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The Bank Failures of September 1985

Background

Because no Canadian bank had failed since the Home Bank in 1923, very few players in the financial system had any knowledge of what happens to the payments being processed on the day that such a situation arises. Virtually everyone—even the financially sophisticated—believed that the receipt of a certified cheque or a bank cashier's cheque, represented a final, irreversible payment. Through the Great Depression, the Second World War, and its aftermath, the handful of Canadian banks that suffered significant difficulties were absorbed into larger institutions without creating problems for their creditors or depositors. Partly as a result, and also because of other mergers, the degree of concentration in the banking system increased noticeably, a situation that led the federal government to look favourably on new entrants. This was particularly the case for institutions being formed in western Canada, because they might enhance economic opportunities in that part of the country. The Canadian Commercial Bank (CCB) and the Northland Bank of Canada (NBC), established in 1975, were such new players.[1] Both banks concentrated their activities in the western provinces, and both invested heavily in oil, gas, and real estate loans. By mid-1985, their total assets had reached $2.7 and $1.4 billion, respectively. (Together they accounted for only 3/4 per cent of the total assets of the banking system.)

The ways in which each of these banks operated in the national clearing and settlement system reflected the fact that they came into existence before the CPA structure of direct clearers and indirect clearers became operational. (Prior to the CPA, any new bank immediately became the equivalent of a direct clearer, with an account for settlement purposes and for reserve purposes, at the Bank of Canada.) In 1983, the CCB was too small in the clearings to qualify under the CPA by-laws for direct clearer

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1. W. Z. Estey, *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (Ottawa: Supply and Services Canada,1986), 405 and 536.

status, but it chose to take advantage of a five-year transitional provision in this regard.[2] It was formally recognized by the Board of the CPA as a direct clearer. Its clearing activities thus appeared in the daily calculations and statements generated by the Automated Clearing Settlement System. The CCB represented itself in the clearing exchanges either directly, as it did at the Calgary regional settlement point, or indirectly via a clearing agent (the Toronto-Dominion Bank) at all other settlement points. In contrast, the even smaller NBC chose to function in the clearings as an indirect clearer, using the Royal Bank as its clearing agent at all regional settlement points. Its name did not, therefore, appear in the calculations made by the ACSS. To understand what transpired in the autumn of 1985, it is important to realize that the NBC continued to hold its reserves at the Bank of Canada and continued to conduct a few daily transactions through that (transferable) reserve account, even though it had located its settlement account for clearing purposes at the Royal.[3]

Main Events

In western Canada, the economic recession in the early years of the 1980s was centred in the oil and gas sectors and, hence, was particularly stressful for investors in energy-related real estate and for banks that specialized in financing such activities. In 1983, the situation at the CCB still appeared manageable, but was sufficiently uncertain that the federal authorities encouraged five large chartered banks to provide the CCB with support in the form of a special liquidity facility. Early in 1985, downward pressure on the Canadian dollar was met with upward movements in interest rates which made the carrying of real estate positions by investors even more difficult. The loan portfolios of both the western banks deteriorated, and both banks began to experience difficulty in rolling over their maturing wholesale (non-personal) deposit liabilities. In this context, the CCB received a further support package involving six chartered banks and two levels of government in March 1985.[4] Nevertheless, over the summer months, the deposit outflows from both banks continued to worsen, and on most days it proved necessary for them to receive additional liquidity support from the central bank. By the Labour Day weekend, the outstanding Bank of Canada loans to

2. CPA By-law 3, section 10, required each direct clearer to account for at least 1/2 per cent of the number of payment items exchanged in the clearings. But a CPA member receiving items directly in the clearings at the point in time when the by-law came into force could, with the approval of the Board, continue to do so for five years.

3. This arrangement was rare but not unique; two subsidiaries of foreign banks operating in Canada also chose to hold their reserves in this way.

4. Bank of Canada, *The Submission of the Bank of Canada to the Commission of Inquiry on Certain Banking Operations* (Ottawa: Bank of Canada, 1986), 8.

the CCB had reached $1.3 billion; this implied that more than half of the CCB's total assets were being pledged as collateral to the central bank. The similar outstanding loans to the NBC had risen to $0.5 billion, over one-third of its total assets.

Events came to a head on the three-day weekend of 31 August through 2 September. The Inspector General of Banks issued a press release on the Sunday, 1 September, stating that he had informed the Minister of Finance that the CCB and the NBC were unable to meet their liabilities as they came due. The Minister of State (Finance) issued a press release the same day indicating that, since the two banks were no longer viable, the Bank of Canada had ceased to provide liquidity support to the two institutions. Curators (accounting firms) were appointed by the Minister of Finance at 7 p.m. that Sunday evening to take over the management of the banks' affairs. The Governor of the Bank of Canada also issued a press release on 1 September, stating that he had received the notification from the Inspector General of Banks that neither of the two banks could be considered viable operations and that there was thus no basis for further liquidity support to them. Accordingly, the Bank of Canada was ceasing immediately to provide advances to the CCB and the NBC. The Bank's press release included the exact amounts of outstanding advances as at Friday, 30 August.[5]

On the Labour Day holiday, Monday, 2 September, there were communications by conference call between senior officers of the CPA and officers of the two firms that had been appointed as curators: Price Waterhouse Limited for the CCB and Touche Ross Limited for the NBC. In the course of these conversations, it was agreed that in each case the settlement account of the bank would be frozen and that notifications to this effect would be issued as soon as possible. (The two accounting firms were subsequently appointed as liquidators pursuant to the Winding Up Act.)

On the following morning, Tuesday, 3 September, it became apparent that the two closed banks were in very different positions in terms of the just-completed results of the clearings process, which had taken place, as usual, on the evening of Friday, 30 August. Calculations by the ACSS indicated that the CCB, the direct clearer, was in the fortunate position of experiencing a very slight net *gain*. (Its degree of success in rolling over its maturing wholesale deposit liabilities that Friday, together with any creditors' loan repayments, had been sufficient to offset outflows of other types of deposits.) As a result, the CCB settlement account at the Bank of Canada was actually slightly higher on Tuesday than on the preceding business day. The $1.3 billion figure for outstanding advances from the

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5. Bank of Canada, "Record of press releases," *Bank of Canada Review* (September 1985): 19–26.

central bank published on Sunday was thus still correct. Moreover, in the strict sense of the CPA by-laws, the CCB was not in default *in the clearings*.

In contrast, the indirect clearer, the NBC, needed another $30 million in its settlement account at the Royal Bank to offset substantial net maturities of term deposit liabilities (and to cover other debits reflecting the clearings of Friday evening, 30 August, particularly the impact of cheques written on the NBC by clients wishing to reduce their deposits at the troubled institution). The Bank of Canada thus faced an awkward and complex problem. In order to complete the daily settlement process, it had to expand its assets vis-à-vis the NBC one more time, but it had announced on Sunday that it was immediately ceasing to lend. Several additional details compounded the problem.

On the basis of operating procedures that had been in place for many months, the NBC had, on the Friday, written a cheque drawn on its central bank account, in an amount (net of offsetting flows) that would approximate the firmly expected clearing loss for value on that day, and had deposited it in the Royal. (Such deposited items had regularly been used by the NBC to pass the funds advanced to it by the central bank along to its clearing agent.) The problem arose because, according to the CPA by-laws and rules, the Bank of Canada could claim that the amount in the deposit account of the NBC at the Bank was insufficient and that the cheque could therefore be returned to the institution that had delivered it in the clearings, with the result that the accounting effects would be unwound. Had the central bank acted in this way, it would have forced the NBC's clearing agent into the risky position of having a new and unsecured $30 million claim on the estate of the NBC.

After numerous telephone communications on Tuesday, 3 September, and after holding the cheque for one day to allow for careful consideration, the central bank chose not to return the item. The net effect of this decision was a $30 million increase in the indebtedness of the NBC to the Bank of Canada, recorded on the central bank's balance sheet under *other assets*. In coming to its decision about what should properly be done in such circumstances, the Bank concluded that "it was essential for the integrity of the payments system" that a financial institution acting as a clearing agent should not be placed in a position of jeopardy on account of payments initiated by its indirect clearer client and drawn on its account at the central bank.[6]

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6. Bank of Canada, "Record of press releases," *Bank of Canada Review* (September 1985): 26

Immediate Aftermath

On Tuesday, 3 September, the Royal Bank fulfilled its obligation under the CPA Clearing By-law in the context of the default of an indirect clearer. It proceeded to return, through the clearings, all those payment items that had been drawn on its client the Northland Bank—items that had been remitted to payees in the underlying financial or commercial transactions at some point during the preceding week, subsequently deposited in various other deposit-taking institutions, and ultimately cleared on Friday evening to the Royal. The Royal correctly indicated that the reason why the items were being returned was "funds frozen." This long-standing default-sharing procedure immediately produced numerous effects throughout Canada, depending on the circumstances of particular payees, payors, and their respective institutions. For example, payors (who had written cheques on the NBC and assumed that their funds had been successfully transferred to the relevant payees) now received unexpected communications from payees to the effect that the payments had failed and that replacement cheques had to be delivered. Payees were informed by their deposit-taking institutions that the accounting credits of the preceding business day had necessarily been reversed; in some cases unexpected overdrafts were the result. For the Royal Bank, the return of NBC items through the clearings on Tuesday had the effect of producing a clearing gain approximately equal to the preceding business day's net shortfall in the account of its indirect clearer client. For the curator/liquidator of the NBC, the deposit liabilities of the estate grew by the same amount. In summary, the reversals required by the default-sharing procedure had the effect of widely redistributing the financial burdens associated with the event—often in unforeseen ways.

A different, yet equally surprising, story was unfolding during that week in the case of the Canadian Commercial Bank. In the rush to take over management of the CCB, the liquidator took several days before communicating that the settlement account of that bank at the Bank of Canada was frozen. It was therefore several days before the CPA deleted the CCB from the set of direct clearers and before the bank was eliminated from the clearing and settlement procedures of the ACSS. The liquidator took full advantage of this delay and ordered the return, through the clearings, of a number of large-value payment items that had earlier been drawn on the CCB, then deposited elsewhere in the financial system, and eventually cleared to the western bank. For example, some the CCB's own cashier's cheques, issued on Friday, 30 August to pay out funds as required by maturing wholesale term deposits, were so returned.[7] The result was most painful for the corporate and government treasurers involved.

Longer-Term Impact

The failure of the two small western banks in 1985 had serious consequences, some of which persisted for more than a decade. Two additional banks, the Bank of British Columbia and the Continental Bank of Canada, which also depended on wholesale deposit funding, proved unable to weather the period of extreme caution about institutions that relied on such financing. Both needed liquidity support from the Bank of Canada, and both ended by merging with larger banks. In addition to these developments caused by "contagion" among similar institutions, the extensive court proceedings surrounding the closures of the CCB and the NBC continued for a full 15 years. In retrospect, it is surprising to note that all this could result from problems originating in less than one per cent of the banking system.

If the 1985 bank failures had one salutary aspect it was the increased awareness that the pervasive use of cheques in Canada, especially for large-value transfers in the securities markets and in the foreign exchange market, carried significant risks because such payments were not final. A large-value funds transfer system (LVTS) that did not involve the unwinding of the clearings in the event of a default and that provided immediate finality of payment; i.e., a system similar to those either existing or emerging in other countries, was essential for Canada. It is one of the ironies of the history of the CPA that the first extensive discussion by the Board about the need to create an LVTS had already been scheduled; it took take place in a planning session on 18 September 1985, less than two weeks after the bank defaults occurred.

Developments in the Canadian payments system during the subsequent five years were, as it turned out, focused not on large-value payments but on the small-value payments made at retail locations such as department stores and gasoline stations. (Chapter 7 takes up the LVTS story.)

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7. Some items received by the CCB in clearing exchanges *prior to* 30 August were also returned.