Bank of Canada

Ottawa, February 26th, 1946

Personal and
Confidential

The Hon. Marriner S. Eccles,
Chairman of the Board of Governors,
Federal Reserve System,
Washington.

Dear Mr. Eccles,

As a central banker, you will be interested to know of certain changes in Canadian banking arrangements which the Minister of Finance expects to announce very shortly. The necessity for the changes arises from the fact that the chartered banks' holdings of Dominion Government bonds have increased very substantially during the war years for reasons of which you are well aware. By "Dominion Government bonds" I mean securities acquired by the banks in the open market as distinct from Treasury Bills or Deposit Certificates sold directly by Government to banks. Further substantial increases in the banks' portfolios of such securities, unmatched by a similar increase in savings deposits which bear interest at 1-1/2 per cent per annum, would open the door to a very significant increase in banking profits. The banks have agreed that such a development would not be desirable, and they therefore intend not on the average to hold more Dominion Government domestic bonds than 90 per cent of the amount of their Canadian savings deposits. They also undertake that their earnings on such Dominion Government bonds should not exceed their costs for interest and other operating expenses on Canadian savings deposits by more than a reasonable profit margin.

Statistics showing banks' earnings, expenses and profit on Canadian savings deposits are contemplated. It is expected that this information - covering the whole group of banks rather than individual institutions - would be made public annually by the Minister of Finance. In making up the profit and loss statistics for the group, a bank whose holdings of Dominion Government bonds are less than 90 per cent of Canadian savings deposits will be assumed to have lent the difference to its commercial department and to have charged the commercial department the maximum rate of

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earnings on Dominion Government bonds for which provision is made in the agreement.

If banks find themselves holding an excessive amount of cash, and cannot find more attractive outlets for it, they will be able to buy from Bank of Canada six months Treasury Notes bearing interest at 5/8 of 1 per cent per annum. The Bank of Canada holds, or will shortly hold through conversion of certain maturities, a substantial amount of these Notes. It would be understood that Bank of Canada normally would readily repurchase such notes in case of need.

I may add that the interest rate on Deposit Certificates - the instrument used by the Government for direct financing with the banks - will be reduced to 5/8 of 1 per cent per annum as fresh issues are sold or existing issues mature. The rate up to the present time has been 3/4 of 1 per cent per annum.

I have made a note to send you a copy of the Minister of Finance's statement when it is released.

Yours sincerely,

G. F. Towers

Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 6, 1946.

To Members of the Board

Subject:

From Mr. Thurston

The Chairman thought you would be interested in seeing the attached personal and confidential letter to him from Governor Towers, together with the press release that the Canadian Minister of Finance issued in connection with the new government interest rates on deposit certificates sold to the chartered banks.

Attachments

Mr. Ransom ---------

Mr. Evans ---------

Mr. Szymczak ---------

Mr. McKee ----------

Mr. Draper ----------

(Please return to Mr. Thurston)

Bank of Canada

Ottawa,

February 27th, 1946

Dear Mr. Eccles,

When I wrote you my letter of February 26th I had expected that the announcement by the Minister of Finance would not be made until March 1st. Unexpectedly, however, he released the statement to-day. I enclose herewith a copy of the statement.

Yours sincerely,

G. F. Towers

The Hon. Marriner S. Eccles,
Chairman of the Board of Governors,
Federal Reserve System,
Washington.

Ottawa,
February 27, 1946.

PRESS RELEASE:

Rt. Hon. J. L. Ilsley, Minister of Finance, announced today a reduction in the interest rate paid by the Government on Deposit Certificates sold to the chartered banks, and also the results of an agreement reached with the banks limiting their holdings of Dominion Government securities other than very short term securities such as Deposit Certificates and Treasury Bills to a fixed proportion of their savings deposits.

The rate of interest on Deposit Certificates sold to chartered banks will be 5/8 of one per cent per annum instead of the present 3/4 of one per cent. The new rate will be effective on any further issues of Deposit Certificates and on outstanding issues as they mature during March and April.

Financing arrangements between the Dominion Government and the chartered banks have been on the basis of maintaining rates of remuneration to banks which would be sufficient to cover their costs but which would leave only a reasonable margin for profit. Up to date it has been possible to follow this policy by appropriate arrangements with respect to Deposit Certificates which have proved to be a very suitable type of security to use in meeting direct Government borrowing needs from the chartered banks.

Because of the scale of war-time Government financing the Canadian public - like people in most other countries - has chosen in recent years to hold an increasing amount of its accumulated savings in the form of interest-bearing savings deposits at the chartered banks. At one time banks were able to invest such deposits largely in their commercial banking activities, chiefly in the form of loans. Times have changed, however, and the counterpart of Canadian savings deposits in banks' balance sheets of necessity has more and more become their holdings of Dominion Government bonds. This situation is not peculiar to Canada alone, but exists today in many other countries. The association between savings deposits and holdings of Government bonds is more obvious of course in countries where there are special savings institutions than in Canada where chartered banks perform the functions of both commercial and savings banks.

To the extent that chartered banks' holdings of Dominion Government securities are associated with their Canadian savings deposits which nearly all bear interest at the rate of 1-1/2 per cent per annum, it is appropriate, in order to cover banks' costs, that such investments be in the form of Dominion Government bonds rather than Deposit Certificates. However, as banks' holdings of Dominion Government bonds are becoming more nearly the full counterpart of their Canadian savings deposits, certain arrangements appeared to be desirable for the future.

Following discussions on this subject between the Government, Bank of Canada and the chartered banks, the banks have agreed that their holdings of Dominion Government domestic bonds (including guaranteed issues) will not average more than 90 per cent of the amount of their Canadian savings deposits (i.e., their notice deposits other than balances of corporations). The banks have also agreed that their earnings on such Dominion Government bonds held for investment account should not exceed their operating costs on Canadian savings deposits in the form of deposit interest and other expenses, by more than a moderate profit margin for this type of banking business.

The agreement regarding the amount of their holdings of Dominion Government bonds places the savings bank function of the chartered banks in approximately the same position as if it were being performed by separate savings institutions which would tend to have about 10 per cent of their deposits in the form of cash and other non-earning assets. Chartered banks, of course, may add to their holdings of Dominion Government bonds to the extent they now hold an amount less than 90 per cent of their Canadian savings deposits and also in proportion to any increase in such deposits which may take place in the future. If chartered banks wish to invest in Dominion Government securities beyond the amount which has been recognized as appropriate in connection with their Canadian savings deposits, there will be available to them short term securities bearing interest at the rate of 5/8 of one per cent per annum, or Treasury Bills.

The new arrangement will not affect the ready marketability of Dominion Government bonds. Banks will be able to engage in their usual day to day dealin s with buyers and sellers of these securities.

The effect of the agreement with respect to earnings on Banks' holdings of Dominion Government bonds is that banks will not increase the average maturity of such investments beyond the point where their earnings from this source would leave more than a reasonable margin of profit over their costs in connection with operating Canadian savings deposits. Separate statistics of banks' earnings, expenses and net profit on Canadian savings deposit business will be made available to the public by the Minister of Finance in the form of a supplement to the statutory annual return of banks' earnings and expenses.

These agreements, with respect to chartered banks' holdings of Dominion Government bonds, provide for continuing the existing objectives of financing arrangements between Government and chartered banks which have hitherto been evident in Deposit Certificate financing, in the changing situation which has been described. The fact that it has been possible for a voluntary agreement on this subject to be reached through discussions between Government, Bank of Canada and chartered banks is a tribute to the co-operative spirit with which the chartered banks have approached the various problems involved.

PERSONAL AND CONFIDENTIAL March 11, 1946.

Dear Governor Towers:

This is to thank you for your personal and confidential letter of February 26 in regard to the new arrangements with the Canadian banks which the Minister of Finance has announced. I was, of course, greatly interested to see it because it relates to a problem of immediate concern to us here.

I have sought to emphasize several times how important it is to stop further monetization of our public debt through the commercial banking system, and I am taking the liberty of enclosing two public statements in this connection; one issued at the time the Board raised margin requirements to the full limit of 100 per cent, and the other which I presented before the Banking and Currency Committee of the House in urging extension of price control legislation. Members of this Committee pressed me rather hard to make a special report recommending specific legislation which would be necessary to deal with our problem and I have that among other things, including the British loan, on my calendar.

The arrangements which you are making strike me as particularly wise. You have, of course, been much more successful than we have in minimizing commercial bank holdings of the debt. I often wish we had a few large banks to deal with instead of some fourteen thousand, about half of which are not members of the Federal Reserve System, as you know. I shall be interested to see, if possible, the statistics showing bank earnings, expenses and profits on Canadian savings deposits when they are compiled by your Government. I took the liberty of showing your letter in strict confidence to the other members of the Board, together with Mr. Ilsley's public statement.

Needless to add, I hope you will be in Washington before long and that you will be available to take lunch with me, or at least come in to see me.

Sincerely yours,

The Honorable G. F. Towers,
Governor, Bank of Canada,
Ottawa.

Enclosures 2

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Canadian Information Service,
1205 - Fifteenth Street, N. W.,
Washington 5, D. C.

March 1st, 1946

Right Honorable J. L. Ilsley, Minister of Finance, announced today a reduction in the interest rate paid by the government on deposit certificates sold to the chartered banks, and also the results of an agreement reached with the banks limiting their holdings of Dominion Government securities other than very short term securities such as deposit certificates and treasury bills to a fixed proportion of their savings deposits.

The rate of interest on deposit certificates sold to chartered banks will be 5/8 of one per cent per annum instead of the present 3/4 of one per cent. The new rate will be effective on any further issues of deposit certificates and on outstanding issues as they mature during March and April.

Financing arrangements between the Dominion Government and the chartered banks have been on the basis of maintaining rates of remuneration to banks which would be sufficient to cover their costs but which would leave only a reasonable margin for profit. Up to date it has been possible to follow this policy by appropriate arrangements with respect to deposit certificates which have proved to be a very suitable type of security to use in meeting direct government borrowing needs from the chartered banks.

Because of the scale of war-time government financing the Canadian public - like people in most countries - has chosen in recent years to hold an increasing amount of its accumulated savings in the form of interest-bearing savings deposits at the chartered banks. At one time banks were able to invest such deposits largely in their commercial banking activities, chiefly in the form of loans. Times have changed, however, and the counterpart of Canadian savings deposits in banks' balance sheets of necessity has more and more become their holdings of Dominion Government bonds. This situation is not peculiar to Canada alone, but exists today in many other countries. The association between savings deposits and holdings of government bonds is more obvious of course in countries where there are special savings institutions than in Canada where chartered banks perform the functions of both commercial and savings banks.

To the extent that chartered banks' holdings of Dominion Government securities are associated with their Canadian savings deposits which nearly all bear interest at the rate of 1 1/2 per cent per annum, it is appropriate, in order to cover banks' costs, that such investments be in the form of Dominion Government bonds rather than deposit certificates. However, as banks' holdings of Dominion Government bonds are becoming more nearly the full counterpart of their Canadian savings deposits, certain arrangements appeared to be desirable for the future.

Following discussions on this subject between the Government, Bank of Canada and the chartered banks, the banks have agreed that their holdings of Cominion Government domestic bonds (including guaranteed issues) will not average more than 90 per cent of the amount of their Canadian savings deposits (i.e., their notice deposits other than balances of corporations).

The banks have also agreed that their earnings on such Dominion Government bonds held for investment account should not exceed their operating costs on Canadian savings deposits in the form of deposit interest and other expenses, by more than a moderate profit margin for this type of banking business.

The agreement regarding the amount of their holdings of Dominion Government bonds places the savings bank function of the chartered banks in approximately the same position as if it were being performed by separate savings institutions which would tend to have about 10 per cent of their deposits in the form of cash and other non-earning assets. Chartered banks, of course, may add to their holdings of Dominion Government bonds to the extent that they now hold an amount less than 90 per cent of their Canadian savings deposits and also in proportion to any increase in such deposits which may take place in the future. If chartered banks wish to invest in Dominion Government securities beyond the amount which has been recognized as appropriate in connection with their Canadian savings deposits, there will be available to them short term securities bearing interest at the rate of 5/8 of one per cent per annum, or treasury bills.

The new arrangements will not affect the ready marketability of Dominion Government bonds. Banks will be able to engage in their usual day to day dealings with buyers and sellers of these securities.

The effect of the agreement with respect to earnings on banks' holdings of Dominion Government bonds is that banks will not increase the average maturity of such investments beyond the point where their earnings from this source would leave more than a reasonable margin of profit over their costs in connection with operating Canadian savings deposits. Separate statistics of banks' earnings, expenses and net profit on Canadian savings deposit business will be made available to the public by the Minister of Finance in the form of a supplement to the statutory annual return of banks' earnings and expenses.

These agreements, with respect to chartered banks' holdings of Dominion Government bonds, provide for continuing the existing objectives of financing arrangements between government and chartered banks which have hitherto been evident in deposit certificate financing, in the changing situation which has been described. The fact that it has been possible for a voluntary agreement on this subject to be reached through discussions between government, Bank of Canada and chartered banks is a tribute to the cooperative spirit with which the chartered banks have approached the various problems involved.
