

THE EFFECTS OF THE CANADIAN BANK ACTS OF 1967 AND 1980 ON
COMPETITION IN THE FINANCIAL SECTOR: A WELFARE LOSS
APPROACH

by

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ABSTRACT

The following study evaluated the effectiveness of Canadian legislation, embodied in the revisions to the Bank Act, in curbing the market power wielded by the five largest Canadian Banks. If the legislation was as effective as it was proclaimed to be, then one would expect the magnitude of the "welfare loss" to diminish with each revision.

An analysis of the Canadian banking sector using the standard Structure-Conduct-Performance model suggests that Canadian banking markets are characterized by excessive concentration and considerable market power. However, as the expressed intent of Canadian bank legislation (the 1967 and 1980 Bank Act revisions) was to enhance "effective" competition in Canadian financial markets, it is possible to quantify the effectiveness of such legislation by using welfare loss techniques.

In order to accurately determine the monopoly profits (and hence, subsequently, the welfare loss) associated with Canadian chartered banks, bank profits were compared to profits earned by Canadian trust and loan corporations. This comparison entailed the application of a standardized accounting system to eliminate accounting differences which could alter or distort the actual profitability of the financial institution(s).

The application of this standardized methodology allowed for a cross sectoral comparison of financial institution profitability. Differences between the profit rates of the five largest chartered banks and trust and loan corporations reveal considerable disparity in profitability, particularly after the revisions of the Bank Act in 1967 and 1980. Prior to 1967, average bank profitability was slightly lower than the profitability of trust and loan companies. However, with the advent of the 1967 Bank Act, Canadian chartered bank profits exceeded those of trust and loan companies by a considerable margin. Likewise, welfare loss estimates indicate a substantial increase following the 1967 Bank Act revision. While the welfare loss declined marginally after the passage of the 1980 Bank Act revision, it is unclear whether the decline represents an increase in


domestic bank competition or rather, a deterioration in the profitability associated with the overseas operations of the major chartered banks.


Although the Bank Act revisions were to be a "blueprint for competition", detailed analysis of the legislation indicates that there was no major amendment that would have substantially altered the underlying structure of the Canadian banking system and so increased competition in the banking sector. While there may be several reasons that could explain this "bias" among policy makers, the major reason appears to be the power exerted by various "pressure groups". In particular this applies to the Bank of Canada, which had no interest in promoting freer entry, given the Bank's preference for "covert" policy tools such as moral suasion; and the Chartered Banks, which did not want to compromise their joint monopoly position.

Since the passage of the 1980 Bank Act, there has been considerable debate pertaining to the potential for competition in the Canadian banking sector. Although federal proposals contained in the Green Paper would have significantly increased competition through the establishment of Schedule C banks, the subsequent collapse of two Canadian chartered banks and the rash of failures among Canadian trust & loan companies has resulted in the government withdrawing such legislation in preferencing instead to maintain the "stability" of the financial sector. Given the government's past record in introducing "effective and equitable competition", it is unlikely that the projected 1990 revisions to the Bank Act will contain legislation that will substantially alter the oligopolistic structure of the Canadian chartered banking system.

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CHAPTER 1: INTRODUCTION

The object of this thesis is to assess the impact of the 1967 and 1980 Bank Act revisions on competition in the Canadian financial sector using welfare loss techniques. The rationale for the thesis and the welfare loss methodology is two-fold.

First, as the major policy objective of both revisions was to increase competition, this thesis measures the extent to which the Bank Act changes actually enhanced competition in the Canadian financial sector. The 1967 Bank Act, introduced by the Minister of Finance, Mitchell Sharp, was proclaimed as a "Blueprint for competition" that would result in a "more competitive and flexible financial system".¹ Similar objectives were expressed with the passage of the 1980 Bank Act in which the government stated that:

Overall, the main purpose of the bill is to strengthen and develop the Canadian financial system through the promotion of effective and equitable competition.²

There is some doubt, however, as to whether the revisions to the Bank Act were effective in promoting such competition. In the mid-1970s, it was concluded in several studies, including those of Dean & Schwindt³ and the Economic Council of Canada⁴, that competition in the

financial sector did not improve dramatically after the 1967 Bank Act. For example, in a 1976 study of the Canadian financial system, the Economic Council of Canada concluded that:

... chartered banks have sufficient market power not only to maintain high profit rates before taxes but also to have higher profit rates after taxes than most other industries.⁵

Further concern as to the lack of competition among the major chartered banks was expressed after the passage of the 1980 Bank Act. It was recognized in recent Federal studies⁶ that current banking legislation included "regulatory restrictions that no longer serve public policy goals and that, in fact, risk denying the full benefits of competition, efficiency and innovation to Canadian users of financial services".⁷

The second rationale for this thesis is to quantify the effectiveness of the Bank Acts in promoting competition using the welfare loss technique. While the usual method of measuring competition in any particular industry is through the application of the standard Structure-Conduct-Performance model⁸, given the introduction of a distinct change - as there would be with the Bank Act revisions - the welfare loss technique can be employed. Utilization of this welfare loss

methodology is not unique, given the previous studies of the U.K. clearing banks by B. Griffiths⁹ in the mid-1970s and the analysis of the welfare loss associated with U.S. banking completed by S. Rhoades¹⁰ in the early 1980s. Consistent with these previous studies, it is hypothesized that, if the Bank Act revisions had been successful in promoting competition, then one would expect a decline in the welfare loss associated with Canadian banking after the introduction of the 1967 and 1980 revisions. The object of this thesis, therefore, is to estimate changes in the magnitude of the welfare loss associated with Canadian banking during the period from 1965 to 1986.

Given the rationale for this thesis, the study is developed in the following four chapters. Chapter 2 provides an overview of the structure and performance of the Canadian banking sector and the pertinent legislation that applies to the industry - namely, the Canadian Bank Act. In analyzing the structure and performance of the Canadian banks, it appears that the banks continue to exercise considerable market power, despite the revisions of the Bank Act in 1967 and 1980 which were supposedly designed to increase competition in the financial sector.

The welfare loss model is outlined in Chapter 3. This Chapter focuses on the development of the welfare loss model in the financial sector, and its application to previous banking studies for the United Kingdom and the United States. The subsequent development of the model follows that of other similar studies, as well as incorporating factors that are "unique" (such as the reporting of nominal rather than effective profits) to the Canadian banking sector.

The empirical results and conclusions are presented in Chapters 4 and 5 respectively. In Chapter 4, the extent of the social loss from monopoly is calculated and the results reveal that the banks have enjoyed considerable market power as indicated by the persistent above-average profitability and increases in the welfare loss. The increase in the welfare loss following each revision of the Bank Act suggests that Canadian banking legislation has done little to promote competition in this industry during the period from 1967 to 1986. This is consistent with the findings in Chapter 2.

In Chapter 5, the possible reasons why the welfare loss increased after each Bank Act are considered. These reasons include the role of "moral suasion" in government policy and the implications for competition in the

financial sector, the effect of pressure groups (the Canadian Bankers Association for example); and the federal government's focus on stability rather than competition in the banking sector. In addition, this section also examines the direction of federal financial legislation in the 1980s. It appears that from this review of recent federal proposals that the Federal government continues to emphasize the need for "stability" in the Canadian financial system, with little reference for the need to introduce "effective and equitable competition" within this sector.

FOOTNOTESChapter 1: Introduction

1 Grant Reuber, "An Evaluation of the 1967 Bank Act" Queen's University Conference on Monetary Issues (Kingston: Queens University, 1975), p.1.

2 John Evans, Parliamentary Secretary to Minister of Finance, Commons Debates, Vol. 124, No. 14. (Ottawa: Queen's Printer, 1980), p.762.

3 James Dean and Richard Schwindt, "Bank Act Revision in Canada: Past and Potential Effects on Market Structure and Competition", Banca Nazionale del Lavoro - Quarterly Review, No. 116, June 1976, p. 30.

4 Economic Council of Canada, Efficiency and Regulation: A Study of Deposit Institutions (Ottawa: Supply and Services, 1976), pp. 40-43.

5 Ibid., p.41.

6 Government of Canada, New Directions for the Financial Sector, (Ottawa, December 1986), pp.6-8.

7 Ibid., p.7.

8 For a general introduction see, for example, D.F. Greer, Industrial Organization and Public Policy (New York: MacMillan, 2nd edition, 1984), Chapter 1; for a number of specific industry applications see W. Adams, The Structure of American Industry, (New York, MacMillan, 7th edition, 1986); for applications to Canadian banking see Dean and Schwindt, op. cit.

9 B. Griffiths, "The Welfare Cost of the U.K. Clearing Banks' Cartel", Journal of Money, Credit and Banking, (May 1972), p. 240.

10 S. Rhoades, "Welfare Loss, Redistributive Effect and Restriction of Output due to Monopoly in Banking", Journal of Monetary Economics, Vol. 9, (1982), p. 380.

CHAPTER 2: AN OVERVIEW OF THE STRUCTURE, CONDUCT AND PERFORMANCE OF THE CANADIAN BANKING INDUSTRY

Conventionally, an examination of competition within an industry involves the application of a Structure - Conduct - Performance model in which factors such as concentration, barriers to entry and profitability are examined. Through the use of such a model, it will be demonstrated that the Canadian chartered banks have exercised, and continue to exercise, considerable market power in Canadian financial markets. Furthermore, the analysis of the barriers to entry in Canadian banking suggests that the concentration in the financial sector has not been the result of competitive market forces but, rather, reflects the considerable barriers imposed by Canadian Bank legislation.

2.1 Structure

An indication that an industry enjoys excessive market power is the relative concentration within that industry. Industries with high concentration are more likely to charge higher prices and earn above average profits than are industries which have a lower concentration.¹ An analysis of the barriers to entry provides an indication as to why an industry remains concentrated. A review, however, of most of the possible

barriers to entry in Canadian banking such as economies of scale, managerial expertise and product differentiation does not support bank concentration as a natural outgrowth of competitive market forces. In analyzing the 1967 and 1980 Bank Acts, it appears that the legislation has been the major factor in preventing the free entry of potential competitors into the Canadian banking sector.

2.1.1 Concentration

As shown in Table 2-1, the Canadian financial sector is highly concentrated, despite the introduction of two major revisions to the Bank Act (1967,1980) designed to promote entry into, and generate competition within, the Canadian banking system. For example, the share of total financial assets accounted for by the five largest Canadian banks (Royal, Bank of Commerce, Bank of Montreal, Bank of Nova Scotia and the Toronto-Dominion Bank) increased substantially during the period from 1967 to 1977 and has remained fairly constant since 1977. In 1987, the five largest chartered banks controlled in excess of 83 percent of total bank assets (the only institutions allowed to make commercial loans) and held 59.5 percent of total financial assets.

Furthermore, chartered banks continue to hold a

Table 2-1: Assets Held by Five Largest Canadian Banks, All Other Banks, and All Other Financial Institutions - 1967 - 1987

<u>Institution</u>	(\$ Billions)		
	<u>1967</u>	<u>1977</u>	<u>1987</u>
5 largest banks ¹	21.4	131.2	400.7
% of total assets	50.7%	59.7%	59.5%
% of total bank assets	93.5%	85.5%	83.5%
All other banks ²	1.5	22.3	79.4
% of total assets	3.6%	10.2%	11.8%
Total Bank Assets	22.9	153.5	480.1
% of total assets	54.3%	69.9%	71.2%
Other Financial Institutions			
Trust & Mortgage Loan Co's	6.7	27.3	87.4
Credit Unions/Caisse Pop.	3.1	19.6	54.1
Sales finance/consumer loan	4.4	11.9	18.4
Quebec Savings banks	<u>0.5</u>	<u>1.3</u>	<u>n.a.</u>
Total	14.7	60.1	159.9
% of total assets	34.8%	27.4%	23.7%
Life Insurance Companies	2.3	2.5	4.8
Mutual Funds	2.0	3.0	27.7
Other	<u>0.1</u>	<u>0.5</u>	<u>1.4</u>
Total	4.6	6.0	33.9
% of total assets	10.9%	2.7%	5.0%
Total Assets	42.2	219.6	673.9

¹ Includes Royal Bank, Bank of Commerce, Bank of Montreal, Scotiabank and Toronto Dominion Bank.
Source: Financial Post 500, various issues.

² Includes other domestic and foreign banks.
Source: Bank of Canada Review, Table C-9, various issues.

Source: Bank of Canada Review, Tables 39, 41, 45. Various issues.

Table 2-2: Consumer Credit: Outstanding Balances of Selected Holders - 1967 - 1987

<u>Institution</u>	1967		1973		1987	
	<u>(\$B)</u>	<u>%</u>	<u>(\$B)</u>	<u>%</u>	<u>(\$B)</u>	<u>%</u>
5 largest banks ¹	2.8	32.1	n.a.	n.a.	45.1	61.7
All other banks ²	0.2	2.7	n.a.	n.a.	2.8	3.8
Total Bank sector	3.0	34.8	9.8	57.6	47.9	65.5
 Non-Bank Sector						
Trust & Mort Co's	-	0.0	0.1	0.6	6.0	8.2
Credit Unions	1.1	12.7	2.4	14.1	9.2	12.6
Sales/consumer loan	2.4	27.9	2.9	17.1	5.1	7.0
Dept stores	1.6	19.0	0.9	5.3	2.2	3.0
Life Ins. co's	<u>0.5</u>	<u>5.6</u>	<u>0.9</u>	<u>5.3</u>	<u>2.7</u>	<u>3.7</u>
Total Non-Bank Co's	5.6	65.2	7.2	42.4	25.2	34.5
 Total	 8.6	 100.0	 17.0	 100.0	 73.1	 100.0

¹ Includes Royal Bank, Bank of Commerce, Bank of Montreal, Scotiabank and Toronto Dominion Bank.
Source: Bank Annual Reports, various issues.

² Includes other domestic and foreign banks.
Source: Bank of Canada Review, various issues.

³ Data for 1967 from J. Dean and R. Schwindt, "Bank Act Revision in Canada: Past and Potential Effects on Market Structure and Competition", Banca Nazionale del Lavoro - Quarterly Review, No. 116, June 1976, p. 43.

Source: Bank of Canada Review, Table E-2, Various issues.

substantial portion of total consumer debt. As highlighted in Table 2-2, the share of consumer debt held by the five largest chartered banks has increased from approximately 32.1 percent in 1967 to 61.7 percent in 1987. This share has declined marginally since 1982, when the five largest banks held 62.7 percent of total consumer debt.

2.2.2 Barriers to Entry

If Canadian banks were operating in a truly competitive environment, persistent above average profits would encourage new firms to enter the industry. We know that above average profits have existed for some time in the Canadian banking sector (see section 2.5, pages 24-28). Therefore, given that few banks entered the industry from 1967 to 1981 (during the period from 1967 to 1972, only one new bank was started in Canada as opposed to the 14 new trust/loan firms in 1972), it is likely that "barriers to entry" exist in this sector. These barriers to entry include: economies of scale, the requirement of specialized management or technological resources, and non-economic legislative barriers. An analysis of these barriers suggests that the major constraint to entry in Canadian banking has been restrictive government legislation. These barriers, as they relate to the Canadian banking system, are as follows:

2.2.2.1 Economies of Scale

A barrier to entry in Canadian banking might include economies of scale. If there are significant cost savings with large banks then it would be difficult for new entrants, operating on a smaller scale, to effectively compete in the industry. A number of studies, however, indicate that no substantial economies of scale exist in either the Canadian or U.S. banking industries.²

Overall, there is little evidence supporting the existence of scale economies in Canadian banking. Jones and Laudadio concluded that "the smallest bank (which is one tenth the size of the largest) is at no cost disadvantage vis-a-vis the large banks"³. Mintz, who compared asset size and profitability for the period from 1968 to 1973, disclosed that "upon examining the individual firms, the most outstanding performers in the banking industry were banks of medium size". However, he added that "the empirical evidence was not sufficient to allow any conclusions to be drawn regarding the existence of economies of scale to entry into banking".⁴ Neave and Purvis indicated that "operating expenses decrease for banks until they attain a size of about \$1 to \$3 billion in total assets, after which operating expenses remain roughly constant on a per unit basis."⁵ Similarly, studies by D. Orr concluded that "a

bank with as little as 0.6 million in capital may eventually be able to attract sufficient loans and deposits to attain MES (minimally effective size). However, a bank with capital of 5.1 million can grow to MES and considerably beyond."⁶

In reviewing previous studies, it appears that no significant economies of scale exist for banks with assets in excess of \$3 billion. Hence, the concentration and persistent profitability of Canadian chartered banks cannot be attributed to economies of scale. In fact, assuming that a bank required \$3 billion in assets to achieve competitive scale economies, there would have existed the potential for more than 40 banks to operate in Canada in 1976, rather than the 11 chartered banks (of which five controlled 90 percent of the total assets) which were in operation during this period.

2.2.2.2 Specialized Management/Technological Resources

Another potential barrier to entry in the banking industry is the requirement for specialized management and the technology necessary for financial intermediation.⁷ Large institutions might attract and retain effective managers and pay them less because of their unwillingness to administer smaller banks where

promotion and/or responsibility could be limited. In addition, if the managers attracted to large banks are of better quality than managers in other industrial sectors, then it would be expected that larger banks would have a higher rate of return than that of other industrial sectors. However, Mintz points out that between 1968 and 1973, the larger institutions failed to show significantly higher profit rates than the smaller institutions.⁸ Furthermore, since all U.S. banks and manufacturing industries had approximately the same after-tax rate of return, it does not appear that American banks received a premium from "managerial specialization" in comparison to U.S. manufacturing.

In summary, economic barriers to entry such as economies of scale or managerial expertise do not appear to have significantly contributed to the concentration in Canadian banking. However, there is considerable evidence to suggest the presence of "regulatory" barriers which have prevented the entry of potential competitors (both domestic and foreign owned) into the Canadian banking sector.

2.2.2.3 Legislative Barriers

Canadian bank legislation has long focused on the "stability" of the financial system. The original Bank

Act of 1871 was tabled in response to numerous bank failures, and was designed to bolster the financial sector (through provisions relating to paid-up capital requirements, ownership and incorporation) rather than to enhance competitiveness within the Canadian banking industry. This focus on stability resulted in several regulatory barriers that imposed considerable economic and non-economic constraints on potential entrants.

A review of both the 1967 and 1980 Bank Acts suggests that the regulatory barriers to entry were considerable. Although the 1967 Bank Act amendments were designed to promote greater competition within the banking industry, the existing legislation affecting the entry of new domestic banks, near banks, and foreign banks remained basically unchanged. Competition from near banks, primarily the trust and loan corporations, was limited as they were excluded from commercial lending.

In other important areas, such as ownership and capital requirements, the 1967 Bank Act amendments actually increased the barriers to entry. Although the capital requirements to form a bank remained unchanged - \$1,000,000 of which \$550,000 had to be paid in, at least five directors, and the approval on necessary start-up expenses⁹ - the real cost of entry was the time and

effort required to obtain approval from parliament. This effort was not insignificant. For example, it took four years before the Bank of British Columbia obtained a charter; and, the Unity Bank waited two years. In a five year period (1967-1972) only three new bank charters were issued. Of these, one was never used, and a merger between two banks resulted in a net gain of only one. Compared to this parliamentary process, the trust and loan corporations, which were incorporated by letters patent, witnessed a 28 percent increase (from 42 to 56 firms) during the one year period between 1972 and 1973.¹⁰

Another regulatory barrier was the restriction that one "interest" could hold no more than ten percent of the total equity of the bank. This ceiling on principal ownership diminished the chances of a single entrepreneur from engaging in banking, for the maximum ten percent share would not guarantee current or future control of the firm.

One of the most effective regulatory barriers was the restriction that banks operating in Canada have no more than 25 percent of their shares held by foreign residents. This restriction prevented entry of established banks into the country: in effect, it barred competitors who could match Canadian banks in size and

banking expertise. Up until the 1980 Bank Act, foreign banks were allowed to operate in Canada but were severely restricted as to the services they could offer. They could neither accept deposits, nor were they extended the benefits associated with deposit insurance. As a result, foreign banks were excluded from much of the banking market. In December 1976, the Royal Commission on Corporate Concentration reported that the 22-25 foreign bank affiliates operating in Canada held less than two percent of the Canadian chartered bank assets, and only one percent of the total assets held by private sector financial institutions.¹¹ Additional information pertaining to the key amendments of the 1967 Bank Act are provided in greater detail in Appendix B.

The 1980 Bank Act redressed only some of the legislative barriers to entry in Canadian banking. While foreign banks were permitted to establish in Canada, they were limited in size (originally 8% then raised to 16% of domestic assets), number of offices (establishment of each office had to be approved by the Minister of Finance) and asset-capital ratios (20 to 1 for Schedule B banks as opposed to approximately 24 to 1 for Schedule A banks). In addition, trust companies remained excluded from lending to corporations, and from forming subsidiary loan companies. Additional information pertaining to the

regulations of the 1980 Bank Act is in Appendix C.

It appears therefore, that the concentration in the Canadian banking industry is the result of substantial legislative barriers which have impeded the free entry of new firms into this sector. The ineffectiveness of the 1967 Bank Act in reducing barriers to entry have been well documented. Dean and Schwindt stated that:

The fact that concentration was maintained in the face of increased inducement to entry leads to the suspicion that the Bank Act of 1967, regardless of its intent, did not significantly lower barriers to entry into the industry.¹²

Similarly, despite provisions in the 1980 Bank Act for a more competitive banking environment, the federal government acknowledged in the Green Paper that several measures could be introduced to facilitate greater competition in the financial sector. These measures included the extension of commercial lending powers to trust/loan companies (creation of Schedule C banks) and the prohibition of mergers that would have an "undesirable effect on market competition and the competitive environment for financial services".¹³

Given that the conditions of entry into the banking industry have been restricted by existing bank legislation, economic theory suggests that the Canadian

chartered banks enjoy a higher degree of market power than that which would exist in a competitive environment. It is not surprising therefore, that the banks have acted as a "collusive" oligopoly to discourage competition and thereby realize "monopoly" profits in excess of the long run competitive return. An analysis of the subsequent conduct of Canadian banks since 1967 underscores the oligopolistic practices "permitted" in Canadian banking despite the introduction of legislation designed to enhance competition in the Canadian financial sector.

2.3 Conduct

There is considerable evidence that Canadian banks have followed oligopolistic practices with respect to price coordination and new product innovation. For example, prior to 1967, price coordination was facilitated by the Canadian Bankers Association (CBA) which allowed banks to charge standardized prices for financial services. As a result, banks tended to simultaneously announce changes in the prime rate and interest paid on personal savings accounts. However, although under section 38 of the 1967 Bank Act banks were prohibited from explicitly engaging in joint price setting, it appears that the legislation succeeded in altering only the frequency and timing of the rate change. Jones and Laudadio concluded that although there

was a "slight discrepancy in the timing of rate changes by different banks ... this does not indicate that competition has taken over the banking industry".¹⁴

The Bank Acts of 1967 and 1980 contained little legislation to reduce the power of the Canadian Bankers Association with respect to cheque-clearing and the determination of service charges. For example, the 1967 Bank Act did not prohibit collusive agreements on bank service charges, although this was changed with the extension of Combines legislation to the banking sector in the mid-1970s.

The chartered banks, however, through the Canadian Bankers Association, continued to control cheque-clearing operations and the determination of processing charges for such services. Even after the introduction of the 1980 Bank Act in which the Canadian Payments Association (CPA) was established, the banks retained substantial control of the cheque-clearing system through the Board of Directors (5 of the 11 positions were appointed by the banks) as well as the continued control of the daily operations of the association.

In addition, the recent controversy surrounding bank service charges¹⁵ suggests that Canadian chartered banks continue to operate as an oligopoly. For example, since

1983, the five major chartered banks have increased service charges such that non-interest income has climbed by an average of 23 percent per year (see Table 2-4, page 28) which is far in excess of the annual increase in non-interest expenses of 10.3 percent.

Given the ineffectiveness of the Bank Acts in substantially changing market structure or conduct, a marked change in performance and profitability in the Canadian financial sector is unlikely.

2.5 Performance

An analysis of the "performance" of an industry is essential to determine whether optimal resources have been allocated to the industry. Whereas persistent, below-average profitability suggests that too much capital has been allocated to a specific industry, the presence of persistent, above-average profits suggest that too little capital has been allocated to that same industry.

The major premise of this thesis is that the Canadian chartered banks have persistently earned above-average profits as a result of the considerable market power they exercise. If the banks were operating in a truly competitive environment, the high profit levels

would have encouraged new firms to enter the industry. Also, if capital is completely mobile and no barriers to the entry of such capital exist, capital should flow into those industrial sectors with an above average rate of return until the risk adjusted rate of return declines to a level equivalent to the average market rate. Similarly, if the risk adjusted rate of return is lower in any one particular industry than the market average, in the absence of economic or legislative impediments, capital should flow into other sectors until the rates of return have been equalized.

In a competitive, open (firms free to enter/exit various industrial sectors) economy, excessive profitability would be a transitory phenomenon. However, excessive profits over a protracted period of time suggest the existence of substantial barriers to entry. Given the presence of barriers, above average profits serve no socially useful purposes in that additional capital cannot enter "protected" industries.

Since 1968, in the Canadian banking industry the after-tax realized rate of return has been consistently higher than that of most Canadian industries. It has been concluded in numerous studies published since the 1967 Bank Act that bank profits have been invariably higher than the industry average since that year. In 1976, the

Economic Council of Canada published the study, Efficiency and Regulation: A Study of Deposit Institutions in which it was indicated that the after-tax profits (return to shareholders' equity) of the Canadian chartered banks increased dramatically after the 1967 Bank Act, whereas for most financial sectors there was a decline in overall profitability.

In comparing the periods 1963-1967 to 1968-1973, it was found that while the average rate of return for the chartered banks increased by 4.8 percent, the rates of return for all manufacturing and textiles declined by 0.3 and 3.0 percent respectively. Other industries, such as transportation, wholesale trade and retail trade also recorded declines of between .1 and 1.2 percent during the two time periods.¹⁶

In addition to the Economic Council of Canada Study, it was noted in several other government reports that the Canadian chartered banks regularly recorded profits which were significantly higher than the industry average. For example in the 1976 White Paper it was reported that the after-tax rate of return on the banks shareholders' equity increased considerably after the 1967 Bank Act.¹⁷; and, in the 1978 Report on Corporate Concentration, it was indicated that the average after-tax return on shareholders' equity for

Canadian chartered banks, between 1968 and 1975, was consistently higher than that of non-financial Canadian institutions (13.6% as opposed to 10.3%) and American banks (13.6% as opposed to 12.6%).¹⁸

The banks' profitability has consistently exceeded that of other industrial sectors even during recessionary periods. Unlike other industries, the banks increased their profits and growth despite the economic recession which resulted in diminished returns for most other sectors in the Canadian economy. Whereas for most industries there were substantial declines in net income from 1981 to 1983, the five largest banks continued to post record profits, as net income increased by 6.7 percent during this period. As highlighted in Table 2-3, only the utility industries (generally crown corporations or regulated monopolies) experienced a greater increase in net income than did the banks during the recession.

The persistent, above average, profitability of Canadian banking reflects the substantial market power held by the five largest banks. During the recessionary period, the chartered banks maintained comparatively high profit levels by increasing the "spread" (difference between interest received on loans and interest paid on deposits) on domestic interest rates. The spread increased from 2.38% in 1982 to 2.89% in 1983 and 3.39%

Table 2-3: Profits of 5 largest Companies by Industry Group
1981-1983

Industry/ 5 largest Companies 1981	Net Income (\$M)		% Change 1981-83
	1981	1983	
<u>Banking</u> Royal, Commerce, Montreal, Scotia, TD	1640.0	1715.4	6.7%
<u>Petroleum</u> Imperial Oil, Shell, Texaco, PetroCanada	1520.1	1087.0	-28.5%
<u>Retail Sales</u> Hudson's Bay, Simpsons, Eatons, Woolworth, Woodwards	125.3	100.8	-19.5%
<u>Food/Beverage</u> Safeway, Steinberg, Dominion, A&P	145.2	129.6	-10.7%
<u>Transportation</u> Air Canada, Wardair, PWA, Laidlaw, Greyhound	88.1	55.6	-36.9%
<u>Heavy Industry</u> Manufacturing, Stelco, Dofasco, Domtar, Abitibi, Price, Atco.	477.4	225.8	-52.7%
<u>Utilities</u> TransCanada Pipelines, Ontario Hydro, Quebec Hydro, Bell Canada, Alberta & South Gas	1671.3	2153.4	28.9%

Source: The Financial Post 500. 1984, 1982 issues

in 1987.¹⁹ Although complete data for each of the five banks is unavailable, it must be emphasized that the rise in the interest margin reflected increases in domestic margins, as the differential for international activity declined from 1.92% in 1981 (average for Toronto-Dominion, Canadian Imperial Bank of Commerce, Royal Bank and Bank of Montreal) to 1.65% in 1983.²⁰

Aside from increases in the interest spread, the banks were able to impose considerably higher charges for various bank services. As highlighted in Table 2-4, since 1983, bank service charges accelerated considerably; and, the growth of such income was markedly higher than the growth in non-interest expenses. For example, from 1983 to 1987, non-interest income (service charges, credit card fees etc.) climbed by an average of 23.2 percent annually, an increase notably higher than that of non-interest expenses (staff, computer charges etc.) which grew by only 10.3 percent per year during the corresponding period. The increase in bank profitability during periods of economic malaise prompted one financial analyst to comment that:

Earnings have increased strongly without the benefit of asset growth and it shows you the industry's power to improve profitability when the need arises.²¹

The persistent above average profitability of

Table 2-4: Average Annual Growth in Non-Interest Income and Non-Interest Expenses - Five Largest Banks (% per year)

<u>Bank</u>	Average Annual Increase - Non-Interest Income (Service Charges) & Expenses			
	1981 - 1983		1983 - 1987	
	<u>Income</u>	<u>Expenses</u>	<u>Income</u>	<u>Expenses</u>
Royal Bank	16.7%	13.1%	18.9%	8.3%
CIBC	11.1%	5.6%	23.3%	9.6%
Bank of Montreal	20.1%	12.1%	30.8%	16.1%
Scotiabank	6.3%	7.4%	19.6%	7.7%
Toronto Dominion	14.3%	9.7%	27.0%	10.0%
Average	14.0%	9.8%	23.2%	10.3%

Source: Bank Annual Reports, various years.

Canadian banks suggests that Canadian Bank legislation has not been successful in providing a competitive environment similar to that in which the majority of Canadian companies must operate.

Given this lack of competition, the use of welfare loss techniques will serve to "quantify" the net social cost of the banks' market power as well as identify the extent to which the 1967 and 1980 revisions to the Bank Act improved or reduced effective competition in the Canadian financial sector.

FOOTNOTESChapter 2

¹ R. Caves, American Industry: Structure, Conduct, Performance, (Toronto: Prentice Hall, 1977), p. 13.

² Recent studies of economies of scale in U.S. banking contend that there was little evidence to support the view that larger bank size resulted in greater bank profitability. Studies contained in The Economist, "The Myth of the Leviathan", (March 26 - April 1, 1988), pp.14-16, including those of S. Shaffer and E. David, "Economies of Superscale and Interstate Expansion" Federal Reserve Bank of New York, (October 1986), found no correlation between asset size and profitability. Similar studies by U.S. economists such as B. Oppen, "Profitability of Insured Commercial Banks in 1982", Federal Reserve Bulletin, Volume 69, No. 7, July 1983, p. 498, highlighted the minimal effect of scale economies in U.S. banking.

³ J.C.H. Jones and L. Laudadio, "Canadian Bank Mergers, The Public Interest and Public Policy," Banca Nazionale del Lavoro Quarterly Review, No. 105, June 1973, p. 16.

⁴ J.M. Mintz, The Measure of Profitability in Canadian Banking (Ottawa Economic Council of Canada, discussion paper 101, 1977), p. 30.

⁵ E. Neave and D. Purvis, "A Comparison of Banking System Performance in Canada and the United States," Queen's University Conference on Monetary Issues (Kingston: Queen's University, 1975), pp. 18-19.

⁶ D. Orr, "The Economic Determinants of Entry into Canadian Banking: 1963-7", Canadian Journal of Economics, VII, no. 1, February 1974, p.91.

⁷ J. Mintz, op. cit., p. 4.

- 8 Ibid., p. 88.
- 9 Brian Griffiths, "Competition and Regulation in Oligopoly Banking: The Canadian Experience with the 1967 Bank Act", Queen's University Conference on Monetary Issues (Kingston: Queen's University, 1975), p. 18.
- 10 Ontario: Loan and Trust Corporations Statement (Ontario: Department of Insurance, 1972, 1973), pp. 335-337.
- 11 Canada, Report of the Royal Commission on Corporate Concentration, pp. 234-236.
- 12 James Dean and Richard Schwindt, "Bank Act Revision in Canada: Past and Potential Effects on Market Structure and Competition", Banca Nazionale del Lavoro - Quarterly Review, No. 116, June 1976, p. 30.
- 13 Canada, Department of Finance, The Regulation of Canadian Financial Institutions: Proposals for Discussion (The Green Paper) (Ottawa: Supply and Services, 1985), pp.23-25.
- 14 J.C.H. Jones and L. Laudadio, op. cit., p. 16.
- 15 Canada, Standing Committee on Finance and Economic Affairs, Charges for Personal Financial Services, (Ottawa: Supply and Services, June 1988), pp. 6-27.
In general, the Committee found that the increases in service charges were on average, more than twice the rate of inflation and proposed amendments to the Bank Act to limit/reduce or eliminate such charges.
- 16 Economic Council of Canada, Efficiency and Regulation, A Study of Deposit Institutions (Ottawa: Supply and Services, 1976), p. 40

- 17 Canada, Department of Finance, White Paper, p. 14.

It was stated in the White Paper that:

The after tax rate of return on bank's shareholders equity has not been on average significantly different from that of non-financial corporations over the period from 1963 to 1973 ... There is however, a marked difference between the pre 1967 period and after ... since that date, the banks' ratios exceeded those of other sectors.

- 18 Canada, Report of the Royal Commission on Corporate Concentration, p. 227.

- 19 Globe & Mail, Banks Near Record with 2nd Quarter Profits, (June 10, 1983), p.B1. 1987 data from Canadian Bankers Association, Operating Results and Statistics: Chartered Banks, 1987 (Toronto, December 1987), p.9.

- 20 Calculated from various bank Annual Reports, 1981-87.

- 21 Globe & Mail, Banks Near Record with 2nd Quarter Profits, (June 10, 1983), p.B1. Quote from Roy Palmer of Alfred Bunting & Co.

CHAPTER 3: THE WELFARE LOSS MODEL

Given the structure, conduct and above average profitability in Canadian chartered banking, it would appear that, contrary to government claims, the legislation contained in the 1967 and 1980 Bank Act revisions did little to promote effective competition in the Canadian financial sector. Using welfare loss techniques, it is possible to measure the extent to which the Bank Act revisions affected competition in the banking sector. This chapter focuses on the development and utilization of the welfare loss model as applied to the banking sector by B. Griffiths and S. Rhoades¹, with adjustments made to account for the "unique" Canadian financial environment.

3.1 Previous Research

While there has been considerable effort directed towards estimating the welfare loss associated with monopolistic practices in the manufacturing sector, and with the cost of tariffs or quotas², studies related to the welfare loss in service industries tend to be relatively scarce. This is probably due to the lack of pertinent data. However, there were two major studies which examined the social costs associated with excessive

market power in the financial sector. In 1972, B. Griffiths estimated the net social cost of collusion in the United Kingdom banking system and concluded that the welfare loss associated with the excessive market power ranged from .0002% to .0059% of the United Kingdom's GNP in 1967.³ It was estimated in a similar study that the welfare loss and redistributational effect due to monopoly in U.S. banking amounted to \$11.9 million in 1978, although the redistributational effect of such a monopoly exceeded \$1.3 billion for the same period.⁴ To date, there has not been a comparable welfare loss study completed for the Canadian banking sector.

3.2 Research Approach

The specific research methodology utilized in this thesis will proceed as follows:

1. Utilizing standard welfare loss models, the deadweight loss and redistributational effect associated with monopolistic practices in the Canadian banking sector for the period from 1965 to 1986 will be estimated. The pre-requisites for such an analysis includes:
 - (i) an estimation of the "true" profitability of the banking sector (by netting out the excess costs and/or by determining the banks' "true" profitability) as opposed to using their reported profits;
 - (ii) the measure of excess profits by comparing the banks' "true" profits to those of other competitive industries;

(iii) the use of accepted price elasticity of demand estimates to calculate the welfare loss and redistributitional effects.

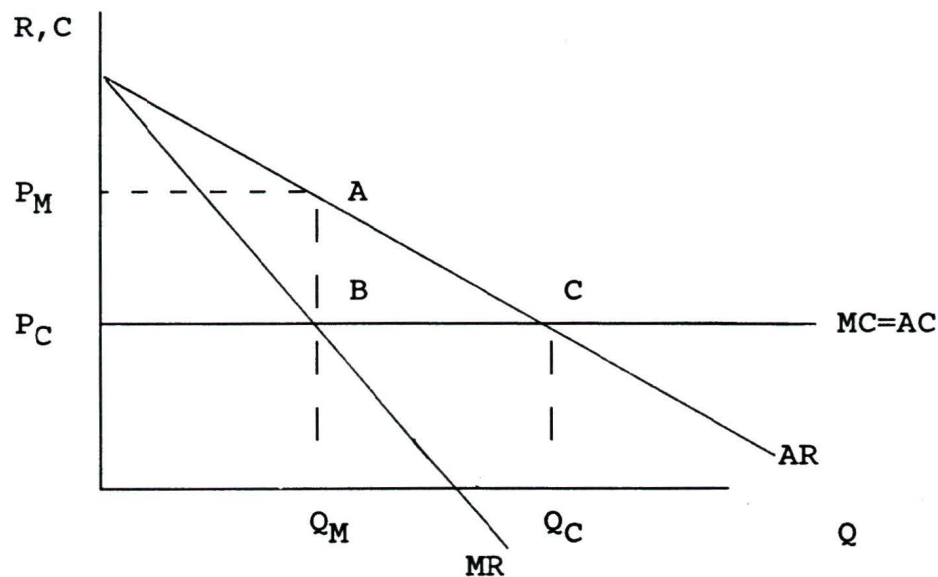
2. As the objective of this thesis is to evaluate the effectiveness of the 1967 and 1980 Bank Acts in promoting competition, analysis will focus on changes in welfare loss (adjusted for inflation) for the periods from 1965 to 1967, 1968 to 1980 and 1981 to 1986. It is hypothesized that if the Bank Acts had been successful in promoting competition, there should have been corresponding declines in the deadweight loss associated with the Canadian banking industry.

3.3 The Welfare Loss Model

Although the profitability of Canadian banking has been examined in several studies, the overall allocative or welfare loss effects attributable to an oligopoly have not been analyzed. In measuring this loss, the model chosen must yield consistent results from available data. Although the Harberger model used in this study might not address the X-efficiency aspects of Canadian banking, the model provides an appropriate methodology through which accessible data yields a consistent estimate of the social cost of monopoly in Canadian banking over a 20 year span. As the focus of this study is to estimate relative changes in, rather than the absolute amount of welfare' loss, the model serves as an appropriate framework for determining such changes.

The basic model used to calculate the welfare loss associated with oligopoly in Canadian banking is illustrated in Figure 3-1. Over the demand curve AR, the monopolist charges price P_M and output Q_M is produced. Assuming that banking markets are characterized by relatively constant costs, a reasonable assumption for the banking industry (see section 3.3.4), then, in a competitive system, the competitive firm would operate where Price (P_C) equals Marginal Cost (MC). This also equals the Average Cost (AC) in the relevant range so that competitive output is Q_C .

Figure 3-1



In this situation, ABC is a measure of the deadweight loss associated with monopolistic pricing. The rectangle $P_C P_m AB$ represents the "redistribution" of income from consumers to monopolists. An estimate of both the deadweight loss and redistributational effects associated with monopoly in Canadian banking will be provided in this thesis.

Estimating the welfare or deadweight loss arising from the exercise of excessive market power entails the calculation of the triangle ABC in Figure 3-1. Utilizing the methodology employed by Jones and Laudadio⁵, and Rhoades⁶, the estimate of the deadweight loss (W) is calculated as follows:

$$W = \frac{1}{2} \Delta p \cdot \Delta q$$

$$= \frac{1}{2} \Delta p \cdot \Delta q \cdot \left(\frac{\Delta p \cdot q^2 \cdot p}{p \cdot q^2 \cdot p} \right) \quad (3.1)$$

$$= \frac{1}{2} \Delta p^2 \cdot q^2 \cdot \frac{1}{p \cdot q} \cdot \frac{p \cdot \Delta q}{q \cdot \Delta p} \quad (3.2)$$

$$= \frac{1}{2} \hat{\pi}_m^2 \cdot \frac{1}{TR} \cdot k \quad (3.3)$$

where $\hat{\pi}_m$ = monopoly profits, TR = total revenue, and k = price elasticity of demand. Monopoly profits are determined by multiplying the excess profit rate (% above

competitive rate) by total shareholders' equity. Derivation of these explanatory variable will now be discussed.

3.4 Estimations and Assumptions

3.4.1 Monopoly Profit ($\hat{\pi}_m$)

(a). "True" Bank Profits

Estimating the extent to which Canadian banks have earned "monopoly profits" entails the calculation of "true" profits, as opposed to reported profits, and the comparison of the "true" profit rates of the Big Five Canadian banks to the rate of return earned in "competitive" financial industries, namely, Canadian loan and trust companies.

Prior to calculating the monopoly profits in Canadian banking, it is necessary to choose the correct measure of profitability. For example, there are three measures that can be used to describe profitability within an industry: return on sales, return on assets and return on shareholders' equity.

The evaluation of the banks' profitability using the return on sales as a measure is difficult, given the complexity of "output" produced by financial firms (ie. income earned on loans as opposed to income earned on other financial services). For example, banks that

specialize in the output of commercial loans (typically high loan volumes, lower service charges) would appear to be less profitable than banks specializing in "retail" operations which generally have lower loan volumes but higher non-interest (service charge) income.

Traditionally, Canadian banks have sought to describe profitability in terms of profits per dollar of assets. However, Mintz criticizes this method noting that financial assets are not a true measure of the actual output of banks and other financial companies. Output consists of several types of services: financial intermediation and advice, foreign exchange, and the leasing and handling of trust accounts. Although two firms might report the same profit, the firm specializing in financial intermediation would have more financial assets than would a firm which participates in several activities. Hence, profits per dollar of assets for the first firm are lower than those for the second firm. Mintz also notes that profits per dollar of assets is a poor measure when comparing financial firms which supply differentiated financial intermediary services, such as wholesale (commercial) versus retail banking.⁷

A more appropriate measure of the profitability of financial firms is the rate of return on shareholders' equity. This measure is the most appropriate in that

profits can be compared against a common denominator, namely, the resources/capital invested in the firm/industry by the shareholders. In a competitive environment, an above average rate of return would serve as a signal for the entry of additional resources (shareholders' capital) until the rates of return have been equalized. If barriers to entry exist, then the monopolized sector would consistently record above average rates of return on shareholders' equity. In addition, by using this profit measure the comparison of the return of capital actually employed to finance the production of output, whether it be in banking, loan, or trust sectors, can be more easily examined.

A crucial element in welfare loss analysis is the distinction between real and declared profits. Griffiths recognized the need to calculate "true" profits given that United Kingdom bank legislation allowed the clearing banks to declare a profit figure after allocations had been made to inner reserves.⁸ G. Mercier pointed out that the difference between the reported and "true" profits was widely recognized in the Canadian financial community. He stated that:

In the banking sector, financial analysts usually consider that the profits as declared are quite different from real profits ... Profits declared by banks are generally rejected by the financial community because of their little significance.⁹

In analyzing the "true" profitability of the banks, it must be recognized that the profits (total revenue less expenses) of Canadian chartered banks are regularly adjusted through transfers to, and recoveries from, the banks' "Appropriation For Losses" account. These transfers and recoveries have served to obscure the actual profits of the Canadian chartered banks.

A provision in the 1967 Bank Act, ostensibly to protect the depositors, allowed banks to establish reserves (appropriations) for possible losses. Banks were permitted to transfer 1.5% of eligible assets into this fund, tax-free. However, appropriations greater than 1.5% (subject to change) were not tax deductible. Such a reserve enabled banks to reduce tax obligations in any particular year. In addition, as Mercier indicated, the tax paid appropriations could be transferred directly to the capital account at the banks' discretion, such that:

...consequently the banks may use transfers to "Appropriations for Losses" to cushion fluctuations in profits and conceal their level. Indeed, the capital account may be inflated by a same amount directly by transferring a portion of the profits of the year or indirectly through a transfer to the Appropriations of losses. Declared profits, nevertheless are not the same, when in fact, nothing has changed.¹⁰

The size of this reserve is not trivial. At the end

of 1981, the five chartered banks, collectively, had almost 1.4 billion dollars set aside to cover loan losses. Such an account has enabled banks to mask increases in profits despite escalating revenues. For example, for the one year period from Oct. 31, 1979 to Oct 31, 1980, while the balance of revenue increased by more than 11 percent for the five major chartered banks, taxes paid actually declined by 21 percent, because banks increased their current years loan loss appropriations by 18.6 percent.

As indicated by Mercier, it was possible to calculate the "real" profits of banks and trust and loan companies using one of two equivalent, but different, methods: however, both the "operations" or the "capital conservation" (changes in net worth) method yield identical results. For simplification, the "operations" method is preferred because it allows for the easy comparison of revenues and profits between banks, and trust and loan companies. By way of illustration, we outline in Table 3-1 the calculation of the "declared" profits and "real" profits for the Toronto-Dominion Bank and Guaranty Trust Company for 1972.

(b). Trust and Loan Companies Profits

Identifying the true profits of trust and loan companies was simplified because, as they are regulated

Table 3-1
 Declared vs "Real" Profits Using the Operations Method
 Toronto-Dominion Bank & Guaranty Trust Co.
 1972

	T.D. Bank (\$000) -----	Guaranty Trust (\$000) -----
Total Revenue	470824	62149
Total Expenses - including Provision for loan losses	392435	53074
Balance of Revenue	78389	9075
Appropriations for Losses	25000	279
Provisions for Income Taxes	24800	3939
Declared Profit	28589	5415
REAL PROFIT CALCULATION		
Balance of Revenue	78389	9075
Losses on loans less Provisions included in operating expenses	(1812)	
Other Profits/losses	3132	279
Provision for Income Taxes - CY	(12400)	(3986)
- APP	(24800)	(47)
Real Profit	42509	5321
% Difference between Real & Declared Profit	48.7%	-1.7%

Source: G. Mercier, "Declared & Real Profits of Canadian Chartered Banks", Chartered Accountant, Vol. 102., (June 1973), pp. 1-4.

Data obtained from Company Annual Reports.

by provincial authorities, trust companies are not allowed to deduct the 1.5% of eligible assets from current income as appropriations for loan losses. A general and investment reserve are maintained (approximately 0.75% of total assets in 1984). However, all funds in these accounts have been subject to tax. As with banks, trust companies can freely transfer funds from the reserve to the capital account, but funds can only be directed from profits to reserve accounts after tax has been paid. Consequently, unlike the chartered banks, the profits of trust and mortgage loan companies cannot be reduced by an "appropriation for losses" transfer.

Since funds in the "Accumulated Appropriations for Loan Losses" account can be transferred directly to the capital account (but only for the portion on which taxes have been paid), shareholders' equity must be adjusted for the inclusion of these funds. With respect to banks, shareholders' equity consisted of Shareholders' Capital, the Rest Account, Undivided Profits and Appropriations for Losses. Trust and loan companies reporting to the Ontario Registrar were obligated to list Capital, General Reserve, Investment Reserves and, Retained Earnings as shareholders' equity.

In addition, it was possible to compute simple and

compound rates of return on shareholders' equity. The compound rate was annual profits (reported and real) divided by shareholders' capital averaged for each point of time during the year. The use of the compound rate assumes that firms could reinvest earned income at anytime. Given the flexibility in the financial sector, the compound rate of return was a more appropriate measure of profitability than the simple profit rate. Hence, the average shareholders' equity is calculated rather than the year-end figure. By using this realized rate of return, profits and losses on securities are also deemed to occur throughout the year rather than only at year end. The effect of new share issues is also calculated using this average measure. Table 3-2 illustrates the method by which the after tax realized rate of return to average shareholders' capital may be calculated for the year 1972, using both declared and "real" profits.

(c). The Market

Integral to the calculation of the welfare loss in Canadian banking is the comparison between profits in the monopolized sector and profits in "competitive" industries. Griffiths determined the excess profit to be the difference between the rate of return in U.K. banking

Table 3-2
 After Tax Realized Rate of Return To Average
 Shareholders' Equity - Toronto-Dominion Bank & Guaranty Trust Co.
 1972

	T.D. Bank (\$000)	Guaranty Trust (\$000)
Declared Realized Profit	28589	5415
Real Realized Profit	42509	5321
Average Shareholders' Equity		
Shareholders' Capital - 1972		8889
Cap/Gen. Reserve	30000	33000
Rest Account/Inv. Reserves	190000	238
Retained Earnings	1611	2115
Acc. App. For Losses	71574	
Total Shareholders' Equity - 1972	293185	44242
Total Shareholders' Equity - 1971	264488	42451
Realized Avg. Shareholders' Equity		
Shareholders' Equity - 1972	293185	44242
Shareholders' Equity - 1971	264488	42451
Change in assets not admitted		
Less New Issues (/2)		
TOTAL	557673	86693
Divided by 2	278837	43347
Less Profit/Loss on Sec.	307	-140
REALIZED AVG. SHAREHOLDERS' EQUITY	279144	43207
DECLARED REALIZED AVG. RETURN ON S.E	10.24%	12.53%
REAL REALIZED AVG. RATE OF RETURN	15.23%	12.32%

Source: G. Mercier, "Declared and Real Profits of Canadian Chartered Banks", Chartered Accountant, Vol. 102, (June 1973), pp.1-4.

Data obtained from Company Annual Reports.

compared to that of all other industries.¹¹ Rhoades, however, highlighted the difficulty of such an analysis, pointing out that the costs across industries producing different products cannot be easily compared.¹² A comparison between the Canadian financial sector and that of the U.S. would incur similar problems, as American banks have been subject to several regulations since 1967 that have not applied to Canadian banking. Mintz documents several of the problems in comparing Canadian and American banking systems. These differences include: U.S. restrictions on branching (local/state restrictions), different asset-capital ratio restrictions, deposit and loan interest rate ceilings, taxation, and transfers to nontaxable reserve funds.¹³

Given the difficulty in comparing Canada's banking system to that of the United States, the excess profits of Canadian chartered banks were calculated, for the period from 1965 to 1986, by comparing the adjusted rate of return on shareholders' equity for the five Canadian chartered banks to that of trust companies, mortgage loan companies, and all trust and loan companies.

3.4.2. Total Revenue (TR)

To compute the extent of the deadweight loss

associated with excessive market power, it was necessary to multiply the monopoly profit rate by the banks' total revenue. Total revenue data was obtained for each of the five major chartered banks from their annual reports.

3.4.3 Price Elasticity of Demand (k)

As only very little data exists pertaining to the price elasticity of demand for financial services, proxy or arbitrary (ie. $k=1$) measurements have been utilized. Griffiths, who cited several problems in estimating the elasticity of demand, stated that the "Estimates of elasticity of the demand for money have varied depending on the type of equation fitted and the definition of money or deposits used".¹⁴

Griffiths relied on previous studies in estimating the elasticity of demand for financial services. These measurements tended to be "narrow", as they examined only the elasticity of demand of the current accounts of the London Clearing Banks, or the interest elasticity of the demand for currency and bank deposits. The estimates of the elasticity of demand ranged from $-.28$ to $-.88$, although Griffiths acknowledged that the "most reasonable set of assumptions are those ... given an elasticity of demand of -1.0 ".¹⁵

Rhoades accepted the arbitrary value of -1.0 for the price elasticity of demand for banking services, stating that his estimates of elasticity relied on:

... precedent in order to estimate welfare loss rather than dealing with the problem of measuring the elasticity of demand. And, any attempt to 'measure' elasticity of demand for use in estimating welfare loss is likely to have serious problems as Worcester (1969) has shown.¹⁶

Freedman cited additional problems in estimating the demand for money. He suggested in his analysis that elasticity estimates are subject to considerable uncertainty given the constant introduction of new services and financial innovation. Freedman stated that the recalculation of the demand for money is necessary because of:

... the introduction of the daily interest chequing account and the spread of cash management packages to intermediate-sized corporations Difficult as the first part of the exercise proved to be, it was relatively straightforward compared to the problems of predicting future shifts which depended on such factors as the marketing expenditures of the banks, the spread of computer technology, and the prevailing level of interest rates.¹⁷

Given the comparative lack of data on the elasticity of demand for financial services and the difficulty in measuring elasticity, it is not inappropriate to follow previous convention and accept unit elasticity ($k=1$).

3.3.4 Economies of Scale

The assumption of constant costs is an important consideration in developing a welfare loss model. As highlighted in Figure 3-1, costs are assumed to be constant in the banking industry, irrespective of bank size. In a competitive system, price (P_c) is assumed to equal the Marginal Cost (MC) which also equals the Average Cost (AC). However, if the banking sector enjoys economies of scale, the average cost should decline as bank size increases, necessitating changes in the welfare loss estimates.

As outlined in Chapter 2, the assumption of constant costs in the banking industry has been subject to considerable study, with most research indicating that there are no significant economies of scale in the banking sector. Given that there exists little evidence to support economies (or diseconomies) of scale, it is not unreasonable to assume that the Canadian banking sector is characterized by constant costs.

3.3.5 Quasi-Monopoly Profits in Canadian Banking

Recent calculations of the welfare losses, arising from monopolization within selected industries, tended to incorporate expenditures on advertising and monopoly wages as "quasi-monopoly" profits.¹⁸ Given the low rates

of pay prevalent throughout the non-unionized Canadian bank system, it is unlikely that excess profits have been transferred to employees in the form of "monopoly wages". However, the major banks in Canada have committed significant amounts to their advertising budgets. An analysis of "other non-interest expenses" which include professional fees, computer operator costs, deposit insurance and business promotion indicates that these costs are greater than property expenses, and represent approximately 50 percent of the banks' salaries and wages.

Although it is not possible to calculate the actual amount spent on advertising, increased advertising or business promotion costs have been cited as major factors in the growth of "other non-interest expenses" among the various chartered banks¹⁹. Although it appears that advertising expenditures represent an increasing proportion of bank expenses, it is not clear whether the bulk of this advertising can be strictly defined as "persuasive" rather than "informative". With respect to the former, any such expenditures could not be considered "quasi-monopoly profits". Hence, the absence of data on both the quantity and nature of bank advertising poses considerable problems in attempting to estimate "quasi-monopoly profits" attributable to consumer advertising by

the Canadian chartered banks.

Given the difficulty in obtaining data on advertising expenditures and the accurate measurement of quasi-monopoly profits, no adjustments have been made to the results obtained. In excluding these quasi-monopoly profits, the results obtained in this study are likely to understate the actual welfare loss in Canadian banking²⁰. We now turn to the estimates of welfare loss before and after the Bank Acts.

FOOTNOTESChapter 3

¹ For examples of previous research on welfare loss in the banking sector, the reader is encouraged to review the work of B. Griffiths, "The Welfare Cost of the U.K. Clearing Banks' Cartel", Journal of Money, Credit and Banking, (May 1972), p. 240.; and S. Rhoades, "Welfare Loss, Redistributive Effect and Restriction of Output due to Monopoly in Banking", Journal of Monetary Economics, Vol. 9, (1982), p. 380.

² The analysis of monopoly/market power using welfare loss techniques is not unique. Since Pierre Dupuit's treatise on "consumer surplus" in 1844, economists have attempted to measure the extent of this social benefit/loss. It, however, was not until 1954 that a "workable" welfare loss model was developed. Harberger's landmark study of the welfare loss associated with monopoly in American manufacturing, ("Monopoly and Resource Allocation", American Economic Review, Papers and Proceedings, XLIV, May 1954), provided the foundation for future welfare loss analysis.

Subsequent studies of welfare loss associated with monopoly typically focused on the manufacturing sector, for which data pertaining to costs and profitability were more readily available. These studies also broadened the scope of welfare loss analysis, encompassing such aspects as relative elasticity of demand (D. Kamerschen, "An Estimation of the Welfare Loss from Monopoly in the American Economy," Western Economic Journal, 1966), the redefinition of the competitive rate of return by excluding industries earning sub-competitive rates (D. Cowling and D. Mueller, "The Social Costs of Monopoly Power," Economic Journal, September 1978), and the measurement of inefficiency and waste (H. Leibenstein, "Allocative Efficiency vs X-efficiency," American Economic Review, 1966). As a result of such refinements, estimates of the welfare loss associated with monopoly in the United States increased from the 0.1% of GNP estimated by Harberger to 6.8% of GNP estimated by Kamerschen, or from 4% to 7% of Gross Corporate Profits as estimated by Cowling and Mueller.

- 3 B. Griffiths, op. cit., p.240.
- 4 S. Rhoades, op. cit., p. 380.
- 5 J.C.H. Jones and L. Laudadio, "The Empirical Basis on Canadian Anti-Trust Policy, Resource Allocation and Welfare Losses in Canadian Industry", Industrial Organization Review, Vol.6, 1978, pp. 50-55.
- 6 S. Rhoades, op. cit., pp. 376-380.
- 7 J. Mintz, op. cit., pp. 10-12.
- 8 B. Griffiths, op. cit., p.236.
- 9 G. Mercier, "Benefices declares et benefices reel des banques a charte canadienne", Translation, Chartered Accountant (CA), Vol. 102, No.6, (June 1973), pp. 1-4.
- 10 Ibid., p. 4.
- 11 B. Griffiths, op. cit., pp. 238-239.
- 12 S. Rhoades, op. cit., p. 377.
- 13 J. Mintz, op. cit., pp.66-77.
- 14 B. Griffiths, op. cit., p. 239.
- 15 Ibid., p. 240.
- 16 S. Rhoades, op. cit., p. 377.
- 17 C. Freedman, "Financial Innovation in Canada: Causes and Consequences", American Economic Review, Vol. 73, No. 2, (May 1983), p. 105.

18 While Jones and Laudadio were able to measure the extent of "quasi-monopoly" profits in Canadian manufacturing using data available for only a three year period. Similar data on advertising expenditures does not exist for Canadian chartered banks.

19 The Bank of Montreal (Bank of Montreal Annual Report, 1983, p. 12) cites the growth of non-interest expenses as a major factor in the growth in the Companies expenses. Similarly, the Toronto-Dominion Bank (Toronto-Dominion Bank, Annual Report, 1979, p. 8) expressed concern over the increase in non-interest expenses.

20 The problem of estimating "quasi-monopoly" profits would be of greater importance after 1967. Prior to 1967 there was virtually no persuasive advertising, however, since 1967 this has not been the case.

CHAPTER 4: THE EMPIRICAL RESULTS

In this chapter we report the results of estimating the components of the model outlined in Chapter 3, which will allow us to draw some conclusions about the influence of the Bank Act revisions on competition. We proceed by discussing: profitability, the redistribution effects, and the welfare loss effects from 1965 to 1986.

4.1 Monopoly Profits

As with previous studies¹, in which the banks' rate of return was found to be higher than that of competitive industries (banks' profits averaging 3.1% higher than trust and loan companies for the period from 1965 to 1973), the results obtained in this thesis suggest that the rate of return on shareholders' equity for the five largest Canadian banks has consistently exceeded that of trust and loan companies for the period from 1965 to 1986. As highlighted in Table 4-1, during these 22 years, bank profit rates were on average 1.6 percentage points higher than comparable trust and loan profit rates. Furthermore, although prior to the 1967 Bank Act bank profit rates were below those of trust and loan companies, after the enactment of this legislation bank profits increased substantially.

Table 4-1
Adjusted Profit Rates - 5 Largest Chartered Banks &
All Trust & Loan Companies
(Return on Shareholders' Equity)

Year	Profit Rate - % per Year			
	Banks	Trust Co's	Loan Co's	Trust & Loan Co
1965	6.6	10.5	9.7	10.2
1966	9.5	12.1	9.8	11.1
1967	10.6	11.1	10.2	10.7
Avg. 1965-67	8.9	11.2	9.9	10.7
1968	14.4	10.7	8.9	9.9
1969	11.9	9.5	8.9	9.2
1970	10.4	8.3	8.1	8.2
1971	11.4	15.9	10.6	13.6
1972	14.0	16.2	13.7	15.1
1973	14.8	15.4	12.8	14.3
1974	13.7	9.4	9.7	9.5
1975	16.2	17.3	16.8	17.1
1976	15.4	14.8	11.6	13.5
1977	16.2	14.2	15.0	14.5
1978	19.6	14.3	10.4	12.8
1979	19.5	13.3	8.6	11.5
1980	19.9	11.5	17.1	13.7
Avg. 1968-80	15.2	13.1	11.7	12.5
1981	20.6	9.6	9.4	9.5
1982	7.4	9.3	10.0	9.6
1983	8.2	12.6	12.4	12.5
1984	11.3	10.6	9.7	10.1
1985	12.2	14.6	13.6	14.1
1986	9.2	6.6	5.4	5.9
Avg. 1981-86	11.5	10.6	10.1	10.3
Avg. 1965-86	13.3	12.2	11.0	11.7

Note: Weighted average of adjusted profits for the 5 major chartered banks and all trust & loan companies.

While the spread between bank profits and trust and loan profits declined after the 1980 Bank Act, much of this reduction can be attributed to the significant losses on foreign loans. For example, as outlined in Table 4-2, the overall profitability of the chartered banks with significant international loan exposure (Royal Bank, Bank of Montreal, Bank of Commerce, Bank of Nova Scotia) has been markedly below that of the Toronto Dominion Bank. From 1978 to 1981, the banks enjoyed relatively high profitability as the rate of loan losses was comparatively low and equal (approximately .39% of loans outstanding) for both domestic and international operations. However, beginning in 1982, the four major banks with significant international loan exposure suffered significantly higher losses, as such losses on foreign loans increased from .39 percent for the period from 1978 to 1981 to 1.12 percent for period from 1982 to 1986.

By comparison, the losses of the Toronto Dominion bank which had a lower international loan base, were considerably lower, and, consequently, their rate of return was much higher (13.5% as compared to 8.9% for the period from 1982 to 1986 for the four other major banks).

The divergence between the rates of return earned by the Toronto Dominion bank (predominantly domestically

Table 4-2
Growth in International Loan Losses in Canadian Banking
Share of Loan Losses - Domestic & International
Period Averages - 1978-81 & 1982-86

Loan Losses by Operation (% of Loans)	Royal, CIBC, B of M, BNS		TD	
	1978-8	1982-86	1978-8	1982-8
Domestic Operations	.39%	.93%	.31%	.88%
Foreign Operations	.38%	1.12%	.11%	.65%
Total Bank	.39%	.99%	.23%	.80%
Rate of Return on Shareholders' Equity	18.50%	8.91%	20.41%	13.53%

oriented) as compared to the profitability of the other four major banks (with substantial international operations), suggests that profitability on domestic operations of the Canadian chartered banks continues to be relatively high, despite the increase in competition from trust and loan companies and schedule B banks. Unfortunately, data itemizing income and expenses of the chartered banks, for their respective domestic and international operations is unavailable. Given, however, the significant differences in loan losses, and relative profitability of the domestically oriented banks, it would be reasonable to assume that the chartered banks still exercise considerable market power within the Canadian financial system.

4.2 Estimate of Redistributive Effect

The estimate of the redistributive effect (rectangular area $P_C BAP_m$ in Figure 3-1) was calculated by multiplying the banks' "excess" profit - defined as the difference between the rate of return of the banks and that of trust, loan, and trust and loan companies combined - by total bank shareholders' equity. Estimates presented in Table 4-3 indicate that the profits attributable to the monopoly power exercised by the Big Five chartered banks averaged \$124.1 million annually

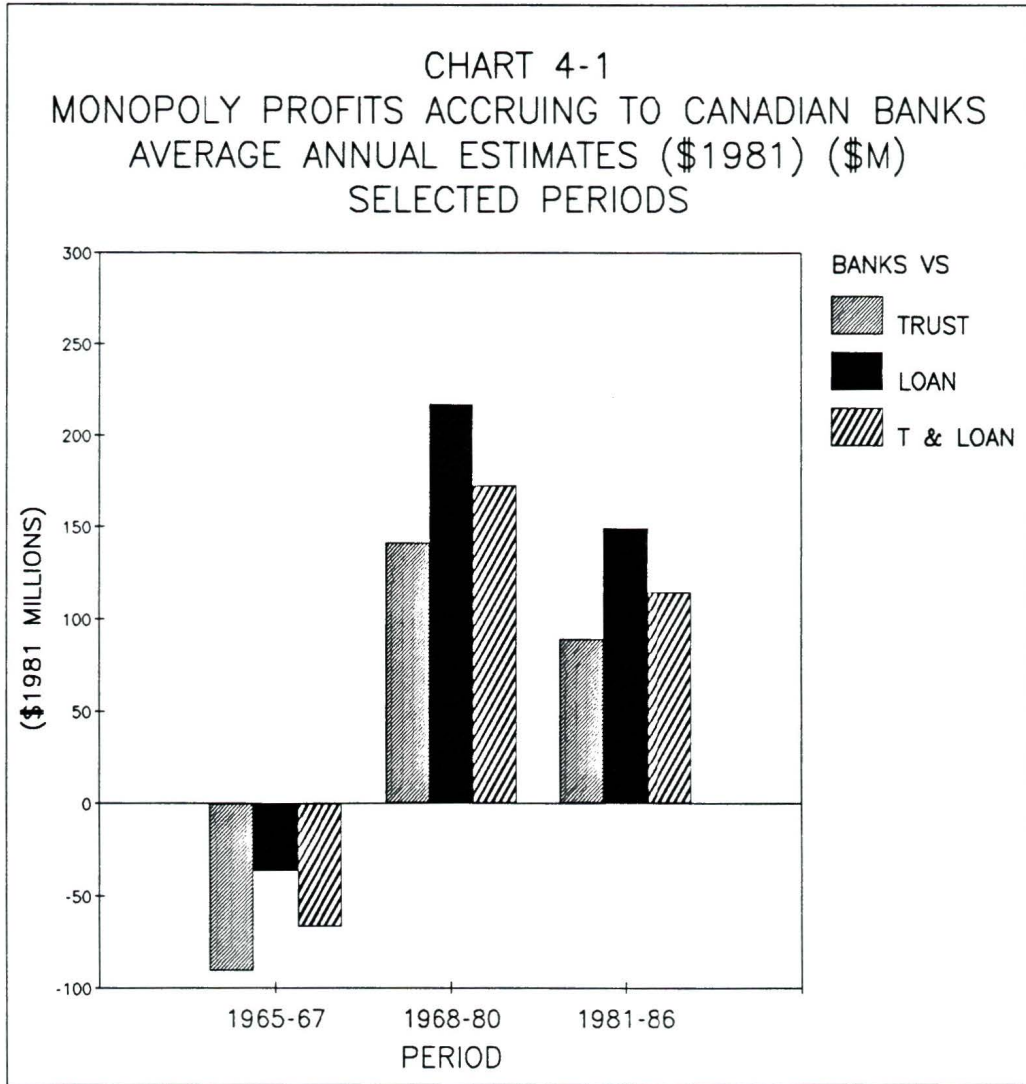
Table 4-3
 Monopoly Profits of the Canadian Chartered Banks
 (in current and \$1981)

Year	Current Dollars			Real (\$1981) Dollars		
	M1 B vs T	M2 B vs L	M3 B vs T&L	RM1 B vs T	RM2 B vs L	RM3 B vs T&L
1965	-49.5	-39.4	-45.2	-144.3	-114.9	-131.8
1966	-37.3	-4.3	-22.8	-106.3	-12.3	-65.0
1967	-7.8	6.2	-1.6	-21.4	17.0	-4.4
Avg. 1965-67	-31.5	-12.5	-23.2	-90.7	-36.7	-67.0
1968	62.3	92.6	75.4	163.9	243.7	198.4
1969	44.5	55.6	49.2	112.1	140.1	123.9
1970	42.2	46.2	43.9	102.9	112.7	107.1
1971	-94.4	16.8	-46.7	-223.7	39.8	-110.7
1972	-51.4	7.0	-26.6	-116.3	15.8	-60.2
1973	-15.6	52.2	12.6	-32.8	109.7	26.5
1974	124.1	115.5	120.5	235.0	218.8	228.2
1975	-34.3	-18.7	-27.9	-58.6	-32.0	-47.7
1976	22.2	140.9	68.7	35.3	224.0	109.2
1977	85.6	51.4	73.0	126.1	75.7	107.5
1978	269.6	468.0	345.9	364.8	633.3	468.1
1979	375.4	659.9	486.3	465.2	817.7	602.6
1980	591.7	197.2	435.2	665.6	221.8	489.5
Avg. 1968-80	109.4	145.0	123.8	141.5	217.0	172.5
1981	1034.2	1053.0	1043.6	1034.2	1053.0	1043.6
1982	-208.2	-284.9	-241.0	-187.9	-257.1	-217.5
1983	-515.6	-492.1	-563.9	-439.9	-419.9	-481.1
1984	96.8	221.3	166.0	79.1	180.9	135.7
1985	-385.5	-224.9	-305.2	-303.1	-176.8	-239.9
1986	467.1	682.7	592.8	352.8	515.6	447.7
Avg. 1981-86	81.5	159.2	115.4	89.2	149.3	114.7
Avg. 1965-86	82.55	127.37	101.46	95.58	163.94	124.09
Total 1961-86	1333.80	2750.00	1920.80	1578.76	3601.86	2412.83

(\$1981 - loan and trust comparison) for the period from 1965 to 1986. There is, however, considerable variation in bank monopoly profits. For example, prior to 1968, the banks earned "negative" monopoly profits averaging -\$67 million (\$1981) per year (compared to trust and loan companies combined); and, after 1967, the banks' monopoly profits increased to an estimated \$172.5 million (\$1981) annually from 1968 to 1980 before declining to \$114.7 million for the period from 1982 to 1986.

The monopoly profit data is presented in both current and real (inflation adjusted) terms for the years from 1965 to 1985. The estimates M_1 , M_2 , and M_3 are current dollar monopoly profits calculated by comparing bank profits to that of trust, loan, and trust and loan companies respectively. Deflating these estimates by the Canadian Consumer Price Index (CPI - 1981 = 100) yields constant (1981) dollar estimates - RM_1 , RM_2 and RM_3 .

After adjusting for inflation, the five largest Canadian chartered banks have realized between \$1.5 billion (RM_1) and \$3.6 billion (RM_2) in monopoly profits from 1965 to 1986. However, this income transfer occurred after 1967 as prior to that time consumers actually benefitted from banks earning less than competitive rates of return. As highlighted in Chart 4-1, although monopoly profits have declined since 1981,



they have averaged in excess of \$114 million per year.

Comparatively, the monopoly profits of the Canadian chartered banks accounted for a substantial portion of the banks' total profits. From 1981 to 1986, the \$692 million of monopoly profits earned by the chartered banks represented almost 10 percent of their total profits. It is therefore probable that one out of every ten dollars of bank profits was attributable to monopoly. Furthermore, from 1967 to 1981 the real monopoly profits of the Canadian banks (using the RM_2 measure) has exceeded the total real after-tax profits of both trust and loan companies.

4.3 Welfare Loss in Canadian Banking

The underlying premise in this thesis is that if the revisions of the Bank Act had been successful in promoting greater competition, then the welfare loss attributable to oligopoly should have declined after the introduction of such legislation.

Based on the research methodology outlined in Chapter 3, the welfare or "deadweight" loss estimates for the years from 1965 to 1986 were generated by comparing the adjusted bank profits to that of trust companies

(W_1), loan companies (W_2), and all trust and loan companies combined (W_3). In order to provide a meaningful comparison of welfare losses over time, the current dollar welfare loss estimates have been deflated using the Canadian Consumer Price Index (1981=100). These real (\$1981) welfare loss estimates are denoted by RW_1 (calculated in \$1981 using trust companies as the "competitive" industry, RW_2 (loan companies), and RW_3 (trust & loan companies combined).

Welfare loss estimates (both in current (W) and real (RW)) terms have been provided in Table 4-4. The size of the estimated deadweight losses range from -4.7 million in 1986 (\$1981) to \$14 million in 1978. Using both trust and loan companies as the "competitive" benchmark, welfare losses associated with Canadian banking have averaged \$1.47 million per year for the 1965 - 1986 period, although the welfare loss averaged -\$1.0 million prior to 1967. In 1986, the welfare loss of \$3.53 million represented approximately .001% of total Canadian GDP. The results obtained are consistent with those of similar welfare loss studies in that the absolute magnitude of the welfare loss is relatively small (Griffiths estimated that the welfare loss in U.K. banking amounted to .003% of GNP while Rhoades calculates the welfare loss in U.S. banking to be less than .001% of GNP in 1978). Of

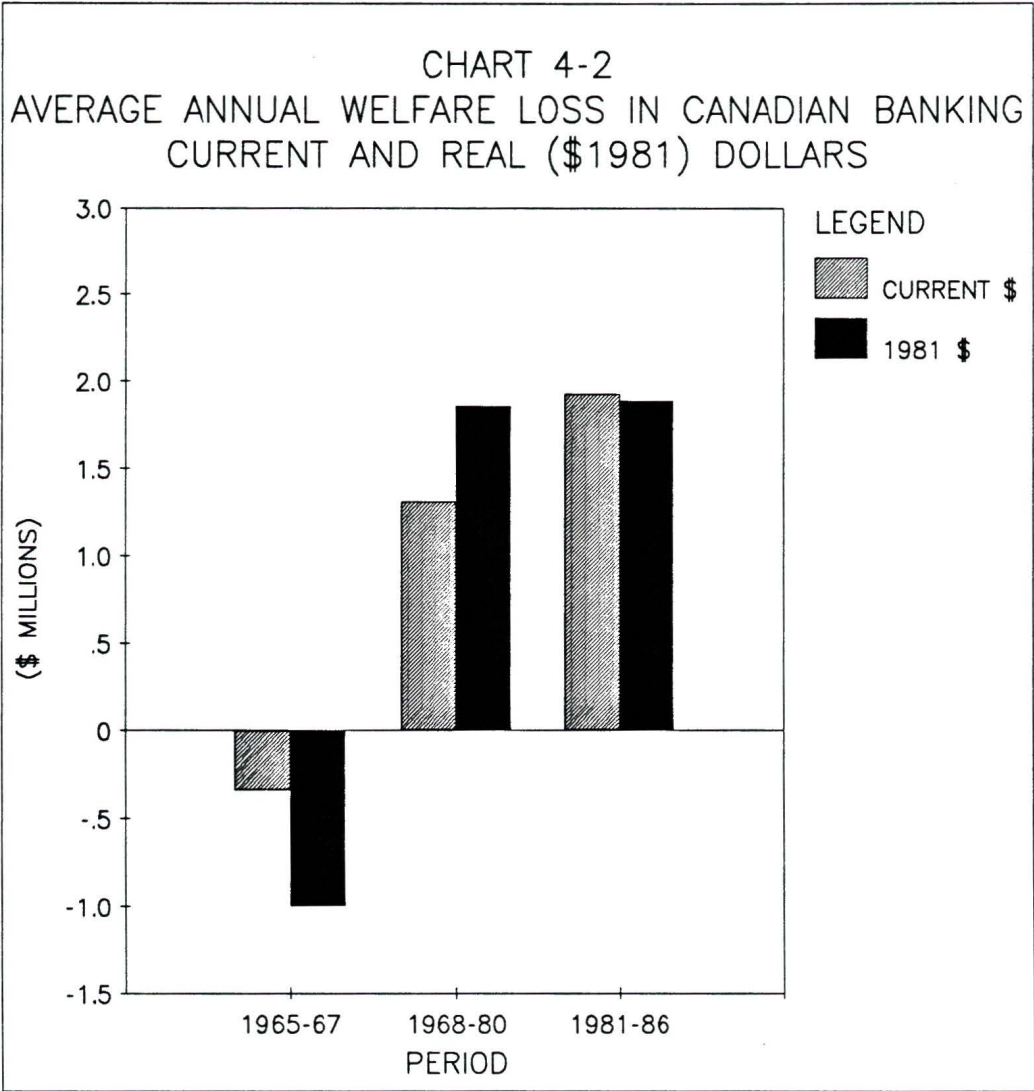
Table 4-4
 Estimates of the Extent of Welfare Losses in Canadian Banking
 (in current and \$1971)
 (\$ millions)

Year	Current Dollars			Real (\$1981) Dollars		
	M1 B vs T	M2 B vs L	M3 B vs T&L	RM1 B vs T	RM2 B vs L	RM3 B vs T&L
1965	-1.01	-0.64	-0.84	-2.94	-1.87	-2.45
1966	-0.50	-0.01	-0.19	-1.42	-0.03	-0.54
1967	-0.02	0.01	0.00	-0.05	0.03	0.00
Avg. 1965-67	-0.51	-0.21	-0.34	-1.47	-0.62	-1.00
1968	0.94	2.09	1.39	2.47	5.50	3.66
1969	0.36	0.56	0.44	0.91	1.41	1.11
1970	0.27	0.32	0.29	0.66	0.78	0.71
1971	-1.36	0.04	-0.33	-3.22	0.09	-0.78
1972	0.37	0.01	-0.10	0.84	0.02	-0.23
1973	-0.03	0.29	-0.02	-0.06	0.61	-0.04
1974	1.04	0.90	0.98	1.97	1.70	1.86
1975	0.07	0.02	0.05	0.12	0.03	0.09
1976	-0.03	-1.07	-0.26	-0.05	-1.70	-0.41
1977	0.35	0.13	0.26	0.52	0.19	0.38
1978	2.80	8.43	4.60	3.79	11.41	6.22
1979	3.66	11.32	6.15	4.54	14.03	7.62
1980	6.51	0.72	3.52	7.32	0.81	3.96
Avg. 1968-80	1.09	1.83	1.31	1.52	2.68	1.86
1981	12.70	13.20	12.90	12.70	13.20	12.90
1982	-0.47	-0.89	-0.63	-0.42	-0.80	-0.57
1983	-3.79	-3.45	-4.53	-3.23	-2.94	-3.87
1984	0.13	0.67	0.37	0.11	0.55	0.30
1985	-1.95	-0.67	-1.23	-1.53	-0.53	-0.97
1986	2.90	-6.20	4.68	2.19	-4.68	3.53
Avg. 1981-86	1.59	0.44	1.93	1.63	0.80	1.89
Avg. 1965-86	1.04	1.17	1.25	1.14	1.72	1.48

considerable importance, however, are the changes in relative magnitude during the period from 1965 to 1986. In real terms, the welfare loss increased (using trust & loan companies combined) after the advent of both the 1967 and 1980 Bank Act. Highlighted in Chart 4-2 are average annual welfare loss estimates , in both real and current dollars, for the years from 1965 to 1967, 1968 to 1980 and 1981 to 1986.

While the losses are not large, they represent an absolute loss to society, for the potential benefits are not enjoyed by either the monopolists or consumers. It must also be emphasized, that given the exclusion of advertising and other "quasi-monopoly" profits, the data obtained in this thesis will likely understate the actual magnitude of the welfare loss attributable to Canadian banking.

Although these welfare losses are relatively small, they do, however, provide a means with which to evaluate the effectiveness of both the 1967 and 1980 Bank Acts in having promoted competition in this industry. For example, the substantial reversal in the size of the welfare loss after 1967 (from -\$1.0 million in 1965-67 to \$1.86 million for the period from 1968 to 1980), suggests that the 1967 Bank Act did very little to promote competition within the financial industry, and, instead,



most probably enhanced the considerable market power of the Canadian chartered banks. Given that the size of this welfare loss has not diminished since the passage of the 1980 Bank Act, the extent to which effective competition has been introduced in the Canadian banking industry is subject to considerable doubt.

FOOTNOTESChapter 4

¹ A number of studies have concluded that Canadian banks have consistently earned above average profits. For general, see Chapter 2 of this thesis.

**CHAPTER 5: CONCLUSIONS ON COMPETITION:
REFLECTIONS AND FUTURE PROSPECTS**

During the period from 1986 to 1986, the five largest Canadian chartered banks consistently registered profit rates well above those of other comparable financial institutions, namely the trust and loan corporations. The increase in excess profits of the banks becomes most apparent after the passage of the 1967 Bank Act; and although bank profitability has declined since 1981, this decrease can be attributed to the banks' poor performance in international markets rather than the introduction of substantial competition in domestic banking.

While the welfare loss due to monopolistic practices is relatively small, the significant increase in the size of the loss after 1967 suggests that the 1967 Bank Act did little to promote competition in the financial sector. In comparison, the greater variation in welfare loss since 1981 suggests that the 1980 Bank Act allowed for additional competition into the financial system, although the international operations of the chartered banks have "masked" the true profitability of domestic banking operations. Given that the 1967 Bank Act did not appreciable increase competition in the financial sector,

one must examine the possible reasons as to why legislation favoured an oligopolistic market structure rather than a competitive system. Further, a review of recent financial proposals suggests that the government has yet to embrace the concept of effective competition in the Canadian financial sector.

5.1 Bank Policy and Pressure Groups¹

Banking legislation in Canada is affected by several key groups, including the political executive (cabinet), the relevant bureaucratic administrative agencies (Department of Finance, Bank of Canada), and private sector organizations (Canadian Bankers Association, Trust Companies Association of Canada, etc.).

The legislation reflects the relative influence of each group in promoting their respective interests. An analysis of the revisions of the 1967 and 1980 Bank Acts suggests that one arm of the bureaucracy, namely, the Bank of Canada, together with the Canadian Bankers Association (CBA) were the most effective groups in promoting legislation that limited competition. This limitation benefited both the Bank of Canada and members of the Canadian Bankers Association.

5.1.1 Pressure Groups & The 1967 Bank Act

A review of the goals of the Bank of Canada, specifically, to enhance the Bank's "prestige" and ensure its "survival"² provides an insight into the policy environment the Bank would favour. Jones and Laudadio suggest that both the "survival" and "prestige" objectives require that the Bank minimize risk. To reduce risk, the Bank would utilize policy tools that would not be subject to public scrutiny or criticism. In this context, the Bank would clearly favour "moral suasion" rather than other, more visible monetary instruments such as open market operations or changes in the Bank Rate or reserve requirements.³ While the overall object of the Bank Act revision was to increase competition, this objective would be in conflict with the Bank's goal of "prestige" and "survival", since it would increase the number of banks and therefore impair the effectiveness of the Bank's preferred use of "moral suasion"⁴ to achieve these goals. Jones and Laudadio argue that in the absence of significant pressure from other key players (other government departments, the Cabinet, or the Canadian Bankers Association), the Bank of Canada would not want the degree of competition to increase.

Jones and Laudadio point out that there would be

little likelihood of the other major bureaucratic pressure group, the Department of Finance, opposing the Bank given the necessity of cooperation in debt management policies. Similarly, in the absence of conflicting information from any other bureaucratic group (Department of Finance) or organized voter group, the Cabinet would likely adopt the recommendations advocated by the Bank of Canada and supported by the highly visible and effective private sector pressure group - the Canadian Bankers Association.⁵

The Canadian Bankers Association (CBA) in 1967 was a powerful pressure group. For example, Jones and Laudadio argue that the CBA was successful in promoting its competitive position vis-a-vis near-banks given the dependence of the Bank of Canada on the banking system, particularly the "cooperation" of the chartered banks in using "moral suasion" as a policy tool. Jones and Laudadio stated:

"the Bank's objective could be met either by the status quo or by a situation in which changes take place which do not increase competition. But, the chartered banks objective would not be met by the status quo. They would favour changes which improve their competitive position vis-a-vis the near banks... given the influence of the chartered banks on the Bank, we would anticipate legislation that improved the competitive position of the chartered banks vis-a-vis the near banks."⁶

As highlighted in the results, the 1967 Bank Act substantially improved the competitive position of Canadian chartered banks relative to that of the loan and trust companies. That is, it reduced competition in the financial sector. As shown in Table 4-1 (p.57), the profitability of Canadian chartered banks increased from an average of 1.8% below that of Trust and Loan companies (1965-1967) to an average 2.7% above that of trust and loan companies after 1967, confirming the hypothesis that the CBA was successful in lobbying for changes which would enhance the competitive position of chartered banks in Canadian financial markets.

5.1.2 The 1980 Bank Act

A review of the 1980 Bank Act revision suggests the presence of changing goals and objectives among other key players which resulted in reducing somewhat the influence of the Bank of Canada and the chartered banks. For example, the Ministry of Finance had no major interest in enhancing bank competition in 1967, but by 1980 the globalization of financial services resulted in growing demands by foreign banks to gain equal access to Canadian markets (prior to 1981 Canadian banks had access to the U.S. market but U.S. banks were prohibited from establishing subsidiaries in Canada), as well as

recognition by the Ministry of Finance of the need for greater control over foreign banks "and to provide economic and financial surveillance by Canadian authorities"⁷.

In addition to the changing objectives of other bureaucratic pressure groups, the Cabinet, other private sector organizations (including the CBA) were adopting positions that were in conflict with the Bank's objectives of "survival" and "prestige".

For example, in the three year period from 1978 to 1980, three successive governments introduced banking legislation that would have had the effect of increasing competition by allowing establishment of foreign based banks in Canada.⁸ Aside from the heightened interest of the Cabinet, any desire by the Bank of Canada to limit/constrain bank competition in the 1980's was in conflict with a growing number of private sector organizations. The near banks and foreign banks demanded access to traditional "banking" markets and the Bank of Canada could not rely unequivocally on the CBA to support policies limiting new entrants into the Canadian banking sector. It is interesting to note that the 1980 Bank Act was one of the few times that the CBA could not present an "industry" position, and individual banks made their own presentations.⁹ The majority of the chartered banks

indicated that foreign banks should be allowed to establish in Canada, primarily to ensure that all "banks" were required to submit to reserve requirements; and to reduce the possibility of retaliatory regulations in the U.S. However, it is important to note that the chartered banks with only minor international exposure (with less of a concern for reciprocal treatment) remained opposed to the establishment of foreign banks in Canada.¹⁰

Unlike the 1967 Bank Act revision, in which there appeared to be little or no opposition to the Bank of Canada's objective of limiting entry into the banking sector, the 1980 Bank Act revision reflected conflicting pressures exerted by a variety of pressure groups. In effect, while the 1980 Bank Act recognized the need for financial stability (excluded loan and trust companies from many banking functions), the Act also represented the desire of the Cabinet, Department of Finance and some chartered banks to permit, for a variety of reasons, the entry of foreign based banks into the Canadian financial system.

5.2 Canadian Bank Legislation: Future Directions

Since the passage of the 1980 Bank Act, there has been considerable debate concerning the desirability of introducing additional competition into the financial

sector. The necessity to review the banking sector became apparent in early 1982, when the "excessive" profitability of the chartered banks (during a period of economic recession) prompted the government to appoint a committee to investigate bank profits including the Evan's Committee in 1982. Although the committee concluded that bank profits were not excessive, it recommended that competition be increased, and that trust and loan companies be allowed to engage in commercial lending.¹¹

In early 1985, the government released a discussion paper The Regulation of Canadian Financial Institutions: Proposals for Discussion (the Green Paper) in which a number of initiatives designed to enhance financial competition were put forward. The main provision was to be the introduction of legislation that would enable trust and loan companies, and other financial companies to engage in banking services (including commercial lending) through the establishment of schedule C banks. The government indicated that the purpose of such banks would be to "provide financial holding companies access to a wider range of business powers".¹²

However, the government's objective of increasing financial competition was severely shaken by the failures of several financial institutions. Between 1980 and

1985, there were 22 financial institutions that failed in Canada. Furthermore, the collapse of two chartered banks (the Canadian Commercial Bank and the Northland Bank) in 1985 prompted the government to postpone the introduction of "competitive" legislation in lieu of legislation which would provide for greater stability within the financial sector.

In December 1986, after the release of the Estey Commission findings, the government released a new report, New Directions for the Financial Sector the focus of which was the need to improve consumer protection, and minimize self-dealing and conflict of interest. In this report, the federal government abandoned its proposal to establish schedule C banks, although the report included proposals which allowed for the expanded commercial lending powers of trust, loan and insurance companies. Offsetting these competitive proposals, however, were stringent ownership rules for new trust and loan companies (exclusion of applicants with significant commercial interests, wider ownership criteria etc.). Although the banks could now expect greater competition in consumer lending markets, banks were allowed to acquire other financial services (trust operations, investment dealers etc.).¹³ While the banks have taken full advantage of the opportunity to acquire their new

services¹⁴, legislation permitting the free entry of other near banks (such as financial holding companies) into banking activities is still under review. Given the governments past record in introducing "effective and equitable competition" , it is unlikely that the oligopoly position of the Canadian chartered banks will be altered in the foreseeable future.

FOOTNOTES

1 It should be noted that costs of lobbying may dissipate some or all of the "transfer" P_{MABP_C} in Figure 3.1 in order to maintain economic rents: Thus, the area P_{MABP_C} and the estimate of the transfer in Chapter 4 (4.2) could become an additional measure of allocative inefficiency. See, for example, R.A. Posner, "The Social Costs of Monopoly," Journal of Political Economy, 83, August 1975.

2 K. Acheson and J.F. Chant, "The Choice of Monetary Instruments and the Theory of Bureaucracy," Public Choice, Spring 1972.

3 J.C.H. Jones and L. Laudadio, "The Bureaucracy as Pressure Group: The Bank of Canada and the 1967 Revision of the Bank Act" unpublished manuscript, p.4.

4 J.C.H. Jones and L. Laudadio, "Canadian Bank Mergers, The Public Interest and Public Policy," Banca Nazionale del Lavoro Quarterly Review, No. 105, June 1973, pp. 27-31.

5 J.C.H. Jones and L. Laudadio, op. cit., pp.6-7.

6 J.C.H. Jones and L. Laudadio, op. cit. p. 8.

7 Canada, Ministry of Finance, White Paper, p. 26

8 In 1978, Hon. Jean Chretien, Minister of Finance, introduced Bill C-57, "The Banks and Banking Law Revision Act, 1978". In 1979, Hon. John Crosbie, Minister of Finance, introduced Bill C-14 dealing with revisions to the Bank Act. In 1980, Hon. Allan MacEachen, Minister of Finance, introduced Bank Act as Bill C-6, which went into effect on December 1, 1980.

9 J.H. Perry, "Bank Act Revision 1980", The Canadian Banker and ICB Review, Vol. 87, No. 6, December 1980, p. 9.

10 The Royal Bank, Bank of Nova Scotia and Bank of Montreal favoured the incorporation of foreign banks in Canada, although these foreign banks would be subject to a different Bank Act and different regulations. For example, the Bank of Montreal advocated the Foreign Banks' Act, in which foreign banks would be subject to reserve requirements but limited in the number of branches established. In contrast, the Toronto Dominion Bank, and to a lesser extent, the Bank of Commerce, opposed the establishment of foreign banks in Canada. Notwithstanding the poor record of domestic bank formation, the president of the TD Bank stated that allowing foreign banks would "greatly reduce" the prospects for new, small Canadian banks (Toronto Star, October 6, 1977, p. C8)

11 Canada, Standing Committee on Finance, Trade and Economic Affairs, Bank Profits, (1982), p.24.

12 Canada, Department of Finance, The Regulation of Financial Institutions: Proposals For Discussion, (The Green Paper), (Ottawa: Supply and Services, 1985), p.35.

13 Canada, New Directions for the Financial Sector, (Ottawa, December 1986), pp. 11-17.

14 As of August 1, 1988, four of the five major chartered banks had acquired a securities brokerage subsidiary.

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APPENDIX ACanadian Bank Legislation: 1867-1982

The British North American Act of 1867 granted the federal government exclusive jurisdiction over currency and coinage, issue of money and promissory notes, banking and the incorporation of banks and saving banks. In order for a company to call itself a bank and carry out "banking", defined as "the acceptance of deposits that are transferable to third parties by cheque or similar instrument", the interested party required a special act of parliament - the granting of a parliamentary charter. These "chartered banks" were governed solely by federal legislation as set out in the various Bank Acts.

The difficulty of obtaining a parliamentary charter, capitalization requirements, and the legislation (ie. prohibition of real estate lending) of the early Banks Acts reinforced the monopolistic position of the established Canadian banks. Although a large number of parliamentary charters were granted, the increasing prominence of the "established" banks resulted in legislation that did little to encourage competition in this industry. The original Bank Acts were in fact debated by members of Parliament who were also bank officers and directors. In 1871, the first Bank Act was

primarily concerned with the promotion of bank stability. The lack of legislation which did little to encourage competition in the public interest set the tone for future Bank Acts.

Apparently, public figures did not feel that their close association with the banks posed any conflict of interest. George Hague, who in 1871 was the General Manager of the Bank of Toronto, commented on the drafting of the first Bank Act:

We were really a joint committee of Parliament and Banks ... set in conference, day by day discussing the clauses of the proposed Act one by one ... Many of the directors at the banks and several of the presidents were members of Parliament, some in the Senate, some in the House of Commons. These of course, sat with us from time to time.¹

Although subsequent Bank Acts were assented to by a less partisan legislature, with the introduction of the Canadian Bankers Association (CBA) in 1901, the established Canadian banks pursued a policy that reduced competition and thwarted regulation which would inhibit the banks' ability to earn profits. For example, the CBA was granted the power to veto the charter application of prospective banks. Furthermore, the aggressive policy of the CBA to have non-banks declared as such, and the CBA's efforts to lobby for legislation specifically in the banks' interest significantly affected the number of

competitors in the Canadian banking industry. The effect of the CBA on banking concentration cannot be overestimated. In 1895, there were more than 200 institutions which operated as "banks" in Canada. However, by 1914 there were only 26, and by 1961, with the merger of the Bank of Commerce and the Imperial Bank, only eight banks remained in Canada.²

Because of the CBA and the increased concentration in the bank industry, Canadian banks were better able to operate as a "tight cartel", in that action among the large Canadian banks could be co-ordinated to minimize both price, and non-price competition. For example, agreements made among the banks ensured that each institution paid a common rate on personal savings deposits and earned a minimum rate for personal and commercial loans. Competition in lending was further constrained by the formation of "no raiding" pacts; and, all banks agreed to levy the same service charges for personal chequing and current accounts, as well as maintain uniform hours of business at most branches. The concentration in the Canadian banking system has contributed significantly to the joint market power exercised by the major Canadian chartered banks.³

The Report of the Royal Commission on Banking and Finance (the Porter Commission) in 1964 was Canada's

response to similar investigations undertaken in Britain and the United States concerning the competitiveness and role of financial institutions in their respective economies. Since no such review had been prepared since 1933, the Porter Commission was charged to:

... enquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital market.⁴

The bulk of the Report was comprised of a review and assessment of the financial system encompassing banks and near banks. The Report was unique, however, in that it was the first to specifically examine the state of competition within the banking industry and provide a set of comprehensive reforms which could enhance competition within the financial industry. These proposals included:⁵

- a) Eliminating the 6 percent ceiling on bank loans
- b) Permitting the banks to hold conventional mortgages
- c) Reduction of banks' reserve requirements and permission for the bank to issue debentures (which carry no reserve requirements)
- d) Prohibition of interlocking directorships between banks and near banks
- e) Restricting bank ownership in near banks and other companies
- f) Prohibition of interbank agreements on interest rates and other charges
- g) More detailed reporting to be submitted

- h) Deposit insurance extended to near banks
- i) Foreign banks be allowed to establish agencies in Canada to engage freely in all types of banking activities except the acceptance of deposits
- j) New cheque clearing arrangements be set up with the Bank of Canada rather than the Canadian Bankers Association overseeing the settlement of balances
- k) That all business carrying on the business of banking be classified as a bank and brought under Federal control

An analysis of the Porter Commission recommendations suggests that instead of promoting competition in the Canadian financial sector, the recommendations served to further the banks' interest at the expense of the major financial competitors - near banks (trust and loan companies) and foreign banks. Although several recommendations explicitly addressed the need to change the oligopolistic behavior of banks (prohibition of interlocking directorships, restricting bank ownership in near banks, prohibition of interbank agreements on interest rates and other charges and the requirement for more detailed reporting), the recommendations did not include structural changes which would have encouraged competition by allowing for near banks to engage in commercial lending, or facilitate the entry of new banks by lowering ownership, chartering and capitalization requirements.

The "pro-competition" recommendations were partially

offset by several initiatives which would have effectively strengthened the oligopolistic position of the chartered banks. Despite the many proposals to limit the potential for price-fixing and other oligopolistic practices, there were also several proposals that would have further enhanced the profitability and market power of the banks. For example, the removal of the six percent ceiling on loans, combined with the banks' entry into mortgage markets, and the reduction in reserve requirements would have enabled the banks to increase revenues and lower their costs.

It was on the basis of these recommendations that the 1967 Bank Act was revised. In May 1967, Bill C-222, the 1967 Bank Act was passed into law by parliament and was proclaimed by the Minister of Finance, Mitchell Sharp, as a "Blueprint for competition" to achieve a more "competitive and flexible financial system".⁶ Of the eleven major Porter Commission proposals, the 1967 Bank Act implemented only the first eight (see Appendix B). These eight proposals aided the banks by: allowing them access to previously inaccessible markets, reducing bank reserve requirements, and removing the interest rate ceiling of 6 percent. In essence, these ratified proposals dealt with the industry's behavior rather than alter the underlying structure. The exclusion of the

remaining three proposals meant that foreign banks were exempted by the "25 percent rule" from operating in Canada. Also, the CBA still maintained control over the cheque clearing system; and near banks, under Provincial rather than Federal control, were denied certain "bank" privileges such as the right to participate in large scale commercial lending.

Between the time of the 1967 Bank Act and the 1980 Bank Act, the rapid expansion and profitability of Canadian chartered Banks sparked a number of inquiries about the state of banking. In 1976, the Economic Council of Canada published a report, Efficiency and Regulation, A Study of Deposit Institutions, which recommended that trust and loan companies be permitted to undertake commercial and consumer lending, and that foreign banks be allowed to operate in Canada.⁷ Similar conclusions were expressed in 1978 in another Royal Commission, the Royal Commission on Corporate Concentration, which stated that:

... the oligopolistic nature of competition among the banks makes it desirable to promote by whatever means are practical a greater ease of entry, into the business of banking itself, and a greater degree of competition between other financial institutions and the banks.⁸

Prior to the 1980 Bank Act, the government recognized the need to review the Canadian Banking

industry so as to promote greater competition within the financial sector. In 1976, the Minister of Finance released the White Paper, Canadian Banking Legislation, which provided the basis for the recommendations contained in the 1980 Bank Act. Such recommendations included the chartering of banks through letters patent rather than by parliamentary approval. For example, the need to hasten bank incorporation was made apparent with the establishment of the Bank of B.C. which waited four years for the issue of its parliamentary charter. Also, in recognizing the need to allow foreign banks into Canada, the White Paper proposed that foreign banks be permitted to operate on a basis equal to their Canadian counterparts; however, foreign banks were to be limited to 15 percent of total commercial lending.⁹

On the basis of the recommendations outlined in the White Paper, the 1980 Bank Act - Bill C-6 - became law. Revisions to the 1980 Bank Act were designed to ease barriers to entry into the banking system. These revisions allowed for the establishment of banks through letters patent rather than parliamentary charter. In addition, while the 1980 Bank Act permitted wholly-owned foreign bank subsidiaries in Canada to gain bank status, these foreign (schedule B) banks were initially limited to eight percent of total domestic assets (although this

limit was increased to 16 percent in 1983); and, the size of these schedule B banks was limited to paid-up capital of \$100 million - substantially below that of the major Canadian banks (in 1987, the capital stock of the TD bank, the smallest of the Big Five, was \$1.2 billion).

Although the 1980 Bank Act represented a move toward greater bank competition, it remains to be seen whether in fact the touted competition will emerge to challenge the dominance of the "Big Five". As early as 1982, the Standing Committee on Finance, Trade and Economic Affairs stated that:

Competition should be further increased by expediting revisions to the Trust Companies Act and the Loans Companies Act, to allow an expansion of lending powers in the consumer and business loan markets.¹⁰

It is, however, unlikely that significant amendments will be made with respect to banking legislation in Canada before the next decennial revision scheduled for 1990 (the last revision, due in 1977, was enacted in late 1980). Government initiative to enhance competition through the creation of schedule C banks as outlined in the Green Paper have been delayed, reflecting a recent instability in the financial sector and government concern about other macroeconomic issues such as the Canada - U.S. Free Trade Agreement.

In summary, although the two Bank Act revisions of 1967 and 1980 have encouraged some competition in the Canadian financial system, the revisions have not, contrary to industry and government claims, provided a "blueprint" for effective competition. Although the government stated in the 1976 White Paper that:

... effective and equitable competition
... remains the basic underlying
objective of the government in its
approach to banking legislation.¹¹

it appears that such legislation has done little to promote competition. The results of this thesis, therefore, suggest that the 1967 Bank Act increased the market power enjoyed by the five largest Canadian chartered banks, and that the 1980 Bank Act succeeded in only moderately encouraging competition within this industry.

FOOTNOTESAppendix A

- 1 Tom Naylor, The History of Canadian Business 1867-1914, (Toronto: Lorimer Press, 1975), p. 75.
- 2 W. Stewart, Towers of Gold, Feet of Clay (Toronto: Collins Publishers, 1982), pp. 50-51.
- 3 J.C.H. Jones, L. Laudadio, "Canadian Bank Mergers, The Public Interest and Public Policy," Banca Nazionale del Lavoro Quarterly Review, No. 105, June 1973, pp.13-18.
- 4 Canada, Report of the Royal Commission on Banking and Finance, (Ottawa: Queen's Printer, 1964), p. 569.
- 5 Grant Reuber, "An Evaluation of the Bank Act, 1967" Queen's University Conference on Monetary Issues (Kingston: Queen's University, 1975), pp. 11-17.
- 6 Ibid., p. 1.
- 7 Economic Council of Canada, Efficiency and Regulation: A Study of Deposit Institutions (Ottawa: Supply and Services, 1976), pp. 132-134.
- 8 Canada, Report of the Royal Commission on Corporate Concentration (Ottawa: Supply and Services, 1976), p. 248.
- 9 Canada, Department of Finance, White Paper on the Revision of Canadian Banking Legislation (Ottawa: Supply and Services, 1976), p. 22.
- 10 Canada, Standing Committee on Finance, Trade and Economic Affairs, Bank Profits, (Ottawa: Supply and Services, 1982), p. 24.
- 11 Canada, Department of Finance, White Paper, p. 16.

Appendix B: Major Reforms Introduced Under the
1967 Bank Act

In May 1967, Bill C-222 (1967 Bank Act) was passed into law. The important aspects of this bill included:

Section 91: Removal of the 6% ceiling on interest rate changes applied to loans. The ceiling was raised to 7 1/4% for 1967 and completely removed on January 1, 1968.

Section 75: Removal of restrictions in mortgage lending. The Banks were permitted to make conventional mortgage loans on real property up to a gradually increasing limit. No limit was applied to National Housing Association Mortgages.

Section 75(2): Limited ownership in the Chartered Banks. Maximum ownership was limited to 10% for any single person (or associated group), whether resident or non-resident. Furthermore, foreign ownership was limited to a maximum of 25% in total. Thus, Foreign owned banks were excluded from Canada.

Section 72: Cash reserves reduced from 8% to approximately 6 1/2% by requiring that after a transition period the banks hold a 12% cash reserve against demand deposits and a 4% cash reserve against time deposits.

Section 76: The chartered Banks were restricted to owning a maximum of 10% of the equity of a trust or loan.

Appendix C: Major Reforms Introduced Under the
1980 Bank Act (Bill C-6)

(a) Canadian Payments Association (CPA)

The Canadian Payments Association was established to provide a clearing system which would enable all deposit institutions to participate in cheque clearing and transfer. Although the board of the CPA was not dominated by the major banks, (of the 11 directors, 1 was appointed by the Bank of Canada, 5 from chartered banks, 2 from central credit co-operatives, 2 from trust/loan corporations and 1 from other financial institutions), the banks effectively controlled policy regarding penalties, budgets etc. through their control of day to day operations.

(b) Primary Reserve

The primary reserve requirement was reduced from 12% to 10% on demand deposits and from 4% to 2% on notice deposits. Reserves can now be kept in the form of deposits with other banks, and not solely with the Bank of Canada.

(c) Entry Into Banking

Bill C-6 facilitated entry into banking by allowing the interested party the option of chartering through letters patent issued by the Minister of Finance or incorporation via a private members bill by an Act of Parliament. Bill C-6 also distinguished between Schedule A and Schedule B banks. A Schedule A bank is a domestic bank where no shareholder can hold in excess of 10% of the voting stock. A Schedule B bank is a foreign bank subsidiary which incorporates as a Bank under the Bank Act, or a domestic bank in which one shareholder temporarily holds in excess of 10% of the voting stock.

(d) Foreign Bank Operations

Foreign bank subsidiaries were allowed to establish branches in Canada to openly engage in banking activities. However, their activity was heavily regulated. Foreign banks could only open a head office in Canada, additional branches require approval by the Minister of Finance. The average outstanding total domestic assets was limited to 8% of total domestic bank assets. Total domestic assets of foreign banks were limited to a maximum of 20 times the authorized capital.

(e) Mortgage Lending

Under Section 75 of the 1967 Bank Act, chartered banks were allowed to hold up to a maximum of 10% of their deposits and debenture liabilities in residential mortgages and could own no more than 10 percent of a mortgage subsidiary. Although the 1980 Bank Act still limited a bank's mortgage portfolio to the same 10%, the Act removed any ownership constraint on mortgage subsidiaries and allowed banks to wholly own mortgage subsidiaries.

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THE EFFECTS OF THE CANADIAN BANK ACTS OF 1967 AND 1980 ON
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APPROACH

Author_



ROBERT A. MALATEST

OCTOBER 1988

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