March 1998

*The Canadian Banking System**

Charles Freedman

* Revised version of a paper delivered at the
Conference on Developments in the Financial System:
National and International Perspectives
The Jerome Levy Economics Institute of Bard College
Annandale-on-Hudson, New York, 10–11 April 1997.

ISSN 0713-7931
ISBN 0-662-26464-9

Printed in Canada on recycled paper

CONTENTS

ACKNOWLEDGMENTS

I am grateful to Nikola Swann for research assistance and to a number of my colleagues at the Bank of Canada and at other Ottawa agencies who commented on earlier versions of this paper. The analysis in this paper draws heavily on earlier analyses of the Canadian financial system in Freedman (1987; 1992; 1996), Daniel, Freedman, and Goodlet (1992-93), and Armstrong (1997).

ABSTRACT

This paper examines the major changes in the Canadian banking system since the Second World War, with special attention paid to the differences between Canadian and U.S. developments over this period. An important difference between the countries is the nationwide branch banking arrangements in Canada. Two other differences are a result of regulatory dimensions of the Canadian scene: periodic reassessment and updating of banking legislation as a legislative requirement; and the absence of any ceilings on interest rates on deposits or, since 1967, on loans. The amendments to the Bank Act from 1954 to 1997 are examined, and significant developments in the Canadian financial system, typically associated with changes to legislation governing banks and other financial institutions, are discussed. The effects of these changes are then looked at, including the market share of banks in various markets, and the developments in money market mutual funds and mortgage securitization in Canada and the United States.

RÉSUMÉ

L'auteur examine les changements majeurs subis par le système bancaire canadien depuis la Deuxième Guerre mondiale, tout en accordant une attention particulière aux différences ayant caractérisé l'évolution des secteurs bancaires au Canada et aux États-Unis durant cette période. Une différence de taille tient à l'exploitation par les banques canadiennes de réseaux de succursales couvrant tout le pays. Deux autres différences encore découlent du cadre réglementaire canadien : 1) la loi prescrit une réévaluation et mise à jour périodiques de la législation bancaire; 2) les taux d'intérêt applicables aux dépôts et, depuis 1967, aux prêts ne sont soumis à aucun plafond. L'auteur passe en revue les révisions apportées à la *Loi sur les banques* de 1954 à 1997 et analyse les faits marquants de l'évolu-

tion du système financier canadien, qui ont généralement été associés aux modifications apportées aux lois régissant les banques et les autres institutions financières. Il étudie l'incidence de ces modifications, notamment en ce qui concerne les parts détenues par les banques sur les divers marchés et l'évolution des fonds mutuels du marché monétaire et de la titrisation hypothécaire au Canada et aux États-Unis.

1 INTRODUCTION

Over the postwar period, the Canadian banking system has undergone major changes, both regulatory and market-driven. This paper outlines some of these changes, with special attention paid to the differences between Canadian and U.S. developments over this period. The focus of the paper on the banking system is motivated both by the relative importance of banks in the Canadian financial system and by the comparison that it permits with the U.S. banking system.

Three key differences between the U.S. and Canadian financial systems account for many of the divergences seen in banking system developments in the two countries over the years. The first difference, and the one most frequently emphasized in cross-border comparisons, is the nationwide branch banking arrangements in Canada. But equally or perhaps more important are two crucial regulatory dimensions of the Canadian scene. One such element, the inclusion of a "sunset" clause in Canadian banking legislation, requires a periodic reassessment and updating of the laws governing Canadian banks. There has thus been a formal process of re-examining the legislative arrangements approximately once every decade through the postwar period, leading to significant revisions of the Bank Act in 1954, 1967, 1980, 1987, 1992, and 1997.[1] Only some of these sets of legislative amendments were fundamentally significant for the banking system's ability to cope with change. However, the opportunity and requirement for government to re-examine periodically the issues affecting the financial industry (and more particularly, the banking sector's place in that industry) and to make legislative changes to respond to market-driven developments assisted banks in adjusting to an ever-changing environment. The other important regulatory element in the Canadian system was the absence of a ceiling on interest rates on deposits, and the elimination of

1. All except the 1987 changes were required by the sunset provision in the Act. The 1992 amendments contained a 5-year sunset provision, as do the 1997 amendments.

the ceiling on interest rates on loans in the 1967 amendments to the Bank Act. In contrast, the elimination of Regulation Q on deposit rates in the United States did not take place until the 1980s.

The process of updating the legislative structure governing federally incorporated non-bank financial institutions was less formalized.[2] Although these institutions were concerned that changes to their legislation lagged behind changes to the Bank Act, the legislation governing their activities was also amended from time to time to allow them to adjust to changing circumstances, and the relevant statutes were completely rewritten in 1992.

The next section of this paper provides some background material on the historical structure of the Canadian financial system.[3] The following section focuses on the major developments in recent decades, typically associated with changes to the legislation governing banks and other financial institutions. The effects of these changes are illustrated in the subsequent section that looks at the market share of banks in the various markets in which they compete, and at the different pattern of development in money market mutual funds and in mortgage securitization in the United States and Canada.

2 BACKGROUND

Historically, the Canadian financial system was based on five principal groups: chartered banks, trust and loan companies, the co-operative credit movement, life insurance companies, and securities dealers.[4] These groups were characterized by their core business activities and, to a lesser

2. Their legislation did not contain a sunset clause until 1992.

3. This section draws heavily on Daniel, Freedman, and Goodlet (1992-93).

4. There are, of course, other sectors in the financial industry, such as the property and casualty insurance companies, sales finance companies, pension funds, and venture capital companies.

extent, by the jurisdiction under which they are incorporated and supervised—federal, or provincial, or a combination of the two. For example, banks are under exclusive federal jurisdiction for their banking activities, while trust and loan companies and life insurance companies can be incorporated through either federal or provincial charters.

Chartered banks are incorporated and supervised by the federal government and have always been involved in commercial lending. Since the mid-1950s, they have become significant sources of personal loans and residential mortgage credit. In addition, over the years, banks have developed substantial international business operations.

Trust and loan institutions tended to specialize in residential mortgage lending and in term deposits. Federally incorporated and supervised institutions control the bulk of assets within this sector of the financial industry, but some companies operate under provincial charters. All are subject to various provincial licensing requirements. Through the 1980s, these institutions moved aggressively into consumer lending and certain types of commercial loans. As well, trust companies were the only institutions permitted to offer discretionary fiduciary services.

The co-operative credit movement (credit unions and caisses populaires) operates almost entirely under provincial jurisdiction.[5] Traditionally, credit unions and caisses populaires invested in residential mortgages and personal loans, but more recently they have also been moving into the commercial loan area.

On the liability side, chartered banks, trust and loan companies, and co-operatives compete strongly for personal deposits. In recent years, competition among these three groups of institutions has also increased for

5. However, the Credit Union Central of Canada (CUCC), a national organization that provides credit unions with technical and financial support services, is governed by federal legislation, the Cooperative Credit Associations Act. As well, some aspects of provincial centrals that are members of CUCC are governed by the same federal legislation.

business and government deposits, an area previously dominated by the banks. As well, insurance companies and mutual funds have become strong competitors for household savings.

The vast majority of life insurance companies are federally incorporated and supervised, although some companies are provincially regulated. The traditional business of this sector has consisted of selling life insurance and investing the proceeds in a mix of mortgages and bond and stock investments. Over the 1980s and 1990s, life insurance companies have generated significant funds from the sale of single-premium deferred annuities, which closely resemble fixed-term deposits at other institutions, and have invested the proceeds in a more diversified range of assets. Life insurance companies continue to be generally restricted by legislation from directly accepting deposits.

Finally, the securities dealers have traditionally operated under a legislative framework established by provincial governments. This group typically engaged in activities associated with the underwriting and selling of bond and stock issues, offering investment advice, and trading of securities in secondary markets.

The functions of the different types of institutions in the Canadian financial system were traditionally separated. However, over the past couple of decades, the lines of separation became blurred with the accelerated penetration into each other’s primary area of business.

Two other important traditional traits of the Canadian financial sector were the widely held ownership of the major financial institutions until the early 1980s, and the absence of any significant downstream links between financial and commercial companies.[6]

---

6. A “downstream” link in the present context refers to a controlling ownership position held by a financial institution in a non-financial corporation. An “upstream” link refers to a controlling position held by a non-financial corporation in a financial institution.

Upstream links between banks and the commercial sector are restricted by the requirement that banks be widely held. Since 1967, the holding of any one individual or group of associated individuals has been limited to 10 per cent of any class of shares of a bank. Although this restriction was introduced to prevent the concentration of ownership and control of Canadian financial institutions and to provide assurance of continued Canadian ownership and control of such institutions, it also had the effect of preventing significant upstream commercial-financial links.

The 1980 Bank Act revision maintained the regime of widely held ownership (with no single person or group of persons allowed to own more than 10 per cent of the voting shares) for existing banks, now called Schedule I banks.[7] However, it also introduced a new class of banks, Schedule II banks, that could be started and owned on a closely held basis. Schedule II banks that were subsidiaries of foreign banks and, following the 1992 amendments, those that were owned by widely held regulated non-bank financial institutions, would be permitted to be closely held indefinitely. Otherwise, Canadian-owned Schedule II banks would have to become widely held 10 years after being incorporated.

Most of the large life insurance companies in Canada are mutual companies, that is, they are owned by their policyholders. The nature of co-operatives, whereby institutions are owned by their members, prevents the development of upstream commercial linkages. Prior to June 1987, securities dealers, in general, were owned only by individuals actively engaged in the securities business.

Trust and mortgage loan companies were generally widely held until the early 1980s when most of the large trust and mortgage loan companies were taken over by unregulated firms engaged in commercial activities. In some cases, these same purchasers bought or established life

7. Until recent changes associated with the coming into force of various trade agreements, aggregate foreign ownership of Schedule I banks was also limited to 25 per cent.

insurance companies, property and casualty insurance companies, and other types of financial companies to create a diversified financial conglomerate.

Downstream linkages for deposit-taking institutions and insurance companies are restricted by legislation that limits the amount of equity investments that they are permitted to make in commercial enterprises, except in special circumstances.[8] For their part, securities dealers traditionally have not made long-term investments for control purposes in commercial companies.

Virtually all of the large financial institutions (except in the co-operative credit sector) have operations across the country. In the case of banks, nationwide branching developed to a considerable extent out of the wave of mergers in the latter part of the nineteenth century and the early part of the twentieth century. This left Canada with a relatively small number of major banks, each of which had a large number of branches. These banks also had important international activities, providing retail banking services in the Caribbean area, and becoming involved in the business of foreign currency deposits and loans at a very early stage.

3 THE SERIES OF BANK ACT AMENDMENTS

This section surveys the various changes in the legislation governing the banks, as well as the 1992 changes governing non-bank financial institutions. It looks at some of the pressures for change along with those legislative changes that were important factors in the banks' ability to adjust their business lines and cope with competitive pressures. The next section examines some of the effects of these changes on the banks' activities and their share of various markets. One of the principal goals of the various sets

8. The 1992 amendments loosened somewhat the restrictions on downstream investments in areas such as information services and relaxed the rules governing specialized financing corporations.

of legislative amendments, particularly the 1967 and subsequent amendments, was to increase competition in the financial sector. A key outcome has been a gradual erosion of the segmentation of the financial system across the five pillars.

3.1 The 1954 amendments

The key changes in this round of amendments were the powers given to banks to make mortgage loans insured by the National Housing Association (i.e., government guaranteed) and to make personal loans secured by chattel mortgages on personal property. These amendments permitted banks to enter into the business of household lending in a serious way for the first time.[9]

3.2 The 1967 amendments

In these amendments, the 6 per cent ceiling on the interest rate on bank loans was eliminated. As market interest rates had moved above 6 per cent in the mid-1960s, this ceiling had effectively forced banks out of mortgage lending to households.[10] In addition, banks were prohibited from making agreements with any other bank on the rate of interest paid on deposits or the rate of interest charged on loans.[11] The 1967 amendments also eliminated restrictions on the banks' involvement in residential mortgage financing, permitting them to invest in non-insured or conventional

9. The 1954 amendments also formalized the arrangement whereby the banks held reserves at the Bank of Canada.

10. Business lending had been maintained through the use of compensating balance and other arrangements, by which means the effective interest rate on a loan could be maintained above the ceiling rate.

11. There were some exceptions to this provision, including an agreement requested or approved by the Minister. The last such arrangement was the "Winnipeg agreement" of June 1972, which set ceilings on wholesale deposit rates. This agreement was terminated in January 1975.

mortgages.[12] At the same time, banks were prohibited from owning trust companies, and a 10 per cent ownership limit on the shares of banks was introduced.[13] The latter was intended to ensure that Canadian banks remained under domestic ownership and control and to prevent concentration of ownership. It also came to serve as a way of preventing commercial ownership of banks (of the sort that later became prevalent in the trust industry) and as a way of avoiding self-dealing between a bank and its owners.

At about the same time, deposit insurance for banks and trust and mortgage loan companies was introduced in Canada, following the failure of two small finance companies and the subsequent financial difficulties of some trust and loan companies.

3.3 The 1980 amendments

With these amendments, banks were allowed to have subsidiaries in a number of different financial areas, including venture capital companies and mortgage loan companies. The mortgage loan subsidiaries could raise deposits that were exempt from reserve requirements. The banks could then compete more effectively in the mortgage lending market with trust companies, whose deposits were not reservable. Foreign banks were allowed to establish subsidiaries in Canada, albeit with restrictions on the total size of the business of such banks in Canada. These aggregate size restrictions, which were never constraining, were removed in 1989 for U.S. banks as part of the Canada-U.S. Free Trade Agreement, in 1994 for

12. There was a ceiling of 10 per cent of bank deposits that could be held in conventional mortgages. It was not binding at the time and, following the 1980 amendments, the banks were able to book such mortgages in their mortgage loan subsidiaries (which had no ceiling on mortgage lending). The ceiling was formally eliminated in 1992.

13. The 25 per cent limit on aggregate ownership by non-residents was also introduced at this time. It was subsequently removed in 1995.

Mexican banks as part of NAFTA, and in 1995 for the rest of the foreign bank subsidiaries as part of the world trade negotiations.[14]

In 1980, Parliament also passed the Canadian Payments Association (CPA) Act. The CPA, comprising both banks and non-bank deposit-taking institutions, took over responsibility for running the cheque-clearing system from the Canadian Bankers Association and was given the responsibility for planning the future evolution of the Canadian payments system.

3.4 The 1987 amendments

In this year, changes to the Bank Act and to Ontario legislation effectively eliminated the Canadian equivalent of the U.S. Glass-Steagall Act, which had previously kept banks out of much of the securities business.[15,16,17] Until this time, a combination of custom and law (both federal and provincial) had limited the involvement of banks in the securities business. There were tight restrictions on both upstream and downstream linkages between banks and securities dealers. Also, there were very explicit rules regarding the types of securities activities in which banks were able to engage and those from which they were excluded. Thus, for example, banks were permitted to invest in corporate securities (both debt and equity) for portfolio purposes. They were also permitted to underwrite and distribute government bonds, buy and sell securities generally on an agency basis,

14. The ceiling was originally 8 per cent of the total domestic assets of all banks in Canada but was raised to 16 per cent in 1985 when it appeared that the ceiling might become a binding constraint. When the U.S. bank subsidiaries were exempted from the limitation in 1989, it was reduced to 12 per cent for the remaining foreign bank subsidiaries. There were 41 active foreign bank subsidiaries operating in Canada at the time of writing.

15. This was the only major set of Bank Act amendments that was not triggered by the sunset clause in the legislation. Of course, most legislative changes were a response to market-driven developments. What the sunset clause did was to force a periodic re-examination and response to such market developments.

16. The discussion in this section relies heavily on Freedman (1992; 1996).

17. Somewhat earlier, the province of Quebec had permitted banks to enter the securities business by acquiring a securities firm.

and distribute corporate securities as members of a selling group. However, until the 1987 amendments to the Bank Act, the banking sector was prohibited from underwriting corporate securities (subject to the selling group exception). As well, until the 1992 amendments, a bank could not hold itself out as engaging in portfolio management or investment counselling in Canada. Also, provincial laws imposed significant restrictions on the access of foreign dealers to Canadian securities markets at this time.

Among the key factors motivating the changes in legislation were the increasing use of market borrowing by corporations at the expense of bank lending, the trend to globalization, and the concern that securities dealers would not be able to generate the larger amounts of capital that would be needed in the future. In addition, banks and securities dealers had been penetrating increasingly into each other's core business areas. For example, the payment of interest on credit balances by dealers brought them into competition with bank deposits, and banks made syndicated loans that competed directly with bond issues.

The separation of banking and securities business was coming under increasing pressure as banks were entering the discount brokerage business and a growing share of the short-term financing business of the corporate sector was being done in the form of commercial paper and bankers' acceptances. Indeed, the increasing use of securities markets by corporate borrowers was probably the single most important factor driving the integration of the banking and securities industries.

As the traditional bank loan was losing ground to bond, equity, and especially paper market financing (including bankers' acceptances), as well as Euro-Canadian dollar and foreign currency issues, the banks were becoming increasingly concerned about their ability to operate profitably and to compete effectively with both domestic securities dealers and foreign banks and securities dealers. Some observers in the mid-1980s went so far as to argue that there was no future for the traditional bank with its focus on corporate loans, and that the future would belong to institutions that could offer their clients the widest possible range of financing options.

In a similar vein, it was also argued that considerable synergy results from one institution being able to service all the financing needs of the corporate borrower. The banks also argued that it was essential that they be able to underwrite securities in the domestic market to develop the expertise that would enable them to compete with universal banks and investment banks in a world of increasing securitization, globalization, and integration of functions.

At the same time, there was growing debate about the capacity of securities dealers, as they were then constituted in Canada, to compete in an increasingly globalized market. This debate reflected an increasing concern about the performance of the Canadian securities industry, composed of relatively small firms in a rather protected environment, at a time of increasing competition in and from other major world securities markets.

A principal argument of supporters of change was that securities dealers needed a larger capital base, particularly in a world of "bought deals" with greater-than-traditional risks and the associated need for more capital. The structure of the industry, with its reliance on individual investors, had limited the amount of capital that could be invested in the industry. There was also concern that the Canadian securities market would become a backwater if it did not open up to the rest of the world and that more competition was necessary to ensure that the Canadian securities industry did not fall behind in a very innovative world environment. This concern was exacerbated by the fear that, if the Canadian securities industry was insufficiently efficient or innovative, developments in communications would reduce transaction costs and permit an increasing share of Canadian lending and borrowing to be handled by foreign financial institutions.

In summary, there was a perceived need for lenders to corporations to be involved in both direct lending and market intermediation, and it was believed important for Canada to have an innovative and competitive securities industry at a time of increasing pressures from globalization. These were probably the two most important factors leading to the breakdown of the barriers between the banking and securities industries.

These pressures for change in the securities business resulted in the introduction of new legislation by both the federal government and Ontario; this had the effect of opening up the Ontario securities industry to outsiders. Thus, from 30 June 1987, there was to be no limit on investments in securities firms by Canadian financial institutions. Non-residents were permitted to own up to 50 per cent of an existing securities firm from 30 June 1987, and up to 100 per cent from 30 June 1988. Also, direct entry into the Ontario market by foreign securities firms was to be permitted without limit from 30 June 1987.[18]

3.5 The 1992 amendments

The 1992 legislative changes involved a major rewrite of the legislation governing banks, trust companies, and insurance companies. Among other things, it dealt most notably with the powers of the various financial institutions, ownership, and ways of managing self-dealing and conflicts of interest. The legislation effectively continued the process of breaking down the traditional pillars by allowing financial institutions to enter into domains in which they were previously limited or from which they were entirely excluded.

18. See Freedman (1996) for a discussion of the regulatory developments surrounding these changes.

A number of factors motivated this widespread financial restructuring. These included the following:

- The need to modernize near-bank legislation.
- The desire to break down further the barriers between the pillars in order to increase competition.
- The pressure and the need to define the appropriate range of business powers that would be available to each type of financial institution. The various financial sectors had gradually interpenetrated each other's principal area of business, as exemplified by the issue of short-term deposit-like instruments by insurance companies.
- The need to deal with the concerns raised by the increased potential for self-dealing, conflicts of interest, and concentration of ownership. These concerns resulted from the development of closely held ownership, commercial-financial links, and common ownership of different types of financial institutions.
- The need to respond to questions about the structure of the deposit insurance system and about the adequacy of the supervisory structure. These concerns were raised by the failure during the 1980s of a number of trust and mortgage loan companies and two small western banks and by the pressures on some small banks that resulted in their mergers with other banks.
- The introduction by provincial governments of new legislation governing the non-bank financial institutions under their jurisdiction, creating the need for the re-harmonization of federal and provincial policies.
- The increasing recognition of the importance and the impact of internationalization and securitization.

The first four factors were mainly responsible for initiating the change process, while the last three added to the impetus and changed its direction.

The 1992 amendments gave federal financial institutions (banks and federally incorporated trust companies, mortgage loan companies, and insurance companies) the power to diversify into new financial businesses through financial institution subsidiaries, as well as through increased in-house powers.[19] Those institutions without fiduciary powers, such as banks and life insurance companies, were allowed to own trust companies. Similarly, banks and trust and loan companies were permitted to own insurance companies. Finally, widely held regulated non-bank financial institutions were permitted to own Schedule II banks, without the requirement that applies to other entities for divestiture of significant positions within 10 years.

As for in-house powers, trust, loan, and life insurance companies were generally given full consumer and commercial lending powers. Also, banks and loan companies were permitted to offer a number of in-house activities, such as portfolio management and investment advice, just as trust companies, life insurance companies, and securities dealers had long been able to do. Finally, all institutions were permitted to network most financial services offered by affiliates or independent financial institutions. The 1992 legislation also addressed the competitive equity of imposing non-interest–bearing reserve requirements on banks and not on other deposit-taking institutions. Thus, it was decided to phase out the reserve

19. There are certain limitations to these powers, as discussed in Daniel, Freedman, and Goodlet (1992-93). Most notable are the restrictions on the networking of most types of insurance through branches of federal deposit-taking institutions and the prohibition on federal financial institutions from engaging in car leasing or owning a car-leasing company.

requirements on the banks over two years to remove the unequal treatment of institutions competing for the same business.[20]

As a result of the 1987 and 1992 amendments, Canadian financial institutions were able, if they wished, to develop into financial conglomerates with involvement in a wide variety of financial areas. Because of continuing limitations on investments in non-financial business, however, they were not allowed to become German-style universal banks.

3.6 The 1997 amendments

These amendments include a number of changes to update and fine-tune the 1992 legislation and are in part a response to minor problems that became apparent after it entered into effect. The amendments also deal with such issues as consumer privacy and the ability of banks not engaged in retail deposit-taking to opt out of membership in the deposit insurance agency. At the same time, the government announced that foreign banks, which have been required to establish a separately capitalized subsidiary to operate in Canada, will be allowed to establish branches directly in Canada, subject to certain conditions. Legislation on foreign bank entry, including branching, will be made public in 1998. The next set of amendments is scheduled for 2002.

3.7 Current studies

In 1996, the government established two advisory bodies to provide input into the development of its future legislative agenda. The Payments System Advisory Committee was established in August 1996 and completed its work towards the end of 1997. It was co-chaired by the Depart-

20. The elimination of reserve requirements required certain changes in the techniques used to implement monetary policy but has not otherwise affected the Bank of Canada’s ability to implement policy. See Bank of Canada (1991).

ment of Finance and the Bank of Canada and examined various aspects of the Canadian payments system, with particular emphasis on questions of access to the payments system and issues related to the oversight of the payments system. The second advisory body, the Task Force on the Future of the Canadian Financial Services Sector, was appointed in December 1996 and is expected to make its recommendations by September 1998. It has a very broad mandate to address issues facing the financial industry and "may make recommendations on any public policy issues that affect the environment within which Canada's private financial services providers operate." Furthermore, in the press release announcing the establishment of the task force,[21] the government drew specific attention to its desire to have the task force give it advice on "ways to enhance

- the contribution of the financial services sector to job creation, economic growth and the new knowledge-based economy;
- competition, efficiency and innovation within the sector;
- the international competitiveness of the sector in light of the globalization of financial services, while maintaining strong, vibrant domestic financial institutions;
- the ability of the sector to take full advantage of technological advances as they occur, meeting the competitive challenges resulting from the introduction of new technologies; and
- the contribution of the sector to the best interests of Canadian consumers."

21. Canada, Department of Finance, Press Release 96-101 (19 December 1996).

4 THE OUTCOMES

What have been the outcomes of the pressures on banks from technological, economic, and legislative developments over recent decades? Over the postwar period, banks gradually lost share in the deposit market, although they recovered some of that lost share through their acquisition of trust companies in the 1990s. In contrast, they have significantly increased their share of residential mortgage lending and consumer lending. Their share of business credit markets has followed a cycle over the last quarter century, rising sharply in the early 1980s and falling gradually thereafter. Overall, the banks seem by and large to have more than maintained their position vis-à-vis other institutions (in part by acquiring institutions in the other "pillars" since 1987). Also, as will be seen in the course of the discussion, they have not faced the same competition from money market mutual funds (MMMFs) or from the securitization of loans as have their American counterparts.

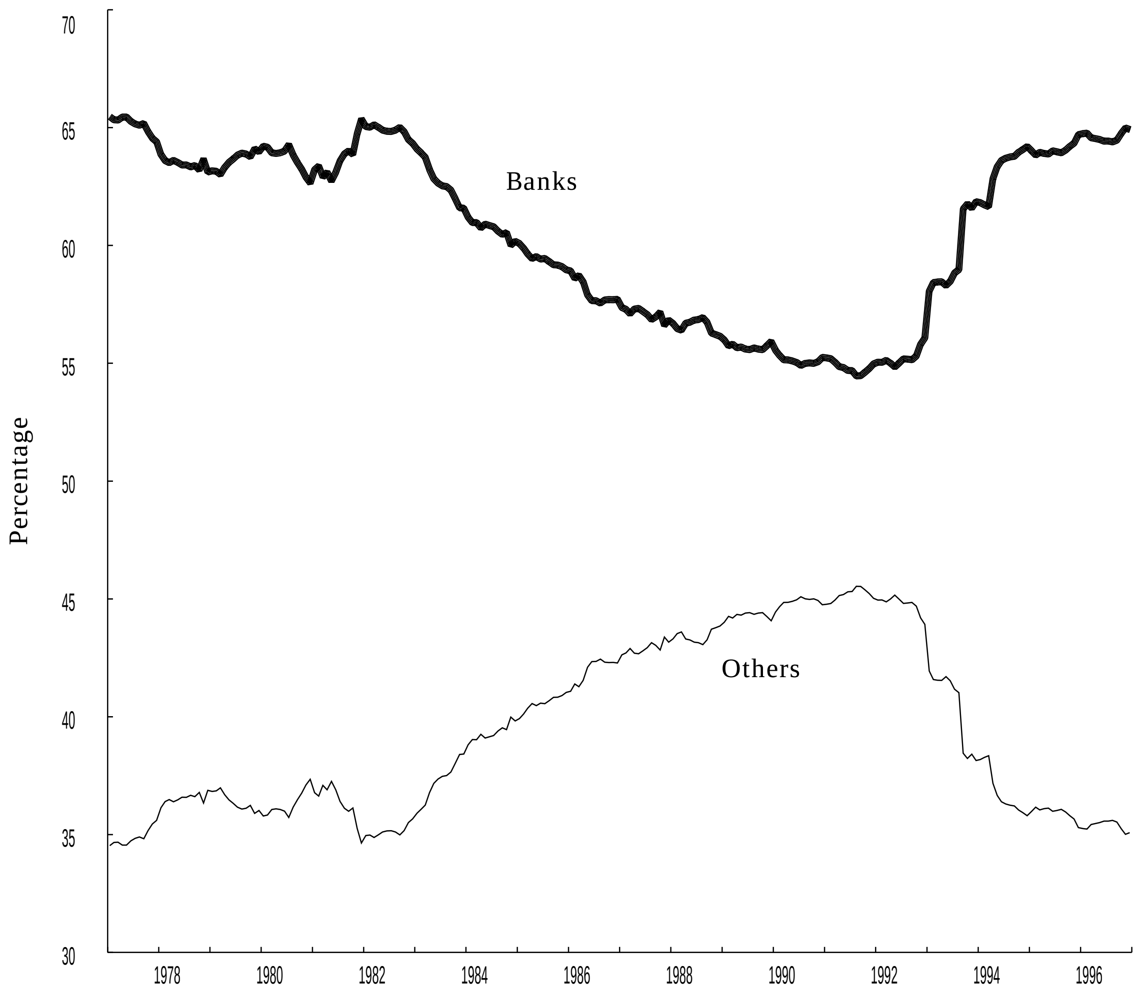
4.1 Deposits

Chart 1 provides a time series of Canadian dollar deposits at banks as a percentage of Canadian dollar deposits at all financial institutions plus individual annuities at life insurance companies plus MMMFs. From a level over 80 per cent in the 1950s (not shown in the chart), the bank share fell to about two-thirds in the early 1970s. The persistent decline through the 1980s (from about 64 per cent in 1980 to about 55 per cent in 1990)[22] was entirely

22. At times in the postwar period, as banks lost market share in deposits, concerns were expressed that they would not be able to compete with near-bank deposit-taking institutions. One disadvantage faced by banks vis-à-vis such institutions arose from the fact that non-interest–bearing reserve requirements were imposed on deposits at banks (until 1994) but not on deposits at other financial institutions.

reversed in the 1990s as the banks acquired a number of trust companies in financial difficulty.[23]

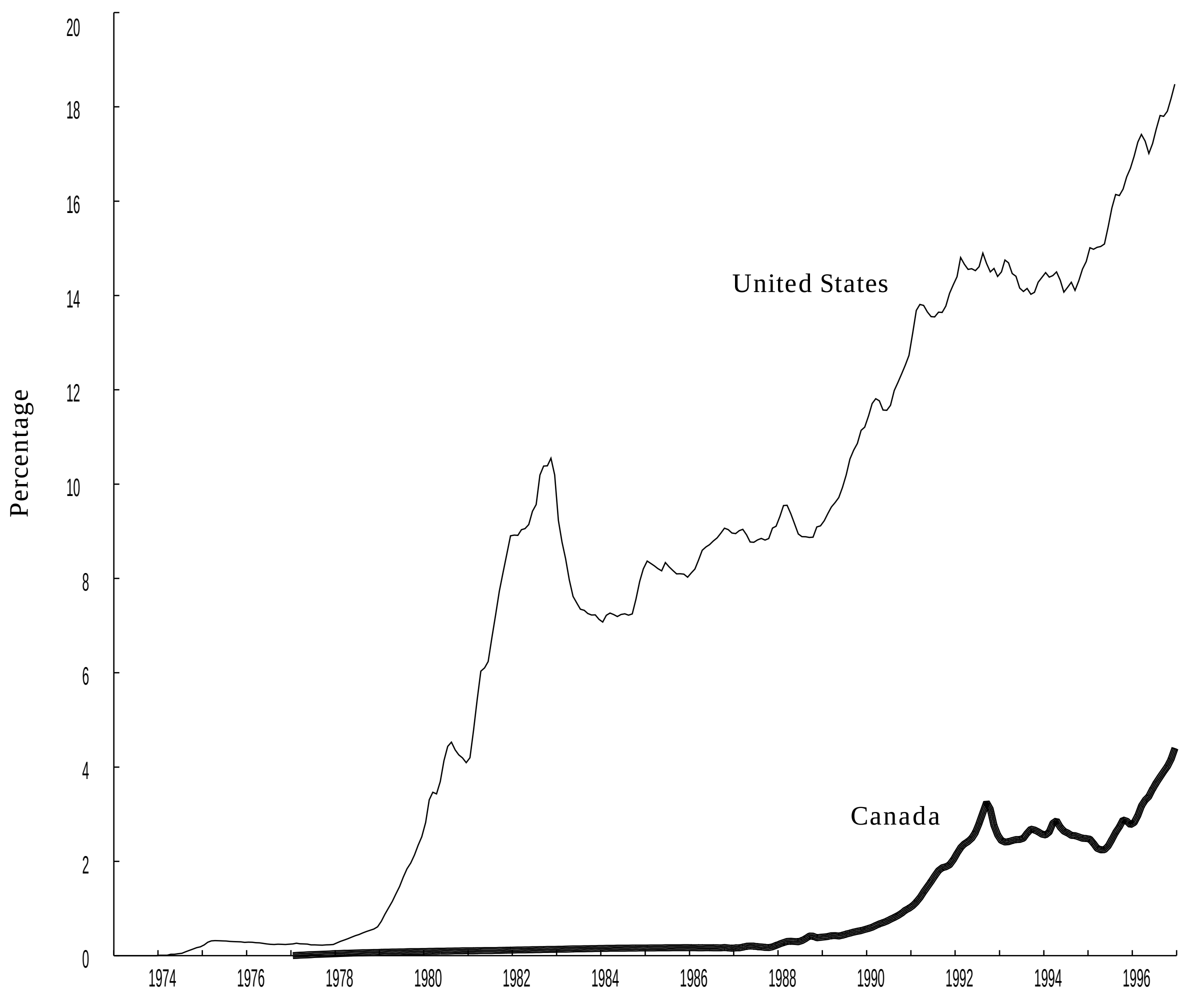
Chart 1 Bank share of deposits plus money market mutual funds



23. If all mutual funds and not just MMMFs were included in the denominator, the bank share would be lower by an increasing amount over time. See Neufeld and Hassanwalia (1997) for a comparison over a much longer time period of the shares in financial intermediation of banks and other financial institutions.

Unlike the United States, money market mutual funds (MMMFs) have not taken much of the market for liquid assets in Canada. As shown in Chart 2, their share of the sum of deposits and MMMFs was barely noticeable until the 1990s and is only 4.5 per cent currently, very much less than the corresponding 18 per cent figure in the United States.

Chart 2 Money market mutual funds as a percentage of total deposits



The key difference between U.S. and Canadian experience in this regard was the absence of legislated interest rate ceilings on deposits in

Canada while Regulation Q continued to exist until the early 1980s in the United States. When interest rates rose significantly in both countries in the mid-1970s and again in the latter part of the 1970s, the spread between market rates and the maximum rate of 5.25 per cent on U.S. saving deposits under Regulation Q widened sharply. The very wide spreads in the United States opened up an enormous window of opportunity to the developers of MMMFs, since the interest rate incentives for households and businesses to switch to such instruments were so great. By the time banks were able to offer near-market rates on their own deposits in the early 1980s (the money market deposit accounts that became available following the elimination of Regulation Q), a substantial part of the market had already been lost to the by-then-entrenched MMMFs. The MMMFs have since maintained a significant and even growing share of the market for very liquid, short-term deposit-like instruments.

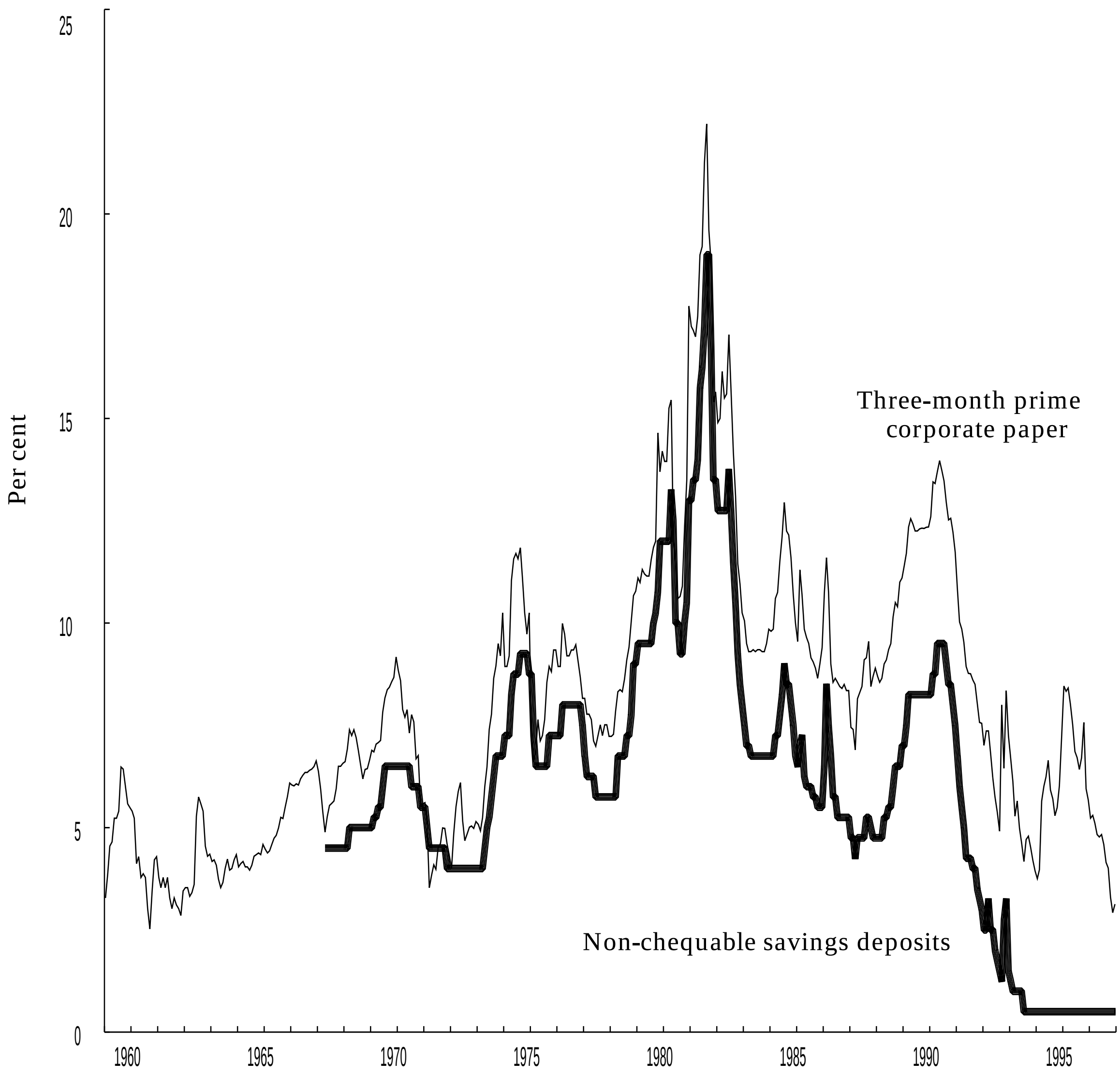
In Canada, in contrast, banks (and other deposit-taking financial institutions) were able to offer near-market rates on savings accounts and term deposits that moved in line with market rates throughout the 1970s and 1980s (Chart 3). The spreads were never so large as to give much incentive to households and businesses to shift to MMMFs. Thus, most of the deposit business remained with deposit-taking financial institutions and did not migrate to MMMFs. Over the last few years, with very low short-term rates, a widening of the spread between the rates on saving accounts and market rates, and households searching for extra income, there has been some pickup in the growth in MMMFs, but they still account for only 4.5 per cent of the overall deposit market. Moreover, following the legislative changes of 1987, banks have become the major issuer of MMMFs and currently hold over two-thirds of this market. They are thus able to maintain fee income on a significant proportion of the lost deposits.[24]

---

24. Indeed, they have about the same share of the MMMF market as they do of the deposit market. Other types of deposit-taking institutions that do not offer MMMFs may have been affected more than banks by the recent spread of these instruments.

However, since their share of equity and bond mutual funds is much smaller than their share of deposits, shifts from deposits to these types of mutual funds involve a net loss of funds to the banks.

Chart 3 Interest rates on corporate paper and on deposits



4.2 Consumer loan market

This market encompasses virtually all loans by financial institutions to households except for residential mortgage loans. It thus includes fixed-term, fixed-rate loans for the purchase of automobiles, loans to finance the purchase of securities, credit card loans, and a large residual category of other loans, which are primarily floating-rate loans.[25]

As noted earlier, banks were permitted to enter this market by the 1954 Bank Act amendments, and their operations in this market were facilitated by the elimination of the ceiling on loan rates in 1967. By providing such loans at relatively low rates of interest, banks were able to raise their share of the market over the 1960s and 1970s (from about one-third in the late 1950s[26] to about one-half in 1970 to about two-thirds in 1980), mainly at the expense of finance companies. The banks' share has flattened out at about two-thirds of the market over the last 15 years (Chart 4). Most of the rest of this market is held by trust and mortgage loan companies not associated with the banks (9 per cent), co-operative credit institutions (11 per cent), and finance companies (5 per cent).

4.3 Residential mortgage market

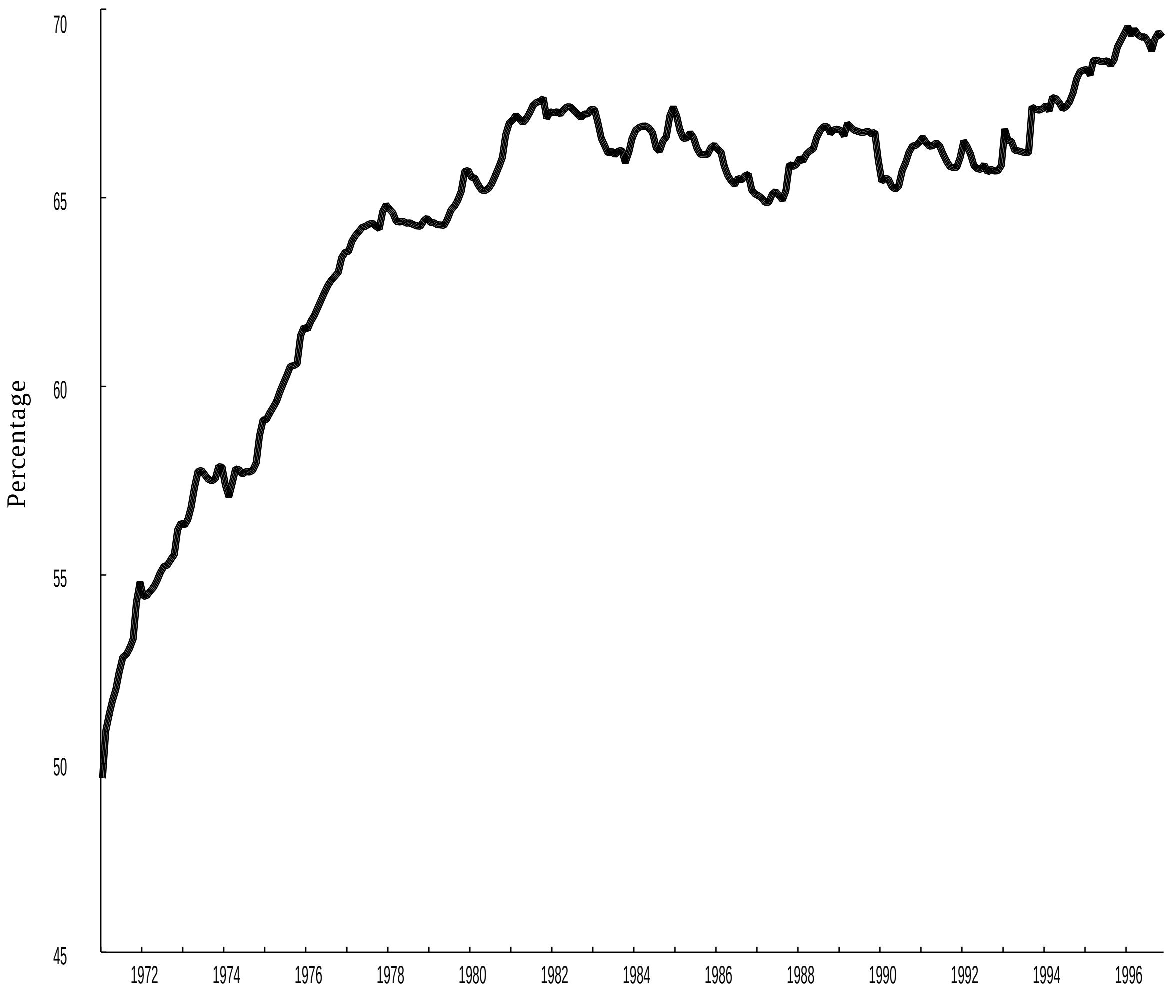
The 1954 Bank Act amendments permitted banks to lend against government-insured mortgages. However, their operations in this market in the mid-1960s were hampered by the ceiling on loan rates until the ceilings were eliminated by the 1967 amendments. Even more important were the 1967 amendments that permitted the banks to enter the conventional mortgage market and thus to make mortgage loans that were not insured.[27]

25. See Montplaisir (1996-97) for a description of the term structure of these loans.

26. See Neufeld and Hassanwalia (1997).

27. The Bank Act limits conventional (non-insured) residential mortgage loans to 75 per cent of the value of the property at the time the mortgage is issued. This ratio can be exceeded in cases where there is private or public insurance on the amount of the loan in excess of 75 per cent.

Chart 4 Bank share of consumer loan market



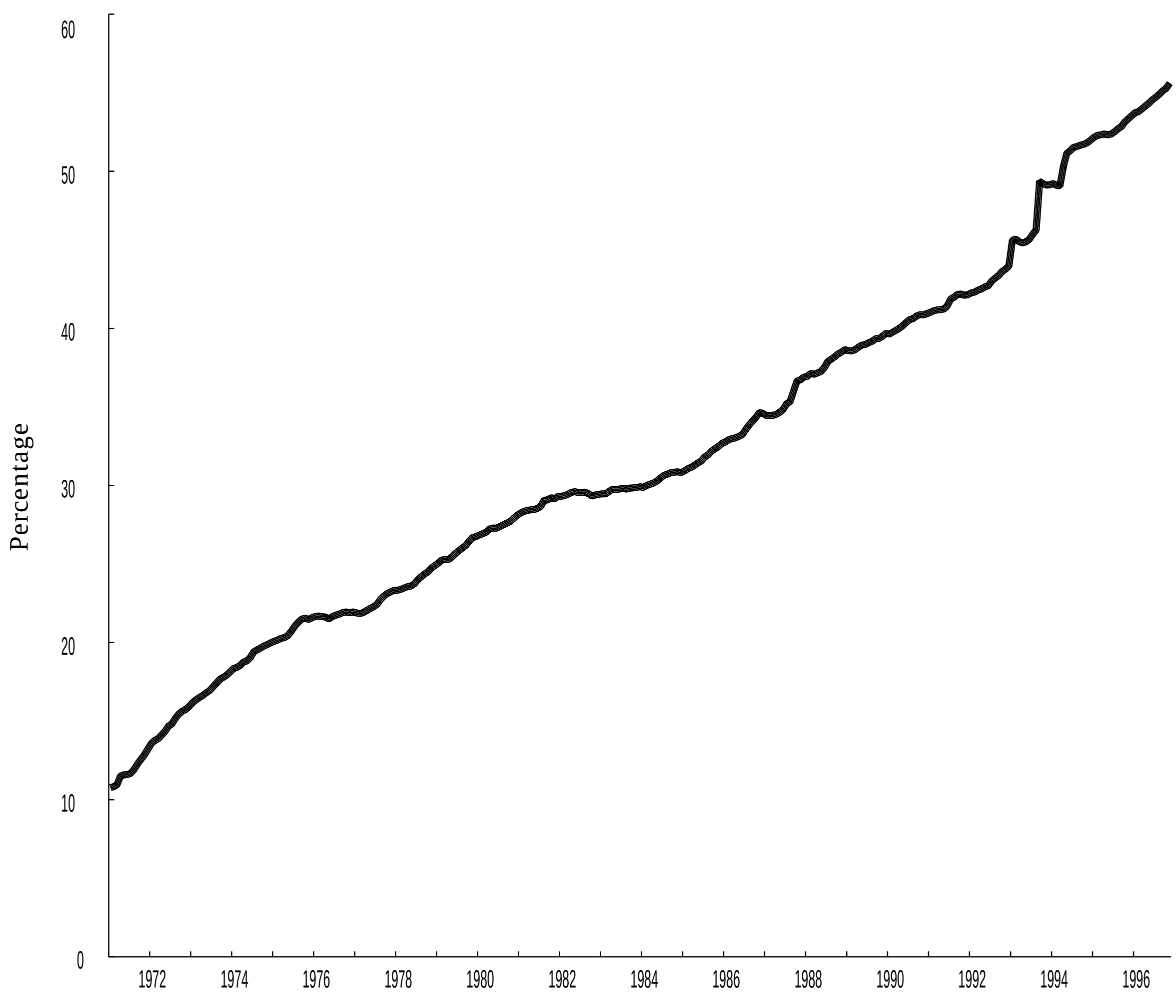
The bank share of the residential mortgage market (as defined by financial institution holdings of mortgages plus mortgage-backed securities) climbed steadily from 10 per cent in 1970 to about 55 per cent currently, as the banks took advantage of their new powers and their nationwide branching structure to expand their mortgage lending business (Chart 5).[28]

---

28. Also, as the rollover period of mortgages declined, life insurance companies had some difficulty finding liabilities to match the shorter-term mortgages until they began to sell deposit-like annuities.

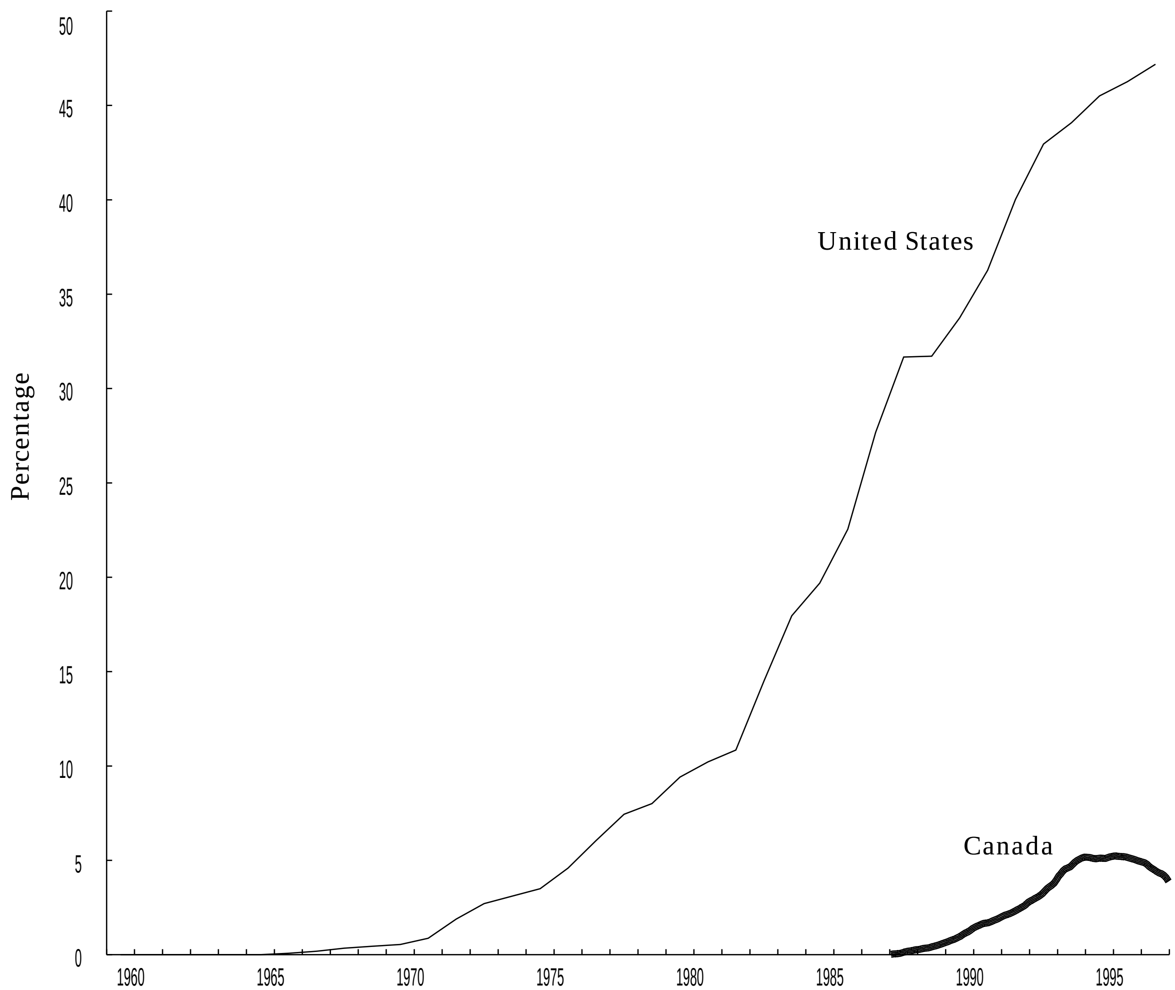
The upward step in the 1992 to 1994 period is largely attributable to the purchase by banks of a number of trust companies in financial difficulty. At present, other important participants in the mortgage market are trust companies (11 per cent), co-operative credit institutions (14 per cent), and life insurance companies (6 per cent).

Chart 5 Bank share of residential mortgage market



While there has been some growth in the securitization of mortgages in Canada in recent years, securitization has played a much less important role in Canada than in the United States. As shown in Chart 6, securitization accounts for only about 4 per cent of the Canadian mortgage market, compared with about 47 per cent in the United States. This difference between the two countries is largely attributable to institutional differences that in turn derive partly from differences in legislative arrangements.[29]

Chart 6 Percentage of residential mortgages securitized



Traditionally, maturity transformation was considered to be an important attribute of financial intermediation. The extreme case of such behaviour was the savings and loan associations in the United States, which

29. The following account is drawn heavily from Freedman (1987).

held 25-year mortgages and issued savings account and short-term deposits. The mismatch to which this type of behaviour gave rise proved to be very costly when short-term rates rose well above longer-term rates. While Regulation Q remained in force, the savings and loan associations faced serious disintermediation, and when it was removed, they faced severe losses. It is not surprising that, in such circumstances, mortgage-backed securities were an immense success. Rather than take on extra risk by holding more 25-year mortgages and issuing more savings or short-term deposits, many U.S. institutions opted to focus on brokering mortgages and to administer the mortgages for a fee. Ultimate lenders and those financial institutions willing and able to invest in longer-term instruments held the securitized mortgages in their portfolios.

In Canada, the situation was and is completely different. Since the late 1960s, banks and trust and mortgage loan companies have issued mortgages and term deposits that were more or less matched in terms of rollover period. Initially five years,[30] the mortgage instrument today ranges typically from one to five years, and both fixed- and floating-rate loans are available.[31] Canadian financial institutions made a concerted effort to match their deposit book and their mortgage book.[32] Furthermore, mortgages were seen by these institutions as a very desirable asset to hold in their portfolios. Hence there was very aggressive competition in the market for mortgages and term deposits, and spreads were fairly narrow. Moreover, nationwide branching facilitated the diversification of mortgage lending by financial institutions across regions and thus enabled them to avoid the risk of undue concentration of loans in any area of the country facing an especially difficult economic situation. With institutions eager to add mort-

30. The move away from longer-term mortgages was in part the result of the desire of institutions to avoid mismatches following their experience with volatile interest rates in the mid-1960s, together with the limitation of deposit insurance (introduced in 1967) to deposits of no more than five years in duration.

31. The amortization period, however, typically remains 25 years.

32. In recent years, they have also used derivatives to hedge mismatches that have developed.

gages to their portfolios, there was much less scope in Canada for the kinds of securitization that have dominated the U.S. mortgage market.

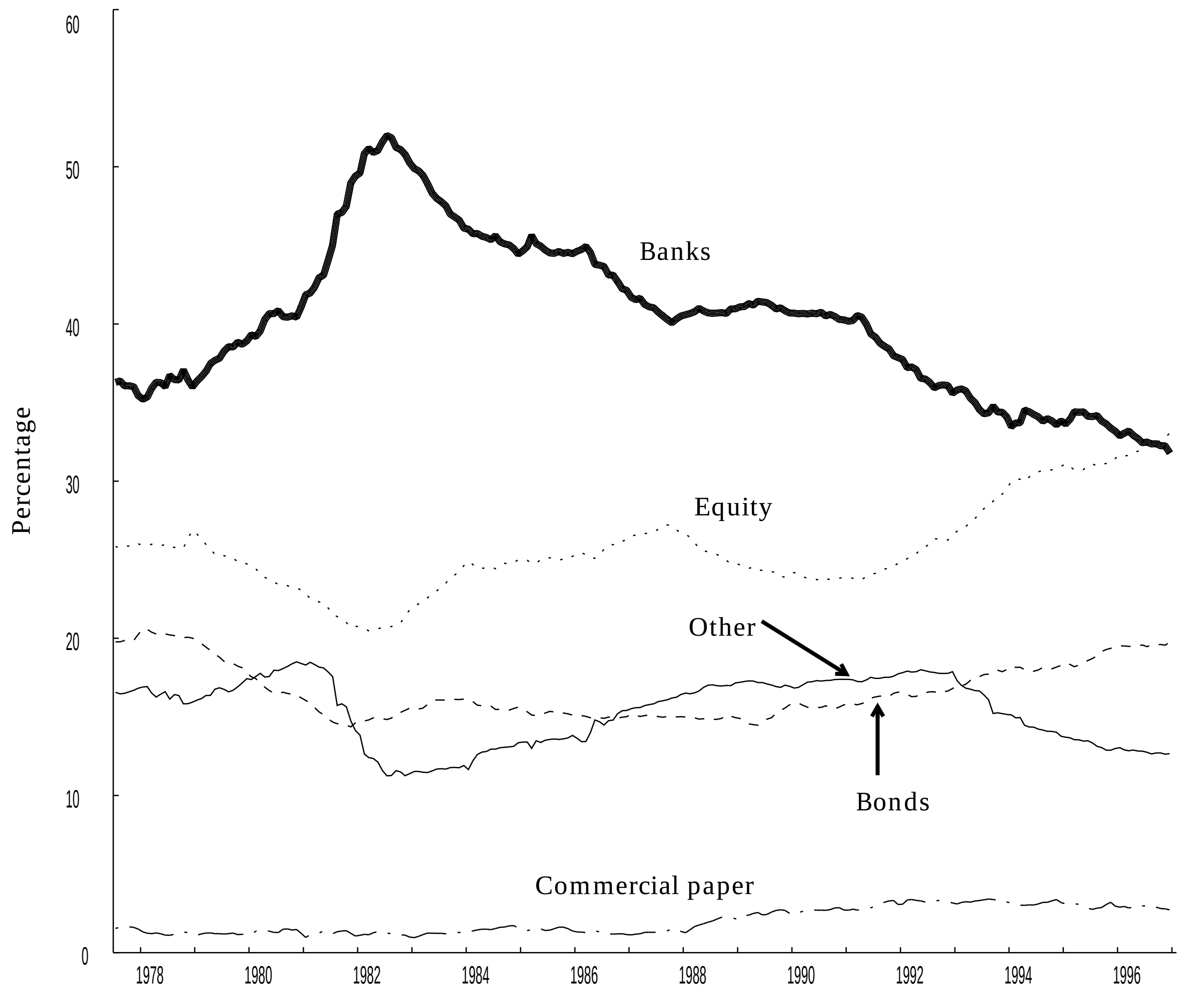
Other elements accounting for the slow growth of the securitized mortgage market in Canada were the absence of pressure from MMMFs on the ability of institutions to fund mortgage loans, and some uncertainty about regulatory issues that was resolved only in 1994. One factor that has encouraged financial institutions to do some securitization of their mortgage portfolios in recent years is the freeing up of capital as such instruments are moved off the balance sheet. In addition, with the shifting of funds from deposits to equity and bond mutual funds, funding pressures appear to be developing that are leading to increased securitization and will likely result in a more important role for securitization over the coming period.

4.4 Commercial lending

Chart 7 shows the bank share of the business credit market in Canada, as well as other major components of business credit. Included in the bank share are chartered bank loans (including foreign currency loans to residents), bankers' acceptances, leasing receivables, and non-residential mortgage loans. The other major components of total business credit are bonds and debentures, equity, commercial paper, and loans issued by financial institutions other than banks.[33] As depicted in the chart, the bank share of this business rose appreciably in the early 1980s, has since declined in a very steady downward trend, and is now slightly below its share in the late 1970s.

33. The measure does not include commercial loans by non-regulated institutions, such as Newcourt or GE Capital Canada, which appear to have been making appreciable inroads into this market.

Chart 7 Bank share of business credit market



The late 1970s and early 1980s was an anomalous period in Canada with its extraordinarily high share of intermediation by banks. It reflected a situation of very high nominal interest rates, at a time of very high inflation, and increasing uncertainty about the future paths of inflation and interest rates. The result was a dramatic shortening of desired term to maturity on the part of both lenders and borrowers. Activity in the market for long-term fixed-rate corporate bonds decreased markedly. Since, at that time, a market in medium- to long-term floating-rate instruments did not exist in Canada, the growth of loans at the chartered banks practically exploded.

Subsequent to this episode, there has been a tendency towards increasing use of direct market borrowing. While banks were involved in some of this business (directly in the case of bankers' acceptances, and by providing backup lines of credit in the case of commercial paper), they were concerned about their loss of business to direct market lending. This concern was one of the factors that underlay the banks' arguments in the period leading up to the 1987 amendments to the Bank Act that they needed to be able to enter the securities business. Following the passage of these amendments, banks have been heavily involved in corporate stock and bond issues through their securities subsidiaries.

4.5 Effect on bank activities of the 1987 and 1992 legislative changes[34]

The large chartered banks entered the securities business in a major way following the 1987 legislative change. Most of them bought (outright or in part) an existing securities dealer, while one major bank established a dealer *de novo.* As a result, the largest dealers are now all part of a broader financial services group headed by a bank. Some are wholly owned, while others are majority owned with minority ownership by the management and staff of the securities dealer.

Among the banks, the degree of integration of the management of the bank and securities business differs, with some relationships being more at arm's length than others. The tendency over the recent period, however, has been towards increased integration. Also, a number of Canadian dealers do continue to exist as independent entities, many as boutiques but some of a more significant size. There was a significant influx of foreign dealers (about 20 new entrants) in the late 1980s, although not as many as

34. This section of the paper relies heavily on Freedman (1996), with data brought up to date.

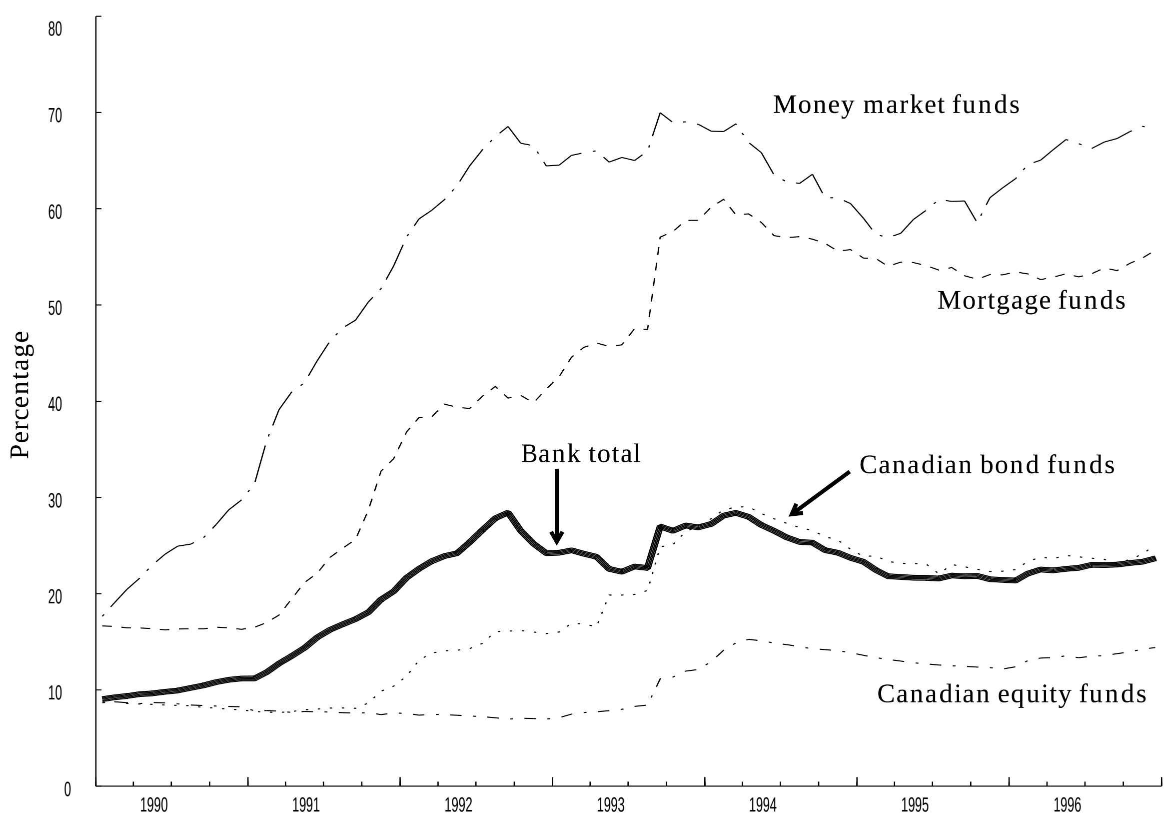
might have been expected before the 1987 stock market crash. A second wave of foreign dealers entered the Canadian market in recent years.

Some numbers regarding the share of business of the various types of primary distributors will give an indication of the extent of the change. In 1987, before the legislative changes, the Schedule I banks had about 15 per cent of treasury bill auction winnings and 19 per cent of Government of Canada bond auction winnings. In 1996, the comparable numbers for the banks and their securities dealer subsidiaries combined were 62 per cent and 50 per cent, respectively. Furthermore, the banks and their dealer subsidiaries accounted for 82 per cent of the turnover in the secondary market for treasury bills and for 59 per cent of the turnover in the secondary market for bonds.

Banks have also entered into the mutual fund market in a major way, offering a wide variety of bank-sponsored funds in their branches. Chart 8 depicts the bank share of various mutual fund categories. The banks have been especially successful in marketing money market and mortgage funds, but less successful in the bond and equity fund segments of the market. Thus at the end of 1996, the banks' share of money market mutual funds was 68 per cent; that of mortgage funds was 56 per cent. However, the banks' share was only 25 per cent of bond funds and 14 per cent of equity funds. These were up from 10 per cent and 8 per cent respectively at the end of 1991, but still far short of their market share of those funds whose features were much closer to traditional notice and term deposits. Overall, the banks' share of mutual funds is currently almost 25 per cent.

The increase in the share of securities markets by banks and their subsidiaries does not appear to pose problems, for two reasons. First, there is significant competition among the various bank-owned dealers, while the independent dealers also contribute appreciably to the competitive environment.[35] Second, an important aspect of the original legislative change was to permit foreign financial institutions to enter the Canadian securities markets. In part, this was intended to ensure that these markets remain "contestable," that is, that there be sufficient actual or potential competition. While fewer foreign dealers than had been expected chose to enter the Canadian market in the aftermath of the stock market crash of 1987, there are nonetheless a number of large foreign dealers who have set up subsidiaries in Canada and who have been active in the market. For example, of

Chart 8 Bank share of selected mutual funds markets



35. A concern has been expressed, however, about whether there will be sufficient competition in the money market as the banks and their subsidiary dealers merge their operations.

the 32 primary distributors of government bonds and bills, 13 are foreign owned;[36] in 1996 they accounted for about 17 per cent of treasury bill auction winnings and about 38 per cent of bond auction winnings.

All the major banks now have a trust subsidiary, acquired either by purchase or *de novo* establishment. The purchase by banks of some major trust companies in the past few years, while facilitated by the recent legislation, was spurred mainly by the financial difficulties encountered by trust companies that had invested heavily in real estate or commercial mortgages backing real estate before the substantial decline in real estate prices in the early 1990s. The absorption of much of the trust industry by the banks was neither a goal nor a direct result of the legislation, but neither did the legislation put barriers in the way of such acquisitions. The acquisitions have thus served as a way of facilitating exit from one segment of the financial services industry.

With the entry of banks into the trust business, they have become important players in the market for assets under administration. The $1.3 trillion in assets under the administration of the six largest Canadian banks represents about 80 per cent of the total market.

Some of the large banks have set up or purchased life and property insurance subsidiaries. Their ability to market insurance products is restricted because banks are not permitted to use their banking information to target insurance customers. Moreover, they are prevented by the legislation from retailing insurance through their bank branches. Thus, separate distribution mechanisms, such as telemarketing and “stuffers” in the mailings of statements and credit card bills, have been used in the marketing of insurance.

36. Of those, two are jobbers and have a special relationship with the Bank of Canada.

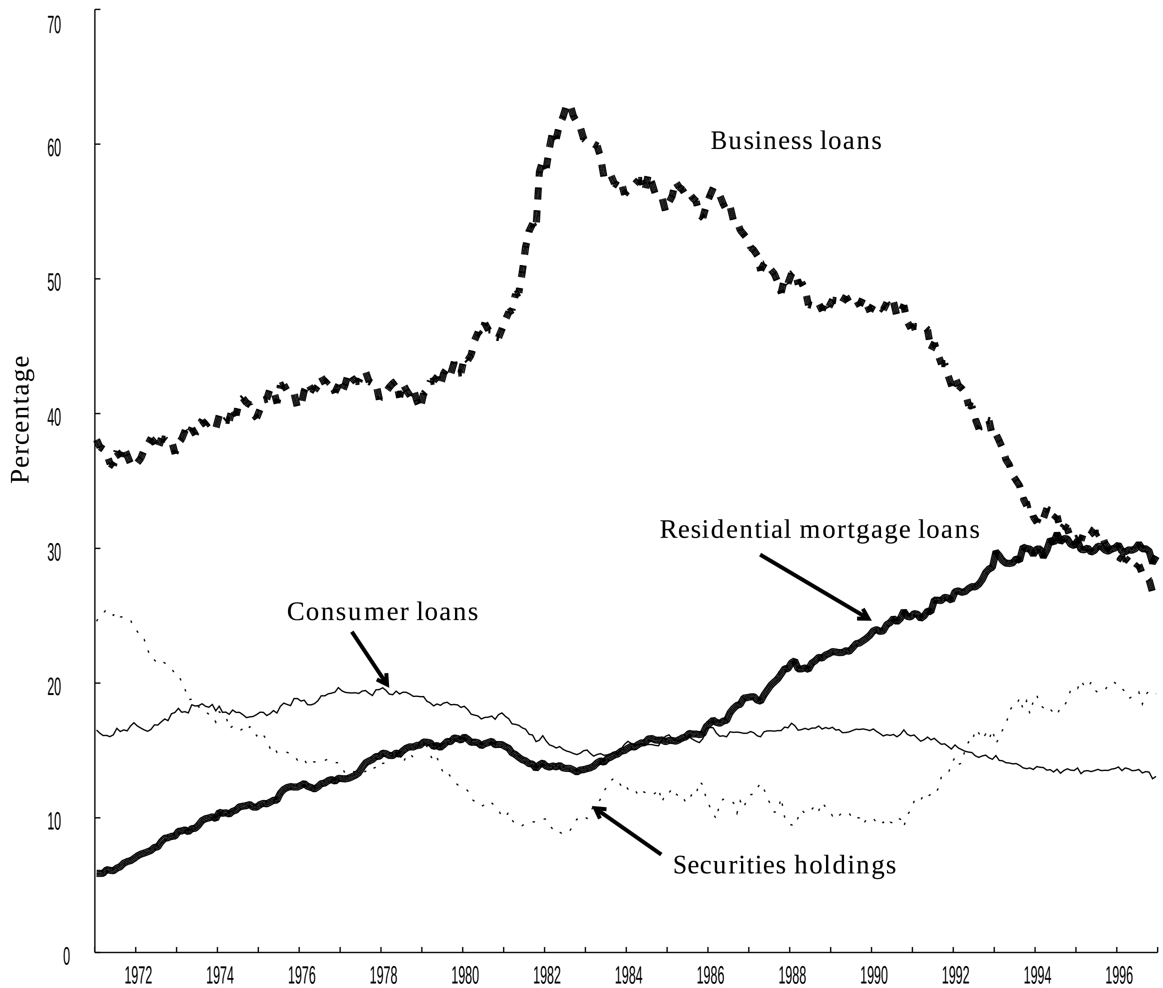
4.6 Changes over time in the balance sheet of the banking sector: a summary

As a result of the various developments described above, the distribution of Canadian dollar assets on the balance sheet of the Canadian banks has changed rather markedly across major categories over the last 25 years (Chart 9).[37,38] With the exception of a short period of decline in the early 1980s and a flattening in the last couple of years, residential mortgages have shown a continuously rising trend as a share of assets and are now the largest category of domestic bank assets. Consumer lending has had a slight downward trend as a share of bank assets, while business lending has declined fairly sharply after its very strong increase in the early 1980s. Holdings of securities, which had declined to about 10 per cent and had maintained that ratio through the 1980s, have grown back to about 20 per cent in the recent period. This tendency is partly due to banks' participation (usually through dealer subsidiaries) in the rapidly growing securities lending and repo markets, as well as to the use of securities to hedge interest rate swaps and other derivatives transactions.

37. See Armstrong (1997) for further details.

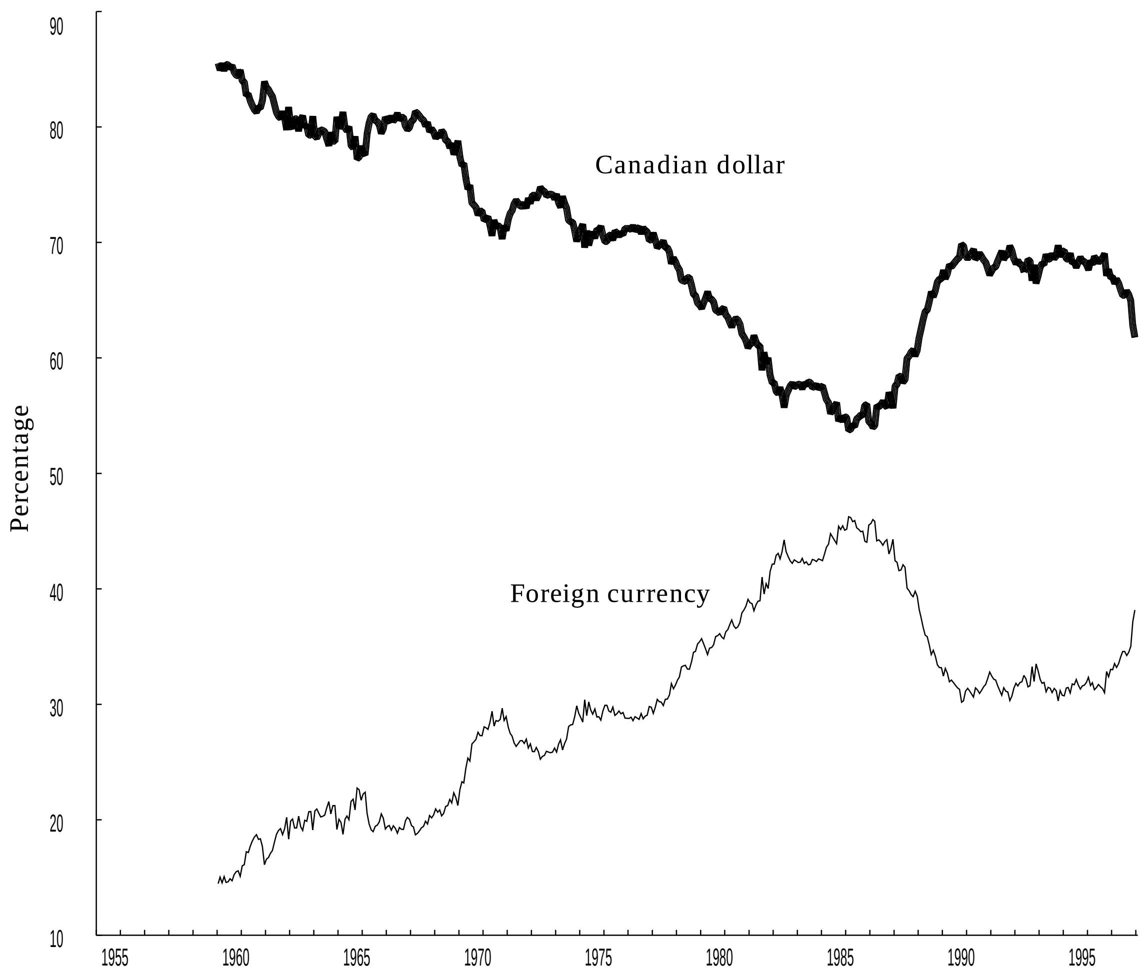
38. The data for the major categories are based on the consolidated Canadian dollar balance sheet of the banks, with the exception of business lending, which also includes foreign currency loans to residents.

Chart 9 Percentage of Canadian dollar assets in major bank asset categories



While this paper has focused on the Canadian dollar business of Canadian banks, it should be noted that Canadian banks have traditionally been important players in foreign markets and that foreign currency assets and liabilities have been an important component of their balance sheets. As can be seen in Chart 10, foreign currency assets as a percentage of total assets rose from about 15 per cent in the late 1950s to a high of 46 per cent in the mid-1980s before falling back to almost 30 per cent in the mid-1990s. At the end of 1996, they are about 38 per cent. While a small part of this business reflects retail operations abroad, especially in the Caribbean area, much of the growth in the 1970s and the first half of the 1980s reflected increasing involvement in the burgeoning Euro-markets as well as lending to less-developed countries (LDCs). Following the serious difficulties in LDC lending, and with increased competition and lower margins in Euro-markets, Canadian banks retrenched and tended to focus their attention more on the North American market. More recently, some banks have shown renewed interest and involvement in Mexico and the rest of Latin America, resulting in a number of joint ventures by Canadian banks in those areas.

Chart 10 Share of Canadian dollar assets and foreign currency assets



4.7 Other changes and challenges

Another important trend in the operations of Canadian banks in recent years, in line with developments in other major banks worldwide, has been the shift towards off-balance-sheet activities and fee income. For the six largest Canadian banks, “other income” rose from about 18 per cent of total revenues in 1984 to 38 per cent in 1996. While this category includes income from a disparate group of activities (see Table 1), a very significant part is associated with the provision of services to businesses. As emphasized earlier, direct lending has been a declining part of the banks’ balance

Table 1 Share of “other income” for the six largest banks, by category

Category	1994	1995	1996
Investment banking and other securities fees	**21.7**	**19.4**	**26.5**
Service charges on deposits and other retail charges	**21.4**	**21.4**	**19.1**
Foreign exchange fees	**10.4**	**10.2**	**9.9**
Credit fees	**16.2**	**16.3**	**15.1**
Credit card services	**9.8**	**10.7**	**9.5**
Trust and mutual funds fees	**11.3**	**11.9**	**11.6**
Other	**9.3**	**10.1**	**8.3**
Total	**100.0**	**100.0**	**100.0**

sheet and a declining source of funds for business. The banks have become heavily involved (though their securities subsidiaries) in the flotation of bonds and equities by corporate customers and in the provision of backup loans on the issue of commercial paper. In 1996, investment banking and other securities fees provided over one-quarter of “other income” for the six largest Canadian banks. Earnings from derivatives transactions, in which the Canadian banks are heavily involved, also contributed to this category of income. Moreover, other new areas, such as trust activities and the promotion and sale of mutual funds, provided another 12 per cent.

The major Canadian banks, having become full-fledged financial conglomerates, are all now in the process of developing strategies for the next decade or two. Among the challenges to be faced are the rapid technological changes now impinging on the banking industry, ongoing demographic changes, increased competition in certain of their activities from the non-regulated sector, possibly enhanced competition from foreign financial institutions, and considerable uncertainty about what the financial services industry will look like in 10 or 20 years.[39] Among other things, decisions will have to be made about the extent and speed of their involvement in electronic banking, the degree of their international involvement, the areas in which they will focus their efforts (e.g., areas in which they are most efficient and in which they want to be significant participants), and perhaps, further mergers and acquisitions. The next few years will undoubtedly see further important developments in banking and in the entire financial sector.

39. A detailed discussion of these matters can be found in Freedman and Goodlet (1998).

REFERENCES

Armstrong, J. 1997. “The Changing Business Activities of Banks in Canada.” *Bank of Canada Review* (Spring): 11–38.

Bank of Canada. 1991. “The Implementation of Monetary Policy in a System with Zero Reserve Requirements.” *Bank of Canada Review* (May): 23–34.

Canada. Department of Finance. Press Release 96-101, 19 December 1996.

Daniel, F., C. Freedman, and C. Goodlet. 1992-93. “Restructuring the Canadian Financial Industry.” *Bank of Canada Review* (Winter): 21–45.

Freedman, C. 1987. “Aspects of Securitization.” *Bank of Canada Review* (January): 5–16.

———. 1992. “Universal Banking: The Canadian View.” In *Financial Regulation: Changing the Rules of the Game,* edited by D. Vittas, 369–390. Washington, D.C.: The World Bank.

———. 1996. “Financial Structure in Canada: The Movement towards Universal Banking.” In *Universal Banking: Financial System Design Reconsidered,* edited by A. Saunders and I. Walter, 724–36. Chicago: Irwin Professional Publishing.

Freedman, C. and C. Goodlet. 1998. *The Financial Services Sector: Past Changes and Future Prospects.* Technical Report No. 82. Ottawa: Bank of Canada.

Montplaisir, M.-C. 1996-97. “The Maturity Structure of Household Financial Assets and Liabilities.” *Bank of Canada Review* (Winter): 33–46.

Neufeld, E.P. and H. Hassanwalia. 1997. “Challenges for the Further Restructuring of the Financial-Services Industry in Canada.” In *The Banking and Financial Structure in the NAFTA Countries and Chile,* edited by G.M. von Furstenberg, 44–106. Boston: Kluwer Academic Publishers.

Bank of Canada Technical Reports

Copies of the above titles and a complete list of Bank of Canada technical reports are available from

PUBLICATIONS DISTRIBUTION, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9
Tel: (613) 782-8248; fax: (613) 782-8874