April 9, 1946

To: Chairman Eccles

Subject: Canadian Banks' Agreement

From: Woodlief Thomas

Attached is a memorandum discussing a recently announced agreement, entered into by the Canadian chartered banks with the Government and the Bank of Canada, designed to limit the expansion in bank earnings. Information given in this memorandum is based in part on the published statement and in part on confidential comments supplied to us by the Bank of Canada. It, therefore, should be kept within the System.

W. T.

Attachment

CONFIDENTIAL

April 8, 1946

CANADIAN BANKS' AGREEMENT

The Agreement. -- On March 1 the Canadian Minister of Finance announced a reduction in the rate of interest on deposit certificates sold to chartered banks from 3/4 per cent to 5/8 per cent. At the same time he announced a voluntary agreement by the chartered banks entered into with the Government and the Bank of Canada designed to limit the expansion of bank earnings. The banks 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.
>
> that their earnings on such Dominion Government bonds 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 business.

Chartered banks 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 the 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 per cent, or Treasury bills.

Banks will not increase the average maturity of their holdings beyond the point where their earnings would leave them more than a reasonable margin of profit. Statistics of bank earnings, expenses, and net profits on Canadian savings deposit business will be made public annually by the Minister of Finance.

Comments. -- Several questions might be raised with respect to the agreement:

1) How are Canadian savings deposits defined?

Canadian savings deposits are defined as notice deposits other than balances of corporations. Notice deposits bear interest and are also subject to a limited checking privilege. They, therefore, differ significantly from time deposits in the United States.

2) How restrictive is the 90 per cent limitation?

On the basis of confidential information furnished by the Bank of Canada, it appears that the 90 per cent limitation is designed to preserve the status quo with respect to Canadian chartered bank holdings of Dominion

Government domestic bonds. Several of the larger banks had portfolio positions close to the permissive limit as of the date of the agreement. Because of larger holdings of provincial-municipal securities, or a larger volume of commercial loans, other banks had portfolios substantially below the limit. It is anticipated that the latter banks will continue to follow the same investment policy as in the past and will not increase their holdings of Dominion Government bonds more than is consistent with the growth of their Canadian savings deposits.

3) Is the agreement closely geared to existing average returns of chartered banks obtained on their portfolios of Dominion Government domestic securities?

The agreement definitely appears to be adjusted to the existing level of Canadian bank earnings on long-term Government security holdings. At the time of its introduction the net earnings of most banks on such holdings were slightly less than the standard agreed upon as moderate. In the case of the exceptions, enough flexibility existed to make it possible to apply the agreement without major changes in the maturity distribution of portfolios.

4) What is the standard of a moderate profit margin on Canadian savings deposits that has been adopted?

Special information indicates that a net profit before income taxes of 3/10 of 1 per cent of the amount of Canadian savings deposits is considered to be a moderate profit of margin. In determining costs for interest and other expenses a formula is applied based on the experience of the "average" bank. This plan makes it possible for the more efficiently operated institution whose costs are lower than average to earn slightly more than 3/10 of 1 per cent. On the other hand, if a bank has higher average costs it may earn less than this figure. It is estimated that the net profit margin of 3/10 of 1 per cent would yield for the "average" bank a net return on capital of 3.6 per cent after allowance for the present minimum corporate income tax.

5) Is it anticipated that this new arrangement will tend to reduce the differential on interest rates as between public and private indebtedness?

The differential that prevails in interest rates between public and private indebtedness in Canada is influenced by so many factors that it is not possible to anticipate the effects that the agreement may have on them. Conceivably the banks that are invested up to the limit in Dominion Government domestic bonds may be interested in liquidating some of their holdings and investing in other securities and in commercial loans. If this happens it is possible that yields on long-term Dominion Government bonds may rise somewhat thus decreasing the differential that prevails currently.

Conclusion. -- In endeavoring to maintain the differential in interest rates between long-term and short-term securities, the Canadian banks have agreed to follow certain practices with respect to their holdings of long-term Dominion Government securities. It remains to be seen how effective this method will prove to be.

While the principle of restricting bank holdings of long-term securities might be applied in the United States to accomplish the same purpose, the method of application by informal agreement is not suitable here where there are 13,000 banks, as compared with 10 chartered in Canada. Application by legislation, on the other hand, would entail more precise and more rigid requirements and would lack much of the flexibility possible under the Canadian system.