The Report of the Canadian Royal Commission on Banking and Finance: A Review

By FRANCIS H. SCHOTT*

A Canadian Royal Commission appointed by the Canadian Government in 1961 "to inquire into and report upon the structure and methods of operation of the Canadian financial system" and to make recommendations regarding possible changes has recently submitted its Report.[1] Under the chairmanship of Chief Justice Dana Porter of Ontario[2] and assisted by an able staff, the Commission spent two and one-half years in preparing the first comprehensive survey of Canada's financial system since the Macmillan Report of the early 1930's (which led to the establishment of the Bank of Canada in 1934). The Commission held sixty-nine days of public hearings in eleven centers across Canada, received and evaluated 110 briefs from interested parties—including a number of papers solicited from distinguished foreign central bankers and economists—and undertook extensive research of its own.[3]

The resulting document is worthy of the attention of students of central banking and of monetary theory and practice everywhere. Due to the Commission's pragmatic yet thorough and scholarly approach, the Report constitutes a valuable case history of the evolution of a modern financial system and as such makes a contribution that is likely to be lasting. In complying with its terms of reference, however, the Commission did not stop at description and evaluation. In a series of important recommendations, it proposes corrective measures for regulatory and institutional lags it believes it has found. And the philosophy underlying these recommendations, regardless of whether one agrees with all of them, is appealing. Monetary and banking regulation there must be, the authors say, but

> We have favored a more open and competitive banking system—carefully and equitably regulated under uniform legislation, but not bound by restrictions which impede the response of institutions to new situations (p. 564).

Because of the close economic and financial ties between Canada and the United States, the Report is of special interest in this country. The Commission's analysis and recommendations are in fact likely to exert a considerable, although probably only a gradual, influence on future Canadian-United States financial relations. This review, which must necessarily be highly selective, therefore places emphasis on matters of special interest to United States readers.

BANKING STRUCTURE

The possible need for structural reform in the regulation of Canada's financial institutions attracted the Commission's closest attention. The Commission was aware of the opportunity for reform afforded by the statutory decennial Parliamentary renewal of Canada's basic Federal Bank Act during 1964. The Commission was, furthermore, impressed by the rapid growth over the past decades in the types and numbers of institutions competing with the present eight chartered banks both as lenders of funds and as issuers of highly liquid short-term

---

* Manager, Research Department, Federal Reserve Bank of New York.

[1] *Report of the Royal Commission on Banking and Finance* (Ottawa, Canada: The Queen's Printer, 1964), 587 pages.

[2] The other members of the Commission were W. Thomas Brown of Vancouver, investment dealer; James D. Gibson of Toronto, commercial banker; Gordon L. Harrold of Calgary, farmer; Paul H. Leman of Montreal, corporation executive; John C. MacKeen of Halifax, public utility executive; and Dr. W. A. Mackintosh of Kingston, university executive.

[3] The foreign central bankers who submitted papers and testified at the request of the Commission included Governor Holtrop of the Netherlands Bank, Lord Cobbold, former governor of the Bank of England, and Allan Sproul, former president of the Federal Reserve Bank of New York. Non-Canadian economists assisting the Commission in a similar fashion included, among others, Erik Lundberg, Paul Samuelson, Woodlief Thomas, and Jacob Viner.

claims; and it noted that the commercial banks had been losing ground to their competitors in terms of their share in both assets and liabilities of the financial system.

The mixing of functions does indeed appear to have gone very far in Canada. As regards lending, for example, the chartered banks have expanded their personal loan business so much that they are now the largest participants in a market in which sales finance companies had pioneered; but the finance companies have meanwhile greatly expanded their medium-term business financing since the chartered banks have not been very active in term lending. Another example is that the chartered banks—excluded from the conventional mortgage field, which is handled largely by the mortgage loan and the trust companies—have nevertheless been able to acquire a substantial mortgage portfolio through the exemption granted in the case of mortgages insured under the National Housing Act (NHA), although this portfolio has not been expanding for several years.[4]

It is striking that, in the Commission's view, the customary distinction between money and near money is not so meaningful as it is sometimes considered to be, either in terms of the institutions or of the instruments usually associated with each of these two categories. Savings deposits in chartered banks are in practice subject to transfer by check. The same is true of deposits in the two Quebec savings banks and of deposits in credit unions which, together with their equivalent in the French-speaking sections of Canada, constitute an especially fast-growing part of the financial structure. Moreover, both the mortgage loan and the trust companies accept demand deposits and savings deposits subject to transfer by check, besides issuing their own paper over a broad maturity range.

Against this background, the Commission questioned, first, whether the special restrictions placed upon institutions exercising a banking function—presently defined only by actual chartering under the Federal Bank Act—were still justified; and, second, whether other groups of institutions doing a closely similar business should continue to be permitted to operate partially under separate Federal, but largely only under Provincial, laws and regulations. In regard to the first of these questions, the Commission recommended that the chartered banks be relieved of the two most important of the special restrictions, namely the prohibition on taking non-NHA mortgages as security and the 6 per cent ceiling on their interest charges on loans in Canada.[5]

In answering the second and more basic question, the Commission took the view that nothing less than a functional definition of banking and equal regulatory treatment of all institutions falling within that definition would satisfy its standards of equity, competitiveness, and efficiency. The distinction between banks and nonbanks, the Commission says, should be drawn on the liabilities side; specifically, banking is the creation of "claims which serve as a means of payment or close substitutes for them" (p. 378). Therefore, the acceptance of

> term deposits, whatever their formal name, and other claims on institutions maturing, or redeemable at a fixed price, within 100 days of the time of the original issue or of the time at which notice of withdrawal is given by the customer (p. 378)

should, in the Commission's view, make the accepting institution one that is engaged in banking; and any such institution would have the choice of operating in accordance with Federal banking laws and thus becoming subject to chartered-bank regulations as revised or, alternatively, of getting out of the banking business (as newly defined).[6] The Commission does not deny that there is an element of arbitrariness in the proposed specific maturity range of liabilities the acceptance and issue of which would make an institution a bank. But it emphasizes that any shorter maturity would be unrealistic in view of the very close similarity of the various short-term instruments, while a longer maturity is not needed to achieve an "equitable, sound and uniform pattern of banking regulation" (p. 378).

The Commission does not hesitate to pursue this sweeping recommendation in terms of the required rearrangements of Canada's financial structure. Thus, institutions choosing to remain nonbanks would benefit from a removal of all restrictions on their portfolios related to their previous near-bank status; and those choosing to

[4] The Central Mortgage and Housing Administration, which administers the NHA, is similar to the United States Federal Housing Administration.

[5] As noted, the banks have been permitted to invest in mortgages guaranteed under the NHA, and, in the case of personal loans, service fees have added to the effective interest charge to the customer. Nevertheless, the two restrictions have had concrete effects, especially in limiting indirectly the chartered banks' ability to compete for deposits on a rate basis.

[6] A number of specific exceptions would, however, be made. One would be for institutions such as sales finance corporations which sell short-term claims upon themselves through independent investment dealers.

become full-fledged banks would acquire all corresponding rights. For example, the present mortgage loan and trust companies could, if they became banks, make personal and short-term business loans.

On the other hand, any institution taking out a bank charter would also become subject to all obligations attached to being a bank; and many of the present nonbanks —in fact, entire groups of institutions—would not have much choice but to become banks, given the present nature of their business. Among their new obligations, those bearing on cash reserve requirements would be of particular importance. At present, only the chartered banks and the Quebec savings banks are subject to specified cash reserve requirements, which for the chartered banks amount to 8 per cent against all deposits. Other institutions hold cash reserves as they deem necessary for the conduct of their business, with actual ratios tending to be somewhat, although not drastically, lower than those of the chartered banks.

The Commission recommends that all banks (as newly defined) be required to maintain cash reserves of 8 per cent on deposits repayable on demand or on notice of up to seven days, and of 4 per cent on all other deposits repayable on notice of up to one year, with strict enforcement of the distinction between the two types of deposits. This would mean that the average effective reserve requirements for chartered banks would drop slightly while many of the present nonbanks would be required to hold a higher level of cash reserves than is their current practice, although the Commission would permit a few concessions. The chartered banks, however, would lose the deposits of present nonbank financial institutions holding their reserves with them should these institutions choose to take out bank charters. The Commission can see no reason why uniform regulation, for which it strives, should not also mean that all banks would hold their required reserves with the central bank, and it therefore submits that recommendation.[7]

[7] The Commission also suggests dropping the liquid-asset ratio (cash plus highly liquid assets must equal 15 per cent of deposit liabilities) which the chartered banks have maintained since 1955 under an agreement with the Bank of Canada; the Commission would be willing to grant the Bank of Canada stand-by powers to impose (and vary) such a ratio to achieve monetary policy objectives. From a supervisory point of view, the Commission does not consider such a liquidity requirement necessary. The chartered banks have generally maintained ratios substantially higher than 15 per cent in order to meet their liquidity needs as judged by themselves; and the actual needs of different institutions will vary with the nature of their other assets and liabilities. The Commission expresses the hope, however, that the institutions concerned will "support wise supervision in a matter which bears so directly on their own best interests" (p. 395).

INTERNATIONAL FINANCIAL RELATIONS

The Commission considers both broad questions of international financial policy and those relating to banking relationships between Canada and the United States. Given the fact that Canada returned to a fixed exchange parity only in 1962 (during the Commission's study) after a twelve-year experience with a fluctuating exchange rate, the Commission naturally gives special attention to the type of exchange rate system and the level of the exchange rate appropriate for Canada. The Commission evaluates the main claim made for a fluctuating rate—that it confers a greater degree of freedom upon domestic monetary and fiscal policy than does a fixed-rate system —and arrives at the judgment that in practice the claim has limited merit. It therefore concludes firmly that

> in our view the existing parity of 92½¢ U.S. is a good exchange rate for Canada and one which we hope can be maintained for a long time to come. . . . Our financial policies, particularly our monetary and debt policies, should never be carried out without regard to their international consequences and a fixed exchange rate will help to ensure that this is the case (p. 503).

The Commission also takes note of the current official international studies of the world's payments system, which have focused on the question of international liquidity, and comments

> that it is in the interests of this country [Canada] that, with appropriate safeguards against irresponsible borrowing, international reserves should be gradually increased so that time will be available to national financial authorities to make adjustments to their international positions while at the same time retaining some freedom of action to pursue domestic objectives of policy (p. 502).

In this connection, the Commission endorses the network of inter-central bank currency arrangements (swaps) that have been developed in the last few years. Such arrangements are

> . . . now temporary expedients, but if the "temporary" period is long enough, and if the facilities are put on a regular basis and the amounts involved are large enough, a considerable step has been taken to provide time for more fundamental adjustments to take place (p. 502).

As regards international banking relationships, the Commission observes that agencies of Canadian banks now do a very extensive business in New York and that branches and agencies of these banks are very active in many other countries. Careful consideration was therefore given to the possible granting of certain reciprocal rights in Canada, and the Commission recommends that Canadian law explicitly provide for the establishment of foreign bank agencies, which would be empowered to do most types of banking business except for receiving deposits. (There are now some representative offices, but no foreign bank agencies, in Canada.) The Commission would insist, however, upon specific Canadian Treasury Board approval of all acquisitions of shares of Canadian banks by foreign banking interests since it believes that "a high degree of Canadian ownership of financial institutions is in itself healthy and desirable" (p. 374).[8]

In examining the present foreign activities of Canadian banks, the Commission notes that the foreign-currency business of these banks, in particular, has grown enormously. Between 1954 and 1962, the chartered banks' foreign assets increased (in Canadian dollar equivalents) by $2.8 billion, or almost 250 per cent, as against a roughly 60 per cent growth of domestic assets; and foreign-currency deposits, at roughly $4 billion (end-of-1962 figure), exceeded one fifth of total deposits. The Commission holds, however, that this growth generally has not influenced internal Canadian credit conditions heavily and therefore has not vitiated the effectiveness of domestic monetary policy. The banks generally maintain balanced exchange positions on an over-all basis spot and forward combined (i.e., match their foreign-currency liabilities with foreign-currency assets); however, the Commission acknowledges that the banks' spot balances in foreign exchange have at times been reduced to generate additional Canadian dollar funds and that doing so has helped the banks to get through periods of especially tight domestic liquidity conditions.

The Commission thus regards additional controls in this area as unnecessary, but it does issue two explicit warnings. One of these relates to the banks' willingness to accept short-term Canadian-dollar deposits and denominate them at their foreign-currency equivalent through a corresponding foreign exchange transaction. Should the banks ever abandon on a significant scale their present practice of covering these deposits by corresponding short-term foreign-currency assets, it might be necessary to remove the present exemption of such deposits from cash reserve requirements. The second warning relates to the need for liquidity of the banks' foreign-currency assets in general. The Commission notes that the chartered banks are a factor of considerable significance in the Euro-dollar market and (through their agencies) in the New York call loan market.[9] A high degree of liquidity is currently being maintained: only 34 per cent of foreign-currency assets was in other than call loan form at the end of 1962. Should these liquidity standards be relaxed by the banks, however, official liquidity ratios on the banks' exchange position might have to be imposed.

THE EFFECTIVENESS OF MONETARY POLICY

The Commission submits both the instruments and the effectiveness of monetary policy to a searching analysis. Its contribution in the second of these areas is especially significant, since the Commission made detailed studies of its own in seeking to ascertain the degree and timing of the economy's response to changes in monetary policy. Thus, the Commission's staff interviewed eighty firms, which account for over one half of total corporate capital expenditures, and sampled the rest of Canada's corporations to find out how these users of funds were affected by variations in credit conditions. Sample surveys were also made of local governments and of households; and the Commission supplemented this technique with econometric analysis designed to isolate the effect of monetary policy on a sector-by-sector basis. As a result of these studies, the Commission endorses the effectiveness of monetary policy, through its influence on general credit conditions, as an instrument for moderating fluctuations in aggregate economic activity—but this endorsement is subject to some qualifications.

These qualifications, it might be noted, do not involve two points that have been brought up in some recent questioning of the effectiveness of monetary policy in the United States. As regards one of these points, the Commission does not believe that monetary policy has been vitiated by the rise of near banks and of financial intermediaries in general, rapid though that rise has been. Its recommendations in this area, as has been pointed out,

[8] There already exists a requirement that any new bank, whether established by foreigners or by Canadians, obtain a charter from Parliament. The Commission would leave undisturbed foreign control of the smallest and newest chartered bank, which was founded by foreign interests in 1953.

[9] The Canadian bank agencies, as pointed out by the Commission, have occasionally accounted for about one half of all call loans to New York securities dealers.

are based primarily on grounds of equity. The Commission recognizes that financial intermediaries can affect the velocity of money—and, at the same time, the rate of credit expansion of the financial system as a whole—even without central bank-induced variations in the system's cash base. But the Commission holds that the intermediaries' operations tend to bear a fairly stable relationship to those of the banks and hence can be compensated for by the central bank. With respect to another point recently raised in the United States, the Commission gives no support to the view that monetary policy might be impaired by any inability—whether or not it exists—to control directly such factors as the money supply which, unlike bank reserves, are affected only "at one remove" by central bank operations. On the contrary, the Commission emphasizes that Bank of Canada action on bank reserves and other measures at the central bank's disposal should seek to, and in fact do, influence credit cost, terms, and availability over a wide spectrum.

The Commission's doubts thus are of a different nature, relating primarily to potential limitations upon the effects on aggregate economic activity of monetary policy changes, if applied in moderate doses; and to the possibility that such effects as do occur may show up only after a significant time lag, which implies that the impact of policy might be inappropriate in terms of stabilization requirements at the time it actually takes place. The Commission goes on, however, to emphasize the important role it does in fact see for monetary policy. Thus, some degree of responsiveness of expenditures to changes in credit conditions was found in numerous sectors of the economy, most clearly during periods of monetary restraint; and the aggregate response was sufficient to convince the Commission that the effects of monetary policy "are significant enough to be worth striving to achieve at the right time" (p. 444). Furthermore, in the case of very substantial changes in credit conditions, the response in terms of expenditure decisions was considerably more discernible and rapid than in the more general case of gradual changes; and, quite apart from its potential for influencing the domestic economy, monetary policy had proved of indubitable effectiveness over the past years in maintaining or restoring international payments equilibrium.

On balance, the Commission's doubts were sufficient to lead it to emphasize very strongly the need for coordinated fiscal and monetary policies in achieving over-all stabilization objectives. In this connection, the Commission endorses Governor Rasminsky's suggestion for a "directive" procedure in resolving Government-central bank disputes—i.e., a method whereby in a deadlock the Government would give the Bank explicit, written, and binding policy instructions for temporary periods. This recommendation is accompanied by expressions of hope that the procedure will never be utilized.

REGULATORY EQUITY: A COMPARISON OF THE CANADIAN AND TWO UNITED STATES REPORTS

The issue of regulatory equity in the treatment of competing groups of financial institutions, which is so prominent in the Canadian Royal Commission Report, has also received considerable attention in two recent United States reports—those of the privately sponsored Commission on Money and Credit (CMC) and of the official President's Committee on Financial Institutions (the Heller Committee).[10] Both of these reports recognized, as does the Canadian Report, that financial evolution can lead to a considerable overlapping of functions among groups of institutions that might have started with distinct objectives and hence with distinct legal rights and obligations; and both of the United States reports also made corrective recommendations. Hence, parallels with the Canadian Royal Commission Report can be drawn, although significant differences do of course exist among the three reports.

To recall only some of the reforms suggested primarily for equity reasons in the United States reports: both groups recommended measures (although not the same ones in the two cases) to put banks that are not members of the Federal Reserve System on a more nearly equal footing with member banks;[11] and both groups sought to place commercial banks in a position to compete on even terms with other types of institutions for time and savings deposits. The Heller Committee recommended introduction of a cash reserve requirement for shares at savings and loan associations and for deposits at mutual savings banks identical to the commercial bank time deposit requirement; and the CMC would equalize relative positions by repealing reserve requirements against time and savings instruments no matter where held. The CMC also recom-

[10] See "Money and Credit—Their Influence on Jobs, Prices and Growth", *The Report of the Commission on Money and Credit* (Englewood Cliffs, New Jersey: Prentice Hall, 1961); and *Report of the Committee on Financial Institutions to the President of the United States* (Washington, D.C.: United States Government Printing Office, 1963).

[11] The CMC would require all banks using Federal Deposit Insurance Corporation facilities to become Federal Reserve System members; the Heller Committee suggests that all commercial banks be subject to System cash reserve requirements and have access to the Federal Reserve discount window, while leaving System membership optional for state-chartered banks.

mended that commercial banks (in the investment of their time and savings deposits), savings banks, and savings and loan associations should all enjoy the least burdensome restriction which is commonly available to any of them. Furthermore, both groups recommended equalization of time and savings deposit interest-rate regulations for all institutions and the placing of such controls on a stand-by basis.

Important as these recommendations are in the United States context, however, they clearly represent even in combination a considerably more gradual approach to reform than that adopted by the Canadian Royal Commission. This does not necessarily mean, however, that the equity criterion was given less attention in the United States reports. The difference in the respective sets of recommendations can be traced at least partly to differences in underlying circumstances. In particular, important groups of nonbanks have more closely stuck to their original specialized purposes in the United States than similar groups have done in Canada. All three reports are agreed, however, in urging public and legislative consideration of the problems arising from the structure of financial institutions with a view to adapting the regulatory machinery to current economic and financial conditions and to facilitating efficient and rapid response to further evolution.