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An Introductory Statement
by
Gerald K. Bouey
Governor of the Bank of Canada
in an appearance before the
House of Commons Standing Committee
on Finance, Trade and Economic Affairs
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I would like to begin by saying that the activities of the Bank of Canada are not a major determinant of the profits of the chartered banks. The Bank regulates the quantity of cash reserves available to the banking system in order to influence short-term interest rates and the growth of the money supply. Its actions are not directed to influencing bank profits. Interest rate movements can have some temporary effects on the level of bank profits, which I will come to in a moment, but one has to look elsewhere for the fundamental factors determining the banks' profit rate.

The profitability of an individual bank or other financial institution depends primarily on its ability to compete effectively in the financial market for the business of savers and borrowers. The larger the volume of business it can attract and the wider the margin between the interest revenue from its loans and its costs in the form of interest, overhead, operating expenses and losses on loans, the greater are its profits. During a period of inflation such as we have been going through the dollar volume of business in the financial system has been growing rapidly and therefore the dollar volume of the profits of financial institutions as a group has grown rapidly as well. In the case of the chartered banks the profits they have earned on their business outside Canada have been a significant part of their total profits.

The country's economic interest lies in having an efficient intermediation between lenders and borrowers. The more efficient the intermediation process, the lower the spread between borrowing and lending rates can be. In a market system it is the competition among financial institutions that provides the incentive for efficiency. In a competitive environment, these institutions are under constant pressure to minimize their costs in order to be able to maintain a narrow spread and thus attract borrowers and savers.

Banking legislation and the legislation regarding other financial institutions in this country provide a framework within which banks and non-bank financial institutions compete. The legislation imposes different reserve, liquidity and prudential requirements on different groups of financial institutions and in some instances it restricts the types of business in which certain institutions can engage. Such differences in regulations can be a factor influencing the competitive positions of particular financial institutions.

There are a number of other factors which can cause differences in earnings between various institutions or groups of institutions. To the extent that some institutions specialize in particular areas of borrowing and lending, there may be differences in the amount of profits they earn due to differences in the pace at which business in their specialized area is expanding. For example, in a period of high inflation and expectations of high inflation, with considerable uncertainty about future movements in interest rates, both lenders and borrowers may choose to use mainly short-term instruments. In this case financing done through intermediaries that offer short-term or fluctuating-rate instruments will increase more rapidly than through those specializing in longer term financing. This development is an important factor explaining the rapid growth of the Canadian banking system in recent years. Thus for any individual bank or other deposit-taking institution, its profit at a given time will depend in part on the demand for the types of financing in which it specializes, whether it is, for example, business loans, mortgages, or consumer loans.

Interest rate movements, including those related to the monetary policy actions undertaken by the Bank of Canada, can have a transitory effect on the profits of banks and other financial institutions depending on the composition of the loans and deposits which make up their balance sheets. The interest rates on those loans and deposits which are payable on demand or after very short terms to maturity will change quickly in response to general movements in interest rates, while rates on loans and deposits which are fixed for longer terms can only be changed as they come to maturity. As a result financial institutions which make use of short-term deposits to finance fixed-rate longer term loans will suffer a profit squeeze for a time when interest rates rise and the interest costs of their deposits increase more quickly than the interest return on their loans. However, they will reap temporary profit gains when interest rates fall. By contrast those institutions with large portfolios of demand loans at adjustable rates that are financed, at least to some extent, with fixed-rate term deposits will have a temporary increase in profits when interest rates rise and a profit decline when interest rates fall. Chartered banks typically fall into this latter category.

These temporary movements in profits will persist only until such time as loans and deposits with fixed rates come to maturity and are rolled-over or replaced by new loans and deposits at the changed level of interest rates. Movements in the general level of interest rates are therefore a source of variability in the profits of banks and other financial institutions but do not affect the average level of their profits over time.

I would like to conclude this brief statement by saying that the Bank of Canada has a strong interest in a sound and efficient financial system. For financial institutions to be successful in the role of intermediating between savers and borrowers, there must be public confidence in their soundness and stability. For an individual bank or any other financial institution to maintain that confidence it needs an adequate amount of capital, and if it is going to be able to attract and retain that capital, it must be profitable. This is the function of profits in our financial system, and it is an important one.