THE REGULATION OF TRUST COMPANIES AND FINANCE COMPANIES IN BRITISH COLUMBIA

by

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A	Annual
BC	British Columbia
CDIC	Canada Deposit Insurance Corporation
GIC	Guaranteed Investment Certificates
ITC	Inspector of Trust Companies
ITCQ	Inspector of Trust Companies for Quebec
NHA	National Housing Act
Q	Quarterly
QDIB	Quebec Deposit Insurance Board
RA	Registrar of Alberta
RO	Registrar of Ontario
SA	Semi-Annual
SI	Superintendent of Insurance

INTRODUCTION

The Regulation of Trust Companies and Finance Companies in British Columbia

Financial intermediaries[1] have been grouped conventionally into banks and non-banks on the premise that the former created money and the latter did not. In the banking category were placed the central bank and the commercial banks directly controlled by it. The second category comprised those institutions which issued claims of a nonmonetary nature. Examples are savings banks, trust companies, finance companies, insurance companies, credit unions, mortgage loan companies, pension funds and mutual funds.

The techniques for controlling the banking sector are well known and similar in all developed countries. The traditional methods of influencing the money supply and interest rates by varying cash reserve ratios, open market operations, rediscounting and moral suasion have been adapted to the particular needs of each country, while retaining in each the same basic concept under which a non-profit earning central bank controls through accepted procedures the private and profit earning commercial banks in their function of creating money and credit. In the view of traditional monetary theory, these controlling techniques were adequate for the task of influencing the economy in the desired direction.

More recent monetary theory acknowledges the central role played by the banking system but claims that the rigid distinction between banking and nonbanking intermediaries has

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[1]Financial intermediaries are defined on page 7.

been overdrawn. The substitutability of the financial assets now offered by many intermediaries, and the varying liquidity preferences of savers, have affected both the supply and the demand for money and tended to lessen the influence of the central bank. If it confines its operations to the banking sector, monetary policies may therefore be rendered less effective by these new influences. The central bank will then encounter difficulties in altering total effective demand, or some particular component of it, and in maintaining stability in the financial markets, with repurcussions on the product and factor markets. In any event, the control by the central bank of total effective demand in the economy is partial and qualified as long as it is confined only to the commercial banks.

Objective of the Thesis.

The two major types of nonbanking intermediaries offering close substitutes for money in Canada are trust companies and finance companies. In 1966, the assets of all financial institutions whose liabilities are mainly short term totalled $38,924 million, of which the trust companies owned 10% and the finance companies 11%.[2] The trust companies are distinctive Canadian institutions operating under special legislation passed by the Government of Canada or a province, depending on its charter. Their prime function, according to the statutes, is to act as trustee or administrator of property but they are becoming increasingly important as intermediaries channelling individual and corporate savings

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[2]Table 1, p. 30.

into mortgages and securities. A finance company provides credit to the private sector in the form of instalment financing, personal loans, business financing, leasing, mortgage financing and commercial financing and factoring.

The purpose of this thesis is to examine the trust companies and finance companies in British Columbia to determine the extent and scope of their existing regulation and to recommend policy measures to rectify any deficiencies. The empirical evidence is expected to show that, at this stage of their growth, these institutions are sufficiently controlled by the central bank through the credit conditions created by its monetary policy and debt management. However, more effective regulation of these companies may be needed to increase the efficiency of the capital market and to protect savers. Only then will savings be allocated to their most productive employment at the minimum cost. Intensive regulation and attempts to ensure against all uncertainty are not suggested as they would hamper these goals. Instead, the recommended policies aim at a high standard of self-regulation, enforced by necessary government powers, adequate disclosure of financial affairs and deposit insurance.

The Significance of the Work

Trust companies and finance companies have been subjected to a minimum of regulation in British Columbia, a condition that has favoured aggressive intermediaries seeking funds but at the cost of bankruptcies, inefficient use of resources and avoidable imperfections in the capital market. Awareness of some of these factors prompted some government action this year, but it was a piecemeal approach to a problem that can only be solved by a comprehensive analysis of the regulatory system to establish the goals of regulation and to propose measures to attain these goals. It is also necessary to assess the relative importance of these goals to avoid imposing regulations whose advantages are outweighed by the effort needed to enforce adherence to their requirements. Furthermore, the directional consequences of regulations should be considered to avoid incidental effects which may be more detrimental to the economy than the benefits to be derived from the proposed regulations.

A Review of the Contributions of Other Researchers

Regulation of non-bank intermediaries has been a legal actuality for many years in the United States and has been the subject of considerable academic concern. The theoretical implications and practical experience of this regulation are well known and provide a basis for appraising Canadian attempts to deal with this problem. Deposit insurance, for example, was instituted there in 1933.

The subject only achieved prominence in Canada at the hearings before the Royal Commission on Banking and Finance in 1962.[3] The momentum generated at that time, plus subsequent evidence of more serious defects in the Canadian system, have resulted in research and investigation on a substantial scale for the first time. However, no material of an academic

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[3] The Royal Commission on Banking and Finance, Report (Ottawa: Queen's Printer, 1965).

nature has been published specifically on the regulation of trust companies and finance companies in British Columbia.

Limitations of the Study

The emphasis will be on the control of trust companies and finance companies incorporated in British Columbia, and therefore under the jurisdiction of the British Columbia government. Statistical information will be obtained from public companies only but this is not a serious limitations because private companies compromise only a small percentage of total assets in either industry.

A Description of Research Procedures and Principal Data Sources

Statistical material will be obtained from reports issued by federal and provincial governments and from annual reports and prospectuses of pertinent companies. Legal requirements will be obtained from the appropriate statutes. Factual information will be supplemented by interviews with senior men in government and industry.

Preview of the Organizational Plan

The role of financial intermediaries in an economy will be discussed in terms of their function, the causes and implications of their growth and the reasons advanced for their regulation. These concepts will then be applied to trust companies and finance companies in Canada. A detailed study will follow on the regulation of trust and finance companies in British Columbia in terms of their capitalization, source of funds, use of funds, reserves and supervision. The conclusion of the thesis will attempt to appraise this regulation and make policy recommendations to improve its effectiveness.

PART 1.

REGULATION OF FINANCIAL INTERMEDIARIES

CHAPTER I

The Impact of Financial Intermediaries on the Economy

Financial intermediaries first appear in a free enterprise system in the early stages of its development from a monetary economy to a credit economy. The initial form of intermediation is normally commercial banking, but the expanding economy with its accumulating wealth encourages the development of nonbanking financial institutions to serve its more sophisticated wants and needs. The banking sector may then decline in relative significance in the economy and the more dynamic contribution to growth may be made by the nonbanking intermediaries.

Conventional monetary theory largely ignored the implications of this changing structure of financial claims until the pioneering study of Gurley and Shaw was published in 1960.[1] Since that time, additional research has added to our knowledge and understanding of these institutions and their impact on the economy, although we do not have sufficient data to determine precisely how the operations of many of these institutions affect economic stability and growth. Nevertheless, regulation of these institutions has been widely advocated for a variety of purposes and in a variety of ways. This chapter will attempt to discuss the principal forms of these suggested regulations in the light of recent research,

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[1] John G. Gurley and Edward S. Shaw, Money in a Theory of Finance (Washington, D.C.: The Brookings Institution, 1960).

both of a theoretical and a statistical nature, in order to provide a background for assessing the regulatory framework which has been devised to control trust companies and finance companies in British Columbia.

Function of Financial Intermediaries

An institution is considered to be a financial intermediary if it has a preponderance of financial instruments on both sides of its balance sheet. Its assets comprise mainly the primary securities of final borrowers in the form of mortgages, government securities, or corporate indebtedness and equity. To a lesser extent, financial intermediaries also hold indirect securities of other intermediaries such as currency, demand deposits, savings deposits and shares, policy reserves and other claims. Their liabilities consist of promises to pay which are held by final lenders or, to some extent, by other financial intermediaries.[2]

These liabilities add to the total private claims to wealth in the economy by pyramiding indirect claims on a base of direct claims to the ownership of physical capital. For example, a company's decision to purchase new equipment with a bank loan rather than with retained earnings does not increase the amount of invested capital, but it does increase the gross financial claims in the economy by the amount of the new deposits created by the loan, assuming of course that it is

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[2]Financial intermediaries are defined in this manner in two basic works in the field. Raymond Goldsmith, Financial Intermediaries in the American Economy since 1900 (Princeton, New Jersey: Princeton University Press, 1958) pp. 50-51. John G. Gurley and Edward S. Shaw, pp. 192-4.

a net new loan. Another form of pyramiding occurs in an organization, such as a mutual fund, which sells shares to the public and invests the proceeds in the shares of industrial corporations. Gross financial claims have been multiplied by this process but net private investment is unchanged.

This description of intermediation should not be construed as indicating that these institutions do not have an important and beneficial role in the economy. On the contrary, intermediation may contribute to the expansion of the economy in several ways. For instance, it increases economic efficiency by narrowing and moderating price fluctuations which occur as a result of variations in the claims desired by final suppliers and users of loanable funds, subject to the constraints of institutional limitations and monetary policy. Intermediaries achieve this result by diversification of risk, scheduling of maturities to prevent liquidity crises, and economies of scale in both lending and borrowing operations.

The financial intermediaries may also contribute to economic growth by encouraging saving and investing through innovations in financial instruments. The cost of funds to ultimate users may thereby be lowered, while at the same time the securities are made more attractive to savers through their greater liquidity or security of capital.

The éssential function of financial intermediaries is therefore to reconcile the portfolio preferences of surplus savers with those of deficit spenders in either the private or public sector. Wealth holders and investors in real assets have changing needs and desires for liquidity, return, stability of return over time, and auxiliary services such as insurance. It is the role of financial intermediaries to increase the efficiency of the savings transfer mechanism by supplanting the inefficiencies and problems encountered by individual savers seeking investment outlets and capital users attempting to finance capital formation directly.

Financial intermediaries also have a wider function in the economy. Kuznets in his study of capital formation and financing in the American economy stresses that:

> The main social purpose of the complicated and elaborate structure of financial institutions, practices, and so forth, is to facilitate greater production. Its more immediate purpose is the channelling of savings into nationwide capital formation to ensure an effective use of savings. This complex and ramified structure of claims and counterclaims, of gross and net flows ... originated as a means of increasing economic production through additions to the stock of capital goods.[3]

This aggregate approach to the study of financial intermediaries concentrates on the similarities between all financial institutions, although it recognizes that the banks have a special position in the economy. They are the pivotal institution because they provide the payments mechanism and serve as the principal vehicle for the monetary policy of the central bank. The banks also play the leading role in credit creation; however they are not the only intermediary capable of expanding credit, and like other financial institutions, they are true intermediaries to the extent that their expansion is related to their ability to attract savings.

Financial intermediaries lend the same commodity which

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[3]Simon Kuznets, Capital in the American Economy: Its Formation and Financing. (Princeton, N.J.: Princeton University Press, 1961) p. 35.

they borrow, usually cash. Banks and trust companies borrow cash in the form of deposits and lend it by writing a cheque on themselves. Consumer loan companies sell their liabilities for cash and make personal loans with the proceeds. There are some technical differences in these various operations but the principle is the same in every case. Each intermediary has been able to lend only to the extent that it has been able to attract cash.

This generalization on the lending capacity of financial institutions is valid, however, only to the individual institutions and only on the assumption that the intermediaries are working to minimum cash balances while cash reserves and cash reserve ratios are fixed. If the banks have excess reserves, or if the central bank either increases the cash reserves of the banks or lowers their cash reserve ratios, the banking system as a whole can expand without the necessity of attracting savings. Furthermore, this expansion in the banking sector can provide a base for the expansion of other financial intermediaries.

The extent of the expansion engendered by the action of the central bank depends initially on the reaction of the banking system, but ultimately it depends on the degree to which nonbank intermediaries can attract deposits away from the banks. Thus nonbanking intermediaries as well as banks play a part in credit creation in addition to acting as intermediaries. The following example illustrates this interaction. Assume the central bank increases the cash reserves of the chartered banks by $100 through its open market operations. If the banks are working to an 8% cash reserve ratio, they will be able to expand their loan portfolio by $1,150, creating new deposit liabilities as they do so. Total new bank deposits will now be $1,250. In a simplified model of the banking system, no further expansion of credit would take place on this cash basis. If, however, a nonbank intermediary such as a trust company is introduced into the model, a further expansion in credit is made possible.

The trust company, we will assume, is able to attract $100 in deposits away from the banks. There will be no decrease in total bank deposits in the system as a result of this shift in deposits because trust companies normally deposit their cash in excess of till money in the banks; but the change in ownership of the bank deposits does alter the lending capacity of the system, for the trust company is able to loan out that cash received in the new deposit which is in excess of its reserve requirements. If the trust company is operating on a 5% reserve ratio, it can loan out $95. This cash will probably return to the banks as a deposit, and the end result of this process is that the existence of a nearbank has added $95 to the $1,150 created initially by the banks. More generally, the nearbank has stretched the money supply, as it is traditionally defined, through introducing liabilities which are close substitutes for money.

Monetary theorists have become more aware of this effect of intermediation and it is now generally conceded that the traditional idea of a rigid division between banks and nonbanking intermediaries should be supplanted by a more realistic view which would recognize that the liabilities of all financial intermediaries possess a degree of moneyness or liquidity.[4] The central bank, therefore, cannot ignore the nonbanking intermediaries in any estimate of the consequences of a change in credit conditions. Rather, it must consider the whole range of the liquidity spectrum as comprising the payments mechanism underlying demand.

Growth of Financial Institutions

Financial institutions prosper in an era of expanding national output if this expansion is based mainly on private expenditures financed through primary securities. Gurley and Shaw point out that:

> in such a climate the distribution of income among spending units is markedly different from the distribution of spending among them, so that budget deficits and surpluses are large relative to national output. Also the location of these budget imbalances in private sectors gives the maximum stimulus to financial intermediation. Then ultimate borrowers' primary security issues are not only large but are highly suitable to the specialized functions of the intermediaries, while ultimate lenders not only have large accumulations of financial assets but are disposed to accumulate indirect rather than primary securities.[5]

Some additional elements in the economy favouring intermediation, which are mentioned by these authors, are a restrictive monetary policy combined with low deposit rates, insurance of their deposits, and the absence of competition from government lending institutions.

Underlying these many factors in the growth of inter-

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[4]The concept of liquidity is discussed in more detail in W.T. Newlyn, Theories of Money. (Oxford: Clarendon Press, 1962), pp. 119-134.

[5]Gurley and Shaw, pp. 228-229.

mediaries are several long-term trends which are of much greater ultimate significance. Possibly the greatest single impetus to intermediation has been the rise and dispersion of personal incomes which brought into existence a large stratum of society able to accumulate savings in small individual amounts. These small savers generally favoured the liquidity and security of capital provided by the liabilities of financial intermediaries, in preference to the growth potential of direct investment which is favoured by large individual wealth holders. Kuznets mentions also that "the long term shift in what might be called the financial habits of ultimate savers (including unincorporated enterprises, and even corporations) is a result of far-reaching changes in the pattern of economic and social life."[6] As one example he cites the lessened demand for funds to reinvest in one's own business due to the decline in the percentage of the labour force that is self-employed. Urbanization also affects these institutions by providing easier access to them and by producing more knowledgable savers. Savings, therefore, tend to be placed in financial forms rather than in gold, jewels or similar tokens of wealth. Consequently, Kuznets contends that much of the growth and increasing variety of the services provided by the intermediaries would have occurred even without many of the factors cited previously.

As a result of this growth in intermediaries, a large percentage of the funds in the economy flow through these institutions. In the United States during the mid-1950's,

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[6] Kuznets, p. 422.

78% of the funds moving from savers to borrowers passed through financial intermediaries, and that percentage increased to 83% in the period from 1961 to 1964 and to 85% in 1965. (A stringent monetary policy in 1966, which forced borrowers into the capital market directly, induced a drastic disintermediation and the percentage of funds flowing through financial institutions dropped to 66%. This phenomenon occurred also in 1955 and 1959 but these cyclical episodes have been temporary deviations from a long term trend.)[7]

This secular growth of financial intermediaries has not been a uniform progression for all institutions. Some have lagged behind, while others have increased their share of the total claims. Goldsmith determined that, although the total assets of all financial institutions in the United States grew at an average annual rate of 6.7% from 1900 to 1952, there were wide variations in the growth rates of different types of institutions. As a result, there was substantial shifting of position among them and the share of the commercial banks in the total shrank from 52.8% in 1900 to 33.9% in 1952.[8] Most of this decline appears to be due to a relative decrease in their trust business and their time and savings accounts, as demand deposits increased faster than Gross National Product from 1929 to 1955 and nearly twice as fast as the assets of

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[7]Daniel H. Brill with Ann P. Ulrey, "The Role of Financial Intermediaries in the U. S. Capital Markets", <u>Federal Reserve Bulletin</u> (January 1967), p. 18.

[8]Goldsmith, p. 75.

nonbank intermediaries.[9] The concern about the alleged decline in the banking sector may then be needless.

Nonbank intermediaries, nevertheless, were the major beneficiaries of the developments in the economy which favour intermediation. Furthermore, they were assisted by the commercial banks themselves through the latter's specialization of function and reluctance to compete more aggressively. But this era has ended. All financial institutions are becoming multi-product firms operating in many markets and competing vigorously for both savings flows and investment outlets.[10] Commercial lending is no longer the prerogative of the banks, nor is mortgage lending now the prerogative of the savings institutions. Financial packaging and the decline in specialization is just another facet of the regulatory problem faced by the central bank in its attempt to control monetary conditions on a comprehensive basis.

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[9] Ezra Solomon, "Financial Institutions in the Saving-Investment Process", <u>Readings in Financial Institutions</u>, ed. Marshall D. Ketchum and Leon T. Kendall (Boston: Houghton Mifflin Company, 1965), p. 26.

[10] Some theorists have suggested that banks should be deterred from competing for deposits with nonbanks by prohibiting interest payments on bank deposits. Since deposit competition results in no significant decrease in the amount of deposits in the banking system, competition in the form of higher interest rates is wasteful. However, this contention ignores the fact that banks must compete for savings to retain their influence in the economy. Cf. J.A. Galbraith, <u>The Economics of Banking Operations</u> (Montreal: McGill University Press, 1963) pp. 138-46. Lester V. Chandler, "Should Commercial Banks Accept Savings Deposits," <u>Money, Financial Institutions and The Economy</u>, ed. James A. Crutchfield, Charles N. Henning, and William Pigott (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1965), pp. 40-48.

Regulation of Financial Intermediaries

Because of the major impact on the economy of the expansion of financial intermediaries, monetary theorists and others have recognized the necessity for their regulation. One reason advanced for regulation is based on the theory that these institutions can alter the demand and supply of money in such a manner that the monetary authorities may be unable to control total effective demand. The composition of effective demand may also be altered and instability increased if the intermediaries' lending policies intensify the demand for goods in boom periods, or allocate scarce resources to less socially desirable uses. Inefficient or larcenous management must also be prevented from impairing the solvency or liquidity of individual institutions because of the disruptive effects on the capital markets and personal savings.

Monetary Policy to Regulate Aggregate Demand

In the basic model of monetary theory, the total money supply is held in the form of currency outside the banks, together with deposits in the chartered banks. Both of these forms of money are closely controlled by the central bank. The money supply can then be considered to have zero elasticity at the amount set by the central bank, if one assumes that all excess liquidity has been mopped up. The introduction of nonbanking intermediaries providing another form of money may then impart slope to this supply schedule if the additional money is interest elastic.[11]

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[11] The supply curve of money may also be shifted if savings deposits are not counted as part of the money supply. In that case, a shift from demand deposits to time deposits

Financial intermediaries may also lower the demand schedule for money by developing new and highly liquid liabilities such as finance company paper and nonchequable deposits. The desired stock of money may then be less than it was formerly at the same rate of interest. Furthermore, the sensitivity of the public to small interest rate differentials is increased by this competition for cash and this may alter the elasticity of the demand schedule for money.[12]

The decreased demand for money and the increased demand for the liabilities of nonbank intermediaries has also been interpreted in terms of changes in the velocity of money. As wealth holders are attracted from cash to income-yielding assets by their high yields (and certain quality changes), the demand for money falls. Ceteris paribus, the transactions velocity and to a lesser extent, the income velocity of money must rise. There is therefore a positive correlation

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reduces the money supply. If the shift is from demand deposits in commercial banks to deposits in a near-bank, the money supply will be unchanged (except for a small leakage) because, as mentioned previously, the near-bank redeposits the money for its own account in the commercial bank.

[12]This is essentially the Keynsian version of the Gurley-Shaw thesis as interpreted by Don Patinkin, "Financial Intermediaries and the Logical Structure of Monetary Theory", American Economic Review, LI (March 1961), pp. 95-116. Cf. Irwin Friend, "The Effects of Monetary Policies on Nonmonetary Financial Institutions and Capital Markets", Private Capital Markets, (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1964), pp. 1-172 and Alvin Marty "Gurley and Shaw on Money in a Theory of Finance", Journal of Political Economy, LXIX No.1 (February, 1961) p. 59.

between the velocity of money and the yield on nonbank liabilities.[13]

The economizing on cash which the development of near-money has promoted has been given as the explanation for the post-way rise in income velocity in the United States,[14] but it is not the cause of cyclical swings in velocity. Empirical evidence has shown that consumers shift from demand to savings deposits mainly in recessions, and that increases in velocity during expansionary periods are due rather to dissaving for consumer expenditures and corporate investment.[15]

The combined result of these possible changes in the demand and supply conditions of money caused by nonbank intermediaries is that the central bank may have to make greater variations in the money supply than formerly to achieve the same rate of interest or velocity. It may also decrease the certainty of impact of any particular measure. The central bank may also have to compensate for the declining quantitative share of the commercial banks by restricting them to the point of impairing their growth. This would, of course, be to the advantage of the non-bank intermediaries.

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[13] T.H.Lee, "Substitutability of Non-Bank Intermediary Laibilities for Money", Journal of Finance, XXI (September, 1966), pp. 441-457.

[14] Cf. Milton Friedman and Anna J. Schwartz, A Monetary History of the United States 1867-1960 (Princeton, N.J.: Princeton University Press, 1963), pp. 659-672.

[15] Ernest Bloch, Corporate Liquidity Preference (unpublished Ph.D. dissertation, Graduate Faculty of Political and Social Science of the New School for Social Research, pp. 273-278. Commission on Money and Credit, Money and Credit: Their Influence on Jobs, Prices and Growth (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1961), p. 79.

If the development of financial institutions affects the rate of growth of the economy in this manner, as Gurley and Shaw contend, a case could be made for extending the reserve requirements of near-money to increase the influence of the central bank on general credit conditions. Lacking this power, it is held, the central bank will not be able to induce changes in the money market to alter the price, terms and availability of credit and so in turn to influence and control economic activity.

In accordance with the findings of the Radcliffe Committee[16] and the Commission on Money and Credit[17], the Royal Commission on Banking and Finance concluded that this was not the case.

> Whatever the underlying patterns of competition, the effect of central bank action spreads through the whole financial system because of the competition in financial markets and does not depend on all institutions holding their cash reserves with it .... Indeed, the central bank would be able to exert this general pressure on the financial institutions and markets even if no reserve requirements were imposed on any financial institution, for it is the final source of cash for the whole system.[18]

This conclusion does not mean that these Commissions felt that there was no meaningful difference between money and near-money. They wished rather to emphasize that it is misleading to concentrate on the money supply instead of the

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[16]Great Britain, Chancellor of the Exchequer, Committee on the Working of the Monetary System, Report, Cmnd 827 (London: HMSO, 1959) para. 394.

[17]Commission on Money and Credit, pp. 80-81.

[18]The Royal Commission on Banking and Finance, pp. 95-96.

structure of interest rates and to distinguish between institutions on the grounds that one type creates money and the other merely mediates between savers and investors. The maximum amount of creatable demand deposits is determined by the central bank but, since these are only part of the assets of the banking sector, all financial institutions are able to expand their liabilities to the extent that they attract cash and sell their claims. Since the central bank is able to control this total asset growth of all intermediaries by operating on general credit conditions, there is no cause to extend cash reserve restrictions to non-bank intermediaries.

Selective Credit Controls

Measures designed to direct the allocation of credit among competing uses have been recommended to achieve a socially desirable use of resources, to influence areas that are relatively unresponsive to general monetary policy or as a countercyclical measure. They have also been advocated to correct the economic instability which is believed to be created or increased by lending operations in the fields of instalment finance, especially of consumer durables, and also in capital investment and speculation in equities and real estate. The problem, as James S. Duesenberry says, is to make a "fairly clear distinction between alleged scientific knowledge about the impact of any particular monetary policy action or credit policy action on housing or any other type of expenditure, and value judgments on some side effects of monetary and credit policy, such as effects on income distrbution or the 'pain in the neck' which comes from some kinds of rationing."[19]

The mortgage market has probably been the area with the most confusion in goals and methods of monetary policy. It has had to cope with measures designed to raise the welfare of the community through more and better accommodation while at the same time being used as a countercyclical policy because of the high labour content in the construction industry. As a result, the flow of funds into the market has been irregular and subject to market limitations such as interest rate ceilings and minimum downpayments. The Canadian government has only recently recognized the disadvantages in these direct controls.[20] There also appears to be greater awareness of the need to separate social goals from stabilization measures in housing policy.

The de-stabilizing effect of lending policies on consumer durable goods has also been a subject of considerable controversy. A study of consumer instalment credit indicates that instalment finance tends to reinforce the direction of economic activity. Its impact is greatest in the early stages of an upswing and least as the economy approaches full employment when it tends to provide merely a diversion of total spending rather than an increase in aggregate demand. On the downside, repayments accelerate the decline in consumer

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[19] James S. Duesenberry, "The Relation of Housing Policy to Monetary Policy", Readings in Financial Institutions, p. 230.

[20] Beginning in April 1967, the maximum rate on NHA loans will be set quarterly at one and one-half per cent above the average yield on long-term Government of Canada bonds.

spending. The comparative magnitude of these effects is relatively slight, however. From 1929 to 1962 in the United States, the expansion of consumer credit accounted for only 5½% of the funds made available to all borrowers (or 8% if federal debt is excluded), and annual changes in instalment debt accounted for only 9.7% of cyclical change in the GNP during expansions and 17.5% during contractions, an average of 13.6%. This rate is well below the average of 35.8% attributed to changes in inventories and 18.8% due to changes in fixed investment.[21] The argument for direct control of instalment credit is therefore relatively weak (in peace time) and also it has been found to be more responsive to credit restrictions than was thought previously.

The case for direct controls on borrowing for business investment and working capital is clearly much stronger. Both types of lending have increased economic instability but they also appear to be relatively insensitive to interest rates and are extremely difficult to control. Measures such as capital issues control and direct control of business loans have been rendered inoperable by administrative problems, penalized small companies and proved ineffective against companies with substantial retained earnings.[22]

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[21] P.W.McCracken, J.C.T.Mao and C.V.Fricke, Consumer Instalment Credit and Public Policy (Ann Arbor: Graduate School of Business Administration, University of Michigan, 1965) p.63. E.P.Neufeld, "The Economic Significance of Consumer Credit", Consumer Credit in Canada, ed. J. S. Ziegel and R.A. Olley (Saskatoon: The University of Saskatshewan, 1966), pp. 5-19.

[22] Committee on the Working of the Monetary System, para. 461-463, Commission on Money and Credit, p. 75. Royal Commission on Banking and Finance, pp. 430-432 and 477, and McCracken, Mao and Fricke, pp. 143-165.

In summary, the advisability of applying selective credit controls depends initially on proving that the general techniques of monetary control are not providing the desired level and composition of demand and secondly, on proving that the advantages of direct controls outweigh the disadvantages. In the opinion of the Porter Commission, "Extensive use of direct measures may create distortions in the financial system, lower its efficiency, and indeed lead to widespread practices designed to evade the impact. The immediate usefulness of such techniques must be carefully weighed against the inequities and lasting harm they may cause."[23]

Measures to Protect the Solvency and Liquidity of Publicly-Owned Securities.

If financial intermediaries are to perform their function of reconciling the portfolio preferences of savers and investors, they must operate in an atmosphere that inspires confidence and operates efficiently and economically. This state can only be attained if purchasers of financial claims are kept fully informed of the claims available, are able to transfer claims freely and are protected from fraud and exploitation. Possibly the most difficult problem in this regard is the degree to which competition should be encouraged to lower costs and to provide equality of financial opportunity and mobility of funds.

The first measure required for greater stability in financial markets is insurance of savings deposits to encourage

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[23] Royal Commission on Banking and Finance, p. 450.

and protect the small saver with a high liquidity preference and a desire to avoid risk. The counterpart of deposit insurance is strict and adequate measures to maintain reserve ratios for uninsured securities payable on demand. A major cause of chaos in financial markets has been calls for payment which financial institutions were unprepared to meet.

The second line of defence is securities regulation. It was originally designed to curb the more obvious abuses such as fraud without, at the same time, eliminating the element of risk which is indigenous to venture capital. It was inevitable, however, that public pressure would be placed on the Securities Commissions to provide better protection for the purchasers of securities in financial intermediaries because, as Gurley and Shaw point out, the ultimate motive for preferring indirect securities to primary securities is to avoid risk.[24]

Allied with this trend has been a greater awareness of the fundamental role of the Securities Commissions in increasing the efficiency of the capital markets. Williamson, in his study of security regulation in Canada, contends that this is the more important function in the long run. The disclosure provisions of recent Canadian legislation, for example, seem:

> to recognize the economic value of full disclosure as something apart from the traditional investor protection. Confidence in individual companies, and in the securities market generally, rests on adequate information. And efficient investment of institutional and individual funds is not possible without a constant flow of information to facilitate continuous evaluation of portfolios.[25]

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[24]Gurley and Shaw, p. 117

[25]J. Peter Williamson, Supplement to Securities Regulation in Canada (Ottawa: Queen's Printer, 1966), p. 5.

There are, however, dangers in securities regulation, similar to those encountered in using selective credit controls. The Jenkins Report on company law and securities regulation in England recognized that a considerable degree of regulation is necessary but, if carried too far, it may defeat its purposes. The Committee consequently warned of:

> the undesirability of imposing restrictions which would seriously hamper the activities of honest men in order to defeat the occasional wrongdoer, and the importance of not placing unreasonable fetters upon business which is conducted in an efficient and honest manner.[26]

Retention of this freedom in financial markets is possible or desirable only if there are high standards of self-regulation. These have not existed in Canada until recently but the strengthening of government supervision and the awareness by the business community that any vacuum would be filled quickly by government has prompted many long overdue improvements.

The other important area of control is the regulation of entry and capitalization. Freedom of entry, according to traditional theory, is essential to perfect competition for only then will costs be minimized and resources be allocated in the most efficient manner. The financial markets of the real world, unfortunately, are not perfectly competitive despite many regulations designed to encourage mobility of funds and increased knowledge. There are also grave dangers in unrestricted entry to financial institutions whose solvency takes priority over their competitiveness. Governments have,

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[26] Great Britain: Report of the Company Law Committee, Cmnd 1749 (London: HMSO, 1962), para. 11.

therefore, felt it necessary to restrict entry by chartering or licensing. Applicants must satisfy minimum capital requirements and prove, to the satisfaction of the authorities, that the company will be ably and soundly managed. The quality of the institution is thereby improved but competition is lessened.

Purists may protest this interference with the competitive process but, as Roland I. Robinson points out:

> The trouble is that the public interest is involved in the solvency as well as the competitiveness of financial institutions ... But the losses that result from the insolvency of financial institutions, particularly those that handle the money of the relatively unsophisticated public, are thought to be socially if not economically intolerable.[27]

Conclusion

From this survey of the literature on financial intermediaries it is apparent that monetary theorists consider that these institutions perform a vital function in the economy and that governments can and should assist them in making an even greater contribution. However, these theorists are not in agreement on the degree and methods of government participation that would best serve this purpose. At one extreme, great reliance is placed on impersonal market forces and, at the other extreme, a wide range of discretionary policies are urged.

The evidence at this point in time indicates that the

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[27] Roland I. Robinson, Money and Capital Markets (New York: McGraw-Hill, Inc., 1964), p. 318.

growth of many types of financial institutions has not prevented the central bank from controlling economic conditions. Therefore, no major revision of the cash reserve basis is necessary nor are selective credit controls. The principal emphasis of the authorities should be directed instead to measures which are designed to improve the profitability, solvency and innovating ability of financial intermediaries and thereby improve the efficiency of the saving-investment process. In other words, regulation should be considered as having a predominantly positive function rather than an inhibiting one.

The regulation of financial institutions in Canada has been viewed mainly as a legislative problem and, because of this legalistic bias, emphasis has been placed on restrictive provisions such as portfolio controls, capital/liability ratios and chartering requirements. These measures no doubt added to the solvency of the system byt they also generated a conservative proclivity and monopoly profits. These features of our financial institutions were criticized by the Royal Commission on Banking and Finance with the result that, for the first time in Canada, measures have been taken to develop greater competition in our capital markets and financial intermediaries. Since that time, other defects in our regulatory framework have been exposed. The combined effect of these developments is a new regulatory environment for financial intermediaries in Canada.

CHAPTER II

Trust Companies and Finance Companies in the Canadian Economy

Financial intermediaries have become increasingly important to the Canadian economy through their absorption of primary debt and the diversity of services which they now offer to borrowers and lenders.[1] The major position among these intermediaries continues to be held by the chartered banks in the short-term field and by the life insurance companies in the long-term field, but the proportion of the total assets held by these two institutions has declined with the rise of other institutions able and willing to serve the more complex needs of the expanding economy.[2] From the figures in Tables 1 and 2, it is apparent that the banks and the life insurance companies not only dominated the field of financial services but were virtually without any competitiontion in 1945. Since that time, though, the less regulated and more agressive intermediaries such as trust and loan companies, finance companies and mutual funds, have attracted

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[1]Institutional assets as a percentage of primary debt increased from 47% in 1935 to 59% in 1962. Royal Commission on Banking and Finance, p. 106.

[2]Short-term institutions offer mainly liabilities with a high degree of liquidity such as chequable and nonchequable demand deposits, term deposits and money market securities while long-term institutions offer liabilities of a less liquid or a contractual nature such as insurance, pension funds, annuities and mutual funds.

TABLE 1

Assets of the Main Financial Institutions
(millions of dollars) Selected Years, 1935-1966

Institution	1935	1945	1950	1955	1960	1965	1966
Bank of Canada	308	2032	2350	2620	3044	3956	4207
Chartered Banks[3]	2514	5997	7918	10440	13121	19022	20249
Quebec Savings Banks	77	143	204	265	311	430	461
Trust Companies	225	266	441	714	1274	3422	3902
Mortgage Loan Co's.	230	235	367	570	945	2417	2564
Caisses Populaires & Credit Unions	11	140	302	643	1314	2542	2850[1]
Finance & Consumer Loan Companies	80	100	468	1244	2322	4237	4386
Industrial Development Bank	-	10	31	45	107	262	305
Subtotal	3445	8923	12081	16541	22438	36288	38924
Life Insurance Assets in Canada	1991	3125	4304	6043	8007	12163	n.a.
Pension Funds	n.a.	n.a.	875	1835	3616	6600	n.a.
Mutual Funds	n.a.	n.a.	42	191	563	1574	1889
Subtotal	1991	3125	5221	8069	12186	20337	1889
Fire and Casualty Insurance Assets in Canada	226	234	563	929	1316	1658[2]	
TOTAL	5662	12282	17865	25539	35940	58283	
Primary Debt Outstanding	12163	25961	31721	44050	n.a.	n.a.	n.a.
Institutional Assets as a percentage of primary debt	47%	47%	56%	58%			

Source: Royal Commission on Banking and Finance, Report, p.106 and Bank of Canada, Statistical Summary.

[1]Estimated by The Financial Post, June 3, 1967, p.11.

[2]Assets in 1964, the latest available figure.

[3]Ex net Canadian dollar items in transit and customers' liability under acceptances, guarantees and letters of credit.

TABLE 2

Assets of the Main Financial Institutions
(percentage distribution) Selected Years 1935-1965

Institution	1935	1945	1950	1955	1960	1965
Bank of Canada	5.4	16.5	13.2	10.3	8.5	6.8
Chartered Banks	44.4	48.8	44.3	40.9	36.6	32.6
Quebec Savings Banks	1.4	1.2	1.1	1.0	0.9	0.7
Trust Companies	4.0	2.2	2.5	2.8	3.5	6.0
Mortgage Loan Companies	4.1	1.9	2.1	2.2	2.6	4.1
Caisses Populaires & Credit Unions	0.2	1.1	1.7	2.5	3.6	4.3
Finance & Consumer Loan Companies	1.4	0.8	2.6	4.9	6.4	7.3
Industrial Development Bank	-	0.1	0.2	0.2	0.3	0.4
Subtotal	60.8	72.7	67.6	64.8	62.4	62.2
Life Insurance Assets	35.2	25.4	24.1	23.7	22.3	21.0
Pension Funds	n.a.	n.a.	4.9	7.2	10.1	11.3
Mutual Funds	n.a.	n.a.	0.2	0.7	1.6	2.7
Subtotal	35.2	25.4	29.2	31.6	34.0	35.0
Fire and Casualty Companies	4.0	1.9	3.2	3.6	3.6	2.8
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

a progressively larger percentage of the nation's savings.

This development was largely ignored at all levels of government in Canada until recently. At the federal level, the Bank of Canada is still of the opinion that the near-money substitutes developed by the nonbanking intermediaries are not presently of a sufficiently large size in relation to the conventional money supply to warrant their inclusion in the cash basis of the economy.[3] In any event, the Bank believes that the institutions are amenable to control by the usual techniques of monetary management. The concept of selective credit controls is also in abeyance because of the new emphasis on encouraging the flow of funds by competitive market forces. However, the federal government has been forced to recognize that financial intermediaries, if left to their own devices, can create serious disturbances in the capital markets or other areas which are inimical to the public interest. Provincial governments, who have the legislative power to control some of these institutions, have also been prodded from years of lethargy as a result of recent revelations of fraud, mismanagement and excessive assumption of risk by companies in their jurisdiction. Consequently, federal and provincial governments have passed legislation in

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[3]The money supply consists of notes and coins held outside the banks and demand and savings deposits of chartered banks, according to the Governor of the Bank of Canada as quoted in Canadian Banking and Monetary Policy, ed. James P. Cairns and H. H. Binhammer (Toronto: McGraw-Hill Company of Canada Limited, 1965), p. 313. At December 31, 1966, the money supply totalled $17,829 million and near-money in the form of deposits in Quebec Savings Banks, caisses populaires, trust companies and mortgage loan companies subject to withdrawal on demand totalled $3,036 million. Bank of Canada, Annual Report for 1966, p. 47.

the last year concerning deposit insurance, disclosure of financial affairs, more adequate reserve ratios, restrictions on the source and use of funds and higher qualifications for entry.

The immediate impetus for this rash of government action was the default of Atlantic Acceptance Corp. Ltd. on June 14, 1965, the consequent impairment of the solvency of British Mortgage and Trust Co. a shoft time later and finally the bankruptcy of Prudential Finance Corp. Ltd. in November 1966. In the case of the two finance companies there were criminal activities involved, but in all three cases there were many examples of incompetent management of company funds which the deficient regulatory and supervisory system failed to expose, let alone deter. The collapse of these companies also revealed the sensitivity of the capital markets and forced the Bank of Canada to revise some long-held views and take immediate action to restore confidence.

The Governor of the Bank of Canada explicitly called attention to the dangers to which the whole financial system has been exposed by the default of Atlantic Acceptance.

> The failure of Atlantic Acceptance in June had a disturbing impact on financial institutions and markets which was compounded by rumours regarding a trust company which had large investments in Atlantic and which was taken over by another trust company in September. There was some risk that soundly-managed institutions which had exercised prudence in the conduct of their business might find themselves in a position of difficulty and be unable to renew maturing short-term obligations until the confidence of investors had been restored. The dangers arising out of this situation were of major concern to the central bank.

Immediately after the default, the Bank of Canada added to the cash reserves of the chartered banks in order to ease the liquidity of the banking system and financial markets generally. Within a few days, I consulted with the chartered banks and indicated to them that while I did not wish to influence their judgment as to the credit standing of any customer I hoped that they would not feel unable, for reasons relating to the total amount of their resources, to accommodate credit-worthy finance companies which might find themselves in a difficult liquidity position. This unusual step was taken because in the atmosphere prevailing at the time there was risk that difficulties in any part of the credit system might have wider repercussions of a disturbing character. For their part, the chartered banks recognized that it was in the general interest that serious liquidity difficulties be avoided and their action in making credits available was helpful in the circumstances.

While the central bank is not entrusted with the function of appraising the soundness of the participants in the credit market, it is nevertheless very concerned with the maintenance of confidence in all parts of the financial system. Where such confidence is in danger of being seriously impaired the central bank may have to allow itself to be diverted from the pursuit of the current objectives of monetary policy and give priority to measures which help to maintain confidence. The events of last summer provided a dramatic illustration of the extent to which the whole financial system is dependent on the maintenance of high credit and liquidity standards, on the disclosure of adequate information, on the exercise of discrimination by investors and lenders, and on satisfactory arrangements for supervision and inspection of all parts of the credit system.[4]

A brief resume of the rise and fall of these three institutions is necessary to indicate the immensity of the changes which they precipitated in Canada. All three companies

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[4]Bank of Canada, Annual Report for 1965, p. 7.

reported phenomenal increases in assets to their security holders in the 1960 to 1965 period. Each was basically run by one man, with little or no interference from other management or directors. And they all collapsed within a year and a few months of each other, leaving professional investors and unsophisticated savers with losses now estimated at a total of $81.8 million. As a guide to assessing the size of this loss, it is equivalent to a loss of $736 million in the United States, if adjusted for comparative populations.

Atlantic Acceptance is a Toronto-based finance company which engaged in personal lending, instalment financing and lending to commercial and business organizations. In fact, Atlantic would make loans for almost any conceivable purpose. It would lend $500 to $700 for the purchase of electric guitars to persons in the twenty to twenty-five age bracket, and it financed the sales of door-to-door salesmen. It made a $2 million loan to a small plastics company, supposedly secured by the accounts receivable and fixed assets, but there were practically no accounts receivable or fixed assets of any value. The estimated loss on that loan is ninety to one hundred percent of the face value. The President was also involved, through loans and capital issues, with several men of unsavoury or criminal reputation and through these alliances was able to filter off funds through a maze of private banks in Europe and dummy companies in Canada, the United States and the Bahamas in some of the most complicated and devious transactions that have ever been revealed.[5]

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[5] M.J.Rossant, The New York Times, November 14, 1965, p. 86, F.J.McDiarmid, The Financial Post, November 20, 1965, p. 18.

To promote its fund raising activities, Atlantic presented reports to its shareholders and institutional lenders which grossly misrepresented the true financial picture. One commentator claims that:

> It is now evident that any net earnings ever reported by that company were in fact manufactured out of thin air. Its last annual audited report before its collapse - that for the year 1964 - showed net income of over $1 million, stockholders' equity of $16 million, subordinated debt of $14 million and senior secured debt of $92 million. Its unaudited report for the quarter ending March 31, 1965, showed a substantial increase in all these figures. Yet in July 1965, a cursory but remarkably accurate examination of its affairs indicated that all equity and subordinated debt then totalling nearly $40 million would be wiped out, while holders of $107 million of senior debt might hope to receive about 75 cents on the dollar by and by.[6]

Most of these facts could have been ascertained with a little research by auditors, directors or debt holders but they were all incredibly complacent about the company's image as a fast-growing finance company, an image that was maintained by putting more and more money into high-risk loans. Most of these debt holders were large investors such as commercial banks, industrial corporations, insurance companies, mutual funds, investment advisors, tax-exempt foundations, churches and educational institutions. So prestigious in fact were some of these companies that others bought simply on that account, without any further investigation into the company.

It is apparent, therefore, that the bankruptcy of

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[6] F.J.McDiarmid, "Crisis of Confidence", <u>Barron's</u>, April 10, 1967, p. 5.

Atlantic hit the experts, who were shown to be as gullible and greedy as the most inexperienced investor. Two important reasons for Atlantic's ability to raise money from these sources were the relatively high commissions and interest rates offered. The company had a policy of paying short-term interest rates that averaged one-eighth to one-quarter of one percent a year higher than the rates paid for money offered on similar terms by the two largest Canadian-owned finance companies, Industrial Acceptance Corp. Ltd. and Traders Finance Corp. Ltd. Atlantic also paid dealers a commission of 36¢ per annum per $100 borrowed compared to the 24¢ paid by Industrial and Traders. Corporate treasurers reaching for maximum returns and investment dealers hungry for commissions dealt in this paper without questioning its security although it was becoming increasingly perilous. In 1964 and 1965, there were very few occasions when the company's unused bank lines of credit amounted to even 10% of the short-term notes outstanding, but to the last minute there was apparently no concern for the company's liquidity position. It was not until after the actual default in June, 1965 that the facts gradually emerged to expose bookkeeping that was designed to maximize profits, financial reports that so grossly misrepresented the true financial condition that they can only be regarded as statistical fiction, and a lending policy that bore no relation to conventional practices.[7]

Among the many other companies that were found to be

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[7] J. K. Abell, Report on the Money Market Aspects of the Failure of Atlantic Acceptance Corporation, August, 1966, a submission to the Royal Commission on Atlantic Acceptance Corporation.

insolvent as a result of the Atlantic debacle was the eighty-eight year old British Mortgage and Trust Co., a well-regarded Ontario trust company. The reason initially advanced for its financial troubles was the default of Atlantic on its short-term notes. British Mortgage held debt and equity of Atlantic's and a personal loan to its President which totalled $8.7 million. Subsequent investigations into the affairs of the company revealed, however, that its investment practices in all areas had been unwise, to put it in the kindest light. The company held a $4 million short-term note, half of which was unsecured, and the collateral on many of its secured loans was unmarketable stocks and bonds, including a part interest in a gambling casino in the Bahamas. The legislation under which this trust company operated specifically forbade such practices. In addition, its $76 million mortgage portfolio had probable losses of over $10 million from doubtful investments and arrears in payments.

British Mortgage had acquired these investments in its foolhardy drive for rapid growth, much of which was attained by assuming greater and greater risks. For example, it had the reputation of lending to contractors that no other company would touch and charging 12% or more on the loans. The connection with Atlantic was also part of its assumption of risks that no prudent trust company would consider, even when such risks were within its powers under the trust companies act. It is interesting to note in this regard that while the presidents of both Prudential and Atlantic were charged with criminal wrong-doing, the President of British Mortgage, a former Bencher of the Upper Canada Law Society, was not investigated.[8]

The effect that Atlantic had on the Canadian economy can be seen in Table 3. Monetary conditions were tightening that year, due to the pressure generated by a substantial increase in capital expenditures and American measures designed to improve their balance of payments. The default of Atlantic accelerated this trend to tighter money despite the increase in cash reserves to provide loans to sales finance companies. It also doubled the spread between the yields on 91 day treasury bills and 90 day prime finance company paper and caused a major disinvestment in finance company paper. American investors were particularly disenchanted. In Canada, there was a clearly discernible switch of investors' preferences in financial claims from finance company paper to bank term deposits during the summer and early fall, a trend that has continued but with slightly less fervour. Because finance company paper is the leading money market instrument provided by the private sector, these trends to a new structure of interest rates and altered demand conditions are of considerable significance to the monetary authorities.

Prudential Finance was the next significant financial institution to fail in Canada. This organization had changed in the 1960's, under its new president, from a small conventional finance company to a diversified holding company with twenty-

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[8] Maclean's, January 22, 1966, pp. 10-12, 34-36, Harold R. Lawson, President of National Life Assurance Co. of Canada, The Financial Post, November 27, 1965, pp. 17-18, and The Financial Post, Dec. 11, 1965, p. 25.

TABLE 3

Selected Financial Statistics, Monthly, 1965

	Monetary Conditions Indicated By Yield at Month End			Net New Issues Finance Company Paper (Quarterly)	Chartered Banks Loans To Finance Companies	Non-Personal Term & Notice Deposits
	91-day Treasury Bills	90-day Finance Co. Paper	Yield Spread	Millions of Dollars		
January	3.74%	4.25%	0.51		265	1622
February	3.74	4.25	.51		275	1737
March	3.62	4.40	.78	83	288	1827
April	3.77	4.40	.63		295	2019
May	3.90	4.62	.72		281	2063
June	3.93	4.75	.82	4	357	2153
July	4.05	4.95	.90		384	2290
August	4.08	5.15	1.07		386	2345
September	4.13	5.15	1.02	-133	425	2395
October	4.15	5.37	1.22		442	2432
November	4.16	5.62	1.46		441	2371
December	4.54	6.00	1.46	-111	527	2303

Source: Bank of Canada, Statistical Summary, Supplement 1965
Greenshield Ltd., Comparative Money Market Rates.

six branch offices dealing in small loans and sales financing. Its funds were raised from small savers in the form of deposits, short-term promissory notes and long-term debentures, part of which were used to expand its branch network and part to finance subsidiary companies or companies controlled by the president. These companies were in such widely varying fields as steel fabricating, brick manufacturing, general insurance and real estate, a diversification which presented acute problems to management. Many of the companies lost substantial sums annually and were kept operational only by the sale of assets between these companies at inflated values, by not writing off losses, and by making inter-company loans. Prudential finally defaulted on its notes as a direct result of its inability to earn sufficient revenue to cover even the heavy administrative and overhead costs resulting from the rapid expansion of its branch network, the high cost of borrowed funds and the losses incurred on special loans and investments. Some 8700 investors, mostly unsophisticated savers, found there was only \$4.1 million in estimated realizable assets to meet unsecured claims of \$32.6 million.[9]

The collapse of these three companies has had far-reaching implications for the economy. Atlantic had its major impact on the central financial markets where finance companies traditionally raise the bulk of their funds, but Prudential

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[9]Frank Kaplan, The Financial Post, November 26, 1966, p. 3, Arthur Wishart, Attorney General of Ontario, The Financial Post, December 10, 1966, p. 4, Frank Kaplan, The Financial Post, December 17, 1966, p. 3 and statements issued by the Ontario Securities Commission and Clarkson, Gordon & Co., The Financial Post, April 1, 1967, p. 30.

and British Mortgage affected the politically sensitive areas of the pensioner, the widow and the unwitting investor. It is not surprising, therefore, that these companies radically altered the approach of governments, the public and the business community towards regulation. They also gave the accounting profession the severest shake-up it has had since the collapse of the Home Bank in 1925.[10] Of particular relevance to this paper is the considerable impact it has had on the remaining trust and finance companies.

Trust Companies

Canadian trust companies are a distinct form of financial institution, part fiduciary and part intermediary, with no counterpart in either the United Kingdom or the United States.

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[10]The Home Bank was incorporated in 1903 with headquarters in Toronto and, at the time of its collapse in 1923, it had 71 branch offices, mostly in Ontario, and deposits of $23 million. The unsatisfactory condition of the bank was brought to the attention of the Canadian Minister of Finance in 1916 but no enquiry was made at that time because the Minister wished to avoid a financial crisis in wartime. In 1923 however, the bank finally failed and the gross inefficiency and negligence of the management was exposed. The President, the Vice President, five other Directors, the General Manager, the Chief Accountant and the Chief Auditor were all charged with making false and deceptive returns. The President died before the trial began, the Vice President was acquitted and the others were sentenced to imprisonment but were also later acquitted. In 1925 the Canadian Parliament came to the partial relief of the depositors who were deemed to have a moral claim against the Government. A. B. Jamieson, Chartered Banking in Canada (Toronto: The Ryerson Press, 1953) pp. 59-63.

Their original function was considered to be the administration of individual assets under trust and agency agreements and they were the only corporations granted this power. Their intermediary function developed from this trustee business, since the companies were allowed to accept deposits and other funds, in trust, for the purpose of investing in securities and mortgages. Legally, most of the companies are still prohibited from borrowing money but in practice they operate in the same manner as many other financial intermediaries, borrowing from the public and investing the proceeds. Funds are obtained mainly in the form of deposits and investment certificates and are placed in first mortgages on real estate, government securities and the bonds and stocks of companies with established earnings records.

The trust companies played a minor role in the saving-investment process until this decade. From 1946 to 1960 inclusive, the increase in their deposits and investment certificates was equal to only 1.5% of total gross saving, or 6.1% of total net personal saving during that period but, in the succeeding six years, the trust companies were able to absorb 5.1% of total gross saving and 18.0% of total net personal saving. This changing distribution of national saving is shown in Table 4.

The greatest sectoral impact of the trust companies has been in the mortgage market, where they provided 23.6% of the mortgage loans approved by lending institutions from 1960 to 1962, compared to their 7.1% share of the market from 1951 to 1953 and 10.4% from 1954 to 1959.[11]

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[11] Royal Commission on Banking and Finance, p. 274.

TABLE 4

Distribution of National Saving in Selected Financial Institutions 1946-1966

(Millions of Dollars)

Year	Total National Saving	Net Personal Saving	Chartered Banks Deposits held by General Public	Trust Co's Deposits & G.I.C's.	Mortgage Loan Co's Deposits & Debentures	Credit Unions Shares & Deposits
1947	2534	494	5908	245	180	206
1948	3238	994	6477	274	198	239
1949	3293	926	6862	305	223	264
1950	3636	662	7292	343	250	289
1951	4439	1334	7396	354	276	334
1952	4935	1291	7881	374	301	396
1953	4996	1312	7884	379	329	453
1954	4235	809	8676	525	392	511
1955	4951	850	8945	597	445	603
1956	6366	1320	9185	617	476	700
1957	6115	1202	9234	649	515	787
1958	5469	1635	10519	825	578	935
1959	5834	1357	10356	919	648	1060
1960	5978	1535	10875	1132	725	1208
1961	5769	1545	11533	1408	846	1382
1962	6932	2317	11961	1704	970	1521
1963	7862	2531	12635	2098	1108	1730
1964	9083	2059	13395	2592	1302	1981
1965	10337	2927	14473	3092	1451	2275
1966	11592	3438	15397	3515	1859	n.a.

Source: Bank of Canada, Statistical Summary, Financial Supplement 1957, Supplement 1965, November 1966, August 1967, July 1967. Dominion Bureau of Statistics, National Accounts, Income and Expenditure.

In comparison, the trust companies are an insignificant factor in the long-term capital market. Their participation in the money market, however, has been increasing steadily.

Apart from these intermediary operations, the trust companies exert an important, if less direct, influence on the economy through their individual and corporate trusteeships. A large volume of trustee work is still handled by individuals (no statistics are available as to the exact amount) and provincial governments provide some trustee services to wards of the state. The trend though is to increasing institutionalization of the trustee function to provide the advantages of unlimited life, wider experience and a greater guarantee of solvency. The demand for trustee services has also grown because of the growth of pension funds, the general rise in personal wealth and the greatly increased volume of capital issues. Consequently, the trust companies have been gaining fiduciary business in large amounts and at accelerating rates. This aspect of their business is regulated by the provinces by virtue of the property and civil rights provision of Section 92 of the British North America Act.

The industry is highly concentrated although entry is relatively easy. There are presently 54 trust companies in Canada, but the ten largest companies, which are listed in Table 5, hold 76% of the total assets of all companies. The Estates, Trust and Agency business in particular is so highly concentrated that ten companies were reported to have 90% of the funds under administration and two companies

TABLE 5

Leading Canadian Trust Companies

Assets and Earnings - Fiscal 1966

Name of Company	Total Assets	Assets Under Administration for Estates, Trusts and Agencies	Guaranteed Funds	
			Savings and other Deposits	Guaranteed Investment Certificates
	Millions of dollars			
The Royal Trust Company	561	3,702	33	506
Guaranty Trust Company of Canada	441	279	180	233
Montreal Trust Company	398	3,113 (1965)	100	274
National Trust Company Limited	351	1,192	201	129
Eastern & Chartered Trust Co.	304	668 (1965)	114	172
Victoria & Grey Trust Company	277	38	66	189
The Canada Trust Company	217	860	80	119
Canada Permanent Trust Company	178	1,087	41	125
The Waterloo Trust & Savings Co.	164	76	69	86
Trust General du Canada	94	397	6	80
TOTAL	2,985	11,412	889	1,913
Total - all trust companies	3,902	12,588	1,094	2,421
% Held by Leading Companies	76%	91%	81%	79%

TABLE 5 - Continued

Source: Financial Post, Survey of Industrials 1967, Annual Reports of each Company, Dominion Bureau of Statistics, Business Financial Statistics, and Report of the Inspector of Trust Companies for the Province of Quebec for 1966.

Capital Funds	Net Profit	Capital/Liability Ratio	Return on Equity
Millions of Dollars			%
30	3.8	1:18	12.7
26	2.7	1:16	9.9
22	2.2	1:18	10.2
21	1.9	1:16	11.0
17	1.6	1:17	9.0
16	1.5	1:16	9.5
17	1.4	1:12	8.3
12	1.1	1:14	9.4
10	.5	1:15	5.7
7	.6	1:13	11.7
178			
321			
55%			

alone had more than 50%.[12] Beyond these usual signs of market power is the intangible control of these companies provided through interlocking directorates with banks and life insurance companies and the large blocks of trust company stock held by these institutions.[13] Several of the large trust companies are also owned by or allied with large mortgage loan companies, survivors of early building societies in Upper Canada and subject to legislation that is similar to trust company legislation.

The 1967 Bank Act has attempted to lessen these concentric forces by requiring a bank to divest itself of any stock in a trust company that is in excess of 10% of the company's outstanding shares, although the requirement is relaxed to 50% of the outstanding shares if the trust company does not accept deposits. Furthermore, no bank director can be a director of a trust company after 1970. The efficacy of these restrictions is questionable, however. For example, Canada Permanent Mortgage Corporation and Eastern and Chartered Trust Company are merging for the ostensible purpose of watering down the percentage holdings of the Bank of Nova Scotia and Toronto Dominion Bank. The banks are also pressing for trustee powers such as the American banks have had since 1913.[14]

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[12] Royal Commission on Banking and Finance, p. 175.

[13] Cf. John Porter, "The Concentration of Economic Power", The Vertical Mosaic: An Analysis of Social Class and Power in Canada (Toronto: The University of Toronto Press, 1965) pp. 231-263.

[14] State banks were allowed to operate as fiduciaries as early as 1903 but federal banks were not authorized to do so until ten years later.

The necessity of regulating trust companies has been recognized since their inception because of the privileges and responsibilities of their fiduciary position. These institutions were consequently exempted from the provisions of the corporations acts governing other companies and made subject to special trust company statutes. Unfortunately, these statutes have been far from uniform and companies operating on a nationwide basis have been subjected to a bewildering variety of regulations.

The basic problem underlying all attempts to regulate trust companies in Canada has been the location of responsibility under the British North American Act. Both the federal and provincial governments have the power to incorporate companies and so both bodies have passed special acts regulating trust companies. The majority of the companies, for historical and other reasons, have been incorporated under provincial acts and so escape federal regulation. However, they are subjected to provincial regulation in every province in which they are licensed to carry on business.[15] As a result, there is overlapping of regulation which is further complicated by the wide disparities in the quality of supervision between various governments.

The aspect of trust company operations which has brought the strongest demands for regulation has been their chequable demand deposits which, in essence, are indistinguisable from savings account in chartered banks. Section 91 of the BNA Act gives the federal government the power to regulate "banking".

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[15] Federally incorporated trust companies must be licensed by each province in which they operate but this is a nominal requirement.

institutions without defining the term. The courts have taken a broad view of the federal banking power as "including every transaction coming within the legitimate business of a banker,"[16] but the federal government has so far been unwilling to rely on the rule of stare decises or to risk a confrontation with the provinces on this matter. Instead, it has resorted to a deposit insurance scheme which it hopes will bring all trust companies under the supervision of the federal Department of Insurance.

The deposit insurance instituted by the Canadian government has three purposes. It is designed to provide additional security to depositors, rediscounting facilities in the event of a liquidity shortage at one or more companies and, most important of all, inspection and supervision of insured institutions to improve the standards of financial management in institutions accepting deposits from the public.[17] The chartered banks bitterly opposed the scheme on the grounds that their inclusion was an unnecessary cost to them but almost all the trust companies are strong supporters of deposit insurance. They are aware that the insuring of savings and loan company deposits identically with commercial bank deposits in the United States resulted in a rapid rise in savings and loan deposits in that country. The institution of deposit insurance is also likely to strengthen the competitive position

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[16] Bora Laskin, Canadian Constitutional Law, (Toronto: The Carswell Company Ltd., 1960), p. 88.

[17] The Honourable Mitchell Sharp, Minister of Finance, The Senate of Canada, Proceedings of the Standing Committee on Banking and Commerce, Evidence February, 17, 1967, p. 631.

of smaller companies and to alleviate public concern created by the failure of British Mortgage and the liquidity crisis at York Trust and Savings Company which also began in the summer of 1965.[18]

The Canada Deposit Insurance Corporation was established by an Act of Parliament in February, 1967.[19] Membership is obligatory for all banks and for all federally-incorporated trust and loan companies that accept deposits from the public. Membership of provincially-incorporated trust and loan companies that accept deposits is voluntary, but must be authorized by the province of incorporation and is subject to the approval of the CDIC. The corporation acts as a lender of last resort to its members through its power to extend loans to them, and fortifies their liquidity position by guaranteeing loans and deposits or buying their assets if necessary. The Superintendent of Insurance for Canada must inspect all member trust companies at least once a year. Deposits and guaranteed investment certificates with a maximum term of 5 years are insured up to a limit of $20,000 per person per institution through an insurance fund created by an annual assessment on all members. Member institutions who, in the opinion of the CDIC, are carrying on unsound financial practices may have their deposit insurance cancelled on thirty days notice, while an insolvent institution has its insurance cancelled immediately.

As most of the provinces require all their trust

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[18] The rise and near fall of York Trust is described in Macleans, July 1, 1967, p. 19.

[19] Canada; Canada Deposit Insurance Corporation Act, (1967).

companies to join the CDIC, the plan has been effective in promoting a degree of uniformity in trust company supervision and in improving greatly the quality of that supervision. The financial standards which will be prescribed for member institutions have not been settled yet as the variety of assets, liabilities and services preclude rigid rules. It is also still too early to assess the economic impact on the flow of funds or on the capital market.

Finance Companies

Finance companies are such a diverse group that they do not lend themselves easily to generalizations about their functions or operations. They have usually been separated into small loan companies and sales finance companies for legal and historical reasons but the compartments are by no means watertight. The small loan companies are the more homogenous group because they confine their operations primarily to personal loans, although some do a small amount of instalment financing. The sales finance companies do their largest volume of business in the instalment financing of retail and wholesale purchases of consumer durable goods, particularly motor vehicles. Many of them also extend credit to the business sector in the form of commercial and industrial financing of buildings, equipment and machinery, medium-term lending and interim financing of real estate and construction. A few companies engage in mortgage lending, property and equipment leasing and commercial factoring. In addition, many sales finance companies own or control small loan companies and insurance companies.[20]

In terms of impact on the economy, consumer credit is still the most important function of the finance companies. In 1966, they provided 31% of the total funds used for this purpose but, as shown in Table 6, their relative importance has been declining since 1956. During this period there was a slow growth in consumer expenditures on durable goods and the finance companies were faced with the newly aggressive competition of the chartered banks and credit unions. There was also a tendency for consumers to use personal loans rather than instalment financing for the purchase of goods. The result of these changing credit conditions was a sharp drop in the market position of sales finance companies and only a slight rise in that of consumer loan companies. To counteract their declining consumer operations, many finance companies then turned to commercial and industrial lending and ancillary services. These business loans are proving to be an increasingly important source of revenue for companies, as can be seen in Table 7, although these comprise a relatively small proportion of total business financing in Canada compared to internal financing and funds raised through the capital market.[21]

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[20]The equity positions in other companies which many sales finance companies have serve a variety of purposes. The small loan subsidiaries are a legal manoeuvre. The general insurance companies insure the goods sold on time to widen the profit margins of the instalment finance operation. A few companies take an equity position in businesses they finance as partial payment for their services and to obtain more effective control of their debt. Other companies have acquired share control when businesses have defaulted on their loans.

[21]Finance companies provided 16.2% of total commercial and industrial credit in Canada in 1965, compared to 11.9%

TABLE 6

Sources of Consumer Credit in Canada

1957 - 1966

Year	Sales Finance Companies	Consumer Loan Companies Instal-ment Credit	Consumer Loan Companies Cash Loans	Chartered Bank Personal Loans	Quebec Savings Banks
1957	780	15	347	421	4
1958	768	19	382	553	6
1959	806	38	446	719	6
1960	828	45	504	857	6
1961	756	35	559	1030	9
1962	801	52	662	1183	13
1963	874	55	755	1432	14
1964	1035	54	850	1793	15
1965	1131	67	976	2186	16
1966	1212	74	1096	2402	16

Source: Bank of Canada, Statistical Summary, Supplement 1965, pp. 108-113, and August, 1967, pp. 595-596.

TABLE 6 - Continued

Life Insurance Companies' Policy Loans	Department Stores	Credit Unions	Other	Total
295	262	258	594	2976
305	282	320	613	3248
323	314	397	642	3691
344	368	433	637	4020
358	401	516	651	4315
372	427	579	661	4750
385	456	691	685	5347
398	508	836	698	6187
411	565	987	718	7058
445	603	1042	747	7637

TABLE 7

Credit Structure of the Finance Companies

1955 - 1966

Year	Personal Non-Business Loans			Business Loans			Total
	Instalment	Cash	Total	Wholesale Trade	Other	Total	
	Millions of Dollars						
1955	605	273	878	145	192	337	1215
1956	769	343	1112	182	279	461	1573
1957	795	347	1142	202	288	490	1632
1958	787	382	1169	191	257	448	1617
1959	844	446	1290	197	344	541	1831
1960	873	504	1377	229	393	622	1999
1961	791	559	1350	184	395	579	1929
1962	853	662	1515	240	440	680	2195
1963	929	755	1684	301	520	821	2505
1964	1089	850	1939	268	588	856	2793
1965	1198	976	2174	452	665	1090	3264
1966	1297	1096	2393	393	662	1055	3448
	Percent of Total						
1955	49.8	22.5	72.3	11.9	15.8	27.7	100.0
1956	48.9	21.8	70.7	11.6	17.7	29.3	100.0
1957	48.7	21.6	70.3	12.2	17.5	29.7	100.0
1958	48.7	23.6	72.3	11.8	15.9	27.7	100.0
1959	46.1	24.4	70.5	10.8	18.7	29.5	100.0
1960	43.7	25.2	68.9	11.4	19.7	31.1	100.0
1961	41.0	29.0	70.0	9.5	20.5	30.0	100.0
1962	38.9	30.1	69.0	11.0	20.0	31.0	100.0
1963	37.1	30.1	67.2	12.0	20.8	32.8	100.0
1964	39.0	30.4	69.4	9.6	21.0	30.6	100.0
1965	37.1	29.5	66.6	13.5	19.9	33.4	100.0
1966	37.6	31.8	69.4	11.4	19.2	30.6	100.0

Source: Bank of Canada, Statistical Summary, Supplement 1961, pp. 104-108, Ibid., Supplement 1965, pp. 114-115, Ibid., July 1967, pp. 511-512.

At the end of 1966, there were 83 licensed small loan companies in Canada[22] and at least 150 sales finance companies. The exact number of finance companies is difficult to determine because of the many small privately-owned companies, although in terms of balances outstanding these are insignificant. There are no barriers to entry in the industry but competition for business and the problem of raising funds is sufficiently acute to deter the growth or even survival of small companies. As a result, the industry is highly concentrated, with the six largest finance companies listed in Table 8 accounting for over 90% of the outstanding instalment credit. There is also a high degree of U.S. control. In the small loans industry for example, 60% of the business is done by wholly-owned subsidiaries of American consumer loan companies compared to 35% by wholly-owned subsidiaries of Canadian incorporated sales finance companies.[23]

For regulatory purposes, an important distinction is made between sales financing and consumer loans which has its origin in a legal fiction known as "the time-price doctrine." Instalment financing, according to this theory, is the sale of goods on credit. Every good, therefore, has a cash price and a time price, the differential or "add-on"

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in 1955. Canadian Business Service Limited, Finance Companies and the Credit System, August 16, 1966, p. 8.

[22]Federally incorporated companies are legally called small loan companies and provincially incorporated companies are called money lenders. There are presently 5 small loan companies and 78 provincial companies.

[23]Canada One Hundred 1867-1967, (Ottawa: Queen's Printer, 1967) p. 254.

TABLE 8

<u>Leading Finance Companies in Canada, Assets and Earnings, Fiscal 1966.</u>

(Millions of Dollars)

Company	Total Assets	Notes and Accounts Receivable	Debt Short Term	Debt Long Term
Industrial Acceptance Corp. Ltd.[1]	944	876	278	420
General Motors Acceptance Corporation of Canada Ltd.	532	517	302	142
Traders Group Ltd.[1]	524	458	121	241
Laurentide Financial Corp. Ltd.[1]	337	275	125	135
Avco Delt Corp. Canada Ltd.	325	292	101	182
Household Finance Corporation of Canada[2]	228	224	-	215
TOTAL	2890	2642	2264	
TOTAL - All Canadian Sales Finance and Consumer Loan Companies	4386	3706	3465	
Percentage held by Major Companies	67%	71%	65%	

Notes: [1]Controlled by Canadians.

[2]Figures for Fiscal 1965.

Sources: Annual Reports of Selected Companies and Dominion Bureau of Statistics, <u>Selected Financial Institutions</u>.

Table 8 - Continued

Capital Funds	Net Profit	Ratios Capital to Liabilities	Return on Equity
127	13.3	1:5	10.5
18	1.9	1:25	10.8
62	4.0	1:6	6.4
48	deficit 9.6	1:5	-
24	2.6	1:12	10.7
8	3.9	1:27	5.2
287			
474			
61%			

being a charge levied by the vendor to allow the purchaser to pay for the goods over a period of time while gaining their immediate use. Such a charge is not legally considered to be interest and laws relating to interest charges therefore will not apply to sales financing. This distinction, while initially appearing to be of little concern to the economist, does affect the flow of funds through finance companies because of the different legal restrictions placed on small loan companies. This distinction is particularly important in Canada where the BNA Act grants the federal government exclusive jurisdiction over interest and so over lenders, but does not grant any specific jurisdiction over vendors or sales finance companies.

Since small personal loans were most frequently made to lower income individuals with no bargaining power or financial sophistication, governments in both the United States and Canada have controlled the rates on this type of lending for many years. In Canada, all small loan companies must be licensed by the Department of Insurance if they extend personal loans of $1500 or less and charge more than one per cent per month on the unpaid balance. The rates on all other forms of nonbank lending are not regulated in Canada.[24]

The regulation of finance companies for purposes of stabilizing demand or preventing its misallocation by the diversion of savings was considered by the Bank of Canada in

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[24]In the United States, approximately two-thirds of the states set ceilings on finance charges for automobile instalment sales and approximately one-third have ceilings on rates for instalment sales of goods other than automobiles.

1956. Finance companies were held to be an "unregulated rival banking system"[25] that could outbid regulated financial institutions for funds by their unrestricted rates. The decline in their competitive position since that time, plus a greater understanding of their sensitivity to credit conditions, has altered the Bank's view.

Regulatory emphasis has now shifted to concentrating on the effects of these companies on the capital markets. Legislation and supervision is consequently being directed towards fuller disclosure, better investment practices and accounting methods, an improved balance between the asset and liability structure and increasing the legal responsibility of management, directors and auditors. In the following chapters, the problem of supervising and regulating the trust companies and finance companies of British Columbia is examined in detail.

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[25] Bank of Canada, Annual Report for 1956, p. 27.

PART 2

THE CONTROL OF TRUST COMPANIES IN BRITISH COLUMBIA

CHAPTER III

The Regulation of Trust Companies

The trust companies which operate in British Columbia are regulated by the provisions of the Trust Companies Act[1] and and Trustee Act[2], both of which were passed in 1948 and have been only slightly updated in the intervening nineteen years. The supervisory power over these companies is vested in the Inspector of Trust Companies, a functionary in the Department of Finance who lacks the time, the experience and the staff to perform his duties in a competent manner. Consequently, the trust companies in this province encounter effective government regulation and supervision only when they come within the jurisdiction of the federal government or that of a very few other provinces. Trust companies which operate solely in British Columbia are a relatively recent phenomenon and the lack of effective regulation may well lead to a serious problem for these companies, unless there is a change in the attitude of the provincial government.

There are presently fifteen trust companies operating in British Columbia, all of which are listed in Table 9. Their 65 branch offices are naturally concentrated in the populous lower mainland, but 12 of these branches have been opened in the thriving communities of Prince George (3), Kamloops (3), Vernon (1), Dawson Creek (2), Kelowna, (2)

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[1] British Columbia, Trust Companies Act, R.S. 1948, c.61.

[2] British Columbia, Trustee Act, R.S. 1948, c. 345.

TABLE 9

Current Rates on Trust Company Obligations

Offered in British Columbia

Company	No. of Branches in B.C.	Deposits Chequing Rate	Deposits Chequing Basis Code	Deposits Non-chequing Rate	Deposits Non-chequing Basis Code	Term Rate	Term Basis Code
NATIONAL COMPANIES							
Administration and Trust Co.	1	4	5	4½	3		
Canada Permanent Trust Co.	8	3½	5	4	3		
Canada Trust Co.	9	4	5	4½*	3		
Crown Trust Co.	1	3½	5	4½	3		
Eastern & Chartered Trust Co.	8	4	5	4½	2		
Guaranty Trust Co. of Canada	4	4	5	4½	3		
Montreal Trust Co.	4	4	5	4½	4		
National Trust Co.	6	4½	5				
Royal Trust Co.	3	4	5	4½	3		
SMALLER WESTERN-BASED COMPANIES							
City Savings & Trust Co.	1	4½	5	5	3		
Commonwealth Trust Co.	8	4½		5		4.5/8	1
Investors Trust Co.	2	4	4	4½	3		
North West Trust Co.	4	4½	5	5	3		
Yorkshire Trust Co.	6	4	5	4.3/4	3	4.5/8	1

* Plus ½ of 1% per annum on minimum quarterly balance, provided that the minimum balance during the quarter is at least $500 and only one withdrawal is made during that period.

Basis Code: 1. Computed daily. 2. Computed monthly, paid quarterly.
3. Computed monthly, paid semi-annually.
4. Computed quarterly, paid semi-annually.
5. Computed semi-annually, paid semi-annually.

TABLE 9 - Continued

Less than 1 Year	Guaranteed Investment Certificates 1 Year	2 Year	3 Year	4 Year	5 Year
5-5.3/4	6.1/4	6.1/4	6.1/4	6.1/4	6.1/2
	6.1/2	6.1/2	6.1/2	6.1/2	6.1/2
4.5/8-5.3/4	5.3/4	5.3/4	6.1/2	6.1/2	6.1/2
	5.3/4	5.3/4	6	6.1/2	6.1/2
4.5/8-5.1/4	6	6.1/4	6.1/4	6.1/4	6.1/2
Subject to negotiation	6.1/4	6.1/4	6.1/4	6.1/4	6.1/4
4.3/4-5.3/4	6.1/4	6.1/4	6.1/4	6.1/4	6.1/4
Subject to negotiation	6	6	6.1/4	6.1/4	6.1/2
4.5/8-5.3/4	6.1/4	6.1/4	6.1/4	6.1/4	6.1/2
5.1/2-6.1/8	6.1/4	6.3/8	6.3/8	6.1/2	6.1/2
	6.1/4	6.3/8	6.1/2	6.5/8	6.3/4
	5.3/4	6	6	6.1/4	6.1/2
5.1/2 - 6	6	6	6	6.1/2	6.1/2
5 - 5.7/8	6.1/2	6.1/2	6.1/2	6.1/2	6.1/2

and Penticton (1). Only the comparatively undynamic area of the southeast of B.C. lacks trust facilities. The density of this branch network is equal to approximately 28,600 people per branch, only slightly less than the comparable ratio for Ontario of 28,000 people per branch. In considering these figures it is also noteworthy that B.C. was reported to have one bank branch per 2600 people, the highest ratio of any province and almost twice the 5500 per banking facility in the United States.[3] These figures indicate that, generally speaking, British Columbia has adequate trust facilities, a conclusion that agrees with the Porter Commission's statement that they did not find any strong evidence of a shortage of trust facilities in Canada.[4]

All but two of these companies were incorporated outside the province and most are large national companies that have been in business for many years. The two operating B.C. companies are Yorkshire Trust Co. and Commonwealth Trust Co.[5] Both are young companies attempting to break into a market that has been dominated for many years by the older companies.

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[3]The Royal Commission on Banking and Finance, p. 120. The American banking facilities include commercial banks, savings banks, and savings and loan associations.

[4]*Ibid.*, p. 188.

[5]There are four other trust companies that were incorporated and are still in existence. Okanagan Loan and Investment Trust Co., Trust Co. of Victoria and Trustee Co. Ltd. (now Mercantile Mortgage Co. Ltd.) and Western Pacific Trust Co. Only the last mentioned company has securities on deposit which are good for new business but the deposit of the others is being held in respect of business previously existing, contracted, arising, or entered into during the period of their currency.

Under these circumstances, a new company must tap some area of the economy that is being inadequately served by the existing companies, if it is to be successful. The new company is also under greater than normal pressure to expand its assets quickly and faces more than the usual resistance in attracting funds, with the result that there is a strong incentive to reach for higher yielding but riskier investments in order to pay for the higher cost of funds. Such companies, therefore, present the special regulatory problem of attempting to assure their solvency without dampening their salutory competitive influence.

Commonwealth was founded in 1961 by a group of British Columbia businessmen. It raised the bulk of its capital and liabilities within the province mostly from small and unsophisticated savers. The cost of guaranteed funds has been relatively high, and so provided a strong incentive to invest in higher yielding mortgages outside the prime area. The company has also reached for funds in the United States which certainly could only be attracted with a considerable risk premium. Unfortunately, an adequate discussion of the company's financial position is impossible because the President, Mr. Duncan Crux, refused to discuss the matter or to allow a discussion with any other officer of the company.[6] A researcher is therefore forced to rely on the company's annual reports which are insufficient for a satisfactory analysis of the company.

Yorkshire Trust Company is controlled by Power Corporation of Canada, Limited, the Montreal-based investment trust.

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[6] Interview with Duncan Crux, President of Commonwealth Trust Company, July 7, 1967.

A predecessor of the present trust company was incorporated in the United Kingdom but, when its British owners sold a sixty-six per cent interest to Power Corporation, it was converted into a British Columbian company. The balance of the $3.2 million equity is held by individuals associated with Yorkshire and by its original owners.

At present, Yorkshire has approximately $9½ to $10 million in its guaranteed account, all of which was raised within the province. The proportion of various liabilities within this account is unusual as Yorkshire has been quite successful in selling short GICs to the smaller companies who are seldom contacted by the larger trust companies. These liabilities are in the following proportions:

	Yorkshire	Average of all Canadian Trust Companies.[7]
Deposits:		
Chequing	7%	15%
Non-chequing	18%	15%
	25%	30%
Guaranteed Investment Certificates		
Under one year	55%	17%
Over one year	20%	53%
	75%	70%
	100%	100%

Most of the deposits are held by individuals but only one-third of the GICs are held by individuals. The cost of these funds has been only marginally higher than the cost of

[7] Dominion Bureau of Statistics, Business Financial Statistics, Selected Financial Institutions, Fourth Quarter, 1966.

comparable funds to large national trust companies, but Yorkshire has had difficulties in attaining the essential minimum pass-through spread of 2% because its mortgage portfolio is still small. To correct this problem the company plans to build up its mortgage holding this year, with a special emphasis on smaller industrial and commercial mortgages rather than N.H.A. or conventional mortgages, to attain the higher yield.[8]

Regulation of Entry in British Columbia

The principal means by which regulatory policy in this province influences competition and attempts to curtail imprudent expansion of trust companies is by its policy on chartering and branching. This regulatory emphasis is unusual in Canada but it is sufficiently common in the U.S.A. for one economist to claim that:

> probably the most pervasive way in which public regulation influences the degree and character of competition is in its control of the chartering of new financial institutions or the establishment of branches by existing instituions.[9]

A trust company is incorporated in British Columbia on the recommendation of the Inspector of Trust Companies but, before commencing business, it must also obtain registration by satisfying a minimum capital requirement of $250,000, of which $100,000 plus $10,000 for each branch operated or proposed to be operated by the company must be deposited in trust in a chartered bank in the province. The new trust

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[8] Interview with William Reid, July 11, 1967.

[9] Roland I. Robinson, Money and Capital Markets, p. 318.

company must also "establish that it is expedient as being necessary for the convenience and advantage of the public, that there should be a trust company or additional trust company in the locality in which the registered or head office of the company within the province is proposed to be situate"[10] and "that the company and its directors and managers have the qualifications necessary for performing the duties of a trust company, so as to command the confidence of the public."[11] A company that does not obtain registration within two years after the date of incorporation will have its incorporation cancelled.[12]

The registration requirements do not apply to a federally incorporated company. Extra-provincial companies, however, must meet the same conditions as a provincial company and one such company was refused registration as a provincial company on the grounds that the management lack the desired degree of integrity.

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[10] British Columbia, Trust Companies Act. R.S. 1948 c. 61, S. 30 (a).

[11] Ibid., s. 30 (d).

[12] This is an important provision in chartering policies because it may prevent a case similar to one that occurred in this province three years ago. Columbia Beneficial Holdings Ltd. bought the dormant charter of B.C.Life and Casualty Co. for $50,000, wrote it up to $570,000 on their books, gave voting control to a group of men in exchange for their interests in a peat moss property in Montana and then began selling life insurance and raising non-voting equity money from the public. In the opinion of a former Superintendent of Insurance, K. R. MacGregor, all instruments of incorporation for trust, loan and insurance companies should expire in two years if the company is not ready to operate, to ensure that the sponsors of these institutions are subject to government scrutiny. Toronto Globe and Mail, February 4, 1966.

Some of these measures to restrict entry, which are inspired by the public-trust nature of the business, appear to have a valid basis. Concern for the character and competence of the sponsors and the management, for example, is essential if a large portion of the nation's accumulated wealth is to be entrusted to these companies. Capital requirements also serve a useful purpose by eliminating frivolous entrepreneurs and by providing protection against losses. The need barrier, however, is a questionable device for protecting the public. As Alhadeff says, "The need doctrine imposes an unenviable responsibility on the chartering authorities who are expected to attain an ill-defined goal by means of ill-defined criteria."[13]

As additional protection for its depositors, creditors and trusts, all trust companies operating in British Columbia are required to maintain a deposit with the Provincial Government that ranges from $25,000 up to $300,000, depending on the amount of funds under administration. Such deposits are customarily required of insurance companies but the B.C. government seems to place great reliance on this concept as also applied to trust companies. Life insurance companies registered in British Columbia are required to deposit $300,000 as a hedge against financial default, six times as much as Ontario requires. This reliance on large deposits is probably the most succinct comment on the quality of supervision exercised over these institutions.

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[13] David A. Alhadeff, "A Reconsideration of Restriction on Bank Entry", The Quarterly Journal of Economics, LXXVI (May, 1962), p. 251.

These measures to restrict entry are backed up by a strong emphasis on holding back excessive branch expansion by the local companies. The Inspector of Trust Companies is granted the power to restrict branching by provincial and extra-provincial companies, but in practice only B.C. companies are subjected to any restraint. They may have to present a market survey of the area they propose to serve and also justify their proposed branch to the Inspector's satisfaction. Commonwealth thinks this system is unduly restrictive while Yorkshire considers it to be a reasonable precaution.

The Porter Commission was critical of this branching policy. In their opinion, such checks on competition are undesirable although they recognized that unnecessary branches are a wasteful form of competition.[14] Selective controls of this nature can also be inequitable. This would certainly be the case if federal companies preempt business that could be done efficiently by local companies, provided they were allowed to expand. To prevent such an eventuality, the B.C. auhtorities should re-examine their branching policy to ensure that it is a sound way to achieve the objectives of their regulatory policy, and is not being used as a relatively easy way to supervise the local trust companies.

There are no restrictions at present on foreign ownership of B.C. trust companies although such restrictions do apply in some other areas of Canada. For example, a maximum of 25% foreign ownership is permitted for companies that are

[14] The Royal Commission on Banking and Finance, p. 175f.

incorporated federally. This provision could gain new significance if American banks, barred from controlling Canadian banks, seek investment in a banking-type business.

Source of Funds

Trust companies, according to the figures in Table 10,[15] obtain the largest percentage of their funds in the form of deposits and guaranteed investment certificates. Money received in either of these ways is considered legally to be held in trust, not borrowed, and must be segregated in a guaranteed account for investment in a specified list of securities. The company is entitled to retain the profits from the investment of these funds in excess of the interest payable on them but must guarantee payment of principal and interest on all such trust funds, hence the term guaranteed account.

Most trust company legislation sets out the restrictions applying to the guaranteed account in reasonably clear terms but the B.C. Act is confusing and subject to various interpretations. In it, deposits are described as being analogous to bank deposits, although trust companies are forbidden by the Act to engage in the business of banking. No specific mention is made of GICs, but the Inspector of Trust Companies has subjected them to the same conditions of segregation and guarantee as deposits, on the grounds that they are also funds received in trust.[16]

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[15] p. 74.

[16] Interview with J. W. Minty, Inspector of Trust Companies, July 10, 1967.

TABLE 10

Canadian Trust Companies

Source and Use of Funds 1960-1966

(Millions of Dollars)

Source of Funds	1960	1961	1962	1963	1964	1965	1966
Guaranteed Funds							
Deposits:							
Chequable	m.a.	m.a.	m.a.	451	513	558	566
Nonchequable	m.a.	m.a.	m.a.	368	544	561	528
	403	512	610	819	1057	1119	1094
Term Deposits and GIC's	729	896	1094	1272	1535	1973	2421
Total	1132	1408	1704	2098	2592	3092	3515
Other Liabilities	11	18	11	23	18	60	66
Shareholders' Equity	131	164	178	201	249	272	321
Total	1274	1590	1894	2321	2860	3422	3902
Use of Funds							
Cash	41	54	54	71	86	98	88
Securities							
Govt of Canada	264	286	299	318	385	388	437
Provincial	105	131	136	154	168	193	228
Municipal	63	82	94	114	139	125	126
Corporate Short Term Notes	n.a.	112	122	108	153	176	282
Corporate bonds	198	127	140	196	218	242	236
Canadian Preferred & Common Shares	42	53	63	65	67	74	82
Other Assets	11	13	15	14	24	23	43
Total							
Mortgages	468	630	845	1103	1449	1912	2161
Collateral Loans	54	63	83	123	110	118	118
Total	1274	1590	1894	2321	2860	3422	3902
Estates, Trust and Agency Funds Under Administration	7390	8119	9014	9966	11272	12588	m.a.

Source: Dominion Bureau of Statistics, Business Financial Statistics, and Report of Superintendent of Insurance for Canada, Trust and Loan Companies.

The savings accounts offered by trust companies take a variety of forms, not all of which are offered by every company. The basic types are demand deposits with limited or even unlimited chequing privileges, demand deposits with no chequing privileges, and term deposits with or without a demand provision. The non-chequing accounts have proved to be the more popular in recent years and they now account for about one half of all savings accounts, compared to about one third in 1962. Nevertheless, the fast turnover of chequable demand deposits indicates that many savers have substituted these accounts for chequing accounts in banks.[17]

Guaranteed investment certificates are similar to debentures in effect, except that they are not usually transferable. Their basic form is a non-redeemable, interest-paying obligation with a term of one to five years. The willingness of the trust companies to tailor maturities to suit the requirement of investors has overcome the disadvantages of unmarketability and has attracted considerable corporate business as well as individual savings. Many of the large trust companies have also developed what is called a "wholesale market" for very short GICs which compete with other money market instruments for corporate and institutional funds.

The interest rates quoted in Table 9 for trust companies operating in B.C. indicates that the small companies pay little or no premium on chequable demand deposits, from one-quarter to one-half of one percent on nonchequable demand

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[17] Deposits in trust companies were reported to turn over 3 to 4 times a year which is more than twice the rate of turnover of bank savings accounts. Royal Commission on Banking and Finance, p. 182.

deposits, and the same or sometimes up to one quarter per cent more for GICs.

Interest rates do not tell the whole story, however. The smaller companies have added to the cost of their savings accounts by offering gifts to new depositors, a competitive device, which the larger trust companies have generally eschewed. Commonwealth gives away such things as barbecue kits, electric shavers, heating pads and cigarette lighters, depending on the size of the new deposit. Yorkshire gives a centennial coin set for a new deposit of at least $100. The extraneous costs of these funds could become excessive if new deposits are providing a significant proportion of additional funds, which could well be the case with a small aggressive company.

Commonwealth has also expressed an interest in attracting funds from the United States and other foreign sources. If done on any substantial scale, this would be a new departure for Canadian trust companies and should be carefully watched by the regulatory authorities. The Savings and Loan Associations in the U.S.A. have been very successful in attracting funds from surplus savings areas interregionally and internationally, but at the cost of paying a premium over local funds to compensate for market frictions due mainly to investor preference for nearby outlets. Such a premium would be considerably higher for a small local company and would therefore place considerable pressure on the company to seek higher-yielding investments to compensate for the added cost. The capital imports, being marginal, would also be extremely volatile. The company's liquidity position would then have to be watched even more carefully to ensure that maturing obligations were always balanced by maturing investments and cash reserves.

Trust companies have been extremely successful in attracting funds, expecially in periods of easier money. The main factor influencing this flow of funds is generally held to be the ability and willingness of these companies to raise their interest rates, but there are also other important factors such as unlimited chequing privileges, wide branch systems and more convenient office hours.[18]

Interest rates on savings accounts are closely related to rates on their closest substitutes, savings accounts in chartered banks. Until the practice was forbidden in the latest Bank Act, the rates on bank deposits were established by agreement among the banks. The trust companies then set their rates approximately three quarters of one percent above the bank rate. In 1966 the spread widened to one percent in order to provide stronger competition for household savings. These rates have been relatively stable over the business

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[18] The role of the rate of interest on personal savings deposits in contributing to the relative decline of the chartered banks was discussed by Vladimir Salyzn. "The Competition for Personal Savings Deposits in Canada". Canadian Journal of Economics and Political Science.XXXII, No. 3, pp. 327-37. The writer contended that there was some question whether it had contributed to the decline at all as the ability of the trust companies to attract deposits was due mainly to product rather than price competition. This article was criticized on the ground that it was based on inadequate data by Lawrence Smith. "The Competition for Personal Savings Deposits in Canada: A Comment". Canadian Journal of Economics and Political Science. XXXIII No. 2 (May, 1967), pp. 291-94 and Leonard Laudadio, "On the Competition for Savings", op. cit., pp. 295-96.

cycle and usually change only at intervals of several years. They generally lag behind market rates and show a definite rachet effect, not having fallen once in the last seventeen years except for a brief and minor downward adjustment in trust company rates at the end of 1958.

The rates on GICs, in comparison, change frequently and quickly in response to changes in the money market rates because buyers of GICs tend to be more rate conscious than depositors. This does not mean that deposits are unaffected by short term fluctuations in the money market. It means rather that, while GICs respond through a flexible rate, savings deposits respond through the quantity of money flowing in and out at a fixed rate. In times of easier money when the rate on GICs is falling and the yield on savings accounts hold, money flows into savings accounts of the trust companies. In times of tight money when GICs are relatively more attractive, money flows out of savings accounts in GICs.

Market interest rates also affect the rates paid by trust companies through the return they can receive on their investments. The companies attempt to get a minimum yield spread of one and one-half percent between the cost and the return on these funds. If the monetary authorities are holding down rates in a manner that affects trustee investments, the companies cannot prudently bid for funds at rates that would lower the yield spread below that one and one-half percent minimum. This is the basic way in which the monetary authorities influence the flow of funds through the trust companies.

The cost and supply of deposits and GICs are thus seen to be generally under the control of the federal monetary authorities. The funds flowing into equity capital, however, are affected to some degree by the provincial authorities through the methods they will permit for raising these funds. The two main considerations are the form of base capital and the method of selling it.

The usual base capital is composed of common shares and retained earning. Trust companies are not allowed to borrow money by way of debentures, although the chartered banks are now permitted to issue subordinated debentures and the trust companies would like to have similar powers. Preferred share capital is permitted for federal, Ontario and British Columbia companies but it is not a common form of trust company capital.

Yorkshire raised its capital privately and pays no dividend as yet so that its capital was raised at a reasonable cost. Commonwealth, however, sold preferred and common shares to the public. The common shares do not pay a dividend. The preferred shares pay a 75¢ dividend which yields 2.7% on the issue price of $27.50, an astoundingly low yield on a preferred share of even prime quality, and one that should not be taken as any yardstick for normal costs on that class of equity.

Commonwealth sold both the preferred and common shares locally through its own sales organization. This is usually a more expensive way to raise money as the commissions are often greater than underwriting costs on comparable issues. For example, Commonwealth's selling costs as a percentage of gross mark-up were 13.9% in 1964 and 17.6% on later issues. The comparable expenses for issue of under $3 million if underwritten by an investment dealer were reported to range from 2 to 14% with a median of 9.09% on common stock issues, and from 3.5% to 11.1% with a median of 4.77% on preferred issues.[19]

There is presently no public market for either class of Commonwealth stock although there appears to be a limited private market. This lack of marketability is a frequent consequence of shares that are sold directly rather than through an underwriter. A contributing factor is that Commonwealth has not made any attempt to improve marketability through listing on a stock exchange. It seems to have actually discouraged any such possibility by having shareholders sign a form granting to Commonwealth Investors Sundicate irrevocable voting power for three years with full power of substitution. This company holds a substantial interest in Commonwealth Trust Company, according to its prospectus, so that this voting trust agreement leaves it in complete control of the Trust Company.

Shares which are offered to the public over a three year period and still have no quoted market value are a most unusual occurrence for a profitable company. This matter should be examined because transferability is one of the most important features of a public security. Furthermore, this capital is not being efficiently allocated because the pricing mechanism

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[19] Investment Dealers Association of Canada Submission to the Royal Commission on Banking and Finance, Appendix "B", A. 365.

of the capital market is not being encouraged to "maintain a logical relationship between a company's financial position and the price of its stock."[20] The market should therefore be regulated to the extent that prices are allowed to respond to the genuinely shifting economic status of the company. This objective could be furthered by encouraging or even demanding that new issues be underwritten and sponsored by an investment dealer. Listing on the Vancouver Stock Exchange would also improve their marketability.

Trust and loan companies are the only financial institutions in Canada that are legally subject to specified capital ratios. Trust company legislation in Canada has placed considerable emphasis on the adequacy of the net worth cushion to absorb unexpected and substantial losses over and above those already provided for by voluntary investment reserves. The measurement of such adequacy is the ratio of capital to liabilities and the federal, Ontario and Alberta Acts all specify a maximum permitted ratio. The Federal and Alberta Acts limit the guaranteed account of a trust company to fifteen times equity, and the Ontario Act limits the guaranteed account to an aggregate of cash reserves plus four times capital and surplus, although the Registrar may increase the ratio to cash plus fifteen times capital and surplus. New companies are reportedly held to the initial ratio and it is gradually raised to the maximum as the equity grows.

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[20] Sidney Robbins, The Securities Markets: Operations and Issues (New York: The Free Press, 1966), p. 33.

There has been some controversy over the usefulness or necessity of imposing minimum capital/liability ratios on trust companies. The Porter Commission concluded that it was an ineffective method of regulating financial institutions, mainly because it would be difficult to determine a specific ratio that would be equitable for all companies regardless of size, experience, degree of specialization or type of assets and liabilities.

The attitude of the B.C. authorities in this area is a negative one. The Trust Companies Act does not stipulate a maximum capital/liability ratio and no specific restrictions are placed on the companies. New companies are also treated with great leniency on the grounds that they have not had the time to accumulate sufficient retained earnings for a conservative capital structure. Of course, this attitude is in complete contradiction to sound investment practices because such practices demand that capital leverage vary inversely with the degree of risk. When investment reserves are not required, and with the risks attendant upon the entry of new and aggressive companies in the field, the B.C. government should follow other jurisdictions and impose maximum capital ratios for the protection of the depositors and shareholders of these companies.

The Use of Funds

Trust companies first employ their funds to set up a cash reserve, the size of which is based on their experience of the need for cash, and the balance of the funds are placed in any of the variety of ways shown in Table 11 permitted by the Trustee Acts or the Trust Companies Acts applicable

TABLE 11

Investments Authorized by Legislation for Trust Companies

Type of Investment	Parliament of Canada	Nova Scotia	New Brunswick
Government Obligations	Co/Gtd	Co/Gtd	
Mortgages	Co/Gtd	Co	
Trustee Investments	Gtd	Gtd	Gtd
First Mortgage Bonds of Corporations	Co/Gtd	Co	
Other Corporate Obligations (1) (5)	Co/Gtd	Co	
Preferred Shares (1) (5)	Co/Gtd	Co	
Common Shares (1) (5)	Co/Gtd	Co	
Obligations Secured by Government Subsidy	Co/Gtd		
R.R.Equipment Certificates	Co/Gtd		
Leased Real Estate			
N.H.A. Mortgages	Co/Gtd		
International Bank for Reconstruction and Development	Co/Gtd		
"Basket Clause"	Co		
Loans on Security of Authorized Investment	Co/Gtd (2)	Co/Gtd	

Note: Co - Company Funds Gtd - Guaranteed Funds

Source: Submission of the Trust Companies Association of Canada to The Royal Commission on Banking and Finance, with subsequent amendments.

(1) Subject to limited proportion (2) 1, 2 and 4 only
(3) Subject to requirement that 50% of Guaranteed Funds be invested in trustee investment
(4) Special margin requirement, except for 1, 2 and 4.
(5) Earnings test.

Quebec	Ontario (2)	Manitoba	Saskatchewan	Alberta	British Columbia
Gtd	Co/Gtd	Co	Co/Gtd	Co/Gtd	Co/Gtd
Gtd	Co/Gtd	Co	Co/Gtd	Co/Gtd	Co/Gtd
Gtd	Co/Gtd	Gtd			Gtd
Gtd	Co/Gtd	Co	Co	Co/Gtd	Gtd
	Co/Gtd	Co	Co	Co/Gtd	Gtd
	Co/Gtd	Co	Co	Co/Gtd	Gtd
	Co/Gtd	Co	Co	Co/Gtd	Gtd
	Co/Gtd			Co/Gtd	Gtd
	Co/Gtd			Co/Gtd	
	Co/Gtd			Co/Gtd	
	Co/Gtd			Co/Gtd	
	Co/Gtd			Co/Gtd	Co/Gtd
	Co/Gtd			Co/Gtd	
	Co/Gtd (4)			Co/Gtd	

to them. These provisions vary somewhat from province to province but such portfolio controls are all basically similar in form and intent.

Present trust company legislation in regard to portfolio control is based on the premise that investment restrictions are the main safeguard of depositors. The fallaciousness of this argument was proven in the case of British Mortgage when it was discovered that poor investment judgment can cause serious losses no matter whether the funds are placed in stocks, bonds, loans or mortgages. The real protection for the public against investment losses is sufficient unimpaired capital plus the skill and maturity of management, both of which must be backed by thorough government inspection and supervision.

The regulations in the B.C. Act have failed to appreciate this viewpoint because its requirements are among the most restrictive of any trust company act. There is no "basket clause" although the Inspector of Trust Companies may allow the companies to make unspecified investments, which he has not done to date. The "basket clause" that is found in other acts allows a company to invest a certain percentage of its assets in investments not specifically approved under the Act. It has been used mainly to acquire assets which could eventually qualify.[21] With such a provision, it would be possible, for example, for the local trust companies to buy shares in companies with a relatively assured future such as the Bank of British Columbia.

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[21] W.C.Hood, Financing Economic Activity in Canada (Ottawa: Queen's Printer, 1958), p. 350.

Secured loans are also not permitted by the B.C.Act. Trust companies in other provinces have not stressed this facet of their operations as they comprised only 3% of their total assets at the end of 1966. There seems to be no valid reason for not allowing B.C. trust companies to extend such secured loans however, because trustee investments are the only allowable collateral for these loans and all trust companies are thoroughly familiar with this security.

The trust companies have also expressed some interest in being able to make unsecured personal loans on the same basis as the banks are permitted.[22] Unsecured lending is an entirely different proposition and requires skills and experiences not now possessed by trust companies. It is therefore difficult to estimate how many of the companies would make such loans if permitted, and there is little reason to believe that worthy borrowers have suffered from this limitation on credit sources. The merit or need of extending this power to trust companies is therefore hard to assess.

These criticisms of the portfolio controls which are imposed by B.C. legislation are not made with the idea that the controls should be drastically relaxed. There are many dangers in such a course of action. In addition, loosening portfolio restrictions may make only a limited contribution to economic growth because there are many ways around restrictions and the flow of funds may not therefore be as

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[22]Federal officials now allow trust companies incorporated federally to invest up to fifteen percent of capital funds in unsecured personal loans. This is a new interpretation of the "basket clause".

restricted as the portfolio controls imply. The first consideration in any widening of the investment powers of the trust companies, consequently, must be to increase the company's capacity to bear risk by imposing capital requirements and reserves against possible losses which vary with the amount and the degree of risk in their portfolio.[23]

During the postwar period there has been a pronounced shift in the use of funds by trust companies. The proportion invested in Government of Canada bonds declined from 39.7% in 1945 to 11.2% in 1966, and the proportion invested in mortgage increased from 22.9% to 55.4% in the same period.[24] Some companies have also become increasingly active in the money market through their secured loans to investment dealers for inventory financing, whereby they acquired the name "country banks".

The increased mortgage lending is a reflection of the higher proportion of funds raised through GICs and term deposits. Most such money is placed in mortgages to achieve the desired yield spread between the higher-yielding term money and mortgages. These mortgages were almost always written with a five year term amortized over a longer period and renewable at five year intervals at the prevailing rate of interest. In this way maturities of GICs and mortgages tended to match. There is a tendency now though to write

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[23] Cf. Commission on Money and Credit, p. 171

[24] The Royal Commission on Banking and Finance, p. 181, Dominion Bureau of Statistics No. 61-006, Fourth Quarter 1966, p. 6.

longer mortgages of up to 25-30 years, with the rate not subject to change during the full term of the mortgage.

Trust companies, like all financial institutions offering short term liabilities, must provide a cash reserve to meet the demands for cash that arises in the normal course of their business. At any point in time they carry assets that are either cash or can be sold quickly without any significant loss. In addition to this stock liquidity, the companies must consider their flow liquidity by arranging the maturities of their assets so that the inflows from this source coincide with the expected demands for cash for maturing liabilities. These liquidity provisions are not designed for unpredictable demands for cash, such as a panic run on a trust company, which can only be provided by a lender of last resort such as the Canada Deposit Insurance Corporation.

B.C. trust companies are required by legislation to establish a liquidity reserve but its requirements are inadequate and unrealistic. All deposits that are withdrawable on demand within 30 days, with or without notice, must be covered to the extent of 25% by cash or debt issued by or guaranteed by federal or provincial governments. The original purpose of such a liquidity provision was to prevent too large a percentage of assets from being invested in mortgages in the days when mortgages were not repaid in regular monthly instalments to any great extent. Today, however, all mortgages held by trust companies are amortized monthly, so that mortgages may be more liquid than government bonds. In addition, the allowable securities include many issues such as provincial guarantees that are notoriously unmarketable, and long term bonds whose wide price fluctuations give a marked pin-in effect.[25]

The latest Ontario Act has tried to overcome some of these disadvantages by specifying that 25% of the reserve requirement must be in the form of cash or Government of Canada bonds maturing in 3 years or less and 50% must be in the form of cash or Government of Canada bonds maturing in ten years or less.[26] Some revision of this nature should certainly be made in the B.C. Act.

In addition to cash reserves held for the purpose of maintaining liquidity, the suggestion has been made from time to time that the trust companies should be required to hold cash reserves with the Bank of Canada. At present, their cash reserves are held mainly in the form of deposits in chartered banks. The ratio of these cash holdings to demand liabilities was approximately five percent in 1962,[27] and appears to have been about the same in recent years when allowance is made for year-end window dressing. This system of pyramiding reserves is advantageous to the banks in their efforts to retain cash but it removes the trust companies

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[25]Lending firms may be reluctant to realize capital losses on bonds when the interest rate falls and so they refrain from selling these securities. This pin-in effect is rational if the loans or securities that could be substituted for these securities would be unprofitable because of inflexible lending rates. The effect is irrational if the substitution would be profitable because of flexible lending rates.

[26]RSO 1960 c. 222 s. 84 re-enacted 1966.

[27]The Royal Commission on Banking and Finance, p. 183.

from the direct control of the central bank. The Porter Commission contended that institutions issuing demand claims or liabilities maturing within 100 days that are not issued through independent investment dealers or their agents should be required to hold their cash reserves other than till money at the Bank of Canada. The reasons given were not primarily monetary control but rather the advantages of closer contact with the Bank of Canada and greater equity between institutions.[28] This suggestion was rejected by the government to avoid constitutional problems involved in regulating provincially incorporated companies.

The other form of reserves which should be set up by all prudent management are investment reserves to provide for probable or possible losses in their assets. These reserves are essential for trust companies if the value of the guaranteed fund is to be maintained, and regulation should specify such a provision.

The B.C.Act and the supervisory authorities have ignored this matter entirely, with the result that local companies do not have to make any provision for present losses, let alone future ones. Commonwealth Trust, for example, carries its marketable securities on its balance sheet at a cost that exceeds their market value by more than the company's earned surplus, although usual accounting practice is for securities to be carried on the balance sheet at a total that does not exceed market value, with Canadian and provincial securities

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[28] _Ibid._, p. 393.

written down to amortized cost[29] and other securities written down to their quoted market values. The federal trust company act also requires that securities in the guaranteed account must be taken into account in every annual statement at a total value that does not exceed the amortized values of federal and provincial debt and the market value of all other securities.

Tax incentives have been suggested to encourage the companies to build up reserves. At present, trust companies may, like any other company, set up specific reserves out of pre-tax earnings to write down the cost of assets to their estimated market value and, in addition, they are entitled under the Income Tax Act to set aside pre-tax amounts equal to one-half of one percent of their conventional mortgage portfolio per annum to create a maximum reserve of three per cent of their mortgage portfolio. Unlike the banks, however, trust companies are not allowed to accumulate tax-free inner reserves.

The trust companies are under pressure from the informed financial public to disclose information about their reserves, their losses on investments and the basis they use for valuing investments. By not disclosing this information management is able to juggle the net profit reported to shareholders and to conceal poor investment results. The Bank Act now requires full disclosure of inner reserves and the loss

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[29] Amortized value of a redeemable security at any date after its purchase means a value so determined that if the security were bought at that date and at that value, the yield would be the same as the yield on the original purchase price.

experience on a five year moving average. At least that much information should be mandatory for trust companies and, in effect, responsible companies are now providing it.[30]

In contrasting the many improvements that have been made recently in the regulation of trust companies in other parts of Canada with conditions in B.C., the most significant feature is the laggard attitude of the B.C. government. However, this pales into insignificance when compared to the quality of supervision that is provided in this province.

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[30]The Jenkins committee studied the question of disclosing the inner reserves of banks and discount houses and came to the ambiguous conclusion that such information might impair confidence in the stability of the banking system but at the same time "shareholders in banking companies are deprived of information they need in order to judge the value of their shares: and the right to conceal the size of, or transfers to and from inner reserves can be used to conceal weaknesses as well as strength." Report of the Company Law Committee, para. 403.

CHAPTER IV

The Supervision of Trust Companies

The extent to which a regulatory system achieves its aims depends ultimately on the quality of the supervision applied over the controlled area. Government agencies charged with the administration of regulatory statutes must fill the roles of prosecutor and administrator in their efforts to prevent violations of the Act and to regulate the practices of the industry. In carrying out these functions, the supervisory agencies have often been handicapped by lack of funds and insufficient knowledge of the industry. Under these circumstances, associations formed by the regulated companies can fulfil a socially useful purpose by attempting their own self-regulation, but such action is not entirely effective and in no way rectifies the irresponsibility of governments who abnegate their obligations in this regard.

The Porter Commission found evidence of particularly inadequate supervision in several provinces and the general consensus of the witnesses before the Commission was that only the federal inspection was "very close and very comprehensive"[1] at that time. The conclusion of the Commission was that:

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[1] W. Leo Knowlton, Vice-President and General Manager Canada Permanent Trust Company, Transcript of the Hearings Before the Royal Commission on Banking and Finance, p. 3272.

> While far from perfect, supervision is much more thorough in Ontario and Quebec than in those provinces outside Quebec and Ontario which are not inspected by the Superintendent of Insurance. For instance, in Saskatchewan and Alberta there is no inspection of local companies, and although there is provision for it in British Columbia, we were told that it is not too consistently carried out.[2]

Ontario, Quebec and Alberta have greatly improved the quality of their supervision since that time but the situation in British Columbia appears to be basically unchanged.

The position of Inspector of Trust Companies in British Columbia is only one of many positions held by the incumbent in the Department of Finance. He has a very small staff so that it is impossible for him to adequately supervise the trust companies operating in the province. The reports of federal and extra-provincial companies are consequently accepted with only nominal verification, while companies incorporated within the province are subject to some inspection; however, it is perfunctory by comparison with federal standards. This became quite evident when the local companies were first visited by the inspectors for the Canada Deposit Insurance Corporation, whose detailed and knowledgeable procedures greatly impressed officials of the local trust companies.

This comparison between the federal and the local inspection of trust companies points out the need to justify local inspection of these companies. The benefits for the companies and their depositors in having uniform supervision far outweigh such possible reasons as provincial

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[2] Royal Commission on Banking and Finance, p. 177.

TABLE 12

Main Supervisory Functions of Supervisory Agencies Controlling Trust Companies Operating in British Columbia

Supervisory Function	Supervisory Authority Exercising Specified Function with respect to: Dominion Incorporated Companies	British Columbia Companies
Chartering or Incorporation	Parliament	ITC
Registration	ITC	ITC
License	Minister	
Permission to open business	ITC, Minister	ITC
Admission to Canada Deposit Insurance Corporation	SI	SI
Examination (visitorial)	SI, CIDC, ITC	ITC, CDIC
Required Reporting:		
Assets and Liabilities	SI(A), ITC(A)	ITC(A)
Earnings	SI(A), ITC(A)	ITC(A) RO(A)
Guaranteed Funds	SI(A), ITC(A)	ITC(A)
Liquidity Reserves	---	ITC(A)
Required Approval for:		
Increase in Capital/ Liability Ratio	SI	
Branching	---	ITC
Sale of Company	SI	
Merger or amalgamation	SI	
Acquisition of other trust company	SI	
Issue preferred shares	SI	SC
Unspecified investments	---	ITC
Issuance of Regulations Regarding:		
Reserves	SI	
Acceptable Investments	SI	ITC
Taking Disciplinary Action:		
Violation of Trust Co.Act	SI	ITC
Continued Engagement in unsafe or unsound practices	CDIC	CDIC, ITC
Closing for insolvency	SI	CDIC, ITC
Overvaluation of real estate	SI	

Source: Trust Companies Acts.

TABLE 12 - Continued

Supervisory Authority Exercising Specified Function with Respect to Ontario Companies	Quebec Companies	Alberta Companies
RO	ITCQ	RA
ITC, RO	ITC, ITCQ	ITC, RA
ITC	ITC	ITC, RA
SI	SI	SI
ITC, RO, CDIC	ITC, ITCQ, QDIB	ITC, RA, CDIC
ITC(A) RO(SA)	ITC(A) ITCQ(A)	ITC(A) RA
ITC(A)	ITC(A) ITCQ	ITC(A) RA
ITC(A) RO (Q)	ITC(A) ITCQ	ITC(A) RA
ITC(A) RO (Q)	ITC(A) ITCQ	ITC(A) RA
RO		
ITC, RO	ITC	ITC
RO		RA
RO		RA
RO		
RO		
RO		RA
ITC, RO	ITC, ITCQ	ITC, RA
ITC, RO	ITC, ITCQ	ITC, RA
CDIC		CDIC
CDIC, RO		CDIC, RA
RO	ITCQ	RA

desire to maintain local autonomy in this area. Inspection by provincial authorities may then become a vestigial feature of the regulatory system.[3]

Now that the establishment of the CDIC appears to have corrected many of the deficiencies of the inspection system within the province, the principal remaining areas of weakness appear to lie in the Trust Company Act itself and in the disclosure of the financial condition of the companies concerned. It is surprising that these matters have not merited some action in view of the recommendation of the Porter Commission and the Trust Companies Association, in addition to the many changes that have occurred in trust company regulation in other provinces. However, such inactivity on the part of provincial governments is not unusual. Trust company representatives speaking at the hearings before the Porter Commission claimed that:

> The easiest part of the job is to get agreement of the professionals, the supervisors and the registrars and so forth; they are much more willing to discuss uniformity than their masters, the various Ministers to whom they report.[4]

It is not known if this is the cause for the seeming indifference of the British Columbia government to improving the regulation of trust companies. The fact remains that British Columbia is the only major province in Canada that

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[3] Several of the smaller provinces, Nova Scotia, New Brunswick and Manitoba, wisely recognized this and ceded their supervisory powers to the federal government.

[4] Transcript, p. 4391.

has not passed, or at least announced, major changes in the regulation of trust companies. In the interim, however, there are several imperative measures which the Inspector of Trust Companies could take to increase public knowledge of these companies and to achieve greater uniformity in their accounting practices.

An Annual Report should be published by the Inspector and made available to the public on the same pattern as those published by the Federal Superintendent of Insurance or the Registrar of Trust Companies in Ontario. A report of this nature should be relatively simple now that all the companies in the province are being examined by federal inspectors.

The Inspector also has the power to introduce badly-needed improvements in the reports issued by the companies to the public. The public is more likely to read these reports than the official government report and is entitled to a statement that expresses the position of the company in terms that are comprehensible and comparable. Annual reports issued by trust companies in Canada have often been conspicuous for their absence of information and disparity in accounting methods. Many of the larger companies have understated their assets and earnings through transfers to hidden reserves and thereby deprived their shareholders of a correct assessment of the value of their investment. Newer companies have been prone to overstate their earnings and assets. Both types of financial accounting appear to have been acceptable to auditors, no doubt under pressure from management. Supervisory authorities can do much to remedy these deficiencies.

Some of the more important areas requiring uniformity are the methods of valuing securities, capitalizing branch opening expenses and of transferring investment reserves. These figures can be handled in such a way that the financial position of a company can be grossly overstated or understated, depending on the intention of management. The method of carrying securities should be standardized to that required by the federal Act. Branch opening expenses should be clearly stated and the amounts written off, preferably in the year in which they occur or at least amortized over a maximum of five years in accordance with the general experience that five years is a reasonable period for a fully integrated office to arrive at a profitable state. The CDIC requires that all such expenses be written off in the year in which they are incurred to prevent inflation of the capital/liability ratio.

The subject of investment reserves has received little explicit regulation in British Columbia, although it is one that should at least receive attention. A new company is particularly interested in increasing its capital base quickly so that it may have the added leverage for the guaranteed account. To do this, the company may show high profits and make no provision for investment losses on securities whose market value has fallen below their cost, or for the possibility of losses being realized on such investments. The profits may even be paid out in dividends providing they do not impair capital.

To guard against such eventualities, the savings and loan associations in the United States are required by their insuring corporation to accumulate a loss reserve of at least five percent of their insured accounts. All newly-insured associations with a loss reserve of less than five percent must execute a reserve agreement which provides that fifteen percent of net income shall be transferred to general reserves during the first three to five years that the association is insured.[5]

The promotional activities of trust companies are another area that requires investigation and supervision. The Alberta government was so concerned over these activities, and the companies' ability to pay the high costs of their funds, that an examiner was appointed to investigate the companies and consideration was given to curtailing some of these schemes through a government-imposed code of ethics.

Increasing government domination of the industry is inevitable unless the companies take it upon themselves to establish and maintain the high standards that are expected of them. A self-regulatory association is the usual vehicle for enforcing standards in an industry and the Porter Commission placed great emphasis on such self-regulation of financial institutions. Laudable as this idea is in theory, it does have at least two major weaknesses in practice. Self-regulation can obviously apply only to those companies who wish to regulate themselves. The majority of the companies may then be effectively regulated by the association to which

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[5] United States, Congress, House, Subcommittee on Domestic Finance, Committee on Banking and Currency, <u>Comparative Regulations of Financial Institutions</u>, 88th Congress, 1963, p. 110.

they belong, but companies who do not choose to join or who are refused admission are still outside the framework of self-regulation and it is frequently these very companies who are most in need of this regulation. Furthermore, an industry association may even fail to regulate its own members effectively if it lacks the power to enforce its aims or rules. On both these counts, the trust industry has yet to achieve satisfactory self-regulation.

The Trust Companies Association of Canada was formed in 1952 to unify the six local provincial organizations in British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Quebec and two regional sections in New Brunswick-Prince Edward Island and Nova Scotia-Newfoundland. The activity of each section is limited to matters of local interest while the national association has the primary purpose of maintaining and encouraging high standards of industry management.

The Association has at the present time forty-three member companies, which is equivalent to 61% of the trust companies doing business with the public. This membership consists of twenty-seven companies holding regular membership status, six trust companies having provisional membership status and two Bermuda banks with associate member status. The same associate member status was also accorded last year to eight mortgage loan companies who were previously members of Dominion Mortgage and Investment Association, which ceased to operate in mid-1965.

Membership in the Association is voluntary and the only specific requirement is that the trust company must do business with the general public. The Executive Committee, which is the senior governing body, has the right from time to time to establish requirements and conditions for admission to membership. Furthermore, seventy-five percent of the regular members of the Association must approve in writing of an applicant company. In general, the Association requires evidence of good ethical standards on the part of the applicant as well as sound financial status. Obviously, most companies have been able to meet these requirements although Commonwealth Trust Company applied for admission and was refused.[6]

The Association has the right to expel a member by the action of the Executive Committee and there is provision for a hearing of the institution involved. It has not as yet expelled a member. This power of expulsion is considerably weakened, however, by the inability of the Association to force a member company to follow any particular policy. This deficiency, in company with the admission standards, lessens the ability of the association to provide comprehensive self-regulation for the trust industry.[7]

The Association has been asked frequently to make submissions to various governments on many subjects and it has said that "in matters of importance to trust companies generally, various government departments have indicated a

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[6] Duncan Crux.

[7] The factual information on the Association was provided by E.F.K.Nelson, Executive Director, The Trust Companies Association of Canada, August 14, 1967.

strong preference for dealing with the Association rather than with individual companies."[8] This may well apply outside of British Columbia but, within this province, the regulatory authorities prefer to remain as remote as possible from the provincial section of the Association.

The responsibility for supervision is therefore thrown squarely back at the government that controls these companies. The need for this supervision was clearly recognized by the originators of the Trust Company Acts and provisions were made in the Acts for it. In so doing, it was made evident that the fiduciary nature of the trust company business requires an ethos quite different from that of the typical industrial corporation. The basis of this distinction is the "principle that a trustee, generally speaking, ought to be detached, independent and prudent on the merits of every case that is submitted to him."[9]

This concept of the trust company business has been ingrained into the management of the older companies to such an extent that they have been criticized for their ultra-conservativism. Preservation of capital has been their over-riding concern, rather than the growth of capital, and newer companies have fought this attitude with some beneficial effects. Nevertheless, their aggressiveness does present new problems to the supervisory authorities, ones they really never had to consider until a few years ago.

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[8] Submission of The Trust Companies Association of Canada to the Royal Commission on Banking and Finance, A. 62.

[9] Transcript, p. 3539.

Several examples of these have been given in preceeding pages. As yet no sound method has been developed in British Columbia for meeting these changed conditions but it should be apparent that undue restrictions would only retard innovation and lessen competition. The solution lies in a thorough understanding by the supervisory authorities of the industry which they are attempting to control and by a forward looking approach to its problems and possible contributions to the economy.

PART 3

THE CONTROL OF FINANCE COMPANIES

IN

BRITISH COLUMBIA

CHATPER V

The Regulation of Finance Companies

The finance industry in British Columbia is dominated by a few large companies based in Eastern Canada, many of which are subsidiaries of American companies. There are numerous locally-incorporated and owned companies but few of them have achieved national status or even operate beyond the borders of the province.[1] The majority of these companies are confined to a single office and are unlikely to expand much further. The capital needed for growth is often excessively expensive, if available, while the competition for business is so intense that marginal companies can often service their debt only by supplying credit at high rates to sectors of the economy that larger institutions cannot or will not consider. For example, many conventional mortgage lenders such as insurance and trust companies are prohibited from lending on the security of second mortgages or engaging in interim financing. In that way, however, the smaller companies may serve a useful function in the economy and should be encouraged to grow providing such growth is soundly conceived.

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[1] The exact number of these companies is difficult to determine because statistics are not available for private companies other than licensed small loan companies. The evidence that was available showed there were 6 licensed small loan companies, none of which were publicly-owned, although one was a subsidiary of a large publicly-owned sales finance company; 15 sales finance companies, 6 of which have publicly-held securities; and 16 mortgage financing companies, of which 10 have publicly-held securities.

Finance companies in Canada were subjected to little in the way of direct government regulation other than the requirements of the Corporations Acts, the Securities Acts and the Small Loan Act until a few years ago when two major forms of regulation were implemented. The first was a number of "truth-in-lending" acts which were designed principally to make the consumer more aware of the cost of his borrowed funds. The other form of regulation which has been implemented recently involves a new approach to the financial reporting of finance companies.[2] In a more general sense, though, the industry has been controlled to a considerable extent by monetary policy on interest rates and availability of funds.

The regulatory problem with finance companies is very different to that encountered with trust companies. Because most of their capital is raised from professional, or at least experienced investors there has not been the same emphasis on assuring the solvency of the companies through minimum capital requirements, licensing, branch restrictions and investment policies. Instead, regulation has been advocated primarily to increase the efficiency of the capital market through full and continuous disclosure of their

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[2]There is also federal and provincial legislation with respect to sale of goods, consumer protection, bankruptcy and criminal law that is applicable to finance companies, but this is beyond the scope of a paper which is considering these intermediaries from the economic viewpoint. Mortgage broker legislation in Ontario and some other provinces has also introduced some regulation and supervision into the second mortgage field.

financial position, and through meaningful disclosure of their financing charges. These forms of regulation are closer to the concept of competitive market forces operating between parties with approximately equal bargaining power in an atmosphere of complete knowledge, unlimited entry and mobility of resources. The validity of too much reliance on this theoretical model is questionable unless greater responsibility is imposed on auditors, security dealers, directors and management. This is being done in some parts of Canada but as yet only applies to B.C. companies attempting to raise funds or operate outside the province.

Entry and Branching

Entry into the finance industry in Canada is restricted only by the licensing requirements of the Small Loans Act but these are not prohibitive because the Act is designed mainly to impose rate regulations, not to restrict entry. A license is granted if the Minister is satisfied as to the experience, character and general fitness of the sponsors. The standards employed by the Minister in this regard are not known but judging by the number of licenses, they are not difficult to meet. No finance companies are subject to minimum capital requirements or to restrictions on branching. Consequently new entrants have entered this industry easily, attracted by the high profit margins of past years and the small scale of operations on which it was possible to break even. As neither of these conditions exist to the same degree to-day, many firms have since left the industry or diversified into other fields.[3]

Theoretically, the freedom of entry and exit that is characteristic of a competitive industry provides goods and services to consumers at the lowest possible price by the elimination of inefficient firms and excess profits. In the real world of the finance industry however, freedom of entry has introduced strong price competition into the area of business lending but it has not caused any noticeable reduction in the rates charged to consumers. The cause generally given for this phenonemon is the rate consciousness of business borrowers in contrast to the relative rate ignorance and indifference of consumers. On this basis, the finance companies have been able to supplant price competition in personal lending by non-price competition in the form of extensive branch expansion and saturation advertising, with the socially undesirable result of raising the cost structure of the industry.

Freedom of entry has also been of doubtful benefit to consumers because it has allowed a number of "fringe operators" to enter the industry who engage in questionable lending practices and charge exhorbitant rates on their loans. Several of the leading firms in the finance business strongly objected to being classified with these companies and advocated the licensing of financing companies to provide a means of controlling the industry. It has also been suggested by

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[3]Changes in the cost structure of the industry are elaborated in Paul W. Smith, Consumer Credit Costs 1949-59 (Princeton, N.J.: Princeton University Press, 1964).

some industry representatives that the word "finance" or "acceptance" in a company's name would only be permitted when the supervisory authority is satisfied with the bona fides and financial stability of the applicants.[4]

Source of Funds

The acquisition of funds is a major and continuous problem for finance companies. In general, the companies are secondary intermediaries, raising the largest percentage of their funds in the central financial markets and from other financial intermediaries. Equity capital and some long-term debt is sold to the public but most of their funds come from banks, trust and loan companies and corporations, in the short end, and from insurance companies and pension funds, in the long end. However, any generalization is open to question because the liability and equity structure of these companies, as shown in Table 13, and the source of their funds vary widely depending on the type of business, the size of the company and the degree of domestic ownership. This is a nationwide pattern so that local companies show similar characteristics to comparable companies in other areas.

There is little or no government regulation of their liabilities, other than the prohibition of deposit-taking for companies licensed under the Small Loans Act or for corporations operating in Ontario. Reputable companies

[4]Ontario: Final report of the Select Committee of the Ontario Legislature on Consumer Credit. Sessional Paper (No. 85) (Toronto: Queen's Printer, 1965), p. 18.

TABLE 13

Canadian Sales Finance and Consumer Loan Companies

Source and Use of Funds 1960-1966

(Millions of Dollars)

Use of Funds	1960	1961	1962	1963	1964	1965	1966
Cash	30	29	29	41	62	57	83
Accounts and Notes Receivable	2049	2037	2365	2751	3200	3746	3706
Other Current Assets	-	-	-	-	-	-	7
Investments:							
Canadian Debt Issues	100	61	90	88	78	66	96
Canadian Preferred & Common Shares	-	4	10	13	14	15	8
Foreign Securities	8	19	-	4	1	2	32
Subsidiary & Affiliated Companies	109	160	195	252	264	274	386
Other	28	30	38	43	69	79	68
TOTAL	2322	2340	2726	3191	3686	4237	4386
Source of Funds							
Owing Parent and Affiliated Co's	362	415	464	493	452	690	794
Short-Term Bank Loans	281	195	247	308	310	521	403
Short-Term Loans & Notes	544	493	636	803	1062	923	997
Other Current Liabilities	91	92	95	112	140	167	177
Long-Term Debt	623	689	760	869	1031	1176	1271
Unearned Income and Other Deferred Credits	139	137	159	183	217	245	267
Other Liabilities	-	-	-	2	1	1	2
Shareholder's Equity							
Paid-In Capital	167	192	223	261	288	329	354
Retained Earnings	113	127	140	163	186	175	120
TOTAL	2322	2340	2726	3191	3686	4237	4386

Source: Dominion Bureau of Statistics, Business Financial Statistics, Selected Financial Institutions, Quarterly.

have generally considered that the acceptance of deposits would create liquidity problems for them, apart from the fact that the Companies Acts do not clearly authorize their acceptance. Prudential Finance was one of the few larger companies that did venture into this field but the dangers were so apparent that the Ontario Government banned them in 1962 in the Deposits Regulation Act. This ingenious organization then issued short-term promissory notes with demand provisions which preciptitated further legislative restrictions.[5] Several B.C. companies are selling debt with demand provisions after a period of six months or a year from the date of issue, even though one company, Sterling Pacific Mortgage, went into bankruptcy within the last year partially on that account.

To overcome some of these problems, one local company, Oxford Mortgage Corporation Ltd., has applied to the Canada Deposit Insurance Corporation for membership. It is not clear from reading the Act how this company could be included in the insurance scheme because the Act states that the CDIC is to provide deposit insurance for provincial institutions that are regulated by the Trust Company Act or the Loan Company Act, neither of which apply to this company. Oxford Mortgage provides mainly interim financing to real estate developers through a first charge on the project.

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[5] Up to that time, it had been legal to sell such paper without first having it registered with the Securities Commission. The Acts now state that exemption is granted only if negotiable promissory notes are not offered for sale to an individual (B.C.) or if offered to an individual in minimum amounts of $50,000 (Ontario).

These mortgages have an average life of less than two years and their interest rates vary from 15% to 25%. The company's funds have been raised principally in the form of eight per cent investment certificates that are redeemable at any time after twelve months upon demand but are not redeemable within six months. Between six months and a year after their issue there is a redemption penalty of five percent. There is no maturity date on the certificates. Deposit insurance on these certificates would enlarge the intended range of the insurance scheme but the necessity or wisdom of this extension is doubtful.

The simplest capitalization for a finance company would naturally be one consisting only of common shares and retained earnings but such capitalization is impractical in this industry. The return on total assets is too low to attract funds into the industry unless share capital is leveraged by debt. For example, sales finance companies in 1961 earned 1.4% on total assets and consumer loan companies earned 2.4% on total assets, but through leverage, the rate of return on equity was raised to about 11%.[6]

Profitability is therefore seen to depend to a large extent on the amount of funds that a company can borrow at reasonable rates. This leverage is not regulated by legislation, as it is for most trust companies, but it is restricted by the trust deeds for the security issues to fairly conventional ratios which have been established between insititional borrowers and the lenders. These debt/

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[6] Royal Commission on Banking and Finance, pp. 215-216.

equity ratios usually have an initial proviso that common shares and surplus may support an equal amount of preferred shares and that the total shareholders' equity may in turn support an equal amount of unsecured debt or debentures. This base capital can then be leveraged by issuing four times that total in secured debt. This senior capital may take the form of bank loans or secured notes of any term.[7] As a further limitation, all short term notes must be covered by cash, marketable securities and unused bank lines. The security for the notes is held by a trust company which must ensure that these receivables are in good standing and equal to from 112% to 135% of the secured debt outstanding, depending on the company.[8]

This 1:4 rule for the capital/liability ratio serves as an effective brake on the expansion of finance companies,

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[7] Subsidiaries of American companies use unsecured notes which are a promise to pay resting on the credit of the corporation and are often guaranteed by the parent company. The issuing company convenants to preserve a certain ratio of equity and junior unsecured notes to senior unsecured notes. Most consumer loans companies also have a different capital structure because a large percentage of their funds are advanced by the parent company. As a result, these companies may never enter the capital market directly and the amount of funds involved for those who do is slight.

[8] Only the most elementary restrictions have been mentioned. Others commonly found are ratios limiting debt to a percentage of net circulating assets, net earnings available for interest payments, net worth and common shareholders' equity. As an example, see Supplement of the Annual Report, the IAC Group of Companies, 1966, pp. 46-47.

as ultimately the company can only grow through an increase in its base capital. If it attempts to increase the base through excessive use of unsecured debt, the cost of its borrowed funds must increase rapidly to compensate new lenders for the added risk. There is also the possibility that these funds can only be invested rapidly if the company lowers its rates to customers or increases dealer commissions. The result, in any event, is likely to be a narrowing of the differential between net revenue and total costs.[9]

The primary form of debt for all finance companies is bank loans and this may be the only form for companies too small to raise funds in the capital market. These loans are drawn down from bank lines of credit which the companies establish to ensure their liquidity. The banks charge interest on the balance outstanding and, in addition, may require a compensating balance on deposit with the bank and a standby fee on unused lines of credit.

The rate of interest charged by the banks was held to a maximum of 6% by the Bank Act until this year when a revised formula plus a period of high short-term rates raised the ceiling on bank interest rates. The prime bank rate is still 5.3/4% but the rates to finance companies have been raised in many cases. The largest of the locally-incorporated companies, for example, now pays just over 6% on its bank loan but it must maintain a 10% compensating

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[9] A more detailed exposition of this restriction is given in Canadian Economic Research Associates, Sales Finance Companies in Canada (Toronto: The Ryerson Press, 1958), pp.56-58.

balance which brings the effective rate up to more than 6.6%, while one of the larger local mortgage financing companies pays only 6% on its bank loan and maintains no compensating balance. This latter company has also been able to increase its bank lines to the equivalent of approximately 20% of its current and working assets, and the terms on which it draws down its bank lines have been made more flexible. Smaller finance companies have had the rates on their bank borrowings raised to the 7% to 8% range but they are seldom asked to maintain compensating balances, because of the relatively insignificant amount involved.

This reliance on the banks for their basic financing places the companies in the anamolous position of being competitors on the asset side and dependents on the liability side. The finance companies have lost business to the banks, while at the same time they have had their credit lines curtailed through the banks diverting loanable funds to their own lending operations. The situation has been further complicated on the occasions when the Bank of Canada has chosen to restrict or assist the activities of the finance companies by operating through the banks. In 1956, it requested the banks to freeze their lines to the finance companies, while in 1965 it authorized the banks to act as a form of lender of last resort to finance companies caught in the aftermath of the default of Atlantic.

To offset this dependence on the banks for funds, and to lower the cost of short term money, the finance companies became the first substantial borrowers in the money market and are still the largest single group of borrowers in that market. About 80-85% of finance company paper is placed by money market dealers and chartered banks. The balance is sold by direct placement and the trend is to increasing reliance on this method, following the example of the U.S.A. where about 65% of all paper is handled this way.

The long-term secured notes of a finance company are sold mainly to institutional investors such as insurance companies, trust companies and pension funds. The maturity dates vary between five and twenty years and the cost of these funds relative to bank loans and short-term paper has varied widely over the last decade. In 1957 long-term notes actually cost less than bank loans, and about the same as short-term notes, but to-day there appears to be about a one percent spread between bank lines and long-term notes, and about one quarter per cent more between short-term and long-term notes.

Subordinated debt in the form of debentures is sold to both institutional investors and individuals. The term is normally from five to fifteen years and the rate is about one eighth to one quarter of one percent higher than the rate on secured long-term debt.

Equity capital for the finance industry has generally been provided by the investing public to large companies and by management and its associates to smaller companies. The return on this investment was sufficiently high until 1965 to attract risk capital into the industry but conservative investors have, with a few exceptions, avoided the industry. Even the investing public has only sporadically considered that the equities of finance companies possessed either growth potential or security of income and capital.

Since 1965, only one finance company in Canada, Industrial Acceptance Corporation, has been able to hold funds at a reasonable cost. It is also impossible at this time to determine what the cost of new funds would be to a finance company if equity were sold to astute investors, because not one company has attempted to raise funds in this manner for two years.

The collapse of Atlantic Acceptance had a profound impact on the cost and supply of funds to finance companies. Temporarily not even some of the largest and most reputable companies were able to borrow funds on anything approaching a reasonable basis. The chartered banks, who normally act as a sort of lender of last resort to the finance companies, were also slow to respond to the emergency. Although the Bank of Canada had immediately increased their lending ability and encouraged them to accommodate credit-worthy finance companies, the banks took so many weeks to approve increases in credit lines that they proved themselves to be unfit for the task.

The crisis gradually subsided but the flow of funds to finance companies slowed down drastically. American buyers are still noticeably absent from a market in which they were formerly large participants. And those buyers who have returned to the market are asking a risk premium that is treble what it was two years ago. From 1959 until June 1965, the spread between the yeild on 91 day treasury bills (which can be considered a pure rate) and the yield on 90 day finance company paper averaged about 0.5%, never exceeded 0.75% and occasionally completely disappeared.[10] During this period, there was also little difference among the rates paid by the larger companies other than Atlantic. Now even the largest and most soundly finance company, Industrial Acceptance Corp. Ltd., pays 1.60% more on its long-term debt and 1.65% more on its short-term paper than Canada issues of a similar term. Other companies pay a variety of higher rates depending on their credit rating. This change in investor preferences is also noticeable in the terms for which money has been available. For many months after the default of Atlantic, Traders Finance Co., another large finance company, could only borrow for terms of six, eleven and twenty-one days. There is consequently an entirely new structure emerging in the money market, one based on appraisals of individual companies rather than industries, and with a more conservative assessment of the risks involved.

The B.C. companies who have attempted to raise funds in the capital market in the last two years have been seriously affected by these developments also. Not only has the rate at which they can borrow risen, but borrowing of any kind has been made extremely difficult. In an attempt to make their securities more acceptable to investors, some of the companies have adopted more stringent and fairly uniform accounting methods, restricted their lending operations and increased their write-offs and reserves against losses. These measures have cut sharply into assets and profits but they appear to have been a necessary operation to establish the creditworthiness of the companies.

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[10] Greenshields Ltd., Current Money Market Rates.

The most drastic measures were taken by Laurentide Financial Corporation Ltd., the largest of the finance companies incorporated in B.C. and the third largest finance company owned by Canadians. It is controlled by Power Corporation of Canada Ltd., but, until last year, was operated by its Vancouver-based founders. At its peak in 1965, Laurentide had assets of $390 million which made it a large company even by American standards. It was also a company that had grown rapidly over the previous decade and had had its share of growing pains. This growth was abruptly arrested in 1966 when the reported net profit of $3,791,000 for the fiscal year ended June 30, 1965 turned into a reported loss of $9,627,000 in the following fiscal year, a total decline in one year of over $13 million. The earned surplus was wiped out completely and the shareholders' net worth declined even after $9 million in new equity money was purchased by Power Corporation. Laurentide also wrote off $10 million in receivables, and added $2 million to its allowance for doubtful accounts to bring it up to 2.2% of total gross receivables. The cash position was increased by selling an American subsidiary that was said to be losing money, and by running down their receivables.

The result of these measures is a much more conservatively capitalized company. Base capital is now $45 million, which could support $400 million of receivables compared to the $170 million now on the books. The problem is to raise the funds. The publicity surrounding this drastic overhaul of the company has frightened away potential investors to such an extent that it is extremely difficult for Laurentide to raise debt money from the public. The outstanding debentures that mature in twelve to thirteen years are presently bid to yield about 8.50% and the market is thin. The market value of the equity has fallen drastically because dividends have been suspended on both the preferred and common shares. In fact, the common shares are now selling below their net worth.

This situation raises several questions. The most obvious one is whether "the financial reporting for 1965 and prior years attested to by the auditors was unrealistically rosy"[11] as Power Corporation and others claim. Part of the answer lies somewhere in the power struggle between Power Corporation and the previous management over the wisdom of incorporating a bank to restore the growth element to the company which had been lost when the banks entered the consumer lending business. Power Corporation, which has a strong affiliation with the Royal Bank, opposed the idea and ultimately forced the withdrawal of the application for a bank charter. The accounting policies of the management were subsequently given as the reason for replacing the management although the auditors had been investigating a change in accounting methods for some time and many other finance companies had weathered similar problems by instigating gradual changes in their policies. If the company was not in as serious a financial condition as the present management claims, it appears that the general problems of the finance industry at that time were capitalized on. In any case, it illustrates the need for uniform accounting methods and supervision of

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[11] F.J.McDiarmid, Crisis of Confidence, p. 5.

finance companies to precent needless destruction of capital values, loss of income to investors and impairment of confidence in important financial institutions.

The largest locally operated company is First National Mortgage (1962) Co. Ltd., a holding company which acts as a financial medium for a fully integrated real estate group. About 32% of its mortgage portfolio is invested in first mortgages, but its main lending area is second mortgage loans which are subordinated to first mortgages granted by institutional lenders such as insurance companies and trust companies. The combined total of the first and second mortgage is limited to a maximum of 85% of the appraised value of the property.

First National has also felt the effects of monetary conditions, although its accounting practices are considered to be sound and its losses have been negligible. The cost of its money has not risen greatly in the past two years. A $1 million debenture issue was sold in June 1967 at a net cost of 7.92%, only 0.36% higher than the previous issue in June 1965, which is a reasonable increment considering the increase in interest rates generally during that time. The effect of public scepticism of finance companies was felt in the alternative way of availability of funds. For two years this company and its underwriters felt that funds were not available at a reasonable cost and so First National was compelled to restrict its financing operations through lack of funds.

In strange contrast to these two well-known and established finance companies, many smaller finance companies have offered securities to the public in the last two years with amazing success. These companies have chosen to sell their securities directly to the public, rather than through underwriters, and they have raised sums which range from less than a million dollars per company to over four million dollars.

The Securities Act allows a company to employ sales personnel with a limited securities license to sell the securities of that company. This system of direct selling of securities to the public has certain advantages for the company but may be open to some serious objections from the public standpoint. Members of the Investment Dealers Association have been criticized for refusing to underwrite new or small companies, and there is little doubt that their record in this field could be improved. On the other hand, the record of companies who have sold securities in recent years without the assistance of an underwriter is even worse. Very few of these companies to-day have a marketable security which is selling close to its issue price.

The Use of Funds

Finance companies in total employ a majority of their funds in the consumer sector. At the end of 1966, according to Table 7,[12] personal non-business loans comprised 69.4% of total balances outstanding, 37.6% in the form of instalment loans and 31.8% in the form of cash loans. Wholesale loans, comprising 11.4% of the total, are loans extended by sales finance companies to dealers or retail sellers to finance

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[12] p. 56.

their inventories. The balance of 19.2% consisted of business loans. Total loans has more than doubled in the decade due mainly to the fast growth rate occurring in cash loans.

The rates charged by finance companies on their lending operations are regulated only if the amounts and charges come within the provisions of the Small Loans Act, a discrimination which is based on the philosophy that excessive rates should not be charged to necessitous borrowers. This form of price control was accepted, both within and without the industry, as serving a socially necessary purpose, but the Superintendent of Insurance has stated that it does penalize the smaller companies because the rates were set with no specific correlation to the cost structure of the industry:

> It would seem that the maximum rates now prescribed require a lender to have a considerable volume of business in order to operate successfully. This situation is not, however, unique in the small loans industry. I think it is observable in many areas of business activity. Again it points up something of a dilemma for the legislatures. If the maximum rates are set high enough to permit small operators to make a profit, they are probably at a level that enables the large nationwide concerns to make a still higher return.[13]

There is no regulation of the rate charged on the substantial amount of personal loans for sums in excess of $1500, nor for personal loans at rates of less than 1% per month, instalment finance contracts or business loans. As Table 14 indicates, the finance companies have generally been able to charge higher rates than the banks, a fact that has been attributed to the different risk grade of borrowers

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[13] Consumer Credit in Canada, p. 130.

TABLE 14

Current Lending Rates in Canada

Type of Loan	Banks	Insurance Companies	Trust & Loan Co's	Credit Unions & C.P.s.	Consumer Loan Companies	Sales Finance Companies
Mortgages:						
N.H.A.	7%	7%	7%			
Conventional (prime rate)	7.3/4%	7.3/4%	7.3/4%	Less than 7.3/4%		
Cash Loans:						
Fully secured -						
1) by stocks and bonds	5.3/4% prime 6¼-½% other					
2) on life insurand policy		5-6%				
Secured by chattel mortgage	9½-11½					
Unsecured				CU-8-10% CP 7-9%	1st \$300 24% max \$301-\$1000 - 12% max \$1001-\$1500 - 6% max (rate on \$1500 15.24%) over \$1500, 12-24% average 17-18%	
Instalment Finance						
new car						12-15%
used car						18-22%
furniture, appliances						18-22
Home Improvement loans	6%					

Source: Financial Post, June 3, 1967.

served by the two groups as well as to the more accessible atmosphere and wide branch network of the finance companies. It may also indicate insensitivity on the part of consumers to borrowing costs, due partially to ignorance and partially to their reputed concern for monthly payments rather than total cost.

The Porter Commission recommended that all lenders who extend personal loans should be subjected to the same rate restriction[14] but they argued against control of other forms of lending. Governments have generally chosen to disregard the positive part of this advice and, as an alternative measure, they have passed disclosure or "truth-in-lending" acts. B.C., for example, passed the Consumer Protection Act in 1967, which requires that the purchaser of goods or services on credit must be clearly shown in writing the cost of his borrowing in dollars and cents and in percentages.

The effect that this legislation will have on the rate structure and the flow of funds is strictly conjectural at this stage but it might have some beneficial effects. For example, recent surveys made by the Universities of Michigan and California indicated that four-fifths of the families who had not compared interest charges paid an average interest rate of 22.9% while the one-fifth who checked the rates that other companies were charging paid only 12%.[15] The main defect of the B.C. Act is that no method of supervising the

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[14] Royal Commission on Banking and Finance, p. 376.

[15] Consumer Credit in Canada, p. 140

companies is provided so that a consumer who wishes to protest must take legal action on his own. Because very few people will go to this trouble and expense, there is little likelihood of many finance companies being charged under the Act.[16]

The larger B.C. companies have recently made greater efforts to improve their credit-granting standards and collection practices. It seems doubtful however, if these higher standards have been adopted to any great extent by most of the smaller companies who, for competitive reasons and the greater cost of their funds, are tempted into higher risk. They also appear to lack the business acumen of some of the well-established companies and commit errors which in retrospect appear incredible.

A case in point is Sterling Pacific Mortgage Co. Ltd., a Vancouver company that sold $4,167,000 of 8% investment certificates to 2700 B.C. residents from 1964 to 1966. Some of these certificates were redeemable on demand, some on 30 day notice, and all were redeemable without penalty after one year. Withdrawals normally averaged $50,000 to $100,000 a month, which contributed to an excessive roll-over cost that the company was not prepared to meet. The funds were invested in mortgages which yielded around 10%, a spread that might have been workable except for the lack of diversification and security behind the mortgages. At the time of the company's

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[16] One of the biggest problems in applying rate disclosure legislation arises in determining the required formula for calculating the cost of the transaction. For a fuller treatment of this question, see Wallace P. Mors, Consumer Credit Finance Charges: Rate Information and Quotation (New York: National Bureau of Economic Research, 1965).

default on its certificates in November 1966, the company had \$213,000 in cash, \$504,000 in small and mostly residential mortgages, and \$3,900,000 in mortgages on Slumber Lodge Motels. The latter mortgages had been made at the full cost of the motels so there was no equity beneath them. When their cash flow fell in the winter, the motels defaulted on their excessive debt burden and Sterling, with little other income to fall back on, defaulted on its debt.[17]

Unlike many other financial institutions, there are no legal requirements regarding cash reserves or liquidity cover. The responsibility for maintaining adequate provision of this nature has generally been left to the companies, sometimes with fatal results. The amount of liquidity required by a company depends on the structure of its maturing assets and liabilities. For example, a mortgage company such as Sterling Pacific that sells investment certificates that are cashable on demand or short notice requires considerably greater liquidity than a company such as First National that has no publicly held securities with demand provisions. To provide some form of reserve, the companies of the former type set up a cash reserve equal to 3.5% of their outstanding certificates, which is held in trust by a trust company. The default of

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[17] The elaborate sales brochure of Sterling Pacific made these statements. "Sterling Pacific Mortgage Trust Fund thus gives the private investor all the advantages available to the large financial institutions, namely broad diversification, safety of capital, excellent income and expert management." A few pages further on, it asked the question "Is this a safe investment? Positively, because investments are secured by highly selected mortgages which do not exceed the conservative mortgage value of the properties involved."

Sterling Pacific proved that a reserve of this size was completely inadequate when demand liabilities were invested in long-term, over-mortgaged properties without any real diversification to spread the risk.

The Ontario Securities Commission is tackling this situation by forcing companies to disclose such unrealistic practices, as part of its new policy on the reporting requirements for finance companies. If maturing assets, cash and marketable securities are not sufficient to cover any likely or possible current liabilities, the company must give full details of the manner in which it proposes, and is able, to overcome the liquidity deficiency. For example, it may have unused lines of bank credit. The commission has not as yet extended these requirements to mortgage finance companies.

The larger finance companies have also been forced to make more provision for liquidity by their institutional borrowers. Cash, marketable securities and unused bank lines are being built up close to the amount of short term paper, a practice that has been standard in the United States for many years. For example, Laurentide now has available and unused bank lines which are $18 million in excess of their outstanding short term paper. To what extent smaller companies not affected by these conditions have improved their liquidity is difficult to determine because they are not required to release this information and are reluctant to discuss it. A skeptical opinion of the situation would, however, lead one to contend that nothing much has been done about it.

Some B.C. companies are equally deficient in providing reserves for investment losses, especially in view of their predilection for second and third mortgages and other high-risk paper. The larger companies like Laurentide, Corontation and Commonwealth, have added substantially to their reserves in the last year. First National has a mortgage reserve of one quarter of one percent of its portfolio, although total losses since the company's inception have been only $5000. In contrast, most smaller companies have not established any reserve for losses and few of them disclose such information on their balance sheets.[18]

From this survey of the regulations currently applicable to finance companies in British Columbia, it is apparent that there are many gaps and insufficiently regulated areas and unfortunately, supervision over these institutions is also far from adequate. These conditions are not peculiar to British Columbia, but that is not a convincing argument for their existence.

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[18] American finance companies generally maintain reserves for losses at 3-4% of gross notes receivable. John W. Boyer, Jr., Investment Analysis and Management, (Homewood, Illinois: Richard D. Irwin, Inc., 3rd Ed., 1966) p. 380.

CHAPTER VI

The Supervision of Finance Companies

The concept of supervising finance companies in any comprehensive way is just beginning to achieve coherent form in Canada. The federal government has supervised the small loan companies to some extent since 1940 but the wider problems of lending charges, solvency and financial practices were left to individual discretion within the framework of the existing civil and criminal law. Events which were described in the previous chapters indicated that the economy has not always benefited from this freedom of action so that the present concern for greater supervision of the finance companies is understandable.

Presently, what supervision that exists is fragmented among several trade associations and among government agencies at both the federal and provincial level. The principal self-regulatory agencies in this area are the Federated Council of Sales Finance Companies and the Canadian Consumer Loan Association while government supervision operates through the various provincial securities commissions as well as the federal Department of Insurance. In terms of the percentage of assets controlled by these various organizations, supervision is reasonably comprehensive. However, each supervisory body has different aims, different powers and limited scope. Furthermore, there are still many small finance companies who escape completely from the purview of these regulatory bodies.

The licensed small loan companies receive the most thorough supervision of any form of finance company and the Superintendent of Insurance has stated that, in his opinion, "the small loans field is well regulated and well run, and I think it is fair to say that there is little or no abuse of the borrower in the area covered by the Act."[1] Examinations of the main offices of the licensed lenders are made annually and the branch offices are also inspected occasionally. The purpose of these visits is to verify the annual statements submitted by the companies to the Superintendent of Insurance, and to make random samples of the loans to determine if the companies are complying with the rate requirements of the Act. There have been only nine prosecutions under the Act since it came into force twenty-seven years ago. This supervision therefore appears to be achieving its purpose of protecting the borrower, but it must be remembered that its scope is limited basically to that area. The informative annual report of the Department adds greatly to public knowledge of the industry, but it is defective in the sense that the Superintendent of Insurance is not charged with supervising the financial practices of these companies. Furthermore, small loan companies are not supervised on the liability side of their operations.

Supervision of other forms of finance companies by governments is presently confined to the aspects of their operations which come within the powers of the various securities commissions. In British Columbia, a company must file a prospectus and have it accepted by the Securities Commission

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[1] Consumer Credit in Canada, p. 129.

before offering the securities to the public. It is important to realize that such acceptance does not mean that the Commission has passed any judgment on the viability of the company or the wisdom of its financing plans.[2] It must also be recognized that the same standards of disclosure are applied to all companies who file prospectuses, regardless of the type of company.

The Ontario Securities Commission has recognized the weakness of this undifferentiated supervision between finance companies and other companies by establishing a disclosure policy aimed specifically at sales finance companies. In their preamble to the new requirements, the Commission justified their new rules on the grounds that "all sales finance companies, treated by interpretation as industrial companies, are by the very nature of their business different to a marked degree from the usual industrial company."[3] The usual provisions of the Securities Act for industrial companies must therefore be supplemented by additional information which designates clearly the working capital position and the company's ability to meet future obligations. The company must report the maturities of their receivables due within

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[2] The Ontario Security Commission has refused to accept a prospectus for filing when the indicated resources of the company were insufficient to accomplish the objects indicated in the prospectus. If the B.C. Securities Commission refuses a prospectus, the grounds for refusal are not published. Therefore public information is not available on the degree of discretion used by the Commission in this regard.

[3] Bulletin of Ontario Securities Commission for January 1967 (Toronto: Queen's Printer, 1967), p. 20.

one year, due within the next two years and due after that period. They must also provide a liquidity schedule showing its assets which mature within twelve months and its liabilities which become payable in that time. Any deficiencies in the flow of this liquidity must be pointed out and justified. As an aid in appraising their different issues, the company must also provide the interest and dividend coverage as well as the asset coverage for each class of security and list the sinking fund requirements on each type of security.

Finance companies in British Columbia are under no similar obligations to publish such information and none do so. The adequacy of the financial disclosure of finance companies operating in this province is questionable in every case but there is a noticeable distinction between the information supplied by companies whose securities are underwritten by an investment dealer and companies who have sold their securities directly to the public. For this reason alone, the Commission should re-examine its present policy of allowing so many of these companies to raise funds in this manner.

The underwriting of securities is a process whereby a company is guaranteed the funds it needs for expansion or other corporate purposes, while the risk involved in obtaining these funds is assumed by the underwriter. This is the usual way to place primary issues in Canada and there are several valid reasons for its general acceptability. The company benefits from the specialized knowledge of the underwriter and the intensive analysis he normally makes of prospective underwritings. The costs are normally lower than those of direct selling, as was mentioned on page 80, because of the economies of scale and the competition for business among underwriters. The public benefits because an underwriter normally weighs new issues so that securities are distributed at prices which reflect their financial risks. A conscientous underwriter will also attempt to maintain a secondary market in the issue. These are all important advantages for the public as well as the company.[4]

The reason usually given by the companies to explain their use of direct selling is that the underwriters will not touch a small issue. It is certainly true that a large national house is loath to touch an issue of less than $1,000,000 but local underwriters will consider an issue for an amount as low as $200,000. For example, a local underwriter sold a $250,000 Convertible Debenture for Western Acceptance Corporation Ltd. in November, 1966 at a cost to the company of only $5 per $100 principal amount plus $5000 for legal and other expenses.

Direct selling can also be queried on the grounds that the salesmen are not properly qualified. The investment community is attempting to upgrade the quality of its salesmen by requiring that every applicant for a licence must pass a reasonably onerous and difficult course in all phases of the investment business. A registered salesman should then be fairly knowledgable about the securities he is selling. By contrast, a limited licence is issued to salesmen employed

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[4] The Ontario Securities Commission announced in January that an important addition to its duties will be to register and regulate underwriters. The Commission will develop a policy on the standards that must be maintained by registrants.

by a company selling its own securities directly to the public with no reference to his educational qualifications. These men are consequently more prone to misstatements and exaggerated claims of the present and future value of the securities they are selling. Such misrepresentation is particularly serious when it deludes people with limited incomes into believing that their money is securely placed in a financial institution whose solvency is as assured as that of the largest trust company or mortgage loan company.

It is difficult to say whether companies should be denied this method of raising funds, but if the Securities Commission continues to allow it on the present scale, it must devote more attention to supervising these companies. This would require an augmented staff fully qualified in the appraisal of such issues or insistence that the companies employ competent advisors recommended by the Commission before filing a prospectus. This latter method was used by First National Mortgage for their first issue and it proved to be a sound base for their subsequent financing, all of which have been underwritten.

The sales literature of these companies should also be scrutinized for misleading or inaccurate statements, because very few investors ever read, much less understand, a prospectus or an annual report. The Securities Commission therefore has an obligation to supervise what investors do read, namely the sales literature. The Ontario Securities Commission felt that sales literature was one of its main concerns this year.

As an example of the absurdity to which such literature can rise, consider the message on the Thrift Can given to prospective investors by Empire Acceptance Corporation Limited.

WHAT TO EXPECT FROM YOUR INVESTMENT

<u>SECURITY</u>

<u>INCOME</u>

<u>GROWTH</u>

<u>EQUITY</u>

<u>THRIFT</u>

> 1. In this industry, your investment is always represented by cash or secured loans. Funds are not dissipated to build factories, assembly lines, etc.

This must be the first time that anyone claimed that capital investment dissipated funds, or that every possible aim of investment could be achieved in one security.

In the absence of strong leadership from governments, the self-regulatory organizations have been far more effective in the finance industry than the trust industry. They possess greater powers over their members and they seem to take a more prominent part in improving the effectiveness of their industry as financial intermediaries.

Fifty-four of the licensed small loan companies belong to the Canadian Consumer Loan Association, out of a possible eighty-three licencees, but these companies do 99% of the business. This organization was commended for its active co-operation with the Superintendent of Insurance in policing the small loans business,[5] and its members take an active

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[5]The Royal Commission on Banking and Finance, p. 203.

part in ensuring that all money lenders comply with the provisions of the Act. Their reports on infractions have resulted in two expulsions since the CCLA was formed in 1944, and, as an additional deterrent, these reports are sent to the Superintendent of Insurance.

It was pointed out in the previous chapter that the small loan companies are a negligible factor in the capital market in Canada, so that their association has not been concerned with the regulatory aspects of raising funds to any great extent. However, sales finance companies depend for their existence on obtaining a steady flow of funds from the capital market at a reasonable cost. Under these circumstances, it is amazing that the self-regulatory organizations involved in this process took so little interest until recently in promoting a more efficient capital market.

One excuse that was used for accepting the status quo was that the companies were dealing with astute investors who could fend for themselves, and that regulations or supervision would only add imperfections, not remove them, The Investment Dealers Association typified this view.

> There has been concern expressed in recent years as to the responsibility of the dealer in the placement of the securities of "near banks". The pressure exerted within a firm to secure funds for a client have, undoubtedly, resulted in the placement of securities of dubious quality. We believe that the investment dealer must bear responsibility for the quality when the investing client is not in a position to judge the credit risk. The sophisticated investor requires no such protection. It is the belief of this Association that any rules or regulations in this respect can be easily circumvented.[6]

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[6] Brief to the Royal Commission on Banking and Finance, submitted June 1962 by the Investment Dealers Association of Canada, Appendix "H", para. 58. Near-banks were defined as

From this lofty pinnacle, all but one of the money market jobbers felt justified in offering the paper of Atlantic Acceptance. The confidence of the investment dealers has since been shaken and stringent new rules have been instituted with the assistance of the Federated Council of Sales Finance Companies. These two organizations developed the Canadian Sales Finance Long Form Report, otherwise known as Cansaf, to combat many of the abuses that have come to light in recent years. It requires the following information:

(1) Full details of investment by the borrowing company in its subsidiaries and affiliates.

(2) A schedule of the maturity of the receivables, broken down by type and term.

(3) A similar schedule of the maturities of the debt.

(4) Full explanation of the borrowing company's method of computing income.

(5) A breakdown of the range of credit-granting authority in the borrowing company's management structure to indicate whether the company is run essentially as a one-man operation or a well-constructed management group.

(6) Detailed disclosure of the borrowing company's liquidity, including coverage of demand and short term notes because, for the first five years or so, the maturities of the receivables should be substantially greater than the maturities of the debt.

(7) Statements of policy and definitions of terms used.

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all other institutions which receive deposits (sometimes with chequing privileges) and/or make loans as for example trust companies, mortgage loan companies, caisses populaires, credit unions and in some respects of their operations, finance companies, small loan companies, provincial and municipal governments and industrial and commercial corporations.

In addition to the annual release of Cansaf, the sales finance companies must also provide annual audited statements and semi-annual reports known as the Robert Morse Questionnaire, a form developed in the United States and used widely there for many years. By-law #25 of the Investment Dealers Association now prohibits a member from raising money, as principals or agents, for sales finance companies which fail to provide this minimum amount of information.

An important feature of these requirements is that the companies are required to explain fully and define the basis on which they compile their operating figures. This is extremely important because there are very few other businesses in which investors must rely so heavily on financial reports as is the case with finance companies. The assets of these companies consist almost entirely of intangible promises to pay and the whole structure of financial obligations created by these companies rests on the quality of their initial loans. In addition, earnings are computed by a complicated statistical process which is seldom understood by investors and in which management has considerable latitude. It is therefore a simple matter to report more favourable earnings, depending on the manner in which finance charges are taken into earnings, losses are either absorbed or deferred, loss reserves are set-up and uncollected interest is capitalized or charged off.

The requirements also seek to influence the borrowing companies with respect to the role and responsibility of their auditors. Auditors are expected not to deviate from a high standard of performance in order to accommodate a client, a practice of which some have been guilty in the past. Atlantic's auditors, for example, were a large and prestiguous firm but they accepted the statement prepared by another auditor for two major subsidiaries where, as it turned out, the most serious financial problems lay. The senior partner of this second accounting firm was the recipient of a loan from Atlantic, and was a director of a company that dealt with Atlantic. He has since been convicted of evasion of income taxes and has been expelled from the Institute of Chartered Accountants, while another partner in the same firm has been ruled unacceptable to submit filings to the Ontario Securities Commission.

The Federated Council of Sales Finance Companies, in addition to developing Cansaf, is co-operating and consulting with federal and provincial governments to achieve meaningful legislation for the protection of investors and consumers alike, and it is developing standards of practice to which all member companies will be required to conform. It is also working with the Canadian Consumer Loan Association to publish an annual statistical fact book and it is financing an academic research programme into the field of consumer credit in Canada to determine, authoritatively and objectively, the role of credit in the social and economic life of Canadians.

In announcing this programme, the President of the Council added that these measures to promote higher standards in the industry do not pretend to eliminate risk or to supplant the need for judgment on the part of the public.

> While this information standard cannot help but contribute to the restoration of investor confidence in the industry, it should be cautioned that it will not completely

> safeguard investors from all risks. No form or law can be devised which will preclude, for example, a planned act of fraud. It should also be emphasized that corporate statistics are not sufficient to reveal to investors what must be the final criterion of corporate soundness - good management. Corporate statistics must always be measured against the known competence, experience and integrity of the management of the companies under review.[7]

Nevertheless, these new requirements for the financial reporting of sales finance companies should increase the efficiency of these companies as financial intermediaries. It will take several years to determine if this amount of disclosure is adequate and adjustments in the requirements will have to be made from time to time in response to new developments affecting the industry. Governments will also undoubtedly be under pressure from the public to widen the scope of the regulations to include other forms of finance companies. Ontario has considered doing so but is presently stymied by the problem of actually defining a finance company for regulatory purposes.

Meanwhile, there is no explicit supervision of finance companies in British Columbia. The majority of finance companies who operate solely within the province are not subject to supervision from any source. The provincial government has not established a supervisory body or announced any regulatory policies to control these companies other than the disclosure requirements on lending charges. Some of the sales finance companies and all of the mortage finance companies are not members of self-regulatory organizations and most of

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[7] W. W. Evans, Press Conference, National Club, Toronto, July 5, 1967.

these companies have not had their securities underwritten by an investment dealer. The total responsibility for the supervision of these companies therefore lies with the provincial government.

Conclusion and Recommendations

The trust companies and finance companies operating in British Columbia have a significant contribution to make towards the stability and growth of this economic region. Their contribution will not be optimal, however, unless they are under prescient and enlightened regulation by the Provincial Government. To date, the Government has neglected its responsibilities in this field and the consequences can be seen in the low prestige of the local capital market and many of its financial institutions.

The basis for this attitude is difficult to determine because of the lack of published information and the aura of obscurity fostered by the Government. If there is a policy on these matters, it is a policy of obfuscation as far as the public is concerned. Yet many of the defects could be rectified with comparative ease; others may require greater research into the ramifications of possible corrective measures. In any case, workable policies are not beyond the ability of a regulatory agency staffed by personnel of a high calibre and charged with the continuous supervision and review of these institutions.

As an initial step towards a new approach to financial intermediaries, the Government should formulate an economically tenable concept of the role of finance in economic development. At the present time, the Provincial Government appears to base its monetary policies on ideas derived from Social

Credit easy money theories,[1] on opposition to a central bank employing orthodox monetary theory, and on the direction of the flow of funds by nonmarket forces. Financial intermediaries operating under these conditions are unlikely to fulfill their function of channelling savings into their most productive uses at a minimum cost.

In a rapidly growing and prosperous economic region such as British Columbia, the conditions are ideal for the growth and profitability of the intermediaries, providing they are adequately regulated.[2] British Columbia has had the highest average wage and salary rate in Canada for many years.[3] It has a high rate of capital formation, population increase and gain in gross provincial product.[4] Moreover, the province is in a relatively early stage of economic development compared to a province such as Ontario. This fact is apparent in its reliance on capital imported from outside the province for the development of its resources. Financial intermediaries can play an important part in this process by taking the financial liabilities of local spending

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[1] C.H.Douglas, Social Credit (London: Eyre and Spottiswoode, 1933), W. A. Tutte, Douglas Social Credit for Canada (Vancouver: Social Credit Publishing Co., 1934).

[2] Cf. California Banking in a Growing Economy: 1946-1975. Ed.Hyman P. Minsky (Berkeley, Calif: Institute of Business and Economic Research; University of California, 1965).

[3] Canadian Statistical Review (Ottawa: Queen's Printer) monthly.

[4] British Columbia, Financial and Economic Review, (Victoria: Queen's Printer) 1967.

units into their portfolios and thereby making them nationally acceptable. The intermediaries, in so doing, provide an important source of financing for local enterprises that are still too small to tap the national capital markets but who make a worthwhile contribution to the growth of the provincial economy.

To perform this function of capital importation, the financial instruments that are generated within the province must be widely accepted in Canada, and to some extent also in the United States. This acceptability implies that security issuers in British Columbia must conform to standards and requirements which are demanded of them by these extraprovincial sources of capital.

The Provincial Government can assist the financial intermediaries in their vital role of capital importers by encouraging uniformity in the regulatory framework which encompasses these institutions in all parts of Canada. This is now being attained to some degree through the supervision of trust companies by the Canada Deposit Insurance Corporation and the new B.C.Securities Act, which is modelled on the latest Ontario Securities Act. Nevertheless, significant areas are still subject to differential regulation in various provinces. The Trust Companies Act and the disclosure requirements for finance companies are conspicuous examples.

The ability of financial intermediaries to serve the economy would also be increased by measures designed to improve the efficiency of the local capital market. The developing economy would then achieve a more productive use of savings and this, in turn, would lead to a faster rate of economic growth by directing funds to areas that national capital markets are not serving sufficiently, such as new and higher risk industries and second mortgage financing. Savers would also benefit by receiving higher returns on their assets, both in an explicit price form and in the advantages of wider choice and greater marketability. The combined result for the economy would be greater economic efficiency in the transfer of funds from savers to investors.

The development of a local capital market would also strengthen locally-owned financial intermediaries and lessen their dependence, to some extent, on eastern capital markets. It would not, of course, isolate them from monetary conditions existing in the rest of the country nor enable them to avoid the effects of federal government monetary policy. It would however raise the possibility of instituting a measure of decentralization or regional differentiation in a country that is so conspicuously fragmented into economic areas. A development of this nature might introduce an element of understanding and co-operation between the Provincial Government and the Federal Government on monetary problems.

As far as the Provincial Government is concerned, the basis for any policy changes must be a new awareness of its responsibilities in this area. Like all modern governments, the Government of British Columbia has enlarged its role in the economic affairs of society, but, strangely enough, little of this increased and sometimes improved influence and surveillance has been directed towards such important financial intermediaries as trust companies and finance companies. The government has emphasized some industries which provide vital and universally used services in return for a monopoly right, while virtually ignoring others. Public utilities, for example, have been a major concern of the Government, and quite rightly so, but trust companies and life insurance companies have received little attention. Other financial institutions such as finance companies whose operations may also affect the stability and growth of the economy have been left to the control of the market place and the invisible hand that presumably directs cost-price relationships in a private enterprise economy.

A concomittant aspect of the type of regulation which is favoured by the British Columbia Government is its legalistic rather than economic approach. This is a common occurance in many other jurisdictions in North America and the bias is observable in several ways. The activities of the trust companies, for example, are approached primarily from the angle of their effect on private property. An economic approach, in contrast, would assess the activities of these institutions mainly on the basis of their efficiency as allocators of capital. Furthermore, the government agencies charged with the regulation of these institutions prefer to issue edicts or strictures in an attempt to correct specific abuses without correlating these defects in the institutions and incorporating the new regulations into a unified plan for improvements in the whole regulatory system. The result of such an approach is a preoccupation with judicial decision-making and legislative rules, a heavy burden of routine business, a staff of low calibre and a neglect of its essential planning and creative function.

In comparison, the regulation of financial institutions which precedes from an economic viewpoint is designed to increase savings and investment opportunities, and consequently raise the rate of economic growth by encouraging resources to respond to shifting economic conditions and prospects. This form of regulation also recognizes that institutions and markets do not always act in the public interest so that, in some cases, legislation is necessary to remove market imperfections or to ensure that human weaknesses are not encouraged or exploited. Furthermore, a competitive market may not produce a socially desirable allocation of resources, or a sufficiently rapid rate of economic growth, if savings are being diverted from socially necessary investment to finance unnecessary consumption or more profitable investment.

The regulatory authorities must therefore assist in directing market mechanisms to obtain a more optimal composition of financial structures. This objective requires frequent reviews of public policy on the number, type and legal powers of the financial intermediaries, to assist them in adjusting to the altering needs of a constantly changing economic environment. It also demands recognition of the fact that adequate capital markets require efficient marketing agencies, a minimum of restraints on investment policies, some provincial regulation of the mechanism that sets prices and widespread information on prevailing market conditions to enable yields to reflect the full play of supply and demand.

In furthering these multifarious objectives of regulation, the Government of British Columbia is constrained by the constitutional framework of Canada and by intergovernmental agreements on the division of powers. Many aspects of policy concerning money and finance are in the realm of the federal government operating through the Bank of Canada, the Department of Insurance, the Combines Investigation Branch and the Departments of Finance and National Revenue. To the Provincial Government, therefore, interest rates, corporate taxation policies, anticompetitive activity and the supply of money are ultra vires. However, the Provincial Government has the power to control the chartering and branching of nonbank financial intermediaries, to supervise their accounting methods, to define their investment powers, to determine their capital structure, to control their financing and, possibly most important of all, to increase their prestige and so inspire public confidence in the institutions. Certainly these powers provide sufficient scope and incentive to encourage the Government to assume its responsibilities for the efficient regulation and supervision of these institutions.

The first and over-riding policy measure should be the establishment of one government agency to determine public policy on all phases of the operations of capital markets and financial institutions. This agency, which could be called The Commission of Financial Institutions, must have a budget which is sufficient to attract personnel with expertise and vision.[5] One of their main tasks, in addition to routine

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[5] Cf. Ian Street, "Protection of a Sort", <u>The Province</u> (Vancouver) January 19, 1967. p.5. "There is little official comfort for those who ask, in the wake of the recent collapse of two insurance companies in eastern Canada, can it happen in B.C.? . . . There still seems to be room for argument on the basis of the sketchy outline given by Bonner that proposed

business, should be the development of a body of statistical data upon which policy decisions can be based. Continuous research of this nature is necessary to provide a complete description of the financial system and so determine accurately the part which different institutions play in financing the economic growth of the region. In addition, the unified approach to financial institutions should weigh against the present differentiated regulation of financial intermediaries which may distort the flow of funds. In other words, the different parts of the financial system would be viewed as elements of an integrated system, not as a group of relatively separate units.

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new measures are insufficient to fulfil responsibilities that rightly belong to government. He claims, for instance, there will be a modest increase in the present nine-member staff of the B.C. Securities Commission. Estimates show the Commission this year has a budget of some $67,000, three administrators, two investigators and four clerks. By comparison, the Ontario Government Securities Branch has a staff of approximately 50 and a budget of more than $500,000 a year. Yet this government boasts that B.C. and Ontario are the two most important stock trading areas in Canada.

"Government spokesmen here tend to reject this kind of comparison, on the grounds that Ontario has always had a richer mixture of staff than most other provinces. B.C. officials are in no position to disagree publicly, but they do disagree all the same. While the securities commission must see stock offerings are as represented, it is the insurance branch that must be able to see insurance companies can meet their guarantees. This branch has a current budget of some $107,000 and provision for a staff of 16 but experts claim they could use at least five additional accountants.

"One of the key jobs listed in estimates for the past couple of years - the position of deputy superintendent - is still unfilled. Nobody it seems can say why. So the function of watchdog to 347 insurance companies operating in B.C. is handled by one inspector, one auditor examiner, one consulting actuary and the superintendent."

At the present time there are five basic areas requiring investigation and action by such a government agency. There are probably others as well, but these are the main points which emerged from this study of the regulation of trust and finance companies in British Columbia.

1. Self-regulation of these institutions should be encouraged by developing greater rapport between the government agency entrusted with their regulation and the members of the self-regulating association, and by requiring that the industry assume considerable responsibility for the conduct of its members. In this interplay between the public and private sectors, the government must recognize its responsibility for continually evaluating the proposals and actions of the industry association and demand changes which it considers to be in the public interest. The self-regulatory associations, on their part, must broaden their membership to eliminate the atmosphere of a private club, encouraging innovation and develop a professional as opposed to a trade outlook.

   In following these policies both the government and the self-regulatory associations must keep in mind the economic function of their business and must define their objectives in this light. They should also work together on research projects to increase their comprehension of this role and to provide a basis for measures to increase their contribution to the economy.[6]

   The essential feature of this self-regulation must be a realization on the part of the industry and the government that public respect for trust and finance companies is frequently impartial between companies. The crisis of confidence created by the nefarious activities of Atlantic Acceptance damaged every finance company in Canada. The conditions which were revealed in British Mortgage and Trust and Tork Trust temporarily endangered the liquidity of many other trust companies.

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[6] Cf. Robbins, p. 282.

It is therefore incumbent on the members of both industries to take steps to continually maintain and raise the standards of their industry and these steps should be taken before they are forced upon them by an irate public or an aroused government.

2. The structure of each industry should be examined to determine if the degree of competition is sufficient to provide the desired financial services at reasonable prices. In the case of trust companies though, these objectives must be subject to the constraint of tempering profit or asset maximization in order to provide for the continued solvency of these institutions. The Government must also consider the long-term advantages to this economy of local ownership or at least local decision-making at the possible expense of a higher cost structure in any industry characterized by economies of scale.

Due largely to interlocking directorates and share ownership in Canada, this country has not had a truly competitive financial system, nor has any real counter-prevailing power developed despite the fact that it is so clearly dominated by a few giants. Our monolithic banking system, for example, has acted in unison on nearly all important matters in the past. Furthermore, it has probably deterred innovation in the trust industry, although this is a difficult fact to pinpoint. It has, however, had a clearly discernible and detrimental impact on the finance companies. The banks have persistently encroached on the lending operations of these companies by pulling away their better credit risks and thereby causing the deterioration of their lending portfolios. The banks have also impeded the finance companies in their attempts to raise funds by creating excessive delays in granting lines of credit and in fostering public concern over the quality of finance company paper. It is noteworthy that, in the United States, the finance companies have a far more satisfactory relationship with the commercial banks and the likely reason is the goad of a more competitive banking system. The Government of British Columbia must therefore take these factors into consideration if it attempts to strengthen local institutions in their competition with national and international financial institutions.

Because trust companies are repositories of the nation's savings, as well as being custodians and managers of accumulated financial assets, the public interest is best served by encouraging their continued existence at the expense of some degree of competition. For this reason, it is imperative that these companies maintain reserves against future investment losses, adhere to minimum capital requirements, and have their financial practices thoroughly supervised. Branching restrictions, in that case, would be unnecessary. Chartering policies, while continuing to stress the financial resources of sponsors, should place greater emphasis on the quality and experience of prospective management.

Finance companies, in contrast, need no such restrictions on entry and exit. The Government should continue to allow complete freedom to fail, providing investors have been able to make an intelligent opinion of the company's securities through continuous disclosure of the company's affairs.

3. Complete and continuous disclosure of the financial position and policies of intermediaries is an indispensable characteristic of a competitive financial market. The Securities Act passed in British Columbia in 1967 includes new requirements for such disclosure, but it is deficient in many respects. Trust companies are exempt from the disclosure provisions, and the reporting requirements for finance companies are identical with those of industrial companies.

The Government should devise reporting forms for each type of financial institution and require quarterly reporting on a uniform accounting basis to enable investors to make comparisons without elaborate adjustments. "It is not in the public interest for accounting permissiveness to create informational shadows that limit the effectiveness of security prices to mirror true performance."[7] For this reason the Government

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[7] Robbins, p. 52.

should consider a ruling similar to that adopted in the United States which requires all companies to report to their shareholders on the same basis that they report to the Government.[8] In addition, the information should be made easily accessible to the public, not squirreled away in some filing department in Victoria.

4. The sources and methods of raising funds should also be examined to assist the institutions in their efforts to attract funds on a reasonably consistent basis and at a cost that allows an adequate yield spread. The time profile of the liabilities should also be examined to assure that assets and liabilities are not mismatched. Some specific measures which should achieve these purposes would be restrictions on uninsured demand liabilities, the development of a local money market and higher standards for security issuers and salesmen. These measures should increase public confidence in these institutions and so lower the cost of their capital.

5. The investment policies of the trust and finance companies must be examined to determine their financial soundness and economic efficiency. The trust companies are subject to some investment restrictions which presently appear to be both unnecessary and unwise as they force a degree of specialization on these institutions which leaves them prey to extinction, that fate of all over-specialized animals. No prior reasoning or empirical evidence indicates that the companies should be barred from lending on the security of trustee investments, for example. Nor does the absence of a "basket" clause in the B. C. Act appear to serve a valid purpose in an economic region where external financing of new businesses is so necessary to economic growth.

The finance companies should be minutely examined on the quality of their lending practices. If the evidence indicates, as appears likely, that local companies

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[8] United States, Securities and Exchange Commission, General Rules and Regulations, Securities and Exchange Act of 1934, Rule 14a-3(b).

are being persistently driven into marginal credit risks by the banks and extraprovincial finance companies, their investment policies will require much closer supervision to prevent frequent defaults.

These recommendations for the effective regulation of trust companies and finance companies in British Columbia are all designed with one overall objective in mind. The status and efficiency of the financial institutions in this province, and of the capital market which they serve, must be improved to enable them to make a greater contribution to the economy. Without question, the implementation of these recommendations will achieve this primary aim of the regulatory system.

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