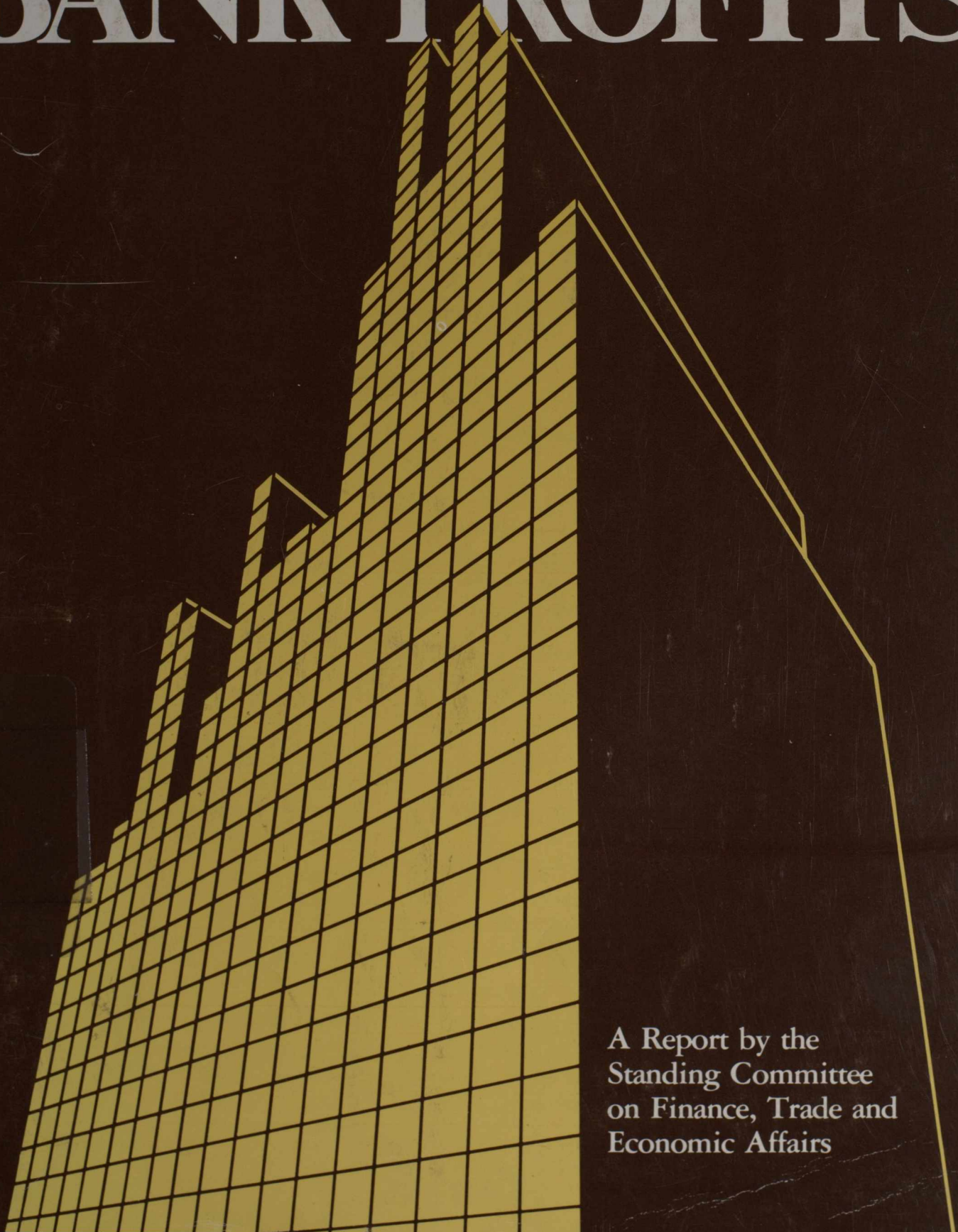




HOUSE OF COMMONS
CANADA

BANK PROFITS



A Report by the
Standing Committee
on Finance, Trade and
Economic Affairs

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HOUSE OF COMMONS

Issue No. 109

Tuesday, July 27, 1982

Chairman: Mr. John Evans

CHAMBRE DES COMMUNES

Fascicule n° 109

Le mardi 27 juillet 1982

Président: M. John Evans

*Minutes of Proceedings
of the Standing Committee on*

Finance, Trade and Economic Affairs

*Procès-verbaux
du Comité permanent des*

Finances, du commerce et des questions économiques

RESPECTING:

Profit situation of the Chartered Banks

INCLUDING:

The Sixteenth and Seventeenth Reports to the House

CONCERNANT:

Les profits des banques à charte

Y COMPRIS:

Les seizième et dix-septième rapports à la Chambre



STANDING COMMITTEE ON FINANCE,
TRADE AND ECONOMIC AFFAIRS

COMITÉ PERMANENT DES
FINANCES,
COMMERCE ET
QUESTIONS ÉCONOMIQUES

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Président: M. John Evans

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Lambert
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Orlikow
Riis
Stevens
Wilson
Wright—(20)

(Quorum 11)

Le greffier du Comité

J.M. Robert Normand

Clerk of the Committee

Pursuant to S.O. 65(4)(b)

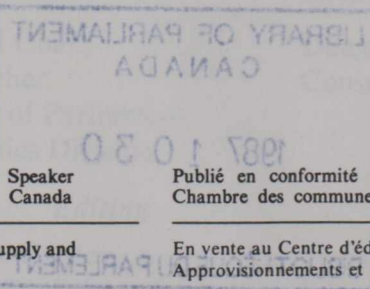
Conformément à l'article 65(4)b) du Règlement

On Tuesday, July 27, 1982:

Le mardi 27 juillet 1982:

Mr. Masters replaced Mr. Reid (*Kenora—Rainy River*);
Mr. Stevens replaced Mr. Thomson;
Mrs. Beauchamp-Niquet replaced Mr. Masters;
Mr. Bachand replaced Mr. Ferguson;
Mr. Gourde (*Lévis*) replaced Mr. Mackasey.

M. Masters remplace M. Reid (*Kenora—Rainy River*);
M. Stevens remplace M. Thomson;
M^{me} Beauchamp-Niquet remplace M. Masters;
M. Bachand remplace M. Ferguson;
M. Gourde (*Lévis*) remplace M. Mackasey.



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REPORT TO THE HOUSE

Friday, July 23, 1982

The Standing Committee on Finance, Trade and Economic Affairs has the honour to present its

SIXTEENTH REPORT

In relation to its Order of Reference of Thursday, February 25, 1982 relating to the review of the profit situation of the chartered banks, your Committee recommends that if the House is not sitting and notwithstanding the usual practices of the House, the Committee be allowed to make its Final Report public before it is tabled in the House.

A copy of the relevant Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs (*Issues Nos. 108 and 109*) is tabled.

Respectfully submitted,

Le président

JOHN EVANS

Chairman

RAPPORT À LA CHAMBRE

Le vendredi 23 juillet 1982

Le Comité permanent des finances, du commerce et des questions économiques a l'honneur de présenter son

SEIZIÈME RAPPORT

Relativement à son Ordre de renvoi du jeudi 25 février 1982 portant sur l'examen des profits des banques à charte, votre Comité recommande que, si la Chambre ne siège pas lorsque le rapport final est terminé et nonobstant les pratiques en usage à la Chambre, il lui soit permis de rendre public ledit rapport avant qu'il ne soit déposé en Chambre.

Un exemplaire des procès-verbaux et témoignages pertinents du Comité permanent des finances, du commerce et des questions économiques (*fascicules nos 108 et 109*) est déposé.

Respectueusement soumis,

MINUTES OF PROCEEDINGS

TUESDAY, JULY 27, 1982
(157)

[Text]

The Standing Committee on Finance, Trade and Economic Affairs met, *in camera*, this day at 9:48 o'clock a.m., the Chairman, Mr. Evans, presiding.

Members of the Committee present: Messrs. Berger, Blenkarn, Bloomfield, Deniger, Duclos, Evans, Ferguson, Lang and Wilson.

Other Member present: Mr. Yurko.

Witnesses: From the Economic Division of the Research Branch, Library of Parliament: Messrs. Marion Wrobel and Randall Chan. Mr. L. Robin Cornwell, Consultant to the Committee.

The Committee resumed consideration of its Order of Reference dated Thursday, February 25, 1982, relating to the profit situation of the Chartered Banks. (*See Minutes of Proceedings dated Tuesday, May 11, 1982, Issue No. 84.*)

At 12:56 o'clock p.m., the Committee adjourned until 3:30 o'clock p.m., this afternoon.

AFTERNOON SITTING
(158)

The Standing Committee on Finance, Trade and Economic Affairs met, *in camera*, this day at 3:38 o'clock p.m., the Chairman, Mr. Evans, presiding.

Members of the Committee present: Messrs. Berger, Blenkarn, Bloomfield, Duclos, Evans, Ferguson, Mrs. Hervieux-Payette, Messrs. Masters, Peterson and Wilson.

Witnesses: From the Economic Division of the Research Branch, Library of Parliament: Mr. Marion Wrobel. Mr. L. Robin Cornwell, Consultant to the Committee.

The Committee resumed consideration of its Order of Reference dated Thursday, February 25, 1982, relating to the profit situation of the Chartered Banks. (*See Minutes of Proceedings dated Tuesday, May 11, 1982, Issue No. 84.*)

At 5:53 o'clock p.m., the Committee adjourned until 8:00 o'clock p.m., this day.

EVENING SITTING
(159)

The Standing Committee on Finance, Trade and Economic Affairs met, *in camera*, this day at 8:14 o'clock p.m., the Chairman, Mr. Evans, presiding.

Members of the Committee present: Mr. Bachand, Mrs. Beauchamp-Niquet, Messrs. Blenkarn, Bloomfield, Deniger, Duclos, Evans, Gourde (*Lévis*), Peterson, Stevens and Wilson.

Witness: From the Economic Division of the Research Branch, Library of Parliament: Mr. Marion Wrobel.

The Committee resumed consideration of its Order of Reference dated Thursday, February 25, 1982, relating to the profit situation of the Chartered Banks. (*See Minutes of Proceedings dated Tuesday, May 11, 1982, Issue No. 84.*)

Mr. Deniger moved,—That, notwithstanding stipulations of the resolution adopted on Wednesday, June 23, 1982, the

PROCÈS-VERBAL

LE MARDI 27 JUILLET 1982
(157)

[Traduction]

Le Comité permanent des finances, du commerce et des questions économiques se réunit aujourd'hui à huis clos à 9h48 sous la présidence de M. Evans (président).

Membres du Comité présents: MM. Berger, Blenkarn, Bloomfield, Deniger, Duclos, Evans, Ferguson, Lang et Wilson.

Autre député présent: M. Yurko.

Témoins: De la Division de l'économie du Service de la recherche de la Bibliothèque du Parlement: MM. Marion Wrobel et Randall Chan. M. L. Robin Cornwell, conseiller du Comité.

Le Comité reprend l'étude de son Ordre de renvoi du jeudi 25 février 1982 portant sur les profits des banques à charte. (*Voir procès-verbal du mardi 11 mai 1982, fascicule n° 84.*)

A 12h56 le Comité suspend ses travaux jusqu'à 15h30.

SÉANCE DE L'APRÈS-MIDI
(158)

Le Comité permanent des finances, du commerce et des questions économiques se réunit aujourd'hui à huis clos à 15h38 sous la présidence de M. Evan (président).

Membres du Comité présents: MM. Berger, Blenkarn, Bloomfield, Duclos, Evans, Ferguson, M^{me} Hervieux-Payette, MM. Masters, Peterson et Wilson.

Témoins: De la Division de l'économie et du Service de recherche de la Bibliothèque du Parlement: M. Marion Wrobel. M. L. Robin Cornwell, conseiller du Comité.

Le Comité reprend l'étude de son Ordre de renvoi du jeudi 25 février 1982 portant sur les profits des banques à charte. (*Voir procès-verbal du mardi 11 mai 1982, fascicule n° 84.*)

A 17h53, le Comité suspend ses travaux jusqu'à 20h00.

SÉANCE DU SOIR
(159)

Le Comité permanent des finances, du commerce et des questions économiques se réunit aujourd'hui à huis clos à 20h14 sous la présidence de M. Evans (président).

Membres du Comité présents: M. Bachand, M^{me} Beauchamp-Niquet, MM. Blenkarn, Bloomfield, Deniger, Duclos, Evans, Gourde (*Lévis*), Peterson, Stevens et Wilson.

Témoin: De la Division de l'économie du Service de recherche de la Bibliothèque du Parlement: M. Marion Wrobel.

Le Comité reprend l'étude de son Ordre de renvoi du jeudi 25 février 1982 portant sur les profits des banques à charte. (*Voir procès-verbal du mardi 11 mai 1982, fascicule n° 84.*)

M. Deniger propose,—Que, nonobstant la résolution adoptée le mercredi 23 juin 1982, le greffier du Comité soit

Clerk of the Committee be authorized to pay Mrs. Lorraine Fairley and Miss Hélène Barbès for the extra hours worked editing the English and French versions of the Committee's Report to the House on Bank Profits.

The question being put on the said motion, it was agreed to.

Mr. Deniger moved,—That the Committee's Report to the House on Bank Profits be adopted as amended, subject to the approval on Wednesday of the amendments to the section on Small Business by the Chairman and Messrs. Berger and Wilson and that the Chairman be authorized to take the necessary steps to ensure that it is tabled in the House on Friday, July 30, 1982.

The question being put on the said motion, it was agreed to.

Mr. Blenkarn moved,—That the Committee print an additional 9,000 copies of Issue No. 109 of the Committee's Minutes of Proceedings and Evidence, with a special cover and that, if possible, the Report be printed in English and in French, under separate cover. The quantity of the reports to be decided by the Chairman, in consultation with representatives from the Official Opposition.

The question being put on the said motion, it was agreed to.

At 9:38 o'clock p.m., the Committee adjourned to the call of the Chair.

autorisé à payer à M^{me} Lorraine Fairley et M^{lle} Hélène Barbès les heures additionnelles de travail pour faire l'édition des versions anglaise et française du rapport du Comité à la Chambre sur les profits des banques.

La dite motion, mise aux voix est adoptée.

M. Deniger propose,—Que le rapport du Comité à la Chambre sur les profits des banques soit adopté tel que modifié sous réserve de l'approbation, à la séance du mercredi, des amendements à l'article sur les petites entreprises, amendement approuvé par le président et MM. Berger et Wilson et que le président soit autorisé à prendre les mesures nécessaires pour s'assurer que ce rapport soit déposé à la Chambre le vendredi 30 juillet 1982.

Ladite motion, mise aux voix est adoptée.

M. Blenkarn propose,—Que le Comité fasse imprimer 9,000 exemplaires additionnels du fascicule no 109 des procès-verbaux et témoignages du Comité y compris une couverture spéciale et que, s'il y a lieu, le rapport soit imprimé en anglais et en français sous pli séparé. La quantité de rapports sera décidée par le président, de concert avec les représentants de l'opposition officielle.

Ladite motion, mise aux voix, est adoptée.

A 21h38, le Comité suspend ses travaux jusqu'à nouvelle convocation du président.

Le greffier du Comité

J.M. Robert Normand

Clerk of the Committee

SEANCE DU SOIR

(139)

EVENING SITTING

(139)

In April 1982, the Committee held organizational meetings to draft a work plan for this study and to organize the necessary research staff. During these meetings, Mr. Jean-Aimé Guerin of the Library of Parliament's Research Branch was appointed Research Coordinator. The research staff initially comprised a total of six members, including Mr. J. Robin Corawell of McCarthy Securities, Professor Henri-Paul Renaud of Laval University and associated with REUMA Ltd. for this Report, Mr. Randall Cune of the Library of Parliament's Research Branch, Mr. Marion G. Wrobel of the Library of Parliament's Research Branch, and Mr. Douglas Baylis. The administrative duties were handled by the Clerk of the Committee, Mr. J.M. Robert Normand, and the Assistant Clerk, Mr. Jean Michel Roy. In June two others, Mrs. Lorraine Fairley and Madame Hélène Barbot, were hired by the Committee to assist in the final preparation of the Committee's Report. In addition, Mr. Louis Yablonsky of the Bureau of Management Consulting, Supply and Services Canada, was seconded to the Committee for editorial assistance.

The Committee embarked on reading Canadian newspapers with a view to soliciting a wide range of observations for its public hearings. The intention was to provide a forum in which all interested parties could make their views known, and to produce useful information for the preparation of this report. On May 6, 1982, the Committee issued a press release outlining its work plan. On Tuesday, May 11, the first public hearing was held in Ottawa.

The Standing Committee on Finance, Trade and Economic Affairs has the honour to present its:

SEVENTEENTH REPORT

In accordance with its Order of Reference of Thursday, February 25, 1982, your Committee has examined the profit situation of the chartered banks.

Shortly after the Committee's public hearings began, the focus of public attention changed. The chartered banks' profit figures for 1982 were becoming available, following a sharp drop in after-tax earnings. The banks' loan losses attracted concern, the adequacy of their capital base was questioned, as was the capacity of the banks to finance an economic recovery. Again, we feel that our Report has adequately addressed these issues.

Other questions concerning bank profitability were also dealt with, including the system of taxation applied to the banks, and their responsibilities to the needs of clients. This latter issue required an examination of the competitive and regulatory environment under which the banks operate.

The Committee faced a very real dilemma in deciding upon a plan of study. The Order of Reference given by the House of Commons allowed us to examine the banking system in a detailed and in-depth fashion. On the other hand, public apprehension and the importance of this subject required that we make a statement on these issues with little delay. We believe that the Report answers the essential questions related to banking that are vital to today's economic situation.

On Thursday, February 25, 1982, the Standing Committee on Finance, Trade and Economic Affairs received the following Order of Reference from the House of Commons.

ORDERED,—That the Standing Committee on Finance, Trade and Economic Affairs be empowered to review the profit situation of the chartered banks, and that the Committee be empowered to engage the necessary expert staff.

In April 1982, the Committee held organizational meetings to draft a work plan for this study and to organize the necessary research staff. During these meetings, Mr. Jean-Aimé Guertin of the Library of Parliament's Research Branch was appointed Research Coordinator. The research staff eventually comprised a total of six members, including Mr. L. Robin Cornwell of McCarthy Securities, Professor Henri-Paul Rousseau of Laval University and associated with REDMA Ltd. for this Report, Mr. Randall Chan of the Library of Parliament's Research Branch, Mr. Marion G. Wrobel of the Library of Parliament's Research Branch, and Mr. Douglas Baylis. The administrative duties were handled by the Clerk of the Committee, Mr. J.M. Robert Normand, and the Assistant Clerk, Mr. Jean Michel Roy. In June, two editors, Mrs. Lorraine Fairley and Madame Hélène Barbès, were hired by the Committee to assist in the final preparation of the Committee's Report. In addition, Mr. Louis Vadboncoeur of the Bureau of Management Consulting, Supply and Services Canada, was seconded to the Committee for editorial assistance.

The Committee advertised in leading Canadian newspapers with a view to soliciting a wide range of submissions for its public hearings. The intention was to provide a forum in which all interested parties could make their views known, and to produce useful information for the preparation of this report. On May 6, 1982, the Committee issued a press release outlining its work plan. On Tuesday, May 11, the first public hearing was held in Ottawa. Fifteen days were allotted to these public hearings, ending on June 14, 1982. In addition, a number of submissions were received by individuals or organizations that did not appear before the Committee.

The Order of Reference given to the Committee by the House of Commons was broad enough to enable us to structure our Report in a way that reflects current events in this area. The issue of bank profits was first raised when profit figures for 1981 were being released. At that time, particularly in the first quarter of the banks' 1981 fiscal year, interest rates were rising rapidly, reaching record levels. The economy was starting to feel the negative effects of the high interest rates and, on the surface at least, it appeared that the banks were the only beneficiaries of their steady rise. This has been thoroughly analyzed in this Report, and the Committee feels confident that the factors leading up to the record bank profits in 1981 have been explained.

Shortly after the Committee's public hearings began, the focus of public attention changed. The chartered banks' profit figures for 1982 were becoming available, indicating a sharp drop in after-tax earnings. The banks' loan losses attracted concern, the adequacy of their capital base was questioned, as was the capacity of the banks to finance an economic recovery. Again, we feel that our Report has adequately addressed these issues.

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The Committee faced a very real dilemma in deciding upon a plan of study. The Order of Reference given by the House of Commons allowed us to examine the banking system in a detailed and rigorous fashion. On the other hand, public apprehension and the importance of this subject required that we make a statement on these issues with little delay. We believe that the Report answers the essential questions related to banking that are vital to today's economic situation.

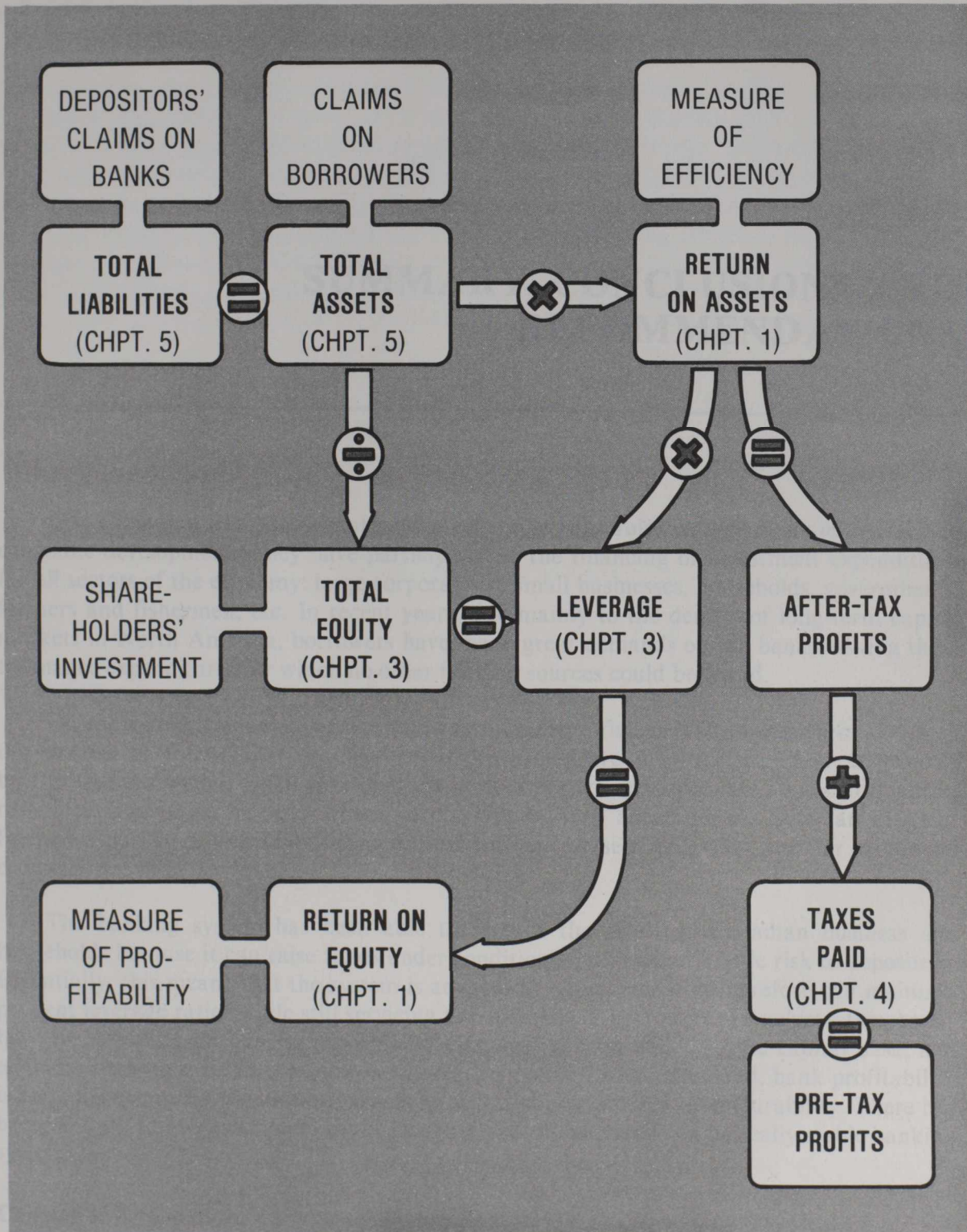
**REPORT OF THE HOUSE OF COMMONS STANDING COMMITTEE ON
FINANCE, TRADE AND ECONOMIC AFFAIRS ON
BANK PROFITS**

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DIAGRAMATIC EXPOSITION OF BANK PROFIT RELATIONSHIPS



Since the early 1970s, the banks' relative importance in the Canadian economy has increased. Their lending activities have grown at a faster rate than the business activities of

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The Canadian chartered banks have played a vital role in Canadian industrial and economic development. They have participated in the financing of investment expenditures for all sectors of the economy: large corporations, small businesses, households, governments, farmers and fishermen, etc. In recent years, due mainly to the demise of long-term capital markets in North America, borrowers have made great demands on the banks, asking them to finance expenditures for which no other funding sources could be found.

On the whole, Canadian banks have proven to be efficient instruments through which the savings of Canadians are channelled into productive investments. Their large-scale branching network has given developing regions of the country adequate access to financial resources from other regions where surplus funds have accumulated. Such an efficient financial market is essential for recovery from the present recession and for continued economic growth.

The banking system has been able to finance the needs of Canadian business and households because it can raise funds under conditions which provide little risk to depositors. Essentially, this means that the system is adequately capitalized and therefore can maintain prudent leverage ratios while still servicing the demands of borrowers. To achieve this, banks have to be profitable, generating retained earnings that are added to the capital base, and enabling them to raise new capital in the market place. On the one hand, bank profitability is an indicator of the system's efficiency, and, on the other, a sign of its durability. There has been no bank failure in Canada in the last fifty years. The result is a basically stable banking system.

Chapter 1: Profits in the Canadian Banking System

Since the early 1970s, the banks relative importance in the Canadian economy has increased. Their lending activities have grown at a faster rate than the business activities of

other sectors. This asset growth has had a direct and major impact on the overall level of their profits, with the result that the banks are now earning an increasing share of national income.

In 1981, the total after tax profits of Canadian chartered banks amounted to \$1,700 million, an increase of 38 per cent over 1980. These high profits were not earned to the detriment of Canadian consumers or businesses. Three factors explain this increase. First of all, total bank assets increased by 27 per cent in 1981, over their 1980 level. Secondly, profits on international operations increased by 46 per cent in 1981, compared to a 32 per cent increase in profits from domestic operations. Finally, the rapid increase in interest rates in the first quarter of the banks' 1981 fiscal year resulted in increasing spreads that produced inventory profits, because the rates charged on loans adjusted faster than those paid on deposits. These inventory profits were temporary, and should have been expected, given the nature of financial intermediation. Indeed, these inventory profits have been reversed as interest rates fell in late 1981 and early 1982.

The profitability of the chartered banks can be measured in two ways: return on average assets (ROA), the ratio of the balance of revenue after taxes to average assets held during the year; and return on average equity (ROE), the ratio of after tax revenue to the value of shareholders' equity. In 1981, the Canadian banks earned an ROA of 0.57 per cent, (i.e. 57¢ per \$100 of assets) up from the 1980 figure of 0.51 per cent, but equal to the average ROA of the past ten years. In 1981, their ROE reached 18.7 per cent. This compares with the 15.9 per cent return of 1980, the 16.3 per cent earned in the latter half of the 70s, and the 14.8 per cent of the first half of the decade.

The record level of bank profits in 1981 and the dramatic increase over 1980 are understandable, taking these factors into account. On the basis of measures of profitability, the banking sector's 1981 performance was not out of line. The 1981 ROA equalled the average over the past ten years, achieved mainly because of the high ROA on international operations—0.78 per cent, compared to 0.48 per cent on domestic assets.

On the basis of ROE as well, bank profits are not excessive. The 18.7 per cent return on equity results from the division of an increasing dollar value of profit by a slower increasing value of equity. This implies that each dollar of shareholders' equity is used more intensively to support the sharply rising growth in assets. In other words, the ratio of bank assets to equity has been increasing rapidly over the last decade. In 1971, bank assets were twenty-one times as large as shareholders' equity; in 1981, this ratio reached thirty-one times. The substantial diversification of bank assets and the stable deposit base permit this higher leverage. This has resulted in an increased exposure of the capital base, which when accompanied by the weakness in the economy, explains in part why bank shares traded substantially below their book value in 1981.

Bank profitability, as measured by return on equity, has been average when compared to other industries. Out of thirty-three industries, the banks ranked eighth over the period 1972-1981, and second in 1981. This compares to their rank of sixteenth in 1980 and eleventh during the 1970s. The higher ranking in 1981 was due as much to the decline in other sectors' profitability as to the increased bank profitability.

It is difficult to compare the profitability of international banks. They operate in vastly different institutional and regulatory environments. Taxation and accounting methods vary

widely, and in some countries banks are government-owned. Nevertheless, the most consistent and comprehensive data at the Committee's disposal indicates that Canadian banks are not overly profitable when compared to banks in the rest of the world. Their ROA compares poorly with that of foreign banks and, to the extent that Canadian ROE appears to compare well, this is largely due to the more leveraged position of Canada's banks.

The Canadian banking sector has undergone some major changes over the 70s, and especially in the last several years. The chartered banks have moved increasingly into international operations that are now relatively more profitable than domestic operations. By 1981, 40% of bank assets were denominated in foreign currencies. Canadian dollar deposits with the banks are not used for funding foreign currency loans; these are funded by foreign currency deposits. Moreover, during the last ten years, banks used foreign currency deposits to finance Canadian dollar loans. To put it another way, the banks' foreign operations have been used to finance Canadian exports and investment and other expenditures and are, in themselves, an export of financial services generating foreign exchange. When these foreign operations were set up, the banks did incur expenditures in the form of training Canadian employees and establishing branches and subsidiaries. Through their foreign and domestic operations, the banks are a major supporter of Canadian investment and export activity.

The deposits and assets of the banks have also undergone some major changes. Bank assets in the form of securities are increasingly replaced by loans. More and more, Canadian dollar deposits at Canadian banks are in the form of term deposits, although the term to maturity is becoming shorter. These changes in the structure of assets and liabilities are generated by volatile interest rates.

Chapter 2: Interest Rates and Bank Profits in Canada

The past decade can be characterized as one of steadily rising interest rates. Especially since 1979/80, they have been extremely volatile, making a significant impact on financial markets and the banks.

Increasingly, bank deposits have become fixed-term deposits, but of short maturity. This is a direct result of volatile interest rates. Reacting to this volatility, savers demand shorter term deposits. Borrowers, in turn, do not want to commit themselves to high interest rates for long periods, and thus the term to maturity has fallen on bank loans. On their part, banks try to match the term to maturity of bank loans to their shorter term deposits; for example, five year mortgages have virtually disappeared, because five year term deposits have all but disappeared. Banks have reduced the extent to which they take risks with respect to interest rates: this intermediation risk has been shifted, in many cases, to borrowers. Such a move protects bank depositors and shareholders, but can result in serious problems for corporate and household borrowers.

Caution also characterizes behaviour in the long term capital market, now all but disappeared because of inflation and volatile interest rates. The severe recession and the accompanying fall in corporate profitability have seriously reduced the amount of internally-generated corporate financing. At the same time, corporate financing needs have increased significantly. Corporations spent heavily on capital equipment in 1980 and 1981, but more especially, in 1981 in purchasing financial assets in mergers, notably in the oil and gas

industry. Moreover, large capital outflows restricted the funds available for the corporate sector. The upshot of all this was that corporations required very large amounts of external financing in 1981. Essentially, the only avenue open to them was the banks. And because of the changing term structure of bank deposits, the corporate sector had to rely on short-term business loans.

Therefore, the large increase in bank assets in 1981, particularly as this relates to the business sector, was mainly due to the demand for credit. The banks expanded to fill the gap in business financing as other sources of financing disappeared. This higher level of lending activity was made possible by the health of the system and resulted in an increase in overall profits.

Individual borrowers in the household sector have reacted quite differently to high and volatile interest rates, than did corporate borrowers. With little growth in real disposable personal income, this sector was reluctant to commit itself to increased debt.

Thus the growth in the assets of banks and the change in the composition of the banks' asset portfolios reflect the changing demands for credit from the various sectors of the economy. In 1981, demand for credit was down among households and up in corporate business.

It must be said that, although the banks have supported the current needs of the corporate sector, this could prove to be expensive in the longer term. The corporate sector has become increasingly illiquid. Corporate reliance on debt financing, and in particular short-term debt financing, at a time of high interest rates and decreasing cash flow, has undermined the ability of many companies to meet their debt obligations.

The liquidity strain of the corporate sector, caused by two recent factors, high interest rates and a severe recession, is worsened by two more long-term problems: 1) the shortening maturity of outstanding debt; and 2) the erosion of the equity base of Canadian corporations. In this situation, the rapid increase in the cost of money has been sufficient to create a liquidity crisis which is the worst experienced by the corporate sector in the post-war period. This crisis may, in itself, prolong the current recession.

Inflation, taxation, and fiscal and monetary policies have all combined to hinder the working of the capital market. This scarcity of long-term capital is also a significant problem for the non-financial corporate sector. This sector has become increasingly reliant on debt financing and, recently, on short-term debt, precipitating a serious deterioration in corporate leverage ratios.

The liquidity crisis, discussed above, is a major problem for the corporate sector and the economy as a whole; not only does it aggravate the current recession, but it also affects resource allocation. In addition, it could have implications for the future health of the banking system. Although this problem is a long-term one, a number of measures can be applied quickly to help resolve this problem, and this situation can only reinforce the need for a healthy banking sector and for a renewal of the traditional sources of long-term capital. Thus, the Committee recommends that:

1. The Standing Committee on Finance, Trade, and Economic Affairs should request a reference from the House of Commons to conduct an immediate inquiry into the full

causes of the decline in the long-term capital market in Canada, and to recommend policies to ensure the adequacy of long-term debt and equity capital to fund future economic growth. In addition, the Minister of Finance should take immediate and appropriate steps to encourage the corporate sector to issue equity capital and rely less on loans, and other debt instruments.

Banks are not responsible for the level of interest rates; the supply and demand of the market place, as affected by the actions of the Bank of Canada and conditions in international financial markets, determine this level. Banks do, however, establish actual interest rates on specific loans, according to different levels of risk. For example, banks charge higher rates on loans to new companies than they do on loans to well-established businesses.

For a given level of assets, the dollar value of bank profits is directly influenced by interest rate spreads. These spreads are determined by 1) the difference between interest rates on various assets and liabilities; 2) differences amongst the terms-to-maturity of various assets and liabilities; and 3) the proportion of floating rate and fixed rate assets and liabilities. Spread is essentially a combination of these three factors; thus it is measured by the difference between realized interest revenue and realized interest expense, divided by average total assets. Thus rapidly and irregularly changing interest rates can temporarily alter spreads for a short period of time and result in temporary inventory profits or losses for the banks.

Chapter 3: Bank Capital

The adequacy of a bank's capital base is fundamental to good banking practice and the protection of depositors' savings. It is also fundamental to the system's ability to finance the needs of Canadian businesses and households.

Increasing the capital base is directly and indirectly related to bank profitability. Earnings' retention increases the size of shareholders' equity and is obviously related to bank profits. Healthy profit performance also increases the value of equity and thus reduces the cost of raising new equity through capital markets. Over the past 18 months, the banks used the capital market to sell new capital issues whose total value far exceeded the banks' relative size in this market. Because of the large demands placed by the banks on the capital markets, some new issues were reduced. During this period, the banks took the maximum amount of new capital made available to them.

The Committee believes that Canadian chartered banks should be owned and controlled domestically; yet consideration should be given to greater use of foreign capital to fund their capital base. This can be done in such a way as to present no threat to the domestic control of the industry. The 1980 Bank Act revisions moved in this direction, by allowing banks to issue non-convertible debentures in foreign currencies. But it is unclear whether banks are allowed to issue convertibles in foreign currencies. In this respect, the Committee recommends that:

2. Banks should be permitted more flexibility in issuing equity capital in foreign markets, in order to remove the onus on Canadian capital markets to fund future growth in the banks' foreign operations. The 75 per cent Canadian ownership constraint under the Bank Act should continue to be observed, however, as should the rule limiting individual ownership of a bank to 10 per cent.

It is not expected that the present level of bank capital would prevent the banking system from financing a recovery from the current recession. Nevertheless, a healthy and well-capitalized system is a prerequisite for strong and sustained recovery and, in that respect, investor confidence is vital. This confidence has been somewhat shaken recently by the realization that a few individual bank loans have been made that represent a very high proportion of bank capital. This problem is further compounded by the fact that the current definition of capital is being reconsidered, creating uncertainty as to what constitutes the capital base of a bank.

The Committee, therefore recommends that:

3. The Inspector General of Banks should provide an **official definition of bank capital** that precisely specifies the weights attached to components of each class of capital. Bank capital should be identified as either primary or secondary. Primary capital is to be permanent in nature, including common equity and non-redeemable preferred shares. Secondary capital would include all other forms of capital that meet minimum standards as to type and maturity, including such forms as convertible and subordinate debentures.
4. The total outstanding value of any one bank's loans to any borrower or associated group of borrowers should be limited to 25 per cent of that bank's total capital (as defined in Recommendation 3), unless otherwise approved by the Office of the Inspector General of Banks.
5. In the event that the above recommendations are implemented, **bank leverage ratios should not be legislated**. However, the Inspector General of Banks should closely monitor long-term trends and short-run variations in the leverage ratios of individual banks.

With an official and precisely defined capital base specified for each bank, the public could be made much better aware of the financial position of the banking system. Such specifications, combined with limitations on the size of individual bank loans, would provide the constraints necessary to ensure prudent banking practices. **The Committee feels that, because bank leverage ratios can be subject to significant short-run variations, any limits fixed to these ratios would impose undue burden on the banks.**

Over the past seven years, the calculated loan loss provision reported in the banks' annual income statements has proven to be a poor indicator of actual loan loss experience in any particular year. Moreover, the banks' loan portfolios include loans classified as non-current and/or non-productive. The actual status of such loans is unclear, and the Committee has not had available to it the extent to which individual banks carry such loans. The Committee accordingly recommends the following:

6. The formula used for calculating the average provision for loan losses (currently a five-year moving average) should be reviewed by the Minister of Finance with a view to moving to a system that more accurately reflects a bank's actual loan loss experience in its income statement.

7. The non-current loan category as outlined in the Bank Act should be redefined, so as to classify outstanding bank loans according to their contribution to bank income. All loans on which i) future interest payments are not expected to be received or ii) interest payments have not been received for ninety days or iii) for which bank officials treat interest payments on a non-accrual basis, should be classified as non-contributing loans. All loans on which i) contractual interest payments are not made in full and, on which ii) the differential is treated on a non-accrual basis, should be classified as partially-contributing loans. All other loans should be classified as fully-contributing loans. Such information should be included in each bank's annual report.

An adequate capital base is necessary to protect the interests, not only of bank depositors, but also of the banks' shareholders. **The steps recommended should further enhance the security and stability of the Canadian banks and foster domestic and foreign confidence in our banking system.**

Deposit insurance is also important as a means of protecting depositor's savings. Since it was first implemented in 1967, the value of the protection this insurance offers to depositors has been seriously eroded by inflation. The Committee therefore recommends that:

8. Deposit insurance should be increased to afford a better **real** protection of depositors' savings. The level of insurance for each individual depositor with any bank should be raised from the present \$20,000 to at least \$60,000, which restores the real value of protection offered when it was introduced in 1967. The level of deposit insurance should be reviewed every five years.

The Committee's investigation of the banks raised many questions which could not be answered adequately for lack of information. Certain witnesses expressed the view that banks operate under a shroud of secrecy that hides their activities from the public.

In response to that perception, and recognizing the central role played by the banking system in the economy, the Committee recommends a greater openness in disclosure of banking operations.

9. Information should be available as to:

- i) non-contributing and partially contributing loans and all loans rescheduled in the past twelve months which had not previously been fully contributing loans, (as in Recommendation 7);
- ii) actual loan loss experience;
- iii) distribution of loans by size;
- iv) taxation;
- v) sources of "other income"; and
- vi) characteristics of bank assets and liabilities.

In all of the above cases, the data should be broken down according to domestic and international operations, categories of loan size and major industrial sectors. For example, data should be provided, on an individual bank basis, in a format like the one by which aggregate data are to be published under the revised Bank Act.

With increased disclosure, there will be improved external analysis of the banking system. The Office of the Inspector General of Banks can perform two roles in this respect: it can be a mechanism by which better and more consistent information is made available; and it can be one of many sources of external analysis. The Committee, therefore, recommends:

10. The Office of the Inspector General of Banks should produce an "Annual Report on Banks in Canada" and make it available to the general public. The Inspector General's office should also study the lending practices of banks and include these results in its Annual Report. This report could be modelled on the Report of the Superintendent of Insurance.

Chapter 4: Taxation of Canadian Banks

The statutory tax rate applied to bank income has changed only very slightly in recent years. Nevertheless, the banks' effective tax rate has fallen significantly. This is because the banks have substituted non-taxable income for taxable income, by offering several types of loan substitutes, introduced and encouraged by government policy as a kind of interest rate relief for borrowers. Tax-exempt financing reduces the cost of funds to those classes of borrowers who qualify for this indirect government subsidy. It has significantly reduced the taxable income of banks and thus their effective tax rates have fallen.

The main beneficiaries of this form of financing have not been the banks, but rather those business borrowers who, for one reason or another, could not make full use of the deductibility of interest expenses from their income. Small businesses also have benefitted from this type of financing, since their corporate tax rate is less than that paid by larger companies, including the banks. Under more usual forms of financing, the deductibility of interest expenses is of less benefit to a small business than to a company paying a higher marginal tax rate. Thus, as indicated in the text, this form of financing has had a minimal effect on bank profitability; the borrower receives the benefits of after-tax financing.

The banks' use of loan substitutes has had the sanction of government tax law or the explicit approval of government policy. Bank purchases of Small Business Development Bonds and Small Business Bonds have been actively promoted by the Federal Government. **Thus the fall in the effective tax rate on banks relates to the extent to which banks act as agents of government policy.** In some instances, bank spreads have widened through the use of such financing; however, the value of collateral on these loan substitutes has tended to be less than would normally be the case.

The widespread use of after-tax financing has resulted in some unforeseen tax problems for the banks. Because of the way bank profits are taxed, and because high interest rates and the use of loan substitutes have prompted the banks to defer the use of some tax deductions on domestic expenses, they risk losing some of these in the future. In some instances, banks may even lose some foreign tax credits. If that happens, then it will be bank shareholders, rather than the government, who will subsidize certain classes of borrowers.

The extent to which banks offer loan substitutes is directly related to their taxable income. If bank profitability declines, banks will reduce their offerings of loan substitutes, and the government policy that encouraged these substitutes will be frustrated.

Thus the Committee recommends:

11. The Federal Government should consider the future use of after-tax financing through financial institutions very carefully as a means of subsidizing certain classes of borrowers, taking into full account the consequences of this form of financing on bank profit levels, and on effective tax rates on banks, and assessing its net effect on the financial needs of borrowers. If after-tax financing continues to be used, then consideration must be given to extending the banks' tax loss carry-forward provisions beyond five years.

Chapter 5: Banks and Small Clients: Their Evolving Relationships

Households and small businesses transact business with banks in three ways: as borrowers, as savers, and as consumers of banking services. The extent to which these clients receive adequate treatment at the hands of the banks is largely a function of the level of competition amongst the individual banks and amongst the various institutions engaged in these financial markets.

Although household savers have a choice of many ways to invest their savings, they have shown a marked preference for deposits with the banks. Yet, banks are not the sole deposit-taking institutions; they must compete with trust companies and credit unions, etc. There is competition in the rates of return on savings and in the quality, quantity, and price of services. The banks can only increase their share of this market to the extent that they meet the needs of savers better than their competitors do.

Already dominant in the consumer loan business by 1970, the banks increased their share of it dramatically over the next ten years. After the revisions to the Bank Act in 1967, the chartered banks effectively displaced sales finance and consumer loan companies from the market.

From 1970 to 1980, the banks also increased their share of the mortgage market. This was made possible by the removal of the 6 per cent interest rate ceiling that had existed prior to 1967, and by the banks' use of subsidiary companies that circumvented the restriction on bank activity in mortgages. The banks used these companies for matching assets and liabilities, and to provide themselves with alternative sources of funds not subject to reserve requirements. The large-scale entry of banks into this field has also brought about a number of innovative mortgage instruments for coping with the current high rates of interest.

The trend toward greater corporate reliance on bank loans and short-term loans is even more pronounced for small businesses. **There is no indication that the availability of loans to small businesses are inadequate in any well-defined sense.** The evidence rather suggests that bank loans to various sizes of business are demand determined.

Similarly, with regard to the pricing and quality of loans to small businesses, there is no hard evidence that banks discriminate amongst the various sizes of firms as to what they required for collateral, or what they charge as interest. Where small businesses appear to pay higher prices or make other concessions, higher administrative costs to the banks and greater risk exposure tend to explain these differences.

On the whole, the existing regulatory system allows greater freedom to banks than to other financial institutions. The results presented in the Committee's Report, are consistent

with what would be found in a competitive market. No discrimination appears to exist, and pricing seems to be tied to cost. In this respect, the impact of regulation appears to be neutral. Indeed, **competition defined by regulation is less likely to guarantee such results in the long-run, than competition determined by market forces.** Currently, financial markets are competitive, but future competition may be hindered by regulatory constraints placed on the banks' competitors. We are particularly concerned with the ability of small businesses to obtain funds from a wide variety of financial institutions.

The Committee recommends that:

12. Competition should be further increased by expediting revisions to the Trust Companies' Act and the Loans Companies' Act, to allow an expansion of lending powers in the consumer and business loan markets.

In the hearings, the Committee received a number of complaints regarding inadequate and over-priced services to some clients. It is a general perception that such behaviour is widespread and frequent; however, the nature of the Committee's evidence does not indicate that such practices are employed systematically. To the extent that such accusations are valid, the fostering of greater market-oriented competition can do much to remedy this situation and to ensure that it does not become a significant problem in the future.

Competition tends to reduce any systematic bias against specific groups of bank clients and any propensity to provide inadequate or over-priced services. Nevertheless, isolated instances of such practices will undoubtedly recur, and therefore there should be some mechanism whereby consumer complaints can be heard and dealt with, and through which the nature of various bank services can be explained. The Insurance Bureau of Canada maintains such a service in its "Hotline" facilities. Many of the complaints heard by the Committee concerned Electronic Funds Transfer that, under the law, is the responsibility of the Canadian Payments Association.

The Committee recommends that:

13. The Canadian Payments Association should establish and maintain an office where complaints can be lodged and filed, and minor disputes settled, and where services can be explained to the public.

This office is to respond to complaints that apply to the overall payments system. The Committee encourages all banks to establish offices of their own for dealing with complaints that are directed to their own operations. Moreover, we recognize the role of the Inspector General of Banks as the ultimate arbiter of complaints concerning the banks. (The Committee recognizes that other avenues are available to individuals who have valid complaints, one of which is the courts.) Thus a "complaints structure" can be initiated with complaints about individual banks being handled by those institutions and systemic complaints being handled by an office established by the Canadian Payments Association.

The entry of Schedule B banks into the Canadian banking sector can be a potential source of increased competition. Accordingly, the Committee recommends that:

14. The Office of the Inspector General of Banks should report to Parliament within two years on the status of Schedule B banks with respect to leverage, branching, and asset ceilings.

The measures described above may still prove to be inadequate to resolve some of the serious financing problems faced by small businesses, especially in today's economic environment. The Minister of State for Small Business has established a committee to examine the question of small business financing.

We recommend that:

15. The Advisory Committee on Small Business Financing give specific attention to the problems faced by small firms with respect to the possible crowding-out of small borrowers during times of high interest rates, the impact of taxation on the demand for credit by various sizes of firms and the problems inherent in the institutional setting under which small firms must seek financing. This advisory committee should also examine possible solutions to these problems which may include: the introduction of loan insurance for small business loans, similar to that which the CMHC provides for mortgages; an extension of the size and scope of SBLA loans; and measures to increase the accessibility of pension plan funds to the small business borrower.

1.1.1 AN OVERVIEW OF THE CANADIAN CHARTERED BANKS

Every sector of the economy, whether industry, business, governmental, financial institutions, or households, receives revenue and incurs expenditures. They will accumulate surpluses when their revenues exceed their expenditures, and deficits when their expenditures exceed their revenues. The re-allocation of funds from sectors with surpluses, to satisfy the competing demands of sectors with deficits, is accomplished in this country by financial institutions or, less frequently, by direct lending in the open money market. In both cases, the price of funds, that is, the interest rate, is determined by the supply of and demand for funds. The first function of the financial system, therefore, is to allocate funds between surplus and deficit sectors by the use of the market mechanism. Another function of the financial system is to facilitate payments among the various sectors of the economy.

Chartered banks in Canada play a major role in both these functions. In the payments arena, they provide cheque-clearing, credit card transactions, and inter-bank debit and credit transactions, etc. As financial intermediaries, they accept deposits and make loans. Deposits represent the chartered banks' debt vis-à-vis depositors, and are recorded as a liability on their balance sheets. Loans constitute borrowers' debts vis-à-vis the banks, and are recorded as assets on the banks' balance sheets.

The difference between total assets and total liabilities equals the shareholders' equity: the investment made by the owners of a bank. The principal components of shareholders' equity are common shares and retained earnings.

The size of common equity in the financial statements of the banks is the product of the number of shares outstanding multiplied by their issue price. Retained earnings are the cumulative total of undivided profits over the years. Shareholders' equity in any period can be increased by either issuing new shares or retaining part of earnings. In essence, bank profits are derived from the interest income on loans less overhead costs and the interest paid on deposits.

Chapter 1

Profits in the Canadian Banking System

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The Bank Act revision of 1980 distinguishes between schedule A banks (Canadian owned chartered banks and widely held) and schedule B banks (closely held Canadian and foreign banks). As of June 1982, there were 11 schedule A banks and 57 schedule B banks, the latter all being owned by foreign banks. Foreign banks began to receive their official bank status in Canada only after November 1980, and, in most cases, their actual banking operations commenced in the second half of fiscal year 1981. Therefore, the present Report pertains only to Canadian banks.

The Canadian banking industry is characterized by the small number of banks that dominate it: the Big Five, as they are called—the Royal Bank of Canada, the Canadian Imperial Bank of Commerce, the Bank of Montreal, the Bank of Nova Scotia, and the Toronto-Dominion Bank—and by their vast branch networks, comprising more than 7,000 branches in Canada, and over 300 branches and representative offices abroad.

The small number of chartered banks and the high degree of concentration in the industry are not the result of any limitation to initial bank charters. In fact, between 1792 and 1981, 164 charters were issued, of which 61 (37 per cent) were never used. For the remaining 103 charters, there have been 43 cases (26 per cent) of merger and 49 instances (30 per cent) of failure. The evolution of these developments has been such that there are only 11 chartered banks (7 per cent) today in Canada.⁽¹⁾ Most bank failures took place between 1857 and 1917.⁽²⁾ Mergers have tended to follow at the initiative of banks in difficulty. There has been no bank failure in Canada since 1923. In this respect, the Canadian banking system can thus be considered stable.

Table 1.1

CHARTERED BANKS IN CANADA

(31 Oct. 1981)

Chartered Bank	Total Assets in millions of dollars	% of Total Assets of All Banks	Foreign Currency Assets in million of dollars	No. of Branches (1)
1) Royal Bank of Canada	87,516.1	25.4	34,815.9	1,506
2) Canadian Imperial Bank of Commerce	66,844.6	19.4	19,842.8	1,631
3) Bank of Montreal	63,779.9	18.5	24,872.9	1,297
4) Bank of Nova Scotia	50,138.1	14.6	23,694.7	1,017
5) Toronto-Dominion Bank	44,862.3	13.0	17,589.2	1,020
6) National Bank of Canada	19,157.2	5.6	6,612.8	787
7) Mercantile Bank	4,102.0	1.2	1,053.2	15
8) Bank of British Columbia	2,995.8	0.9	521.1	47
9) Continental Bank	2,527.9	0.8	30.9	38
10) Canadian Commercial Bank	1,532.8	0.4	330.7	9
11) Northland Bank	517.4	0.2	69.7	7
Total	343,974.1	100.0	129,433.9	7,374

SOURCE: Supplement to the Canada Gazette, 12 December 1981. P. Papadopoulos, "Les réseaux de succursales bancaires au Canada", *Le Banquier et Revue IBC*, août 1981, p. 32.

⁽¹⁾ As of April 30, 1981.

The evolution of the gradual reduction in the number of banks, coupled with an ever increasing number of branches, can be explained by at least two factors. First, there has never been any law, Canadian or British, which forbade the creation of a branch banking system, as was the case in the United States. Second, from the banks' point of view, our geographic diversity, coupled with a low population density, made it necessary for them to branch out, so as to enhance the movement of capital from one region to another, and in so doing, to spread the headquarters overhead costs over many branches.

Chartered banks are regulated by the Bank of Canada with regard to matters of monetary policy, by the Office of the Inspector General of Banks in regard to compliance with the Bank Act, and by the Parliament of Canada for revision of the Bank Act or any other related banking matter. Changes to the Bank Act in 1967 and 1980 have had a great impact on banking operations. In addition, depositors and borrowers have changed their behaviour fundamentally, in response to unabated inflation, fluctuating economic growth, and volatile interest rates. The chartered banks have adjusted their operations accordingly. These changes have not been limited to domestic operations only. Indeed, one of the major developments in the Canadian banking system over the last decade has been the unprecedented growth in foreign currency operations. A more detailed discussion on chartered bank operations from 1971 to 1981 is considered below.

The assets of the Canadian banking system, that totalled \$52,317 million in 1971, had grown to \$350,051 million ten years later: a 20.9 per cent compound annual growth rate. This growth rate compares favourably with the average annual growth of the Gross National Product (GNP) in current dollars—13.3 per cent over the same period.⁽³⁾ Chartered bank asset growth during this decade was slightly higher than that of trust companies and mortgage loan companies (18.7 per cent), and credit unions and caisses populaires (19.6 per cent). It was identical to that of the Quebec Savings Bank (20.9 per cent).⁽⁴⁾

This bank asset growth has been augmented by an unprecedented growth in foreign currency operations. The compound average annual growth rate of foreign currency assets was 25.8 per cent, compared to the 18.5 per cent growth in Canadian dollar assets. From 1971 to 1981, the proportion of foreign currency assets to total assets increased from 27 per cent to 40 per cent. Foreign currency liabilities as a percentage of total liabilities rose from 26.5 per cent in October 1971 to 41.6 per cent at the end of October 1981. Our discussion of the increase in the banks' international operations will follow the discussion of domestic assets, below.

Major changes in domestic assets

The most important change in the composition of domestic assets over the period 1971 to 1981 was the shift in emphasis from cash holdings, Treasury Bills, and securities to loans and mortgages. Canadian liquid assets as a percentage of total assets dropped from 19.9 per cent to 5.9 per cent, whereas that of securities decreased from 4 per cent to 2.5 per cent (Table 1.2). Canadian liquid assets include Bank of Canada notes and deposits at the Bank of Canada, day to day loans to investment dealers, Treasury bills, bonds issued or guaranteed by the Canadian Government, and other demand or short-term loans.

Table 1.2

ASSETS AND LIABILITIES OF CANADIAN CHARTERED BANKS 1971 and 1981

	Millions of dollars		% of Total Assets		Annual Growth Rate
	End of October 71	End of October 81	End of October 71	End of October 81	From end of October 71 to end of October 81
ASSETS					
Canadian liquid assets	\$10,409	\$20,674	19.9%	5.9%	7.1%
Loans	22,272	137,150	42.5	39.2	19.1
Securities	2,062	8,571	4.0	2.5	15.3
Other assets	3,453	43,506	7.0	12.4	28.8
Total Canadian dollar assets	38,196	209,901	73.0	60.0	18.5
Total foreign currency assets	14,121	140,150	27.0	40.0	25.8
Total assets	52,317	350,051	100.0	100.0	20.9
LIABILITIES					
Canadian dollar deposits	\$33,918	\$157,127	64.9%	44.9%	16.5%
Other Canadian dollar liabilities	2,765	38,235	5.3	10.9	30.0
Foreign currency liabilities	13,896	145,634	26.5	41.6	26.4
Shareholders' equity	1,738	9,056	3.3	2.6	17.9
Total liabilities and shareholders' equity	52,317	350,051	100.0	100.0	20.9

SOURCE: Bank of Canada *Review*—various issues.

Chartered banks' holdings of cash and deposits at the Bank of Canada declined in this period, for two reasons. Firstly, the Bank Act revision in November 1980 lowered the required reserve ratio for demand deposits from 12 per cent to 10 per cent and, on term deposits, in stages from 4 per cent to 2 per cent. Secondly, the proportion of demand deposits to total deposits declined dramatically. Holdings of Treasury Bills and securities declined because growing inflation, rising interest rates, and a growing demand for loans resulted in higher profitability of loans relative to securities and a reduction in the secondary reserve ratio.

Even though the share of total assets comprised of bank loans dropped slightly from 42.5 per cent to 39.2 per cent, total bank loans recorded a compound average annual growth rate of 19.9 per cent, higher than the growth rate (18.5 per cent) of all Canadian dollar assets. The decline in the proportion of domestic loans to total assets was attributed to an even stronger growth in foreign currency loans. The greatest demand for loans originated from the mortgage and business sectors, more so than from the agriculture and consumer sectors or provincial and municipal governments. The growth of other assets denominated in Canadian dollars is a result of the development, in the 70s, of the market for banker's acceptances, guarantees, and letters of credit.⁽⁵⁾

Table 1.3

CHARTERED BANK LOAN PORTFOLIOS

1971 and 1981

	Millions of dollars		% of Total Assets		Compound Average Annual Growth Rate
	End of October 71	End of October 81	End of October 71	End of October 81	From end of October 71 to end of October 81
Personal loans	\$6,320	\$32,864	12.1%	9.4%	17.9%
Mortgage loans (excluding loans by mortgage loan companies associated with chartered banks) ⁽¹⁾	2,167	16,400	4.1	4.7	22.0
Loans to businesses ⁽²⁾	10,552	70,562	20.0	21.0	21.4
Loans to farmers	1,349	7,472	2.6	2.1	18.7
Other ⁽³⁾	1,884	6,852	3.6	1.9	13.8
Total Loans	22,272	137,150	42.5	39.2	19.9

SOURCE: Bank of Canada *Review*.

⁽¹⁾ Loans from mortgage loan companies associated with chartered banks amounted to \$11,731 million at the end of October 1981. At the end of October 1981, the banks' loan portfolio in this sector was \$28,131 million. This amount represented 7.7 per cent of the banks' and their companies' consolidated assets.

⁽²⁾ Includes only loans in Canadian dollars. At the end of October 1981, Canadian banks held \$19,969 million in foreign currency loans issued to Canadian residents.

⁽³⁾ Include loans to provinces, municipalities, grain dealers, sales finance and consumer loan companies, and Canada Savings Bonds.

Major changes in domestic liabilities

The proportion of Canadian dollar deposits to total liabilities of chartered banks dropped from 65 per cent to 45 per cent between 1971 and 1981, whereas the ratio of other liabilities to the total doubled from 5.3 per cent to 10.9 per cent over the same period (Table 1.2).

In the 70s, the structure of Canadian dollar deposits underwent some major changes. At the end of October 1971, demand deposits and other chequable deposits accounted for 13.5 per cent and 11.7 per cent, respectively, of Canadian chartered banks' total liabilities, for a combined total share of 25.2 per cent. At the end of October 1981, the two same categories of deposits represented only 6.2 per cent of total liabilities. Personal fixed-term savings deposits and non-personal term and notice deposits gained importance as sources of funds for the banks. Their respective shares of total liabilities rose from 8 per cent to 10.8 per cent and from 11.2 per cent to 12.4 per cent between 1971 and 1981. Their respective rates of growth over the ten year period were 24.6 per cent and 22.2 per cent (Table 1.4).

The drastic decrease in the demand for chequable-savings deposits and demand deposits, and the corresponding increase in fixed-term deposits, is due to the changing behaviour of businesses and households in their cash management. High interest rates and

the rise in the rate of inflation have been incentives for small investors and businesses to manage their financial assets in a more efficient way and to reduce their liquid cash assets as much as possible.

Business deposits

In 1967, business non-demand deposits accounted for a little less than one third of all business bank deposits. By 1981, they represented more than three quarters of all business bank deposits. Conversely, the share of business demand deposits decreased from two thirds to a little less than one quarter of all their deposits. This shift in the composition of business bank deposits is mainly due to the amendments made to the Bank Act in 1967, the acceleration in the rate of inflation, and the rise in interest rates.⁽⁶⁾

Before 1967, Canadian chartered banks did not actively try to attract business deposits. In the first place, the legal ceiling of 6 per cent imposed on the banks' loan rates did not permit them to offer competitive rates on deposits. Moreover, the 8 per cent reserve requirement on demand and term deposits made them costly. The legislation brought down in 1967 eliminated the 6 per cent ceiling on loan rates and set the reserve requirement at 12 per cent on demand deposits and at 4 per cent on term deposits. It thus became more advantageous for banks to offer term deposits. These changes served as an incentive for banks to solicit term deposits from businesses and, given the significant size of these deposits, the costs of administration were lower than those prevailing at the retail level.

High interest rates and computerized cash management also invited businesses to switch deposits more rapidly than before. By offering a cash and deposit account management service, banks enabled large businesses with geographically dispersed operations to obtain information on the level of their cash balances almost daily, through their deposit accounts at the bank. When the daily national balance shows a surplus, it can be invested on the money market or in short term savings deposits with the bank for periods as short as twenty-four hours. In contrast with the United States, Canada has no restrictions regarding interest rates on deposits or on the issuance of deposit certificates whose term to maturity is less than 14 or 30 days. So rates for bank deposits in Canada are at levels competitive with rates offered on the money market or by other deposit-taking institutions.

Household deposits

The evolution in the composition of householders' bank deposits between 1971 and 1981 was significantly different from that of businesses. As Laurie Landy points out, when the 1967 Bank Act came into force, only 3 per cent of household bank deposits were in the form of non-interest bearing demand deposits.⁽⁷⁾ This was largely because individuals could invest their assets in chequable interest-bearing savings deposits. From 1967 to the middle of the 1970s this percentage rose from 3 per cent to 7 per cent, before declining to 4 per cent in 1981. Conversely, personal savings deposits, that had represented more than 97 per cent of the total of personal bank deposits in 1967, accounted for 93 per cent in 1975 and 96 per cent at the end of 1981.⁽⁸⁾

By abolishing the ceiling on interest rates⁽⁹⁾ and by amending the reserve requirements, the 1967 Bank Act also induced banks to introduce non-chequable savings deposit accounts bearing a competitive interest rate. So banks encourage their clients to open two types of accounts: a chequable demand deposit account and a separate account for non-chequable interest-bearing savings deposits.

Individuals then reduced their chequable savings deposits, in order to increase their demand deposits in personal chequing accounts; they added to their deposits in non-chequable savings accounts only slightly. Consequently, between 1967 and 1975, the percentage of savings deposits decreased (from 97 per cent to 93 per cent) and demand deposits increased.

From 1975 to 1979, the distribution between demand deposits and personal savings deposits was relatively stable. During the last two years, however, the rise in interest rates encouraged individuals to considerably reduce their demand deposits and to increase their savings deposits in the form of fixed-term deposits.

Lastly, the introduction of daily interest savings accounts in 1980 enabled savers to collect interest, if only for a few days, on money which otherwise would have been placed in their chequing accounts.

Table 1.4
CHARTERED BANK CANADIAN DOLLAR DEPOSITS
 1971 and 1981

Monthly average of Wednesdays	Millions of dollars		% of Total Canadian dollar Liabilities		Compound Average Annual Growth Rate
	End of October 71	End of October 81	End of October 71	End of October 81	From end of October 71 to end of October 81
Demand Deposits	\$6,984	\$14,460	18.2%	7.1%	7.5%
Personal savings deposits and other notice and chequable deposits	6,119	7,298	15.9	3.6	1.8
Personal non-chequable savings deposits excluding fixed-term deposits	8,345	43,919	21.7	21.5	18.1
Personal fixed term-savings deposits	4,207	37,874	10.9	18.5	24.6
Term or notice non-chequable deposits other than personal deposits	5,862	43,454	15.2	21.2	22.2
Total deposits by the general public	31,516	147,006	82.0	71.9	16.6
Government of Canada deposits	1,139	4,191	2.9	2.0	13.9
Total Canadian dollar deposits	32,656	151,198	85.0	74.0	16.5

SOURCE: Bank of Canada *Review*.

In brief, the composition of domestic assets has shifted from liquid assets to loans, while the shift on the liability side (from the banks' standpoint) has been from demand and chequable-savings deposits to fixed-term deposits. The 30 per cent rate of increase in respect of all other liabilities is largely due to the increase in bankers' acceptances, guarantees and letters of credit⁽¹⁰⁾ and debentures issued by the banks following amendments to the 1967 Bank Act.

Major changes in international operations

One of the noteworthy features of the operations of Canadian chartered banks over the last decade has undoubtedly been the very substantial increase in their international operations and the changing nature of these operations. They expanded their foreign base aggressively, and established a position in the world market. Foreign currency assets of Canadian banks increased at an annual rate of 25.8 per cent in this period, while Canadian dollar assets rose by 18.6 per cent. Foreign currency liabilities grew by 26.5 per cent per year, somewhat higher than that for foreign currency assets. At the end of October 1981, the net foreign currency position of the banks was a negative \$5.5 billion, implying that Canadian chartered banks borrowed \$5.5 billion more than they loaned out in foreign currencies. (This net borrowing is largely used to finance Canadian business operations.)

The increase in foreign currency operations is attributable to a number of factors: to begin with, the downward trend of the Canadian dollar since 1976 has meant a devaluation of over 20 per cent of the Canadian dollar against the U.S. dollar. The simple fact of the conversion of these foreign currency assets into Canadian dollars made them appear to grow at a higher rate than they actually did. For example, the compound average annual growth rate would have been only 23.6 per cent instead of 25.8 per cent, if all foreign currency assets were denominated in U.S. dollars, and their growth evaluated in U.S. rather than Canadian dollars.

International operations became more profitable than domestic operations as the decade of the 1970s progressed. **The compound average annual growth rate of after-tax earnings on domestic operations was 15 per cent from 1971 to 1981, whereas that on international operations was 33 per cent.**⁽¹¹⁾ It was to be expected that the banks would look to expand their international operations, and they did. In 1971, the after-tax return on average assets for Canadian dollar operations was 63 cents per \$100 of assets, whereas the after-tax return on average assets for foreign operations was 38 cents, for an overall return on assets of 57 cents. But in 1981, the change was fully in operation. The rate of return on Canadian dollar operations was 48 cents, and on foreign operations, 78 cents.

Not only was the return on international operations higher than the return on domestic operations, there is every indication that loan losses were lower in international operations as well. According to the brief submitted to the Committee by Mr. Hugh Brown of Burns, Fry Limited, aggregate loan losses on Canadian dollar assets were higher than on foreign currency assets. In the first half of the 1970s, the loan loss ratios were not significantly different, since Canadian dollar assets were much higher when compared to foreign currency assets. However, during the second half of the 70s and by the early 80s, the difference was obvious. On average, between 1970 and 1975, Canadian dollars assets were 2.5 times greater than foreign currency assets, whereas losses on loans in Canadian dollars were 2.4 times

greater. However, between 1976 and 1980, when Canadian dollar assets were on average only 1.84 times greater than foreign currency assets, losses on Canadian dollar operations were 7.7 times as large. (Tables 1.5 and 1.6). (Nevertheless, it must be noted that past experiences are not necessarily indicative of future trends in loan losses, as these depend on current and future economic conditions.)

Table 1.5

CANADIAN CHARTERED BANKS
ASSETS AND LIABILITIES IN CANADIAN AND FOREIGN CURRENCIES

	Millions of dollars		% Breakdown		Compound Average Annual Growth Rate
	End of October 71	End of October 81	End of October 71	End of October 81	From end of October 71 to end of October 81
Total assets and liabilities	\$52,317	\$350,051	100.0%	100.0%	20.9%
Canadian dollar assets	38,196	209,901	73.0	59.9	18.6
Foreign currency assets including: Deposits with banks	14,121	140,150	27.0	40.1	25.8
Loans	7,447	49,022	52.7	35.0	20.7
Other	5,971	81,902	42.3	58.4	29.9
Other	703	9,226	5.0	6.6	29.4
Canadian dollar liabilities	38,421	204,417	73.4	58.4	18.2
Foreign currency liabilities including: Bank deposits	13,896	145,634	26.6	41.6	26.5
Other	5,807	80,833	41.8	55.5	30.1
Other	8,089	64,801	58.2	44.5	23.1
Foreign currency net assets	225	-5,484	—	—	—

SOURCE: Bank of Canada *Review*.

Table 1.6

CANADIAN CHARTERED BANKS
ACTUAL AVERAGE ANNUAL LOAN LOSS EXPERIENCE

	1971-1975	1976-1980	1981
	Millions of dollars		
Domestic operations	\$88	\$373	\$697
International operations	36 (E)	48	155
Total of operations	124	421	852
as a percentage of total loans	0.28%	0.39%	0.41%

SOURCE: Submission to Standing Committee on Finance, Trade and Economic Affairs in regard to "The Profit Situation of the Chartered Banks", Burns, Fry Limited, 29 April, 1982, Table 6, p. 9.

E—Estimates

A last cause of the increase in foreign currency operations is the growth of world trade generally, and of the Euro-dollar market in particular. For example, the average annual growth rate of Euro-dollar deposits was 27.22% between 1974 and 1980.⁽¹²⁾

Foreign currency transactions with Canadian residents

Foreign currency operations conducted in Canada between banks and Canadian residents increased significantly since 1971 (Table 1.7). The increase became more pronounced after 1975. In 1971, foreign currency assets held by Canadian residents in Canadian banks accounted for only 8.5 per cent of overall foreign currency assets; this proportion increased to 18.7 per cent in 1981. The opposite held true for liabilities, which declined from 14.3 per cent to 5.9 per cent over the same period. We can see that Canadian banks used an increasing share of foreign currency deposits by non-residents to provide foreign currency to Canadian residents. These loans amounted to \$19.9 billion by the end of October 1981. In addition, \$4.4 billion was used to purchase foreign currency securities issued by Canadian corporations. Canadian corporations were using offshore borrowings obtained through Canadian banks to finance their exports, expansion, and acquisitions.

In summary, several general observations can be made about the operations of Canadian chartered banks since 1971. International operations have become increasingly

Table 1.7

CANADIAN CHARTERED BANKS

FOREIGN CURRENCY OPERATIONS WITH CANADIAN RESIDENTS;

CANADIAN HEAD OFFICES AND BRANCHES ONLY

MILLIONS OF CANADIAN DOLLARS

<i>Assets</i>	OCT. '71	OCT. '75	OCT. '81
Loans (excluding loans to Government of Canada)	\$1,184	\$2,539	\$19,969
Securities	40	93	4,144
Deposits with banks	7	286	2,133
Drawing of Government of Canada on credit lines	0	0	724
Total assets	\$1,231	\$2,918	\$26,246
Percentage of total foreign currency assets	8.5%	9.3%	18.7%
<i>Liabilities</i>			
Banks' deposits	10	274	2,130
Other	2,014	3,781	6,456
Total liabilities	\$2,024	\$4,055	\$8,586
Percentage of total foreign currency liabilities	14.3%	12.8%	5.9%

SOURCE: Estimate based on information published by the Bank of Canada.

important; Canadian dollar liabilities are less liquid; and loans have taken even greater precedence over liquid assets in the overall composition of the banks' asset structure. Much of this comes from changes in customers' preferences relating to bank notes, deposits, and bank credit. Changes in the financial system since 1979 also account for these changes in the structure of assets and liabilities, changes closely linked to the volatile nature of interest rates around the world. In conclusion, the profitability of the chartered banks was greatly affected by the structure of assets and liabilities (especially the high incidence of floating rate loans and fixed term deposits), and the growth of international operations.

1.2 SOURCES OF BANK REVENUES, EXPENSES AND PROFITS

Profits of the Canadian chartered banks rose to \$1.7 billion in 1981 from \$1.2 billion in 1980, an increase of 38 per cent. Taken by itself, this absolute dollar level of profit is large, but absolute size tells us little about whether or not profits were excessive. To address this question, bank profits in 1981 must be put into a context allowing a measurement of these profits relative to several things: the historical absolute level of profits, the size of the banks that earned the profits, and the amount of capital investors employed in those banks. In addition, the profits must be compared to the level of profits in other banking systems and other industry groups. Given this perspective, it will be easier to determine whether or not bank profits in 1981 were excessive.

It is also important to analyze the sources of bank revenues and expenses, to find how their profits were made. Finally, it will be necessary to put the trends in bank profits into perspective and see whether profits have been increasing over time and whether the profits of one particular year in isolation represent the general profitability of the banking system.

How bank profits are earned

In the simplest terms, bank revenue is derived from two major sources: (i) their financial intermediary operations; and (ii) other revenues, for the most part fees charged for bank services. The financial intermediary revenues are those derived from lending money to borrowers.

Essentially, banks rent money from their depositors and then rent it out at a higher rate to borrowers. The difference in the price between the deposit cost and the loan revenue is called the interest rate spread. The spread, when applied to bank's total loans and investments, produces a source of revenue commonly referred to as net interest revenue. In other words, net interest revenue is the total interest received on loans and investments less the total interest cost of deposits.

From the total revenue derived from lending money and levying service charges, the banks must pay their overhead in salaries and rent, pay taxes at all levels of government, cover the risk involved in making loans, and have enough remaining profit to provide their shareholders with a return on their investment.

Table 1.8

CHARTERED BANK MIX OF REVENUE AND EXPENSE

(millions of dollars)

	As of Oct. 31 1971	% of Total Revenue or Expense	% of Average Assets	As of Oct. 31 1976	% of Total Revenue or Expense	% of Average Assets	As of Oct. 31 1981	% of Total Revenue or Expense	% of Average Assets
REVENUES									
Net Interest Revenue*	\$1,337	79.8	2.75	\$3,355	81.6	2.95	\$7,835	81.2	2.59
Other Revenue	339	20.2	0.70	757	18.4	0.67	1,816	18.8	0.60
Total Revenue	\$1,676	100.0	3.45	\$4,112	100.0	3.62	\$9,651	100.0	3.19
NON-INTEREST EXPENSES									
Salaries and Benefits	\$669	59.8	1.38	\$1,700	58.4	1.49	\$3,407	53.3	1.13
Property and Depreciation	196	17.5	0.40	452	15.5	0.40	959	15.0	0.32
Other Expenses	208	18.5	0.43	529	18.2	0.47	1,205	18.0	0.40
5-year Average Loan Loss Experience	46	4.2	0.09	231	7.9	0.20	817	12.7	0.27
Total Non-Interest Expenses	\$1,119	100.0	2.30	\$2,912	100.0	2.56	\$6,388	100.0	2.11
Pre-Tax profit	\$556			\$1,200			\$3,263		

SOURCE: Chartered bank financial statements.

* Taxable Equivalent Basis—Figures for Tax-Exempt securities income have been grossed up to reflect equivalent full taxable pre-tax income the bank would have received if these had been normal loans. Excludes Continental Bank of Canada, Northland Bank and Canadian Commercial Bank. Source: Office of the Inspector General of Banks.

The major determinant of the absolute level of a bank's profit is the size of its operation as measured by the total amount of assets put to work to earn those profits. An appropriate measure of profitability, then, within the world of banking operations, would be the comparison of bank profits with the total assets employed by the bank—the bank's return on assets. Another important measurement of profitability is derived by comparing a bank's profit as a percentage of the capital that shareholders of the bank have invested. This ratio, termed a bank's return on equity, is useful also in comparing the profitability of the banking industry with that of other industries.

Source of bank revenues and expenses

A chartered bank's operations as a financial intermediary are the principal source of its revenue. Because of the way a bank lends its money, revenues are referred to on a net basis, so as to show the revenues earned from the spread assets and liabilities. As noted in Table 1.8, a bank's net interest revenue is the sum of total interest received on loans, plus the total interest and dividends on investments, less the interest costs associated with raising funds. Investments include investments in Treasury Bills and bonds and stocks as well as dividends from bank subsidiaries. Security revenue also includes revenue received from income debentures and term-preferred shares, issued in large amounts in place of loans. The cost of deposits is deducted from total interest revenue in order to determine the net revenue the bank has earned from an interest-rate spread. This amount is the bank's net interest revenue and, as of October 31, 1981, represented 81 per cent of the total revenue of Canadian banks. As noted in Table 1.8, the proportion of the total revenues derived from their operations as financial intermediaries has changed very little since 1971, when it represented 80 per cent of total revenue.

The remaining 19 per cent of the banks' total revenue in 1981, as shown by Table 1.9, breaks down into six categories, namely deposit service charges, foreign exchange, credit card fees, loan fees, investment fees and commissions and "other" revenues. Service charges, like those for cheque writing, amount to \$371 million, or 20 per cent of other revenue. Foreign exchange totals \$391 million, or 22 per cent of other revenue, and includes trading profits as well as charges for converting from one currency to another. Credit card fees, paid by dealers using the banks' credit card services, come to \$244 million, or 13 per cent of the total. Loan fees include fees charged for management services when a bank is manager or co-manager of a syndicated loan, domestic or foreign. The table shows these loan fees amounting to \$192 million or 11 per cent of the total. Investment fees and commissions include commissions for selling securities and other investment related fees; the revenue from these services totals \$85 million, or 5 per cent of other revenue. Finally, there are various charges such as safety deposit box fees and service charges on bankers' acceptances, guarantees, and letters of credit. These fees amounted to \$537 million, or 29 per cent of total other revenues.

Net interest revenue as a percentage of average assets outstanding has decreased from 2.75 per cent in 1971 to 2.59 per cent in 1981, suggesting that the banks generated less revenue from their financial intermediary operations in 1981 relative to total assets. Other revenue as a percentage of average assets has declined from 0.70 per cent in 1971 to 0.67 per cent in 1976 and 0.60 per cent in 1981, thus indicating that other revenues did not keep pace with the overall growth in bank assets over the last ten years.

Table 1.9

BREAKDOWN OF OTHER REVENUE

(millions of dollars)

Other Revenue Items	As of October 31, 1981	% of Total Other Revenue
Deposit Service Charges	\$ 371	20%
Foreign Exchange	391	22
Credit Card Fees	244	13
Loan Fees	192	11
Investment Fees and Commissions	85	5
Other	537	29
Total Other Revenue	\$1,820	100%

SOURCE: Chartered bank financial statements, Office of the Inspector General of Banks.

Non-interest expenses have been arranged in four categories: salaries and benefits, property and depreciation cost, the five-year average loan loss experience, and other expenses. As noted in Table 1.8, total non-interest expenses have increased as a percentage of average assets from 2.30 per cent in 1971 to 2.56 per cent in 1976, but had declined significantly to 2.11 per cent by 1981. In 1981, therefore, banks were employing substantially more assets at a lower cost for each dollar of assets.

The most significant change in the composition of total expenses occurred in the banks' average loan loss experience—it increased significantly from .10 per cent in 1971 to 0.27 per cent in 1981, amounting to only 4.2 per cent of total expenses in 1971, but 12.7 per cent of total expenses by 1981. Yet the loan loss experience was offset by a reduction in overhead: during this same period, salaries and benefits decreased from 59.8 per cent of total non-interest expenses in 1971 to 53.3 per cent in 1981, and property and depreciation decreased from 17.5 per cent of total non-interest expenses in 1971 to 15.0 per cent in 1981. Other expenses, which include basically all other costs of the bank, remained very stable throughout this period, representing 18.5 per cent of total non-interest expenses in 1971 and 18.0 per cent in 1981.

Salaries and benefits as a percentage of average assets outstanding decreased from 1.38 per cent in 1971 to 1.12 per cent in 1981. Property and depreciation expenses decreased from 0.40 per cent in 1971 to 0.32 per cent in 1981. Other expenses also decreased as a percentage of average assets from 0.43 per cent in 1971 to 0.40 per cent in 1981. Total non-interest expenses as a percentage of average assets for the Canadian banks decreased from 2.30 per cent in 1971 to 2.11 per cent in 1981.

How bank profits are measured

In our discussion of how bank profits are earned, we stated that the two most accepted measurements of bank profitability are "return on assets" and "return on equity."

Return on assets is the measurement of the banks' after-tax profits as they relate to the total average assets employed to earn that profit. This ratio measures the average profit that

a bank earns on every \$100 of average assets employed. This is the measurement most commonly used for the comparison of profitability within the banking business throughout the world.

$$\text{Return on Assets} = \frac{(\text{Balance of Revenue after taxes})}{(\text{Average Assets})}$$

Return on assets introduces the concept of volume, and associates the banks' profit growth to the banks' ability to employ more earning assets. **In other words, the size of the bank largely governs the dollar volume of profits:** a large company doing a large volume of business will earn a greater, absolute level of profits than will an equally efficient, smaller company.

Return on equity is generally considered another significant measurement of a bank's profitability. It is most useful to an investor in determining which banks within the banking industry or, for that matter, which company in any industrial sector, will provide the highest return on capital invested. For return on equity, after-tax profits are taken as a percentage of total equity invested by the shareholders. In the case of a bank, total equity includes a bank's shareholders' equity and the bank's accumulated appropriation for losses.

$$\text{Return on Equity} = \frac{(\text{Balance of Revenue after taxes})}{(\text{Shareholders Equity plus Accumulated Appropriations for Losses})}$$

Because bank profits relate to the volume of assets employed, a bank wants to increase the volume of its assets, as well as to manage them efficiently, but the expansion of assets has to relate to the capital supplied by its investors or shareholders, or the bank will not offer sufficient protection to its depositors through equity capital.

$$\text{Leverage} = \frac{(\text{Total Assets})}{(\text{Total Equity})}$$

If a bank increases the ratio of assets to equity or, in other words, increases its leverage, it should be expected that its total profits would increase (under the assumption of course, that every \$100 of additional assets employed would earn the same as did \$100 of assets already employed by the bank.) And the following should also hold: that a bank which doubles its leverage should double its profits and double its return on average equity. It should be stressed that the bank would thereby likely have doubled its shareholders' risk exposure to potential losses as well. And it should be noted that the bank would not have increased the profit on any loan it had made.

It would stand to reason, then, that a bank's return on equity would relate not only to the return on assets but also to the bank's leverage.

$$\text{Return on Equity} = \text{Return on Assets} \times \text{Leverage}$$

In other words, a bank could increase its return on equity by increasing the assets employed relative to each dollar of equity, rather than looking for an increase in profits generated from each \$100 of assets employed.

Table 1.10

CANADIAN CHARTERED BANK⁽¹⁾
 BALANCE OF REVENUE AFTER TAXES—DOMESTIC VERSUS FOREIGN
 (millions of dollars)

	Years Ended October 31											10-Year Compound Growth
	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	
AFTER-TAX EARNINGS												
Domestic Operations ⁽²⁾	\$231.3	\$301.4	\$337.0	\$345.9	\$486.0	\$498.1	\$515.4	\$694.7	\$726.4	\$684.2	\$904.6	+15%
Annual % Change	+8%	+30%	+12%	+3%	+41%	+2%	+3%	+35%	+5%	-6%	+32%	
% of Total BRAT	83.1%	84.8%	83.8%	78.4%	75.5%	75.1%	70.5%	66.5%	64.9%	55.1%	52.6%	
Foreign	\$47.0	\$54.0	\$65.0	\$95.0	\$157.3	\$165.2	\$215.2	\$282.3	\$392.8	\$558.3	\$815.4	+33%
Annual % Change	+26%	+15%	+20%	+46%	+66%	+5%	+30%	+31%	+39%	+42%	+46%	
% of Total BRAT	16.9%	15.2%	16.1%	21.5%	24.5%	24.9%	29.5%	33.5%	35.1%	44.9%	47.4%	
Total After-Tax Earnings	\$278.3	\$355.4	\$402.0	\$440.9	\$643.3	\$663.3	\$730.6	\$977.0	\$1,119.2	\$1,242.5	\$1,720.0	+20%
Annual % Change	+10%	+28%	+13%	+10%	+46%	+3%	+10%	+34%	+15%	+12%	+38%	
TOTAL ASSETS⁽³⁾												
Domestic	\$39,699	\$46,604	\$55,226	\$68,313	\$78,028	\$90,601	\$107,413	\$128,750	\$155,496	\$181,615	\$232,540	+19%
Annual % Change	—	+17%	+19%	+24%	+41%	+16%	+19%	+20%	+21%	+17%	+28%	
% of Total Assets	76.0%	76.9%	73.6%	74.6%	74.1%	74.4%	72.8%	71.6%	70.6%	67.7%	68.1%	
Foreign	\$12,618	\$14,027	\$19,795	\$23,279	\$27,283	\$31,248	\$40,114	\$51,059	\$64,880	\$86,581	\$108,907	+24%
Annual % Change	—	+11%	+41%	+18%	+17%	+15%	+28%	+27%	+27%	+33%	+26%	
% of Total Assets	24.0%	23.1%	26.4%	25.4%	25.9%	25.6%	27.2%	28.4%	29.4%	32.3%	31.9%	
Total Assets	\$52,317	\$60,631	\$75,021	\$91,592	\$105,311	\$121,849	\$147,527	\$179,809	\$220,376	\$268,196	\$341,447	+21%
Annual % Change	+13%	+16%	+24%	+22%	+15%	+16%	+21%	+22%	+23%	+22%	+27%	
<i>After-Tax Return on average</i>												
Domestic Assets	0.63%	0.70%	0.66%	0.56%	0.66%	0.59%	0.54%	0.64%	0.55%	0.44%	0.48%	0.57%
Foreign Assets	0.38%	0.41%	0.38%	0.44%	0.62%	0.56%	0.56%	0.57%	0.61%	0.68%	0.78%	0.63%
Total Assets	0.57%	0.63%	0.60%	0.53%	0.65%	0.58%	0.54%	0.61%	0.56%	0.51%	0.57%	0.57%

⁽¹⁾ Excludes Northland Bank, Continental Bank and Schedule B Banks.

⁽²⁾ Estimated in some cases.

⁽³⁾ Domestic assets include foreign currency loans to Canadian residents.

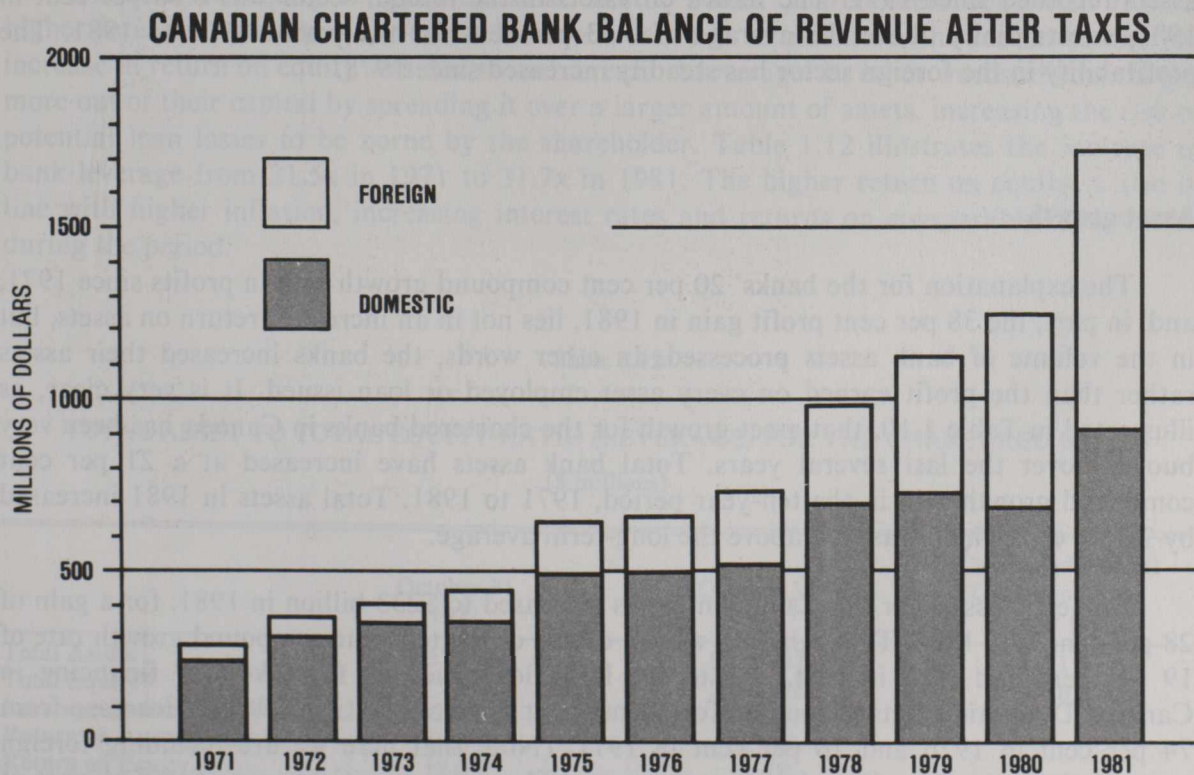
1.3 LONG-TERM TRENDS IN BANK PROFITS

The 1981 profits of the chartered banks in Canada have to be related to their growth in assets, to the return on assets employed, to leverage (the ratio of the volume of assets to every dollar of equity invested, as we have discussed) and to the return on equity. In addition, their earnings should be compared to the earnings of the trust and loan industry in Canada, to those of the foreign banks, with particular emphasis on the major banks in the United States, and to those of the Canadian industrial sector.

After-tax profits of the Canadian chartered banks increased to \$1.7 billion in 1981, a gain of 38 per cent. The increase in profits in 1981 was above the compound growth rate of 20 per cent over the last ten years.

Total after tax profits are essentially irrelevant when taken in isolation for any particular year. That is why we make comparisons over, say, a ten-year period. But the operations of the banks must be reviewed, not only in an historical context, but also in a geographical one. Over the last ten years, Canadian banks have developed vast operating networks in numerous countries around the world, but particularly in the United States and Western Europe. So, when we examine bank profits from 1971 to 1981, we must separate them into their domestic and foreign components.

GRAPHIC 1.1



On a segmented basis, the banks' domestic profits increased to \$905 million in 1981, a gain of 32 per cent over \$684 million earned in 1980. Although the annual increase in profits in 1981 was well in excess of the 15 per cent annual growth experienced over the last ten years, domestic profits were stagnant from 1978 to 1980, as noted in Table 1.10. The banks' foreign profits increased to \$815 million in 1981 from \$558 million in 1980, a gain of 46 per cent. In sharp contrast to the domestic sector, foreign profits increased significantly in both 1979 and 1980. The foreign sector accounted for over 47 per cent of total profits in 1981, up from 35 per cent in 1979 and 17 per cent in 1971.

Return on assets

When after-tax profits are related to the average assets employed by the banking system, another dimension is given to the level of bank profitability. In this context, the return on average assets for the banking system in 1981 was 0.57 per cent. This means that, based on the total assets outstanding for the Canadian banks, they earned an after-tax profit of 57 cents for every \$100 of assets employed. For the period 1971 to 1981, the banks' average annual return on assets was 0.57 per cent, or exactly equal to their 1981 performance. In fact, over this period, their return on assets ranged from a low of 0.51 per cent in 1980 to a high of 0.65 per cent in 1975.

On a segmented basis, the banks' domestic return on assets in 1981 of 0.48 per cent compared very poorly to the 1971 to 1981 annual average of 0.57 per cent. In fact the 1981 performance was only marginally better than the 0.44 per cent of 1980, the lowest return on assets recorded since 1971. The return on assets in the foreign sector was 0.78 per cent in 1981, substantially above the average of 0.63 per cent for the period 1971 to 1981. The profitability in the foreign sector has steadily increased since 1978.

Asset growth

The explanation for the banks' 20 per cent compound growth rate in profits since 1971, and, in part, the 38 per cent profit gain in 1981, lies not in an increased return on assets, but in the volume of bank assets processed. In other words, the banks increased their assets rather than the profit earned on every asset employed or loan issued. It is very clear, as illustrated in Table 1.10, that asset growth for the chartered banks in Canada has been very buoyant over the last several years. Total bank assets have increased at a 21 per cent compound growth rate in the ten-year period, 1971 to 1981. Total assets in 1981 increased by 27 per cent which was well above the long-term average.

Domestic assets for the Canadian banks increased to \$233 billion in 1981, for a gain of 28 per cent over 1980. This gain was well in excess of the ten-year compound growth rate of 19 per cent and was, in part, due to the large loans needed for take-over financing in Canada. Domestic assets accounted for 68 per cent of total assets in 1981, a decrease from 74 per cent in 1976 and 76 per cent in 1971. (Note that here we are including foreign currency loans to Canadians in domestic assets. These are sometimes considered as part of the banks' international operations, as is done elsewhere in this text.)

Foreign currency assets of the Canadian chartered banks increased to \$108.9 billion in 1981, a 26 per cent increase over \$86.6 billion in 1980. This 26 per cent increase is only marginally above the ten-year compound growth rate of 24 per cent annually since 1971. International operations (i.e. foreign currency loans to non-Canadians) currently account for 32 per cent of total assets, up from 24 per cent of total assets in 1971.

Return on equity and leverage

Return on equity for the Canadian chartered banks in 1981 was at a higher level than at any time over the last ten years. As noted in Table 1.11, the banks' return on equity was 18.7 per cent in 1981, higher than the 14.8 per cent average over the period 1971 to 1975 and the 16.3 per cent average for the period 1976 to 1980.

Table 1.11

CHARTERED BANK RETURN ON EQUITY

	Five years 1971 to 1975	Five years 1976 to 1980	October 31 1981
Return on Equity	14.8%	16.3%	18.7%

If return on equity is taken in isolation, the banks' shareholders benefitted from a higher return on the equity invested. However, as we have indicated, the reason behind the increase in return on equity was due to an increase in leverage. In other words, the banks got more out of their capital by spreading it over a larger amount of assets, increasing the risk of potential loan losses to be borne by the shareholder. Table 1.12 illustrates the increase in bank leverage from 21.5x in 1971 to 31.7x in 1981. The higher return on equity is also in line with higher inflation, increasing interest rates and returns on comparable investments during the period.

Table 1.12

TOTAL ASSET TO TOTAL EQUITY RATIO (LEVERAGE) FOR THE CHARTERED BANKS (\$ millions)

	October 31 1971	October 31 1981	Compound Annual Growth over the 10-year period
Total Assets	\$52,317	\$341,447	+21%
Total Equity*	\$ 2,431	\$ 10,766	+16%
Leverage (Assets Equity)	21.5x	31.7x	
Return on Average Assets	0.57%	0.57%	
Return on Equity	12.0%	18.7%	

* Includes preferred shares in 1981

A large portion of the increase in assets represents, as previously noted, a substantial increase in the banks' foreign currency operations. This growth has been more profitable for the banks in recent years and, in addition, has helped Canadian industries to expand in foreign countries.

Comparison of banks to trust and loan companies in Canada

The trust and loan industry in Canada is the one major industry that most closely resembles the operations of chartered banks. These companies are most often referred to as "near banks". The trust and loan industry in Canada is far more fragmented than the banking industry and has, by tradition, substantially more companies, each one smaller in total assets per company. The trust and loan industry is regulated, not only by federal legislation, but, if a company so chooses, under a provincial jurisdiction.

Total assets for eight of the largest trust and loan companies amounted to \$35.7 billion in 1981—10 per cent of the total assets in the Canadian banking industry and 15 per cent of the banks' total domestic assets. However, as far as lending goes, trust and loan companies are restricted to mortgage lending. In addition, they have been granted fiduciary responsibilities that permit them to manage trust accounts, administer estates, manage pension accounts, and engage in other related activities.

As in the case of the chartered banks, the largest proportion, approximately 60 per cent, of the revenues of the trust and loan industry are derived from financial intermediary operations. After-tax profits for the trust and loan companies have increased, since 1972, at a compound growth rate of 6 per cent, compared to 20 per cent for the chartered banks since 1971. The two key profitability ratios for the trust and loan companies have declined dramatically since 1977, as noted in Table 1.13. Return on average assets was 0.57 per cent in 1977, or slightly higher than the banks 0.54 per cent, but profitability declined sharply over the next five years to 0.30 per cent in 1981, compared to 0.57 per cent for the banking industry. Return on equity was 14.5 per cent in 1977, as compared to 15.3 per cent for the banks, declining to 8.8 per cent by 1981, compared to the banks' 18.7 per cent.

The leverage ratio for the trust and loan companies, as used here, has changed little over the last five years. However this ratio is not the same one administered by the Department of Insurance, which is responsible for regulating that industry. The Department of Insurance, in calculating the administered ratio, uses total deposits after making adjustments for liquid assets and deferred taxes. Based on that Department's calculation, many trust and loan companies have actually been allowed to increase their leverage, over the last few years, from a range of 20 to 22.5 times, to 25 times.

Besides not benefitting as much from increased leverage, trust and loan companies have been restricted, throughout most of the last ten years, to lending in mortgages which generally had terms of three to five years. Only in the last several years have the terms on mortgages shortened. Consequently, on average, trust companies were borrowing money for shorter terms than they were lending for. As interest rates rose, the cost of deposits rose faster than the revenue from the loans, causing earnings for the trust and loan companies to decline dramatically, particularly in 1981.

Table 1.13

COMPARISON OF KEY RATIOS
CANADIAN BANKS—U.S. BANKS—CANADIAN TRUST COMPANIES

	Years Ended ⁽¹⁾					5-Year Average 4-Year Compound Growth Rate
	1977	1978	1979	1980	1981	
EARNINGS (AFTER-TAX) GROWTH⁽²⁾						
Canadian Chartered Banks	+10%	+34%	+15%	+12%	+38%	+24%
U.S. Banks	+15%	+27%	+18%	+11%	+ 3%	+15%
Canadian Trust Companies	+25%	+12%	- 8%	+11%	-17%	- 1%
ASSET GROWTH						
Canadian Chartered Banks	+21%	+22%	+23%	+22%	+27%	+23%
U.S. Banks	+17%	+14%	+16%	+10%	+ 7%	+12%
Canadian Trust Companies	+17%	+16%	+20%	+15%	+10%	+15%
AFTER-TAX RETURN ON AVERAGE ASSETS						
Canadian Chartered Banks	0.54%	0.61%	0.56%	0.51%	0.57%	0.55%
U.S. Banks	0.49%	0.55%	0.57%	0.55%	0.52%	0.54%
Canadian Trust Companies	0.57%	0.55%	0.43%	0.40%	0.30%	0.43%
LEVERAGE RATIO-TOTAL ASSETS TO EQUITY⁽³⁾						
Canadian Chartered Banks	28.9×	29.1×	29.5×	30.5×	31.7×	—
U.S. Banks	24.4×	25.0×	25.7×	25.6×	24.5×	—
Canadian Trust Companies	25.6×	25.9×	26.0×	26.0×	25.8×	—
AFTER-TAX RETURN ON AVERAGE SHAREHOLDERS EQUITY⁽⁴⁾						
Canadian Chartered Banks	15.3%	17.3%	16.7%	15.9%	18.7%	17.0%
U.S. Banks	11.1%	12.9%	13.7%	13.7%	12.7%	12.9%
Canadian Trust Companies	14.5%	14.1%	11.1%	10.6%	8.8%	11.1%

SOURCE: Financial Statements of each company or bank.

⁽¹⁾ October 31 for Canadian Banks, December 31 for U.S. Banks and most Trust Companies.

⁽²⁾ Excludes security gains or losses.

⁽³⁾ Excludes preferred shares for U.S. Banks but includes them for Canadian Banks. There are only a minimal number of preferred shares outstanding for U.S. Banks in 1979, 1980 and 1981. The leverage ratios for the trust and loan companies are not representative of the measurement used by the Department of Insurance.

⁽⁴⁾ Includes preferred shares in equity for Canadian banks and Trust Companies and excludes deferred taxes.

Although new legislation has been discussed for trust and loan companies that would enable broader lending powers, particularly in floating rate commercial loans, the legislation has not been forthcoming. Undue delays in revising this legislation could impair the profits of the trust and loan industry further, if interest rates rise from current levels.

Comparison to the ten largest banks in the United States

Although banking in the United States is not precisely comparable to Canadian banking, it is often useful to compare the operations and performance of the two systems. For this discussion, we have chosen the ten largest U.S. banks, including both the major money centre banks and those with extensive branch networks.

The return on average assets for the Canadian chartered banks for the period 1977 to 1981 averaged 0.55 per cent, and for the U.S. banks 0.54 per cent. In both cases the return on average assets increased marginally, although there were fluctuations during the five-year period. The return on shareholders' equity averaged 17.0 per cent for the Canadian chartered banks and 12.9 per cent for the major U.S. banks. It should be noted, when comparing these ratios, particularly that of return on equity, that two other factors should be included, namely, asset growth and the banks' comparative leverage ratios.

Canadian chartered banks increased their assets at a compound rate of 23 per cent annually in the period of 1977 to 1981, compared to 12 per cent annually for the U.S. banks. This explains, in part, the difference in the total growth of after-tax earnings between the two banking systems. Leverage must also be considered, so that it can be determined how many assets have been employed for every dollar of equity employed in the bank. As noted in Table 1.13, U.S. banks did not increase leverage in the period of 1977 to 1981, whereas our banks' leverage increased from 28.9x in 1977 to 31.7x in 1981.

Table 1.13 compares the growth in earnings, growth in assets, and key profitability ratios for the ten largest U.S. banks with the performance of Canadian banks for the five-year period, 1977 to 1981. The profits of the U.S. banks increased by 15 per cent annually, compared to 24 per cent annually for the Canadian chartered banks. This is largely a reflection of different rates of asset growth and higher leverage ratios.

Consequently, the return on equity for the Canadian chartered banks increased from 15.3 per cent in 1977 to 18.7 per cent in 1981 while that of the ten major U.S. banks increased from 11.1 per cent in 1977 to 12.7 per cent in 1981.

The higher level of return on equity for the Canadian banks is also partly explained by the higher absolute level of leverage in the Canadian banking system—31.7x in 1981 versus 24.5x for the major U.S. banks. The difference in this ratio implies that the Canadian banks employ almost 30 per cent more assets for every dollar of equity invested by the shareholder. Given that the profit earned on every dollar of asset employed is approximately the same in both systems, then the Canadian banks should return 30 per cent more to their common shareholders. Based on the return on equity over the last five years, at 17 per cent for the Canadian banks and 12.9 per cent for the U.S. banks, the differential is, indeed, approximately 30 per cent. Put another way, if both systems had equal leverage ratios, return on equity would be the same.

Comparison with banks throughout the world

A true comparison of Canadian banks with banks from other countries of the world is not easily made due to the major differences in the banking operations and accounting conventions of the countries in which the banks operate.

Accounting practices vary materially from country to country such that banks in Germany and Switzerland, for example, value their bond holdings at market rather than cost and make unpublicized appropriations to hidden reserves. Both these factors tend to depress reported earnings. Banks in the United Kingdom and France carry their real estate investments at market value rather than cost which tends to enlarge the reported equity base and lower the return on equity.

In addition to accounting practices, there are other structural differences in the banking systems which are a function more of the countries legal environment. French banks are largely government owned and profit maximization is obviously not a primary objective. Some banks such as Banco do Brazil act as the country's central bank, similar to the Bank of Canada, as well as competing for commercial business. German banks are more universal in nature such that they are involved in a number of diverse banking and non-banking activities, the latter of which are similar to the activities carried out by the Canadian trust industry. The Japanese trust banks present a similar problem since their balance sheets are split into two sections, one for their trust activities and the other for their banking activities but they do not break these activities out the same way on their income statement.

In order to provide some basis of comparison of Canadian bank profitability in 1981 to banks in other countries, a study of the world's largest five hundred banks called Euromoney Five Hundred, published by Euromoney, June 1982, is used. The study compares the same ratios used in this Report to measure the profitability of the world banks; namely, return on assets, return on equity and leverage.

Because of the international scope of the Euromoney study there are certain definitional differences⁽¹³⁾ and in some cases, errors in the data.⁽¹⁴⁾ The major difference is in shareholders' equity, whereby the Euromoney study excludes accumulated appropriation for losses and all interest-bearing capital, namely subordinated debentures. The Euromoney study also uses the banks' net profit figure, after an appropriation for loss deduction used in reporting under the Bank Act (1967), which understates bank earnings by over 30 per cent in 1981. The total asset figure used in the Euromoney study excludes all customer liabilities under acceptances, guarantees and letters of credit which understates total assets as used in the Committee's Report by almost 10 per cent.

The Euromoney study compares the largest five hundred banks in U.S. dollars as a base for calculating and comparing the three ratios. We have averaged the Canadian banks which were included in the report and compare this average to the ranking of all the banks in the survey. It is obvious from the Euromoney data that the averages for the Canadian banks on return on equity of 14.9 per cent and return on assets of 0.41 per cent understate the respective number of 18.7 per cent and 0.57 per cent as stated in the Committee's report. Leverage (total assets to total equity) on the other hand is overstated at 36.1x versus 31.7x as determined in the Committee's report. For this reason, the Euromoney data has been restated—(15) to comply with the data which has been used in the Committee's report. The

restated numbers increase the net profit figures used by Euromoney quite substantially due in part to errors in their data. We continue to use their definition of shareholder's equity which is smaller than our definition and therefore will inflate the return on equity in comparison to the data as it is stated in the Committee's report. For simplicity, we have outlined both rankings "Euromoney Canadian Bank Average" which are the Eurodollar data as reported in the study and "Adjusted Canadian Bank Average" as adjusted to conform more closely with the data used in the Committee's Report. These averages are discussed as they relate to return on assets, leverage (total assets to total equity ratio) and return on equity as outlined in Table 1.14.

Table 1.14

INTERNATIONAL COMPARISONS OF BANK PERFORMANCE IN 1981

A. Return on Assets

Rank	Bank	Net Profit as a Percentage of Total Assets
1	Banco Safra (Brazil)	5.37%
100	Huntington Bancshares	0.89%
..	<i>Adjusted Canadian Bank Average</i> ⁽²⁾	0.51%
..	<i>Euromoney Canadian Bank Average</i> ⁽²⁾	0.41%
401	Long Term Credit Bank of Japan	0.23%
500	Centran Corporation	-0.75%

B. Leverage

Rank	Bank	Total Assets as a Multiple of Total Shareholders Equity
1	Norinchukin Bank	164.8x
58	Long Term Credit Bank of Japan	38.3x
..	<i>Adjusted Canadian Bank Average</i> ⁽²⁾	38.1x
59	Daiwa Bank	38.0x
65	Nippon Credit Bank	36.7x
..	<i>Euromoney Canadian Bank Average</i> ⁽²⁾	36.1x
66	Udruzena Beogradska Banka	36.0x
100	Dai-Tchi Kangyo Bank	30.8x
400	Credito Romagnolo	15.8x
500	Banco De La Republica Oriental Del Uruguay	3.0x

C. Return on Equity

Rank	Bank	Net Profit as a Percentage of Total Shareholders Equity
1	TC Ziraat Bankasi (Turkey)	123.10% ⁽¹⁾
54	Banque De L'Indochine et De Suez	19.4%
..	<i>Adjusted Canadian Bank Average</i> ⁽²⁾	19.4%
55	Texas Commerce Bancshares	19.3%
100	Bankers Trust N.Y. Corporation	15.9%
..	<i>Euromoney Canadian Bank Average</i> ⁽²⁾	14.9%
401	Gunma Bank	6.4%
500	Centran Corporation	-13.6%

Source: *Euromoney*, June 1982

⁽¹⁾ Based on pre-tax profits.

⁽²⁾ Includes The Royal Bank of Canada, Canadian Imperial Bank of Commerce, Bank of Montreal, Bank of Nova Scotia, Toronto-Dominion Bank, National Bank and Continental Bank.

Return on assets for the average of the Canadian banks based on the Euromoney data was 0.41 per cent in 1981 which did not allow them a ranking in the top 100 banks whose return on assets ranged from 5.37 per cent for Banco Safra of Brazil to 0.89 per cent for Huntington Bancshares. The Euromoney average of the Canadian banks therefore ranged between the top 100 and bottom 100 of this ranking. Based on our Adjusted Canadian Bank Average, the average return on assets was 0.51 per cent which was still not high enough to rank the average of the Canadian banks in the top 100 banks in the world.

Leverage of the Canadian banks, as measured by the Euromoney Canadian Bank Average, ranked at a level equivalent to 66 out of 500 as noted in Table 3.4. Based on the Adjusted Canadian Bank Average, the banks were equivalent to 59 out of 500. Both cases demonstrate that Canadian banks appear to be among the most highly levered banks in the world.

Return on equity as measured by the Euromoney Canadian Bank Average was not in the top 100 banks in the world. The 14.9 per cent return on equity, ranked between the top 100 and bottom 100 banks in this ranking. The highest return on equity was 123.1 per cent recorded by the TC Ziraat Bankasi in Turkey. However, as noted, the profits were before tax and not very comparable to the other banks. Based on the Adjusted Canadian Bank Average, the banks ranked 55 out of 500 banks. This is not an unexpected ranking given that the banks are among the highest leveraged in the world.

Comparison with other industries in Canada

The most common measurement of profitability, inviting the comparison of the banking industry in Canada with other industries is that of return on equity. It is more meaningful to compare rankings over time rather than in a single year. In 1981 the banks registered an increase in profitability, while most other industries registered significantly lower profits. In Table 1.15, supplied by Wood Gundy, banks ranked 8 out of a total of 33 industrial categories in profitability over the period 1972 to 1981. In 1981, the banks ranked 2 out of 33. In Table 1.16, supplied by McLeod, Young & Weir Limited, the banks ranked 6th out of 14 categories for the period 1976 to 1980 and ranked the same for the extended period 1970 to 1980. In 1980 the banks ranked 11th among the 14 categories.

Table 1.15

ANNUAL AFTER-TAX RETURN ON AVERAGE COMMON SHAREHOLDERS' EQUITY⁽¹⁾
FOR CANADIAN INDUSTRIAL CORPORATIONS⁽²⁾

Corporate Sector	Annual Average Return on Equity 1972-1981	Rank 1972-1981	Average Return on Equity 1981	Rank in 1981
Printing & Publishing	22.03	1	21.01	1
Misc. Merchandising	19.15	2	12.18	14
Hotels & Restaurants	18.21	3	5.82	25
Office Equipment	17.85	4	17.44	3
Oil & Gas Producers	17.35	5	9.61	20
Gas utilities	16.82	6	14.12	7
Pipelines	16.41	7	15.77	4
Chartered Banks	16.05	8	18.70	2
Fabricated Metals	15.97	9	13.27	11
Broadcasting & Cable	15.95	10	12.46	13
Oil & Gas Refiners	15.81	11	13.48	10
Real Estate	15.24	12	3.93	26
Construction & Materials	15.09	13	10.66	19
Forest Products	14.58	14	9.50	21
Metal Mining	14.31	15	5.87	24
Electric Utilities	13.97	16	15.19	5
Hardware & Auto Supplies	13.63	17	11.51	16
General Industrial Diversified & Mgmt. Cos.	13.45	18	3.31	27
	13.18	19	9.03	22
Electrical Equipment	13.01	20	14.80	6
Steel	12.97	21	11.51	16
Not Elsewhere Classified	12.76	22	11.58	15
Food & Kindred Products	12.68	23	10.68	18
Chemicals	12.33	24	10.78	17
Transportation	11.79	25	13.05	12
Telephone Companies	11.61	26	13.93	8
Textiles & Apparel	11.33	27	3.19	28
Food Stores	11.21	28	8.61	23
Beverages	11.02	29	13.73	9
Department Stores	10.26	30	2.40	29
Auto & Auto Parts	9.97	31	-4.64	31
Non-Metal Mining	9.94	32	0.78	30
Machinery	-6.27	33	-53.41	32

⁽¹⁾ Income available for distribution to common shareholders divided by total common shareholders' equity retained earnings and reserves.

⁽²⁾ Source: Financial Research Institute and Wood Gundy.

Table 1.16

INDUSTRY PROFITABILITY COMPARISON
AFTER-TAX RETURN ON AVERAGE COMMON SHAREHOLDERS EQUITY

Year	(1) Metals and Minerals	(2) Golds	(3) Oil and Gas	(4) Paper and Forest Products	(5) Consumer Products	(6) Industrial Products	(7) Real Estate and Con- struction	(8) Transpor- tation	(9) Pipelines	(10) Utilities*	(11) Communica- tions and Media	(12) Merchan- dising	(13) Manage- ment Compa- nies	(14) Compa- nies Except Banks Chartered Banks
1982														11.9**
1981														18.0
1980	19.15	22.08	26.52	21.20	6.47	9.26	26.85	29.20	18.78	13.77	21.91	13.86	21.01	19.09
1979	25.07	27.83	23.08	30.10	11.49	16.15	27.78	26.77	18.30	14.13	23.65	15.51	19.87	21.22
1978	11.92	20.24	18.29	23.24	9.85	8.37	20.76	24.33	14.90	13.41	24.03	14.34	14.34	14.43
1977	8.77	15.72	17.56	12.86	8.53	11.76	16.50	21.94	12.95	11.58	22.82	13.57	14.28	12.97
1976	8.30	8.08	19.57	7.19	10.54	13.98	16.56	16.81	13.43	12.50	23.58	8.77	10.98	11.99
1975	8.26	15.36	18.28	5.86	11.30	17.04	16.47	17.11	13.35	11.27	22.60	14.71	13.70	13.44
1974	18.82	17.97	17.26	21.17	15.67	18.84	10.49	14.65	12.38	9.74	22.92	16.84	16.03	17.42
1973	19.27	14.79	13.32	19.31	15.66	14.36	10.02	19.38	15.27	10.27	24.13	9.16	14.63	15.64
1972	7.54	8.16	9.71	7.54	12.71	10.73	8.64	18.43	16.09	11.12	25.03	10.15	11.26	10.07
1971	6.40	5.21	8.82	3.44	10.96	8.70	14.05	17.95	14.93	11.20	21.85	10.10	9.88	8.50
1970	12.25	7.08	7.68	3.23	11.03	7.40	9.39	14.66	13.25	9.52	21.62	6.97	8.94	9.15
5 year (1976-80) average	14.64	18.79	20.20	18.92	9.38	11.90	21.69	23.81	15.67	13.08	23.20	13.21	16.10	15.94
10 year (1970-80) average	13.37	15.54	16.84	15.19	11.32	12.92	16.81	20.66	15.04	11.90	23.25	12.70	14.60	14.49

* Normalized accounting

** Annualized first quarter earnings

SOURCES: McLeod Young Weir Limited
Financial Post Investment Databank

1.4 SUMMARY AND CONCLUSIONS

Since the early 1970's, the banks' relative importance in the Canadian economy has increased. Their lending activities have grown at a faster rate than the business activities of other sectors. This asset growth has had a direct and major impact on the overall level of their profits, with the result that the banks are now earning an increasing share of national income.

In 1981, the total after tax profits of Canadian chartered banks amounted to \$1,700 million, an increase of 38 per cent over 1980. These high profits were not earned to the detriment of Canadian consumers or businesses. Three factors explain this increase. First of all, total bank assets increased by 27 per cent in 1981, over their 1980 level. Secondly, profits on international operations increased by 46 per cent in 1981, compared to a 32 per cent increase in profits from domestic operations. Finally, the rapid increase in interest rates in the first quarter of the banks' 1981 fiscal year resulted in increasing spreads that produced inventory profits, because the rates charged on loans adjusted faster than those paid on deposits. These inventory profits were temporary, and should have been expected, given the nature of financial intermediation. Indeed, these inventory profits have been reversed as interest rates fell in late 1981 and early 1982.

The profitability of the chartered banks can be measured in two ways: return on average assets (ROA), the ratio of the balance of revenue after taxes to average assets held during the year; and return on average equity (ROE), the ratio of after tax revenue to the value of shareholders' equity. In 1981, the Canadian banks earned an ROA of 0.57 per cent, (i.e. 57¢ per \$100 of assets) up from the 1980 figure of 0.51 per cent, but equal to the average ROA of the past ten years. In 1981, their ROE reached 18.7 per cent. This compares with the 15.9 per cent return of 1980, the 16.3 per cent earned in the latter half of the 70s, and the 14.8 per cent of the first half of the decade.

The record level of bank profits in 1981 and the dramatic increase over 1980 are understandable, taking these factors into account. On the basis of measures of profitability, the banking sector's 1981 performance was not out of line. The 1981 ROA equalled the average over the past ten years, achieved mainly because of the high ROA on international operations—0.78 per cent, compared to 0.48 per cent on domestic assets.

On the basis of ROE as well, bank profits are not excessive. The 18.9 per cent return on equity results from the division of an increasing dollar value of profit by a slower increasing value of equity. This implies that each dollar of shareholders' equity is used more intensively to support the sharply rising growth in assets. In other words, the ratio of bank assets to equity has been increasing rapidly over the last decade. In 1971, bank assets were twenty-one times as large as shareholders' equity; in 1981, this ratio reached thirty-one times. The substantial diversification of bank assets and the stable deposit base permit this higher leverage. This has resulted in an increased exposure of the capital base, which when accompanied by the weakness in the economy, explains in part why bank shares traded substantially below their book value in 1981.

Bank profitability, as measured by return on equity, has been average when compared to other industries. Out of thirty-three industries, the banks ranked eighth over the period 1972-1981, and second in 1981. This compares to their rank of sixteenth in 1980 and

eleventh during the 1970s. The higher ranking in 1981 was due as much to the decline in other sectors' profitability as to the increased bank profitability.

It is difficult to compare the profitability of international banks. They operate in vastly different institutional and regulatory environments. Taxation and accounting methods vary widely, and in some countries banks are government-owned. Nevertheless, the most consistent and comprehensive data at the Committee's disposal indicates that Canadian banks are not overly profitable when compared to banks in the rest of the world. Their ROA compares poorly with that of foreign banks and, to the extent that Canadian ROE appears to compare well, this is largely due to the more leveraged position of Canada's banks.

The Canadian banking sector has undergone some major changes over the 70s, and especially in the last several years. The chartered banks have moved increasingly into international operations that are now relatively more profitable than domestic operations. By 1981, 40% of bank assets were denominated in foreign currencies. Canadian dollar deposits with the banks are not used for funding foreign currency loans; these are funded by foreign currency deposits. Moreover, during the last ten years, banks used foreign currency deposits to finance Canadian dollar loans. To put it another way, the banks' foreign operations have been used to finance Canadian exports and investment and other expenditures and are, in themselves, an export of financial services generating foreign exchange. When these foreign operations were set up, the banks did incur expenditures in the form of training Canadian employees and establishing branches and subsidiaries. Through their foreign and domestic operations, the banks are a major supporter of Canadian investment and export activity.

The deposits and assets of the banks have also undergone some major changes. Bank assets in the form of securities are increasingly replaced by loans. More and more, Canadian dollar deposits at Canadian banks are in the form of term deposits, although the term to maturity is becoming shorter. These changes in the structure of assets and liabilities are generated by volatile interest rates.

FOOTNOTES

- (1) Data taken from S. Sarpkaya, "Nomenclature des banques au Canada", *Le Banquier et revue IBC*, octobre 1978, and updated.
- (2) Edward P. Neufeld, *The Financial System of Canada: Its Growth and Development*, Toronto, MacMillan, 1972.
- (3) Statistics Canada, 13-001, *National Income and Expenditure Accounts*, Fourth quarter 1981.
- (4) Percentages calculated from data published in the *Bank of Canada Review*.
- (5) For a review of the market for banker's acceptances in Canada, see: D. Merrett, "The Evolution of Banker's Acceptances in Canada", *Bank of Canada Review*, October 1981, p. 3-12.
- (6) See Laurie Landy "Financial Innovation in Canada", *Quarterly Review*, Federal Reserve Bank of New York, Autumn 1980, Vol. 5, No. 3, p. 1-8.
- (7) Laurie Landy (1980), p. 3.
- (8) *Bank of Canada Review*, various issues.
- (9) For a fuller discussion on the interest rate ceiling, see Chapter 5.
- (10) These items constitute what is known as the contra account of the balance sheet. They represent commitments by the banks to the holders (i.e. liabilities) and, when exercised, are loans to the borrowers (i.e. assets).
- (11) Calculated from bank annual reports.
- (12) Edward J. Fryde, "The Euro-dollar Conundrum", *Quarterly Review*, Federal Reserve Bank of New York, Spring 1982, p. 13.
- (13) **Euromoney Definitions:**
- i) **Shareholder's Equity**—Euromoney's definition excludes all interest bearing equity, namely, debentures, both subordinated and convertible and in addition, all appropriations for losses. In the Committee's Report, appropriations for losses are included in shareholder's equity since this category is a direct after-tax appropriation at management's complete discretion. In fact, under the Bank Act (1980), the tax paid part of this amount has been taken out of appropriations and placed directly in shareholder's equity. Euromoney's definition therefore understates the Canadian banks' shareholder's equity.
 - ii) **Net Profit**—Euromoney used the banks' net profit figure after appropriations for losses which is essentially a discretionary after-tax transfer into the appropriation for loss account. The amount transferred does not necessarily have any bearing on the banks' losses in any particular year. The Committee's Report uses the banks' after-tax balance of revenue which more accurately reflects the banks' true earnings. Net profit as used by Euromoney actually understated bank earnings by \$481 million or 30.7 per cent. Net profit has been eliminated as a term under the Bank Act (1980) such that the banks will not report this figure for the year ended October 31, 1982.
 - iii) **Total Assets**—Euromoney defined total assets as those excluding contra accounts and contingent liabilities. In the case of Canadian banks, Euromoney excluded the balance sheet item customers liability under acceptances, guarantees and letters of credit. This has under-stated the total asset figure used in the Committee's Report by 9.4 per cent.
- (14) **Differences in Reconciling Euromoney Data:**
- Euromoney data have been analyzed as to their consistency with data and definitions used in the Committee's Report. The major problem in any international comparison is adjusting for accounting differences between countries. The data used by Euromoney was in several cases, not reconcilable with the figures published by the Canadian banks. These inconsistencies are few, but are as follows: the data for Bank of Nova Scotia was overstated such that total assets, net profits and share-holders equity were \$1.5 billion, \$92 million and \$310 million too high respectively. Bank of Montreal's net profit and shareholders equity were overstated by \$63 million and \$136 million respectively. Most other differences were of a minor nature.

⁽¹⁵⁾ Definitions for Adjusted Data:

- i) Shareholders Equity—Euromoney's definition of shareholders equity is used despite the changes which have taken place in the Bank Act (1980) as previously noted. The return on equity will be higher than that used in the Committee's Report. The discrepancies as noted in Footnote (14) have been included in our data.
- ii) Net Profit—has been changed to use after-tax balance of revenue for all the banks in the Euromoney study. These numbers have been adjusted in order to reflect all loan losses incurred by the Canadian banks in 1981 as being written off against 1981 earnings. This had the effect of lowering after-tax balance of revenue by 1.8 per cent from the data used in the Committee's Report. The latter and as well, using the after-tax balance of revenue figure instead of net profit had the effect of increasing Euromoney's data by 21.4 per cent. This adjustment will raise both the banks' return on equity and return on assets relative to that reported in the Euromoney study.
- iii) Total Assets—The Euromoney's data were not changed except for the relatively minor adjustment to the data for Bank of Nova Scotia of \$1.5 billion. It should be noted that the Committee's Report uses average assets during the year whereas Euromoney uses total assets at year-end.

Since 1979, Canadian interest rates have reached record levels and have been prone to extraordinary volatility over very short periods of time (Graphic 2.1). The causes for this situation are complex, but at least we can say that they are closely linked to the inflationary experience of the 1970s and the restrictive monetary policies that Canada and the United States adopted in response to it.

Between the middle of the 1950s and the end of the 1970s, the rate of inflation tended to increase in both countries and it became increasingly difficult to forecast. During the 1970s, at least, there were strong indications that savers had difficulty anticipating the rate of inflation. Actually, between 1956 and 1970 inflation-adjusted interest rates were usually positive, but between 1970 and 1979 they were in many cases negative. For example, from 1958 to 1970, the average rate of yield on 90-day commercial paper less the annual rate of increase in the consumer price index averaged between 2.5 and 2.7 per cent. But from 1971 to 1979 inclusive, this rate of interest, adjusted for inflation, was negative. This adjusted yield actually went down to -3 per cent in 1973. Although it became positive again at the end of 1975 and the beginning of 1976, it was negative in 1977.¹⁶

Moreover, interest rates (adjusted for inflation) discouraged investment in the years between 1970 and 1979 and, even where inflation-adjusted rates of return were positive, the after-tax rates were negative for a number of investors. For example, if the annual interest rate is 10 per cent, the inflation rate 10 per cent, and the investor's tax rate 40 per cent, the inflation-adjusted rate of return after taxes is -0.4 per cent. When the investor's tax rate is 50 per cent, the after-tax rate of return after inflation is -1.5 per cent. If savers did not correctly forecast inflation between 1970 and 1979, monetary policy did not always allow expected inflation to affect market rates.

However, since October 1979, the Federal Reserve Board in Washington has practiced a restrictive monetary policy that allows interest rates to reach levels compatible with the

Chapter 2

Interest Rates and Bank Profits in Canada

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Moreover, interest rates (adjusted for inflation) discouraged investment in the years between 1970 and 1978 and, even where inflation-adjusted rates of return were positive, the after-tax rates were negative for a number of investors. For example, if the annual interest rate is 16 per cent, the inflation rate 10 per cent, and the investor's tax rate 40 per cent, the inflation-adjusted rate of return after taxes is -0.4 per cent. When the investor's tax rate is 50 per cent, the after-tax rate of return after inflation is -1.8 per cent. If savers did not correctly forecast inflation between 1970 and 1979, monetary policy did not always allow expected inflation to affect interest rates.

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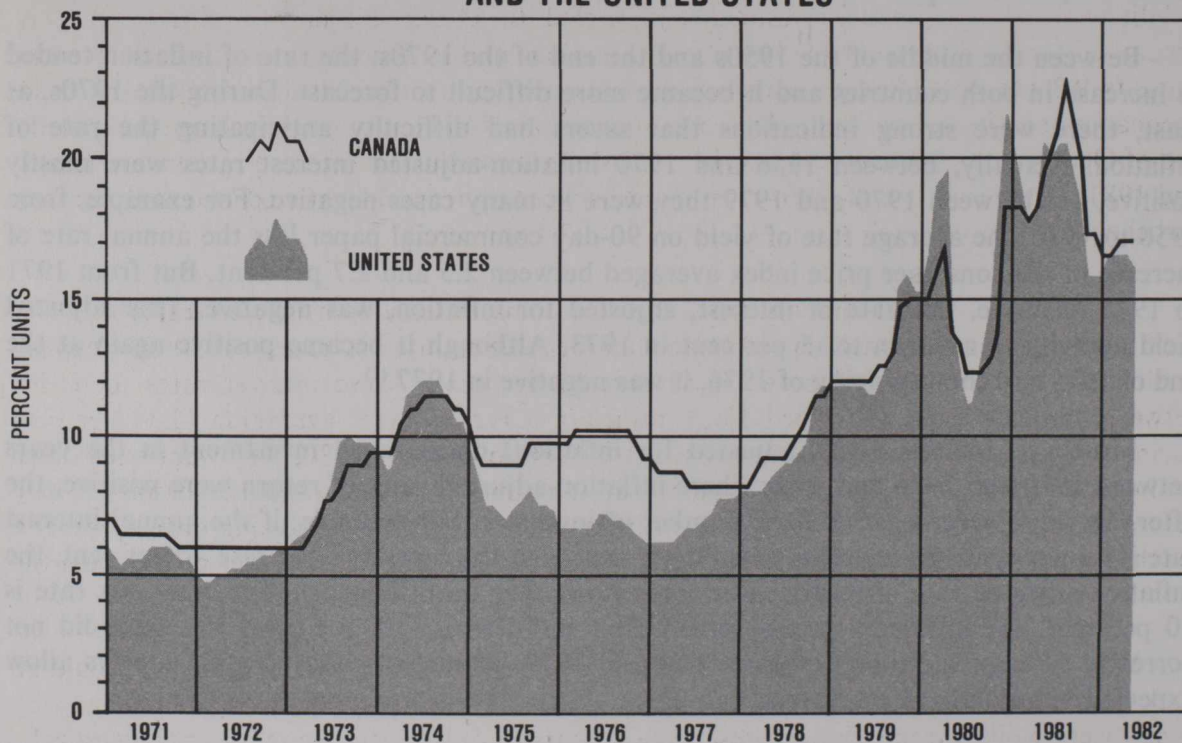
target growth rate in money supply. This monetary policy makes it easier for the anticipated variations in rates of inflation to influence interest rates, just as the experience of the 1970s eventually encouraged savers to consider more precisely the effects of inflation in calculating rates of yield for their investments.

The Bank of Canada has to a large extent followed the United States in the conduct of monetary policy. However its job is made more difficult by the persistent weakness of the Canadian dollar as a result of higher inflation in Canada and continuing outflows of capital at record levels. This has resulted in a widening of the spread between Canadian and American interest rates.

While, previously, interest rates changed slowly, and economic agents had time to make adjustments, interest rates have become volatile and unpredictable in more recent years and, on the average, higher (Graphic 2.1). Savers who in some cases had been frustrated by the unexpected inflation of the 1970s, showed a marked preference for short-term investments. They were no longer as willing to set interest rates for medium and long-term investments. Borrowers, on the other hand, were not ready to commit themselves to paying high interest rates over several years, and resorted to short-term financing.

GRAPHIC 2.1

**BANK PRIME RATES IN CANADA
AND THE UNITED STATES**



In other words, the financial system underwent important transformations during the last two years, with significant repercussions on the composition of the banks' deposit liabilities and the level and composition of their assets. The increased variability of interest rates also greatly influenced the banks' financial performance. It will be useful to examine the behaviour of Canadian savers more closely to see the effect it had on the banks' deposit liabilities (Section 2.1) and to see how the assets of the chartered banks show the effects of borrowers' behaviour. (Section 2.2)

2.1 INTEREST RATE VOLATILITY, SAVERS' BEHAVIOUR AND CANADIAN CHARTERED BANKS' DEPOSIT LIABILITIES

The flow of personal savings in Canada amounted to \$16.7 billion in 1978 and \$17.8 billion in 1979, reaching \$19.5 billion in 1980 and \$25.7 billion in 1981. Between 1978 and 1981, personal savings as a percentage of disposable personal income rose from 10.5 per cent to 11.6 per cent. (This trend has continued into the first half of 1982.)

Over the past few years, part of these personal savings has been added to the stock of financial wealth held by households and businesses, generally in the form of notes issued by deposit institutions such as banks, trust companies, mortgage loan companies, caisses populaires, and credit unions. As of the end of December 1981, the value of all deposits held by the Canadian public in banks and other deposit institutions amounted to \$237.6 billion. Deposits in banks accounted for 69 per cent of the total and those in other institutions, 31 per cent.

At the end of the chartered banks' fiscal year, in October 1981, the banks' deposit liabilities owed to Canadian residents amounted to \$155.8 billion. Fixed-term deposits accounted for 50.6 per cent of this amount, non-chequable deposits 30.3 per cent, demand deposits 9.3 per cent, foreign currency deposits held by residents 5.1 per cent, and other chequable deposits 4.7 per cent. This breakdown stands in contrast to that prevailing at the end of October 1978 (Table 2.1). In the other deposit institutions, in the years between 1978 and 1981, the percentage of fixed-term deposits went up from 63.8 per cent to 68.2 per cent and chequable deposits fell from 29.2 per cent to 7.1 per cent.⁽²⁾

This evolution results mainly from the variations in Canadian interest rates in 1979, 1980 and 1981. From January 1979 to October 1981, interest rates on 30-day deposit certificates at banks ranged between 10 and 20 per cent. These interest rates increased between January 1979 and April 1980, to attain a record high, averaging 14.38 per cent during the quarter ending in April. From April 1980 to October 1980, they went back down again to levels considered more "normal" at the time by savers (and the banks). Then, before the end of 1980, interest rates for savings began their upward swing once again and reached a new high during the second half of 1981 (an average of 20.01 per cent during the months of August, September and October 1981).

When interest rates started rising in 1979, the market did not expect that they would go back down again and then resume their climb to the heights attained in 1981. This was why savers were willing to make fixed-term investments in 1979. They were all anxious to take advantage of the record interest rates. This behaviour is illustrated by the increased percentage of fixed-term deposits in banks during 1979, as compared to 1978; the year-over-

Table 2.1

RECENT TRENDS IN CANADIAN CHARTERED BANKS DEPOSITS

Data are those of the last Wednesday of the month	End of October 1978		Change from the corresponding quarter of the previous year											End of October 1981		
	In millions of Canadian dollars	As a % of total deposits	Quarter ending:											In millions of Canadians dollars	As a % of total deposits	
			Jan.79	Apr.79	Jul.79	Oct.79	Jan.80	Apr.80	Jul.80	Oct.80	Jan.81	Apr.81	Jul.81			Oct.81
Demand deposits	\$ 14,395	14.5%	7.3%	6.3%	6.5%	3.9%	8.6%	4.3%	8.3%	7.5%	4.3%	16.7%	10.4%	9.3%	\$ 14,471	9.3%
Other chequable deposits	7,686	7.6	5.7	-1.2	0.8	1.9	-6.9%	-0.6	-3.5	-0.3	5.4	4.3	-1.5	4.7	7,384	4.7
Non-chequable savings deposits	25,445	25.1	11.6	10.5	13.4	20.7	21.0	27.1	28.3	24.9	26.3	22.8	21.3	30.3	47,219	30.3
Terms and notice deposits	42,927	42.4	27.7	31.3	34.8	33.1	32.0	23.4	18.9	7.5	9.6	7.5	11.8	50.6	78,846	50.6
Foreign currency deposits held by Canadians in Canada	10,826	10.7	65.9	18.8	26.3	16.2	-19.4	6.4	-0.6	2.6	0.4	-34.9	-38.2	5.1	7,869	5.1
Total deposits with chartered banks	101,279	100.0	22.0	18.7	21.9	21.7	17.6	18.6	16.4	10.8	12.1	8.4	9.1	100.0	155,789	100.0
Interest rate on 30-day deposit receipt at chartered banks																
Quarterly average in %			10.30%	11.03%	11.22%	12.50%	13.62%	14.38%	11.79%	10.45%	16.26%	17.16%	19.79%	20.01%		

SOURCE: Bank of Canada *Review*.

year increase was 31.3 per cent in April 1979, 34.8 per cent in July 1979, 33.1 per cent in October 1979, and 32 per cent in January 1980 (Table 2.1). Following the drop in interest rates during the quarter which ended in July 1980, there was a reduction in the demand for fixed-term deposits. Thus, during the four quarters following the end of April (July 80, October 80, January 81 and April 81), annual growth rates for fixed-term deposits were 18.9 per cent, 7.5 per cent, 9.6 per cent and 7.5 per cent. Savers then showed a preference for non-chequable savings deposits that (for the same quarters) grew at a rate of 28.3 per cent, 24.9 per cent, 26.3 per cent and 22.8 per cent. This increase was also attributable to the popularity of daily interest accounts (non-chequable deposits) introduced at the end of 1979 and offered by most banks in 1980.

Therefore, even though interest rates on 30-day deposit certificates were at an average level of 16.26 per cent during the quarter ending January 1981, and at a level of 17.16 per cent during the following quarter, savers increased their fixed-term deposits by only 9.6 and 7.5 per cent respectively, and still preferred non-chequable savings deposits, the value of which increased during this period by 26.3 per cent and 22.8 per cent. This must be because savers were expecting a rise in interest rates. It was only during the quarter ending in October 1981 that the growth rate of fixed-term deposits exceeded that of non-chequable deposits. The former increased by 11.8 per cent and 28.4 per cent during the last two quarters of 1981. Demand deposits and chequable deposits showed a drop in October 1981, in relation to October 1980, of 10 per cent and 5.4 per cent respectively.

We must not give the same interpretation to the rise in fixed-term deposits in 1981 as for 1980. Indeed, whereas in the 1980 the "term to maturity" for more than 75 per cent of the increase in fixed-term deposits was for a period of over one year, in 1981 this percentage had dropped to 15 per cent⁽³⁾

The growth in fixed-term deposits in 1981 was mainly accounted for by 30-day and 90-day deposits.

Having been caught in 1979 and 1980 when interest rates went down after rising and then went on to reach new highs, savers opted for short-term investments, in 1981 to protect themselves from fluctuations in interest rates. During this period the Canadian chartered banks' deposit liabilities became fixed term liabilities but of short maturity. It then became almost impossible for banks, as for other deposit-taking institutions, to continue offering fixed-rate loans for periods of over one year for such things as fixed-rate five-year mortgages.

There is every indication that during this period savers became more astute in the management of their financial wealth. This was reflected in the speed with which they modified the composition of their bank deposits. When the banks became aware of the speed and frequency with which savers reacted to changes in interest rates, they responded by offering new kinds of accounts with varying service charges.

Before 1980, savers could not as easily transfer their funds between non-interest bearing and interest-bearing accounts. In fact, banks calculated interest accrued on personal savings accounts on the minimum monthly balance. At the end of 1980, after several months of hesitation, almost all Canadian banks offered non-chequable daily interest savings accounts. This new service allowed savers to transfer their funds more readily between demand

deposits and chequable or non-chequable deposits, and this is what they did. Confronted with the administration costs of this mobility, several chartered banks then raised service charges on non-chequable savings accounts withdrawals.

In addition, although the first withdrawals of the month on non-chequable savings accounts were free of charge, fees of between 50 cents and a dollar were charged on each additional withdrawal. In order to limit these costly withdrawals, and to take advantage of high interest rates, many savers then made greater use of their credit cards. By increasing the unpaid balance on their credit cards, and by paying once a month just before the end of the billing period to avoid paying interest, they received the maximum amount of interest on their daily interest savings accounts while limiting the number of withdrawals. They were using their credit card as a payment card.

These few examples illustrate the reluctance of bank depositors to purchase financial securities whose rate of return is fixed for a long term, and their preference for more liquid securities, given their expectations with respect to future swings in interest rates. They help to explain why, in 1980 and 1981, the volume of long-term financing through the purchase of conventional bonds on the Canadian market was so weak. As we shall see in the following section, the weakness of the long-term capital market in general is one of the factors contributing to the increase of Canadian chartered bank assets and hence the increase in bank profits of 1981.

2.2 THE VOLATILITY IN INTEREST RATES, THE BEHAVIOUR OF BORROWERS AND THE EVOLUTION OF BANK ASSETS

The volatility of interest rates, especially their upsurge in recent years, and the slump in real economic growth, have forced changes on both households and businesses. During 1980 and 1981, individuals rapidly reduced their outlays on durable goods and the purchase of houses. A little later, near the end of 1981 and the beginning of 1982, businesses reassessed and reduced their borrowing requirements.

As Table 2.2 shows, the respective share of mortgage loans and consumer credit as a percentage of total financing raised in Canada dropped from 15 per cent in 1980 to 6.6 per cent in 1981 in the first case, and from 7.2 per cent to 5.8 per cent in the second. The public sector share was relatively stable in 1980 and 1981; the biggest increase was in the percentage going to businesses—from 41.9 per cent in 1980 to 54.2 per cent in 1981.

The behaviour of household-borrowers

Consumer spending by Canadian households grew at approximately the same rate as Gross National Expenditure (GNE) in 1980 and 1981—11.6 per cent and 13 per cent for total consumer spending and 10.6 per cent and 13.3 per cent for GNE. Spending on durable consumer goods was slower to increase—by 6.9 per cent in 1980, and 9.5 per cent in 1981. But both kinds of expenditure showed the effects of wide fluctuations in interest rates. When these reached new heights in the third quarter of 1981, total consumer spending increased only slowly, at an annual rate of 8 per cent, and spending on durable goods actually fell, at an annual rate of 12.4 per cent.

The reluctance of householders to purchase durable goods (that they finance largely through loans) has served to slow the rate of growth of outstanding consumer loans. Thus, after having reached a growth rate of between 14 and 15 per cent in 1978 and 1979, outstanding consumer loans in Canada rose by only 11.4 per cent in 1980 and 9.7 per cent in 1981. This decline has resulted in a slight decrease in the ratio between outstanding loans and Canadian personal disposable income, the latter having dropped from 22.9 per cent at the end of 1979 to 21.7 per cent at the end of 1981.

Table 2.2

FUNDS RAISED BY MAJOR NON-FINANCIAL BORROWERS

in billions of dollars

	1978	1979	1980	1981	as % of Total			
					1978	1979	1980	1981
USES OF FUNDS								
Business Sector	\$16.4	\$23.8	\$26.1	\$40.0	29.0	42.1	41.9	54.2
Mortgage borrowers (1)	12.9	13.4	9.8E	4.9E	23.0	23.7	15.7	6.6
Consumer credit	4.6	4.9	4.5	4.3E	8.1	8.6	7.2	5.8
Total private sector borrowing	34.0	42.0	40.4E	49.2E	60.1	74.4	64.8	66.6
Provinces and municipalities (2)	8.9	7.8	9.7	13.0E	15.7	13.8	15.6	17.6
Government of Canada (3)	13.7	6.7	12.1	11.6	24.2	11.8	19.5	15.7
Total public sector borrowing	22.6	14.5	21.8	24.6E	39.9	25.6	35.1	33.3
TOTAL (6)	56.5	56.5	62.2E	73.8E	100.0	100.0	100.0	100.0
SOURCES OF FUNDS								
Bank of Canada acquisitions of securities	1.7	1.7	2.3	1.1	3.0	3.0	3.7	1.5
Banking sector (including bank mortgage subsidiaries)	19.9	20.5	20.2	40.9	35.2	36.2	32.5	55.4
Other domestic financial institutions								
Contractual savings institutions (4)	7.4	9.4	10.5E	9.1E	13.1	16.6	16.8	12.4
Other	11.6	12.3	12.6E	6.6E	20.5	21.7	20.2	8.9
Non-residents	7.1	4.2	5.7	6.7E	12.5	7.4	9.2	9.1
Non-financial public (5) (Residual)	8.7	8.4	11.0E	9.5E	15.4	14.8	17.7	12.9
TOTAL (6)	56.5	56.5	62.2E	73.8E	100.0	100.0	100.0	100.0

(1) These are principally mortgages secured by residential property. The figures exclude net mortgage lending by governments and their agencies, which is reflected in the financing requirements of the respective governments.

(2) Loans from the Government of Canada are excluded.

(3) Excludes temporary swap transactions between the Bank of Canada and the Exchange Fund Account. The figures shown are not a measure of Government of Canada cash requirements.

(4) Life insurance companies and pension funds.

(5) Includes Canada Pension Plan and Quebec Pension Plan.

(6) Total may not add precisely, because of rounding errors.

Source: Compiled from information obtained from the Bank of Canada.

E: Estimated

At the end of 1981, chartered banks held 67.4 per cent of consumer loans in Canada, whereas credit unions held only 13.4 per cent, and sales finance companies, 6.4 per cent. The rest was held by life insurance companies (policy loans), trust and mortgage loan companies, department stores, and Quebec savings banks.

In addition to reducing their purchases of durable consumer goods during the last two years, Canadian households have delayed buying residential property, causing a substantial slump in the residential construction sector and the market for existing residential property. Housing starts have decreased substantially in Canada since 1977. While they reached an average of 246,000 units between 1971 and 1977, they barely reached 158,000 units in 1980, and only 179,000 units in 1981. Furthermore, we must point out that 1981 figures are inflated by counting early housing starts that took advantage of tax incentives linked to the construction of multiple unit residential buildings, before this program was discontinued in 1982. As for the situation in the market for residential property, the value of mortgage loans approved for existing units in Canada only reached \$4.7 billion in 1981, a reduction of 57 per cent compared to the previous year.

The decrease in the demand for new and existing homes resulted in a considerable decline in activity on the mortgage market. Thus, whereas the number of approved mortgage loans peaked at 191,300 in Canada in 1977, it reached only 76,600 in 1981. Consequently, in 1980 and 1981 we witnessed a substantial decline in the growth of outstanding residential mortgage loans in Canada. Back in 1979, outstanding loans increased by 16.8 per cent, but they only increased by 13.7 per cent in 1980, and 8.2 per cent in 1981.⁽⁴⁾

The decrease in the growth of outstanding mortgage loans can be explained partly by certain homeowners having reimbursed part of the capital when they renewed their mortgages, in order to limit the increase in their monthly payments, and by these other factors, as well:

- i) A weaker growth of Canadian incomes. While real personal disposable income per capita had increased at an average rate of 5.6 per cent per year in Canada from 1970 to 1977, it only increased by 2.7 per cent in 1978 and by 1.9 per cent in 1979 and decreased by 0.1 per cent in 1980.⁽⁵⁾
- ii) Mortgage interest rates increased considerably during the last two years. Although they had remained relatively stable from 1971 to 1978, averaging between 9 and 12 per cent, they exceeded 20 per cent in 1981. The average mortgage rate was 18.5 per cent in 1981, compared to only 10.15 per cent in 1978.⁽⁶⁾
- iii) Not only have the levels of interest rates risen over the past two years, their fluctuations have also increased. In 1978, mortgage interest rates varied between 10.25 per cent and 11.50 per cent. In 1980, however, they varied between 13 per cent and more than 18 per cent and, in 1981, between 15 per cent and more than 21.5 per cent. Mortgage borrowers therefore have faced greater uncertainty, and many people have delayed purchasing a home.⁽⁷⁾
- iv) The problem is further compounded because mortgage lenders can no longer afford to grant five-year loans, and so must limit themselves, more often than not, to one-year loans. Thus borrowers must face a readjustment of interest rates each year or pay a substantial premium over the one-year rate.

v) Finally, when there is an increase in the anticipated rate of inflation and an equivalent jump in interest rates, the weight of the mortgage payment as a proportion of the borrower's income increases, even with an income keeping pace with inflation. The presence of an inflation premium shifts the weight of the mortgage loan onto the initial years because, in addition to paying the real rate of interest, the borrower immediately reimburses the lender for the loss of purchasing power due to inflation.⁽⁸⁾

Between 1971 and 1976, the banks' outstanding personal loans fluctuated between 16.6 per cent and 19.4 per cent of their total Canadian dollar assets. Since the end of October 1977, the volume of these loans dropped steadily and accounted for only 15.7 per cent of total Canadian dollar assets at the end of October 1981.

Similarly, the outstanding value of mortgage loans granted by chartered banks or their mortgage loan affiliates has decreased steadily since 1979. In 1980 and 1981, these loans accounted for 16.20 per cent and 14.79 per cent of the total Canadian dollar assets of chartered banks and their mortgage loan affiliates.

Table 2.3 shows that business loans and other loans were the only two categories of bank loans which recorded gains in 1981 in relation to 1980.

Other loans, for which the share increased from 2.22 per cent to 2.73 per cent between October 1980 and October 1981, are those granted to provinces, municipalities, grain dealers, and sales finance and consumer loan companies. The minor increase recorded in 1981 is due primarily to bank loans taken out by these provinces and municipalities that turned to short-term bank loans in view of the declining demand for long-term bonds.

Table 2.3

TRENDS IN THE STRUCTURE OF CHARTERED BANK LOANS, IN CANADIAN DOLLARS,
1971-81, AS A % OF TOTAL CANADIAN DOLLAR ASSETS OF THE CHARTERED BANKS

	Personal Loans (1)	Housing Mortgages (2)	Loans to Farmers (3)	Other Loans (4)	Business Loans (5)
Oct. 71	16.55%	6.12%	3.53%	4.13%	27.62%
Oct. 72	17.28	7.80	3.39	4.08	29.45
Oct. 73	18.33	11.02	3.61	3.85	30.98
Oct. 74	17.60	11.81	3.38	4.22	30.71
Oct. 75	18.49	13.22	3.62	4.32	30.75
Oct. 76	19.41	13.66	3.70	3.79	31.88
Oct. 77	19.15	15.25	3.81	2.88	31.44
Oct. 78	19.12	16.33	3.99	2.80	29.53
Oct. 79	18.47	16.69	4.32	2.75	30.77
Oct. 80	17.46	16.20	4.16	2.22	31.21
Oct. 81	15.66	14.79	3.56	2.73	35.02
Outstanding at the end of Oct. 1981 in millions of dollars	32,864	31,037	7,472	5,733	73,506

(1) Source: Bank of Canada *Review*.

(2) Mortgage include banks' subsidiaries' loans since 1973. Total assets include major assets of these subsidiaries.

(3) Source: Bank of Canada *Review*.

(4) These loans include loans to provinces, municipalities, grain dealers, loans to finance companies and Canada Savings Bonds.

(5) Defined here as in the 1967 Bank Act. This definition does not include loans in foreign currencies to Canadian residents.

More important, however, is the increasing proportion of business loans. According to the figures in Table 2.3, at the end of October 1981, bank loans to businesses represented 35 per cent of the banks' total Canadian dollar assets, whereas, in 1980, they represented only 31.21 per cent of these assets. This figure of 35 per cent represents outstanding bank loans totalling \$73.5 billion in Canadian dollars. Foreign currency loans granted by chartered banks to Canadian businesses have to be added to this—nearly \$20 billion in 1981—and outstanding bankers' acceptances—nearly \$6.5 billion in 1981.

Therefore, there is no doubt that the increase of 41.16 per cent in outstanding bank loans to businesses in 1981 contributed significantly to the increase of 29.7 per cent in total bank assets in that year and to the increase of 25.8 per cent in Canadian dollar assets.⁽⁹⁾ The reasons for the increase in the number of bank loans to businesses are given in the next section.

The financial behaviour of businesses

Businesses borrow primarily to finance the acquisition of capital equipment and to cover inventory changeovers. They also borrow to finance the acquisition of financial capital that includes not only cash holdings, bank deposits, and commercial loans to customers, but also financial securities resulting from mergers and takeovers of other businesses. To meet all of their financing needs, businesses hope to draw on their own sources of financing, including retained earnings and capital cost allowances.

To obtain the capital that cannot be raised internally, businesses must borrow in the market place. This external financing can be either on a short-term or on a long-term basis. Capital can be raised either on the domestic market or on international markets.

Canadian businesses felt the need to raise capital acutely in 1980 and 1981. However, the internal sources available to them for financing increased only marginally in 1980 and even declined at the end of 1981. They had to resort to external sources on a massive scale. Simultaneously, there was a dramatic decrease in access to long-term financing (bonds and stocks), so businesses were forced to make much greater demands on Canadian chartered banks for help in the short term.

A closer examination follows, that traces the evolution of the financial behaviour of Canadian businesses in recent years and, in particular, in 1981.

Increasing financial needs

From 1978 to 1981, the principal external financing needs of Canadian businesses grew from \$16.4 billion to \$40 billion, representing a compound average annual increase of 25 per cent (Table 2.4). This substantial change is, of course, largely due to rapid price increases during this period, but the fact remains that such an increased demand for external financing can only be the result of a widening gap between overall needs and what internal financing sources can provide.

The difficulty came about partly because expenditures on capital equipment (machinery, materials and non-residential construction) had been relatively high between 1978 and 1981. For the four years in question, the increase in capital equipment expenditures was 9.4 per cent, 20 per cent, 17.5 per cent and 18.2 per cent respectively.⁽¹⁰⁾

Moreover, Canadian businesses had also moved to acquire more financial capital. On the one hand, higher interest rates and sound profit levels during 1978 and 1979 encouraged them to maintain and develop a high level of commercial credit, at least until 1980. On the other hand, and more significantly, purchases of financial assets as a result of takeovers and mergers in the business sector increased very rapidly in 1980 and 1981, compared to the three previous years. The purchase of financial assets of associated businesses totalled \$2.6 billion in 1977 and \$3.7 billion in 1978. They amounted to \$7 billion in 1980 and \$15.7 billion in 1981,⁽¹¹⁾ primarily as a result of takeover activity

The economic climate of recent years has promoted takeovers and mergers. Policies like the National Energy Program have also encouraged these transactions—according to EMR statistics, Canadian absorption of foreign owned firms in the energy business totalled \$5.57 billion in 1981, in the private sector.⁽¹²⁾ Generally, as a result of low stock market prices during certain periods, the market value of certain businesses drops lower than the replacement value of their physical capital. They become likely candidates for takeovers by investors with sufficient liquidity. Increasingly, however, the companies making these acquisitions could not handle the financing needs provoked by the takeover through internal financing alone. As we have said, these sources of internal financing were insufficient in 1980, and especially so in 1981.

Decreasing internal sources of funds

What are termed “internal sources of financing” are simply retained earnings and depreciation allowances. These are what a company would normally expect to draw on to cover new financing needs. It should be noted that while depreciation allowances represent a significant percentage of internal financing each year, this percentage varies very little on an annual basis. Retained earnings are the key factor in determining the variability of the internal financing sources of business. In 1979, profits grew at an exceptional annual rate of 72 per cent. But, in 1980, the growth rate was only 1.1 per cent and, in 1981, profits declined by a staggering 26.8 per cent in relation to the previous year, dropping to \$13.7 billion as compared to \$18.8 billion in 1980. A comparison of the figures for the last quarters of 1981 and 1980 shows that the difference is even more appreciable: profits declined by 45.7 per cent, falling from \$18.8 billion to \$10.2 billion.⁽¹³⁾ With such a decline in profits, and the subsequent reduction of retained earnings, it is not surprising that, whereas in 1978 and 1979 internal financing accounted for 31 per cent and 35 per cent, respectively, of the overall financing of the industrial corporations sector, this proportion dropped to 20 per cent and 25 per cent respectively in 1980 and 1981.⁽¹⁴⁾

Increasing short-term external financing

Compared to 1978, when financing in the form of stocks, bonds and direct investments by non-residents accounted for 55.4 per cent of the principal sources of financing used by private non-financial corporations in Canada, the proportion was only 8.3 per cent in 1981. (Table 2.4)

Table 2.4

MAJOR SOURCES OF FUNDS RAISED BY PRIVATE NON-FINANCIAL BUSINESS,* 1978-1981
(millions of dollars)

	1978	1979	1980	1981	in % of Total			
					1978	1979	1980	1981
NET NEW ISSUES								
Bonds ⁽¹⁾								
Canadian dollar ⁽²⁾	\$2,154	\$473	\$1,205	\$1,376	13.1	2.0	5.1	3.4
Foreign currency	1,023	749	1,200	3,054	6.2	3.1	4.6	7.6
Stocks								
Common	654	2,443	1,706	2,181	4.0	10.3	6.5	5.4
Preferred ⁽³⁾	5,265	945	1,924	2,049	32.1	3.9	7.4	5.1
Commercial paper	-177	234	163	652	-1.1	1.0	0.6	1.6
Bankers' acceptance	497	1,271	2,430	1,196	3.0	5.3	9.3	3.0
<i>Total</i>	9,416	6,115	8,628	10,508	57.4	25.6	33.0	26.3
INCREASE IN LOANS								
Chartered banks ⁽⁴⁾	5,207	14,240	13,762	29,985	31.7	59.8	52.6	75.0
Sales finance companies	419	1,004	550	156	2.5	4.2	2.1	0.4
Canadian affiliates of foreign banks ⁽⁶⁾	813	1,118	2,760	2,222	4.9	4.7	10.6	5.5
Federal Business Development Bank	105	366	143	-38	0.6	1.5	0.5	-0.1
Syndicated loans of foreign banks located abroad	349	264	-268	2,482	2.1	1.1	-1.0	6.2
<i>Total</i>	6,893	16,992	16,937	34,807	42.0	71.4	64.7	87.0
DIRECT INVESTMENT FROM ABROAD								
	85	675	585	-5,300	0.5	2.8	2.2	-13.2
TOTAL FUNDS RAISED	16,394	23,782	26,150	40,015	100.0 ⁽⁵⁾	100.0 ⁽⁵⁾	100.0 ⁽⁵⁾	100.0 ⁽⁵⁾

* Includes agriculture and institutions.

(1) Canadian dollar issues placed abroad are included with foreign currency bonds, and foreign currency issues placed in Canada are included with Canadian dollar bonds.

(2) Includes income debenture bonds.

(3) Includes term preferred shares.

(4) Total business loans plus foreign currency loans to residents other than the federal government.

(5) Total may not add to 100% because of rounding errors.

(6) Operations of these institutions prior to their becoming chartered banks are included in the category "affiliates of foreign banks", whereas their operations subsequent to becoming chartered banks are included in chartered bank statistics.

Source: Bank of Canada.

Even these figures give less than the whole picture, however, since financial statistics still view as a long-term debt what is in fact short-term or, at best, medium-term financing. For some time now, the long-term bond market has witnessed some major innovations.⁽¹⁵⁾ The average term to maturity of new issues has been reduced substantially, and new types of financial instruments have appeared, the main feature of which is variable interest rates.

Although the stock market did not succeed in maintaining the same share of total financing it held in 1979 (14.2 per cent), its contribution to the financing of businesses in 1981 was still important (10.5 per cent). Even so, that is a far cry from the 1978 performance when, for various reasons (some of them connected with fixed-term preferred shares), the percentage of capital stock financing rose to 36.1 per cent.

Briefly, Canadian (and American) long-term lenders shortened the terms of their loans, refusing to set rates for long periods. In such a context, it is not surprising that the share of external financing through foreign and domestic currency bonds or through stocks issues fell drastically between 1978 and 1981 (Table 2.4).

We see that it was only to be expected that Canadian businesses would turn to the banks as readily as they did for short-term financing, when we review, first, the conjunction of their high and increasing demand for capital with the depletion of their sources for internal financing and, second, when we reflect upon the limitations that have been placed upon external financing.

Record level of bank loans

Table 2.4 clearly shows the increase in short-term financing through the issuing of commercial paper, through bankers' acceptances, the increased role of bank loans granted by foreign banks, and especially the greater number of business bank loans, that rose from \$5.2 billion in 1978, to nearly \$30 billion in 1981. The share of business financing originating from chartered banks increased from 52.6 per cent to 75 per cent between 1980 and 1981. (Table 2.4)

The increase in the demand upon the banks in 1981, compared to 1980, originated mainly from the business sectors, whose share of total financing increased from 41.9 per cent to 54.2 per cent. Mortgage loans and consumer credit, on the other hand, decreased from 15.7 per cent to 6.6 per cent, and from 7.2 per cent to 5.8 per cent, respectively. The public sector's share fell only slightly, from 35.1 per cent to 33.3 per cent (Table 2.2). It bears repeating that the financing needs of businesses could not be satisfied to the same degree as in preceding years by the long-term capital market, mainly because of the hesitation of individual and institutional investors to place their assets in long-term securities in this period of volatile interest rates. In Canada, though short-term financing can be obtained from either the "money market" or the banks, the small size of the "money market" helps to persuade the borrower that the most desirable source is the Canadian banking system.⁽¹⁶⁾

In brief, the strong growth in bank assets during 1981 arose largely from the increase in short-term financing needs of business, which could not be met, to the same extent, from other traditional sources.

As the yield rate of the banks' average assets was comparable in 1981 to the average of the past ten years (57 cents per \$100 of assets), the sharp increase in assets resulted in a significant growth of after tax profits that totalled \$1.7 billion in 1981.

By their direct impact on the composition and level of demand for funds, as well as on the funds supply structure, the volatile nature of interest rates and the economic situation have indirectly contributed to increase bank profits in 1981 in Canada.

Liquidity in the Corporate Sector

The health of the Canadian banking sector is directly related to the financial health of its borrowing customers. The increased reliance on business loans has already been noted;

the ability of the business sector in Canada to repay the principal and interest on outstanding loans is of vital concern to its creditors, namely the banks. An examination of corporate balance sheets makes this point quite clear. The poor condition of these balance sheets can be demonstrated through the use of a number of financial ratios.

Consider first the ratio of interest payments to pre-tax earnings. In 1977, this ratio stood at 25 per cent for all industries in Canada, falling to 20 per cent and rising again to 25 per cent at the end of 1980.⁽¹⁷⁾ However, by the fourth quarter of 1981 it reached 66 per cent and in the first quarter of 1982, it attained 83.3 per cent.⁽¹⁸⁾ For corporations with assets of less than \$10 million, the situation is even worse. In the first quarter of 1982, interest expenses as a percentage of before tax earnings reached 99.4 per cent. In the first quarter of 1981, this ratio stood at 52.2 per cent. Moreover, this ratio has traditionally varied widely over industries, and some sectors have experienced even more drastic increases in the ratio of interest payments to pre-tax earnings the past year.

These figures indicate the reduced ability of business to meet their interest payments. Corporate interest coverage (the ratio of pre-interest and pre-tax income to interest costs) is another measure of this ability. In 1977, corporate interest was covered 4.3 times by earnings. By 1979 this coverage had increased to 5.1 times, but a steady decline in this ratio has since set in. In the first quarter of 1982, interest coverage reached a low of 2.2 times.

The ability of businesses to respond successfully in the event of a financial contingency has also been eroded between 1978 and 1981. Indeed, for all industries in Canada, the ratio of current assets (less inventories) to current liabilities dropped from .99 in the fourth quarter of 1978 to .80 in the fourth quarter of 1981. "To be sure, part of this reduction in liquid asset holdings by non-financial corporations can be explained by the adoption of sophisticated cash management techniques and increased availability of bank credit and other sources of short-term financing. However, the magnitude of the decline suggests that some deterioration had indeed taken place."⁽¹⁹⁾

The situation may be even worse than these ratios indicate. It is well recognized that inflation overstates conventionally-measured profits; capital consumption allowances based on historic cost are understated and inventory profits are exaggerated by inflation. It is these inflated profits that are taxed, with predictable results. "Overall, the impact of inflation and taxes on earnings makes the profits squeeze and solvency problem much more severe than is immediately apparent from conventional earning measures."⁽²⁰⁾

Whatever interpretations may be given to the above ratios, many recent studies on corporate balance sheets in Canada reach the same conclusion: business liquidity is in the worst shape of the post-war period. Most of the studies consider the rise in the ratio of interest expenses to pre-tax earnings as a key indicator of this situation.⁽²¹⁾ The causes of this rise are worth considering.

The severe squeeze on profits has reduced internal sources of funds, implying a decrease in the denominator of the ratio between interest expenses and pre-tax earnings. This reduction in profits is mainly due to the current severe recession and high and increasing costs.

Then, faced with the unprecedented high level of nominal interest rates, the highly-leveraged corporate sector experienced record high debt service burdens. Moreover, given that the proportion of foreign currency debt in the total indebtedness of the Canadian corporate sector, increased from \$7.4 billion in 1979 to \$20.4 billion in 1981, the depreciation of the Canadian dollar during the recent years has swollen interest expenses of the corporate sector. High interest rates, the depreciated dollar, and increased leverage together account for the recent record increase in the numerator of the ratio between interest expenses and pre-tax earnings.

The international inflation experience of the 1970s, the current inflation in Canada, and the Monetary and Fiscal Policies adopted in the United States and Canada are easily admitted as the main determinants of the current level of interest rates and of the depreciated value of the Canadian dollar. What is less evident is the cause of the increased ratio between total liabilities and total equity in the corporate sector.

Between 1962 and 1981, the ratio of total liabilities to equity in the industrial corporate sector in Canada showed a steady increase. At the end of 1962, it stood at 0.91. In 1972, it reached 1.07 and, by the end of 1981, it was 1.42.⁽²²⁾ The increase in the 1970s was much greater than what occurred in the 1960s. Inflation was also much greater in the 1970s. For example, the implicit price index on Gross National Expenditures increased from 72.4 in 1961 to 100 in 1971. Between 1971 and 1981, this price index rose from 100 to 245. This suggests that there is a relationship between inflation and the erosion of the equity base of the corporate sector. Indeed, the combination of inflation and taxation largely determines the extent to which individuals and banks will be willing to buy and hold stocks of the corporate sector.

A corporation can be thought of as an agent for the transformation of household savings into revenue producing, real capital goods. But for households to channel their savings into corporations, the after-tax rate of return on real corporate capital must be as great as the after-tax return they could acquire directly on their tangible assets. It will be worth our while to look closely at how differently the tax system affects corporations and individuals. The tax system discriminates against the acquisition of real assets by corporations and encourages direct acquisitions by households when inflation is high. Corporations generally must pay taxes on the net returns from investments in structures, plant and equipment, producers' durable equipment, and inventories. Households in contrast, can acquire a wide range of tangible assets as investment against which taxes need not be paid, or can be deferred almost indefinitely. This includes homes and land. In addition, no taxes are paid against the stream of services provided by consumer durable goods.

When inflation and taxable investment returns are low, the differential tax treatment between corporations and households probably does not distort resource flow very much. But when inflation and taxable returns on investment rise, the differential between household returns on tangible assets and after-tax returns on real corporate capital widens appreciably. For example, suppose inflation is zero, the pre-tax return on a marginal corporate investment is 4 per cent and home prices are stable. If the marginal tax rate on corporations is 50 per cent, the after-tax return on the marginal corporate investment would be 2 per cent, which would exceed the return on a home.

But now suppose inflation rises to 10 per cent. It can be shown that the pre-tax return on the same marginal corporate investment that had yielded 4 per cent when there was no inflation will then yield 14 per cent. The after-tax yield on this investment, of course, would be 7 per cent. If home prices rise at the inflation rate, the after-tax return on a home would be 10 per cent because no taxes are paid on capital gain on homes.

The discrimination in taxation against corporations during inflationary times reduces the attractiveness of investments in corporations. This in turn should tend to erode the equity base of corporations.⁽²³⁾

There are strong indications that in Canada, the combination of inflation and taxation has had important effects on the composition of the total wealth of the household sector. For example, between 1961 and 1981, the direct cumulative annual acquisition of physical capital by households amounted to \$128,997 million. During the same period their direct cumulative annual acquisition of corporate stocks was negative and amounted to -\$14,500 million. But their indirect cumulative acquisition of stocks via Canadian private financial institutions like banks, near-banks, pension funds, (encouraged by registered pension plans) insurance companies, and other institutions was positive, and amounted to \$27,960 million. Thus one can say that their total acquisition of stocks, amounting to \$13,460 million, is still lower than their direct cumulative acquisition of physical capital.⁽²⁴⁾

In the corporate sector, the combination of inflation and taxation reduced the demand for corporate stocks and decreased the supply of them. The net effect was an increasing trend in the debt-equity ratio and a lessening in the importance of new stock issues in favour of cumulative retained earnings in the equity base. Back in 1962, cumulative retained earnings made up 54 per cent of total equity of the corporate sector. By the beginning of 1978, cumulative retained earnings represented more than 69 per cent of total equity. In the last few years, the demand for stocks decreased dramatically, due to rising inflation, record high interest rates, and a severe recession. It became costly and difficult to issue new stocks (except in 1978 due to tax provisions). When, in 1981, profits decreased and with them total retained earnings,⁽²⁵⁾ the ratio of total debt to equity jumped from 1.26 in 1980 to 1.42. The matter of interest payments on loans has its part to play in encouraging corporations to issue debt instruments instead of equity stocks; interest expenses are deductible from before-tax income, and dividends have to be paid from after-tax earnings.

Today's larger debt is of much shorter term to maturity than before, due to the demise of long-term capital markets in North America. The ratio of long-term debt to short-term debt has been decreasing since 1962. But the drop that occurred after 1979 was extreme. At the end of 1978, the long-term debt of the corporate sector represented 200 per cent of their short-term debt; in 1981, it represented only 120 per cent.⁽²⁶⁾ Again this phenomenon is related to high and volatile interest rates and to fluctuating inflation rates.

The liquidity strain of the corporate sector, caused by two recent factors, high interest rates and a severe recession, is worsened by two more long-term factors: 1) the shortening maturity of outstanding debt; and 2) the erosion of the equity base of Canadian corporations. In this situation, the rapid increase in the cost of money has been sufficient to create liquidity problems.

There is a parallel with the United States' corporate sector⁽²⁷⁾ but one important trend emerged there in the first quarter of 1982 that augurs well for long-run profit performance.

Falling inventory replacement costs, owing to price reductions, are reducing the taxable unrealized gains on inventories, in the United States, contributing to an increased cash flow. Moreover, a prolonged period of price deflation can result in unrealized inventory losses that defer taxes on profits. This factor is not yet present in the Canadian economy, because of our inflation rate. The liquidity situation here is all the more dramatic.

It is apparent that the Canadian corporate sector will have extreme difficulty in restructuring its balance sheets, and it is bound to be recognized as a more risky sector than before. Full-scale reliquification always has been a necessary ingredient for sustained recovery. With prolonged weakness in the bond and stock markets, these sources of funds essentially have been closed to much of the business sector, forcing corporations to borrow heavily at chartered banks on a short-term basis. But short-term debt is costly and must be rolled over more frequently. There is a lack of funding for repayments of short-term debt by long-term issues, and there has been no lengthening of debt maturities. The current recession is one of the major causes of the liquidity problem of the corporate sector, and, in its own right, the current liquidity situation may become a factor that prolongs the recession. The re-establishment of a long term capital market is thus of primary importance for a strong recovery. A long term capital market would also reduce the risk in the banking sector in Canada. Not only would this permit a reduction of short term debt, it might allow a decrease in the leverage ratios in both the corporate sector and the banking system.

The Committee views this corporate liquidity problem with concern, for the effect it has on the economy and because of its implications for Canadian banks. The Minister of Finance should keep this problem in mind in his formulation of economic policy, particularly as it applies to taxation.

For all these reasons the Standing Committee on Finance, Trade and Economic Affairs requests a reference from the House of Commons to conduct an immediate inquiry into the full causes of the decline in the long-term capital market in Canada, and to recommend policies to ensure the adequacy of long term debt and equity capital to fund future economic growth. In addition, the Minister of Finance should take immediate and appropriate steps to encourage the corporate sector to issue equity capital in the place of debt instruments it has come to rely on.

Comparisons with the United States

It should be useful to explain briefly why this same volatility of interest rates and a similar economic situation did not have the same effect on the growth of bank assets in the United States. The comparison between Table 2.2, dealing with the Canadian economy, and Table 2.5, dealing with the American economy, is quite revealing in this regard.

Concerning the demand for funds in the United States, the share of financing obtained by the major economic sectors remained relatively constant in 1981 as compared to 1980.⁽²⁸⁾ Actually, the more significant changes in the composition of the demand for funds in the United States of households dropped from 44.0 per cent to 27.3 per cent. (We should point out, though, that the American Government's financing needs are largely met through the issue of medium- and long-term bonds and Treasury bills, i.e. through financial instruments that are transacted on a very broad market.)

Table 2.5

USES AND SOURCES OF FUNDS RAISED IN U.S. CREDIT MARKETS BY NON-FINANCIAL U.S. SECTORS

(billions of dollars)

	1978	1979	1980	1981	in % of Total			
					1978	1979	1980	1981
SOURCES OF FUNDS								
Public Sector								
U.S. government	\$ 53.7	\$ 37.4	\$ 79.2	\$ 87.3	13.5	9.6	21.3	22.2
State and local governments	20.9	18.4	25.3	22.5	5.3	4.7	6.8	5.7
<i>Sub-total</i>	74.6	55.8	104.5	109.8	18.8	14.4	28.1	27.9
Private Domestic Sectors								
Household sector	164.3	170.6	101.7	106.7	41.5	44.0	27.3	27.1
Business sector	123.5	139.6	136.4	145.8	31.2	36.0	36.6	37.1
<i>Sub-total</i>	287.7	310.2	238.1	252.5	72.7	80.1	64.0	64.2
Foreign Sector	33.2	21.0	29.3	30.8	8.5	5.5	7.9	7.8
Total funds raised in U.S. markets by non financial sectors	395.5	387.0	371.9	393.1	100.0	100.0	100.0	100.0
SOURCES OF FUNDS								
Total funds raised less equities advanced by:	396.3	394.0	357.0	399.9	100.0	100.0	100.0	100.0
1—Public agencies and foreign	65.2	25.8	49.1	46.9	16.4	6.5	13.7	11.7
2—Private domestic financial intermediation	302.4	292.4	270.3	309.6	76.3	74.2	75.7	77.4
Commercial banking	128.7	121.1	99.7	103.3	32.4	30.7	27.9	25.8
Savings institutions	73.5	55.9	58.4	27.9	18.5	14.2	16.4	6.9
Insurance and pension funds	75.0	66.4	79.8	83.8	18.9	16.8	22.4	20.9
Other finance	25.2	49.0	32.4	94.5	6.4	12.4	9.1	23.6
3—Net direct lending	28.7	75.7	37.6	43.5	7.2	19.2	10.5	10.8

Source: *Federal Reserve Bulletin*, March 1982.

With regard to the supply of funds, one must remember that interest rates in the United States were as volatile as in Canada, and that American investors also reacted by demanding high interest rates on short-term investments. In the United States, however, interest rate levels for a number of bank and near bank deposits have been governed for quite some time by regulations of the Federal Reserve Board. Furthermore, until recently, American laws did not permit deposit institutions to receive term deposits for a shorter term than thirty days.⁽²⁹⁾ These regulations are being phased out after the passing in 1980 of the Depository Institutions Deregulation and Monetary Act, resulted in a boom in Money Market Funds. These are investment funds financed by the issuing of shares whose rate of yield matches that of money market instruments such as Treasury bills, commercial paper, etc.

In Table 2.5, these Money Market Funds are included in the category of private domestic financial intermediation, under the heading other finances. The institutions supplying them were responsible for 6.4 per cent of the financing of the American economy in 1978, and 23.8 per cent in 1981. The commercial banks⁽³⁰⁾ share of total financing dropped from 32.4 per cent in 1978 to 25.8 per cent in 1981.

The financial difficulties experienced by U.S. savings institutions in 1981 meant they contributed less to financing the economy: only 6.9 per cent in 1981 compared to 16.4 per cent in 1980. The mismatch of their assets (e.g. 25-year mortgages) and their liabilities (e.g. one-year deposits) resulted in extremely weak yield rates on their average assets.

To summarize, in the United States, volatile interest rates and the economic situation produced a strong government demand for funds and attracted a large supply of funds through the money market. In contrast, the strong demand in Canada came mainly from business, and it had to be financed by bank loans.

The trouble American and Canadian banks have had in adjusting to the volatility of interest rates leads us quite naturally to our next section. There we will see what that volatility had done to the spreads between interest rates on assets and liabilities of Canadian banks.

2.3 INTEREST RATE VOLATILITY AND BANK SPREADS

Considerable concern has developed as to whether banks have any control over interest rates. This topic was dealt with at some length during the hearings with the conclusion that the level of interest rates is not influenced by chartered banks but rather by supply and demand, government policy and domestic and international conditions. The most important factor affecting bank profits is the interest rate spread. This spread is influenced over short term periods by the rapid change in interest rates and not by the actual level of interest rates themselves.

To the chartered banks, money is a commodity. Without it they could not function any more than could a house builder without commodities such as lumber. In other words, banks rent out to borrowers, for a fee, the money they rent from depositors. This is the spread. This spread, more commonly referred to as an interest rate spread, is the difference between the interest rate at which they lend the money to the borrower and what they pay the depositors. On average, the interest rate spread is the difference between the average cost of deposits and the average yield on loans. When the average interest rate spread is applied to all the banks' loans and investments it generates the banks' net interest revenue which, as previously discussed, comprises approximately 80% of a bank's total revenue.

How interest rate volatility affects bank profitability

Banks derive their deposits in Canada from a multitude of sources: savings deposits, chequing deposits, demand deposits, personal term deposits at fixed rates for terms over one year, short term personal term deposits for periods of 30-90 days, and many more. In addition, they also lend these deposits in an equally large number of ways, as outlined in previous sections. For a bank, it would be ideal if both loan and deposit terms to maturity matched perfectly, so that for every deposit received the bank lent the money out under identical conditions, taking a spread to cover the cost of providing the service. However, in the real day-to-day operations of a bank, this does not happen.

Banks do not make all their loans at fixed rates for fixed terms, but rather have a mixture of the two: some loans are made at a fixed rate for a fixed term while others are at floating rates. Besides, depositors can move money from one kind of deposit to another and the rate of interest charged on floating rate loans may change. Over time, the average cost of deposits and the average yield on loans will change to reflect the new level of interest rates. However, during the period of change, the cost of deposits and the yield on loans do not change at the same speed.

When interest rates are rising quickly, the yield on prime-related loans increases with very little lag because these loans are at floating rates. Term deposit rates also rise but the new rate only applies immediately to the new deposits. Thus, the average cost of deposits lags behind the increase in loan yield, because it requires more time for existing deposits to mature and be renegotiated at the new rate. The result is a temporary widening of spread and a temporary increase in the profitability of the bank. This is often referred to as a bank's inventory profit. Of course, when interest rates decline quickly, the banks' floating rate loans can be adjusted quickly to the lower interest rates, but there are commitments to depositors to pay the old, higher, deposit rates until the deposits mature. The bank is left with an inventory of high cost deposits on which it could incur a loss until the old deposits mature and could be renegotiated at the lower prevailing cost of deposits. These are referred to as inventory losses.

It is virtually impossible for a bank to roll its entire deposit base over every day and it is questionable whether the bank would be servicing its customers adequately if they required all depositors to renew their deposits that frequently.

Long-term trends in bank interest rate spreads

The impact on bank profits and bank spreads of changes in short-term interest rates are difficult to ascertain because, as noted, the banks' average cost of funds and average yields eventually come into balance with the new level of interest rates. As illustrated in Table 2.6,

Table 2.6
CANADIAN CHARTERED BANKS
NET YIELD-COST SPREAD ON EARNING ASSETS

	Years ended October 31										
	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
	(in percentage)										
Yield on Average Loans	7.77	7.18	8.24	10.55	10.06	9.64	9.13	9.65	11.99	13.67	16.76
Yield on Average Securities*	5.81	5.58	5.92	7.00	7.42	8.02	8.24	8.86	11.54	13.60	16.72
Yield on Average Earning Assets*	7.43	6.86	7.86	10.04	9.71	9.45	9.01	9.51	11.86	13.64	16.84
Cost of Average Deposits	4.12	3.68	4.60	6.80	6.12	5.98	5.66	6.15	8.66	10.53	13.56
Net Yield Cost Spread*	3.22	3.18	3.26	3.24	3.59	3.47	3.35	3.36	3.20	3.11	3.28

* Adjusted on a taxable equivalent basis. This "grosses-up" tax-exempt income to make the spreads comparable to the period prior to 1976.

Source: Chartered bank financial statements.

the chartered banks' net yield-cost spread (the average yield on loans and securities less the average cost of deposits) has varied, in the period 1971 to 1981, to a high of 3.59 per cent in 1975 from a low of 3.11 per cent in 1980. This rose again to 3.28 per cent in 1981.

If the net yield-cost spread is compared to the level of interest rates in each of the ten years, as illustrated by the banks' average yield on loans, it can be quickly observed that the changes in net yield-cost spread do not relate in any coherent way to the actual level of interest rates. In fact, as interest rates rose from 1977 to 1981, the banks' net yield-cost spread actually decreased from 3.35 per cent in 1977 to 3.28 per cent in 1981.

Quarterly trend in interest rates and bank spreads

The relationship between bank earnings and interest rate movements is not easily discernible on an annual basis because, over time, the yield on average loans and the cost on average deposits outstanding tend to reflect the changes in interest rates throughout that period. A shorter period must be analyzed, if we are to get a clearer picture of the relationship between the changes in bank interest rate spreads and the movements in interest rates.

The three-year period beginning in 1979 and ending in 1981 has been chosen, to be broken down into three-month periods corresponding to the banks' reporting quarters of January 31st, April 30th, July 31st, and October 31st. This period was selected not only because it was the most recent three-year period, but because it contained the most volatile interest rate movements of any such period over the last ten years.

Table 2.7 outlines the average, during each three-month period, of two key interest rates, namely, the average prime lending rate and the average 90-day bank deposit rate. As illustrated in Table 2.7 the bank prime lending rate changed only very marginally throughout most of 1979; however, towards the end of that period, it began to rise rapidly and, on average, reached a peak of 15.83 per cent in the banks' quarter ending April 30, 1980. Subsequently, the prime rate began to fall quite sharply, and dropped to an average of 12.42 per cent by the fourth quarter of 1980. Interest rates then began to rise very sharply and, by the first quarter of 1981, the bank prime lending rate had moved to an average of 16.75 per cent, a gain of 4.33 per cent in the three-month period which was the largest increase in the average prime rate in any three-month period in over a decade.

The spreads between various lending rates and the cost of deposits must be analyzed. Three principle spreads to be considered are as follows:

- i) The difference between the prime lending rate and the non-chequable savings deposit rate;
- ii) The difference between the prime lending rate and the 90-day bank deposit rate;
- iii) The "inventory spread", otherwise referred to as the funding spread, (and that the banks spoke of in their testimony as the "lag" factor) is represented by the bank prime lending rate LESS the 90-day bank deposit rate which prevailed 60 days before. The difference represents the interest rate spread a bank could earn assuming that all its

Table 2.7
CANADIAN CHARTERED BANKS
QUARTERLY INTEREST RATE SPREADS AND PROFITABILITY

	1979				1980				1981			
	1	2	3	4	1	2	3	4	1	2	3	4
<i>Interest Rates</i>												
Average Prime	11.67%	12.00%	12.16%	13.42%	15.00%	15.83%	13.08%	12.42%	16.75%	18.08%	20.17%	21.33%
Change	—	+0.33%	+0.16%	+1.26%	+1.58%	+0.83%	-2.75%	-0.66%	+4.33%	+1.33%	+2.09%	+1.16%
Average 90 Day Bank Deposit Rate	10.71%	11.13%	11.31%	12.85%	13.85%	14.80%	10.93%	11.01%	15.71%	17.11%	19.52%	19.99%
Change	—	+0.42%	+0.18%	+1.54%	+1.00%	+0.95%	-3.87%	+0.08%	+4.70%	+1.40%	+2.41%	+0.47%
<i>Interest Rate Spread</i>												
<i>Average in Period</i>												
Prime Rate Less Savings Deposit Rate	+2.50%	+2.50%	+2.67%	+3.08%	+3.00%	+3.42%	+2.25%	+2.92%	4.58%	4.42%	3.75%	3.08%
Prime Rate Less 90 Day Bank Rate	+0.96%	+0.87%	+0.85%	+0.57%	+1.15%	+1.03%	+2.16%	+1.40%	+1.04%	+0.97%	+0.65%	+1.34%
Inventory Spread Prime Less 90 Day Bank Rate with 60 Day Lag	+1.65%	+1.18%	+0.96%	+1.85%	+1.58%	+1.00%	-1.42%	1.77%	+5.00%	+0.99%	+2.44%	+0.71%
<i>Bank Spread</i>												
After-tax return on Average Assets	0.64%	0.48%	0.51%	0.60%	0.51%	0.49%	0.46%	0.58%	0.67%	0.54%	0.58%	0.51%
Net Yield-Cost Spread: All Banks*	3.62%	3.10%	3.14%	3.22%	3.08%	3.08%	3.04%	3.33%	3.51%	3.14%	3.15%	2.92%

* Adjusted on a taxable equivalent basis.

Source: Chartered bank quarterly financial statements Bank of Canada Review: Item B14020 for Prime Rate and B14043 for 90-day bank deposit rate.

deposits at the time of the prime rate change were bought 60 days before at either the lower or higher interest rates prevailing at that time.

In the case of the first spread, the prime rate less the non-chequable savings deposit rate, there was very little change throughout most of 1979 and the first quarter of 1980. In the second quarter of 1980, the spread rose to 3.42 per cent from 3.00 per cent and then fell to 2.55 per cent in the third quarter of 1980. The prime rate had declined precipitously during that period. The most dramatic change in this spread occurred in the first quarter of 1981, when the prime lending rate rose very rapidly. It caused this spread to increase to -4.58 per cent on average in the first quarter of 1981 and then to decrease marginally to 4.42 per cent by the second quarter of 1981, and again to 3.08 per cent by the fourth quarter of 1981.

The second spread, is the bank prime lending rate less the 90-day bank deposit rate. This spread does not tend to show the actual spread that the banks have at any single moment, since it reflects the current spread banks earn on prime-related loans funded with the 90-day bank deposit rate. In order for a bank to achieve this spread, it would be required to change the interest rates on all prime-related loans and 90-day deposits immediately. Since banks acquire the deposits for different periods of time, this is not achievable.

The third spread discussed is the banks' representative "inventory spread". This is the most important spread, since it illustrates the lag that occurs on changes in deposit costs when interest rates change rapidly. This spread tends to exaggerate the actual "inventory spread" changes because the banks alter the average term of bank short-term paper, depending on market conditions. Generally, short-term deposits have an average term to maturity ranging between 35 and 50 days. Nonetheless, this spread provides a very reliable indicator of the direction that bank spreads take when interest rates change, particularly when they change very rapidly. As illustrated in Table 2.7, the bank prime lending rate less the 90-day bank deposit rate with a lag of 60 days ranged between 1.18 per cent and 1.90 per cent from the first quarter of 1979 to the second quarter of 1980 (except for the third quarter of 1979 when the average spread declined to 0.96 per cent). The wide fluctuations in this rate began in the third quarter of 1980 when interest rates declined steeply. The sharpest change in this spread occurred in the first quarter of 1981, when the prime lending rate rose very dramatically, causing the inventory spread to rise from 1.77 per cent to 5.00 per cent on average during the first quarter of 1981. But then, as the lower-cost deposits rolled over, on average, to the higher prevailing cost of deposits, and the bank prime lending rate slowed its rate of ascent, the inventory spread declined very dramatically to 0.99 per cent on average in the second quarter of 1981. The bank prime lending rate then began to rise rapidly once again in the third quarter of 1981, and in response the average spread rose to 2.44 per cent before declining again to 0.71 per cent in the fourth quarter of 1981.

It is then necessary to relate the banks' net yield-cost spread as previously discussed and the banks' quarterly return on average assets to the quarterly changes in interest rates. The net yield-cost spread is the difference between the average yield on the banks' average earning assets and the average cost of bank deposits. The return on average assets is the after-tax return on average assets for the total Canadian banking system, including domestic and international operations.

In the third quarter of 1980, when the prime lending rate declined substantially, the net yield-cost spread for the banking system declined to 3.04 per cent on average in the third

quarter of 1980, down from 3.08 per cent in the second quarter of 1980. When the prime lending rate rose dramatically in the first quarter of 1981 the net yield cost spread rose to 3.51 per cent on average in the first quarter of 1981, up from 3.33 per cent in the fourth quarter of 1980. Finally, the after-tax return on average assets during the period rose equally sharply to 0.67 per cent, up from 0.58 per cent in the fourth quarter of 1980.

It should be noted that the second quarter of 1981 saw a dramatic decline in the net yield-cost spread to more normal levels that existed over the three-year period, and as well, the after-tax return on average assets also declined back to more normal levels.

Interest rate spreads on specific loans

In the hearings, the question was asked repeatedly why banks charge such high interest rates on certain loans, particularly personal loans and, as previously discussed, why the spread between the prime lending rate and the non-chequable savings deposit rate increased so dramatically in 1981.

The discussion on bank interest spreads up until this point has focussed on the banks' pooled spreads, or, in other words, the average interest rate spreads the banks earn from all loans. Table 2.8 illustrates the interest rate spreads that banks earn on a segmented basis in Canada. This analysis assumes that all prime-related loans (mostly business) are funded with 90-day bank deposits receipts and that consumer and mortgage loans are funded with non-chequable savings deposits. In other words, the non-chequable savings deposit rate is being compared to the average yield on the banks' consumer assets rather with the prime lending rate. It should be noted that non-chequable savings deposits, as stated in Table 2.1, totalled \$47.2 billion as of October 31, 1981, compared with \$49.4 billion for total consumer assets, excluding mortgage loans in subsidiaries of \$14.5 billion. These should be excluded because the subsidiaries have funded their mortgages with term deposits rather than with savings deposits. Without them, a comparison can be made between non-chequable savings deposits and the consumer portfolio because they are similar in size.

In each case, a twelve-month average of the interest rates is used to coincide with the chartered banks' fiscal year ending October 31.

Table 2.8 illustrates the spread banks have earned on business loans to their best clients, made at the prime lending rate and funded at the time of the loan with a 90-day bank deposit. These interest rates are used because banks have typically used short-term deposits to fund the marginal increase in business loans. The spread between the average prime rate and the 90-day deposit rate increased from 0.97 per cent in 1977 to 1.44 per cent in 1980, and then declined, in 1981, to 1.10 per cent. However, it should be noted that banks were required at that time to keep reserves on 90-day deposits of 4 per cent. This adds to the cost of the deposit for the bank because it will not receive any compensation for these reserves. In effect, this raises the cost of the deposit to the bank. After deducting the reserve cost of 0.31 per cent, the net spread as of October 31, 1977, was 0.66 per cent. It should be noted that the reserve cost is calculated at the prevailing interest rate, because, as interest rates rise, so do reserve costs. Therefore, as of October 31, 1981, after adjusting for reserve costs, the net spread between the prime rate and the 90-day deposit rate had actually declined to 0.38 per cent.

When this analysis is extended to the consumer sector an even more dramatic situation is revealed. Several banks testified during the hearings that the profitability on their consumer portfolio had deteriorated drastically as interest rates rose to record levels. The Bank of Nova Scotia, which has its domestic asset mix heavily consumer oriented, stated in its brief that the "the Bank's concentration in this sector (consumer) has triggered a severe decline in its domestic profits because the interest rate paid on these loans, being fixed, cannot respond as rapidly to deposit cost fluctuations as can floating-rate loans." In Table 2.8, the average yield on consumer assets for the Royal Bank of Canada for the period 1977 to 1981, including personal loans, credit card balances, and mortgages, is compared to the average non-chequable savings deposit rate in each of these years. In other words, the non-chequable savings deposit rate is being compared to the average lending rate on personal loans and mortgages. It should be noted that this yield always rises more slowly than the yield on the prime rate loan portfolio, because the loans are made for longer terms and at fixed rates. As illustrated in Table 2.8, the difference between the average yield on consumer assets and the average non-chequable savings deposit rate decreased from 5.22 per cent in 1977 to a negative spread of -0.87 per cent in 1981. After the adjustment for the cost of reserves that followed the rise in interest rates, the net spread declined from 4.97 per cent to -1.48 per cent in 1981.

Table 2.8
SEGMENTED BANK DOMESTIC INTERET RATE SPREADS

	Prime-Related Years ended October 31				
	1977	1978	1979	1980	1981
Average Prime Rate	8.70%	9.14%	12.31%	14.08%	19.08%
Average 90-day deposit rate	7.73%	8.25%	11.47%	12.64%	17.98%
Difference	0.97%	0.89%	0.84%	1.44%	1.10%
Reserve Cost*	(0.31%)	(0.33%)	(0.46%)	(0.51%)	(0.72%)
Net Spread	0.66%	0.56%	0.38%	0.93%	0.38%
	Consumer Years ended October 31				
	1977	1978	1979	1980	1981
Average Yield on Consumer Assets**	11.55%	11.24%	11.77%	12.59%	14.26%
Average Non-Chequable Savings Deposit Rate	6.53%	6.50%	9.63%	11.19%	15.13%
Difference	5.22%	4.74%	2.14%	1.40%	(0.87%)
Reserve Cost*	(0.25%)	(0.26%)	(0.39%)	(0.45%)	(0.61%)
Net Spread	4.97%	4.48%	1.75%	0.95%	(1.48%)

Source: Bank of Canada *Review* and Royal Bank of Canada.

* Cost of maintaining reserves with the Bank of Canada is based on the interest "give-up" on the 4% reserve required (under the old Bank Act) on these deposits. The reserve has been calculated based on the average 90-day deposit rate for prime-related and the average savings deposit rate for consumers.

** Royal Bank of Canada includes personal installment loans, credit card balance and mortgages.

Although the spread between the prime lending rate and the non-chequable savings deposit rate did rise in 1981 to over 4.0 per cent from the mid-1970s range of 2.0 per cent to 2.5 per cent, the spread cannot be taken in isolation, and must be related to other types of business that the bank conducts. The spread between the prime rate and the non-chequable savings deposit rate has been increased, in effect, to mitigate the severe contraction in interest spreads experienced on other services within the consumer sector.

Table 2.9
PRIME LENDING RATE COMPARED TO THE CONSUMER LOAN RATE

	1977	1978	1979	1980	1981	Change from 1977 to 1981
Prime Lending Rate	8.25%	11.00%	14.75%	12.75%	20.00%	+11.75%
Consumer Loan Rate* (min.)	10.50%	10.50%	15.75%	14.75%	22.25%	+11.75%

* Source: The Royal Bank of Canada.

In Table 2.9, the bank prime lending rate and the consumer loan rate of the Royal Bank of Canada are compared as of October 31 for the years 1977 to 1981. Although the two interest rates had not changed at precisely the same time, the total increase in each rate from 1977 to 1981 was exactly 11.75 per cent. Thus there is no evidence to indicate that consumer loan rate rose faster than loans to business.

2.4 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The past decade can be characterized as one of steadily rising interest rates. Especially since 1979/80, they have been extremely volatile, making a significant impact on financial markets and the banks.

Increasingly, bank deposits have become fixed-term deposits, but of short maturity. This is a direct result of volatile interest rates. Reacting to this volatility, savers demand shorter term deposits. Borrowers, in turn, do not want to commit themselves to high interest rates for long periods, and thus the term to maturity has fallen on bank loans. On their part, banks try to match the term to maturity of bank loans to their shorter term deposits; for example, five year mortgages have virtually disappeared, because five year term deposits have all but disappeared. Banks have reduced the extent to which they take risks with respect to interest rates: this intermediation risk has been shifted, in many cases, to borrowers. Such a move protects bank depositors and shareholders, but can result in serious problems for corporate and household borrowers.

Caution also characterizes behaviour in the long term capital market, now all but disappeared because of inflation and volatile interest rates. The severe recession and the accompanying fall in corporate profitability have seriously reduced the amount of internally-generated corporate financing. At the same time, corporate financing needs have increased

significantly. Corporations spent heavily on capital equipment in 1980 and 1981, but more especially, in 1981 in purchasing financial assets in mergers, notably in the oil and gas industry. Moreover, large capital outflows restricted the funds available for the corporate sector. The upshot of all this was that corporations required very large amounts of external financing in 1981. Essentially, the only avenue open to them was the banks. And because of the changing term structure of bank deposits, the corporate sector had to rely on short-term business loans.

Therefore, the large increase in bank assets in 1981, particularly as this relates to the business sector, was mainly due to the demand for credit. The banks expanded to fill the gap in business financing as other sources of financing disappeared. This higher level of lending activity was made possible by the health of the system and resulted in an increase in overall profits.

Individual borrowers in the household sector have reacted quite differently to high and volatile interest rates, than did corporate borrowers. With little growth in real disposable personal income, this sector was reluctant to commit itself to increased debt.

Thus the growth in the assets of banks and the change in the composition of the banks' asset portfolios reflect the changing demands for credit from the various sectors of the economy. In 1981, demand for credit was down among households and up in corporate business.

It must be said that, although the banks have supported the current needs of the corporate sector, this could prove to be expensive in the longer term. The corporate sector has become increasingly illiquid. Corporate reliance on debt financing, and in particular short-term debt financing, at a time of high interest rates and decreasing cash flow, has undermined the ability of many companies to meet their debt obligations.

The liquidity strain of the corporate sector, caused by two recent factors, high interest rates and a severe recession, is worsened by two more long-term problems: 1) the shortening maturity of outstanding debt; and 2) the erosion of the equity base of Canadian corporations. In this situation, the rapid increase in the cost of money has been sufficient to create a liquidity crisis which is the worst experienced by the corporate sector in the post-war period. This crisis may in itself, prolong the current recession.

Inflation, taxation, and fiscal and monetary policies have all combined to hinder the working of the capital market. This scarcity of long-term capital is also a significant problem for the non-financial corporate sector. This sector has become increasingly reliant on debt financing and, recently, on short-term debt, precipitating a serious deterioration in corporate leverage ratios.

The liquidity crisis, discussed above, is a major problem for the corporate sector and the economy as a whole; not only does it aggravate the current recession, but it also affects resource allocation. In addition, it could have implications for the future health of the banking system. Although this problem is a long-term one, a number of measures can be applied quickly to help resolve this problem, and this situation can only reinforce the need for a healthy banking sector and for a renewal of the sources of long-term capital. Thus, the Committee recommends that:

1. The Standing Committee on Finance, Trade, and Economic Affairs would request a reference from the House of Commons to conduct an immediate inquiry into the full causes of the decline in the long-term capital market in Canada, and to recommend policies to ensure the adequacy of long-term debt and equity capital to fund future economic growth. In addition, the Minister of Finance should take immediate and appropriate steps to encourage the corporate sector to issue equity capital and rely less on loans, and other debt instruments.

Banks are not responsible for the level of interest rates; the supply and demand of the market place, as affected by the actions of the Bank of Canada and conditions in international financial markets, determine this level. Banks do, however, establish actual interest rates on specific loans, according to different levels of risk. For example, banks charge higher rates on loans to new companies than they do on loans to well-established businesses.

For a given level of assets, the dollar value of bank profits is directly influenced by interest rate spreads. These spreads are determined by 1) the difference between interest rates on various assets and liabilities; 2) differences amongst the terms-to-maturity of various assets and liabilities; and 3) the proportion of floating rate and fixed rate assets and liabilities. Spread is essentially a combination of these three factors; thus it is measured by the difference between realized interest revenue and realized interest expense, divided by average total assets. Thus rapidly and irregularly changing interest rates can temporarily alter spreads for a short period of time and result in temporary inventory profits or losses for the banks.

FOOTNOTES

- (1) Annual report of the Governor of the Bank of Canada, 1980, published February 27, 1981, p. 18.
- (2) Bank of Canada Review, various issues.
- (3) Bank of Canada Review, May 1982, p. 11, Graph IV. Data are not available on the composition of fixed-term deposit stock according to the length of term; this is why we use the data showing the composition of the increase of fixed-term deposits.
- (4) All these figures are drawn from the Bank of Canada Review and from publications of the Canadian Mortgage and Housing Corporation.
- (5) Canada, Department of Finance, Economic Review, 1980.
- (6) Bank of Canada Review.
- (7) Bank of Canada Review.
- (8) Certain lenders have overcome this difficulty by offering variable rate mortgages with equal monthly payments. Several new types of mortgage contracts are being studied by private and public financial institutions in Canada.
- (9) Bank of Canada Review.
- (10) Statistics Canada, National Income and Expenditures Accounts, 13-201.
- (11) Statistics Canada, Financial Flow Accounts, 13-002.
- (12) Canada, Department of Energy, Mines and Resources, National Energy Program Update, Canada, p. 48.
- (13) Statistics Canada, National Income and Expenditure Accounts, 13-201.
- (14) Bank of Nova Scotia, Monthly Review, November and December 1981 and Statistics Canada, Industrial Corporations, 61-006.
- (15) See: Federal Reserve Bank of New York, Innovations in the Financial Markets, Quarterly Review, Winter 1981-82, Vol. 6, No. 4.
- (16) From 1976 to 1981, business bank loans (in Canadian dollars and foreign currencies) plus bankers' acceptances accounted for 91.8% of overall business short-term financing (see Chapter 5).
- (17) Bank of Montreal, Recent Trends in Corporate Liquidity, June 23, 1982. See also the studies referred to in footnote 21.
- (18) Statistics Canada, preliminary figures.
- (19) Bank of Montreal (1982).
- (20) Pitfield Mackay Ross Ltd., Economics Department, Earnings and Investment—Capitalization and Solvency, June 1982, p. 6.
- (21) These studies include: 1) Bank of Montreal, op. cit.; 2) Pitfield Mackay Ross, op. cit.; 3) Guy Glorieux, «L'environnement financier au Canada; au coeur de l'impasse», Banque Nationale du Canada, 22 juin 1982; 4) The Toronto Stock Exchange, "Discussion Paper on Government action to stimulate an investment-level Recovery", June 1982; 5) Wood Gundy, "Forecast, The Canadian Economy Through 1984", June 1982; 6) Wood Gundy Ltd., Forecast—The Canadian Economy Through 1984", June 1983; Toronto, December 1981; and 7) Wood Gundy Ltd., The Canadian Economy in 1982 and Beyond, Toronto, February 1982 and revised May 1982.
- (22) Wood Gundy, op.cit., p. 11.
- (23) J.D. Paulus, "Inflation and the Corporation", Goldman, Sachs and Co., The Conference Board, Feb. 24-25, 1982, N.Y., p. 6-7.
- (24) Statistics Canada, System of national accounts, Financial Flow Accounts, No. 13-563 occasional and Financial Flow Accounts 13-002. It should be noted that in Canada, financial flow accounts consider the household sector as the residual sector—this means that errors of measurement in other sectors may be

reproduced in the data of the household sector. This is why, for example, in that sector the cumulative acquisition of stocks between two years is not equal to the difference in stocks between these two years.

- (25) Undistributed corporate profits amounted to \$18,597 million in 1979, \$18,805 million in 1980 and \$13,764 in 1981.
- (26) Bank of Montreal, "Recent Trends in Corporate Liquidity", June 1982, p. 13.
- (27) S. Lovestead and A. Sinai, "Nonfinancial Corporate Flow-of-Funds", Data Resources Review of the U.S. Economy, May 1982, p. 1.143-1.151; A Sinai, "Economic Policy and business Liquity", Data Resources Review of the U.S. Economy, June 1982, p. 1.9-1.25.
- (28) For a short period analysis of the evolution of credit flows in the United States, see: "Domestic Financial Developments in Fourth Quarter of 1980", Federal Reserve Bulletin, February 1981, p. 127-133, and "Domestic Financial Developments.—the First Quarter of 1981, Federal Reserve Bulletin, May 1981, p. 410-416.
- (29) See: "Development in Banking Structure, 1970-81", Federal Reserve Bulletin, February 1982, p. 77-85.
- (30) For an analysis of bank profitability in the U.S., see "Profitability of Insured Commercial Banks", Federal Reserve Bulletin, September 1981, p. 657-669; and "Financial Performance of Small Banks, 1977-80", Federal Reserve Bulletin, June 1981, p. 48-53.

Chapter 3

Bank Capital

The confidence of the depositor is critical to the smooth functioning of a bank, since depositors provide about 95 per cent of the funding for the bank's loans and investments. That is why a bank's capital is so vital to its operations. It offers protection to the depositor if the bank incurs financial loss. If depositors perceive that a bank's potential loan risk is too high in relation to the protection offered by its capital base, they may consider the bank a credit risk. It would subsequently cost the bank more (in competitive interest rates) to attract new deposits.

3.1 SOURCES OF CAPITAL

There are three basic components of bank capital as outlined in the table below. (Total Canadian chartered bank capital amounted to \$13.9 billion in 1981). The most important component of this capital is total common shareholders' equity, otherwise referred to as the equity belonging to the owners of the bank itself. It is comprised of all common equity, including both retained earnings from prior years and the accumulated appropriations for loss account, the latter a contingency for future possible loan losses. If a bank incurred a loss on a loan for any reason, the amount would first be deducted against the appropriation for loss account and, if that were not adequate, the balance would be deducted from the bank's common shareholders' equity. (As noted, total common shareholders' equity accounted for \$9.8 billion or 71 per cent of total capital in 1981.)

The next most important type of bank capital is convertible preferred shares (which, under certain conditions, can be converted into common equity) and straight term preferred shares. These shares are called "preferred" because they are protected by a bank's total common shareholders' equity.

TABLE 3.1
COMPONENTS OF CANADIAN CHARTERED BANK CAPITAL
(\$ millions)

	Year Ended October 31, 1981
Common Equity	\$ 7,933.5
Accumulated Appropriation for Losses	1,876.8
<hr/>	
Total Common Shareholders' Equity	\$ 9,810.3
Preferred Shares	955.8
<hr/>	
Total Equity	\$10,766.1
Convertible & Subordinated Debentures	3,148.3
<hr/>	
Total Capital	\$13,914.14

The final form of bank capital is that provided by subordinated and convertible debentures. (Again, under certain conditions, the latter can be converted into common equity.) These debentures are sold to the general public, as is the case with preferred shares. Debentures are not related to, and should not be confused with, deposits left with the bank. Like preferred shareholders, owners of debentures are protected by the total equity of the bank and would not be exposed to loss until after all these other sources of capital had been completely used up.

To sum up: a chartered bank can only increase its capital two ways: through retention of earnings from the profits generated by its ongoing operations, or by issuing new shares or debentures. It is important to note that each layer of bank capital offers a different form of protection to the depositors of the bank, and, therefore, each has a separate element of risk.

Earnings Retention

Profits on their operations have always been an extremely important source of chartered bank capital. This is particularly evident in the trend in the rate of earnings retention over the last ten years.

Table 3.2
CHARTERED BANK EARNINGS RETENTION
(\$ millions)

	5 Years 1971/1975	5 Years 1976/1980	October 31 1981
After-Tax Balance of Revenue	\$ 2,119.9	\$ 4,732.6	\$ 1,720.0
Dividends Paid	750.3	1,432.9	540.6
<hr/>			
Earnings Retained	\$ 1,369.6	\$ 3,299.7	\$ 1,179.4
Dividend Payout Ratio	35.4%	30.3%	31.4%
Earnings Retention Ratio	64.6%	69.7%	68.6%

Table 3.2 illustrates the banks' increased reliance on internally generated capital since 1971. The earnings retention ratio increased from an average of 64.6 per cent in the five-year period 1971-1975 to 69.7 per cent in the five-year period 1976-1980. The retention ratio declined marginally to 68.6 per cent in 1981.

Issuance of New Capital

Canadian chartered banks have traditionally been limited as to the types of capital they could issue. Prior to the revision of the Bank Act in 1980, they were only permitted to issue common equity through rights offerings to existing shareholders, and they were, and still are, limited to issuing subordinated debentures to a maximum of 50 per cent of shareholders' equity.

Equity markets, particularly during periods of economic slow-down and uncertainty, are not always receptive to common or preferred share issues. In the brief submitted by Burns, Fry Limited, it was stated that since December 31, 1980, the chartered banks' equity and convertible debenture offerings have totalled more than \$2.2 billion, representing over 25 per cent of all such offerings in Canada. However, during this period, the market value or capitalization of all Canadian bank common shares came close to 13 per cent of the total market capitalization of all companies listed on the Toronto Stock Exchange. Given these statistics, the banks issued more than their share of the total new capital of all listed public companies in Canada. In a few cases this amount of financing was accomplished with real difficulty, causing the issues to be reduced in size from the lack of demand. Chartered banks raised close to the maximum amount available to them in this period of difficult markets.

3.2 MEASUREMENT OF CAPITAL ADEQUACY

Bank capital adequacy is measured by the ratio of total assets to capital. This ratio is more commonly referred to as a bank's leverage ratio.

$$\text{Leverage} = (\text{Total Bank Assets})/(\text{Capital})$$

Its capital is important to a bank because the volume of loans and investments it can make, or conversely, the deposits it can attract, are limited by its capital base and its leverage ratio. The size of a bank's assets is equal to the size of its capital base times its leverage ratio.

$$\text{Total Bank Assets} = \text{Capital} \times \text{Leverage}$$

If a bank is to increase its total assets, it must either raise its leverage or obtain more capital.

Definition of Bank Capital

As previously noted, there are distinct components of bank capital. The Inspector General of Banks has indicated that the capital of a bank should be considered as shareholders' equity plus appropriation for losses and all other permanent capital including

preferred shares; but there should be no investor retraction privilege or other terms that could shorten the life of the preferred shares. With regard to this definition, the Inspector General of Banks has informed the chartered banks that the maximum ratio of total assets to equity capital should be considered to be roughly 30 times for the foreseeable future. It should be stressed that the Inspector General of Banks' definition does not include subordinated or convertible debentures or some types of preferred shares, and that not all managements of the chartered banks consider this definition sufficiently comprehensive or specific.

Bank Leverage

There is no formal yardstick to determine how much capital a bank should maintain in relation to its total asset size. Using the strictest definition of capital, which is total equity, it is readily apparent that leverage (the ratio of total assets to total equity) has increased over the last ten years, from 21.5x in 1971 to 31.7x in 1981, as noted in Table 3.3. As a measurement of risk, this ratio means that the banking industry has increased the exposure of its total equity by almost 50 per cent, or, in other words, the equity must support potential losses on almost 50 per cent more assets than it did in 1971. What offsets this, however, is that shareholders have more earning assets for every dollar of equity employed, and higher earnings should justify the increased risk.

It was stated throughout the hearings by both the Inspector General of Banks and the bankers themselves that, although the current level of leverage ratio should not be viewed with concern, still, it should not go any higher. For the time being, according to these witnesses, the public's total deposits are adequately protected by the total shareholders' equity currently at risk in the banking system.

Implications of Insufficient Bank Capital

The lack of more specific guidelines as to the definition of bank capital and the consensus that bank leverage should not be further increased, together foster concern over the capacity of chartered banks to lend money over the near term. Since banks are nearing their limits for increasing leverage, they must either raise more capital or slow the rate of asset growth.

3.3 LOAN LOSS EXPERIENCE AND CALCULATION OF THE AVERAGE LOAN LOSS PROVISION IN THE INCOME STATEMENT

The current recession in Canada has caused considerable discussion and raised numerous questions regarding the Canadian chartered bank loan loss provisions in 1982. The actual experience of the banks over the last seven years is analyzed, here, in order to put the loan loss experience into some form of perspective.

The actual loan loss experience is accounted for in three steps: the bank and its auditors assess potential loan loss, add on those loans that were actually written off during the year, then subtract any recoveries from previous years.

Table 3.3
CANADIAN CHARTERED BANKS
CAPITAL ADEQUACY RATIOS
(\$ millions)
Years ended October 31

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Total Assets	\$52,317	\$60,631	\$75,021	\$91,592	\$105,311	\$121,849	\$147,527	\$179,809	\$220,376	\$268,196	\$341,447
Total Capital											
Common Shareholders											
Equity	\$2,430.6	\$2,674.2	\$3,026.8	\$3,227.7	\$3,817.0	\$4,423.7	\$5,111.5	\$6,179.6	\$7,215.9	\$8,380.5	\$9,810.3
Preferred Equity	—	—	—	—	—	—	—	—	244.0	400.6	955.8
Total Equity	\$2,430.6	\$2,674.2	\$3,026.8	\$3,227.7	\$3,817.0	\$4,423.7	\$5,111.5	\$6,179.6	\$7,459.9	\$8,781.1	\$10,766.1
Debentures	185.0	374.0	657.3	705.8	952.6	1,169.4	1,276.8	1,575.0	2,060.2	2,164.3	3,148.3
Total Capital	\$2,615.6	\$3,048.2	\$3,684.1	\$3,933.5	\$4,769.6	\$5,593.1	\$6,388.3	\$7,754.6	\$9,520.1	\$10,945.4	\$13,914.4
Leverage Ratios											
Total Assets to Total											
Equity	21.5X	22.7X	24.8X	28.4X	27.6X	27.5X	28.9X	29.1X	29.5X	30.5X	31.7X
Total Assets to Total											
Capital	20.0X	19.9X	20.4X	23.3X	22.1X	21.8X	23.1X	23.2X	23.1X	24.5X	24.5X

Source: Canadian chartered bank financial statements. All Schedule A banks excluding Continental Bank of Canada.

The actual loan loss experience for the Canadian chartered banks has increased quite substantially over the last seven years, from \$267 million in 1975 to \$852 million in 1981, as noted in Table 3.4 roughly in line with the substantial growth in bank assets. This sharpest increase occurred in a period of three years from \$364 million in 1978 to \$852 million in 1981. Although this rise has been quite sudden, it should be put into perspective by relating the actual loan loss experience as a percentage of the banks' average assets outstanding each year. Table 3.4 indicates that loan loss experience as a percentage of average assets has not changed significantly from 0.27 per cent in 1975 to 0.28 per cent in 1981. The experience has fluctuated however, from year to year. In 1979, actual loan loss as a percentage of average assets declined to its lowest rate in seven years at 0.20 per cent, and then it rose very sharply again in 1980, when loan losses increased by 85 per cent to 0.31 per cent of average assets.

TABLE 3.4
Canadian Chartered Banks ⁽¹⁾
Actual Loan Loss Experience
(\$ millions)
Years Ended October 31

	1975	1976	1977	1978	1979	1980	1981	1982 E
5-Year Average Loan Loss Provision	\$178	\$230	\$294	\$364	\$450	\$592	\$820	\$1,000 E
% change	—	29%	28%	24%	24%	32%	39%	22% E
Actual Loan Loss Experience	\$267	\$263	\$317	\$364	\$406	\$749	\$852	\$1,500 E
% Annual Change	—	1%	20%	15%	12%	85%	14%	
Difference over (under) provided	(89)	(33)	(23)	—	44	(157)	(32)	(500) E
Actual Loan Losses as % of Average Assets	0.27%	0.23%	0.24%	0.23%	0.20%	0.31%	0.28%	0.55% E
Average Common Shareholders Equity	7.58%	6.39%	6.64%	6.45%	6.05%	9.60%	9.37%	13.0% E

⁽¹⁾ Total for the chartered banks excludes Northland Bank, Continental Bank and Canadian Commercial Bank.
E—Estimated.

Source: Canadian Chartered Bank Financial Statements.

It is important to note that the Canadian banks do not try to cover the entire loan loss experience in any one year with their income in that year. The Bank Act requires a chartered bank to average its actual loss experience over a period of five years by using a formula that calculates the average five-year loan loss experience and relates it to the total risk assets outstanding at the end of that period. By applying this average ratio to the bank's actual risk assets outstanding at the end of their current fiscal year, the bank determines what is called a five-year average loan loss provision, to be deducted from its current year's earnings.

Of course, in any one year, a bank's actual loan loss experience could be higher or lower than the five-year average. Consequently, the bank could understate or overstate its earnings, depending on one year's actual loan loss. There is, however, a mechanism available whereby part of this loss can be recovered as a reduction against taxable income; therefore, the difference between the actual and five-year average may not be entirely lost. As noted in Table 3.4, the banks did not charge enough expense for their actual loan loss experience

against earnings in five of the seven years under review. In 1978, the calculations worked out in such a way, that what the banks charged against their current year's earnings was exactly their actual loan loss experience. In 1979, the banks charged \$450 million against their earnings when their actual loan loss experience was \$406 million. The banks therefore charged \$44 million too much against their earnings and thereby understated their actual earnings in that year.

In 1980, the actual loan loss experience rose very substantially; the five-year average experience, rising more slowly to \$592 million, did not compensate for the banks' actual loan loss experience of \$749 million. The difference of \$157 million meant that the banks did not charge enough, and therefore overstated their 1980 earnings. In 1981, the five-year average loan loss provision rose by 39 per cent to \$820 million, whereas the banks' actual loss experience rose by only 14 per cent. Consequently, the banks' overstatement of earnings declined to only \$32 million. For 1982, there were several estimates given to the Committee that indicated that the banks' actual loan loss experience could approach \$1,500 million, an increase of 75 per cent over 1981. The five-year average loan loss experience may rise to as much as \$1,000 million, implying a difference of \$500 million in 1982. Thus, given these estimates, the banks could overstate their earnings in 1982 by \$500 million.

It must be remembered that, when the five-year average loan loss experience charged against earnings does not equal the actual loan loss experience, the difference has to be added to or subtracted from shareholders' equity. In the case of 1979, the banks were able to increase shareholders' equity by \$44 million, because they charged too much expense against the current year's earnings. However, in five of the seven years under review, the banks did not charge enough expense against earnings. In the case of 1980, the difference of \$157 million was deducted from shareholders' equity. For this reason, it is very important to assess these two factors and their impact on capital. On the basis of the estimate for 1982, bank shareholders' equity could be reduced by \$500 million in a period when earnings have decreased and, when, at the same time, capital markets make it difficult for banks to raise new equity through new issues.

It is often important to relate the actual loan loss experience to the average common shareholders' equity outstanding, including the reserve for future loan loss appropriations. When actual loan losses are related to average common shareholders' equity, it can be seen that actual loan losses have risen quite significantly in relation to average equity. In 1975, as noted in Table 3.4, loan losses represented 7.58 per cent of total shareholders' equity, but rose to 9.60 per cent in 1980 before falling slightly to 9.37 per cent in 1981. Both 1980 and 1981 were significantly above the 1975 to 1979 average. As indicated above for 1982, the actual loan loss experience could rise to as high as 13.0 per cent of total shareholders' equity, which would be the highest level in recent history. A similar experience will likely occur in 1982 for actual loan losses as related to average assets. This ratio of actual loan losses as a percentage of average assets would therefore increase to approximately 0.55 per cent, almost double the 0.28 per cent in 1981, and would be the highest level in recent history.

It should be evident from this discussion that the calculation of the five-year average loan loss provision needs to be reviewed by the Minister of Finance, so as to shorten or eliminate this averaging process. Then earnings would better reflect the actual experience incurred by the chartered banks in any one year.

3.4 NON-CURRENT AND NON-PRODUCTIVE LOANS

There was considerable discussion throughout the hearings regarding non-current and non-productive loans. These loans are considered problem loans for the banks, in addition to the actual loan losses incurred in any one year, as discussed in the previous section.

The terms non-current and non-productive are very often confused and warrant clarification. The term "non-current loans" is defined in the Bank Act (1980) as follows:

"... a loan is non-current if

(a) the borrower has not paid the interest on the loan in accordance with the loan agreement without assistance from the bank.

(i) where the loan agreement does not require interest to be paid during a period not exceeding three years from the time of the first advance thereunder, throughout a period of two years commencing not earlier than the expiry date of the period during which interest is not required to be paid and ending on the day as of which the report is to be made, and

(ii) in any other case, throughout a period of two years immediately preceding the day as of which the report is to be made;

(b) the bank has taken any step for the purpose of realizing on security in respect of the loan;

(c) the bank has commenced proceedings to recover all or any part of the loan or interest thereon; or

(d) the manager of the branch where the loan is recorded, or an officer of the bank who has examined the circumstances relating to the loan, is of the opinion that the loan ought to be regarded as non-current."

In summary, "non-current loans" are broadly classified as loans for which, even if the interest payments are still being made, the bank considers it possible that the principal may not be recovered. Several banks stated during the hearings that, in their experience, only a small percentage of these loans, about 10 per cent, become actual losses. In fact, the Bank of Montreal testified in the hearings that as much as 50 per cent of non-current loans are paying interest. The term "non-current loans" should be considered a very broad classification that is largely left to the discretion of the bank itself. For this reason, some banks use the term "non-productive loan" to cover all loans that have not paid interest for a period of 90 days.

Only one bank has publicly disclosed its present non-productive loan position. The Royal Bank of Canada announced that non-productive loans approximated 1.2 per cent to 1.4 per cent of total assets outstanding at the end of April 30, 1982, compared to 0.8 per cent at the same time last year. In dollar terms, this would amount to approximately \$1.2 to \$1.3 billion versus approximately \$500 million last year. If this ratio for the Royal Bank was applied to the asset base for the whole of the Canadian banking system, the total non-productive loan position would approximate \$4.5 to \$4.7 billion as of April 30, 1982. It is important to realize with respect to the non-productive loans that the banks are not currently receiving interest on these loans; therefore the non-productive loan position means postponed revenue and a negative impact on bank earnings.

In testimony, it was stated by the Inspector General of Banks, Mr. W.A. Kennett, that the information concerning the chartered banks' non-current loan position was requested of the banks only once each year, before the annual review of each bank. (The latter is stipulated in the Bank Act (1980).) For this reason there is no recent information available, either publicly or privately, concerning non-current loans or non-productive loans, for the banking industry as a whole. At present, what information there is has indicated to the Inspector General of Banks that non-current loans are increasing in number rapidly. For this reason, it is strongly suggested that the Office of the Inspector General of Banks be provided with information on both "non-current loans" and "non-productive loans" on a regular basis for better monitoring of the whole system, particularly during difficult economic conditions. This would allow the Office of the Inspector General of Banks to be more actively aware of difficulties in the banking system if they should occur.

It is recommended that problem loans be defined and classified according to their contribution to a bank's revenue. This would more precisely isolate those loans that affect a bank's financial condition at any one moment. There should be three classifications of loans, as follows:

- i) fully contributing loans—all loans that are regarded as current on their interest payments and are paying the full contractual rate of interest negotiated at the time the loan was made;
- ii) "partially contributing"—all loans that are current on their interest payments but where the full contractual rate of interest is no longer being charged, and where the interest rate differential between the contractual rate and the rate currently being paid is not being accrued;
- iii) "non-contributing"—all loans where interest was due but not paid for a period of 90 days, or where there is any indication that the borrower is in the process of being placed into receivership, or where, in the judgement of management, the interest on the loan is not being accrued and is considered on a cash-when-received basis only.

The degree of disclosure of these loan classifications should be determined by the Office of the Inspector General of Banks, and be sufficient to enable the isolation of problem loans, whether foreign or domestic and according to industry.

It is also recommended that banks disclose all partially contributing and non-contributing loans which have been rescheduled over the last twelve month period. A "rescheduled loan" is a loan in which the unpaid interest has been capitalized or made part of the new principal amount outstanding on the loan. When a bank takes this step, the loan becomes current because the overdue interest is no longer outstanding. Once this has been done, the loan is usually removed from the non-current and more particularly non-productive loan categories. This information will better enable the Inspector General of Banks to determine the changing status of bank loans.

3.5 SIZE OF LOANS TO INDIVIDUAL BORROWERS

There has been considerable discussion during the hearings relating to the size of loans made to individual borrowers. This became particularly evident during the summer of 1981,

Table 3.5
Potential Size of Bank Loans to Single Borrowers
 As at October 31, 1981
 (\$ millions)

	Royal Bank of Canada	Canadian Imperial Bank of Commerce	Bank of Montreal	Bank of Nova Scotia	Toronto- Dominion Bank	National Bank of Canada
Common Shareholders Equity including						
Appropriations for Losses and Preferred Shares	\$2,547	\$2,012	\$1,555	\$1,500	\$1,583	\$478
Convertible and Subordinated Debentures	779	582	384	517	335	192
TOTAL CAPITAL	\$3,326	\$2,594	\$1,939	\$2,017	\$1,918	\$670
<i>Approximate Maximum Size of Loan</i>						
15% of Capital*	\$500	\$390	\$300	\$300	\$300	\$100
I.G.B. Guidelines** 50% of Common Shareholders' Equity	\$1,300	\$1,000	\$800	\$750	\$800	\$240
Recommended 25% of Total Capital*	\$830	\$650	\$485	\$500	\$480	\$170

* This definition includes all capital issued. It is the broadest definition of capital, and may be broader than the definition eventually established by the Inspector General of Banks.

** As stated by the Inspector General of Banks.

when there were numerous loans related to the Canadianization of the oil and gas industry, as well as other takeover loans. The prudence of the banks was questioned, for lending such sizeable amounts of their equity to any one company or individual. The Inspector General of Banks, Mr. Kennett, testified that in some cases, the amount of the loans approximated 75 per cent to 100 per cent of a bank's capital. Mr. Kennett also testified that he became concerned about the size of these loans, and indicated to the banks that total loans to one borrower should not exceed 50 per cent of a bank's shareholders' equity and preferred shares. However, this was done after most loans had already been made.

Information supplied by the Office of the Inspector General of Banks revealed that there were four loans outstanding that exceeded \$500 million to a single borrower. Besides, there were fifteen loans, exceeding \$500 million, made to connected companies. Connected or associated companies are defined by the Inspector General of Banks as a group of companies under the same direct management or where there are closely related risks.

Table 3.5 outlines the common equity including the appropriation for losses and preferred shares and, in addition, the convertible and subordinated debentures outstanding that, combined, equal total capital for each of the six largest banks in Canada. If the guidelines established by the Inspector General of Banks were kept, where loans did not exceed 50 per cent of total common shareholders equity and preferred, the size of bank loans could range from \$240 million for the National Bank to \$1,300 million for the Royal Bank.

Several banks stated in testimony that they had established internal guidelines. The Canadian Imperial Bank of Commerce has a policy whereby bank loans to a single borrower are not to exceed 15 per cent of total capital. The Royal Bank also has a policy whereby total commitment to one borrower should not exceed this percentage. However, in a very few cases, the Royal Bank has extended as much as 25 per cent of its capital to one borrower. As noted in Table 3.5, 15 per cent of total capital for the Commerce Bank is \$389 million, and 15 per cent of total capital for the Royal Bank is roughly \$500 million. If the Royal Bank made a loan equalling 25 per cent of total capital, it could run as high as \$830 million. The Bank of Nova Scotia stated that it preferred to keep loans under \$500 million, about 25 per cent of total capital, but added that, at times, and in very special situations, this level might be exceeded.

It is not the Committee's intention to reduce the competitiveness of the Canadian chartered banks, particularly in the international sector. However, it is recommended that the size of loans to any one borrower or associated group of borrowers should not exceed 25 per cent of a bank's total capital, as defined by the Office of the Inspector General of Banks, unless that office gives its approval.

Geographic and Sectoral Diversification of Loans

Canadian chartered banks are geographically quite diverse, particularly in their domestic operations. Canadian dollar assets, comprising approximately two-thirds of total assets, are broadly spread throughout Canada by the branch systems. As previously discussed in Chapter 2, the banks have a very diverse loan portfolio according to type of loan and sector of industry. Table 3.6, supplied by Burns, Fry Limited, gives a further estimated breakdown

of bank assets by industries in Canada. The major change in assets by industry is the increase in loans to the oil and gas industry. Over the last three years, the oil and gas industry has become one of the largest areas of risk concentration; risk exposure for this area has increased three to four times over the last several years. Although there are no figures available expressing loan concentration by bank per sector, Burns, Fry Limited estimated in its brief that the Canadian banks have approximately \$22.0 billion of Canadian dollar assets in the oil and gas sector.

In addition, Table 3.6 estimates the breakdown of foreign currency assets by risk according to country. The Canadian banks are heavily oriented to the United States, and to the United Kingdom and other Western European countries. Over 60 per cent of foreign currency assets are located in these countries. Many foreign currency loans are sovereign risks arranged with countries such as Mexico, Venezuela and Indonesia. The incidence of rescheduling loans among sovereign risks, although increasing, has always been low.

Table 3.6

CHARTERED BANK BALANCE SHEET

All Schedule A Banks

December 31, 1981

ASSETS			LIABILITIES		
With Canadian Residents			From Canadian Residents		
Cash	\$ 8.2	2.4%			
With Canadian governments	13.7	4.0	From Cdn. govts.	\$ 8.9	2.6%
With banks & investment dealers	4.4	1.3	From banks	3.2	0.9
With individuals			From individuals		
—personal loans	33.0		—demand	3.8	
—mortgage loans	28.5		—notice	51.6	
	<u>\$61.5</u>	17.9%	—term	<u>49.6</u>	
				<u>\$ 105.0</u>	30.5%
With farmers	10.0	2.9			
With business			From business		
—oil & gas	22.0		—demand	14.1	
—real estate	19.0		—notice	1.9	
—merchandisers	14.0		—term	46.2	
—mining	7.0			<u>\$ 64.4</u>	18.7%
—other businesses	62.0				
	<u>\$ 124.0</u>	36.1%			
Other Assets	4.2	1.2	Other Liabilities	6.8	2.0
			Bank Debentures	2.7	0.8
			Bank Equity ⁽¹⁾	11.6	1.4
			Net Cdn. borrowing from foreigners to balance	22.9	6.7
Total Canadian	\$ 225.8	65.7%	Total Canadian	\$ 225.8	65.7%

Table 3.6 (Cont'd)

ASSETS			LIABILITIES		
With Foreign Residents of ⁽²⁾ ⁽³⁾			From Foreign Residents		
United States	\$ 16.0	10.5%	From other Banks ⁽²⁾	\$79.3	21.1%
United Kingdom	15.0	4.4	From Individuals	8.0	2.3
Remainder of Western Europe	21.3	6.2			
			From Business	49.9	14.5
Japan	6.0	1.7		\$ 137.2 ⁽⁴⁾	19.9%
Remainder of Far East	8.0	2.3			
Mexico	6.5	1.9	Other liabilities	2.6	0.8
Brazil	5.5	1.6	Bank Debentures	0.8	0.2
Venezuela	3.5	1.0			
Argentina	2.2	0.6	Net Deposits lent to		
Remainder of Latin Am. & Carib.	8.0	2.3	Canadian residents	(22.9)	(6.7)
Poland	0.4	0.1			
Other centrally planned economies	3.6	1.0			
Middle East & Africa	2.0	0.6			
Total Foreign	\$ 117.9	34.3%	Total Foreign	\$ 117.9	34.3%
			TOTAL WORLDWIDE		
TOTAL WORLDWIDE ASSETS	\$ 343.7	100.0%	LIABILITIES		
			AND EQUITY	\$ 343.7	100.0%

⁽¹⁾ All equity capital has been allocated to Canadian business.

⁽²⁾ Breakdown of business loans in Canada and breakdown by country outside of Canada are Burns, Fry Ltd. estimates.

⁽³⁾ Assets with foreign residents include short term deposits with other banks of \$38 billion and longer-term loans to other banks of \$10 billion.

⁽⁴⁾ Includes: demand—\$7.1 bil.; Notice—\$1.9 bil.; and term—\$128.0 bil. All other figures are in billions of dollars.

Source: Burns, Fry Limited.

3.6 INCREASED ACCESS TO FOREIGN CAPITAL

Considerable discussion in the hearings into bank profitability focused on the issue that banks were exporting Canadian bank shareholder equity (not to be confused with Canadian dollar deposits with the banks), in order to expand their foreign currency operations. As is the case of most growing Canadian companies, when a new market is entered, it is necessary for the parent company to supply capital to that new venture. In order that banks establish themselves, heavy expenditures are required to establish branch offices or foreign subsidiary banks abroad.

As has been noted in previous sections, the profits from the banks' foreign currency operations have grown dramatically, as have their assets. But not only have the shareholders accrued benefits from these expanded foreign operations, so have Canadian companies doing business abroad where Canadian banks have made lending facilities available to them.

The foreign operations of the Canadian chartered banks are very complex, since some are managed by subsidiaries while others, although operated directly through branches, are involved in numerous tax treaties between Canada and various other countries. For this reason, capital flows across national borders cannot be easily accomplished, because that

capital may be taxed if it is moved from one country to another. It has therefore not been possible to determine just how much Canadian capital was required to establish the foreign operations of the banks.

Canadian chartered banks are termed constrained corporations, meaning that ownership is limited to 10 per cent for any individual or associated group of individuals, and that no more than 25 per cent of it can be held in foreign hands. The change to the Bank Act in 1980 permitted Canadian banks to issue subordinated debentures in foreign currencies. As of October 31, 1981, the Canadian chartered banks had issued \$550 million of subordinated debentures in U.S. dollars. It should be stressed, however, that the Inspector General of Banks has indicated that he does not consider that subordinated debentures should carry a very heavy weight in the calculation of leverage as it relates to a bank's capital adequacy.

It cannot be concluded how much shareholders equity was exported from Canada. However, in recent years, particularly in 1981, the total Canadian banking system was able to obtain new capital from international markets through retained earnings and the issuance of subordinated debentures in U.S. dollars. It should be considered that perhaps banks should fund their foreign currency operations by using more foreign capital, particularly in convertible preferred shares or convertible debentures. The Bank Act (1980) states very clearly the rules for issuing subordinated debentures in foreign currencies, but makes no reference to the rules for other types of equity issues in these currencies. Therefore, it would appear that banks should be encouraged to increase their foreign shareholders, since approximately 95 per cent of present shareholders are Canadian. We believe that the chartered banks should continue to be covered by the rules laid down for them as constrained corporations. Yet, increased foreign ownership would give the banks an international scope in attracting capital, particularly in periods where the banks may have saturated the market, domestically. The latter may indeed have been the case for the chartered banks over the last 18 months, when they raised approximately 25 per cent of all the common and preferred shares and convertible debentures in the entire Canadian market.

3.7 IMPACT OF OTHER FACTORS ON CAPITAL

As discussed in previous sections, capital is extremely important to a bank, as it is to any business, for cushioning unexpected shocks or deficiencies of earnings within a single year. In the light of this, several things must be considered that have a significant impact on a bank's capital base: loan losses; loss on the bank's income statement; and a dividend payout that exceeds earnings.

The first factor that may affect the appropriation for loss account is the difference between the five year average loan loss provision as included in the income statement, and a bank's actual loss experience in any one particular year. For the most part, the difference is netted against the appropriation for loss account. As noted in the previous section, over the last seven years, the difference has generally produced a deduction from the appropriation for loss account.

A second factor is a deficiency in a bank's earnings' statement in any one year or, in other words, a loss. This deficit would be deducted against the bank's retained earnings. In addition, a bank is permitted a tax-loss carry-forward for a five year period, but if this is not used, then it will become a deduction against the bank's capital.

TABLE 3.7

**Source of New Equity Capital
Eight Largest Chartered Banks**

(Year ended October 31—\$ millions)

	1977	1978	1979	1980	1981	First Half 1982 Est.
<i>Net External Equity Financing</i>						
Common Shares	\$ 84	\$ 260	\$ 146	\$ 326	\$ 94	\$ 180
Convertible Preferred Shares	0	0	0	50	475	210
Straight Preferred Shares	0	0	225	88	168	352
TOTAL EQUITY ISSUES	\$ 84	\$ 260	\$ 146	\$ 464	\$ 737	\$ 742
Convertible Debenture Issues	0	0	0	0	\$ 462	\$ 260
Internal Equity Generation	\$ 583	\$ 786	\$ 786	\$ 793	\$1100	\$ 460
TOTAL INCREASE in Equity (and equivalent) capital	\$ 667	\$1064	\$ 932	\$1257	\$2299	\$1462

Source: Brief Submitted by Burns, Fry Limited.

Finally, a bank may have positive earnings but pay a higher dividend than what it is actually earning. In this case, the bank would, in effect, be paying its capital back to its shareholders, and its capital would decrease by the amount the dividend exceeded its earnings on an after-tax basis.

Every one of these elements has had the effect, for certain banks, of decreasing the amount of their capital. However, to date, these adjustments have been very minor. Each of the cases, however, must be considered in light of the importance of capital to a chartered bank and the necessity for keeping it adequate to cover these various uncertainties.

3.8 COST OF NEW CAPITAL

In order for a bank to supplement its total capital, it must, from time to time, raise new equity through the public security markets. This additional capital is often required to supplement a bank's retained earnings in order to maintain adequate total-asset-to-capital ratios (leverage) at any single moment. As illustrated in Table 3.7, supplied by Burns, Fry Limited, it can be noted that, in 1981, the banks raised approximately \$1.2 billion in new capital in order to prevent their leverage ratios from rising substantially further. Perhaps even more significant is that, to date, in the first six months ended April 30, 1982, the banks have raised an additional \$1.0 billion in new capital. In total, they have raised approximately \$2.2 billion in new capital over the last 18 months. As noted previously, this represents approximately 25 per cent of all such offerings in Canada. Wood Gundy Limited stated in its brief that "it would be imprudent to conclude that the banks can issue substantial amounts of new capital year after year, for several reasons"; these reasons are summarized below:

1. During late 1981 and early 1982, several bank issues are believed to have been either significantly reduced in size or shelved indefinitely.
2. Each year, Wood Gundy surveys at least 70 Canadian financial institutions to determine whether their bank holdings are underweighted or overweighted in their investment portfolios. Last year's survey showed that bank shares were heavily weighted in institutional portfolios. In 1981, about 80 per cent of the new issues were sold to retail or individual investors because institutions already owned sufficient bank shares issues.
3. The terms of last year's issues showed considerable ingenuity; some issues had more than one type of warrant attached, and there were some convertible issues with special features. This type of financing is sometimes an indication that the market for the shares for a particular type of corporation is becoming saturated.
4. Bank shares in recent years have been accorded lower price earnings multiples. This raises the cost of capital to the issuing corporation.

In retrospect, it might have been better if the banks had issued more capital prior to the last 18 months when leverage ratios were initially rising and bank share prices had much higher values, particularly in relationship to their book values.

Table 3.8

Simple Average Annual Pre-Tax Rates of Return

(Ten years from Dec. 31/71 to Dec. 31/81)

	Capital Appreciation	+	Dividend Yield	=	Total Annual Rate of Return	less	Average Inflation Rate ⁽¹⁾	=	Pre-Tax Real Return
To an investor in Chartered Bank Common Shares	6.3%		4.7%		11.0%		9.0%		2.0%
From the TSE "300" in general	8.9%		4.0%		12.9%		9.0%		3.9%

⁽¹⁾ Consumer Price Index.

Source: Burns, Fry Limited

To illustrate, the increase in the cost of capital to a bank raising new equity in the current equity markets (Table 3.9, supplied by the Canadian Bankers' Association) has been updated to reflect the current share price of bank stocks in today's economic environment. The C.B.A. submitted the book values of bank shares as of October 31, 1981, relating these to the market value of these stocks as of the same date. At the time, every publicly traded bank stock was trading at a discount to its stated book value per share. The book value of a Canadian chartered bank is basically break-up value in the form of common shareholders' equity and accumulated appropriations for losses. Depending on how investors perceive a bank, they will accord the bank either a market premium or a discount to the book value of the bank's shares. As of October 31, 1981, the banks were trading at a discount to their book value of anywhere between 1 per cent and 64 per cent. On average, on that date, (based on a simple averaging of prices and book values per share) they were trading at a discount to book value of 25 per cent. On updating the share prices to reflect the position as of June 30, 1982, it can be noted that the share prices have fallen by almost 30 per cent and, consequently, the banks are now trading at a discount (on a simple average basis) of approximately 47 per cent from their book value stated October 31, 1981.

The attitude of investors, therefore, is reflected in their evaluation of the banks' share prices in the equity markets. It focuses on concerns over a lower rate of earnings' growth and higher potential loan losses that would, in effect, reduce the banks' book value per share (because, as previously noted, all losses are deducted from capital if they are in excess of the banks' five-year average). Investors also bear in mind what other, more attractive, returns are available to them, and what other securities have less potential risk.

At current low market prices for bank shares, there is an average price-earnings ratio of four to one. The effective after-tax cost of issuing new common equity at current market prices is thus over 25 per cent for most banks. Such financing costs make it almost prohibitive for a bank to issue new common equity in the current market. In addition, it is detrimental to the existing shareholders, since the new capital would be issued so substantially below the current book value. It would dilute the shareholders' invested interest in the bank, and, as well, require the bank to earn a substantially higher rate of return on the new capital than what it was earning on the current shareholders' capital.

Table 3.9
Stock Price Statistics—Chartered Banks

Bank	Book Value ⁽¹⁾ Per Share Oct. 31/81	Premium or Market Value per Share (Discount) to Book Value			
		Oct. 31/81	June 30/82	Oct. 31/81	June 30/82
Royal Bank of Canada	\$28.93	\$25.25	\$19.25	(13%)	(33%)
Commerce Canadian Imperial Bank	43.58	27.50	18.00	(37%)	(59%)
Bank of Montreal	31.53	23.50	17.50	(25%)	(44%)
Bank of Nova Scotia	32.32	24.75	20.38	(23%)	(37%)
Toronto-Dominion Bank	36.07	29.38	22.50	(19%)	(38%)
National Bank of Canada	17.36	6.25	4.75	(64%)	(72%)
Mercantile Bank	18.48	15.13	9.50	(18%)	(49%)
Bank of British Columbia	23.35	23.00	11.87	(1%)	(49%)
Continental Bank	15.71	7.50	6.75	(52%)	(57%)
Canadian Commercial and Industrial Bank	19.53	N/A	N/A	N/A	N/A
Northland Bank	16.98	14.25	9.12	(16%)	(46%)

⁽¹⁾ Shareholders' equity attributable to common shareholders, plus the full amount of accumulated appropriations for losses, divided by the number of equivalent fully paid shares outstanding at fiscal year-end.

Source: Brief Submitted by Canadian Bankers' Association, updated.

N/A: Not applicable.

In the brief submitted by Burns, Fry Limited, it was stated that: "The average bank share generated an average annual total rate of return of only 11 per cent over the last 10 years, which is slightly less than the rate of return achieved by the average Toronto Stock Exchange stock. Bank shares generated a real rate of return of 2 per cent pre-tax and a moderately negative return after-tax." As outlined in Table 3.8, this analysis is based on the banks' capital appreciation over the 10 year period, plus its dividend yield, for a total annual rate of return less the average inflation rate, to give a pre-tax real return for the common shareholder. The Burns, Fry report also states, as a matter of interest, that, during this period, a short-term, low risk, liquid bank certificate of deposit generated an 9.8 per cent annual rate of return.

In concluding on this issue, Wood Gundy states that: "We do not believe it would be prudent to assume the banking industry can continue to raise large amounts of capital year after year." However, the Committee feels that the banks should take advantage of capital markets as they improve and are receptive to new issues.

3.9 DEPOSIT INSURANCE

The Canada Deposit Insurance Corporation (CDIC) was established in 1967 to protect the safety of the public's deposits held by chartered banks. The coverage per individual depositor⁽¹⁾ per financial institution is kept to a maximum of \$20,000. All demand deposits, and deposits with a maturity of five years and under, qualify as insurable deposits. The premium cost is 1/30 per cent of all insured deposits and is borne by the insured institutions. The premium can be reduced modestly, based on a five year deposit growth experience.

Unlike the deposit insurance coverage underwritten by the Federal Deposit Insurance Corporation in the United States, reviewed and revised upward over the years to the present level of \$100,000 per depositor per institution, the \$20,000 insurance ceiling imposed since 1967 has never been revised. Using the all items Consumers Price Index for Canada as a measure of inflation, the purchasing power of the \$20,000 in 1967 would approach \$60,000 in 1982. In order to afford the public the same degree of protection today, it is recommended that the deposit insurance per depositor per institution be increased to \$60,000, a level that restores the real value of protection offered when it was introduced in 1967, and that it be reviewed every five years.

3.10 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The adequacy of a bank's capital base is fundamental to good banking practice and the protection of depositors' savings. It is also fundamental to the system's ability to finance the needs of Canadian businesses and households.

Increasing the capital base is directly and indirectly related to bank profitability. Earnings' retention increases the size of shareholders' equity and is obviously related to bank profits. Healthy profit performance also increases the value of equity and thus reduces the cost of raising new equity through capital markets. Over the past 18 months, the banks used the capital market to sell new capital issues whose total value far exceeded the banks' relative size in this market. Because of the large demands placed by the banks on the capital markets, some new issues were reduced. During this period, the banks took the maximum amount of new capital that the market made available to them.

The Committee believes that Canadian chartered banks should be owned and controlled domestically; yet consideration should be given to greater use of foreign capital to fund the capital base of the banks. This can be done in such a way as to present no threat to the domestic control of the industry. The 1980 Bank Act revisions moved in this direction, by allowing banks to issue non-convertible debentures in foreign currencies. But it is unclear whether banks are allowed to issue convertibles in foreign currencies. In this respect, the Committee recommends that:

2. Banks should be permitted more flexibility in issuing equity capital in foreign markets, in order to remove the onus on Canadian capital markets to fund future growth in the banks' foreign operations. The 75 per cent Canadian ownership constraint under the Bank Act should continue to be observed, however, as should the rule limiting individual ownership of a bank to 10 per cent.

It is not expected that the present level of bank capital would prevent the banking system from financing a recovery from the current recession. Nevertheless, a healthy and well-capitalized system is a prerequisite for strong and sustained recovery and, in that respect, investor confidence is vital. This confidence has been somewhat shaken recently by the realization that a few individual bank loans have been made that represent a very high proportion of bank capital. This problem is further compounded by the fact that the current definition of capital is being reconsidered, creating uncertainty as to what constitutes the capital base of a bank.

The Committee, therefore recommends that:

3. The Inspector General of Banks should provide an official definition of bank capital that precisely specifies the weights attached to components of each class of capital. Bank capital should be identified as either primary or secondary. Primary capital is to be permanent in nature, including common equity and non-redeemable preferred shares. Secondary capital would include all other forms of capital that meet minimum standards as to type and maturity, including such forms as convertible and subordinate debentures.
4. The total outstanding value of any one bank's loans to any borrower or associated group of borrowers should be limited to 25 per cent of that bank's total capital (as defined in Recommendation 3), unless otherwise approved by the Office of the Inspector General of Banks.
5. In the event that the above recommendations are implemented bank leverage ratios should not be legislated. However, the Inspector General of Banks should closely monitor long-term trends and short-run variations in the leverage ratios of individual banks.

With an official and precisely defined capital base specified for each bank, the public could be made much better aware of the financial position of the banking system. Such specifications, combined with limitations on the size of individual bank loans, would provide the constraints necessary to ensure prudent banking practices. The Committee feels that, because bank leverage ratios can be subject to significant short-run variations, any limits fixed to these ratios would impose undue burden on the banks.

Over the past seven years, the calculated loan loss provision reported in the banks' annual income statements has proven to be a poor indicator of actual loan loss experience in any particular year. Moreover, the banks' loan portfolios include loans classified as non-current and/or non-productive. The actual status of such loans is unclear, and the Committee has not had available to it the extent to which individual banks carry such loans. The Committee accordingly recommends the following:

6. The formula used for calculating the average provision for loan losses (currently a five-year moving average) should be reviewed by the Minister of Finance with a view to moving to a system that more accurately reflects a bank's actual loan loss experience in its income statement.
7. The non-current loan category as outlined in the Bank Act should be redefined, so as to classify outstanding bank loans according to their contribution to bank income. All loans on which i) future interest payments are not expected to be received or ii) interest payments have not been received for ninety days or iii) for which bank officials treat interest payments on a non-accrual basis, should be classified as non-contributing loans. All loans on which i) contractual interest payments are not made in full and, on which ii) the differential is treated on a non-accrual basis, should be classified as partially-contributing loans. All other loans should be classified as fully-contributing loans. Such information should be included in each bank's annual report.

An adequate capital base is necessary to protect the interests, not only of bank depositors, but also of the banks' shareholders. The steps recommended should further

enhance the security and stability of the Canadian banks and foster domestic and foreign confidence in our banking system.

Deposit insurance is also important as a means of protecting depositor's savings. Since it was first implemented in 1967, the value of the protection this insurance offers to depositors has been seriously eroded by inflation. The Committee therefore recommends that:

8. Deposit insurance should be increased to afford a better real protection of depositors' savings. The level of insurance for each individual depositor with any bank should be raised from the present \$20,000 to at least \$60,000, which restores the real value of protection offered when it was introduced in 1967. The level of deposit insurance should be reviewed every five years.

The Committee's investigation of the banks raised many questions which could not be answered adequately for lack of information. Certain witnesses expressed the view that banks operate under a shroud of secrecy that hides their activities from the public.

In response to that perception and recognizing the central role played by the banking system in the economy, the Committee recommends a greater openness in disclosure of banking operations.

9. Information should be available as to:

- i) non-contributing and partially contributing loans and all loans rescheduled in the past twelve months which had not previously been fully contributing (as in Recommendation 7);
- ii) actual loan loss experience;
- iii) distribution of loans by size;
- iv) taxation;
- v) sources of "other income"; and
- vi) characteristics of bank assets and liabilities.

In all of the above cases, the data should be broken down according to domestic and international operations, categories of loan size and major industrial sectors.

For example, data should be provided, on an individual bank basis, in a format like the one by which aggregate data are to be published under the revised Bank Act.

With increased disclosure, there will be improved external analysis of the banking system. The Office of the Inspector General of Banks can perform two roles in this respect: it can be a mechanism by which better and more consistent information is made available; and it can be one of many sources of external analysis. The Committee, therefore, recommends:

10. The Office of the Inspector General of Banks should produce an "Annual Report on Banks in Canada" and make it available to the general public. The Inspector General's office should also study the lending practices of banks and include these results in its Annual Report. This report could be modelled on the Report of the Superintendent of Insurance.

FOOTNOTES

- ⁽¹⁾ Depositor refers to any legal entity, person or business. In the case of business, it must be in a "limited" form for the purposes of deposit insurance coverage.

Chapter 4

Taxation of Canadian Banks

The sharp decline in the effective tax rate for Canadian chartered banks over the last five years has been the subject of considerable discussion and criticism. The issue is very complex. It must be placed in the perspective of the banks' statutory income tax rate versus its effective tax rate, the large amount of tax-exempt financing done by the Canadian banks, foreign taxation and the high level of interest rates over the last several years. In addition, the banks themselves claim that they have been paying taxes through other means that are not highly visible to the public.

4.1 TRENDS IN EFFECTIVE TAX RATE

As noted in Table 4.1, the history of the chartered banks' effective tax rate from 1971 to 1981 indicates that indeed this rate declined very substantially over that period. From 1971 to 1975 the banks' average effective tax rate was 48.5 per cent. Beginning in 1976, but accelerating in 1978, their average effective tax rate began to drop very sharply, from 44.7 per cent in 1976 to 14.4 per cent in 1980 rising again to 21.1 per cent in 1981. It should also be noted that during this period the banks' after-tax balance of revenue continued to increase.

During the latter part of the 1970s, the absolute level of taxes payable by the chartered banks actually decreased from \$536.3 million in 1976 to a low of \$209.6 million in 1980. There was a large increase in taxes paid in 1981, but they have since declined in the first half of 1982, giving the Canadian banking industry a small net recovery of taxes. In other words, the Canadian chartered banks have not paid any actual taxes, to date, in 1982.

In order to understand how a bank's effective tax rate can decline, the bank's statutory income tax rate must first be considered.

Table 4.1
CANADIAN CHARTERED BANKS
TAXATION
 (\$ millions)

	Years Ended October 31										
	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Pre-Tax Balance of Revenue	556.0	668.8	778.5	874.6	1,234.3	1,199.6	1,243.0	1,495.4	1,346.5	1,452.1	2,178.8
Taxes Payable	277.7	313.4	376.5	433.6	591.0	536.3	512.4	518.4	227.2	209.6	458.8
After-Tax Balance of Revenue	278.3	355.4	402.0	440.9	663.3	663.3	730.6	977.0	1,119.2	1,242.5	1,720.0
Effective Tax Rate	49.9%	46.9%	48.4%	49.6%	44.7%	44.7	41.2%	34.7%	16.9%	14.4%	21.1%

The Banks' Statutory Income Tax Rate

The Statutory Federal Income Tax Rate was legislated at 50 per cent in 1972, the year of Canada's Tax Reform. It was then reduced by 1 per cent per year until 1976, when it reached 46 per cent. In 1980 the Federal surtax of 5 per cent was imposed, raising the Statutory Tax rate to 48.3 per cent in 1982.

Provincial tax rates, which vary from 15 per cent to 11 per cent, depending on the province, have the effect of raising the "statutory" rate, according to the premium attributed by the province to the taxable income. In order to compute the provincial tax payable, a bank may deduct from its Federal Tax 10 per cent of its taxable income earned within that province. Consequently, tax rates, in total depending on the province, range from 48.3 per cent to 51.0 per cent, which is referred to as the "overall statutory income tax rate".

Foreign Income Tax Paid

Canadian banks expanded their banking operations into the international sector during the early 1970s. By the end of that decade, the largest of the Canadian banks were established as respected international banks with first class credit ratings in the money markets of the world, and were able to compete for business along with the other major international banks. (Prior to the 1980 Bank Act revisions, Canadian banks were refused permission to establish branches in many countries due to the lack of reciprocity granted by Canada.) Profits from foreign banking operations, as previously noted, have increased to 47 per cent of total after-tax income in 1981, from 17 per cent in 1971.

Canadian banks have moved abroad in order to be accessible to foreign clients, to be more sensitive to changes in local markets, to enhance communications and to provide services for Canadian exporting companies. The banks have tended to establish branches abroad, rather than set up subsidiaries, largely because depositors and borrowers prefer to deal directly with the parent institution. More recently, however, there has been some growth of banking operations through subsidiary companies.

The establishment of foreign branches and subsidiaries also has considerable tax implications. Taxation is a major factor in determining whether the operations in a certain country will be performed by a branch of the bank concerned, or by a subsidiary. Tax planning is therefore essential in establishing the proper organization to survive in the highly competitive area of international banking.

Most of the taxation problems banks face in operating in foreign countries can be traced to the withholding tax of 15 to 25 per cent the Government of Canada levies on total interest earned by foreigners from Canadian sources. As a result of the withholding tax, Canada has signed tax treaties with about 35 other countries which insist on a similar rate, even though many do not tax bank interest crossing their borders into countries other than Canada. Canadian tax law therefore allows any income tax paid to a tax treaty country as a credit against Canadian income tax. If Canadian banks did not receive credit for these foreign taxes they pay, they would not be able to compete internationally. A separate calculation must be made for each country, so that the income from that country bears an

effective tax rate equal to the minimum tax payable if the income had been earned in Canada. In other words, if the foreign income tax rate was 62 per cent, the bank would pay only the foreign tax, since that rate is higher than the Canadian tax rate. However, if there were a 20 per cent tax rate, the tax would be raised from 20 per cent to the full tax rate applied as if the income were earned in Canada, with the Canadian government receiving the difference. It should be stressed that these adjustments would only take place if the banks operated through branches.

Banks may establish separate subsidiary companies in certain foreign countries. Such companies are then residents of those countries and the treaty networks established for residents apply to the subsidiaries. Several countries such as the United Kingdom, the Netherlands, and the United States are particularly favourable for carrying on an international lending business because there is generally no withholding tax on loan interest crossing their borders.

Dividends paid by foreign subsidiaries and affiliates to their Canadian parent banks are tax-exempt in Canada. This forms another source of after-tax income for the banks. The only dividends taxed in Canada are those paid by subsidiaries in countries that do not have a comprehensive tax treaty with Canada.

Effective Tax Rates

The effective tax rate of a chartered bank is determined by applying the statutory tax rate to the taxable income of a bank. The result is the tax payable. When it is divided by the banks' total income before tax, it produces the "Effective tax rate". These concepts will be discussed in considerable detail in the following section so as to illustrate that the banks' lower effective tax rate has not been caused by a lowering of the statutory tax rate.

4.2 AFTER-TAX FINANCING

As noted, the principal reason for the decrease in the chartered banks' effective tax rates over the last five years is related directly to the acquisition of a large amount of tax-exempt securities, principally term-preferred shares and income debentures. The basic characteristic of these "loan substitutes" is that the income from them, whether interest or dividends, is deemed to be non-taxable for the chartered banks. Thus, based on the statutory tax rate as previously discussed, banks have been able to structure these loans on the basis of one half the prime lending rate plus a risk-adjusted margin.

The sharp rise in tax-exempt income from the "loan substitutes" began approximately 18 months before the Federal budget restrictions on the tax-exempts, initiated on November 16, 1978. The budget attempted to stop further new investment in these instruments by preventing the banks from treating the income as tax-exempt. Furthermore, disqualification was also to result from any alterations in the terms of the issue after that date, such as extensions of the term, or the holder waiving his right to redeem. Subsequent legislation amended the November 16, 1978 budget, placing strong limitations on the issuance of new income debentures and preferred shares.

Meanwhile, the Federal Government introduced the Small Business Development Bond. The interest income from the SBDB's is neither deductible in the hands of the borrower nor taxable to a bank or other corporate recipient. The government's objective in encouraging "after-tax" financing is to provide funds to borrowers at approximately one half the prevailing prime rate. Government policy has continued to encourage the banking system to increase its investment in tax-exempt loans to financially troubled businesses. This should lower the banks' effective tax rates further, as after-tax income continues to be substituted for taxable income on regular loans. As of October 31, 1981, the banks had \$6.7 billion of term-preferred shares, \$2.8 billion of income debentures and \$1.2 billion of SBDB's for a total of \$10.7 billion.

After-tax income has increased dramatically in relation to the banks' total after-tax balance of revenue. As noted in Table 4.2, tax-exempt income has increased from \$80 million in 1976, 12.1 per cent of after-tax balance of revenue, to \$1,144 million or 66.5 per cent of after-tax balance of revenue in 1981.

Table 4.2
PERCENTAGE OF TAX-EXEMPT INCOME OF THE BANKING INDUSTRY
(in millions of dollars)

	1976	1977	1978	1979	1980	1981
Tax-Exempt Income*	\$ 80	\$166	\$386	\$ 811	\$ 908	\$1,144
After-Tax Balance of Revenue	\$663	\$731	\$977	\$1,119	\$1,243	\$1,720
Tax-Exempt Income as % of After-Tax Balance of Revenue	12.1%	22.7%	39.5%	72.5%	73.0%	66.5%

* Source: Office of the Inspector General of Banks.

Background to After-Tax Financing

Before discussing the impact of after-tax financing on the tax rates of Canadian chartered banks, it is important to fully understand the concepts behind loan substitutes and after-tax financing. Since most of the loan substitutes are in the form of income debentures and preferred shares, these are described in more detail below.

- i) Preferred Share—A preferred share is a class of share capital of a corporation that entitles the owners to a stated dollar value per share in the liquidation of a company and provides the owner with a dividend, paid before the company's common share dividend. Holders of preferred shares usually have no voting rights, unless a stated number of dividend payments have been missed. The dividends are paid out of the company's after-tax income. There are no specific assets guaranteeing these securities, and so their collateral value to a chartered bank is less than what the bank would normally receive when issuing a loan.
- ii) Income Debenture—An income debenture is defined as a security on which interest is payable only if sufficient income has been earned by the issuing corporation. In some

cases, income debenture interest is cumulative and, if not paid, is added to the bond holder's claim upon redemption of the debentures. This position is akin to that of a preferred stock, except that income debenture interest is a debt payable at a fixed date and the debenture holder rates as a creditor. For Canadian income tax purposes, income bond interest is eligible for the same tax credits applicable to dividends of taxable Canadian corporations. The interest payable on the debenture is paid out of the corporation's after-tax income.

These financing instruments are termed "loan substitutes". This term is used because income debentures and preferred shares are actually issued to replace a company's outstanding loans. It appeals to a company to have its short-term loans replaced this way because it improves the balance sheet and debt to equity ratio. The term "tax-exempt financing" is also used because the cost of these loan substitutes is not deductible from a company's revenue, as is regular interest on a bank loan. Likewise, the revenue in the hands of the bank is not taxable. This is not an unusual transfer of funds. The tax laws in Canada permit dividend payments to flow from one company to another to avoid double taxation of corporate profits. In effect this is an after-tax transfer of funds.

The next concept to be explained is the reason why any company would arrange for a "loan substitute" rather than taking out an ordinary bank loan where the interest would be deductible from its income. It happens because a company that does not have any taxable

Table 4.3
CALCULATION OF THE EFFECTIVE TAX RATE FOR BANKS

Calculation of Effective Tax Rate	BANK A	BANK B
Regular Interest Revenue	\$100,000	\$90,000
Tax-exempt Revenue	—	5,000
Total Revenue	\$100,000	\$95,000
Total Expenses	85,000	85,000
Total Income before tax	\$ 15,000	\$10,000
Less: Non-taxable income	—	5,000
Taxable Income	\$ 15,000	\$ 5,000
Statutory Tax Rate	50%	50%
Taxes payable	\$ 7,500	\$ 2,500
Calculation of After-Tax Profit	BANK A	BANK B
Total Income before tax	\$ 15,000	\$10,000
Tax payable	7,500	2,500
After-Tax profit	\$ 7,500	\$ 7,500
Effective Tax Rate (Taxes payable/Total Income Before Tax)	50%	25%

income would not be able to use the deduction arising from the interest payable on a loan. Furthermore, a company that pays a low rate of tax, such as small businesses paying only 25 per cent tax, would also find loan substitutes appealing. Since the income from a loan substitute is not taxable for a chartered bank, a company would obviously expect a reduced rate on any loan substitutes it issues to a bank. The statutory tax rate in Canada is in the range of 48.3 per cent to 51.0 per cent. Thus the banks view a loan substitute earning one-half the normal loan rate to be approximately equivalent to an ordinary business loan. Yet, corporations that would normally be charged the prime rate have been charged one half per cent, or more, over one-half prime as a premium. In the hearings, the banks described this premium as a risk adjustment, reflecting the reduced collateral security and the less assured cash flow of the preferred shares and income debentures. Also, from the bank's standpoint, there is a delayed cash flow because half the effective interest is received only through reduced Canadian income tax payments. These will be described in more detail in the following sections.

How Loan Substitutes Alter Effective Tax Rates

The after-tax revenue generated by "loan substitutes" should be considered a transfer of after-tax revenue from one company to another. The impact that tax-exempt revenue has had on the Canadian chartered bank effective tax rates is best illustrated by using the example in Table 4.3. In the first case, Bank A has \$500,000 of ordinary loans outstanding at the prime lending rate of 20 per cent. Bank B also has \$500,000 of loans outstanding, but \$450,000 are regular loans at the prime rate of 20 per cent, while \$50,000 are "loan substitutes" which produce revenue at one half of the prime lending rate (or 10 per cent).

For Bank A, total interest revenue is \$100,000; there is no tax-exempt income. After expenses, the total income before tax is \$15,000 and, since there is no tax-exempt income, taxable income is also \$15,000. After applying the statutory tax rate of 50 per cent, tax payable is \$7,500. For Bank A, tax payable divided by pre-tax income produces a 50 per cent effective tax rate, the same as the statutory tax rate.

In the case of Bank B, it has \$450,000 of regular loans producing income of \$90,000, and \$50,000 of tax-exempt loans at the prime lending rate (or 10 per cent), producing non-taxable income of \$5,000 (i.e. total loans outstanding are still \$500,000). Total revenue is then \$95,000. After deducting expenses, total income is \$10,000 compared to \$15,000 for Bank A. However, \$5,000 of this income is not taxable and therefore must be deducted in order to determine the bank's actual taxable income, amounting in this case, to \$5,000. When the bank's statutory tax rate of 50 per cent is applied, the tax payable is \$2,500. Bank B's effective tax rate is determined by applying the \$2,500 tax payable to the \$10,000 of total pre-tax income. The "effective tax rate" becomes 25 per cent. In both cases, after-tax profits are \$7,500.

It is important to state clearly that tax-exempt investments do not lower the statutory tax rate payable by the banks on taxable income. However, since all the income received by the banks on loan substitutes is exempt from taxes, these loan substitutes lower the actual taxable income of the banks. It should be added that the banks must still borrow money to lend in the form of loan substitutes, and all the interest paid on the funds borrowed is still

fully deductible in the calculation of pre-tax income. This has the effect of lowering the banks' taxable income, particularly in periods of rising interest rates when the cost of deposits increases faster than the yield on loans at one-half the prime lending rate.

4.3 IMPLICATIONS OF AFTER-TAX FINANCING

After-tax financing is very effective, as a method of lowering a borrower's interest costs, however, the large volume of these loans has created problems with respect to several aspects of a bank's operation. One of the most important has been the decline in the amount of taxable domestic income. In this respect "domestic" refers to income on which taxes are to be calculated and paid to the Canadian government. Several Canadian banks ceased to have any taxable domestic income over the last two years.

If a bank is engaged in after-tax financing, this reduces the amount of its taxable income. Now if the same bank is in business abroad, with its own bank branches, what it owes the Canadian government in taxes can be reduced by the amount of tax paid to the government of the foreign country where it is operating. The dilemma for the banks is that the tax concessions (termed "foreign tax credits") are deductible only in the year in which the foreign tax was paid. If no domestic taxes are payable, the bank will lose the use of the foreign tax credit.

For this reason, many banks have voluntarily deferred deductions regarding loan losses and capital cost allowances, in order to increase taxable domestic income and receive full credit for the "foreign tax credits". This has the effect of increasing the banks' future tax liabilities. If these credits cannot be claimed within the five year period allowed by the Canadian government, they will be lost. In such a case, the amount will be deducted from shareholders' equity and, ultimately, it will be the bank shareholders, as opposed to the government, who subsidize certain classes of borrowers using after-tax financing.

4.4 HIDDEN TAXES

Two major areas have been noted whereby the Canadian chartered banks pay "hidden taxes", not readily apparent to the general public. These include the cost of maintaining reserves with the Bank of Canada and capital taxes paid to provincial governments.

Bank of Canada Reserve Costs

Under the provisions of the Bank Act, Canadian chartered banks must hold cash reserves with the Bank of Canada. In 1981, cash reserves averaged over \$7.0 billion on which the Bank of Canada is not required to pay any interest. The lost revenue on these "loans" to the Bank of Canada represents an opportunity cost to the chartered banks, since these funds are not available to lend to paying customers. The banks state in their briefs to the Committee that they, in effect, paid over \$500 million to the government through the Bank of Canada, in addition to all other taxes.

Provincial Capital Tax

Another form of "hidden tax" for the chartered banks is a tax which is applied to a bank's capital base. Over half the provincial governments in Canada use this method of taxation on banks in order to increase their own tax base. This capital tax is in addition to any other form of taxation which may be paid by the banks.

The method of calculation is uniform among the provinces and is designed to determine the amount of capital used by a bank in any one province. The province then applies a tax ranging from 0.8 per cent to 2.0 per cent on the capital determined by this calculation. The calculation of capital usage within a province is a function of the proportion of a bank's total loans and deposits which originate in that province and the proportion of a bank's total payroll which is spent within that province. From these figures, a formula is used to determine the amount of a bank's capital employed within the province.

The provincial capital tax rates which apply, are outlined in Table 4.4 in decreasing order. As is noted, both Manitoba and British Columbia raised their tax rates considerably for 1982, to 2.0 per cent from 0.8 per cent in 1981, and Newfoundland introduced a tax of 1.5 per cent for 1982. The Province of Quebec has indicated that its tax will be increased from 0.9 per cent to 1.2 per cent for any bank that does not support a program introduced by the government to lower certain mortgage rates to borrowers.

The capital tax on bank capital is discriminatory in that it discourages the building of capital, particularly in certain provinces, which is so necessary in the operation of a bank. In the case of the Province of Quebec, the tax is also being used to penalize banks that do not endorse certain government policies. Information supplied by the Canadian Bankers Association for the six largest banks in Canada indicate that total capital taxes will rise to approximately \$62 million in 1982 from \$48 million paid in 1981, a gain of 29 per cent.

Table 4.4

PROVINCIAL CAPITAL TAX RATES ON CAPITAL USED IN THE PROVINCE

Province	1981	1982
British Columbia	0.8%	2.0%
Manitoba	0.8%	2.0%
Newfoundland	—	1.5%
Ontario	0.8%	0.8%
Quebec	0.6%—0.9%	0.9%—1.2%*
Saskatchewan	0.8%	0.8%

* The Province of Quebec has indicated that if banks do not endorse the Province's mortgage subsidization program, they will be penalized and must pay the higher rate.

4.5 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The statutory tax rate applied to bank income has changed only very slightly in recent years. Nevertheless, the banks' effective tax rate has fallen significantly. This is because the banks have substituted non-taxable income for taxable income, by offering several types of

loan substitutes, introduced and encouraged by government policy as a kind of interest rate relief for borrowers. Tax-exempt financing reduces the cost of funds to those classes of borrowers who qualify for this indirect government subsidy. It has significantly reduced the taxable income of banks and thus their effective tax rates have fallen.

The main beneficiaries of this form of financing have not been the banks, but rather those business borrowers who, for one reason or another, could not make full use of the deductibility of interest expenses from their income. Small businesses also have benefitted from this type of financing, since their corporate tax rate is less than that paid by larger companies, including the banks. Under more usual forms of financing, the deductibility of interest expenses is of less benefit to a small business than to a company paying a higher marginal tax rate. Thus, as indicated in the text, this form of financing has had a minimal effect on bank profitability; the borrower receives the benefits of after-tax financing.

The banks' use of "loan substitutes" has had the sanction of government tax law or the explicit approval of government policy. Bank purchases of Small Business Development Bonds and Small Business Bonds have been actively promoted by the Federal Government. Thus the fall in the effective tax rate on banks relates to the extent to which banks act as agents of government policy. In some instances, bank spreads have widened through the use of such financing; however, the value of collateral on these loan substitutes has tended to be less than would normally be the case.

The widespread use of after-tax financing has resulted in some unforeseen tax problems for the banks. Because of the way bank profits are taxed, and because high interest rates and the use of loan substitutes have prompted the banks to defer the use of some tax deductions on domestic expenses, they risk losing some of these in the future. In some instances, banks may even lose some foreign tax credits. If that happens, then it will be bank shareholders, rather than the government, who will subsidize certain classes of borrowers.

The extent to which banks offer loan substitutes is directly related to their taxable income. If bank profitability declines, banks will reduce their offerings of loan substitutes, and the government policy that encouraged these substitutes will be frustrated.

Thus the Committee recommends:

11. The Federal Government should consider the future use of tax-exempt financing through financial institutions very carefully as a means of subsidizing certain classes of borrowers, taking into full account the consequences of this form of financing on bank profit levels, and on effective tax rates on banks, and assessing its net effect on the financial needs of borrowers. If after tax financing continues to be used, then consideration must be given to extending the banks' tax loss carry-forward provisions beyond five years.

Chapter 5

Banks and Small Clients: Their Evolving Relationships

Two kinds of customers make up the bulk of the banking sector's clientele,—households and businesses. The household sector generates the bulk of net savings of our economy, and so is the major lending source for the banks. It is also a major client on the borrowing side, using the banks to help finance the purchase of durable goods and housing.

The business sector is a large and growing client of the banks, as a net-borrower. As will be discussed more fully, it is becoming increasingly dependent on the banks as a source of financing, this is particularly true of small businesses. Smaller firms account for over 90 per cent of the banks' business clientele and their borrowing for over 40 per cent of the outstanding value of the banks' business loans.

Both consumers and small businesses are generally thought to be at a disadvantage in their dealings with the banks. The size of the banks is intimidating and without a competitive banking environment, smaller clients could be exposed to excessive costs and/or inadequate services. However, the Committee believes that such a competitive environment does exist. The regulatory framework of Canada's deposit-taking institutions—banks and near-banks—adds further protection for borrowers and this regulatory framework is also designed to enhance the working of monetary policy, to foster competition and efficiency, and to preserve Canadian ownership of the financial sector. In recent times, both regulators and bankers have been highly conscious of efficiency and competition, because of the presence of Schedule B (i.e. foreign) banks in the country, and because, in this period of high interest rates consumers have educated themselves about differences in investment vehicles.

Historically, financial institutions have not competed solely on the basis of price. Product differentiation has played a major role in this competition. The merit of this form of competition is to enhance consumer choice, as witnessed by the vast array of consumer-oriented services now offered by various banks.

Because of the different jurisdictional powers conferred by the British North America Act, both federal and provincial governments administer the complex regulatory structure of financial institutions. Classification is by type of corporate structure and place of incorporation, rather than by fields of activity. For example, banks, trust companies, caisses populaires, and credit unions, all of which compete directly in the consumer and mortgage lending field, are subject to considerably different regulatory regimes.

As defined by a report of the Economic Council of Canada "... regulation refers to a variety of measures undertaken by the 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".⁽¹⁾ In regard to the consumer and mortgage loan markets, the most important regulations governing the behaviour of banks and near-banks are the limitation of 10 per cent of total assets in residential mortgage lending, placed on chartered banks,⁽²⁾ and the "basket clause" that allows trust and loan companies to engage in otherwise unauthorized activities (including consumer loans) to the maximum limit of 7 per cent of total assets. Two consequences emerge from such regulations. On the one hand, trust and loan companies are restricted to concentration on their primary activity—mortgage lending—because they have limits placed on them in the consumers' loan market and the business loans market; while banks, on the other hand, can effectively pursue all markets. Their subsidiary mortgage loan companies are not subject to any limitation on mortgage lending and the banks have a history as the major lending institution for the business sector.

This section focuses on the evolution of the relationship between the banks and their clients with respect to the quality of services and the nature of competition in these markets, and the incidence of regulation in a changing environment.

5.1 THE HOUSEHOLD SECTOR AND THE BANKS

The personal savings market

Competition for funds is generally considered strong in Canada because any borrower has to compete with domestic financial institutions, domestic non-financial borrowers, and international markets.

This competitive situation is best illustrated by the personal savings market, where savers can choose to make their deposits at any one of banks, trust and loan companies, credit unions, and caisses populaires, or decide to buy Canada Savings Bonds. Personal savings deposits at chartered banks, as a percentage of total personal savings in the above financial institutions, were 46.3 per cent in 1971 and 49.5 per cent in 1981. During the first part of the decade (1971-1975), the banks' share was 44.9 per cent, on average, and, during the last part of the decade, it averaged 47.3 per cent. There is a slight upward trend in this share, but it is subject to short-run fluctuations, as in 1978 when the share dropped to 44.5 per cent.⁽³⁾

The choice of a deposit-taking institution usually depends on what is offered in location, business hours, service quality and financial advantage. For the sake of attracting customers,

banks and other institutions open new branches, close less frequented branches, extend their business hours, launch automatic distributing devices, and generally offer a greater variety of services.

A bank may:

- (i) offer a higher interest rate than its competitors on savings deposits;
- (ii) charge lower fees for services;
- (iii) offer different terms of maturity; and
- (iv) by advertising, try to convince the Canadian saver that deposits at its branches are better protected and that they are different from the ones offered by other institutions.

Even though a deposit at any one bank may appear identical to a deposit at another institution, over the past fifteen years, that is, since the 1967 Bank Act revision, the personal savings deposits market has been one of great innovation.⁽⁴⁾ The following example illustrates how competition takes the form of product differentiation with respect to interest rates, services, and services charges:

On 10 February 1982 (Table 5.1), interest rates offered by different institutions varied considerably for the same maturity. For example, the City and District Trust Company was offering 14.125 per cent on 30-59 day deposits, while most banks were offering 13.5 per cent. Moreover, minimum deposits differed between institutions and, in some cases, deposits of long-term maturity, like one year and over, did not bear the same interest rate. However, the chief competition is not among interest rates but among services.

For example: in January 1979, the Toronto-Dominion Bank invited the cashing of cheques with only a Visa Card as I.D. In the following August the Bank of Montreal offered a Daily Interest Savings Account. The Toronto-Dominion Bank and the Royal Bank introduced the same service in September. In April 1980, the Bank of Montreal offered its clients consolidated reporting of all personal account balances, called "bottom line balance" and in April 1981, the same bank offered Daily Interest Savings Accounts where interest was credited monthly. To be sure, banks sometimes have to discontinue some retail service because of lack of demand, or because they have lost out to the competition.

Banks also compete on service charges. For example, on 1 November 1978, the charge for writing a cheque on a chequing account was 16¢ at the Bank of Montreal and at the Toronto-Dominion Bank. On 1 November 1980, the charge was 20¢ per cheque written at the Bank of Montreal but 19¢ at the Toronto-Dominion Bank. In the latter case however, there was a minimum service charge of 75¢. A better illustration of product differentiation is given by the service charges on Personal Chequing Accounts shown in Table 5.2.

During the course of this inquiry, the question was raised as to whether service charges were important in explaining the profit situation of Banks in 1981. They are part of a whole range of non-interest operating income like commissions, fees, service charges, all included in the Balance of Revenue. According to data from the Office of the Inspector General of Banks the answer to that question has to be "No". Non-interest income represented 0.60 per cent of average assets in 1981. This percentage is the same as in 1979 and 1978 and is the lowest of the period 1971-1981. In fact non-interest income as a percentage of average assets has been declining from 1971 to 1981. It averaged .68 per cent from 1971 to 1975 and .62 per cent from 1976 to 1980.

The personal savings deposit market in Canada is highly competitive. Service charges, commissions and fees that are an element of product differentiation, and, that help customers decide where to place their deposits, do not, by any means, explain the profit situation of 1981.

The consumer and mortgage loan markets

The consumer loan market is relatively small in comparison to the mortgage market. But its growth in the period under discussion was no less spectacular. Total consumer loans outstanding in 1971 were \$12.1 billion and rose to \$48.4 billion in 1981 for a compound average annual growth rate of 14.8 per cent, identical to that in mortgage lending. Both increased real income growth and price inflation account for much of this growth.

Evidence in Table 5.3 shows that the market shares of caisses populaires, credit unions, and Quebec savings banks have increased modestly over the years. Those of department stores and life insurance companies have declined somewhat. With regard to trust companies, it was noted elsewhere that consumer loans are not one of their prescribed activities; as a consequence, their consumer lending is covered by a "basket clause" which allows them to hold unspecified assets of up to 7 per cent of total assets. While trust companies have made some important gains in consumer lending, this potential is limited. Moreover, this gain had to be made at the expense of holding other potential assets.

By far, the most significant developments throughout this period are the gradual disappearance of sales finance and consumer loan companies from the consumer loan market and the ever growing pressure on it from chartered banks. Although the banks held the largest share of this market from 1971 to 1981, the size of their share grew from under 54 per cent to over 67 per cent of the market in this period. The dollar volume of consumer credit transacted through chartered banks rose from \$6.5 billion in 1971 to \$32.6 billion in 1981. The 13 per cent gain in market share exactly matches the 13 per cent decline of the finance companies.

The reasons for the banks' assumption of so much of the consumer loan market must be traced back to the Bank Act revision of 1967. Since 1877, a ceiling of 6 per cent had been imposed on bank loans.⁽⁵⁾ As long as the general market rate of interest was below this ceiling, it did not affect the operational behaviour of banks, but, as the general level of interest rates rose close to it, it began to infringe upon the banks' lending activities. Their spreads were squeezed. This was precisely the case in the sixties. In some instances, the market rate exceeded the 6 per cent ceiling. However, the use of the "discount" and service charges allowed them to continue to compete in the market and still maintain their profitability.⁽⁶⁾ They were able to offer consumer loans at the prevailing market rate. (The chartered banks had withdrawn from the mortgage lending market, for all practical purposes, during much of the sixties, because the market rate of interest exceeded the 6 per cent ceiling, and The Interest Act precluded them from discounting and imposing service charges).

The removal of the 6 per cent ceiling in the 1967 Bank Act provision and the decrease in reserve requirements gave the banks a competitive boost. They rejoined the mortgage market and pursued further consumer credit business by introducing bank credit cards.

Table 5.1

TYPICAL INTEREST RATES PAID BY MAJOR FINANCIAL INSTITUTIONS ON TERM DEPOSITS

Institutions	Rates											
	Mini- mum deposit	30-59 days	60-89 days	90-119 days	120-179 days	Mini- mum ⁽²⁾ deposit	1 Yr.	2 Yrs.	3 Yrs.	4 Yrs.	5 Yrs.	Semi Annual
	\$	%	%	%	%	\$	%	%	%	%	%	%
Chartered banks & Affiliates ⁽¹⁾ and Trust and Loan Companies												
Bank of Commerce	5,000	13.50	13.75	14.00	14.25	1,000	16.00	16.50	17.25	17.25	17.25	16.75
Bank of Montreal	5,000	13.50	13.75	14.00	14.25	1,000	16.00	16.50	17.25	17.25	17.25	16.75
City & District Sav. Bank	1,000	13.50	13.50	13.50	14.00	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Continental Bank	5,000	13.50	13.75	14.00	14.25	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Mercantile Bank	5,000	14.50	14.75	15.00	15.00	N/A	N/A	N/A	N/A	N/A	N/A	N/A
National Bank	5,000	13.50	13.75	14.00	14.00	1,000	16.25	16.75	17.25	17.25	17.25	16.50
Bank of Nova Scotia	5,000	13.50	13.75	14.00	14.00	1,000	16.25	16.75	17.25	15.25	15.25	14.75
Royal Bank	5,000	13.50	13.75	14.00	14.25	1,000	16.25	16.50	17.00	16.75	—	—
Toronto Dominion	5,000	13.50	13.75	14.00	14.00	1,000	16.00	16.50	17.25	14.00	14.00	13.75
Can. Permanent Trust	5,000	13.75	14.00	14.00	14.25	1,000	16.00	16.25	16.75	16.75	16.75	16.25
Canada Trust	5,000	13.75	14.00	14.00	14.25	1,000	16.00	16.50	17.25	16.75	16.75	16.25
Canadian Italian Trust	5,000	13.75	13.75	14.00	14.00	1,000	15.50	14.50	14.50	14.50	14.50	14.00
City & District Trust	5,000	14.125	14.25	14.25	14.25	500	16.25	17.00	17.25	17.25	17.25	16.625
Continental Trust	10,000	14.25	14.50	15.00	14.00	2,000	17.00	17.00	17.25	16.75	16.75	16.25
Credit foncier	5,000	13.75	14.25	14.25	14.50	500	16.50	16.75	17.25	17.25	17.25	16.75
Crown Trust	5,000	13.75	14.50	14.50	14.75	500	16.25	16.50	17.25	15.50	17.25	16.75
Eaton/Bay Trust	5,000	—	—	15.00	15.00	500	17.00	17.25	17.50	16.50	16.50	16.00
Fidelity Trust	5,000	14.50	14.50	15.25	15.25	500	17.00	17.00	17.25	16.75	16.75	16.00
Fiducie Prêt et Revenu	5,000	14.00	14.25	14.50	14.75	500	16.50	16.00	17.25	17.00	17.00	16.25
Guaranty Trust	5,000	13.75	14.00	14.00	14.00	1,000	16.625	16.625	17.125	16.625	16.625	16.00
Guardian Trust	5,000	14.00	14.00	14.25	14.25	1,000	16.00	16.00	16.00	16.00	17.50	16.75
Hellenic Canadian	5,000	13.75	14.00	14.00	14.00	500	15.50	14.50	14.50	14.50	14.25	14.00
Montreal Trust	5,000	13.75	14.00	14.00	14.00	1,000	16.00	16.25	16.00	16.00	17.00	16.50
Morgan Trust	—	—	—	—	—	1,000	16.75	17.25	17.25	17.00	17.00	16.50
Morguard Trust	10,000	14.50	14.00	—	—	1,000	16.50	16.50	17.00	17.00	17.00	16.25
National Trust	5,000	13.75	14.00	14.00	14.25	1,000	16.25	16.50	16.50	16.50	16.75	16.25
Quebec Trust	5,000	13.75	14.00	14.50	14.50	1,000	16.00	16.00	16.75	16.75	16.75	16.00
Royal Trust	5,000	13.75	14.00	14.25	14.50	1,000	16.25	16.25	16.50	16.50	15.75	16.25
Trust General	5,000	13.75	14.00	14.25	14.50	500	16.50	17.00	17.25	16.50	16.50	16.00
Victoria & Grey	5,000	13.75	13.75	13.75	13.50	500	16.75	16.75	17.25	17.25	17.25	16.75

⁽¹⁾ Rates shown on term deposits of under 1 year are for chartered banks. Rates shown on term deposits of over 1 year are for chartered banks' mortgage loan affiliates.

⁽²⁾ Rates quoted are for certificates and debentures on which interest is paid annually.

Source: The Montreal Gazette, February 10, 1982.

N/A: Not applicable.

Table 5.2

CANADIAN BANKS
PERSONAL CHARGES ON PERSONAL CHEQUING ACCOUNTS

The following charges apply to personal chequing accounts where no interest is paid, where description statements are provided, and cheques are returned to the account holder.

	B of M	BNS	TD	CIBC	Royal	National
Name of account	True Chequing	Scotia Chequing	Personal Chequing	Personal Chequing	Personal Chequing	Chequing Account
Cheque charge	23¢	22¢	23¢***	22¢	23¢	N/C
Minimum monthly service charge for active account	N/C	50¢ & cheques	35¢ plus 23¢/cheque	75¢ plus 22¢/cheque	N/C	N/C
NSF Cheque	\$7.00	\$5.00	\$5.00	\$7.00	\$7.00	\$5.00
Overdrafts*	\$2.00	\$3.00	\$3.00	\$3.50	\$2.00	\$3.00
Chargeback	\$2.00	\$3.00	\$1.50	\$1.25	\$2.00	\$2.00
Certifying cheque (for account holder)**	\$1.00	\$2.00	\$1.00	\$1.00	N/C	\$2.00
Stop payment	\$4.00	\$3.50	\$3.50	\$3.50	\$4.00	\$4.00

Source: The Canadian Bankers' Association

* Service charge only—interest on amount of overdraft is extra.

** Charges are higher for other persons wishing to certify cheque.

*** Waived if minimum monthly balance is over \$500.

Table 5.3

PERCENTAGE DISTRIBUTION OF CONSUMER LOANS BY LENDING INSTITUTION

Year End	Chartered Banks	Sales Finance & Consumer Loan Co.	Life Ins. Co.	Quebec Savings Banks	Depart. Stores	Trust & Mortgage Loan Co.	Caisses Populaires & Credit Unions	Total	Amount (\$ millions)
				(in percentage)					
1971	53.68	19.50	6.46	0.21	6.22	—	13.93	100.00	12,131
1972	55.68	18.44	5.67	0.21	5.74	0.32	13.94	100.00	14,347
1973	57.32	17.04	5.17	0.21	5.62	0.48	14.16	100.00	17,093
1974	58.34	15.73	5.38	0.22	5.68	0.73	13.92	100.00	19,827
1975	61.08	13.30	5.00	0.25	5.37	0.87	14.13	100.00	22,960
1976	63.26	11.34	4.61	0.27	4.92	1.07	14.53	100.00	26,725
1977	64.83	9.77	4.29	0.29	4.59	1.22	15.01	100.00	30,069
1978	64.80	8.86	3.96	0.30	4.38	1.87	15.83	100.00	34,684
1979	66.03	7.31	3.97	0.36	4.13	2.48	15.72	100.00	39,543
1980	67.41	6.21	4.21	0.38	3.77	3.51	14.51	100.00	44,027
1981	67.38	6.47	4.82 ^e	0.32	3.70	3.87	13.44 ^e	100.00	48,361 ^e

Source: Bank of Canada and Statistics Canada

^e estimate

While the market shares commanded by chartered banks in this field may give rise to some concern in certain quarters, the fact that their consumer loan rates have always been much more competitive than those of finance companies indicates that increased competition among financial institutions has benefitted the consumer.

The mortgage loan market in Canada increased enormously from \$34.1 billion in 1971 to \$135.9 billion in 1981, an equivalent of 14.8 per cent compounded annual rate. This growth can be explained by considering two 5-year intervals, 1971 to 1976 and 1977 to 1981.

In the first half of the decade, two new sources of pressure were added to the demand for housing. The number of potential first-time home buyers began to rise steadily as the post-war baby-boom generation reached the labour market and the age of household formation. And spectacular rises in property values, plus the fact that capital gains on housing are not taxable, reinforced the benefit of home ownership as an investment and as a hedge against inflation. The result was a growth of 16.8 per cent in mortgage lending on a compounded average annual basis from 1971 to 1976.

While the second half of the decade can be generally characterized by uncertain economic conditions and a sluggish housing market, the demand for mortgages did not subside correspondingly (the compound average annual growth rate was 13.3 per cent) because the government intervened in housing and in developments in the financial market.

Concern about the availability of "reasonably-priced" housing to first-time buyers amidst inflationary house prices, led the Federal Government and provincial governments to implement programs aimed at boosting housing supply. Interest-free loans, income tax provisions and other forms of assistance combined to maintain the demand for housing and thus mortgage funds.

Another development that buoyed the otherwise sluggish demand for housing and mortgage loans was the substitution of mortgage debt for consumer debt. The escalation of house prices in the early 1970s inflated owners' equity in their houses, and this allowed them to increase their mortgages to raise capital for other types of consumer expenditures.⁽⁷⁾

The market share occupied by the various financial institutions active in mortgage lending from 1971 to 1981 is shown in Table 5.4. Chartered banks, which are prohibited from holding more than 10 per cent of their assets in mortgage loans, have expanded their share of the market from 6.85 per cent in 1971 to 22.84 per cent in 1981. This is made possible by their use of subsidiary mortgage loan companies and mortgage investment companies which are not bound by the same restriction. The compound average annual growth rate based on actual dollar amounts of loan for the entire period was 29.5 per cent. This growth took place at the expense of the life insurance industry and direct government lending. Trust companies whose primary lending activity has traditionally been mortgages, saw their share of the mortgage market grow modestly from 22.38 per cent to 24.31 per cent. The compound average annual growth rate of mortgage lending by trust companies based on actual dollar amounts for the period, was 15.8 per cent.

Another important development of the last ten years, as was alluded to above, has been the Federal Government's gradual withdrawal from mortgage lending. Although the actual mortgage loans held by the Federal Government grew from \$8.1 billion in 1971 to \$13.8

Table 5.4

PERCENTAGE DISTRIBUTION OF MORTGAGE LOANS BY LENDING INSTITUTION

Year End	Life Ins. Co.	Chartered Banks (1)	Trust & Loan Co.	Caisses Populaires and Credit Unions	Gov't Org.	Corporate Lenders (2)	Other Co. (3)	Pension Funds	Estates, Trusts & Agency Funds of Trust Co. (4)	Total	Amount (\$ millions)
	(in percentage)										
1971	23.10	6.85	22.38	4.87	23.99	6.10	1.17	3.43	8.11	100.00	34,109
1972	20.95	9.02	23.69	6.15	22.80	5.62	1.00	3.34	7.43	100.00	38,875
1973	19.03	12.75	23.40	7.29	20.61	5.24	0.95	3.37	7.36	100.00	46,083
1974	17.85	14.34	24.19	7.79	19.21	3.91	0.94	3.59	8.18	100.00	53,622
1975	16.62	15.78	24.53	8.35	17.80	4.04	0.93	3.97	7.98	100.00	62,371
1976	15.77	16.20	24.96	9.36	16.56	3.03	1.09	4.41	8.62	100.00	72,898
1977	14.95	17.76	24.76	10.61	14.90	3.17	1.05	4.64	8.16	100.00	86,390
1978	13.07	19.03	24.90	11.55	12.98	3.26	0.99	4.70	9.52	100.00	100,925
1979	12.90	20.61	25.52	12.18	11.43	3.03	0.98	4.64	8.71	100.00	114,770
1980	12.99	21.52	25.36	12.44	10.91	2.82	0.95	4.63	8.36	100.00	125,592
1981	13.49	22.84	24.31	12.80	10.12	2.77	0.92	4.68	8.07	100.00	135,871

Source: CMHC, Statistics Canada, Bank of Canada.

(1) From 1975 to 1981, amounts include mortgage loans held by chartered banks' subsidiary mortgage loan companies.

(2) Includes mainly consumer loan finance and sales finance companies.

(3) Includes Quebec savings banks, mutual benefit and fraternal societies. From 1976 on, figures have been revised to include mortgage investment corporations.

(4) Includes funds administered for trustee pension plans.

billion in 1981, its share of the market has been reduced by more than half, from about 20 per cent to slightly over 10 per cent. The life insurance companies' share also dwindled from over 23 per cent to approximately 13.5 per cent. The gap has been filled by the chartered banks and the credit unions. High inflation during this period accentuated the traditional attractiveness of relatively higher deposit rates and lower loan rates offered by the credit unions, and as they proliferated, their share of mortgage lending grew from 5 per cent to almost 13 per cent.

As to all other remaining categories of mortgage lenders, their market share has remained remarkably stable. Thus the relative decline of life insurance companies combined with the gradual withdrawal from the mortgage field by the Federal Government has created a vacuum which has been successfully filled by chartered banks and credit unions.

Generally, it can be concluded that the active participation by chartered banks in the mortgage field has intensified competition. This is evidenced by the introduction of more flexible term mortgages and a slower rise in 5 year prime conventional mortgage rate relative to other administered rates throughout much of the early and mid-1970's.⁽⁸⁾

A major public policy concern since 1979 has been the availability of 5 year mortgages. Their virtual disappearance is attributed to the shift of deposit liabilities from long-term deposits (1 year and over) to short-term deposits (under 90 day maturity) as discussed in Chapter 2. The changing term structure on the liabilities side of the financial institutions' balance sheet has caused a mismatch between their deposits and existing loans, thus affecting the general performance. To rectify this mismatch, financial institutions could no longer continue to fund 5 year mortgages during this period of interest rate volatility. However, to fill the void left by the 5 year mortgage market, innovations in mortgage financing were introduced. These include: Graduated Payments Mortgages, Variable Rate Mortgages, etc.⁽⁹⁾

There have been suggestions, from time to time, that the banks be required by law or government directive to reduce their mortgage rates to a level approximating the rate of inflation. The rationale is that the banks could afford to divert substantial amounts of their profits to finance this reduction. There are obvious questions as to whether it is appropriate for the shareholders, borrowers or depositors of the banks, to subsidize mortgage rates in this way, or whether the government do so directly.

In practice this proposal would give rise to numerous problems with regard to its impact on other financial intermediaries in the mortgage market such as trust companies, credit unions and caisses populaires. We specifically asked a trust company witness what effect such a proposal would have on his industry. He replied that it would put trust companies out of the mortgage business, or out of business altogether. The mortgage market is quite competitive. Thus a reduction in mortgage rates by one group of lenders would have to be met by other lenders. As a result, trust companies would thus be forced to reduce their rates to stay competitive. However the cost of savings deposits and term deposits needed to finance their mortgage portfolios would not drop. Since most trust companies must maintain two-thirds of their assets in mortgages and are in a weak profit position, there would be little possibility of shifting to other assets or otherwise subsidizing mortgage rates. For these reasons, among others, the Committee finds no merit in proposals of this sort since they ignore the realities of the market place.

It appears that the household sector is well served by banks and the financial market, due to its competitive nature. This does not preclude the existence of complaints about the system or with respect to certain banks. Some of these were raised before the Committee with respect to bank retail services and loans to households. It is felt that some bank managers are over-reacting to the current economic situation and that the introduction of Electronic Funds Transfers has precipitated apprehension on the part of the public. The information at the Committee's disposal, however, does not allow firm conclusions to be drawn regarding the validity of these complaints. We do believe that more research in this area is needed.

5.2 THE SMALL BUSINESS SECTOR AND THE BANKS

The corporate sector has traditionally enjoyed a wide variety of sources of financing. These include equity, long-term debt through bond markets, bank loans (both long and short-term), trade credit, leasing arrangements, etc. Government financing is also available through deferred taxes, some direct financing programs and loan guarantees. Small business also has access to these sources of financing, although in varying proportions. The nature of smaller firms dictates that certain forms of financing are relatively more expensive to them and so they hold back on the use of these sources.

It is generally believed that small borrowers tend to be squeezed by financial institutions and markets in times of tight credit. Loans are presented with costs or terms more unfavourable to the small borrower than to the large one. Testimony to this effect has been heard before the Committee, alleging that such discrimination is typical in bank lending to small borrowers—small business and farmers. However, such discrimination would appear to be the exception rather than the rule from the evidence we have before us.

Chartered Banks' Business Financing

As financial intermediaries, banks are a significant force in business finance, this being particularly true with small business. From 1976 to 1981, chartered bank financing accounted for over 90 per cent of the net new short-term credit extended to business. Over this same period, the share of bank financing to total sources of the stock of business credit increased from 42 per cent in 1976 to 57 per cent in 1981. In the business financing sector, the banks have increased their importance since 1976, this being especially true of 1981.⁽¹⁰⁾

Banks are the primary source of funds to small business. Tables 5.5 and 5.6 present statistics on the relative importance of various sources of funds, by size of business. What is most evident from these tables is that small firms rely much more heavily on debt financing than do large firms, which have easier access to equity financing. Tax deferral, as a source of financing, is of little importance to the smallest class of firm, while for the largest size class it amounts to almost 7 per cent of corporate funds. On the other hand, smaller firms tend to use other non-financial corporations as a source of short term financing: accounts payable represent 16.5 per cent of the value of assets for the smallest class of firms but only 7.5 per cent for the largest class.

Table 5.5

SOURCES OF FUNDS OF CORPORATIONS OPERATING IN CANADA IN 1977, BY SIZE CLASSES
OF BUSINESS

(Percentage distribution)

Firm Size (by Assets)	\$249,999 and less	\$250,000 to \$999,999	\$1,000,000 to \$4,999,999	\$5,000,000 to \$9,999,999	\$10,000,000 to \$24,999,999	\$25,000,000 and over
Short-term liabilities	42.9%	38.1%	37.5%	33.5%	28.7%	18.9%
Long-term liabilities	14.8	13.1	13.4	12.6	11.6	17.3
Mortgages	(4.4)	(5.1)	(4.5)	(4.0)	(2.0)	(0.7)
Debentures	(0.8)	(0.9)	(1.7)	(1.8)	(2.3)	(12.1)
Others	(9.6)	(7.1)	(7.2)	(6.8)	(7.3)	(4.5)
Total liabilities	57.7	51.2	50.9	46.1	40.3	36.2
Shareholders' equity	41.3	46.8	45.8	49.3	54.8	56.1
Deferred taxes	0.2	0.9	1.9	2.9	3.6	6.9
Other	1.0	1.1	1.4	1.7	1.3	0.8
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Economic Council of Canada, Financial Markets Group

Table 5.6

RELATIVE CONTRIBUTION OF VARIOUS FORMS OF FINANCING TO THE
OVERALL FINANCING OF SELECTED SIZE GROUPS OF FIRMS IN 1977

(as percentage of total assets)

Firm Size (by Assets)	\$249,000 and less	\$250,000 to \$999,999	\$1,000,000 to \$4,999,999	\$5,000,000 to \$9,999,999	\$10,000,000 to \$24,999,999	\$25,000,000 and over
Total bank loans	16.0%	14.7%	15.3%	14.5%	12.7%	6.5%
Short-term bank loans	13.8	12.8	12.9	11.4	9.1	4.2
Long-term bank loans	2.2	1.9	2.4	3.1	3.6	2.1
Accounts payable	16.5	14.0	14.2	8.7	7.3	7.5
Mortgage debt	4.4	5.2	4.5	4.0	2.0	0.7
Funded debt	0.8	0.9	1.7	1.8	2.3	1.2
TOTAL DEBT ⁽¹⁾	57.7	51.2	50.9	46.1	40.3	36.2

⁽¹⁾ Includes short-term and long-term loans from shareholders and affiliates.

Source: Economic Council of Canada, Financial Markets Group

The major point these figures make is that smaller firms rely more heavily on long and short-term debt than larger firms. They also rely proportionately more on bank loans and other forms of bank financing than do larger firms.

Another indication of the role of banks in business financing, in particular for small business, is the extent to which the composition of the banks' assets has changed over time.

It is worth asking whether banks have been reducing the amount of their financing to small business borrowers who rely so heavily on them. The data we are using, are categorized only by the size of the loan, not the size of the borrower. However, it seems safe to assume that small firms tend to borrow small amounts while large borrowers tend to borrow large amounts.

From the end of October 1971 to the end of October 1981, the Canadian dollar assets of the chartered banks grew at a compound annual average rate of 18.5 per cent.⁽¹¹⁾ Over the same period of time, total loans outstanding grew by 20 per cent, while the value of outstanding business loans grew by 21.4 per cent per year. Loans in general, and business loans in particular, have thus become a more important part of the Canadian dollar assets of chartered banks.

The relative importance of various sizes of business loans in the 1970s and early 80s is positively related to loan size. From October 1973 to October 1981 the outstanding value of loans with authorizations in excess of \$5 million grew by 26.3 per cent per annum. For loan authorizations between \$1 million and \$5 million, the annual growth rate was 17.7 per cent and for those between \$200,000 and \$1 million, the growth rate was 16.2 per cent. The value of loans outstanding for the smallest business loan class, less than \$200,000, grew by 13.4 per cent per year, indicating that the real value net of inflation of even the smallest class of loans increased over this period.

Over the last ten years, the outstanding value of larger loans grew faster than the outstanding value of small loans. This pattern is much more pronounced in 1981. The outstanding value of loans under \$200,000 fell in that year by 6.80 per cent, largely due to a 15 per cent decline during the month of October 1981. In contrast, the outstanding value of large loans (in excess of \$5 million) grew by 83.17 per cent in 1981. The growth in loans outstanding for the two intermediate size classes was 15.09 per cent for loans between \$200,000 and \$1 million and 25.03 per cent for those between one and five million dollars.

We know that the demand for large business loans was a major factor in raising the Canadian dollar assets of chartered banks in 1981, accounting for almost 42 per cent of this asset growth. The question to be answered is then whether this growth crowded out the availability of smaller loans. The growth in the outstanding value of medium-sized loans did not fall significantly. Rather it seems that demand factors determined the allocation of the banks' business loans by size class, with the demand for the smallest of loans being greatly affected by high interest rates. The after-tax cost of interest, for any given interest rate, is higher for small business due to the lower marginal tax rate they face. As such, they are more adversely affected by high and rising interest rates than are large firms paying normal corporate rates. Therefore high interest rates tend to reduce the demand for credit from smaller firms more so than for larger firms. Moreover, as large firms become increasingly reliant on the banks, rather than their traditional sources of financing, it can be expected that this increased demand for bank credit will put upward pressure on bank interest rates. To the extent that this happened, the demand for bank loans by small firms would have been reduced even further. It is likely that the increased demand from large companies for bank financing of corporate takeovers in 1981 compounded this problem. However the general increase in interest rates in 1981 is also related to factors other than this, as discussed earlier in the report.

Since the size classes of loans are stated in nominal terms, inflation distorts their usefulness. Accounting for the effect of inflation suggests that the provision of loans to small business was even greater than the figures we used first indicate. For example, a firm with a borrowing requirement of \$200,000 in 1973 would now require in the neighbourhood of \$414,000 if the size of the firm, measured in terms of real output or employment, did not change. This is simply the effect of inflation which increases the dollar values of a firm's inputs and outputs. An attempt to account for this phenomenon, in a manner equivalent to adjusting the nominal amounts of loan classes in accordance with inflation, has estimated that the amount of bank financing available to the smallest of business borrowers grew at a real inflation adjusted⁽¹²⁾ rate of 7.9 per cent per annum over the period 1974-1980.⁽¹³⁾ This rate exceeded the growth of the banks' business loans in general, as well as the growth in their Canadian dollar assets. This rate does not differ significantly from the real adjusted growth in the outstanding value of business loans under authorizations in excess of \$5 million, which was 8.9 per cent over this period. These data do not, however, take into account what happened in 1981. On the basis of our earlier discussion, it is clear that this longer-term relationship did not hold true in 1981 and, therefore, in that year, the real value of funding employed by the smallest of borrowers fell in relation to that employed by the largest of borrowers.

On the basis of these figures, there is no evidence to confirm that small business borrowers were receiving inadequate financing from the banking system. No systematic restriction of small loans is in evidence; rather, as we have said, the pattern of loans by size class seem to be determined by demand. Nevertheless, we recognize that problems do exist for the small business borrower. The bureaucratic nature of large organizations, such as the banking system, may itself work against small firms. Their dealings with branch managers who have low discretionary loan limits impose a number of potential barriers to the acquisition of bank loans. As such, a system which may have served the small business sector well over the longer period, could very well react differently during a period of high and volatile interest rates and economic recession, as is currently the case. We know, for example, that the corporate liquidity problem is more severe for the small firm than for the large firm. If this situation causes bank managers to become excessively conservative in their lending practices in order to minimize their bank's risk exposure, a potentially serious problem could arise for the small business sector.

Another indication of the extent to which the banks finance smaller firms is their provision of loans under the Small Business Loans Act (SBLA) by which the Federal Government guarantees loans to small businesses obtained from the chartered banks. In the testimony before the Committee, a number of complaints were raised concerning the difficulty of obtaining loans under this Act. These loans are restricted to small firms (annual sales less than \$1.5 million) and the borrower cannot be charged more than prime plus 1 for the loan. Loans guaranteed under the SBLA cannot exceed \$100,000 (until 1979 this limit was \$75,000).

In October 1973, the banks held \$96 million in loans under the SBLA. By October 1981, this figure had risen to \$785 million, representing a compound annual rate of growth of 30 per cent. For the latest year, the growth of this type of financing continued to be strong, with outstanding loans increasing by 29 per cent.

These growth rates indicate a strong demand for this type of financing. This is not surprising given the implicit subsidy inherent in these loans. Though the figures show no significant restrictions on the supply of funds through this program, this does not mean that small businesses get all the financing under this program that they wish. Lenders are required to follow normal banking practices with respect to risk exposure, although the default insurance of this program does allow banks to increase somewhat the amount of risk they undertake. So it is expected that some of the complaints about the program come from businesses that were, rightly or wrongly, thought not to represent a good enough risk.

As of October 1981, SBLA loans accounted for only 8.2 per cent of the value of outstanding business loans under authorizations below \$200,000. Because of the conditions placed on the lending institution, many of these loans would likely have been undertaken even without this program, albeit at generally higher rates. Banks appear to have used the implicit government subsidy of the SBLA chiefly to attract more loan business from small firms.

One of the recent complaints levelled against the chartered banks is the unavailability of term loans to small businesses. While 1981 data are not available, those for the period 1974-1980 show that the value of outstanding term loans tended to grow at faster rates for smaller authorizations (i.e. under \$200,000 or between \$200,000 and \$1 million) than for the larger ones. For the two smallest loan size classes, term lending grew in excess of 23 per cent per year, while for the largest loan size class, it grew by under 19 per cent per year.⁽¹⁴⁾ In addition, term lending for these smaller loan sizes grew at a faster rate than total business lending to these size classes. Undoubtedly this situation altered significantly during 1981; all parties testifying before the Committee mentioned the recent fall in term lending, especially fixed-rate term lending. Recently, supply and demand conditions have helped to determine the characteristics of loans; banks were no longer willing to supply funds, at fixed rates, over a long period of time, and borrowers were unwilling to pay the premium required to obtain such financing. Nevertheless, during the greater part of the 1970s, the Canadian banks were increasing their term lending by significant amounts; today the incidence of bank term lending is highest among the small firms.⁽¹⁵⁾ This is to be expected since large firms generally have access to public markets and other financial institutions to attract term financing.

The data at the Committee's disposal do not identify the characteristics of these term loans (i.e. their length, price or other conditions attached); however, it does appear that the chartered banks were largely meeting whatever demand existed for such loans from the small business sector up to 1981. This contrasts with the situation in the early 60s when the Bank Act restrictions tended to keep banks out of the term lending business to smaller firms.

The competitive position of the Canadian chartered banks in financing the corporate sector should be viewed in relation to its competition, including affiliates of foreign banks (now incorporated as Schedule B banks), Roynat, sales finance companies, and the Federal Business Development Bank.

Little is known about the size distribution of business loans made by Schedule B banks and their predecessors; however, if their loan patterns are similar to that of the Mercantile Bank of Canada, which concentrates on business lending and has a large wholesale operation, then the foreign banks tend to concentrate on the upper end of the market. In the

fall of 1981, Schedule B banks held about 70 per cent of their loan portfolio in business loans greater than \$5 million. The large business loans of the Schedule B banks are dwarfed in comparison to the large loans of the Schedule A banks. Although foreign banks seem to concentrate on loans in excess of \$5 million, it is also evident that they participate in the lower end of this market. However, restrictions on their capital base are one of the inhibiting factors here.

From January 1978 to August 1981, foreign bank affiliates' assets grew by almost 43 per cent per year. Although their operations are small by the standards of Schedule A banks, they have the potential to provide a strong new source of competition in the business lending area. The Committee encourages these banks to seek out business opportunities with small and medium-sized companies.

Roynat was established in 1962 to specialize in the provision of term loans to small and medium-sized businesses. Nevertheless, since the mid 1970s, its operations have grown at rates below those of the chartered banks and foreign bank affiliates.

Sales finance companies were much less active during the 1970s as financial intermediaries. They have been moving strongly into the area of commercial business loans, although this still represents only 9.50 per cent of their loan business.

The Federal Business Development Bank is an institution that specializes in term lending to small business. Its relative position as a lender to these firms has deteriorated rapidly since the mid 1970s. At the lower end of the business loan market, the growth of FBDB loans was about one-fifth that of chartered bank loans under \$200,000,⁽¹⁶⁾ in real adjusted terms. In order to maintain any kind of position in the market, the FBDB has moved to very small loans, with the average loan size being \$35,000 in 1980.

In the 1970s, as the chartered banks became very active in business term lending and in small business financing, they had to compete with a number of private lenders as well as with the government as lender. To the extent that the banks have been able to increase their market share, it is largely due to their ability to provide the kinds of services demanded at competitive prices. The competition will increase further as the Schedule B banks reach the upper limit of allowable activities as specified under the Bank Act. However, it has also been indicated that granting charters to foreign bank affiliates in Canada has actually reduced the amount of competition they exert on Schedule A banks because of the regulations they now face.

Studies on Small Business Finance

Two major studies on small business financing have recently been released. A Report to the United States Congress has been prepared by the Interagency Task Force on Small Business Finance.⁽¹⁷⁾ In Canada, a study on the role played by the chartered banks in financing small business has also been completed.⁽¹⁸⁾ Although the institutional environments examined are dissimilar, the results of the studies are in many ways alike.

These studies found that small business borrowers of the chartered banks pay higher interest rates than large borrowers even though the loans appear to be essentially the same in other respects.

There are a number of reasons given for this. In the first place, the fact that small borrowers tend to take out small loans while large customers borrow large amounts significantly alters the per dollar costs of handling a loan. Competition ensures that banks tend to pass on to the consumer whatever advantages there are in administering larger loans. Furthermore, small businesses tend to be higher risk customers than larger firms, particularly if they are new or young firms. Other reasons for the greater risk premium attached to smaller loans are the greater variability in small business profitability and the higher leverage which characterizes such firms. Not all of this risk can be compensated for by, say, higher collateral requirements.

These factors are well known and accepted as reasons for justifying higher loan rates to small firms when compared to larger firms. The issue to be pursued then is whether all of the difference in lending rates can be so justified, or whether large borrowers are being subsidized by small borrowers.

According to the recent Canadian study referred to, about three-quarters of loans to large firms were in the prime to prime plus 1 category, while most loans to small businesses fell in the prime plus 1 to prime plus 2 category. Allowing for differences in risk, location, and variables relating to bank branches, this study concluded that small firms (annual sales less than \$500,000) tended to pay between 42 and 64 basis points (i.e. 0.42 per cent and 0.64 per cent) more for loans than large firms. Intermediate-sized firms (annual sales up to \$2 million) tended to pay a smaller premium (26 to 46 basis points) for their loans. Differences in risk and business location could explain, at most, 25 per cent of the variation in interest rates by firm size.

To find another explanation for this difference, the authors examined administrative costs of lending. They found that, considering everything to do with administration of loans, the larger the loan size, the greater the ease of handling, whether in monitoring, obtaining information, or dealing with irregularities like overdrafts and delayed interest payments.

Although this particular study is not as quantitative in nature as some other discussions of administrative costs, it does lend support to the general conclusion that the difference in administrative costs can reasonably account for the observed interest rate premiums paid by small borrowers. It provides no evidence to suggest that smaller borrowers subsidize larger ones, and even suggests that small borrowers may not pay the full cost of their loans⁽¹⁹⁾ However if this latter phenomenon does exist, market competition should ensure that it is short lived.

The American studies on small business finance arrive at largely similar conclusions to those found for Canada. On the basis of 1979 data, it is shown that administrative costs vary significantly according to loan size.⁽²⁰⁾ It costs 2.20 per cent per year to administer a \$10,000 loan, 1.35 per cent for a \$100,000 loan and 0.96 per cent for a \$500,000 loan. For larger loans, these unit costs fall much more slowly. Nevertheless, different administrative costs explain 39 basis points of interest rate difference between \$100,000 and \$500,000 loans, and 78 basis points of interest rate differential between a \$50,000 and \$500,000 loan.

As expected, interest rates charged to business in the United States also fall with the size of loans; however, they apparently do not fall as quickly as does the cost of loans. For the year under study, 1979, the normal inverse relationship between interest rates charged and size of loan tended to compress and even reverse itself. In 1979 and again in 1981, small loans were actually being charged lower interest rates than larger loans.⁽²¹⁾ One explanation offered by the author of that study was the fact that large borrowers tend to rely on bank credit only irregularly, while small firms are traditionally dependent on banks for financing. American banks thus felt they could discriminate against larger firms since they did not have to cultivate long-term relationships as is the case with smaller firms. In addition, the existence of deposits with interest rate ceilings provided some low cost funds which could be used to keep small business loan rates relatively low.

However, the phenomenon discussed above can also be explained by other factors. Large loans are much more likely to be made on the basis of floating interest rates, while smaller loans are more often at fixed rates. As a result, large loans would react more quickly to rising rates than smaller loans. In other respects, such as the use of collateral, these comparisons are not made among homogeneous loans. Moreover, there is some evidence to suggest that part of the credit rationing imposed by banks was on the basis of quantity rather than price. Small borrowers may have received loans at rates below what their characteristics would normally dictate; but they were restricted in the availability of credit.

Collateral requirements imposed by banks vary greatly by size of borrower. On the basis of a survey of Canadian bank loan files, it was calculated that the average amount of collateral pledged on business loans was 279 per cent of the loan, of which 2/3 was personal collateral.⁽²²⁾ The amount of required collateral was inversely related to firm size; the largest class of firms typically pledged 200 per cent of the loan amount as collateral, while new firms were pledging over 400 per cent of the value of the loan in collateral. The smaller firms also tended to pledge a higher proportion of personal collateral than the larger firms. American statistics tend to support these qualitative conclusions.

Collateral requirements have increased substantially in the past year, according to testimony before the Committee. Part of the reason for this may be that the bank manager and the borrower put a different value on pledged assets; the current recession has done much to reduce the value of certain business assets.

There is no evidence to suggest that the banks' valuations of collateral differ strictly on the basis of loan size or size of borrower. Where companies pledge fixed assets as guarantees, the banks' valuation as a ratio of book value varies little. For the most part, small borrowers are required to pledge more collateral because of higher risk and the lower quality of their assets. In the United States, large loans are far less likely to be secured by collateral than small loans. Moreover, the use of collateral has been increasing since 1977 for small loans while its use has decreased for large loans.⁽²³⁾

Despite the high levels of collateral pledged against loans to small business, banks are still subject to considerable loss at time of default. Banks were found to recover only 38 per cent of the value of collateral, estimated at the last review. This ranges from a low of 15 per cent on personal collateral to a high of 81 per cent on fixed business assets. Overall, banks tend to recover only 23 per cent of the outstanding value of loans in the case of default. The

Committee feels that when the Bankruptcy Act comes up for revision, the practices and procedures of "receivers" should be reviewed as they pertain to the sale of assets at less than fair market value.

Small businesses in Canada tend to deal with small bank branches in the expectation of better access to and familiarity with bank officers. However this tendency does produce a number of potential difficulties. In the first place, managers of small branches tend to be allowed low discretionary credit limits. This increases the role of divisional bank officers who are unfamiliar with the business clients operations and needs. Moreover it simply adds another bureaucratic layer to the process by which smaller firms obtain financing and may increase the chance of loan rejection. Second, managers of small branches are often more likely to attempt to cushion the risk exposure of their loans by demanding larger amounts of collateral. We know that smaller firms are required to pledge more collateral for loans than larger firms and this, in itself, restricts the amount of financing available to smaller firms. Third, managers of small bank branches tend to be frequently transferred. This turnover further reduces the familiarity of lending officers with their small business clients and may adversely affect the ability of small business to receive adequate financing.

As a general rule, banks do not take on high risk loans even if this risk could be compensated for through high interest rates. Commercial loans are charged rates between prime and prime plus 3. For term loans granted to new businesses, only 6 per cent exceeded a rate of prime plus 3. For operating loans, about 1 per cent of the smaller firms were charged such high rates.⁽²⁴⁾ Thus very risky loans are rationed, not by price, but by amount. This may be one reason why some small businessmen complain of inadequate financing by banks.

In 10 per cent of cases, banks lend less than what they were asked for; and, in addition, about 5 per cent of all loan applications are declined, these being usually the riskier ones.

The small business-bank relationship should be considered in both the longer-term perspective as well as in the very recent context. Over the past decade, the evidence indicates that the banks tended to treat their smaller clients no differently than large clients with respect to pricing and availability of funds. This is a direct result of competition in the market. Nevertheless, the nature of the small business sector in Canada and the type of financial institutions they deal with, namely the banks, could pose problems for the future financing of smaller firms.

Recent economic conditions highlight and exacerbate these problems, as was indicated earlier in this Report. During periods of high interest rates, small firms cannot compete for funds as effectively as large businesses, due largely to differential tax rates. As large firms move into the traditional sources of small business financing, as they did in 1981, smaller firms may be shut out. The current liquidity crisis has affected the small business sector more heavily than larger business. Thus the risk exposure of the banks relative to small borrowers has increased more than the risk exposure relative to larger borrowers. The traditional risk aversion of banks, as witnessed by their high collateral requirements, has prompted them to become extremely cautious in their lending practices. The Committee recognizes that these factors can lead to potentially serious problems for small firms, and we strongly urge that the senior management of the banks act to ensure that branch managers and loan officers are more sensitive to the plight of their smaller business customers. In

addition, we recommend that the Minister of State for Small Business quickly appoint the members of the advisory committee to investigate small business financing and that his advisory committee specifically examine the problems outlined above. It should also examine ways of alleviating the financing problems of small business, through means such as: insurance schemes for small business loans, similar to those now provided by CMHC in the case of mortgage loans; the possible extension of SBLA loans to the financing of working capital as well as an increase in the limit on the size of these loans to, say, \$200,000; and the possibility of providing loan insurance, and other innovations which would allow small firms to obtain greater access to term loans from pension plan funds.

Regulation and Competition in Business Lending⁽²⁵⁾

The Canadian chartered banks are allowed to engage in the business of banking in the broadest sense of the term. Their investment portfolios are limited in certain respects, it is true; for example they can invest in no more than 10 per cent of the voting shares of any particular company. But they are freer than the near-banks, which, although they may control up to 30 per cent of the equity of any given firm, must first meet very detailed restrictions.

A similar pattern exists with respect to investment in debt instruments. Again, banks are subject to no specific statutory restrictions, yet near banks are subject to a wide range of restrictions with respect to earnings, security, and type of debt instrument.

Financial intermediaries can expand the scope of their activities through subsidiaries, but once again, the scope for such expansion is more limited for near banks than for banks. Moreover, special statutory powers enable the banks to engage in "core" business banking activities denied to non-banks. Banks can finance all major sectors of the economy, whereas the near banks can only undertake authorized investments. Near banks can make use of the basket clause which enables them to make unauthorized investments; however, they are limited in the use of this provision. For example the total value of unauthorized investments cannot exceed 7 per cent of their total assets in the case of trust and loan companies.

It is clear that the Canadian regulatory system allows the chartered banks greater flexibility in their activities than the near-banks. Competition does exist among a number of institutions in the business lending field and from the newly chartered schedule B banks, although the competitive impact of this latter group of institutions may be lessened if they soon reach their limits on total assets.

Bank Services

Over the past few years the banks have initiated a number of new services for commercial clients. Some of these are in the traditional line of banking business while others represent activities of a more peripheral nature. At the request of the Committee, the Canadian Bankers' Association conducted a survey of bank services provided by three of the five largest banks and it is on this survey that the following discussion is based.

One of the surveyed banks stated that the Bank Act precludes the introduction of new services based on current technology. Thus its "new" services are basically variations on old services. To some extent, this is also true of the other banks surveyed.

These services largely fall into three categories: cash-management services that use the computerized facilities of the banks; financing services that include new lending instruments; and business services.

Financing services contain a number of loan plans with varying terms to maturity and down payment requirements. Interest rates are usually floating although fixed rates for one year are sometimes available. Under some plans, banks take partial equity in assets. Fixed-rate farm mortgages and one year fixed-rate farm equipment financing packages have also been introduced.

Financing plans made in conjunction with various government programs have recently been instituted. These include Small Business Development Bonds, SBLA loans, the Quebec Industrial Development Corporation's Emergency Programme and the Newfoundland Fishery Vessels Assistance Plan.

New or modified services with respect to cash management and business operations largely were the result of increased computerization of bank operations. Electronic collection and centralization of funds and consolidated reporting were introduced in order to reduce the need for idle business cash balances. Daily interest commercial accounts and automatic transfer of funds among accounts were designed to reduce the cost of holding such balances and these services saved on accounting costs to firms.

The choice of new services provided at the retail and commercial levels was stimulated by high interest rates, new modes in computerization, and competitive pressures on banks to differentiate their products. Most of these services were aimed at small and medium-sized firms.

Bank financing of farms

In many ways, the difficulties farmers face in arranging financing for their operations parallel those of small businessmen. They have come to depend heavily on banks for their financing. They, too, lament their slighter chances of obtaining long-term fixed-rate financing, and they question the amount of collateral required.

Bank loans outstanding to farmers have grown at a compound annual rate of 18.30 per cent from December 1973 to October 1981. While this has been slightly lower than the growth rate of total bank loans, it has exceeded the rate of growth of Canadian dollar assets of the chartered banks. In fact, the banks have picked up some of the funding normally provided by the Farm Credit Corporation during the 1970s.

From October 1980 to October 1981, bank loans to farmers increased by only 7.56 per cent. It is likely that much of this drop is due to factors on the demand side. As with small businesses, farmers are required to pledge security greatly exceeding the value of the loan obtained from the bank. Since much of this security is in the form of farm produce that may

not be ready for marketing, the value of the security varies over the length of the farm season. Farmers suffer severe hardship if an operating loan is called. Then there are a number of other non-price conditions attached to their loans. Farm organizations before the Committee questioned the value of advice received from bankers and bank agronomists. Some farmers who followed the advice of their bank managers have found themselves in serious financial difficulties.

The banks' practice of lending on the basis of asset value rather than estimated cash flow, has been called into question, especially as it relates to farm loans. Normally this lending practice would cause no problems. Asset values tend to reflect the future cash flow of the assets generating this income. However, as interest rates rise, a given future cash flow is translated into a lower current value of the asset. Moreover, if a loan were taken out at floating rates, say, future cash flow might be inadequate to cover unexpected rises in interest rates. If future cash flow is also reduced, this problem is further compounded.

This is precisely the situation many farmers now face. Loans taken out in times of expected income growth and continuously rising asset values may have been financially sound at the time. However, rising interest rates and falling incomes have produced a situation where some farmers are facing liquidity problems on loans for which insufficient collateral now exists. What this shows us is that farmers, and the bankers who advised them, were as much at a loss as anyone else in predicting the current economic climate.

Farm incomes are notoriously volatile. This volatility can generate liquidity problems for farmers in the future.

But there is a second, more important reason for questioning the practice of lending on asset value. Prices for farms, like house prices, were significantly bid-up in the early 1970s as a hedge against inflation, because of beneficial tax treatment, and for speculative reasons. This boom increased farmers' equity in their property and therefore the value of their potential collateral. Moreover, the nature of farm land as a stable form of collateral, encouraged banks to possibly over-extend farm loans. Eventually, when this boom in prices for farms subsided, farmers found themselves in a precarious financial position.

One of the reasons farmers find bank financing inadequate is that for a long time their financing has largely been handled through various federal and provincial agencies, at subsidized rates. The shift to bank lending at market rates, at a time when these rates increased to record levels, made financing their operations all the more difficult. Besides, farmers feel that farming's vulnerability to nature and climate should be reflected in flexible conditions and terms for bank loans. In this sector, some provision could be made by amending existing legislation to provide an additional period of time to allow the borrower to arrange alternative financing or to re-negotiate existing loans.

5.3 CUSTOMER COMPLAINTS

It has been argued here that competition in financial markets tends to reduce, if not eliminate, systematic biases in the treatment of customers by the banks. Nonetheless, it is expected that individual cases of discrimination, abuse, poor service, etc. will recur. During

the hearings, a number of such instances were raised by witnesses appearing before the Committee. These complaints included long line-ups at tellers' windows, unexplained service charges, the lack of information regarding electronic funds transfer, loan rejections, the unexpected calling of demand loans, inadequate financing, etc. Undoubtedly, many of these customer complaints have some validity.

In some instances, these grievances are far from trivial. A small business which is denied financing or has a loan unexpectedly called, can suffer serious financial difficulties. The fact that no systematic biases exist, is of little comfort to the individual who suffers from an isolated case of such discrimination. The testimony of Mrs. Alix Granger before the Committee was replete with such case histories of individuals who had a long and mutually-beneficial relationship with a particular bank only to be treated as a poor credit risk. Unfortunately, the Committee has no way of judging the validity of such complaints.

The Consumers' Association of Canada supplied the Committee with a survey of complaints against financial institutions. This survey was useful in indicating the nature and areas of complaints; but, again, the Committee could not put this information into historical perspective nor could it evaluate the extent of these problems.

Nevertheless, the fact that the public used these hearings as a forum in which to air their grievances indicates the perceived need for a body designed to record and possibly resolve such complaints regarding the banks.

While the broad statistical evidence that is available does not support the contention that the banking sector is able systematically to favour some customers to the detriment of others, it is evident that individual cases of valid complaints against the banks do exist. The Committee feels that individuals need a forum where complaints can be registered and which will give the public confidence that, where necessary, appropriate action will be taken.

The Committee is somewhat surprised that individual banks have not established offices in which objections pertaining to their own operations can be dealt with. In this economic climate, it should be expected that the banks would be the target for an increasing number of complaints, and it would seem to be in their own best interest to set up some mechanism to deal with this.

We strongly suggest that those banks which have not yet done so, immediately set up offices to deal with complaints concerning their own operations. In the event that no other means are set up to deal with these matters, we recognize the role of the Office of the Inspector General of Banks as the ultimate arbiter of complaints concerning the banks, as Mr. Kennett pointed out to us in our hearings.

Where the complaints concern the payments system as a whole, as in electronic funds transfer, they should be directed to an office established and maintained by the Canadian Payments Association. We expect that a growing number of future complaints will be directed to this particular service in the future.

5.4 SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Households and small businesses transact business with banks in three ways: as borrowers, as savers, and as consumers of banking services. The extent to which these clients receive adequate treatment at the hands of the banks is largely a function of the level of competition amongst the individual banks and amongst the various institutions engaged in these financial markets.

Although household savers have a choice of many ways to invest their savings, they have shown a marked preference for deposits with the banks. Yet, banks are not the sole deposit-taking institutions; they must compete with trust companies and credit unions, etc. There is competition in the rates of return on savings and in the quality, quantity, and price of services. The banks can only increase their share of this market to the extent that they meet the needs of savers better than their competitors do.

Already dominant in the consumer loan business by 1970, the banks increased their share of it dramatically over the next ten years. After the revisions to the Bank Act in 1967, the chartered banks effectively displaced sales finance and consumer loan companies from the market.

From 1970 to 1980, the banks also increased their share of the mortgage market. This was made possible by the removal of the 6 per cent interest rate ceiling that had existed prior to 1967, and by the banks' use of subsidiary companies that circumvented the restriction on bank activity in mortgages. The banks used these companies for matching assets and liabilities, and to provide themselves with alternative sources of funds not subject to reserve requirements. The large-scale entry of banks into this field has also brought about a number of innovative mortgage instruments for coping with the current high rates of interest.

The trend toward greater corporate reliance on bank loans and short-term loans is even more pronounced for small businesses. **There is no indication that the availability of loans to small businesses are inadequate in any well-defined sense.** The evidence rather suggests that bank loans to various sizes of business are demand determined.

Similarly, with regard to the pricing and quality of loans to small businesses, there is no hard evidence that banks discriminate amongst the various sizes of firms as to what they required for collateral, or what they charge as interest. Where small businesses appear to pay higher prices or make other concessions, higher administrative costs to the banks and greater risk exposure tend to explain these differences.

On the whole, the existing regulatory system allows greater freedom to banks than to other financial institutions. The results presented in the Committee's report, are consistent with what would be found in a competitive market. No discrimination appears to exist, and pricing seems to be tied to cost. In this respect, the impact of regulation appears to be neutral. Indeed, **competition defined by regulation is less likely to guarantee such results in the long-run, than competition determined by market forces.** Currently, financial markets are competitive, but future competition may be hindered by regulatory constraints placed on the banks' competitors. We are particularly concerned with the ability of small business to obtain funds from a wide variety of financial institutions. The Committee recommends that:

12. Competition should be further increased by expediting revisions to the Trust Companies' Act and the Loans Companies' Act, to allow an expansion of lending powers in the consumer and business loan markets.

In the hearings, the Committee received a number of complaints regarding inadequate and over-priced services to some clients. It is a general perception that such behaviour is widespread and frequent; however, the nature of the Committee's evidence does not indicate that such practices are employed systematically. To the extent that such accusations are valid, the fostering of greater market-oriented competition can do much to remedy this situation and to ensure that it does not become a significant problem in the future.

Competition tends to reduce any systematic bias against specific groups of bank clients and any propensity to provide inadequate or over-priced services. Nevertheless, isolated instances of such practices will undoubtedly recur, and therefore there should be some mechanism whereby consumer complaints can be heard and dealt with, and through which the nature of various bank services can be explained. The Insurance Bureau of Canada maintains such a service in its "Hotline" facilities. Many of the complaints heard by the Committee concerned Electronic Funds Transfer that, under the law, is the responsibility of the Canadian Payments Association. The Committee recommends that:

13. The Canadian Payments Association should establish and maintain an office where complaints can be lodged and filed, and minor disputes settled, and where services can be explained to the public.

This office is to respond to complaints that apply to the overall payments system. The Committee encourages all banks to establish offices of their own for dealing with complaints that are directed to their own operations. Moreover, we recognize the role of the Inspector General of Banks as the ultimate arbiter of complaints concerning the banks. (The Committee recognizes that other avenues are available to individuals who have valid complaints, one of which is the courts.) Thus a "complaints structure" can be initiated with complaints about individual banks being handled by those institutions and systemic complaints being handled by an office established by the Canadian Payments Association.

The entry of Schedule B banks into the Canadian banking sector can be a potential source of increased competition. Accordingly, the Committee recommends that:

14. The Office of the Inspector General of Banks should report to Parliament within two years on the status of Schedule B banks with respect to leverage, branching, and asset ceilings.

The measures described above may still prove to be inadequate to resolve some of the serious financing problems faced by small businesses, especially in today's economic environment. The Minister of State for Small Business has established a committee to examine the question of small business financing.

We recommend that:

15. The Advisory Committee on Small Business Financing give specific attention to the problems faced by small firms with respect to the possible crowding-out of small

borrowers during times of high interest rates, the impact of taxation on the demand for credit by various sizes of firms and the problems inherent in the institutional setting under which small firms must seek financing. This advisory committee should also examine possible solutions to these problems which may include: the introduction of loan insurance for small business loans, similar to that which the CMHC provides for mortgages; an extension of the size and scope of SBLA loans; and measures to increase the accessibility of pension plan funds to the small business borrower.

FOOTNOTES

- (1) Economic Council of Canada, *Efficiency and Regulation - A Study of Deposit Institutions*, 1976, p. 49.
- (2) This restriction is less important than it appears because chartered banks can effectively increase their mortgage lending activities (as substantiated in the following subsection on market share analysis) through subsidiary mortgage loan, real estate investment trust and mortgage investment companies.
- (3) Drawn from Bank of Canada Review.
- (4) For a documented study on these innovations, see: H.M. Binhammer and Jane Williams, *Innovations in Deposit-Taking Institutions*, Economic Council of Canada, 1977.
- (5) For a fuller discussion of the history of the interest rate ceiling and the legality of the service charge, see Anna L. Guthrie's "History of the Statutory Ceilings on Bank Lending Rates in Canada", *Economic Trends & Topics*, Economic Research Department, Royal Bank of Canada 1966.
- (6) A.L. Guthrie (1966).
- (7) For a fuller discussion, see "The residential mortgage market, An analysis of recent trends", by W. Paul Jenkins in *The Bank of Canada Review*, January 1979, p. 3-15.
- (8) Jenkins (1979).
- (9) For a fuller discussion of alternative mortgage schemes see for example: J.R. Kesselman, "Mortgage Policies for Financial Relief in Inflationary Periods", *Canadian Public Policy*, VII:1, Winter, 1981; F. Modigliani and D.R. Lessard, eds., *New Mortgage Designs for Stable Housing in an Inflationary Environment*, F.R.B. Boston, Conference Series No. 14, Boston, Mass., 1975.
- (10) These figures come from Bank of Canada statistics.
- (11) The data from which these growth rates are calculated come from the Bank of Canada Review
- (12) This real adjusted rate takes into account the impact of inflation on the nominal rate of growth of loans outstanding and on the nominal value of loan size classes.
- (13) D.G. McFetridge, *The Capital Market and Small Business*, Mimeo, Department of Industry, Trade and Commerce, Ottawa, March 1982, p. 33
- (14) D.G. McFetridge (1982).
- (15) L. Wynant et al., *A study of Chartered Bank Financing of Small Business in Canada*, prepared for the Department of Industry, Trade and Commerce, Ottawa and the Canadian Bankers' Association, Toronto, preliminary draft, May 1981, p. 320.
- (16) D.G. McFetridge (1982).
- (17) United States, Interagency Task Force on Small Business Finance, *Studies on Small Business Finance*, Report to the United States Congress, Washington, D.C., 1982.
- (18) L. Wynant et al., *A Study of Chartered Bank Financing of Small Business in Canada*, prepared for the Department of Industry, Trade and Commerce, Ottawa and the Canadian Bankers' Association, Toronto, preliminary draft, May 1981; see also J. Hatch et al., *Bank Loans to Small Business*, *Canadian Banker & ICB Review*, Vol. 89, No. 1, February 1982, p. 6-14.
- (19) L. Wynant et al., p. 444.
- (20) Neil B. Murphy, "Loan Rates, Operating Costs and Size of Loan: The Evidence from Cross-Section Data", *Studies on Small Business Finance*, Washington, D.C., 1982.
- (21) Thomas F. Brady, *Commercial Bank Business Lending By Size of Loan*, *Studies of Small Business Finance*, Washington, D.C., 1982.
- (22) L. Wynant et al (1981).
- (23) Thomas F. Brady (1982), p. 6.
- (24) L. Wynant et al (1981).

(25) A more detailed look at the regulations governing financial intermediaries can be found in: Katharine Dunkley, Overview of the Regulatory Structure of Deposit Taking Institutions, Background Paper, Research Branch, Library of Parliament, Ottawa, 22 June, 1982.

Appendix A

A Glossary of Terms

BALANCE OF REVENUE AFTER TAXES	Net income after taxes. It is the sum of income from loans, investments and other services less deposit interest costs, loan losses, overhead expenses, and all domestic and foreign taxes.
BALANCE SHEET	A condensed financial statement showing the distribution, type and amount of assets, liabilities and capital of a corporation at the end of the corporation's fiscal year.
BANK INTEREST RATE SPREAD	Not to be confused with interest rate spread. Bank spread is a generic term indicating a measure of the difference between yield on assets and cost of deposits in a bank. Measures of bank spread include after tax return on average assets, net yield-cost spread on earning assets and net spread on loans.
BANKERS' ACCEPTANCES	A bill of exchange or negotiable instrument drawn by the borrower for payment at maturity and accepted by a chartered bank. The acceptance constitutes a guarantee of payment by the bank. By virtue of this feature, the bill becomes negotiable and can be traded in the money market. A company can thus borrow in the money market not only against its own security but also against the guarantee of the accepting bank.
BOOK VALUE	The amount of net asset (i.e. the amount of assets remaining after all liabilities are paid off) belonging to the shareholders of a corporation.

BOND	Certificate of indebtedness issued by governments or corporations when borrowing capital funds. The bondholder is a creditor vis-à-vis the borrower. In case of bankruptcy, bondholders have first claim on the corporation's assets before shareholders.
CAPITAL STOCK	Sum of common and preferred stock representing the proprietary interest of the shareholders in a corporation.
CANADIAN LIQUID ASSETS	Consists of Bank of Canada notes and deposits, day and call loans to investment dealers, Treasury bills and Government of Canada bonds.
COMMERCIAL PAPER	Promissory notes issued by commercial and industrial corporations. Normally, companies wishing to borrow by issuing commercial paper must have standby lines of credit from a bank or guarantee by an affiliated company. Much of the funds thus borrowed are used to provide short-term working capital to the company due to temporary shortages in operating cash requirement.
COMMON STOCK	A class of share capital which represents the shareholders' ownership in a corporation and normally carries voting privileges.
CONVERTIBLE DEBENTURE	A debenture which can be exchanged on specific terms for the company's common shares at the holder's option. It carries a fixed rate of interest and a maturity date as a bond or a debenture. It also offers opportunities of capital gains when the bond is converted.
DEMAND DEPOSITS	Non-interest bearing chequable deposits.
DIVIDEND PAYOUT RATIO	Amount of dividend payment to shareholders related to balance of revenue after taxes, expressed as a percentage.
EARNING ASSETS	Loans and securities are the earning assets of banks.
EARNINGS RETENTION RATIO	Amount of retained earnings related to the balance of revenue after taxes, expressed as a percentage.
EFFECTIVE TAX RATE	Ratio of actual amount of income taxes paid to a bank's balance of revenue before taxes.
EQUITY CAPITAL	Sum of common share capital, preferred share capital, convertible debentures, rest account, undivided profits, and

accumulated appropriation for losses. Currently, there is no uniform definition of capital. The Inspector General of Banks is urged by this Committee to provide a set of precise guidelines relating to the calculation of capital.

EURODOLLAR

Originally, short term deposit liabilities, denominated in U.S. dollars of banks in Europe. Similarly, there is now Asian-dollar, Euro-yen, Euro-mark and so on. It is now generally used to refer to short term deposits, denominated in a specific currency but placed in a bank in a country other than that of the currency.

EXTERNAL SOURCES OF FINANCING

Sources of new funds derived from the outside of a corporation such as borrowing by debentures and new equity capital.

FLOATING RATE LOAN

A loan which does not have a fixed rate of interest throughout the term of the loan. The rate of interest usually adjusts in accordance with some predetermined manner related to changes in the prime rate.

INTEREST RATE SPREAD

The difference between some typical interest rates such as the prime and savings rate.

INTERNAL SOURCES OF FINANCING

Sources of new funds generated from within a corporation such as retained earnings and capital cost allowance.

INVENTORY PROFIT

In banking, it refers to the phenomenon of temporary rising profits when interest rates rise rapidly because earlier deposits are locked in at a lower rate while loans with floating rates immediately reflect the interest rate rise. Conversely, when interest rates decline quickly, a temporary inventory loss is incurred as floating rates on loans decline while deposit rates are locked in at higher rate of the preceding period.

INVENTORY SPREAD

The difference between the current lending rate and the deposit rate of an earlier period. Because banks often have to fund current loans with deposits received earlier, the inventory spread is also known as the funding spread.

LEVERAGE

In the case of banks, it refers to the amount of the total assets a bank has in relation to the equity capital of the shareholders of the bank. It is an indicator of safety and stability of a bank.

LOAN SUBSTITUTES

A term referring to specific instruments used by the Federal Government to enable certain corporations to

	finance their operations at a cost slightly above half of the prime rate. The instruments are income debentures, term preferred shares, Small Business Development Bonds (SBDBs) and Small Business Bonds (SBBs). Today, only the SBBs are still in effect.
MARGINAL TAX RATE	The rate of taxation applicable to the last dollar of earnings. In Canada, the marginal tax rate on personal income rises progressively as income rises.
MONETARY POLICY	A policy of the Federal Government implemented by the Bank of Canada through operations of chartered banks for controlling credit, money supply and the level of interest rates in a manner consistent with the government's major economic policy objectives.
MONEY MARKET	There is not a single specific definition of money market. It usually refers to that part of the capital market where short term (under 3 years) financial instruments are traded. These generally include Treasury Bills, commercial paper, bankers' acceptances, bonds maturing in three years or less and guaranteed investment certificates.
MONEY MARKET FUND	Investment funds financed by the issuance of shares whose yield matches closely those offered by money market instruments such as Treasury Bills, commercial paper, and bankers' acceptances.
MORTGAGE	A loan contract whereby a property is pledged as security for the loan.
NET INTEREST REVENUE	Total interest received on loans and investments less total interest cost of deposits.
NET SPREAD ON LOANS	The difference between the average yield on all loans and the average cost of deposits used to fund those loans.
NET YIELD-COST SPREAD	The difference between the yield on all earning assets and the cost of deposits.
NON-CURRENT LOAN	A loan whereby, in the judgment of the bank, full interest or principal may not be recoverable.
NON-PRODUCTIVE LOAN	A loan on which no interest has been paid for a period of 90 days or more.
PREFERRED STOCK	A class of share capital which entitles the shareholders to certain preferences over common shareholders, such as

dividends and return of the stock's par value in a liquidation. Preferred stock does not have any voting rights attached to them.

PRICE-EARNING RATIO

The market price per share divided by the earnings per share. It must be evaluated in relation to the P/E ratio of other companies in the same industry. A higher than normal P/E ratio indicates either the stock is over-valued by the market or the earnings of the company are expected to rise sharply over the near future or the management, and other factors, are superior.

QUICK ASSETS RATIO

Ratio of current assets less inventories to current liabilities. It shows for every dollar of current liability, the amount of assets that can be used as working capital.

RETURN ON ASSETS (ROA)

Balance of revenue after taxes related to average total assets expressed as a percentage. Along with return on equity (ROE), it is one of the two standard measures of profitability and efficiency for the banking industry. It can be used as a basis for intra-industry performance comparison.

RETURN ON EQUITY (ROE)

Balance of revenue after taxes related to shareholders' equity expressed as a percentage. Along with return on assets (ROA), it is one of the two standard measures of profitability and efficiency for the banking industry. It can be used as a basis for inter-industry performance comparison.

SHAREHOLDERS' EQUITY

Ownership interest of common and preferred stockholders in a company. On the balance sheet, it is the difference between the assets and liabilities of a bank.

SOVEREIGN RISK LOAN

Loans to a sovereign state. Historically, defaults on such loans are virtually unknown.

SPREAD

The difference between two types of interest rates. Typically, it refers to the difference between the cost of funds to the banks (i.e. deposit rate) and the price of loans to the borrower (i.e. loan rate).

STATUTORY TAX RATE

The current federal statutory tax rate applied to chartered banks is 48.3 per cent. Incorporating provincial statutory tax rates which vary from province to province, the overall statutory tax rate applied to banks ranges from 48.3 per cent to 51.0 per cent.

**SUBORDINATED
DEBENTURE**

An unsecured bond representing a direct obligation of the issuing corporation and ranks behind all current liabilities in case of liquidation. Subordinated debentures of banks rank behind all other security and indebtedness including deposits.

TREASURY BILL

Short-term government debt of up to 180 day maturity sold through designated investment dealers known as money market jobbers. It is sold at a discount and matures at par without any specified interest. The difference between the discount price and par value at maturity is the yield to the investor.

**WORKING CAPITAL
RATIO**

Ratio of current assets to current liabilities. It is an indicator of the amount working capital available to a corporation if all current debts are paid off.

Appendix B

Witnesses at Public Hearings

WITNESS	ISSUE	DATE
BANK OF CANADA Ottawa, Ont. Mr. Gerald Bouey Governor	97	Thursday, 03/06/82
BANK OF MONTREAL Montreal, Que. Mr. W.D. Mulholland Chairman and Chief Executive Officer	97	Thursday, 03/06/82
BANK OF NOVA SCOTIA Toronto, Ont. Mr. J.A. Gordon Bell President and Chief Operating Officer Mr. R.R. Holmes General Manager, Investments Mr. R.L. Brooks General Manager, Finance and Administration	100	Monday, 07/06/82
BANQUE NATIONALE DU CANADA Montréal, P.Q. M. Michel F. Bélanger Président du conseil Président et chef de la direction	101	Tuesday, 08/06/82

BRINK, HUDSON & LEFEVER LTD. Vancouver, B.C. Mrs. Alix Granger Vice-President, Investment Management	102	Wednesday, 09/06/82
BURNS FRY LIMITED Toronto, Ont. Mr. Hugh M. Brown Director	85	Wednesday, 12/05/82
CANADIAN BANKERS' ASSOCIATION Toronto, Ont. Mr. R.M. MacIntosh President Mr. W.E. Bradford Mr. Michel F. Bélanger	88	Thursday, 20/05/82
CANADIAN CENTRE FOR POLICY ALTERNATIVES Ottawa, Ont. Mr. R.T. Naylor	86	Thursday, 13/05/82
CANADIAN FEDERATION OF INDEPENDENT BUSINESS Willowdale, Ont. Mrs. Patricia Johnston Vice-President, Legislative Affairs Mr. Jim Bennett Director, National Affairs	92	Thursday, 27/05/82
CANADIAN FEDERATION OF LABOUR Ottawa, Ont. Mr. James A. McCambly President Mr. Jack Kearney	92	Thursday, 27/05/82
CANADIAN IMPERIAL BANK OF COMMERCE Toronto, Ont. Mr. Russell E. Harrison Chairman and Chief Executive Officer	101	Tuesday, 08/06/82
CANADIAN INSTITUTE FOR ECONOMIC POLICY Toronto, Ont. The Hon. Walter Gordon Chairman	88	Thursday, 20/05/82

CANADIAN LABOUR CONGRESS	94	Tuesday, 01/06/82
Ottawa, Ont.		
Mr. Donald Montgomery		
Secretary-Treasurer		
Mr. Ronald W. Lang		
Director, Research and Legislation		
Mr. Vincent Chapin		
Ms. Catherine McGuire		
CANADIAN UNION OF PUBLIC EMPLOYEES	104	Thursday, 10/06/82
Ottawa, Ont.		
Mr. Gil Levine		
Research Director		
Mr. John Calvert		
Mr. Duncan Cameron		
CONFEDERATION DES SYNDICATS NATIONAUX	102	Wednesday, 09/06/82
Montreal, P.Q.		
M. Gérald Larose		
Premier vice-président		
CONSUMERS' ASSOCIATION OF CANADA	87	Tuesday, 18/05/82
Ottawa, Ont.		
Ms. Shirley Northrup		
Director		
Mr. J. Savary		
Mrs. Margaret Cameron		
CONTINENTAL BANK	94	Tuesday, 01/06/82
Toronto, Ont.		
Mr. Stanley S. Melloy		
President and Chief Executive Officer		
Mr. David Rattee		
Executive Vice-President, Operations		
FINANCIAL CONSULTANT INCORPORATED	91	Wednesday, 26/05/82
Toronto, Ont.		
Mr. Michael Jensen		
President		
HAIR WARE HOUSE LTD.	104	Thursday, 10/06/82
London, Ont.		
Mr. Patrick Hogan		
Marketing Manager		

<p>LAFFERTY, HARDWOOD & PARTNERS LTD. Mr. R.G.D. Lafferty President Mr. A. Hagedorn Vice-President Mr. Richard Pound</p>	105	<p>Tuesday, 11/05/82 Montreal, Que.</p>
<p>McLEOD, YOUNG & WEIR Toronto, Ont. Mr. Victor Koloshuk</p>	99	<p>Friday, 04/06/82</p>
<p>OFFICE OF THE INSPECTOR GENERAL OF BANKS Ottawa, Ont. Mr. W.A. Kennett Inspector General Mr. D.M. MacPherson Assistant Inspector General Mr. Ian M.D. Ruxton Director, Research Division</p>	84	<p>Tuesday, 11/05/82</p>
<p>ONTARIO FEDERATION OF AGRICULTURE Toronto, Ont. Mr. Ralph Barrie President</p>	89	<p>Thursday, 20/05/82</p>
<p>PILIPINO BAYANIHAN OF MISSISSAUGA Mississauga, Ont. Mr. Winston Lim Director of Communications</p>	106	<p>Monday, 14/06/82</p>
<p>ROYAL BANK OF CANADA Montreal, Que. Mr. Rowland C. Frazee Chairman and Chief Executive Officer Mr. A.R. Taylor Executive Vice-President International Division Mr. K. Smee Vice-President Ontario Division</p>	103	<p>Thursday, 10/06/82</p>

SERVICE D'AIDE AU CONSOMMATEUR Shawinigan, P.Q. Mme Madeleine Plamondon Présidente et directrice	106	Monday, 14/06/82
TRUST COMPANIES ASSOCIATION OF CANADA Toronto, Ont. Mr. Alan R. Marchment Chairman Mr. William W. Potter President Mr. E. Donald L. Miller Mr. W.H. Somerville	103	Thursday, 10/06/82
UNITED STEEL WORKERS OF AMERICA Toronto, Ont. Mr. A.E. Munro Assistant to the National Director Mr. Peter Warrian Research Director Mr. Hugh Mackenzie	106	Monday, 14/06/82
WOOD GUNDY LIMITED Toronto, Ont. Mr. Julien Hutchinson Vice-President	90	Tuesday, 25/05/82
Mr. J. Stephen Bancroft, C.A. Ottawa, Ont.	94	Tuesday, 01/06/82
Mr. Gordon Boreham Professor of Economics University of Ottawa	108	Friday, 18/06/82 (in camera)
Mr. John S. McCallum Professor of Finance University of Manitoba	95	Wednesday, 07/06/82

Appendix C

Other Written Submissions Received

List of individuals and organizations that submitted briefs and letters to the Standing Committee, but did not appear as witnesses.

Alderson, Mr. William
Cape Breton, Nova Scotia

Atay, Mr. Mal
Toronto, Ontario

August, Mr. John
Brandon, Manitoba

Band, Mr. Lawrence
Thornhill, Ontario

Barth, Mr. Carlos
Regina, Saskatchewan

Beauchamp, M. Jean-Claude
Président
Association des Consommateurs
du Québec
Montréal, Québec

Bell, Mr. Douglas G.
Calgary, Alberta

Bodie, Mr. James N.
Sherwood Park, Alberta

Boggs, Mr. Ernest F.
Calgary, Alberta

Bowie-Reed, Mr. Malcolm J.
Ottawa, Ontario

Brunelle, M. Jean A.

Microlon Quebec Ltée.
Beaconsfield, Québec

Bureau, M. Marcel
Directeur général
Le Conseil diocésain de la
Société Saint-Jean-Baptiste
de Sherbrooke
Sherbrooke, Québec

Buksa, Mr. Wayne
Pickering, Ontario

Cheel, Mr. Dennis W.
Fonthill, Ontario

Clark, Mr. William G.
President
Telecommunication Workers' Union
Burnaby, B.C.

Creed, Mr. George E.
Stoney Creek, Ontario

Delisle, Mme Claire
Pointe-aux-Trembles, Québec

Dorosh, Mr. Grant
Edmonton, Alberta

Farrell, Mr. Michael
Trois-Rivières, Québec

Ferguson, Mr. J.R.
Ottawa, Ontario

Forshaw, Mr. R.P.
Grand Forks, B.C.

Fox, Mr. Leo E. Merrickville, Ontario

Gard, Mr. C.W.S.
Ottawa, Ontario

Geltman, Mr. Harold
Louisville, Québec

Gramaglia, Mr. Salvatore
Edmonton, Alberta

Grayson, Dr. Linda
Toronto, Ontario

Hadland, Mr. Arthur A.
Baldonnel, B.C.

Jaglalsingh, Mr. L.H.
Edmonton, Alberta

Kahl, Mr. Alfred L.
Ottawa, Ontario

Kealey, Mr. Patrick C.J.
South Burnaby, B.C.

Kroeker, Mr. John
President
Canadians for Responsible
Government
Ottawa, Ontario

Kydd, Mr. S.T.
Kentville, Nova Scotia

Lacquement, Mrs. G.
Port Hardy, B.C.

Ledent, Mr. A.
President
Canadian Creditors Association
for the Revision of Rights and Legislation
Montréal, Québec

Lehner, Mr. Joseph V.
Toronto, Ontario

Lincourt, M. Pierre
Montréal, Québec

Munro, Mr. J.J.
President
Western Canadian Regional Council No. 1
International Woodworkers of America
Vancouver, B.C.

O'Brien, Mr. E.
Toronto, Ontario

O'Donnell, Mr. W.T.
Tillsonburg, Ontario

Overton, Mrs. Joan B.
Ashcroft, B.C.

Paquette, Mr. Peter D.
Etobicoke, Ontario

Pollock, Mr. D.C.
London, Ontario

Raspa, Mr. Antoine
Chicoutimi, Québec

Reynert, Mr. K.
Ottawa, Ontario

Rollins, Mr. J. Borden
Tweed, Ontario

Rugman, Mr. Allan M.
Director
Centre for International
Business Studies
Dalhousie University
Halifax, N.S.

Rymes, Mr. T.K.
Ottawa, Ontario

Schleihau, Mr. Glen
Toronto, Ontario

Skilling, Mr. George
Danville, Québec

Stamplecowsky, Mr. E.P.
Arnprior Mobile Homes Ltd.
Arnprior, Ontario

Stevens, Mr. R.H.
Georgetown, Ontario

Trainor, Mr. Richard M.
Pembroke, Ontario

Turmel, Mr. John C.
Gloucester, Ontario

Vreugdenhil, Ms. Barb
Rockwood, Ontario

Waitzer, Mr. Edward J.
Toronto, Ontario

Yungblut, Mrs. Jean
Ottawa, Ontario

A copy of the relevant Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs **Issues Nos. 84 to 92 inclusive; Nos. 94, 96-97; Nos. 99 to 106 inclusive and Nos. 108-109** are tabled.

Respectfully submitted,

John Evans, M.P.

