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FINANCIAL INNOVATION AND PUBLIC POLICY

Remarks of
Louis Rasminsky, Governor of the Bank of Canada,
before a meeting of the Institute of Canadian Bankers,
Montreal, January 20th, 1969

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It is a great pleasure for me to have the honour of addressing this gathering.

The Canadian Bankers' Association is to be congratulated on its efforts to encourage professionalism in banking in this country through the medium of the Institute of Canadian Bankers. The Institute's programme is most impressive both in terms of scope of subject matter and number of participants. Your Chairman, Mr. MacIntosh, and your Director, Mr. Bisson, can properly take pride in the fact that the total number of registrations in the Institute's courses across Canada this year is in excess of 5, 500 -- a truly remarkable figure. I might add that no one in attendance here tonight could fail to note the vigour with which the Institute's programme is being supported in this part of Canada by the Montreal Regional Council.

In thinking over what I might talk about on this particular occasion and to this particular audience, it seemed to me that it might be of interest to offer some comments on the changes which we see taking place in our financial system these days, and on the challenge which these changes pose to the skill, the adaptability and the sense of responsibility both of chartered bankers and of central bankers. Among other things, I shall be saying something about some technical changes which have occurred in banking practices. I would not, of course, suggest that problems relating to bank operations are of the same fundamental importance to our society as are, for example, the great central problems of how to cope with inflation, or with high interest rates, or with disturbances in the international monetary system. On the other hand, I am sure that there is more of economic significance than immediately meets the eye in many operational developments which may seem, on the surface, to be mainly of technical significance.

It must be evident to everyone that we are going through a period of unusual ferment and innovation in our financial system -- in its structure and in the way financial institutions operate. To some extent, this is a matter of response to technological change -- most notably, of course, to the head-long development and spread of modern computer technology. To some extent, the changes constitute a response to the amendments that have recently taken place in the legal and administrative ground rules under which our financial system operates. I have in mind particularly the recent revisions in our banking legislation, and also the introduction of a more flexible formula for determining the maximum interest rate on mortgage loans under the National Housing Act. More fundamentally, the changes we are witnessing in the way financial business is conducted in this country reflect the impact of a more modern and analytical approach to the study of financial processes and problems. And no doubt to some extent too, they reflect the changing mood and temper of our times -- the ebbing influence of those who have had any personal experience with a period of serious economic recession and the growing ascendancy of the ideas and approach of the swinging generation.

It is not hard to draw up a fairly impressive list of such innovations. To take an obvious and perhaps a light-hearted example, something seems to be happening to the traditional public image of chartered banking in Canada, as reflected among other things in bank architecture and bank advertising. The marble mausoleums of the past, presided over by hard-nosed credit managers, seem to have been increasingly supplanted by cheery, informal interiors largely inhabited by attractive girls in mini-skirts. On television commercials, chartered banks project an image at least as friendly as that of the most friendly loan company. Rarely has the public of any country been more charmingly, enticingly, colourfully solicited to use bank credit and other bank services.

Turning to the technical side of things, many of you who are here tonight will have had more direct experience than myself of the impact the computer is having on the operations of financial institutions in Canada. It seems to me that the computer revolution is indeed a major industrial revolution -- analagous to the invention of printing or the invention of the steam engine. No one knows what its full implications will eventually turn out to be. So far one can see that in banking it has posed a major challenge to the traditional payments system of transfers by cheque of demand and chequable savings deposit balances. No doubt that is one of the reasons why the banks have moved so aggressively into the credit card field. Some have even claimed that the computer is in the process of making payments by cheque a relatively inefficient and obsolescent means of settling debts. The computer is also, of course, revolutionizing the amount of information about bank operations that can be collected and analyzed for use by bank managements and other interested parties. One should not underestimate what is involved here. In the past, people who had the responsibility for taking policy decisions had to do a great deal more guessing about the relevant facts than is necessary nowadays with the potential of modern information systems. So far we have only scratched the surface of this application of computers.

I would like to interject a word here about the impact of the computer on our own operations at the Bank of Canada. One of the main jobs we do in which the computer is of enormous help is in the servicing of the public debt -- in maintaining detailed records of new issues and redemptions of Government securities and of the changing ownership of registered bonds, in making bond interest payments, and so on. Another obvious application of the computer in the central bank's task as fiscal agent of the Government is in the help it gives us in keeping track of the many different kinds of payments and receipts that affect the level of the Government's cash balances and borrowing requirements. The filing and analysis of statistical returns received from the chartered banks -- whose initial compilation at the branch level is a familiar chore to many of you here tonight -- is another central bank activity in which the computer is of great assistance. Finally, and by no means least in importance, the analysis by computer methods of economic and financial data for research and current policy purposes is having an important influence on our activities at the central bank. Some of you may have noticed in the newspapers a few weeks ago that the Bank is making its computer file of commonly-used economic and financial data and a set of computer programmes for use in analyzing these statistics generally available at minimum cost to those who want it. The compilation of these economic data and the testing of the relationships that appear to exist among the many economic series that are incorporated in the working model of the economy we have constructed (which will of course be constantly revised), represents a very considerable expenditure of intellectual resources on the part of many people in the Bank. Our object in making this knowledge generally available is to share with other economic research groups at the universities and elsewhere some of the research tools we have developed. The response to this initiative of the Bank has been most heartening and I hope that I may be forgiven a certain pride in the fact that the Bank of Canada is the first central bank that has placed such facilities at the disposal of the public.

To return to my main theme, important changes have also been occurring in the traditional approach of the chartered banks and other private financial institutions to the extension of credit. Since the end of World War II, we have seen in Canada a great increase in the access that consumers and mortgage borrowers have to institutional sources of credit, and the same is true of business borrowers with specialized credit needs. Banks and other financial institutions have devised various new techniques for minimizing the risks of engaging in new types of loan business and in old ones formerly ruled out as too tricky to handle. The costs of credit investigation have been greatly reduced by new simplifying techniques; better advantage has been taken of the possibilities of risk-pooling; and large-scale operation has reduced costs in specialized areas of lending. Liquidity problems have been reduced by the widespread adoption of regular monthly loan repayment schedules. The emphasis in assessing the creditworthiness of borrowers has tended to shift from balance sheet measures and the ability to put up suitable collateral to the analysis of the borrower's current cash flow and his prospective ability to operate profitably. Lending institutions seem to be more and more willing to depart from preconceived notions of the maximum share of particular types of loans they want in their portfolio in order to accommodate themselves to shifts in borrower demand. They also seem more willing to depart from preconceived notions regarding particular fields of credit that they regard as being or not being in their line of business. Increasing efforts are being made to assess the relative costs and profitability of different types of accounts so as to provide a more rational basis for the structure of institutional lending rates and operating charges.

If the spirit of innovation is at work in the lending operations of our banks and other financial institutions, its presence is even more visible in their efforts to attract funds from the public. In the growing literature on bank portfolio management, increasing emphasis appears to be placed on the management of bank liabilities. We have seen in recent years a proliferation of new types of deposit accounts and other kinds of savings instruments tailored to fit almost any conceivable combination of special preferences or requirements on the part of potential suppliers of funds, and offering attractive rates of return relative to those available on short-term market securities or savings bonds. Innovation has blurred many of the traditional distinctions between types of deposit account. We now have foreign currency swapped deposits which are almost indistinguishable from Canadian dollar term deposits from the point of view of the holder. We have deposits which are nominally for a fixed term but which in practice are redeemable virtually on demand at little or no sacrifice of interest. We have deposits which are formally subject to notice but are in practice fully chequable without notice. We even have deposits which are nominally available on demand but are in practice frozen under compensating balance agreements. Banks seem more and more to be reverting to the idea that the development of a flourishing deposit business is just as important a function for bank personnel as the development of loan volume. The loans that the branch offers are coming to be viewed not only as an outlet for funds but also as one among an expanding number of banking services provided by the branch in order to increase the traffic of potential depositors through its doors. The view also seems to be becoming fashionable in bank management that it is sometimes desirable for a bank faced with strong loan demand not only to draw on its holdings of liquid assets or investments but also to try to borrow additional funds in the market for certificates of deposit.

I think that I have said enough at this point to indicate at least the general character of what seems to be happening in our banking system and in our financial system generally. It is an environment of increasing freedom from traditional inhibitions and legal restrictions, in which the qualities and attitudes most in demand seem to be those of the aggressive innovator, the optimistic risk-taker, the trained professional who can quickly recognize and adapt to changed circumstances and new profit opportunities. These are certainly admirable qualities, and ones that have understandably come to the fore at a time when the country has experienced such a long period of uninterrupted expansion -- a period during which risk-taking has so far almost always seemed to have been justified by the subsequent course of events.

For those of you with short memories, however, I hope that I may be forgiven if I offer a gentle reminder that things have not always been so in the past, and may not remain so indefinitely in this uncertain world. After all, there have been periods in our history when the qualities financial institutions needed most in their management were enough independence of mind and skepticism to challenge popular but perhaps over-optimistic assumptions on which a general state of euphoria was based. I hope that these qualities, which were in some ways the hallmark of the vanishing breed of bankers of a generation ago, are not dismissed too lightly by the new generation of bankers. They could serve as a valuable counterweight in an environment in which investment in equities of almost any kind is assumed to be a mark of sophistication and the clear road to riches, and in which the possibility of widespread default on loans of almost any kind is regarded as minimal -- perhaps because in recent years repayment of debt has been made easy by a degree of inflation which cannot be allowed to continue.

In general it seems to me that the direction in which our financial system is evolving puts a premium on people who are market-oriented -- who understand how markets work. This is because in certain respects the changes we are witnessing represent the coming of age of the market for credit and capital in Canada. The degree of isolation which used to exist between channels for particular types of finance is rapidly breaking down before our eyes. To a greater extent than ever before markets for business credit, for personal loans, for mortgage finance, for bond finance, for short-term money, and so on are all becoming part of one big overlapping and interrelated market for funds. It is also a sign of the maturing of our financial markets that movements of funds are becoming increasingly responsive to price considerations as reflected in relative interest rates. Greater flexibility in the deposit and lending rates of financial institutions has made it much more important than in the past for any particular institution to be able to compete on a price basis if it is to capture and hold profitable loan business and if it is to attract and retain the funds of savers and investors. Today's banker often has to calculate with a rather sharp pencil in order to decide how much he can afford to pay for deposits of varying degrees of volatility and how much he needs or dares to charge for loans of varying degrees of risk. Most bankers today seem well aware that their share of the public's financial business will erode over the longer run if they get into the habit of paying too little for the public's savings. They must also, I am confident, realize that another sure way to lose business over a period of time is to get into the habit of charging the public too much for the credit it uses.

So far I have not said very much about the economic implications for Canada of the changes occurring in the way our financial system operates. There are two aspects of this question I would like to touch on briefly. First, does the country stand to gain substantially from an economic point of view as its financial system becomes more mature, efficient and competitive? Secondly, does the job of monetary management on the part of the central bank become easier or more difficult?

Let me preface my answer to these questions by summarizing, very briefly, what I take to be the economic role of private financial institutions and markets on the one hand and the central bank on the other.

The financing of economic growth in a country like Canada involves transferring purchasing power from those individuals and groups who want to save part of their income to those who need to borrow in order to achieve their spending plans. Relatively few borrowers, however, are in a position to incur debt on terms which suit the precise requirements of those who might be induced to supply the funds. This is where banks and other financial institutions which act as middlemen come in. They make their living by supplying savers with a wide variety of financial obligations tailored to the particular needs of savers, and by allocating the resulting pool of funds to borrowers in exchange for financial obligations which are tailored to the particular needs of borrowers. The stock in trade is the ability to pool credit risks and the specialized know-how in bridging the gap between the particular requirements of borrowers on the one hand and savers on the other. The chartered banks play a particularly important role in this regard because one of the special kinds of debt they incur -- chequable demand deposits -- constitutes by far the most important means of payment in Canada, a form of debt as liquid to the deposit holder, in practice, as legal tender.

The rate at which the economy can expand depends in part on the responsiveness of banks and other financial institutions in facilitating a rate of growth in the amount of debt outstanding in the economy that is appropriate in the circumstances -- not too little and certainly not too much.

This is where the central bank comes in. The central bank is the only source in the economy for the kinds of financial obligations the chartered banks need for meeting cash withdrawals and for settling the inter-bank debts that arise when their depositors make payments to each other in the ordinary course of business -- that is, we are the only source of paper currency and deposit balances at the central bank which are convertible into paper currency. Indeed the law prescribes what a bank's minimum holdings of such assets shall be. For both practical and legal reasons, the rate of expansion of the banking system as a whole -- and indirectly the growth in outstanding debt throughout the economy as a whole -- depends on the rate at which the central bank expands this cash base. The job of the central bank is thus to decide how lightly or firmly to hold the reins on the expansion of the banking system, and indirectly on the expansion of total debt outstanding in the economy. Of course the picture I have tried to sketch in is highly over-simplified, and I should warn you of one very important factor I have not mentioned -- the fact that Canada is not a closed economy, so that for many Canadian borrowers it is feasible to obtain funds from credit markets in the United States or elsewhere if credit conditions in Canada become too expensive and difficult.

Having completed my outline of the economic role of private financial institutions and of the central bank, I return to the first question I posed earlier. Does the public stand to gain substantial economic benefits from a more efficient and competitive financial system? It seems to me that the answer has to be in the affirmative, provided that what we are seeing is in fact more efficiency and competition in our financial system. Much depends on the way institutions like the banks use their new freedom and powers in practice. A good case could be made that in the past the legal restrictions on chartered bank lending rates backfired on the groups of borrowers they were intended to protect -- such as small businessmen -- because the banks were deprived of any profit incentive to make a serious effort to increase their access to bank credit. Now that the banks are free to earn a market rate of return on loans to such borrowers, it will be interesting to see to what extent their access to bank credit improves. It is still too early to have a judgment on this.

If the public is to benefit in the longer run from greater flexibility and efficiency in banking and similar areas of finance, the benefit must come either in the form of much improved access to credit, relatively cheaper credit or relatively higher rates of return on savings. The mere increase in the size of banks is not the object of the exercise and it would be regrettable if the increased competition among financial institutions were to result in an undue degree of concentration in the financial system.

Let me conclude by commenting on the implications of change in our financial system for the conduct of monetary policy. It used to be the case that monetary restraint affected lending policies just about as much as it affected interest rates. Flexibility in the banks' lending rates and consequently in their deposit rates was limited by the Bank Act, and when the banks' liquidity was under downward pressure they were forced to adopt more selective lending policies, in other words to ration loans more closely.

Nowadays, the reaction of the banks to monetary restraint may be, as well as curtailing loans, to raise their deposit and lending rates. Since these rates have become more important than they used to be, such rate increases are likely to spread rapidly to other financial institutions and to affect yield levels in securities markets. Moreover, rates charged on mortgage loans now seem likely to rise pari-passu with long-term bond yields, rather than lag behind them as they used to do a few years ago. The consequence is that increased monetary restraint tends to be reflected more quickly in a general rise in interest rates of all kinds, with less impact on the availability of bank credit and mortgage credit than used to be the case with the same degree of increase in interest rate levels. If one focusses chiefly on the interest rate aspect of credit conditions, this can be viewed as making it easier for the central bank to tighten credit conditions substantially; if, however, one focusses on the credit availability aspect, especially through the chartered banks, the opposite may be the case.

An incidental effect of recent changes in the financial system, and in particular of the much improved competitive position of the banking system, has been to distort one of the most commonly-used measures of monetary ease or restraint -- the rate of growth in bank deposits. The rate of growth in the public's total holdings of bank deposits over the past two or three years has been much greater than the growth in their holdings either of money balances narrowly defined, that is currency outside banks and demand deposits, or in the public's liquid assets taken as a whole. There are many reasons for this: among the more important are the increased tendency of the banks to require that their borrowers hold compensating balances and the rapid growth of bank bidding, through the offer of higher interest rates, for large blocks of personal and corporate funds. These term deposits have competed more and more with other types of short-term investments such as securities and deposits in financial institutions other than banks. In general, the effect of these changed attitudes and practices on the part of the chartered banks has been to make the rate of growth in money holdings -- on many definitions and particularly those which include high interest rate deposits -- appear to be much more expansionary than it really is. The result has been that one of the conventional policy guides available to the central bank has become less useful than formerly. It has also led to some public misunderstanding. Those observers who feel that the availability of credit through the commercial banking system is more important than the availability and cost of credit throughout the economy take the view that monetary policy has been much easier than the central bank thinks it has been.

I believe, Mr. Chairman, that this is the appropriate point at which to terminate my remarks, which have in any case been long enough for the occasion. The next logical development of what I have been talking about would be to go on to discuss the various factors that have influenced the course of credit conditions during the recent past -- the government's fiscal position, the international monetary disturbances, and the way in which monetary policy has reacted to these factors as well as the views that have been held from time to time regarding the probable evolution of the economic position. But that is the subject matter for another speech.

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