Canada's Financial System

THE FINANCIAL SYSTEM: SUPPORT FOR A MODERN ECONOMY

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DEPOSITS: THEIR LIQUIDITY AND THEIR RETURN

THE BUSINESS OF BANKING

REGULATION OF THE FINANCIAL SYSTEM

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The Financial System: Support for a Modern Economy

A financial system refers to the financial institutions and financial markets and the set of rules and regulations that affect how money circulates in the economy and make it easier to use money for its various purposes.

Our financial system provides an effective payments system. The efficiency of our financial system and its institutions (banks, trust companies, credit unions, and so on) enables billions of exchanges to occur each year among millions of people. The financial system helps the process of exchange in two key ways. First, our financial system makes it easier to exchange goods and services by enabling consumers to purchase goods and services using money that the system helps to provide and circulate. Consumers exchange money for goods and services by using cash that is circulated via the financial system. Producers willingly accept the money due to its widespread acceptance throughout the economy. Producers can use the money they receive to cover their costs and earn an income that enables them to purchase what they need and want. Money and the financial system greatly facilitate exchange by providing an effective payments system.

Now, you may say that money alone can do this. Why do we need a financial system? The second key way in which our financial system helps the process of exchange is by enabling the use of cheques. In an economy with only cash, all transactions have to be made in cash. That can be burdensome, as well as a little risky. Imagine carrying $10,000 in cash to buy a car, or $150,000 or more to buy a house. Financial institutions and a financial system overcome the problems and risks of dealing in cash. Cheques can be used to make many transactions, particularly larger ones, easier and safer. Instead of carrying $10,000 in cash to buy a car, you can carry a little piece of paper (a cheque) that can handle the transaction for you. Much easier. Much safer.

In addition to providing an effective payments system, the financial system acts as an intermediary, linking savers and borrowers and enabling current purchasing power to be transferred from one group to another.

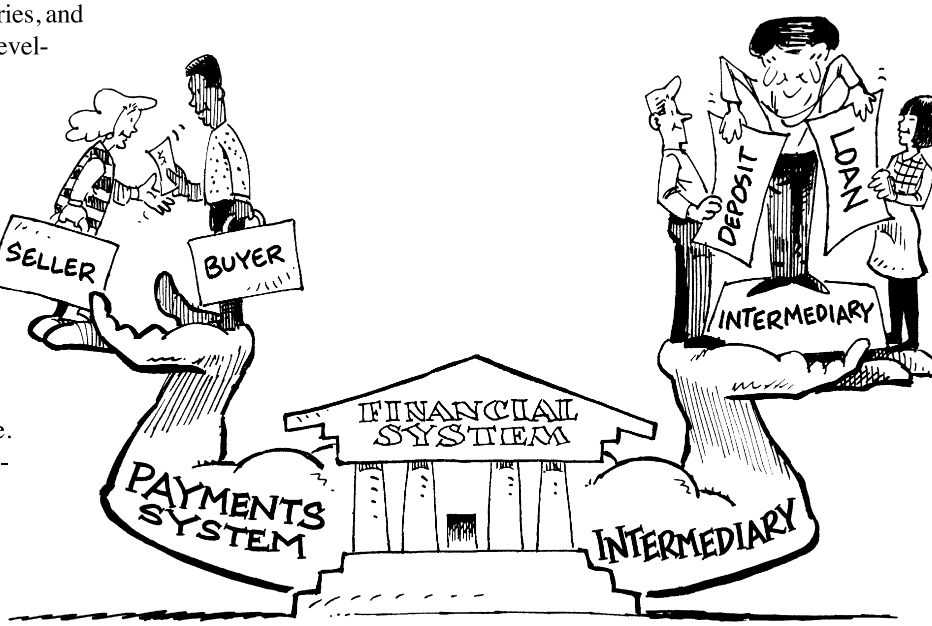
In a system without financial institutions and only cash, people might save their money in cookie jars, under mattresses, and so on. The funds being saved in the cookie jar or under the mattress aren't readily available to anyone in need of funds. Maybe a borrower could find someone, a friend, who might lend the money. But many borrowers would find it hard to get the funds they need. People wanting to borrow large sums of money—like many of today's companies and governments—would find it especially difficult.

Financial institutions, and a financial system, make it easier to link savers and borrowers. Today, it is possible for people, organizations, and companies to borrow large sums of money—thousands, millions, even billions of dollars. These funds represent the savings of those who do not require the funds today, and they are made available to borrowers by the financial system.

Why do savers and borrowers need to be linked, you may ask? Good question. The answer is that this link helps our economy to grow—to expand its ability to produce goods and services, create wealth for our society, and increase our standard of living. Funds not currently required for spending are deposited by savers at the various financial institutions. The financial institutions then use these funds to provide loans to those seeking funds for spending/investment purposes. By directing funds from those who currently don't need them to those who do, the financial institutions help to support investment and growth in our economy. Without these financial institutions and the loans they can provide, many investments could never take place. Much of our technology, plants, factories, and equipment would never be developed.

So our financial system helps our economy by (i) providing a payments system that facilitates the process of trade and exchange and (ii) linking savers with borrowers, thereby promoting investment, growth, and improvements in our standard of living over time. The financial system comprises a large number of different kinds of financial institutions that provide various services to the system.

Let's step back into history for one more brief moment to see how the whole idea of banks, a key component of our financial system, evolved.



The financial system assists our economy by supporting and facilitating exchange through a payments system and by serving as an intermediary between savers and borrowers.

The Evolution of Banking and Fractional Reserves

The use of money in an economy does not require the existence of banks. You've already seen that the use of money preceded banks by many, many years. The banking function evolved, however, to facilitate the use of money in the economy, particularly a large, complex, modern economy.

Modern banking had its origins in the activities of individuals such as the goldsmiths of medieval times who worked with, and shaped, gold. Because they worked with such a valuable commodity, goldsmiths tended to have good security systems to protect their gold. This security system was attractive to those who had valuables that they wanted placed in safekeeping. So people looked to goldsmiths to store their valuables. The goldsmith was paid a fee by the depositor, and the depositor was given a receipt that guaranteed the return of the item upon request.

The valuables that people deposited with goldsmiths for safekeeping included such things as gold bars and coins. The gold bars and coins were indistinguishable—one person's were just the same as any other person's. Depositors weren't concerned with getting back the specific bars or coins that they had deposited. They were only concerned about getting back the equivalent value in gold that had been deposited.

Fractional Reserves

During the period that the goldsmith provided this storage facility for valuables, the goldsmith's profit (the excess revenue earned from fees for deposit over the costs incurred by the goldsmith for protection) was quite small.

However, the goldsmiths became aware of an interesting phenomenon. Each week, as some depositors asked for their gold back, others brought more gold in for deposit. On an ongoing basis, new depositors provided enough gold to service the needs of those who wanted their gold back. It became apparent that a goldsmith didn't actually have to have on hand, at all times, all the gold that had been deposited. A great deal of gold was sitting there, idle, in the vaults.

The goldsmiths discovered that as long as they always had sufficient gold to meet the requests of those who wanted their gold back, they could lend out some of the gold to others who wanted to borrow gold.

So goldsmiths provided loans while holding on to only "a fraction of the gold deposits." This was the beginning of fractional-reserve banking. Over time, the goldsmiths became more and more knowledgeable about the levels of gold that they needed to hold in reserve. The larger the proportion of their deposits they were able to lend out safely, the more income they could earn from the interest they were able to charge on loans.

The goldsmiths counted on the fact that the loans would be repaid and that the inflow and outflow of gold would be relatively stable, or at least predictable. Should the goldsmiths ever be unable to provide people with their gold when they wanted it, the other depositors might quickly panic and come seeking their gold. This would generate a "run" on the goldsmiths' deposits and, without all deposits on hand, the goldsmiths could get into real trouble. Obviously, the goldsmiths had to develop skills in managing the gold deposits.

Modern financial institutions have taken on the role of storing and using people's savings, just as goldsmiths stored and used gold bars and coins. As such, they play a key role in our economy.

The Intermediary Role of Institutions

Interestingly, only about 10 per cent of deposits in financial institutions are in chequing accounts for the purpose of making current payments. The majority of funds are held on deposit as savings for future use. So although the financial system exists to provide an efficient system for making payments, on a relative basis, its intermediary function—transferring funds from savers to borrowers—is more significant. The majority of funds placed in accounts with financial institutions are being held, at least for a short while, as a store of value. These, along with some of the funds held in chequing accounts, can be made available for loans.

Although in these readings, we refer almost exclusively to banks due to their traditional special role in Canada's financial system, it is important for the reader to be aware of the other financial institutions (trust companies, credit unions, caisses populaires, and so on) and the roles they serve and will serve in the future.

People can keep the funds that they are saving in a variety of different forms. They can place the funds in a savings account or a chequable savings account (usually chosen for funds that are being stored for a relatively short period of time), in term deposits (for funds being stored for a longer period of time at a term fixed in days or years with a guaranteed rate of interest), in bonds (which are essentially IOUs to the bond purchaser whose funds are loaned directly to a government or business for a period of time at a fixed rate of interest), in stocks (which are a means of acquiring a share of ownership of a business), or in real estate.

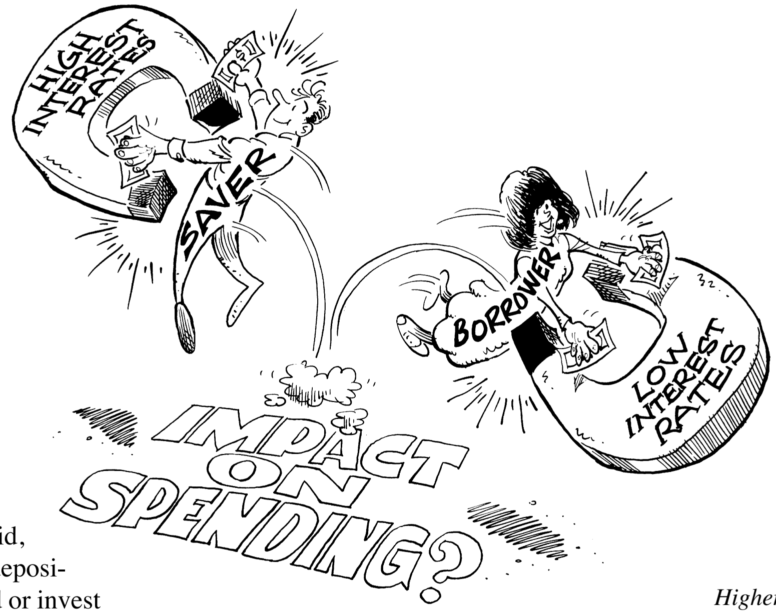
There are other ways in which people store funds as well. For example, people store funds in pension plans for use in retirement. People can store funds in a different way by purchasing some kinds of insurance policies (for example, whole life) for use when emergency situations arise or in the event of death or ill health.

In storing funds, people are postponing current spending and consumption. These stored funds, or postponed purchasing power, can be made available to others through the various institutions that make up the financial system. It should be emphasized that not all the savings funds that are channelled into investment go through financial intermediaries. An individual can invest directly in a company. A company can also use its own savings directly for investments. However, a significant amount of the savings that are channelled into investment in our economy are channelled through a financial intermediary.

The key to the financial institution's role as an intermediary is interest—the cost of using someone else's money. The rate of interest is a major determinant of what people will do with their funds. The quantity of funds saved and borrowed will vary as interest rates change. As a result, the flow of funds into and out of the financial intermediaries will be affected by interest rates. Similarly, the flow of spending in the economy will vary with interest rates.

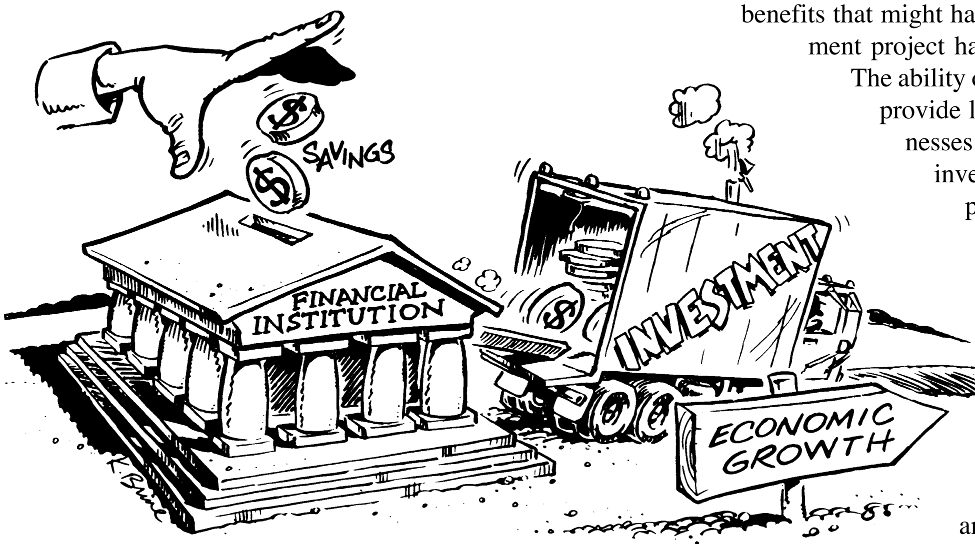
Today, financial institutions seek to increase people's deposits so that they have more to lend. To attract deposits from savers, they offer interest to depositors.

Rather than charging the depositors a fee to keep funds safe, as the goldsmith did, the financial institution pays interest to the depositor of savings so that the institution can lend or invest those funds. The borrowers of the financial institution's deposits will be charged a rate of interest higher than that which is paid by the financial institution to the depositor of the savings. The financial institution earns its rate of return on the spread (the difference between the two rates of interest). The saver gets interest as a return for saving. The institution gets a return from the higher interest rate charged to the borrower. And the borrower gets a return either in the satisfaction of a purchase (such as a car) or as a result of the return generated by the investment made with the borrowed funds. If all works well, everyone can end up with a satisfactory return through use of the funds. In this way, the institutions serve as effective intermediaries between savers and borrowers.



Higher interest rates tend to attract savers, whereas lower interest rates tend to attract borrowers. The decisions of savers and borrowers will have an impact on the level of spending in the economy.

For example, a business in Canada wanting to undertake a very large-scale project requiring millions and millions of dollars might be unable to finance the project with its own available financial resources. If no other funds were available for borrowing, the project would not proceed. The business might lose the opportunity for growth and development and improved performance. As a country, we would lose the investment and the jobs and other



benefits that might have resulted if the investment project had been able to proceed. The ability of the financial system to provide large-scale loans to businesses is one way in which such investments can proceed and potential benefits can be generated.

The importance of investment to an economy cannot be overemphasized. If we want our economy to grow, to be more efficient, to be more competitive, and to produce more output to improve the standard of living in Canada, investment must take place. And the financial system facilitates investment.

In our economy, then, postponed consumption is important for the long-term health of our economy. If all income earned was spent on current consumption, there would be no savings available for investment. Over time, our economy will need new and well-maintained roads, bridges, airports, and so on. Such things affecting our transportation systems, communication systems, water systems, and so forth are referred to as our economic infrastructure, and they will affect the productive capacity of our economy and its competitiveness. Such change and progress require investment, and a great deal of investment comes from postponed consumption channelled to borrowers through the financial system.

Table 3-1
Total Canadian dollar savings deposits in Canada, December 1993

	($ millions)
Chartered banks • personal savings deposits • non-personal term and notice deposits	$343,284
Trust and mortgage loan companies*	82,247
Credit unions and caisses populaires*	77,949
Life insurance companies	50,066
Government savings institutions*	6,786

*Includes both chequable and non-chequable deposits.

Source: Bank of Canada Review (Table E1)

The intermediary role of our financial institutions, which is so important, must be performed well. If it is not, there may be negative consequences for investment and for the economy. If the financial institutions do not manage the funds of depositors well, some of the savings may find their way into poor investments. Serving this intermediary role is no simple task. The more effectively financial institutions perform their intermediary role, the better the outcome is likely to be for our economy. We hope that most of the investments are good, productive investments.

As we mentioned earlier, there are various types of financial institutions involved in the financial system that supports our economy. This reading will tend to focus on the banks. But it is important to note that financial institutions were distinguished, historically, by the functions they served in the financial system. Banks had the primary responsibility for the payments system and the clearing of cheques and focused more on commercial lending. They served as an intermediary between savers and borrowers with respect to savings accounts and shorter-term deposits. Trust companies managed trust funds and invested them, accepted term deposits, and made funds available to borrowers more for mortgages than for commercial loans. Insurance companies received funds for the purposes of insurance protection and invested these funds in various assets. Brokerage firms, or investment dealers, served to bring lenders and borrowers together to facilitate transactions in equities (stocks) or bonds. In the past, each type of institution was quite restricted in the range of financial services that it was able to provide. The functions were so distinct that the four types of institutions were referred to as the four pillars of the financial system—banks, trust companies, insurance companies, and investment dealers.

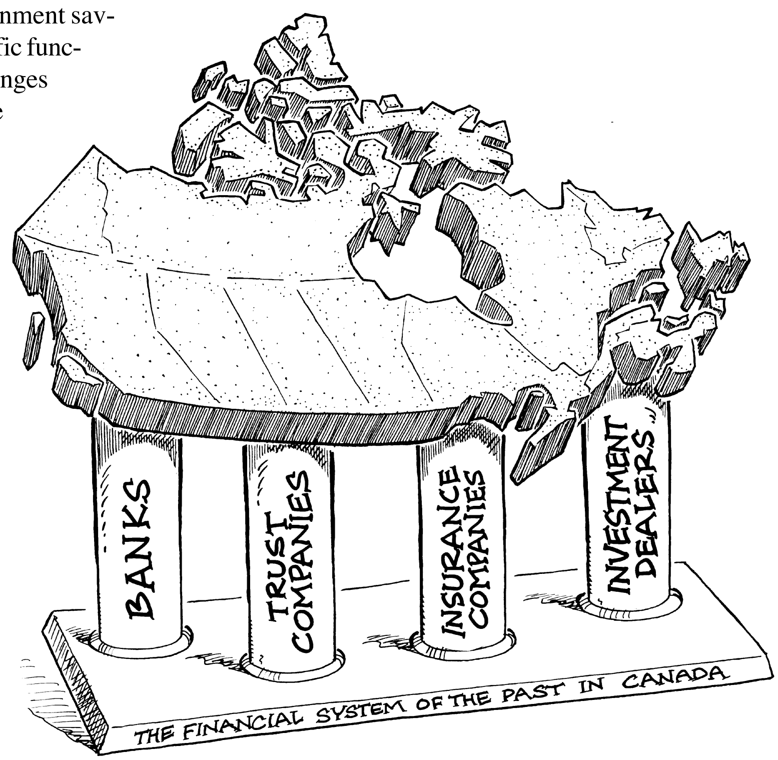
Table 3-2
Total Canadian dollar loans made by financial intermediaries in Canada, December 1993
(average of Wednesday, seasonally adjusted when necessary)

	($ millions)
• Household loans	$401,723
•mortgage loans (excludes mortgage-backed securities)	
•consumer loans	
• Non-financial businesses	210,220
•business loans	
•non-residential mortgages	
•leasing receivables	

Source: Bank of Canada Review (Table E2)

The other financial institutions—credit unions, caisses populaires, mortgage loan companies, government savings offices, and so on—also performed specific functions. In recent times, however, legislated changes and competitive pressures are affecting the nature of the operations of the various financial institutions. The reader should keep an ear to the ground for changes that may lead to major alterations in the structure and operation of Canada's financial system.

As a result of the changes that are occurring and of the new legislation governing financial institutions that came into effect in 1992, many institutions are becoming involved in a wide range of financial services beyond the ones to which they were limited in the past. For example, banks are increasingly involved in the investment dealer business through subsidiaries. Trust companies are functioning more like banks. And so on. It is possible that some day we'll be doing "one-stop shopping." That is, one institution will be able to provide all forms of financial services.



We have noted that there are different types of financial institutions, different types and forms of deposits, and a wide array of assets that can be acquired for investment/saving purposes. One factor that affects where people save money, the form of deposit they may choose, or the type of asset they might acquire as an investment is liquidity. Let's take a moment to examine this concept.

Deposits: Their Liquidity and Their Return

In economics, we say that money flows. It flows from one person to another as purchases are made. It flows from people and organizations to financial institutions as savings. And it flows from individuals and institutions to others for investment. For spending, saving, borrowing, and investing, money flows very easily. It is, therefore, said to have a high degree of liquidity.

It is important to understand the concept of liquidity and how the liquidity of different assets differs. If you hold money in cash or a chequing account, your funds are very liquid, that is, they are readily available.

However, if you store your funds by investing in real estate, those funds are not quickly and easily available for spending. To use those funds, you would have to sell or mortgage the property. This can be done, but it takes time. The funds held as an investment in real estate are much less liquid than cash—the funds aren't able to flow to you as quickly and easily.

Liquidity refers to how readily an asset can be converted to cash. Cash is obviously the most liquid asset. The liquidity of other assets varies depending on how quickly and easily you can convert them.

There is another aspect of liquidity to consider. If you have $2,500 in cash, you know that you have $2,500 in spending power. If prices rise, the purchasing power of that $2,500 may fall, but you will still have $2,500 in your possession. However, if you hold a piece of real estate, you are never exactly sure of its worth until you put it on the market and see what you can sell it for. So an asset's liquidity is also determined by its ability to be converted into cash on short notice at a known price. A Canada Savings Bond is an example of a highly liquid asset. It can be redeemed for cash at any time, and it retains (and usually increases) its value.

The question is, why give up liquidity by locking up your funds in term deposits for periods of time during which you are unable to obtain those funds? For example, if you invest in a five-year term deposit, you cannot access the cash for five years. Why might you give up your cash for five years? The answer is the potential rate of return. For example, if you deposit $1,000 in a savings account for one year at 6 per cent interest, at the end of the year you will have $1,060 (your original $1,000 plus $60 in interest). It might be that a five-year term deposit is providing an 8 per cent return. If you think you will not need the cash for five years, you might go after the higher interest rate. Of course, your decision will depend on where you think interest rates are heading and what options might become available to you over that five-year period.

The financial institutions tend to offer higher interest on funds deposited with them for longer periods of time. This enables the institution to lend or invest those funds for a predetermined period of time knowing that they won't have to return the deposit to you until the end of the term. Longer-term deposits also represent a greater risk to you, the depositor, because the further into the future we look, the less certain we can be of what will occur. Will interest rates be rising or falling? Should you go for 8 per cent now because rates may decline? And what about inflation and your expectations of inflation?

When prices, on average, are rising in an economy, we experience inflation. As prices rise, the purchasing power of each dollar tends to fall. That can affect a decision about whether to spend now or save to spend later. For example, if the rate of inflation is higher than the rate of interest being earned on deposits, the purchasing power of those stored funds will fall as time passes. In those circumstances, a person might decide to spend now rather than later when the purchasing power of the funds will be less. If a person decides to save funds rather than spend them now, that person will seek a rate of return that will protect the future purchasing power of the funds against inflation.

But just protecting your purchasing power from inflation might not be enough. Most savers will also seek a return over and above the rate of inflation. For example, if the interest rate being offered on a savings deposit is 12 per cent but inflation is 9.5 per cent, the real rate of return is 2.5 per cent. If the interest rate is 6 per cent but inflation is 1.5 per cent, the real rate of return is 4.5 per cent. You can see that a saver may in fact earn a higher real return from an interest rate of 6 per cent than 12 per cent, depending on the rate of inflation. If the rate of interest offered by financial institutions doesn't appeal to depositors, especially after the rate of inflation is taken into account, they will tend to spend their funds or store their funds in ways other than as deposits in financial institutions.

To encourage depositors to provide funds for the longer term, institutions will usually (but not always) offer higher rates of interest to recognize that the depositor is giving up liquidity and, perhaps, taking a higher risk, since the more distant future is more uncertain. Financial institutions offer a variety of deposit options that vary according to their term, their liquidity, and the rate of return (rate of interest).

The Bank of Canada, in conducting monetary policy, is quite interested in where funds are deposited in financial institutions. Are funds deposited into very liquid, quite liquid, or less liquid accounts? The reason the Bank of Canada is interested is because the more liquid the funds, the more readily they can be spent. And the level of spending, or possible spending, is an important concern for the Bank. It is important for the Bank of Canada to know the level of

Savers look for ways to protect the purchasing power of their saved funds and prevent inflation from eating away at their value.

total spending in the economy because it affects developments and trends in economic activity. For example, if you put funds into a three-year term deposit, you don't have current plans to spend those funds. However, if you place those funds in a chequing or chequable savings account, those funds are more easily available and could well be in your spending plans for the near future.

Banks and the Bank of Canada play key roles in our economy as major players in our financial system. Let's look at how the banks operate.

The Business of Banking

Banks operate as businesses and, as such, aim to make a profit. The profit earned by the banks can be used in the same ways as the profit of any other business. It can be reinvested, saved for reinvestment in the future, or distributed to shareholders—the owners of the bank. Canadian banks are owned by shareholders. The shareholders receive a share of the profits, which are distributed as dividends. (In fact, hundreds of thousands of Canadians hold shares of Canadian banks.)

Since shareholders receive a share of the profits, they are concerned naturally with how well the bank performs as a business and how well it generates profits and develops effective plans for the future. A bank's overall performance will be determined by the deposits it receives and the decisions it makes about the use of those deposits for loans and investments. Banks have to decide what to do with the various types of deposits they receive. If they leave all the deposits sitting in their vaults, they will soon go out of business since they will be paying interest to depositors while earning nothing in return.

In managing their deposits, banks will allocate their deposits in three general areas:

- as cash reserves in the bank's vaults or deposits with the Bank of Canada. Some of these funds are held to cover day-to-day needs for cash, and some are held for precautionary reasons to cover potential, unforeseen needs. For many years, some were held to meet reserve requirements. These reserve requirements were gradually phased out and were totally eliminated by July 1994. However, although requirements have been eliminated, banks will still need to maintain some cash reserves at the Bank of Canada for settlement purposes, which we'll learn more about in a moment.
- as highly liquid assets such as treasury bills, which earn interest but are quickly convertible to cash if the bank should find that it has additional cash needs. (Treasury bills are issued by governments as a way of borrowing funds for relatively short periods of time, for example, 91 days, 182 days, 364 days, and so on.)
- as less liquid assets such as commercial, consumer, and mortgage loans, which return a higher rate of interest to the bank but are less easily converted into cash and represent greater risk.

To carry out their function of providing an efficient payments system, the banks have to hold on to some funds in a very liquid form, as we noted, for day-to-day business should some people want all or part of their deposits back. Banks hold sufficient funds in this form for depositors to feel confident that they can always get their funds back when and if they need them. The decisions made by banks about the quantity of very liquid assets to hold in reserve

Table 3-3
Deposits at domestic banks

Name	Deposits[1] ($ millions)	Market Share[1] (per cent)
Royal Bank of Canada	$132,690.0	24.9
Canadian Imperial Bank of Commerce	113,492.0	21.3
Bank of Montreal	88,497.0	16.6
Scotiabank	79,981.0	15.0
Toronto Dominion Bank	74,249.0	13.9
National Bank of Canada	34,770.0	6.5
Laurentian Bank of Canada	9,219.1	1.7
Canadian Western Bank	538.6	0.1
Total [2]	$533,436.7	100.0

1. As at January 31, 1994.
2. Totals may not be exact due to rounding.

Source: The Canadian Bankers Association. Domestic Banks' Financial Results, First Quarter, 1994. March 1994.

are determined by a variety of factors. For example, during the Christmas season, people tend to withdraw funds and spend more. The banks will need to have a higher quantity of liquid assets available at such times, although these periods of time are very short.

Another factor affecting the quantity of very liquid assets held by the banks is a little more complicated. It concerns the mismatch that may exist with respect to the maturity dates of the bank's assets (loans and investments) and liabilities (what is owed to depositors). For example, if five years ago a depositor put a quantity of savings in a five-year term deposit, that deposit represents a liability of the bank that is now payable to the depositor. The bank has to give the funds, plus the final year's interest, back to the depositor. (Interest will have been paid annually over the previous four years.) If five years ago the bank had invested those funds in an asset with a seven-year term, then those funds would not now be available. Other deposited funds will have to be used to repay that depositor. It is important that the banks monitor closely the terms of all their deposits and other liabilities. The quantity of very liquid assets that the banks will have to hold will be affected by the maturing dates of their assets and liabilities and the quantity of funds required to pay back depositors whose term deposits are coming due.

But, as we noted, not all the banks' deposits need to be held in highly liquid form in order for them to conduct their operations and serve the ongoing needs of depositors. Recall, once again, the goldsmiths who found that they only needed to hold on to a fraction of the deposits and that they could lend/invest the rest.

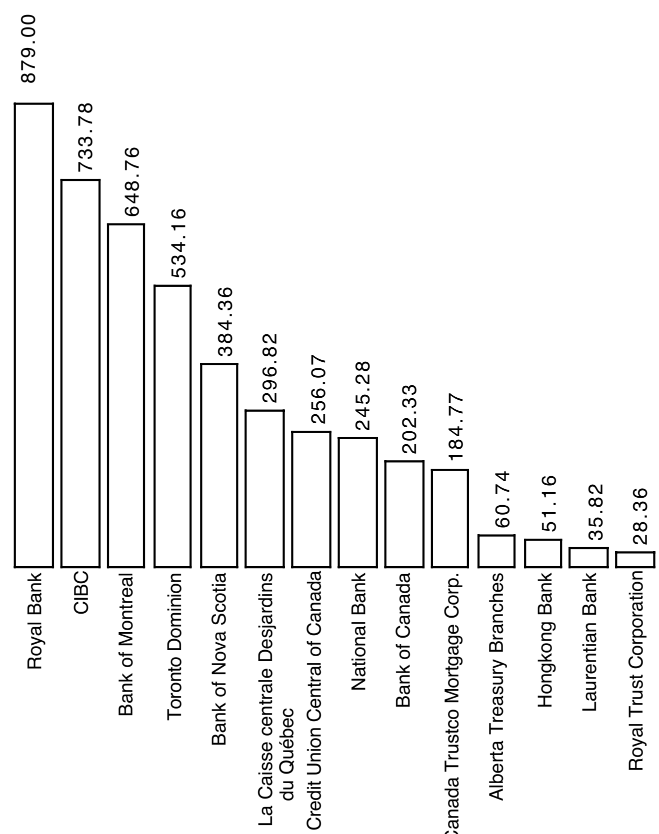
Another reason why the banks don't have to hold on to all their deposits as currency is because the vast majority of payments are made not in cash but by cheque. All the cheques that are written on a given day on chequing accounts held at the Royal Bank may be deposited in the Royal, the Bank of Montreal, the Toronto Dominion Bank, the Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, the National Bank, or other institutions.

Simultaneously, cheques are being written on accounts at these institutions and deposited in accounts at the Royal and elsewhere. At the end of the day, all the cheques are accumulated and totalled. The process of tallying all transfer instructions (for example, cheques) and determining the net positions of each institution is referred to as the process of clearing. Only the net quantities of funds will have to be transferred among banks, and the reconciling of the actual accounts is referred to as the process of settlement. But, as we will see, funds don't actually need to be physically transferred for settlement purposes.

Let's suppose that, on a given day, cheques totalling $60 million were written on chequing accounts held at the Royal Bank and made payable to account holders at the Bank of Montreal. During that same day, cheques totalling $55 million were written on Bank of Montreal accounts made payable to account holders at the Royal. How are the accounts between these two banks settled? Appropriate adjustments would be made to the respective position of each bank in the Bank of Canada's books. The books would be altered and, on net, $5 million in funds would be moved from the Royal Bank's deposits (settlement balances) at the Bank of Canada to the Bank of Montreal's account. In fact, no funds are actually moved. The Bank of Canada simply alters its records in the process of settlement.

So on a day-to-day basis, the banks only need to hold a relatively small portion of all their deposits in the form of deposits at the Bank of Canada and as currency to service the needs of their depositors. Once sufficient funds are held in liquid assets, the rest of the deposited funds should be put to work (as loans or investments) to earn higher rates of interest in order to cover the bank's costs and earn a profit for the bank—a sufficient profit to please the bank's shareholders. In order to maximize the potential for profit, banks will try to hold as low a level of liquid assets as is prudent. And we hope that the actions of the banks to put these deposited funds to work will help to promote growth and development in our economy.

Graph 3-1
Annual national clearing volumes by direct clearer
for year ending March 31, 1994
(volumes of receipts plus deliveries in millions)



Total clearing volumes exchanged through the CPA-operated Automated Clearing Settlement System (ACSS) measured as both receipts and deliveries totalled 4,691.35 million, as compared to 4,435.80 in 1992/93. Direct clearers accounted for 5,541.41 million or approximately 97% of the total volume in 1993/94. The bar chart illustrates the volumes accounted for by each direct clearer. These volumes include receipts and deliveries for own and non-CPA-member accounts. Member indirect clearers accounted for 149.94 million or approximately 3% of the total clearing volume.

Source: Forum (Canadian Payments Association), June 1994.

The Costs of Running a Bank

But what costs does a bank incur? We know that a bank incurs a cost for the funds held as interest-bearing deposits. That is, a bank has to pay interest to depositors. In addition, a bank faces costs such as salaries for employees, property expenses, advertising, branch operations, and taxes. And each bank must pay its share of the costs of operating the payments system. In other words, banks face most of the normal operating costs that other businesses face.

Another potential expense for a bank is the allowance for possible losses on loans. A bank makes a loan on the assumption that it will be repaid. Extensive checks are done on a borrower before the bank provides a loan in order to try to ensure the loan will be repaid. But sometimes borrowers can't meet their payments. For example, some loans made by Canadian banks to certain companies have been put in jeopardy because of difficult economic times or problems the companies have encountered. Examples are the loans made by banks to real estate companies in the 1980s. Many real estate companies experienced difficulties in the early 1990s due to the fall in real estate prices/values. This prevented some from paying the interest on their bank loans and, in some cases, prevented them from repaying the principal (the actual funds borrowed).

If such a company can recover, then the banks will be repaid in the future. However, if the economic problems of the company continue or worsen, there is a risk that the loan will never be repaid. The banks have to allow for the possibility of such losses and make allowances from their earned income to cover their potential loss. These arrangements are usually referred to as loan loss provisions. Most banks have had to make significant loan loss provisions in recent years due to large loans extended to companies and countries that have experienced economic hardship. The loan loss provisions reduce the income of the banks and offset part of the returns that were earned on other assets of the banks.

These loan loss provisions are an important consideration for the banks. Let's suppose that in 1990, Bank X loaned $100 million to a company that subsequently appeared unlikely to repay those funds because of economic troubles. Before making a loan loss provision, Bank X would be showing an asset of $100 million on its books and financial statements that it was now unlikely to realize. That $100 million overstates the value of Bank X's assets because the bank stands a good chance of losing all or part of that $100 million.

It may not be necessary for the bank to make the entire loan loss provision all at once. Bank X may have allocated $50 million in loan loss provisions in each of 1990 and 1991. In this way, it would have covered the potential loss of the $100 million loan. Bank X's profits in 1990 and 1991 would have been lower (or it might even have shown a loss), but the long-term health of Bank X would be better, and its books and financial statements would now accurately reflect its asset position. In essence, Bank X would have written down the value of the loan to zero. Should the company ever repay all or part of the $100 million, Bank X's profit in the future would be improved.

In general, the greater the risk to a bank's loans, the larger the amounts that the bank will set aside as loan loss provisions.

We've looked at the variety of costs that banks incur in serving their functions in the financial system. But banks also earn income. Let's take a closer look at this side of the banking business.

Table 3-4
Provision for loan losses
(total chartered banks, millions of dollars)
1983–1993

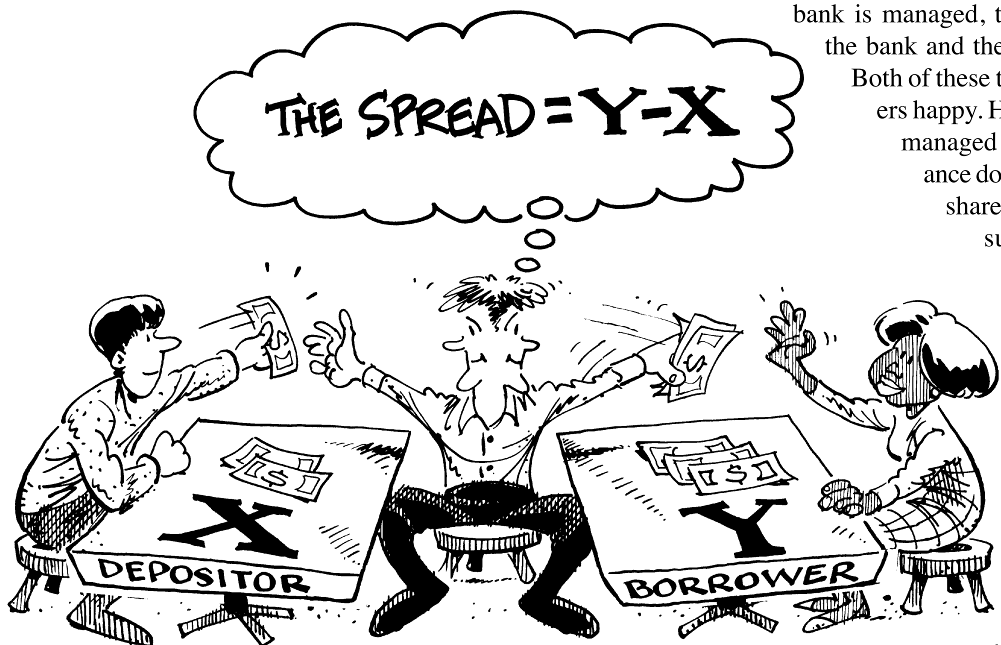
1983	$1,784.4
1984	2,043.1
1985	2,390.1
1986	3,143.7
1987	2,993.0
1988	2,618.2
1989	5,263.2
1990	1,980.1
1991	3,227.6
1992	7,098.9
1993	5,407.9

Source: Bank of Canada Review (Table K2, Spring 1994)

The Income Side

Banks aim to earn income on the spread, which we learned earlier is the difference between the interest rate they pay to depositors and the interest rate that they charge to borrowers. But that's not the only way in which the banks can earn income. Banks earn income from foreign exchange commissions and a number of other fee-earning services such as cheque processing and providing safety deposit boxes. Banks also invest in assets such as bonds and treasury bills that pay interest.

If a bank's total revenue exceeds its total costs, it earns a profit, which is the primary goal of shareholders. A person who buys a share of a business such as a bank usually does so for one reason, and that is to earn a share of the profits either in the form of dividends paid out or capital appreciation from an increase in the share price. Generally, the better a bank is managed, the higher the profit of the bank and the higher its stock price. Both of these tend to make shareholders happy. However, if a bank is not managed well and if its performance doesn't meet expectations, shareholders may exert pressure for changes in the bank's management.



Financial institutions lend funds out at higher rates of interest than they pay to depositors and cover some of their costs (and earn some of their profits) from this "spread."

Because they handle such massive quantities of funds in the Canadian financial system, banks have to be managed well or the consequences could affect large numbers of Canadians—not just shareholders. We would all pay a price if our payments system broke down or if there was significant mismanagement of investments and deposits by the banks. Problems in the U.S. financial system have shown how important it is for financial institutions to be well managed. Over the course of the 1980s, many U.S. savings and loan companies made large risky or questionable loans. In the late 1980s and early 1990s, many of these institutions failed. The deposit insurer is bailing out these institutions by paying depositors their lost funds. These funds will largely come from U.S. taxpayers, and the cost is in the many billions of dollars.

Managing the financial affairs of a bank or other financial institution is a significant challenge and an important responsibility. Public confidence is essential. The financial statements of banks are made public, and poor performance could rock the public confidence that is so important to a financial system.

Let us take a moment to see how the Canadian financial system is regulated. We'll also learn about the protection that is provided to Canadian depositors.

The Bank Act and the Superintendent of Financial Institutions

The activities of Canadian banks are governed by rules and regulations outlined in the Bank Act.

The Bank Act governs how a bank can be established, the capital that is required by a bank, the qualifications of directors, the duties and responsibilities of directors, how mergers and amalgamations are carried out, the distribution and transfer of shares, the financial reports that a bank must present, the type of business that a bank can conduct, and so on.

The Bank Act is revised approximately every ten years to keep up-to-date with changes and developments in our economy and the financial system. During the course of revisions, the Bank Act is examined by committees of the House of Commons and the Senate. Evidence is also heard from officials of the Bank of Canada, the Department of Finance, bankers, economists, business people, consumer organizations, and other interested parties. After intensive review, alterations may be made to the Bank Act that can affect Canada's financial system and how it operates.

The Bank Act provides a direct link between the banking industry and the Minister of Finance. The Superintendent of Financial Institutions, who is appointed by the government, has the responsibility to monitor federally chartered financial institutions by regularly inspecting them to ensure that they are abiding by the provisions of the Bank Act. It is also the duty of the Superintendent to monitor the financial status of the banks to ensure that each is in a sound financial position.

All banks function on the basis of public trust and confidence. We saw in the previous background reading that it took some time for banks to gain public trust and confidence. Until that public trust was gained, banks couldn't function. Today, people place their deposits in a financial institution because they have confidence in that institution's ability to manage its affairs responsibly. They are confident that their deposits will be well cared for and that they will be returned in full as needed or when agreed upon.

If people lose confidence in a bank and question how it is managed or whether they will get their deposits returned, the bank is heading for trouble. If there is a general loss of confidence in a bank, there may be a run on the bank during which many depositors quickly seek to withdraw all their deposits.

Since a bank invests most of the deposits that it receives in commercial loans and mortgages, a run on the bank can mean the bank will have trouble giving people back their deposits. These liquidity problems may lead to a situation where the bank has to seek funds from the central bank, which acts as a lender of last resort. The Bank of Canada can provide loans at such a time—but only if the bank is solvent. If the bank's assets (the value of its loans and investments) are less than its liabilities (what it owes to depositors), the bank would not be solvent, would cease to be a viable financial institution, and would fail. The Bank of Canada will not provide funds to an insolvent bank (one whose liabilities exceed its assets). The bank would fail under these circumstances. Moreover, the failure of an individual financial institution may have significant repercussions if it raises doubts in people's minds about the viability of the entire financial system.

The key to a bank's solvency or strength is the value of its assets relative to the value of its liabilities. If a bank is short of cash, but is otherwise sound with good investments and asset holdings (that is, solvent), the Bank of Canada could lend the bank, in return for collateral, sufficient funds to see it through a difficult period. This would enable the bank to avoid bankruptcy and collapse, cover its needs in the short run, and take steps to stabilize itself and regain the public's confidence in its future. However, if the bank is deemed to be insolvent, then the Bank of Canada will not lend it the needed funds, since lending to an insolvent institution will not solve the problem of that institution.

Existing Canadian financial institutions have large asset holdings that exceed the amount that they owe depositors. An institution's assets minus its liabilities is called its capital, and Canadian banks have significant amounts of capital. Most Canadian financial institutions also have a history of being extremely well managed. However, if things should go wrong for an institution, all is not lost for the depositors, as we shall now see.

Canada Deposit Insurance Corporation

The reader should be aware that, since 1967, Canadians' deposits have been insured by the Canada Deposit Insurance Corporation (CDIC). Currently, the maximum coverage is $60,000. This means that if a financial institution should ever go bankrupt, the depositor would receive his or her money back up to the amount of $60,000. That is only partial consolation to a depositor who has deposited more than $60,000 with a single institution, but it is some protection. (It is worth noting that there are limits as to what constitutes an insured deposit; for example, it must be denominated in Canadian dollars, be for a term of five years or less, and so forth.)

It is interesting to note that in the case of the collapse of the Northland and Canadian Commercial Banks, which failed in the 1980s and were the first banks to fail in sixty years, all depositors got 100 per cent of their deposits back—even that above $60,000. This was a move to help restore confidence in the banking industry. Also, Canadian public officials had gone on record, prior to the collapse of the banks, stating that the Canadian Commercial Bank was solvent. Furthermore, by leaving the Northland Bank open for business, officials conveyed the impression that it, too, was solvent. When the two banks collapsed, the government accepted part of the responsibility for having possibly led people to leave their funds on deposit at the banks when they otherwise might have withdrawn them. This unusual set of circumstances led Parliament to conclude that it would be appropriate to return all deposits.

So Canadians can be comforted by the knowledge that our financial institutions are relatively healthy and some insurance protection is available to deposits. But our institutions must continue to be well managed, and depositors should monitor the performance of the various institutions. And, because not all deposits and investments are insured, depositors should take care to ensure they know which deposits/investments are insured and which aren't.

This brings us to the end of our introduction to Canada's financial system. We have seen that the financial system provides an efficient system for payments and serves to link savers and borrowers, which enhances investment, growth, and development in the economy.