Recent developments for Canadian 'near banks'

By Philip F. Bartholomew

CANADIAN depositories experienced difficulties in the early 1980s not unlike those experienced by banks and thrifts in the United States. Because of these problems, regulators of depositories were restructured. Near banks (thrifts) emerged as viable competitors.

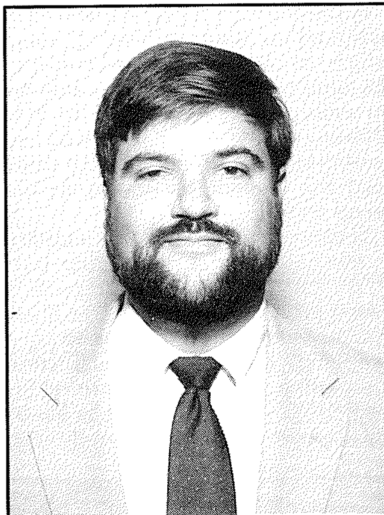
Depository institutions, which were quite stable and prosperous in the years following Word War II, began to run into difficulties in the late 1970s. Failures mounted as economic conditions changed, rates rose and mismanagement occurred. The national deposit insurance corporation started running deficits; the government studied matters in an effort to cope.

Is this a description of the U.S. thrift industry? Yes, but it is also a description of the Canadian financial services industry. While Canadian depositories experienced problems similar to those in the United States, the difficulties for Canadian depository institutions appear to be past. The chartered bank industry has consolidated to a few very healthy institutions (although the chartered banks' exposure to the debt of Third World countries is still not fully addressed).

The trust and loan and mortgage loan companies have also consolidated. Canada's co-operative societies suffered similar problems to those experienced by other depositories, but they continue to adapt to a changing financial environment and remain an important competitor for retail financial services.

Chartered banks

Until recently, the Canadian banking, insurance and securities industries were kept separate. There are four types of financial institutions — chartered banks, near banks, insurance companies and securities dealers — known popularly as the four pillars. Although the distinctions among the four types are eroding, many traditional and legal differences persist, and Canadians remain generally opposed to the commingling of financial with non-financial institutions.



Because of Canada's geography, the chartered banking business, the largest of the four financial industries, was allowed to become highly concentrated. As of the end of 1987, there were only 11 domestically owned chartered banks, of which six are very large institutions that operate extensive branching networks.

To counterbalance the negative aspects of such concentration, Canada has two important legal restrictions. First, chartered banks must obtain their charters through an Act of Parliament. Second, domestically owned chartered banks must be widely held (no more than 10% may be owned by a single individual or organisation).

The notions of chartering and wide ownership are crucial to understanding Canadian preferences in the trade-off of efficiency, safety and competition as it applies to financial institutions. Canadians prefer to regulate, and to administer regulations, more through the honour system than through active supervision. But because of recent difficulties in the depository institutions' industry, and because of a market-driven trend toward commingling of financial institutions, Canadians are reluctantly being forced into creating a system that requires more active supervision.

Domestically owned chartered banks are called Schedule A banks, and foreign-owned chartered banks are called Schedule B banks. (Currently, the only Schedule B banks operating are subsidiaries of foreign banks.) Foreign banks were permitted entry in 1980, but are subject to special capital and asset regulations that are more restrictive than those for Schedule A banks. At the end of the third quarter of 1988, there were 58 Schedule B banks controlling almost 12% of bank assets.

Near banks

There are three other types of Canadian depository institutions besides the chartered commercial bank. These are collectively referred to as near banks, and they resemble US thrifts. The three types are trust and loan companies, mortgage loan companies (also known as loan com-

panies) and co-operative societies (credit unions and *caisses populaires*).

Although chartered banks appear to dominate Canadian depositories in assets (66% of the industry total in 1988), examination of the deposit market better reflects the importance of the near banks. In 1988, chartered banks held 52% and near banks held 48% of total deposits (*Table 1*). In comparison US commercial banks held 57% of the nation's deposits in 1988. Other US depositories (thrifts and credit unions) held 43%.

Canadian near banks developed to satisfy the demand for consumer savings and mortgage lending services, which chartered banks had traditionally ignored. After World War II, chartered banks began to concern themselves more with consumer financial services.

Trust and loans were closely associated with chartered banks until the Bank Act of 1967 limited chartered bank ownership of a trust company to 10% of the voting shares. Since the 1960s, trust and loans have been providing consumer savings and mortgage credit. By the 1970s trust and loans had become a major competitor of the chartered banks for consumer financial services.

Mortgage loan companies were originally patterned after British building societies (as were US savings and loan associations), but they have evolved into mortgage lending subsidiaries (either wholly or jointly owned) of chartered banks, trust and loans, and other financial institutions.

The Canadian co-operative society movement was strongly influenced by the US credit union movement. This movement (and the now non-existent savings bank industry) started in French-speaking Canada — primarily in Quebec. *Caisses populaires* were organised along parish lines and were established principally to foster savings. Credit unions developed as non-French-speaking co-operative societies and were formed to serve the needs of small borrowers.

Table 1
CANADIAN DEPOSITORY INSTITUTIONS
(Third Quarter 1988)

Depository Institution	*Total Deposits (Millions of C$)*	*Percentage of Total*	*Total Assets (Millions of C$)*	*Percentage of Total*
Chartered Banks	233,693	52.4	490,994	66.1
Trust & Loan Companies	90,093	20.2	101,487	13.7
Mortgage Loan Companies	71,262	16.0	90,832	12.2
Co-operative Societies	50,891	11.4	59,864	8.1
TOTAL	445,939	100.0	743,177	100.0

Source: Chartered bank and co-operative society data from Bank of Canada. Trust & Loan and Mortgage Loan data from Statistics Canada.
Note: Canada also has a system of small federal and provincial government savings institutions. In 1986, these institutions held $5 billion or 2% of all deposits in Canada.

Residential mortgage market

In 1988, depository institutions held 87% of outstanding residential mortgages (*Table 2*). Life insurance companies and other non-depository financial institutions held the remaining share. The depository-institution share of this market has been increasing since the 1950s (in 1978, their share was 75%). This increasing penetration was due primarily to increased mortgage activity by chartered banks.

Before 1954, chartered banks were prohibited from making mortgage loans. As a result of the Bank Act of 1954, and revisions of the National Housing Act (NHA), chartered banks were permitted to hold NHA mortgages. The Bank Act of 1967 permitted chartered banks to make conventional residential mortgages, but in an amount not greater than 10% of their holdings of domestic deposits. This restriction still applies and is the principal reason for the chartered banks' use of subsidiary mortgage loan companies. The Bank Act of 1980 forced all mortgage loan company subsidiaries of chartered banks to become wholly owned subsidiaries of the parent banks.

Mortgage instruments

There are two types of residential mortgage in Canada — conventional and NHA (government-guaranteed)

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Table 2
CANADIAN RESIDENTIAL MORTGAGE MARKET
(Thousands of Canadian dollars)

Type of Institution	*1978*		*1988*	
	Outstanding Residential Mortgages	*Per cent of Total*	*Outstanding Residential Mortgages*	*Per cent of Total*
Chartered Banks (Note 1)	18,438	27.7	75,218	40.8
Trust & Loan and Mortgage Loan Companies	21,590	32.4	57,340	31.1
Co-operative Societies	9,888	14.8	26,896	14.6
Life Insurance Companies	7,086	10.6	12,997	7.0
Other Financial Institutions	9,622	14.4	11,938	6.5
TOTAL	66,624	100.0	184,389	100.0

Source: Bank of Canada
Note: Totals may not add properly due to rounding
Note 1: Includes mortgages held by bank mortgage loan company subsidiaries

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mortgages. Currently, there is no well-developed secondary market for residential mortgages; however, the government is trying to nurture one.

The Canada Mortgage and Housing Corporation (CMHC) is a Crown corporation charged with administration of the NHA. It both directly issues mortgages and governs and insures NHA mortgages made by qualified financial institutions. In 1961 the CMHC was ordered to sell a portion of its directly issued NHA mortgages to foster the development of a secondary mortgage market; however, few mortgages were sold even though CMHC was authorised to be a lender of last resort to institutional holders of NHA mortgages. In December 1986 CMHC successfully introduced a mortgage-backed securities programme. These securities have been well-received by securities dealers and investors; a secondary mortgage market may now develop. Also the introduction of these mortgage-backed securities may foster the offering of longer-term mortgages.

Mortgage instruments in Canada, unlike those in the United States, are short term. In the 1970s the term to renewal averaged five years, although the amortisation was for a longer period. At the end of the term to renewal of the mortgage, the borrower could pay off or refinance the remaining principal. These "roll-over" mortgages were, in effect, adjustable-rate mortgages. However, the rate and other conditions of the loan could be amended at the end of the term to renewal.

In the early 1980s additional versions of the rollover mortgages were introduced to address higher interest-rate levels and rapidly increasing property values. A graduated-payment mortgage was developed that allowed the monthly payment to be initially low and increase over the amortised life of the loan.

Changes were made to the rollover mortgage so that renewable-term mortgages could have rollover terms as short as six months. Variable-rate mortgages were also created that had fixed monthly payments and regular adjustments to outstanding principal based upon interest rate fluctuations.

Table 3
ASSET AND LIABILITY STRUCTURES
(Third Quarter 1988)

	Trust and Loan Companies		*Mortgage Loan Companies*	
Liabilities	*Millions of Canadian Dollars*	*Per cent of Assets*	*Millions of Canadian Dollars*	*Per cent of Total*
Savings Deposits:				
Checking	9,153	9.0	19,772	21.8
Other	13,768	13.6	6,187	6.8
Total Savings Deposits	22,921	22.6	25,959	28.6
Term Deposits:				
Less Than 1 Year	8,016	7.9	3,180	3.5
1-5 Years	39,593	39.0	41,804	46.0
More Than 5 Years	150	0.1	9	0.0
Other	19,413	19.1	311	0.3
Total Term Deposits	67,172	66.2	45,304	49.9
Bank & Other Loans:	1,441	1.4	3,395	3.7
Other Liabilities:	5,119	5.0	12,428	13.7
Total Liabilities	96,653	95.2	87,086	95.9
Shareholders' Equity:	4,834	4.8	3,746	4.1
Total Liabilities and Equity	101,487	100.0	90,832	100.0

Source: Statistics Canada

Performance of loan companies

Trust and loan and mortgage loan companies are similar in their asset and liability structures (*Table 3*). Trust and loans hold a higher percentage of assets in liquid and security forms than mortgage loan companies, which are typically associated with other financial institutions. This explains the higher holdings of mortgage loans relative to other assets by mortgage loan companies. Both types of institution engage in non-mortgage lending, but mortgage loan companies are prohibited from extending business loans unless they finance real estate.

Mortgage loan companies receive a high percentage of funds from non-deposit sources — principally, loans from banks and other institutions associated with the companies. Both types of institution hold about the same percentage of term deposits relative to total assets. Trust and loans have developed extensive checking and regular savings services.

Near bank regulation

Near banks are regulated by either federal or provincial agencies or by both. For example, federally chartered trust and loan and mortgage loan companies are supervised by the Office of the Superintendent of Financial Institutions (OSFI), which was created in 1987 through the merger of the Office of the Inspector General of Banks, or OIGB (which supervised chartered banks), and the Department of Insurance (which supervised federally chartered trust and loan, mortgage loan, and insurance companies). Provincially chartered institutions are supervised by the provinces in which they are incorporated.

Federal and non-Quebec provincial institutions subscribe to deposit insurance from the Canada Deposit Insurance Corporation (CDIC), which was established in 1967. The CDIC insures deposits up to C$60,000 per

depositor (increased in 1983 from C$20,000). Trust and loan and mortgage loan companies incorporated in Quebec have Quebec deposits insured by the Quebec Deposit Insurance Board (QDIB).

In addition to providing deposit insurance, the CBIC and QDIB provide liquidity to insured institutions. Eligible institutions have either direct or indirect access to the Canadian Payments Association (CPA) for cheque clearing. Currently, all institutions that offer "chequable" deposits must maintain reserves against these balances in accordance with Bank of Canada regulations. These reserve requirements will probably be phased out for both near and chartered banks, but clearing balances will still be required by the CPA.

Recent failures

As in the United States, depository institutions in Canada were highly stable in the post-World War II period. Difficulties began in 1979; between then and 1985 some 30 trust and loan and mortgage loan companies experienced severe financial difficulties. Despite the problems, not all institutions were closed. Between 1980 and 1987, 15 of these institutions were closed or placed in a form of receivership and merged with other institutions or liquidated. Some chartered banks subsequently suffered similar problems.

There were two principal reasons for the problems that developed in the trust and loan and mortgage loan industry. One was general Canadian economic conditions. The other was misbehaviour and the mismanagement of some institutions.

Beginning in the 1960s, regulations were relaxed on trust and loan and mortgage loan companies. In 1961 the loan-to-value ratio for residential mortgages was increased from 60% to 66.6%, and further increased to 75% in 1975. Within the same period, the same institutions had their capital-to-asset ratio requirements reduced: from 8% to 6.67% in 1965 (a change in leverage ratio from 12.5 to 15) and then to 5% — in 1970 for trust and loans and in 1974 for mortgage loan companies — bringing the leverage ratio to 20.

Higher interest rates between 1979 and 1982 caused some institutions to have a mismatch of asset yields and liability expenses. Property values rapidly escalated between 1975 and 1982 — as certain regions benefited from higher world energy prices — but later paralleled the collapse of world energy prices. Because of the high interest rates, some government assistance was provided to those refinancing their mortgages. This assistance and the nature of Canadian mortgage instruments are considered to be the reasons most mortgage lending institutions weathered the high interest rates. However, the collapse of western real estate prices, especially in energy-rich Alberta, caused some institutions to close their doors.

In addition to the problems associated with general economic conditions, some trust and loan and mortgage loan companies experienced poor managerial judgment or explicit malfeasance, according to Helmut H. Binhammer, dean of arts at the Royal Military College of Canada. In his book, *Money, Banking and the Canadian Financial System,* Professor Binhammer notes that during the 1970s and early 1980s, many trust and loan and mortgage loan companies were formed or acquired by persons who did not live up to the standards of conduct and responsibility usually associated with chartered financial institutions.

"Some ... failed because ... [of] fraudulent practices", he wrote. "Many failed because of self-dealing ... abuses. In nearly all cases of failure, there was inappropriate portfolio diversification." Binhammer also places part of the blame on an antiquated regulatory system and lax enforcement of existing regulations.

The problems experienced by near banks were subsequently experienced by smaller regional chartered banks. These institutions had been established during the 1970s and were located mostly in the western provinces. Two of the regional chartered banks failed and most of the others were merged or sold through arrangements with the bank regulators. The domestically owned banking industry consolidated from 15 banks in 1984 to eight banks in 1986.

Regulatory restructuring

Problems with the regulatory system's structure and the system's traditional methods of operation may have contributed to the costs associated with the chartered and near bank failures of the early 1980s. Different agencies have performed non-overlapping regulatory functions. This has created some difficulties.

The former Office of the Inspector General of Banks (OIGB) provided examination information on chartered banks to the CDIC and the Bank of Canada, enabling them to carry out their respective functions of deposit insurer and lender of last resort. On-site bank examination, however, was not carried out by the inspector general's office because of manpower limitations. Rather, each chartered bank employed two accounting firms to examine the books regularly.

The chartered bank's auditors were responsible for self-examination. These auditors and the outside accounting firms reported their findings to the bank's board of directors, who in turn submitted the reports to the inspector general (who could, and did, consult the external accounting firms independently). The OIGB did conduct on-site "visitations" with each of the chartered banks. These visits were typically with the senior management, and the topics for discussion were capitalisation, operation, and performance.

The Estey Commission, formed to

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examine the failures of two chartered banks, criticised this examination process, which is popularly known as a "wink and nod" system. The OIGB had not considered itself responsible for conducting audits that would determine misbehaviour, which was a task considered to be the responsibility of internal audits. The OIGB also did not consider itself responsible for ascertaining that the books were correct or for asset classification, which were considered to be the responsibilities of the external auditors. Unfortunately, the external auditors did not consider their responsibility to include asset classification. It appears that the OIGB was unaware that the external auditors were not classifying assets rigorously (if at all).

The OIGB was aware that certain chartered banks were experiencing difficulties. Unfortunately, the only disciplinary power held by the chief bank supervisor — the inspector general — was the recommendation to the minister of finance that the bank in question have its charter revoked. This was considered to be too extreme a measure. The inspector general did effectively use moral suasion, but the circumstances of the early 1980s were more than moral suasion could address. Because the inspector general did not know the full extent of the troubled bank difficulties and because the inspector general used traditional disciplinary practices, the troubled banks were not closed quickly.

Near bank examinations

In contrast to the examination process for chartered banks, the Department of Insurance (DOI), the former near bank federal supervisor, conducted on-site examinations of federally chartered trust and loan and mortgage loan companies. However, its manpower, while considerably greater than that of the OIGB, was small relative to the problems it encountered.

When problem chartered or near banks were identified as such, a number of regulatory actions were available. Institutions could be kept open through arrangement of liquidity loans (actually, they turned out to be solvency loans) from the CDIC, the Bank of Canada, or through loan packages from the large chartered banks co-ordinated by the OIGB, the DOI, the minister of finance, the CDIC and the Bank of Canada.

Unfortunately, these efforts only prolonged and deepened the problem. Moreover, institutions that were deemed to be in difficulty were not always placed in formal receivership; thus, the original management maintained control.

The CDIC preferred not to close immediately an institution that had been determined to be insolvent. (The CDIC also had only a few employees.) Rather, the CDIC arranged with other institutions, through agency and operating agreements, to administer the insolvent institution during a winding-down period. During the winding down, the CDIC advanced or guaranteed funds that the agent used to meet depositors' claims. In so doing, the CDIC, in effect, paid off on both insured and uninsured deposits.

In 1985, the government announced that all depositors would be protected during the liquidations of two chartered banks. It would appear that this was the CDIC policy that was in effect for all institutions that the CDIC closed or wound down between 1979 and 1987. After 1985, the CDIC changed its method of dealing with insolvent institutions; it no longer gave preference to the winding-down approach.

The CDIC also did not have the power to issue cease-and-desist orders. It could assess a special surcharge to institutions that the CDIC deemed to be non-compliant with CDIC bylaws, especially those that pertain to standards of sound business and financial practice. This was found to be a useful disciplinary tool for normal operations, but completely valueless in application to institutions that were destined for closure.

Insurance Fund deficit

The CDIC's insurance fund has been in deficit since 1983. In 1987, the deficit was $1.1 billion, down from $1.2 billion in 1986. These figures understate the extent of losses to the public from the chartered and near bank failures. The insurance fund deficit does not account for loans that will never be repaid, which had been made to now-failed institutions by the Bank of Canada, provincial governments and the largest chartered banks.

The problems of the CDIC were examined by a federal committee (the Wyman Committee) and several other provincial and federal government inquiries. The chartered bank failures of 1985 were the subject of inquiry by the Estey Commission. Several changes were initiated as a result of all of the government inquiries. The OIGB and DOI were merged into the OSFI. The OSFI has taken an active stand to develop on-site examinations of all federal depository institutions.

A group of retired bankers has been employed as a consultant group to the OSFI to conduct intensive examinations of identified problem institutions. The OSFI and CDIC have been granted powers to issue cease-and-desist orders. The manpower of both the OSFI and CDIC have been dramatically increased.

Considering the proximity of Canada to the United States and the large and increasing trade relationship between the two countries, the Canadian regulatory policies affecting depository institutions should be of continuing interest to U.S. depository institutions and their regulators. ■

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