

Research Department Federal Reserve Bank of San Francisco

September 10, 1976

Change in Canadian Banking

The Canadian Parliament next year will make its usual decennial review of the Bank Act—the nation's basic commercial-banking legislation—on the basis of a white paper just released by the Minister of Finance. The proposed revisions cover many subjects that have been discussed in the United States, primarily in the 1971 Hunt Commission report and in last year's FINE study (Financial Institutions and the Nation's Economy). Americans will note in particular the white paper's proposal for greater freedom for U.S. banks operating north of the border, especially in view of Congress' consideration of controls over foreign banks operating here. In addition, the white paper reveals a number of contrasts with American domestic practices, reflecting differences in Canadian financial institutions and policies.

Canadian policy should be interpreted in terms of the unique characteristics of the Canadian banking structure—most strikingly, the system of nationwide branching with a limited number of banks and a high concentration of resources. Commercial banks, which are chartered by Act of Parliament, number only eleven, and the five largest branch networks control roughly 90 percent of all commercial-bank assets. Canada's highly developed branch network, spread over great distances as it is, gives sparsely-settled regions just as much access as metropolitan centers to banking services. The Canadian government's policy aim is to stimulate financial competition—partly through in-

creased freedom of entry for both foreign and Canadian institutions—while building upon the resources and skills of the present chartered banks.

Payments mechanism

From a domestic viewpoint, the most important change would be the creation of a Canadian Payments Association, to replace the present clearing arrangements operated by the chartered banks. All institutions "accepting deposits transferable by order" would be required to join this association, as a means of centralizing the operations of the payments mechanism and giving equal access to all financial institutions. Members would have borrowing privileges at the Bank of Canada. The new association would oversee the development of electronics payments systems, which are expected to evolve gradually alongside the existing system of check payments.

In a parallel proposal, all members of the payments association would be expected to conform to Bank of Canada reserve requirements, ranging from 12 percent for demand deposits down to 2 percent for certain time accounts. The Canadian government thus has adopted the principle that all deposit-accepting institutions should come under the central bank's control, and for the same reasons—equity and effective monetary control—advanced in this country for the imposition of uniform reserve requirements on U.S. banks and thrift institutions.

(continued on page 2)

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The proposed increase in the powers of the Bank of Canada, it should be noted, represents a smaller change than has been envisioned here. All chartered banks are already subject to Bank of Canada regulations; the provinces do not license commercial banks, so that there is no Canadian equivalent to the U.S. state-chartered bank which is not a member of the Federal Reserve System. Moreover, the nonbank deposit-accepting institutions are somewhat less important in Canada than in the U.S. Nonetheless, Canada proposes to move farther than the U.S. study groups have suggested in the direction of uniform national controls over the financial and payments systems.

Foreign banks

Foreign financial institutions now operating in Canada face more barriers—but also have more privileges—than their Canadian competitors. The present Bank Act effectively prevents foreign banks from obtaining a charter and engaging in commercial banking inside Canada. At the same time, foreign banks are able to maintain important nonbank operations through subsidiaries and investments in Canadian companies. Some subsidiaries compete with Canadian banks in real-estate and consumer financing by borrowing funds in Canadian money markets, and with their debt guaranteed by their foreign parent banks, they are frequently able to gain cost advantages over similar Canadian bor-

rowers. Also, foreign banks are important in leasing and factoring, while the chartered banks cannot engage in such activities.

According to the Finance Ministry's white paper, some 60 foreign banks have equity investments in Canadian financial corporations. None of these foreign banks are covered by Canadian banking law. The white paper recommends reforms to equalize the competitive situation, but in the process, it would specifically allow foreign banks to operate commercial-banking subsidiaries in Canada. The white paper's view is clear: "Foreign banks are to be encouraged because of the additional competitive and innovative forces that they can bring to bear in the relatively highly concentrated Canadian banking system." As a secondary benefit, permitting freedom of entry would help Canadian banks to push their case for reciprocal treatment in other countries.

Put briefly, foreign banks would be allowed to operate banking subsidiaries under the Bank Act with the same general powers as their Canadian competitors, although they would not have the option of opening branches or agencies of the parent bank. Each subsidiary could use its parent's name and operate up to five branches. Liabilities would be restricted to 20 times authorized capital. Foreign-bank subsidiaries would be exempt from the restriction, now imposed on Canadian-controlled chartered banks, which limits ownership by individuals or associated sharehold-

ers to no more than 10 percent of total shares—a restriction designed to reduce indirect conflicts of interest. But the same effect would be achieved by limiting the activities of foreign-bank subsidiaries to those fields already permitted to chartered banks. A foreign bank may wish to keep its existing nonbank subsidiaries, but then it would not be able to establish a full banking business. However, in view of the proposed freedom of entry for new chartered banks, many foreign banks could simply transfer their nonbank subsidiaries' business to their new bank subsidiaries.

Nationalism and banking

Canadian national policy recently has emphasized reducing the foreign ownership of industry, so that the new banking legislation could be interpreted as a reversal of policy. However, the legislation can be better understood as a modification of policy designed to achieve other important economic aims—primarily increased efficiency. Foreign entry would stimulate competition in the highly concentrated Canadian banking system. The financial sector, unlike manufacturing, is now dominated by Canadian-owned corporations and banks. In that sector, therefore, there is room for more foreign investment, since there is no real threat of foreign domination.

Although the white paper would allow foreign entry into Canadian banking, it would limit the size of any subsidiary to \$500-million in assets, and would also limit the

overall foreign-bank share of Canadian commercial lending to 15 percent of the total. (In the United States, in contrast, foreign banks control only 6 percent of all bank assets, although they account for almost 15 percent of all commercial loans.) This 15-percent ceiling is "subject to review," but it indicates that the government will insure that banking remains basically a Canadian-owned industry. To reinforce that approach, a foreign bank could escape the \$500-million asset limitation only by selling shares to Canadians and by reducing its holdings to the 10-percent ceiling limit imposed on individual shareholders in Canadian chartered banks. In any event, given the Canadian banks' dominant position in their home market, foreign-bank subsidiaries would probably have a difficult time achieving a large market share, regardless of any established ceilings.

Altogether, the Canadian government's proposed legislative changes are designed to encourage entry into banking and thus to equalize competitive advantages, while improving monetary control. Consequently, Canada in some respects is farther advanced than the United States in the field of financial-reform legislation. Of course, Canada begins with a more uniform financial structure, and with its parliamentary form of government, it is better equipped to implement any changes decided upon by the executive branch of the government.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/25/76	Change from 8/18/76	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	88,651	- 410	+ 3,642	+ 4.28
Loans (gross, adjusted)—total	66,621	- 382	+ 2,484	+ 3.81
Security loans	1,390	- 230	+ 87	+ 6.68
Commercial and industrial	21,435	+ 6	- 1,160	- 5.13
Real estate	20,504	+ 35	+ 875	+ 4.46
Consumer instalment	11,328	+ 24	+ 1,193	+ 11.77
U.S. Treasury securities	9,633	- 13	+ 1,520	+ 18.74
Other securities	12,397	- 15	- 362	- 2.84
Deposits (less cash items)—total*	87,725	- 386	+ 2,512	+ 2.95
Demand deposits (adjusted)	24,655	- 264	- 315	- 1.30
U.S. Government deposits	338	- 124	+ 34	+ 11.18
Time deposits—total*	61,286	+ 44	+ 1,450	+ 2.42
States and political subdivisions	5,604	- 54	- 357	- 5.99
Savings deposits	26,821	+ 136	+ 6,017	+ 28.92
Other time deposits‡	26,560	+ 6	- 2,782	- 9.48
Large negotiable CD's	10,849	- 87	- 4,561	- 29.60
Weekly Averages of Daily Figures	Week ended 8/25/76	Week ended 8/18/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves	59	- 6		75
Borrowings	0	17		2
Net free(+)/Net borrowed (-)	+ 59	- 23		+ 73
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	- 383	+ 156		+ 1,495
Transactions of U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 186	+ 91		+ 279

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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