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(see also LB)

COPY OF LETTER

FROM THE GOVERNOR OF THE BANK OF CANADA

TO THE PRESIDENT OF EACH CHARTERED BANK

MARCH 6, 1957

I have recently had some informal conversations with a number of senior officers of the banks regarding the changes in bank loans and investments during the past two years and the possibility of maintaining a greater degree of separation between the commercial bank side and the savings bank side of the chartered banks. It was agreed that it would be desirable to give further thought to these matters, and I am writing the present letter in order to put before you in written form the approach which our own thinking has taken.

I am inclined to agree with those who have said that the implements of monetary policy in Canada are by no means perfect or fully effective, and that the effects of any particular degree of monetary rigour or ease cannot be predicted with nearly as much confidence as one would wish. I believe several bankers have made comments to this effect.

For example, during 1955 and 1956 most banks reduced their total holdings of Government securities, and increased the ratio of loans to deposits, to a much greater degree than most of us would have thought likely or desirable, recalling the conversations among bankers and central bankers of several years ago. Government securities were sold in large volume (about $1,200 million in the 18 months from June 1955 to December 1956), often at a loss, in order to accommodate the increase in loans. I have heard it suggested that there should be some recognized minimum ratio of Government bonds or maximum ratio of loans to total Canadian deposits; I myself believe there may be a better way to achieve greater stability in banking operations.

There is also a very general feeling that the activities of the banks in the field of long-term investment, particularly housing loans and municipal debentures, have changed rather abruptly and that greater stability in this field would be desirable. I know from comments reaching me that the banks are being adversely affected in the eyes of the public by the fact that they have almost entirely withdrawn from the field of housing loans. I have no doubt the banks themselves would like to maintain a greater degree of continuity in such lending and make available a larger volume of such loans than at present if they could see their way clear to do so.

These matters must be considered before the present inflationary period is over because of the problem that will face the monetary authorities when easier conditions and reduced activity require a change in monetary policy. Shall we at that time expand the money supply and the assets of the banking system as has been done in similar situations in the past? One would like to say yes, to some degree, but this would not be desirable if we would thereby repeat once more a cycle in which banks were able to add greatly to their holdings of quite liquid assets and later run them down again in large volume in the course of a perhaps excessive expansion of commercial loans.

In considering what degree of monetary ease or stringency is appropriate, a central bank does not usually regard savings deposits held with specialized savings institutions as being part of the supply of money. In Canada, the savings deposits held with trust companies, loan companies or mortgage corporations, credit unions, caisses populaires, etc., are not regarded as part of the money supply, but a different view has had to be taken of savings deposits held with the chartered banks. This is, in our view, unfortunate, and from a central banking point of view we would prefer to be able to regard such savings deposits as similar to other savings deposits in other institutions. This depends on the use to which the banks put the funds accruing to them from personal savings. The normal outlet for savings deposits in other institutions is housing loans and long-term investments. Bank deposits used for short-term credit expansion, on the other hand, must be regarded as money, and the volume of such money and such credit must be regulated by the central bank in every country.

In other countries, most savings deposits are held with savings banks, building societies, mortgage banks, savings and loan associations, etc., rather than with the commercial banks, although the latter may also have some savings deposits in some countries. In

Canada, as we know, the chartered banks are the custodians of over 80% of all personal savings deposits. I would not wish to see this disturbed-- I believe the facilities of the branch banking system in Canada can be operated more economically and more efficiently for the purpose of accumulating and investing personal savings than would be the case if this business were predominantly handled by specialized institutions which duplicated these facilities.

Some institutions of this sort have considerably increased their deposits and investments in the last few years. One cannot object to healthy competition, but I see no reason why the chartered banks could not effectively meet that competition if they were to make the same kind and amount of long-term investments with the funds of their savings departments--and were as a result in a position to pay the same kind of interest rate on savings deposits--as would be made and paid by such other institutions, as they have operated in Canada and in almost every other country in the world.

I think it would be worth considering, therefore, whether by a combination of voluntary action and ultimately legislation, the principle could be adopted that the chartered banks would to an increasing extent in the future take steps to segregate (on an accounting basis) their savings deposits and long-term investments including Government bonds, from their demand deposits and other deposits together with their commercial loans and other short-term investments. The ultimate goal--which might not be reached for some time--would be that the resources of the savings departments would be wholly or very largely invested in housing loans and in provincial, municipal and corporate securities and Government of Canada bonds. The resources of the commercial banking side would include all deposits other than personal savings deposits together with the greater part of the capital and reserves of the banks, and would be invested in commercial loans and other short-term loans, treasury bills, and short-term Government of Canada bonds.

Such a programme would, of course, require the adoption of different provisions regarding reserve ratios. Cash reserves required against savings deposits--if invested in typical savings bank investments--might be reduced to 5% or 6%, whereas cash reserves required against other deposits might be of the order of 12%. (These figures are given merely to illustrate the principle, and do not necessarily reflect current views of what would be the most suitable ratios.) Similarly, the working principles regarding liquid asset ratios could be revised so that a much smaller requirement than at present would apply to savings deposits and a somewhat higher requirement than at present would apply to other deposits. On balance, I would think that the total requirement regarding liquid asset ratios could be reduced.

The savings department would be assured of additional liquidity, if required, by means of access to the commercial banking department for temporary advances--as is now the case with trust and loan companies and even life insurance companies, which may from time to time borrow from chartered banks--and would be further buttressed by the fact that the chartered bank as a whole would have access to the central bank for temporary advances if necessary.

To the extent that progress could be made towards such a programme, I believe the following advantages would accrue:

1. There would be greater continuity and stability in the channelling of savings through the chartered banks into housing loans, municipal debentures and other long-term investments. As regards housing loans, the banks with their widespread system of branches are in much the best position to maintain a large volume of lending, particularly outside the larger cities. After a time the amount of money accruing to the banks by repayments of principal on such loans would become very substantial and would itself make possible a great measure of stability in the volume of new loans each year.

2. If and to the extent that the banks devoted the increase in their savings deposits to typical savings bank investments, it would be possible for the central bank to regard the savings deposits of the chartered banks as similar in all respects to the savings deposits held with other institutions, that is to regard them as outside the definition of "money". The banks could go on having an increase in their total resources at least equal to (and in most years greater than) the increase in their savings deposits and could go on investing such part of their increased resources as arose from savings deposits in long-term investments without any implications arising with respect to monetary policy. It seems likely that personal savings deposits would in such event go on increasing by even more than the recent annual average of $350 million. As a result, the total assets of the banking system would grow somewhat more than would otherwise be possible, and this growth together with the character of the increased investments would enable the banks both

to achieve higher earnings and to pay higher rates of interest on savings deposits.

3. It would be implicit in such a programme that some part of the banks' investment in Government bonds would be regarded as belonging to the savings departments and would not be available in future for liquidation in order to augment the funds available to the commercial banking department for expanding commercial and general loans. In consequence, the Government securities market would not be subjected to such violent disturbances as must occur when hundreds of millions of dollars of securities in which savings deposits had previously been invested are sold by the banks in order to accommodate large and sudden increases in commercial loans.

4. It is not suggested that such a programme would require the present volume of commercial and general loans to be reduced--in fact, such loans will normally increase each year--but it would presumably mean that short-term credit expansion would be kept under closer control by the banks, and would thereby be more responsive to changes in monetary policy, which in turn could be more flexible and more sensitive to changing credit needs. It would, of course, continue to be the responsibility of the central bank so to regulate the money supply as to provide for an adequate volume of money and credit in a growing economy; both the central bank and the chartered banks would be better able, on the basis indicated, to adjust their operations so as to prevent excessive expansion of credit in periods of unusually strong demand.

In addition to the long-run considerations, there is the question of what to do about the present rather serious situation in regard to chartered bank withdrawal from participation in housing finance. There is of necessity a lag of varying duration, but generally of some months, between the approval of housing loans and the outlay of the relative funds. It is, I think, important that the present period of drought with respect to approvals should not continue much longer. We would be prepared to facilitate some increase in total assets of the banking system if we could be assured that the increase would take the form of a return of the banks to the housing mortgage loan field. Lacking some such assurance, we would not welcome any further expansion in the total assets of the banking system as we do not feel an overall expansion of commercial loans is to be desired at the present time. What we have in mind is some concrete action to meet the short-run situation, consistent with the longer run objective of a greater degree of segregation of savings investments from commercial loans.

We should like to have a meeting with general managers on the subject as soon as possible, and I am writing them today to ascertain whether it would be convenient for them to meet with us in Montreal on Thursday, March 14th.

We should like to discuss with general managers the following proposals for early action:

(1) That the banks would agree to undertake new mortgage loans amounting to at least $150 million in 1957 (including, of course, any loans already approved since the beginning of the year), the allocation of the minimum agreed amount among the banks to be based on each bank's actual share of the increase in personal savings deposits that took place in 1956. We think it likely that approximately the same increase will occur in 1957, but no accurate forecast can be made. The suggested minimum amount of new mortgage loans is less than half the total increase in personal savings deposits expected.

(2) In such event, the Bank of Canada would assure the banks that the total resources of the banking system would increase in 1957 by an amount at least equal to the actual net increase during 1957 in the amount outstanding on mortgage loans, whether such loans were approved during 1957 or earlier, and would ask the banks to operate on the assumption that each individual bank would also experience a sufficient increase in its total resources to enable it to accommodate at least the amount of the increase in its mortgage account. In the event of any bank finding its experience varied from this expectation, the variation would probably only be temporary and we would be prepared to make special arrangements to meet the situation.

As already indicated, we would hope that in due course arrangements with respect to the long-run programme will be such that banks will consistently plan to invest the increase in their savings deposits each year in appropriate savings investments and will have confidence that they can do so without undue difficulty and without any special assurances from the central bank. In the present situation, however, we realize that certain difficulties do exist and hope that the special assurances we are prepared to give will enable the banks to make an early start in that particular field of investment (housing loans) which has experienced a rather drastic interruption of an important source of financing.

For your convenience I enclose extra copies of this letter.

Yours very truly,

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The attached release on bank credit policy went to the following lists:

Chartered bank list
Insurance companies
Trust & loan companies
Federal Reserve Banks
Head Office & Branches Investment Dealers list
Central banks
Daily papers
Weekly papers
Financial Editors (special list)
Press Release list
International Monetary Fund & Int. Banks list
"England" special list
Internal distribution B. of C.