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THE EFFECT OF THE 1967 BANK ACT REVISION ON COMPETITION IN CANADIAN BANKING MARKETS

by

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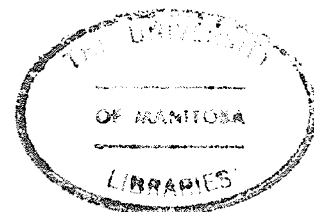

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A thesis submitted to the Faculty of Graduate Studies of the University of Manitoba in partial fulfillment of the requirements of the degree of

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ABSTRACT

The importance of this study centres about the critical nature of the Bank Act in the historical development of the Canadian economy. Since the original Act was passed in 1871 each successive revision has impacted strongly on the Canadian economic environment. The 1967 revision was no exception. At the time of this legislation a new direction for government policy arose such that the revision was, at least in part, designed to promote competitive banking markets. To assess the degree of success this policy directive had, this study evaluates the hypothesis that the passing of the legislation known as the 1967 Bank Act revision caused an increase in the degree of competition within Canadian banking markets.

The thesis assesses the competitive shifts in banking markets rather than the institution of banking due to the fungible nature of most financial instruments. Financial institutions utilize a variety of assets and liabilities in their daily operations and the chartered banks encounter competition from many sources, with the types of institutions competing depending upon the market concerned. Thus, while changes in competition among the banks themselves are considered, a restriction of the analysis to this aspect alone would result in too limited an approach. The competitive thrusts of other financial intitutions must be taken into consideration as well. This is best done through an evaluation of the competitive changes within the individual markets.

The banking markets examined are those of deposits and loans.

Deposits are disaggregated into transaction (savings and demand) and term varieties while the types of loan markets studied are those of consumer, commercial and mortgage credit. All financial institutions are discussed to the extent that they are involved in the identified markets. In all deposit markets the major competitors of the chartered banks are the trust companies, mortgage loan companies and the cooperative banks. Competition in the credit markets comes from the cooperative banks, sales finance and consumer loan companies and retail dealers in the consumer credit market; sales finance companies and foreign bank subsidiaries in the commercial credit market; and trust companies, mortgage loan companies, cooperative banks, life insurance companies and government institutions in the mortgage credit market.

The study applies the theory of industrial organization as a means of assessing shifts in competition. Banking markets are described in terms of the elements of structure and conduct and this resulting characterization is compared to the market models of price theory from pure competition through to monopoly or, in the case of the loan markets, monopsony since the financial institutions are considered buyers of credit instruments. Changes in structure and conduct are taken as indicative of shifts in market competitiveness and as they are altered the markets are considered to change relative to the specific models of theory.

Competition encompasses both price and non-price aspects. Price competition is self explanatory while non-price competition refers to the activities of firms directed toward technological development and

product innovation. Unfortunately there is no exact relationship between this overall concept and the theoretical models, which were originally formulated after the consideration of the pricing aspect of competition only. For this reason it is possible to have a move toward more price competition concurrently with less non-price competition. However, the hypothesis may be analysed in terms of the shifts in both aspects of competition. The final evaluation of the hypothesis must also take into consideration the fact that five different banking markets are being examined at the same time. It is possible that competition within the various markets may be affected differently. A judgemental weighting of these dissimilar competitive shifts is necessary in order to arrive at an overall assessment of the hypothesis.

Historically the chartered banks have been a tightly-knit oligopolistic group with high entry barriers, few and large sized firms, interdependent pricing and low levels of non-price competitive behaviour. Prior to 1967 these circumstances were tolerated by the Canadian government in the interests of promoting an alternative set of policy objectives. In particular the stability of the financial industry and the existence of an effective monetary policy were pursued.

In the period preceding the 1967 Bank Act revision the progressive attitudes of near banks and rapidly rising interest rates led to a serious erosion of the chartered banks' market power. In compliance with the Bank Act the banks were required to maintain a 6% interest rate ceiling on loans. This requirement became more and more

restrictive as rates rose in the early 1960's. The Porter Commission was appointed in 1961 to review the situation and make recommendations. Their recommendations put forward in 1964 were designed to improve the competitiveness within banking markets and among the banks themselves. While the final content of the legislation did not embody all of the Commission's proposals, it was obvious that the government had accepted the competitive objective. Market entry barriers facing the chartered banks were removed in whole or in part, collusive pricing for most financial instruments was formally prohibited and ownership and boardroom relationships across institutional boundaries were curtailed or reduced.

The effectiveness of the 1967 Bank Act revision on the promotion of the competitive objective was analyzed on a market by market basis. The findings were as follows:

(1) The commercial credit market showed some improvement in competition. Openly collusive pricing was prohibited by the revision, but the banks developed an alternative oligopolistic pricing mechanism which produced similar results. However, the revision's removal of the 6% interest rate ceiling allowed the banks to provide a competitive thrust toward the higher-risk end of the market and there was some additional positive change through general improvements in non-price competition. Further, the removal of the rate ceiling led to increases in the involvement of foreign bank subsidiaries and the greater use of commercial paper as a corporate funding alternative. This resulted in reductions in concentration levels within the market.

(2) In the consumer credit market there were modest increases in competition through the removal of the rate ceiling barrier and greater non-price competition. However, there was a significant rise in overall concentration which was severe enough to suggest that the market was less competitive overall.

(3) In the mortgage credit market there was a definite increase in the degree of competition. The removal of two important market entry barriers facing the chartered banks helped bring down concentration ratios. There was also some increase in non-price competition through improved chartered bank progressiveness and the initial movement of some institutions into the market.

(4) The revision caused the term deposit market to become less competitive. Reductions in the entry barriers facing the chartered banks led to a significant increase in market concentration. The increased strength of the chartered banks led to bouts of excessive price competition and a reduction in entry incentives for the near banks.

(5) The revision made the transaction deposit market more competitive. The reduction of the interest rate ceiling removed a major barrier facing the chartered banks. Non-price competitive improvements also resulted, in particular the chartered banks' development of a non-chequable savings deposit.

The study indicates a range in the apparent effect of the revision on the different banking markets and the hypothesis is not fully supported. However, the evidence indicates that there were increases in the degree of competition in the commercial credit,

mortgage credit and transaction deposit markets. Further, in the two markets where there was considered to be a decline in competition there were still isolated instances of improvement. In conclusion the hypothesis is supported with qualifications.

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INTRODUCTION

This study focuses on the competitiveness of Canada's chartered banking community. It will be concentrating on the markets within which the banks operate rather than on the banking industry per se. This approach is chosen because of the fungibility characteristic of financial instruments; that is, that the output of one institutional type is often easily exchangeable for or replaced by that of others. Though they are segregated in legal terms, different institutions can be direct output and input competitors in one or more markets. This makes the analysis of the competitiveness of the financial industry along institutional lines, for example, "banking", an inappropriate application. Instead, similarities of instrument characteristics are used to provide a more realistic classification of the competitive arenas.

The primary banking markets and those upon which this study will focus are those of deposits and loans. Banks solicit funds through the issuing of various forms of deposits, then return these funds to the economy by lending them to various deficit units which need a supply of credit. A major portion of banking profit ensues from the nature of the spread between the rates they charge on loans and the rates they pay to depositors.

Banks are by far the largest type of financial institution in Canada but this is not the only reason they hold center stage. They are also the focal point of the Canadian payments system through their participation in the attraction of the most liquid of financial

instruments (demand deposits) and the operation of a clearing-house system which enables cheques drawn against one institution to be transformed into purchasing power at another. The banks are collectively the primary providers of the facilities needed for the near immediate realization of the financial aspects of economic exchange.

The crucial importance of banking activity led to a natural working liaison with the Canadian Government when the latter body assumed responsibility for the cyclical control of economic activity. The banks are the chief channel by which a government extension, the Bank of Canada, manipulates monetary variables with the eventual purpose of affecting the supply and content of real goods. This policy channel is made operational by legislation applicable to the banks which restricts and directs the scope of their activities.

The primary route the Government of Canada has chosen to take for the changing of banking legislation has been decennial revisions of the Bank Act, first instituted in 1871. One such reform occurred in 1967. The main purpose to which that particular change was directed was the promotion of competitive forces in banking markets. It now seems appropriate to look back and analyze just how successful the 1967 reformulation was in terms of this competitive objective.

For this purpose an industrial organization approach has been utilized whereby elements of structure and conduct are used to evaluate the degree of competitiveness or non-competitiveness existing in a given market. Using this framework then, the hypothesis for the study is established. It is that the 1967 Bank Act revision caused a

movement towards more competitive circumstances within Canadian banking markets.

CHAPTER I

THEORETICAL ASPECTS OF THE STUDY

As stated, the hypothesis to be examined is that a particular piece of legislation (the 1967 Bank Act) made Canadian banking markets more competitive.

To begin, consider what is meant by the term "competition." It can be defined as "the striving of two or more [firms] against one another for the same objective."[1] This definition is multi-faceted with respect to a number of its aspects such as:

(1) the strategies and behavioural patterns involved (i.e. the nature of the striving between firms).

(2) the competitive grouping (i.e., which two or more firms are the competitors).

(3) the objective(s) pursued by the firms.

and (4) the competitive arena (i.e. what product markets are involved).

Competition has both price and non-price aspects. Both embody the striving of firms against one another. The term price competition is self-explanatory. Non-price competition refers to the wide variety of methods used to develop and market new or improved products through product differentiation, improved product quality,

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[1] Kenneth G. Dennis, Competition in the History of Economic Thought (Arno Press, New York, 1977), p. 9.

etc. Any general use of the word "competition" will refer to a combination of both the price and non-price aspects.

Changes in competition will be observed through an application of the industrial organization schema of market structure, conduct (behaviour) and performance. Using this schema, a banking market can be characterized as to the degree of competition by identifying its particular combination of the structure and conduct elements. Altering these elements can result in a change in the market's type to one of more or less competition. This method of analysis will be more fully explained shortly.

The analysis of the structure and conduct of specific markets is crucial to this study. The standard application of the industrial organization approach has concerned itself with the structure and conduct of an industry in which all firms have a great deal of similarity in the types of business pursued. But the fungibility nature of financial instruments allows a great deal of substitution to take place between the outputs of characteristically different financial institutions. Because of this fungibility the examination of Canada's financial system wholly on the basis of firm type (e.g. chartered banks as opposed to trust companies) would be too simplistic. While the structure and conduct of institutional groups is examined, the analysis emphasizes the structure and conduct in the markets for specific financial instruments (e.g. the market for commercial business loans). All of the banking markets to be analyzed are introduced later in this chapter, then discussed in detail in

Chapter II. The competitive groupings (i.e. the firms involved) in each market are discussed in Chapter II as well.

The operations of markets influence a variety of identifiable socially desirable performance objectives. For the purposes of this study these objectives may be divided into three groups as follows:[2]

1. Static Resource Efficiency Criteria; this concept can be further broken down into three sub-groups;[3] "allocative efficiency" or the efficient allocation of resources between different forms of output, "technical efficiency" (also called internal or x-efficiency) or the efficient usage of previously allocated resources in the production process and "distributive efficiency" or, irrespective of what is produced, the efficient distribution of that output among individual economic units.
2. Dynamic Resource Efficiency Criteria; requires that technological change will follow optimal rates and directions.
3. Equity and Other Performance Criteria; the goal of equity requires that the market operates in a way to promote the "fair" distribution of wealth, income and opportunity.

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[2] William G. Shepherd, The Economics of Industrial Organization, (Englewood Cliffs, N.J.; Prentice-Hall Inc., 1979), pp. 31-36.

[3] Douglas Needham, Economic Analysis and Market Structure, (New York; Holt, Rinehart and Winston Inc. 1969).

Other performance criteria are many and include such general goals as freedom, security, job satisfaction, stability, etc.

Economic price theory describes four primary market types or models; pure competition, monopolistic competition, oligopoly and monopoly. As already noted above, definitions of the various market types may be indicated by identifying the mix of the elements of structure and conduct associated with each. For example, the level or situation of those elements most closely associated with the pure competition model may be termed the dimensions of a purely competitive market. Similarly, the other market models may be related to combinations of particular structure and conduct characteristics.

There are many different types of structure and conduct elements which could be identified and this necessarily poses a problem for an analysis of this type. To treat the subject in a comprehensive way would require measuring shifts in all elements. However, many of them are obscure and present difficulties in obtaining and applying data. To simplify the process of data collection and to make the analysis less cumbersome two elements each of structure and conduct were selected. They were chosen partly on the basis of data availability but particularly for their explanatory power in regards to competitive shifts. The two structure elements are (1) the number and size of firms and (2) the existence or non- existence of entry barriers. The two conduct elements are (1) pricing behaviour and (2)

non-pricing behaviour.

The numbers and size of firms can be quantified by calculating concentration ratios for both markets and institutions. The market percentage share of the various institutional types also provides evidence of this structural element. Changes in entry barriers can be observed directly when legislation is involved, or by implication if it is caused by a structural shift. Pricing behaviour can be analyzed through data on changing prices by individual firms (e.g. the prime lending rate of the Bank of Montreal versus the Royal Bank) or institutional type (e.g. all chartered banks' mortgage rates versus those of trust companies). Non-pricing behaviour is more difficult to determine. Some evidence is available regarding the introduction of new financial instruments or complementary financial services. Further, the development of new institutional types to meet specific financial requirements implies a more diversified product base in that the choice available to a customer has been improved.

It will not be necessary here to go into a detailed discussion of the four primary market models. It will suffice to describe these models in terms of the four structure and conduct elements chosen above:

1. Number and size of firms; pure competition and monopolistic competition are characterized by many small-sized firms. Oligopoly generally has a few large-sized firms while monopoly has, by definition, only one.

2. Entry barriers; no entry barriers exist in pure competition while in monopolistic competition there are product differentiation barriers only. Barriers are generally high for both oligopoly and, in particular, monopoly.

3. Non-pricing Behaviour; the non-pricing behavioural element is the main means of differentiating between pure competition and monopolistic competition. A purely competitive market is one in which the product is homogeneous for all firms. In monopolistic competition this homogeneity condition is relaxed. Each firm's output is slightly different from the others' although they remain close substitutes. An oligopoly may produce a homogeneous or differentiated product, though the latter is more likely given constraints placed on an oligopolists' pricing competitiveness. A monopoly produces one homogeneous product.

The technological development of new and improved products is an important part of a firm's non-pricing behaviour. Structurally there is nothing to prevent any of the four market types from having a progressive nature. As Scherer has noted, there is "...no simple one-to-one relationship between market structure and technological progressiveness...".[4]

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[4] F.M. Scherer, Industrial Market Structure and Economic Performance, Chicago; Rand McNally and Company, 1970), p. 7.

The existence of a progressive nature may not be sufficient evidence for differentiating between market types or vice-versa, however, the subject has been one of much debate and some well-substantiated observations can be made. It has been shown that a purely competitive market will innovate more quickly and keep less of the benefits to itself. Consumers will get the innovation sooner at a lower price. However, many innovations will prove too costly and risky for the small purely competitive firm. In monopoly, cost and risk are not major factors but a monopolist will tend to apply a restrictive policy to inventions and seek them less judiciously. Progressiveness is best promoted somewhere between these two extremes. There is some strong argument that "loose oligopoly" is most effective in terms of a progressive performance. In such a market firms are large enough to undertake the more costly and risky innovations but are also small enough to feel great incentives to innovate. As Shepherd states, "... loose oligopoly is the first approximation to optimal setting for innovation."[5]

4. Pricing Behaviour; in pure competition firms are unaware of their competitors and choose their price in response to market stimuli only. In monopolistic competition each firm is able to affect the market price through changes in

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[5] Shepherd, Economics of Industrial Organization, p. 395.