

CHARTERED BANK OWNERSHIP OF COMMON EQUITIES:  
IMPLICATIONS FOR CANADA

By

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## Abstract

The objective of this thesis is to examine the potential ramifications of allowing Canadian chartered A banks to invest in domestic common equities in excess of current regulations. The need for these investments has been born through attempts by companies to seek new common equity so that they may avoid financial catastrophe. However, as time goes on, it is a practice which can be expected to widen in popularity as chartered banks adjust to their new role as venture-capitalists.

We begin our analysis by examining the impact of common equity investments on the financial performance of the chartered banks. Our approach is to conduct simulation studies of chartered bank performance using the Toronto Stock Exchange 300 index as a proxy for common equity behaviour. By adjusting bank financial statements to reflect assumed equity investment levels, we are able to demonstrate the probable impact on a bank's profitability, liquidity, and solvency.

The above is followed by an examination of the potential impact of bank common equity holdings on the existing financial markets. In particular, we seek to examine the probable effect on the cost and availability of funds within the debt and equity markets.

Finally, we strive to evaluate the public policy issues which are associated with bank common equity investments. These range from fears of potential power abuses derived from the corporate voting-power of common equity, to the impact on corporate bankruptcy costs. Our evaluation is based on a combination of traditional economic theory, along with drawing heavily from the West German experience where bank ownership of common

equity has deep historical roots.

In general, our findings indicate that chartered bank ownership of common equities should be encouraged subject to several limitations. These limitations are designed to ensure banking system financial stability, as well as to minimize any potential power abuses. In addition, any movement towards bank ownership of common equities should be accompanied by deregulation of traditional banking services so as to ensure minimal disruption to existing markets and services.

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## I. INTRODUCTION

### 1.1 Purpose

The purpose of this thesis is to examine an element of commercial bank regulation which has existed almost as long as modern banking itself - the restrictions hindering commercial banking involvement in the non-financial sector of the economy. Specifically, I will be reviewing the merits of Section 193(2) of the 1980 Canadian Bank Act which restricts Canadian chartered bank ownership of corporate common equity to a maximum 10% of the voting stock of any individual non-financial Canadian corporation. Considering the American trend towards financial-sector deregulation, combined with the need to provide major common equity infusions to elements of Corporate Canada, the desirability of such restrictions must be questioned.

### 1.2 Relevance

Questions concerning commercial banking involvement in the non-financial sector of the economy are quickly becoming major concerns for both Canadian bankers and regulators. The movement into traditional bank preserves by such commercial entities as Sears Roebuck of Chicago has led to demands by American commercial banks for abolition of such restrictions in the interest of self-defense. Since Canadians tend to follow their American counterparts, this may yet become a Canadian issue as well.

However the need for Canadian reform may originate from more pressing concerns. The past recession of 1981-82 left many Canadian companies over-burdened with heavy debt-loads which threaten their financial survival.



As major holders of Canadian corporate debt instruments, Canadian chartered banks are under pressure to contribute towards their clients' survival by accepting common equity in exchange for the debt claims. The amount of refinancing involved, and its implications for Canada's future economic performance are only now beginning to be recognized. In a recent front-page article, The Globe and Mail's Report on Business listed 14 major corporate refinancing projects which have taken, or are presently, taking place.<sup>1</sup> Others wait in the wings. The resulting bank common equity holdings could ultimately exceed the Bank Act provisions unless Ministerial Discretion is exercised. These events raise questions concerning the ultimate impact of common equity holdings for banking system stability, and for bank domination over the economy. Thus, given the current economic climate, the need arises once again to examine the appropriateness of the policy separating the financial and non-financial sectors of the economy.

### 1.3 Conceptual Framework

In order to properly appreciate the issues involved in this discussion, we will begin by examining the potential impact of bank common equity holdings on Schedule A chartered bank financial performance. This will provide some indication of how major Canadian banks might fare in the absence of the current regulations.

Since no financial market operates in a vacuum, we will also examine the impact of allowing new bank common equity holdings on the operations of existing capital markets. In particular, we will seek to determine the

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<sup>1</sup> "Bailout Plans Swell Banks' Shareholdings," Globe and Mail, Report on Business, May 19, 1984, Toronto, Canada, pp. B1 and B12.

effects of new bank equity holdings on the cost and availability of funds in both the debt and equity markets.

Allowing banks to invest in common equities raises several socio-economic policy issues. These range from the potential of bank equity holdings to lead to abuses of bank powers, to their impact on bankruptcy costs. We will examine these issues using the German experience as a back-drop.

Finally, we will provide recommendations regarding the implementation of our policy within the Canadian environment.

## II. BANK FINANCIAL PERFORMANCE

### 2.1 Introduction

One of the major reasons behind the limitations on bank common equity holdings originated from concerns about the perceived impairment of bank-solvency that such an involvement would bring. According to B. Shull, these fears originated from the "real bills" doctrine articulated by Adam Smith in The Wealth of Nations.<sup>2</sup> At that time, common practice dictated that bank-solvency was assured if bank assets were relatively more liquid than bank liabilities. The failure of many U.S. land banks, which were funded by short-term liabilities, led to the implementation of this doctrine by means of asset restrictions in 1841.

The bank-solvency argument continues today with minor modifications. Now the fear is that bank-solvency is potentially jeopardized because bank-riskiness is increased by allowing commercial banks to hold assets, like equity, which have relatively low priority claims on earnings and bankruptcy assets.<sup>3</sup>

In order to evaluate the impact of bank common equity holdings on bank financial performance, we conducted simulation studies. These studies seek to address the solvency issue by comparing status-quo performance with projected performance in the absence of current regulations.

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<sup>2</sup> B. Shull, "The Separation of Banking and Commerce: Origins, Development and Implications for Anti-Trust," Anti Trust Bulletin, Federal Legal Publications (Spring 1983), New York, U.S.A., pp. 255-279.

<sup>3</sup> A.J. Daskin and J.C. Marquardt, "The Separation of Banking from Commerce and the Securities Business in the United Kingdom, West Germany and Japan," Issues in Bank Regulation, Summer 1983, pp. 21-22.

### 2.1.1 Time-Period Studied

The time-period chosen for our analysis is: October 31, 1979 to October 31, 1983. Two major reasons influenced the choice of this time-period. The period 1979-83 was characterized by an unusually volatile stock market. This will help us to see the extreme range of effects likely to be felt by the banks. Of a more practical nature, bank financial statements lack the necessary data for analysis in earlier time-periods.

### 2.1.2 Banks Analyzed

The analysis was limited to four of the five major Canadian Schedule A banks: The Royal Bank of Canada, The Bank of Montreal, The Toronto Dominion, and The Bank of Nova Scotia. Unfortunately, insufficient data precluded the inclusion of The Canadian Imperial Bank of Commerce, or any of the smaller Schedule A banks.

### 2.1.3 Investment Levels Considered

The range of equity investment levels considered are: 5, 10, and 25% of the nominal value of a bank's Canadian-resident agriculture-commercial loan/security portfolio. (Note: equity investment levels are based on amounts actually invested (i.e. cost), not market-value). This approach eliminates the need to worry about the influences of a bank's international operations on the study. Furthermore, this method eliminates the need to worry about macro-funds demand in other domestic economic sectors.

### 2.1.4 Marginal Loan/Security Revenue

Since we are reallocating bank assets into common equity investments, it becomes necessary to determine what loan/security revenue is foregone

in the process. Bank annual reports provide information on bank holdings of Canadian-resident agri-commercial assets (see Table I). Sufficient data is also available to calculate revenue and cashflow contributions. For simplicity, these procedures are documented in Figure 1.

### 2.1.5 Equity Investment Proxy

The proxy for common equity performance used in this study is the TSE 300 index, and related statistics for earnings, capital gains, and dividends. Considering the size of Canadian chartered A banks relative to the domestic financial system, one would expect that any common equity holdings would be well-diversified. Thus, usage of a well diversified stock index to gauge financial performance is merited. While the TSE 300 is not without its flaws (e.g. large firm orientation), it is nevertheless the only well-recognized Canadian index available. Furthermore, its diversified nature should allow for reasonable results.

## 2.2 Profitability Analysis

### a) Methodology

The base statistic used for the profitability analysis is what we call "R.O.C.R." (Return on total capital and reserves). It is calculated as follows:

$$\text{R.O.C.R.} = \frac{\text{Adjusted After-Tax Net Income}^*}{\text{Avg. Total Equity \& Reserves}}$$

\* Adjusted for loan-losses charged directly to capital and reserves.

When calculating the effects of industrial equity ownership, the net of: the bank's claim on TSE 300 earnings less lost loan/security

Table I

Canadian Bank Involvement in the Agri-Commercial SectorTotal Loans & Securities (Excl. bank deposits) (\$CDN Millions)

<u>Bank</u>	<u>(Oct. 31)</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
Royal		38,591	45,501	63,266	67,438	64,714
Montreal <sup>1</sup>		31,101	37,490	48,609	50,085	50,025
T-D		20,933	24,047	36,216	36,544	35,329
Nova Scotia <sup>1</sup>		23,015	28,727	35,634	37,916	39,342

Canadian Agri-Commercial Holdings (\$ CDN Millions)

<u>Bank</u>	<u>(Oct. 31)</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
Royal		15,618	16,938	25,767	29,381	25,536
Montreal <sup>1</sup>		15,192	18,060	24,523	22,707	18,539
T-D		10,117	11,748	15,864	15,745	14,591
Nova Scotia <sup>1</sup>		8,508	9,814	12,752	13,323	12,642

Canadian Agri-Commercial Revenue (Cashflow) (\$CDN Millions)

<u>Bank</u>	<u>(Oct. 31)</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
Royal		1,014	1,264	2,058	2,280	1,603
		(1,049)	(1,321)	(2,160)	(2,733)	(1,965)
Montreal <sup>1</sup>		914	1,185	1,990	1,820	1,163
		(965)	(1,280)	(2,128)	(2,113)	(1,441)
T-D		608	868	1,252	1,268	856
		(630)	(893)	(1,294)	(1,393)	(1,058)
Nova Scotia <sup>1</sup>		515	643	941	1,000	686
		(540)	(684)	(1,008)	(1,161)	(906)

<sup>1</sup> Sept. 30 data.

Source: Bank Annual Reports.

Figure 1

Calculation of Marginal Revenue & Cashflowa) Calculation of Marginal Revenue Contribution

$$\begin{aligned}
 & \text{Loan Revenue (Agri-Commercial Sector)} \\
 - & \text{Loan Losses}^1 \text{ (Agri-Commercial Sector)} \\
 = & \text{Before-Tax Loan Income} \\
 \times & \text{(1 - Statutory Tax Rate \%)} \\
 = & \text{After-Tax Loan Income} \\
 + & \text{Securities Income} \\
 = & \text{Total After-Tax Agri-Commercial Revenue}
 \end{aligned}$$

1. Including amounts charged directly to capital and reserves.
2. Securities consist primarily of term-preferred shares and Small Business Development Bonds which enjoy tax-free status.

b) Calculation of Marginal Cashflow Contribution

$$\begin{aligned}
 \text{Cashflow} &= \text{Total After-Tax Agri-Commercial Revenue} \\
 + & \text{Total Loan Losses}
 \end{aligned}$$

revenue was added to adjusted after-tax net income. Since equity holdings are assumed to be of a long-term nature, capital-gains taxes are assumed to be indefinitely deferred. Thus the net-earnings stream is effectively tax-free to the bank. Capital and reserves were adjusted in a similar fashion. One can now compare current profitability with the pro-forma version by examining the relevant R.O.C.R. statistics.

#### b) Results

As shown by Figure 2, chartered bank profitability is unquestionably enhanced by the removal of the regulations. In each case, profitability increases as more assets are allocated to common equity investments. This is as expected considering the inherent riskiness of common equity. However, one should also note that the changes are asymmetrical. Profitability increases significantly from current levels when current profitability is high; but is relatively unchanged when current profitability is low. Therefore, bank management can be expected to favour equity investments if given the opportunity.

### 2.3 Liquidity Analysis

#### a) Methodology

Potential liquidity effects are determined by comparing current with pro-forma operating cashflows. For purposes of this analysis, cashflow was defined as adjusted net income plus total loan losses. Pro-forma cashflow was derived by adding to the current level the net of: bank claims on TSE 300 dividends less lost loan/security cashflow. Other non-cash charges were deliberately ignored. They were relatively minor, and lacked data for the entire time-period.



Figure 2

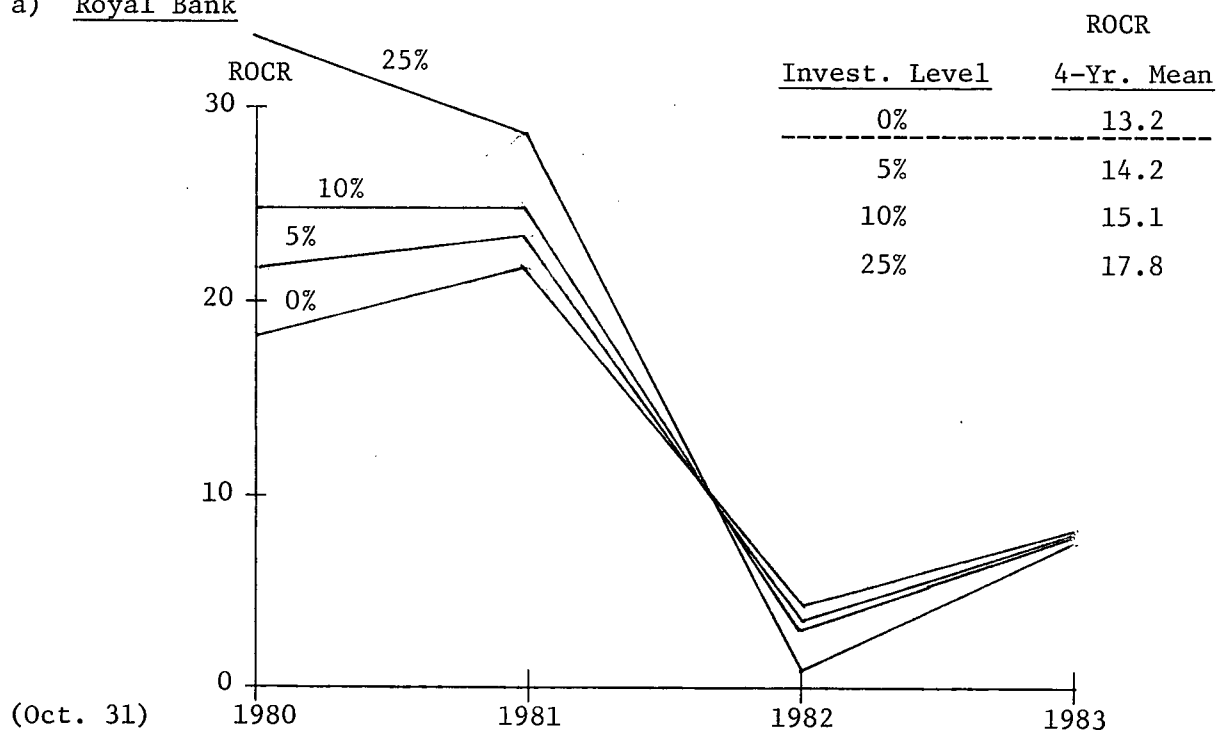
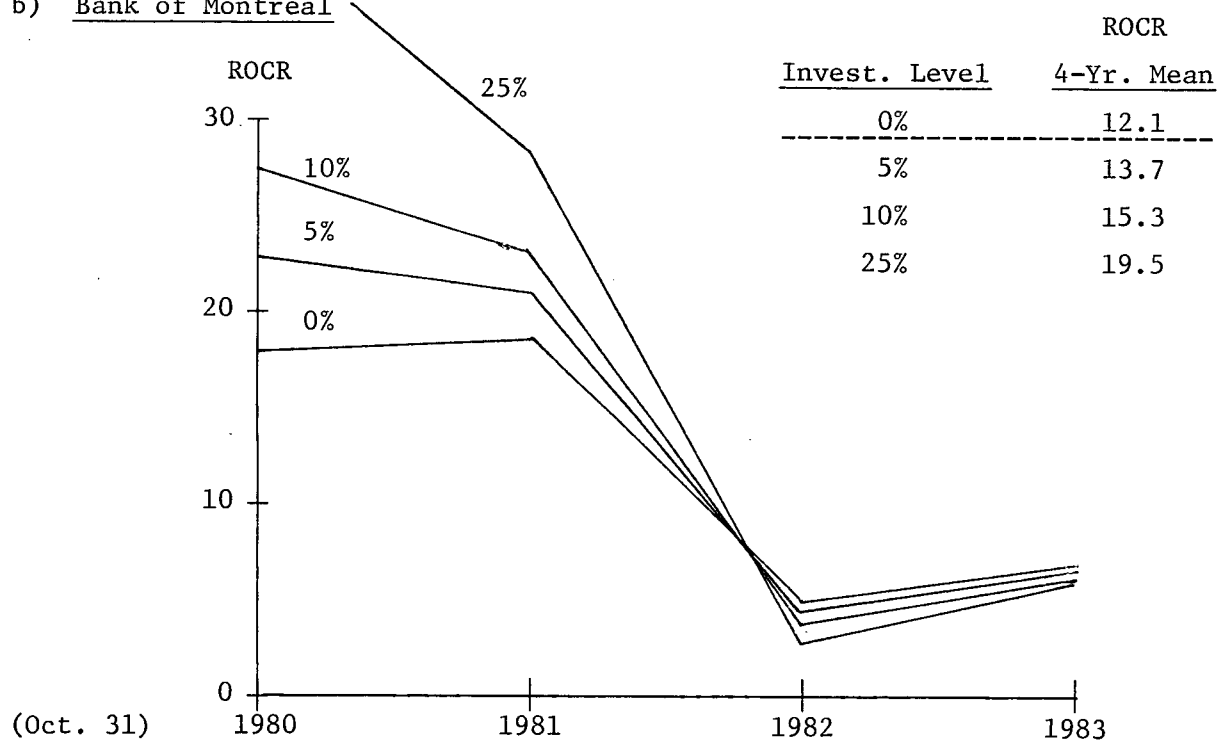
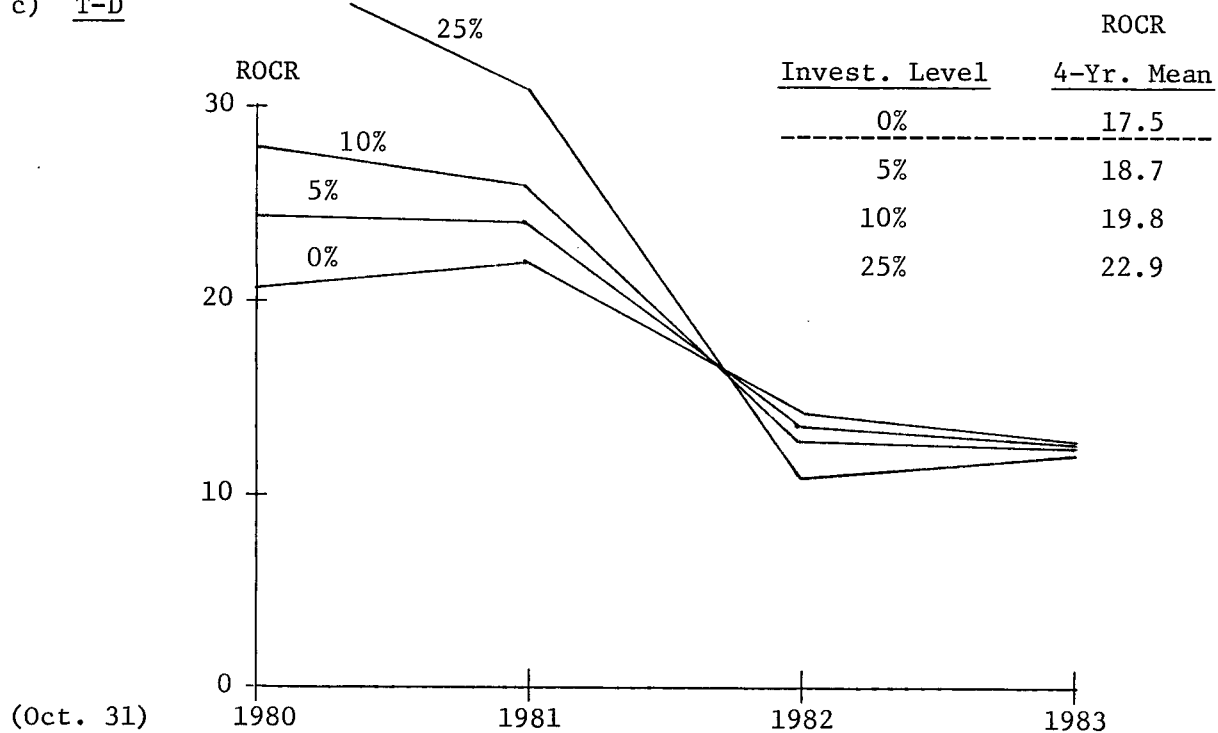
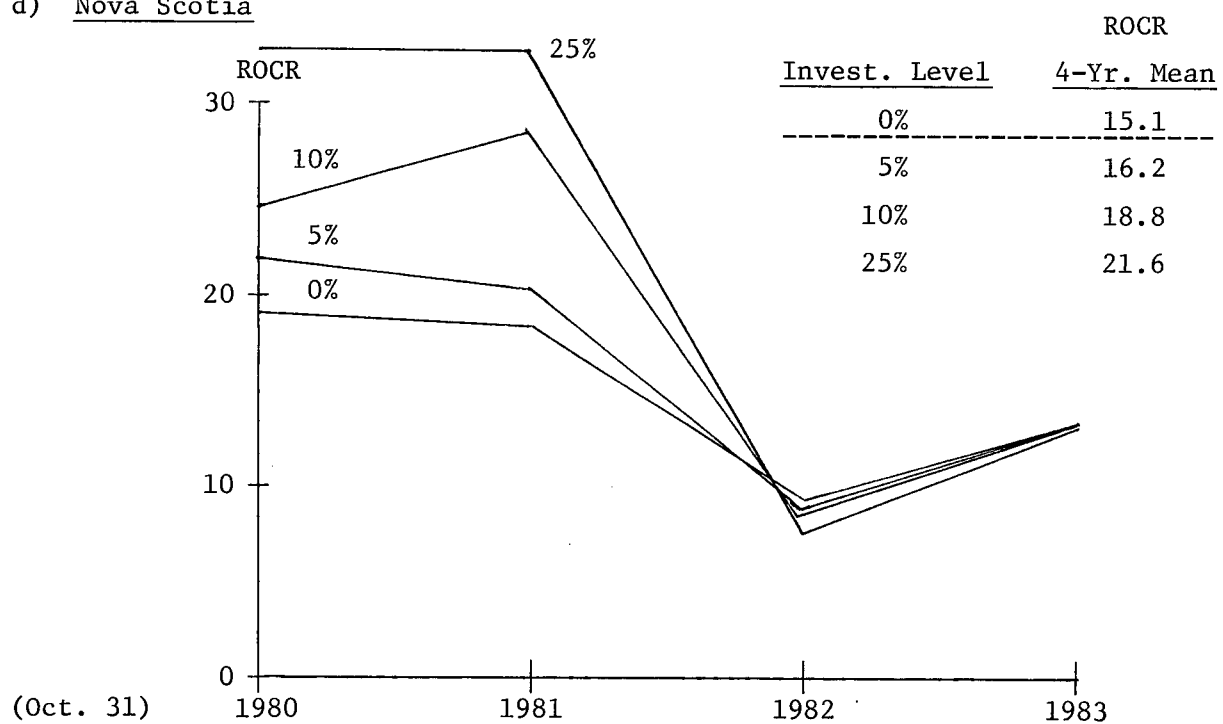
Bank Profitabilitya) Royal Bankb) Bank of Montreal

Figure 2 (Cont'd.)

c) T-Dd) Nova Scotia

## b) Results

Figure 3 reveals that increases in bank common equity holdings hinder cashflow performance. The evidence suggests that 10% is the maximum investment level that can be tolerated before bank liquidity is severely impaired. However these findings are misleading. Unlike current bank portfolios, common equity investments (to the extent that they are publicly traded) enjoy an efficient secondary market. Thus to the extent that banks are invested in publicly-traded securities, liquidity is enhanced by investing in common equities.

## 2.4 Solvency Analysis

### a) Methodology

Solvency analysis attempts to gauge the potential impairment of bank capital and reserves brought about by allowing chartered banks to invest in common equities. Impairment is determined by comparing the current capital and reserves levels with the pro-forma levels. Pro-forma capital and reserves were calculated by annually accumulating, beginning October 31, 1979, the net of: annual bank claims on TSE 300 capital gains and dividends, less lost loan/security revenue, into the capital and reserves accounts. Calculations based on intra-year market highs and lows were also performed so that resulting sensitivity could be ascertained.

### b) Results

The crux of the analysis is to judge the merits of the bank-solvency argument by examining the impact of bank common equity holdings on a bank's capital and reserve position. As shown by Table II, the results here are encouraging. Examination of year-end performance reveals that with the

Figure 3

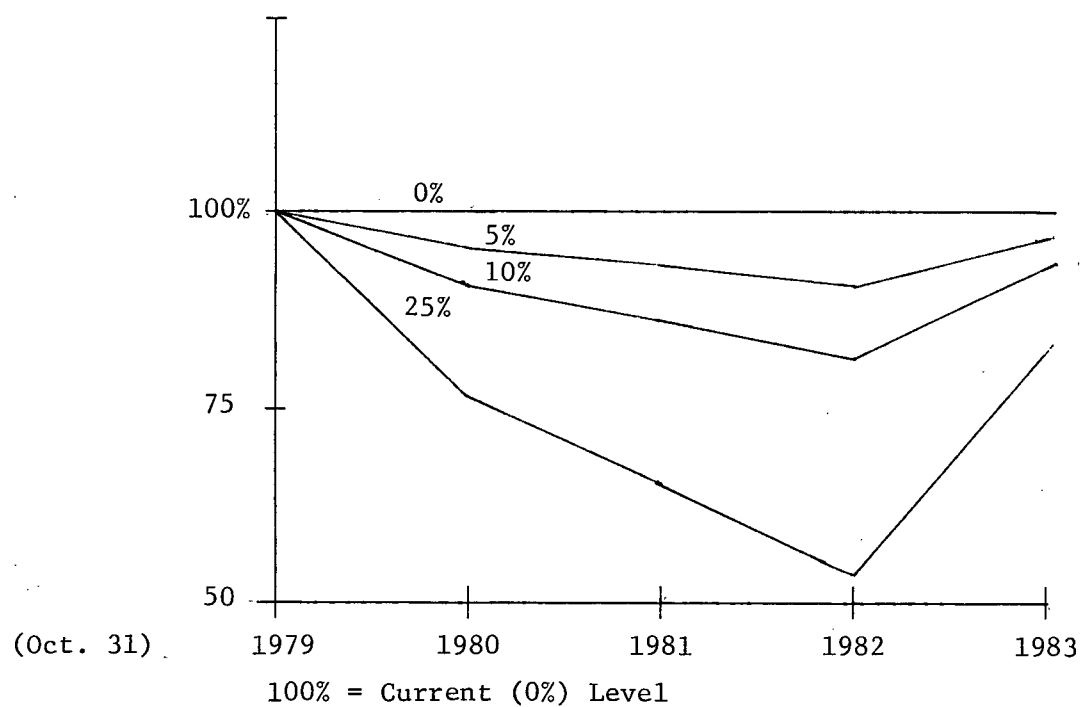
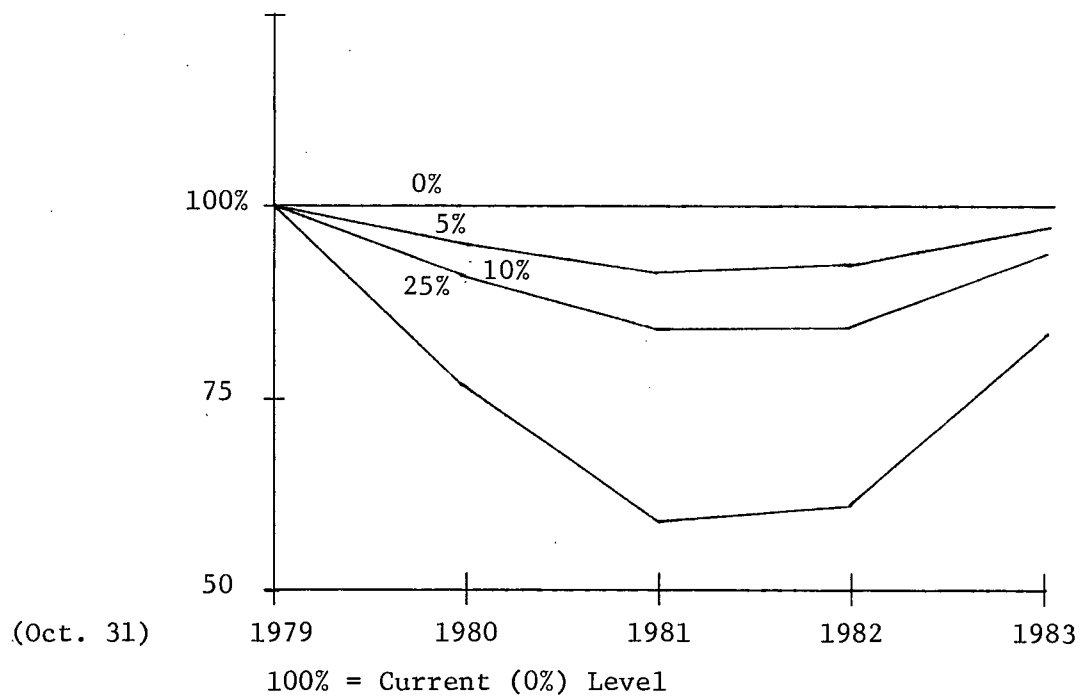
Cash Flow Performancea) Royal Bankb) Bank of Montreal

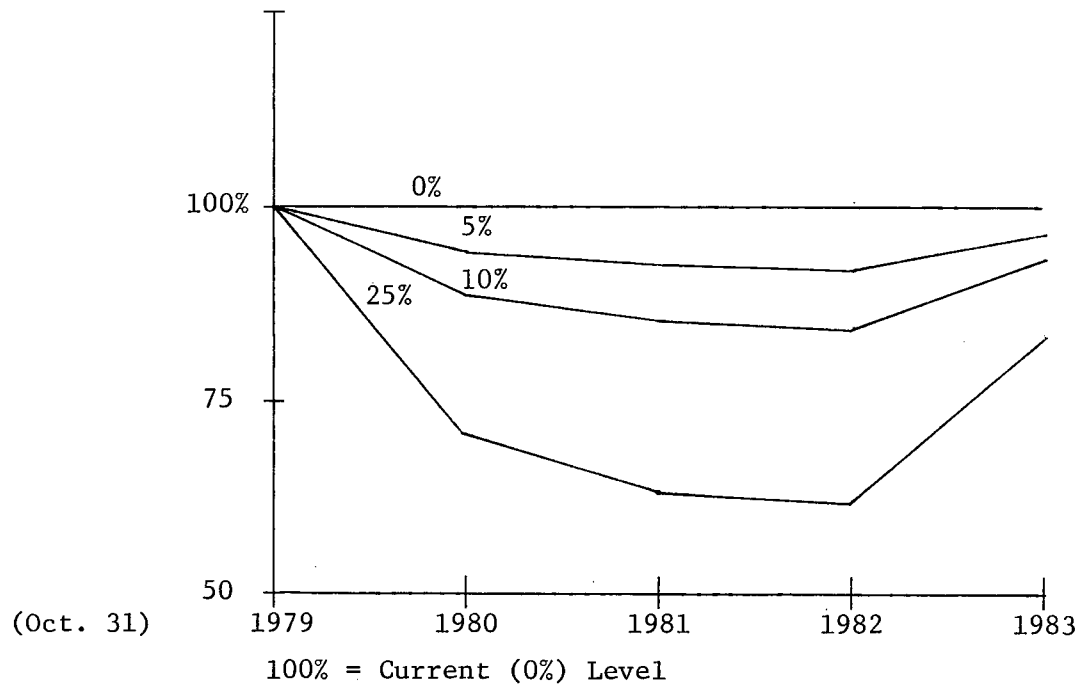
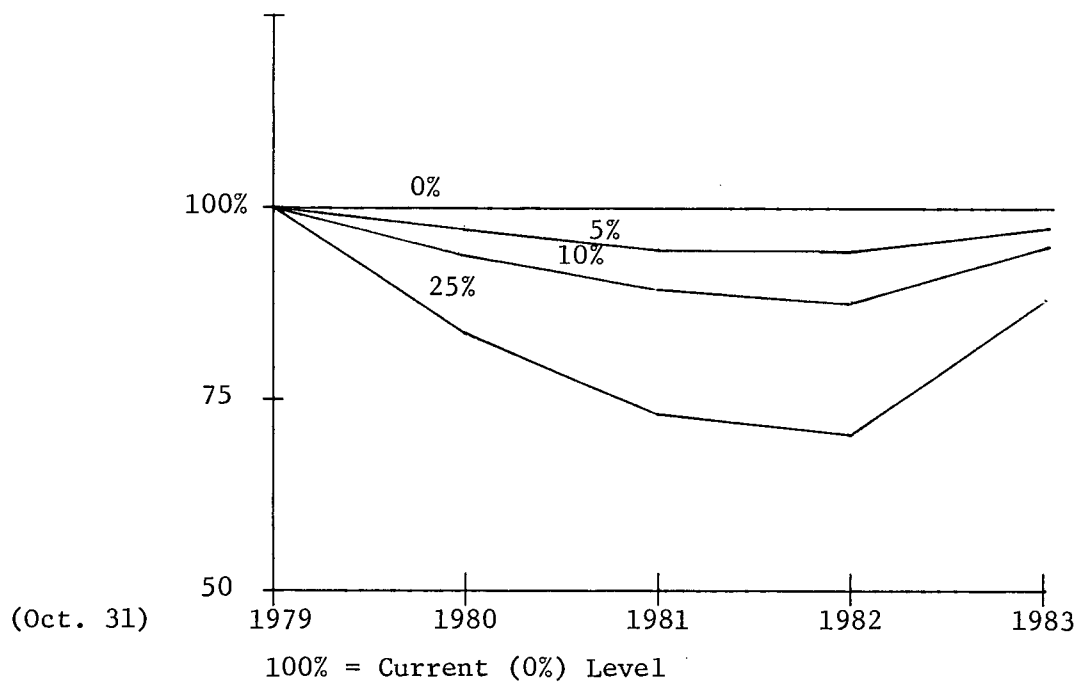
Figure 3 (Cont'd.)c) T-Dd) Nova Scotia

Table II  
Bank Solvency

a) Royal Bank

<u>Equity Invest. Level</u>	<u>Capital + Reserves</u>				
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
0	100	100	100	100	100
5 - Year	100	114.8	100.8	97.1	111.1
- (High)		(118.2)	(113.6)	(102.1)	(11.71)
- (Low)		( 99.0)	( 99.9)	( 84.9)	( 97.0)
10- Year	100	129.7	101.6	94.2	122.2
- (High)		(136.4)	(127.3)	(105.2)	(134.2)
- (Low)		( 98.0)	( 99.8)	( 70.6)	( 93.9)
25- Year	100	174.1	104.1	85.4	155.4
- (High)		(191.0)	(168.2)	(110.7)	(185.6)
- (Low)		( 95.1)	( 99.5)	( 24.3)	( 84.8)

b) Bank of Montreal

<u>Equity Invest. Level</u>	<u>Capital + Reserves</u>				
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
0	100	100	100	100	100
5 - Year	100	120.8	101.8	98.0	112.6
- (High)		(125.5)	(119.0)	(103.4)	(119.0)
- (Low)		( 99.0)	(100.6)	( 84.7)	( 97.6)
10- Year	100	141.6	103.7	95.9	125.2
- (High)		(150.9)	(137.9)	(106.9)	(138.0)
- (Low)		( 98.0)	(101.2)	( 69.5)	( 95.3)
25 - Year	100	203.9	109.2	89.7	163.1
- (High)		(227.2)	(194.8)	(117.2)	(195.1)
- (Low)		( 94.9)	(103.1)	( 23.7)	( 88.2)

100 = Current (0%) Investment Level.

Table II (Cont'd.)

c) T-D

Equity Invest. Level	Capital + Reserves				
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
0	100	100	100	100	100
5 - Year	100	117.5	101.5	98.0	111.5
- (High)		(121.5)	(115.6)	(102.8)	(117.4)
- (Low)		( 98.8)	(100.5)	( 86.3)	( 97.8)
10 - Year	100	135.0	103.0	96.0	123.1
- (High)		(143.0)	(131.2)	(105.7)	(134.9)
- (Low)		( 97.5)	(101.0)	( 72.6)	( 95.6)
25 - Year	100	187.5	107.5	90.0	157.9
- (High)		(207.6)	(178.0)	(114.3)	(187.3)
- (Low)		( 93.8)	(102.5)	( 31.5)	( 89.1)

d) Nova Scotia

Equity Invest. Level	Capital + Reserves				
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
0	100	100	100	100	100
5 - Year	100	112.9	102.0	99.1	111.2
- (High)		(115.7)	(113.7)	(103.3)	(116.5)
- (Low)		( 99.4)	(101.2)	( 89.0)	( 99.0)
10 - Year	100	125.7	104.0	98.3	122.5
- (High)		(131.4)	(127.4)	(107.0)	(132.9)
- (Low)		( 98.8)	(102.3)	( 77.9)	( 98.0)
25 - Year	100	164.2	110.1	95.7	156.2
- (High)		(178.4)	(168.6)	(116.7)	(182.3)
- (Low)		( 97.0)	(105.8)	( 45.0)	( 95.1)

100 = Current (0%) Investment Level.

exception of 1982, bank solvency was universally enhanced by the absence of the regulations. As for 1982, the level of impairment was less than 15% at the 25% investment level. However, consideration of intra-year performance reveals considerable deviations from the year-end results. Examination of intra-year market lows indicates that 10% is the maximum tolerable investment level in the short-term with current capital structures. At the 10% investment level, approximately 30% of the four banks' capital and reserves would have been impaired at the market low-point of 1982.

It should be noted that the solvency study is only capable of forecasting short-term performance. As time progresses, stochastic dominance may affect the simulation results. By this we mean that as equity income accumulates, it will eventually prevent pro-forma capital and reserves levels from dropping below the status-quo levels. This situation exists today for the German banks. They hold common equity investments at a cost far below current market-values. Therefore these banks can weather large drops in stock-prices before they begin to record losses on their common equity investments.

The traditional concerns about bank-solvency are incomplete. Those concerned tend to focus on the added risk of common equity investments, while ignoring the higher returns which compensate investors for this risk.

## 2.5 Changing Interest Rates

When evaluating the impact of common equity investments on a bank's financial performance, one must also consider the potential impact of changing interest rates on our results. Considering the volatile nature of the current interest rate environment, it becomes essential that our



findings be sufficiently robust to withstand large movements in interest rates.

Assuming a Fisherian world of constant real rates of interest, movements in interest rates would be induced by changes in inflation rate expectations. Assume also that only pure inflation exists. How would the banks which hold common equity investments be affected?

If banks have properly hedged their interest rate exposures, current operations are unaffected. Furthermore, with pure inflation, common equity income should also be unaffected. Thus no charge.

Alas, but our's is not a perfect world. The impact of changing interest rates is unlikely to leave the banks untouched. The precise impact is unknown and will vary with the cause of the interest rate movement. However, recourse to the previous results may hold some clues.

One will remember that 1981-82 were years of exceptionally high and rising interest rates. The results indicate that bank financial performance deteriorates in high and rising interest rate years, and vice-versa. However, at a 10% investment level, bank survival was not in jeopardy. Thus it appears at first glance that the usual effects of changing interest rates will be magnified in banks which hold common equity investments, but that banking system stability remains assured.

## 2.6 Funding of Common Equity Investments

### a) Traditional Share Issues

Until now, we have assumed that chartered banks would invest in common equities without any alteration of their current liability struc-

tures. Current thought on banking stresses the merits of liability management. This involves structuring liabilities to match asset characteristics so that exposure to interest rate risk can be minimized. Therefore, one would initially expect banks to issue their own common equity to finance the common equity investments held on the asset side of their balance sheets.

This approach is infeasible. Figure 4 reveals that the subsequent share-dilution would dampen ROCR profitability for existing shareholders. Thus management would reject this approach.

b) "Trust" Share Issue

Another funding method for common equity investments resembles a REIT. Under this approach, common equity investments would be lodged with a bank-managed trust. The trust would issue shares to the bank and the public, in return for cash to fund the equity investments. This is exactly the approach used by the German banks to fund a portion of their common equity portfolios. This method restricts the impact of the dilution to the new equity income. Thus bank financial performance would resemble the earlier discussed pro-forma results except that the banks would have more assets under their management control.

## 2.7 Summary

Traditional concerns regarding bank ownership of common equities are derived from fears that these investments would increase the systematic riskiness of banks, and thus lead to a destabilization of the banking system. It is clear that the systematic risk of a bank will increase

Figure 4

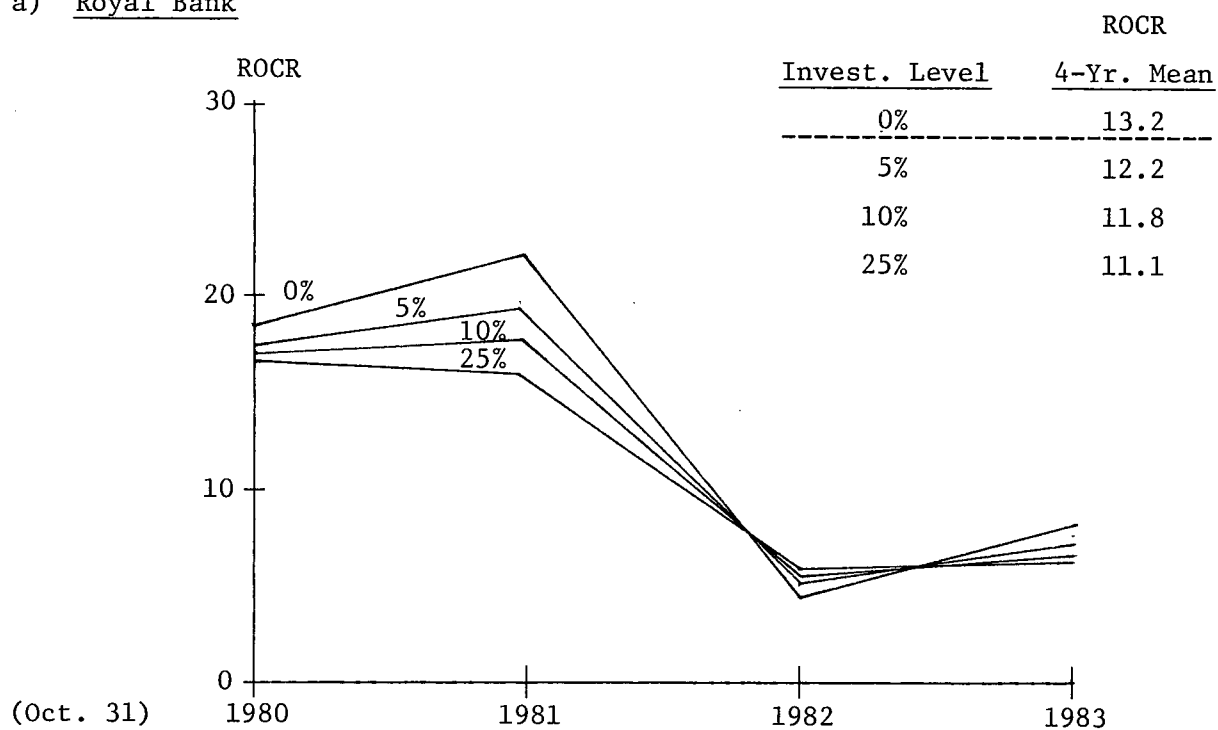
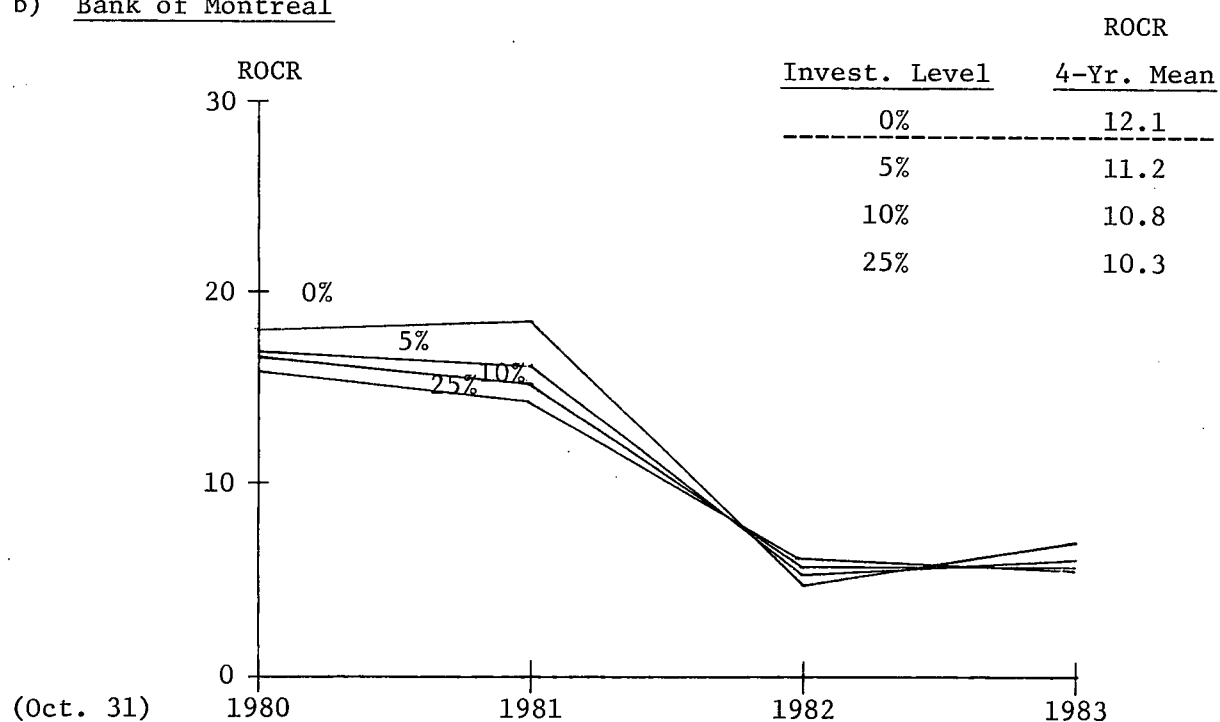
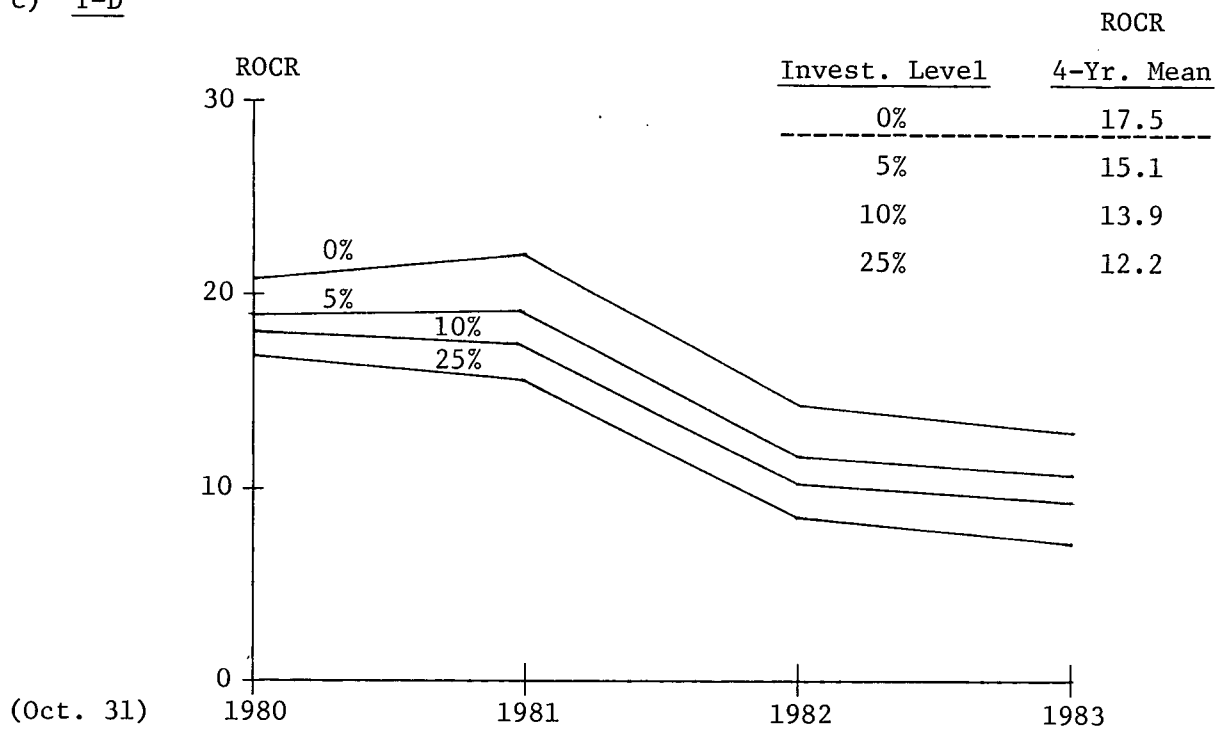
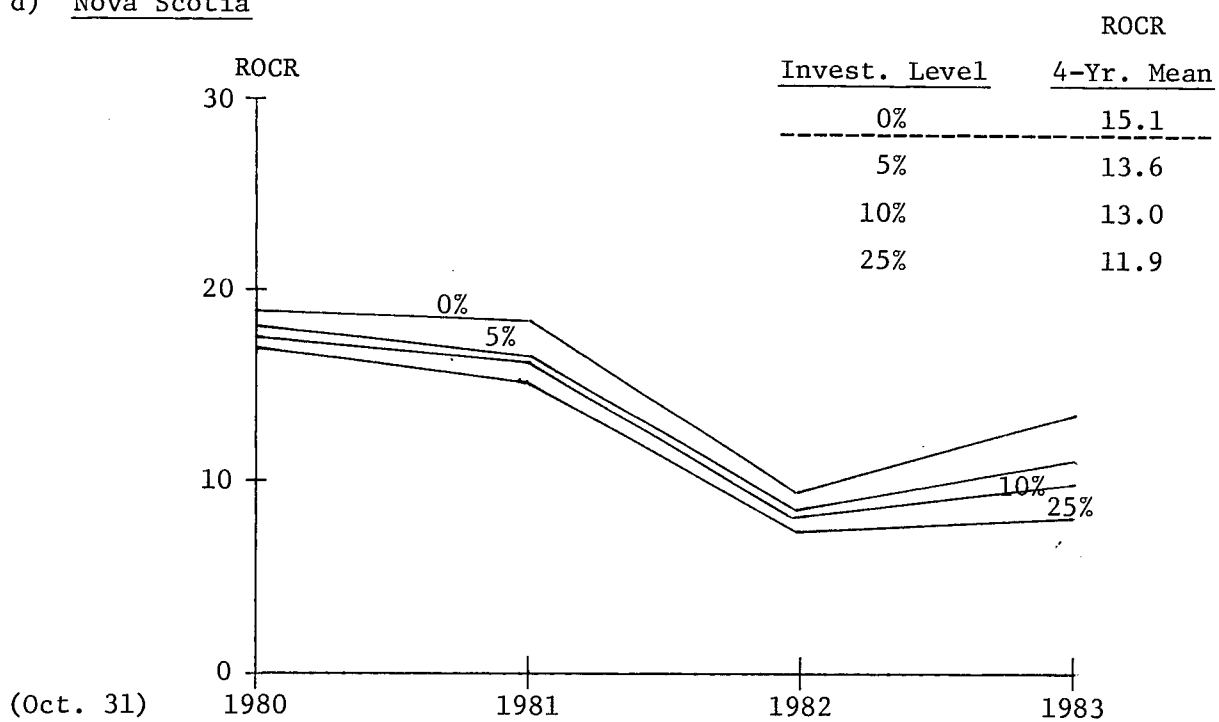
Bank Profitability - New Equity Issuea) Royal Bankb) Bank of Montreal

Figure 4 (Cont'd.)

c) T-Dd) Nova Scotia

when the bank invests in common equities. This occurs because the bank is investing in a portfolio which by its nature is more volatile and co-varies more directly with the standard market portfolio than do traditional bank investments such as bank loans.

However, our simulation studies provide concrete evidence that the increased systematic riskiness of banks need not destabilize the banking system. Our findings indicate that Canadian A banks could initially re-allocate 10% of their domestic agri-commercial portfolio into common equities without unduly jeopardizing bank liquidity or solvency. This amount alone would mean that approximately \$10 billion (CDN), representing about 7% of the Canadian common equity market, could immediately be made available for common equity financings.

### III. FINANCIAL MARKET PERFORMANCE

#### 3.1 Introduction

When weighing the relative benefits of a policy designed to encourage chartered bank ownership of common equity, one must also consider the impact on existing institutions and services. Thus we will now examine the potential consequences of this policy for the operations of existing capital markets.

#### 3.2 Availability and Cost of Debt Capital

One fear associated with allowing banks to hold common equity investments concerns the potential impact that this would have on the cost and availability of normal bank loans. It is true that funds would be diverted away from current banking operations to finance the new common equity investments. However, this need not necessarily either raise interest rates nor lower loan availability. First of all, loan demand can also be expected to drop as companies succeed in refinancing over-leveraged balance sheets with new common equity. Secondly, allowing near banks and Schedule B banks into greater competition with A banks should ensure that any remaining void is filled. The near-banks and B banks are capable of filling the void through their access to both domestic and international savings. Thus an associated financial-sector deregulation should ensure that the lending and debt markets are not unduly disrupted by the A banks investments in common equity.

#### 3.3 Availability and Cost of Equity Capital

Allowing A banks to invest in corporate common equities should also

lead to a drop in the cost of equity capital in Canada for several reasons. The reallocation of bank portfolios in favour of common equity investments should increase the supply of equity funds in Canada. In the short-run, this may well dampen rates-of-return because of the amount of money involved relative to the size of the market. (Approximately \$10 billion (CDN) would be reallocated, representing 7% of Canadian common equities.) Of a more fundamental nature, the funds reallocation would lower corporate financial leverage and social bankruptcy costs. The latter would result from banks being less likely to accept distress prices for asset dispositions when they have a direct stake in the outcome. Therefore, losses and risks associated with potential default are lowered, thus lowering the required rate-of-return on equity investments. Finally, the ability of banks to free-ride on existing lending services for information purposes would lower equity market information costs. The free-ride results because information on client financial and operational prospects are obtained by banks as a normal by-product of their lending decisions. Thus, exploitation of this information for equity investment purposes requires little additional overhead. With competitive equity markets, these savings could be expected to lead to a decline in the cost of common equity capital.

The last argument has particular appeal for small-business equity financing. In the last several years, a phenomenon known as the "small firm effect" has been discovered by financial academics. According to Reinganum, small-capitalization stocks (under \$50 million (U.S.) market-value) earn abnormally high CAPM risk-adjusted returns.<sup>4</sup> This means that

<sup>4</sup> M. Reinganum, "Misspecification of Capital Asset Pricing...", Journal of Financial Economics, 9 (1981), pp. 19-46.

the cost of equity capital is abnormally high for small businesses. To date, the reason behind this phenomenon has yet to be universally agreed-upon. However, one of the stronger arguments relates to the information costs associated with small firm investments. Common equity market trading is dominated by institutions who for reasons of liquidity shun small-capitalization stocks. Thus it does not pay investment analysts to adequately research small firm prospects. However, the banks already possess substantial information regarding small firm operational and financial prospects as a by-product of their lending activities. Therefore, the banks are capable of investing in small businesses without having to engage in the high information costs faced by most would-be investors. Thus the banks would not require as high a return on their capital as the normal marketplace. In short, allowing banks to invest in small business common equities could result in a significant drop in the cost of common equity capital faced by the small-business sector.

### 3.4 Potential for Capital Market Manipulation

In West Germany, where banks are actively investing in common equities, critics claim that this practice disrupts normal financial market operations. Two major reasons are cited. First of all, it is feared that banks will abuse their client relationships and seek to capitalize on the insider-information gained from commercial banking activities.<sup>5</sup> Secondly, critics claim that banks can retard capital market development by using the power derived from their common equity holdings to induce corporate over-reliance on bank-services, rather than allow companies ready access

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<sup>5</sup> "Universal Banks Resist Reform," Euromoney, July 19, 1976, pp. 175-6.



to capital markets.<sup>6</sup>

Before commenting on potential Canadian consequences, it should be pointed out that hard evidence is lacking to support the German critics' claims. The recent Gessler Commission of Enquiry into German banking practices was unable to document any cases of actual abuses during its investigation.<sup>7</sup> Nevertheless the potential for abuse remains, and so must be addressed within the Canadian context.

In Canada, if A banks are allowed to hold common equities, the potential for capital market manipulation would also be present for similar reasons as it is in Germany. Therefore, to ensure that potential abuses are minimized, banks should be made subject to insider-trading disclosure requirements. This will ensure that banks have no more chance to engage in stock market manipulation than any other large shareholder. Thus the potential for stock market manipulation in Canada would remain unchanged.

As for potential capital market retardation, much of the potential German bank power to influence corporate financing behaviour requires the assistance of their additional role as investment banks. Canadian banks are prohibited from engaging in corporate underwriting by order of the Bank Act. Thus allowing Canadian banks to hold common equities should not disrupt the evolution or performance of efficient Canadian capital markets.

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<sup>6</sup> Daskin and Marquardt, pp. 19, 21-23.

<sup>7</sup> "Basic Banking Question," Report of the Gessler Commission of Enquiry: Summary (Bonn, West Germany, 1979).

### 3.5 Summary

Allowing Canadian A banks to hold common equities could prove beneficial rather than disruptive to Canadian capital markets. Our analysis indicates that provided: banking competition is increased, and that insider-trading disclosure requirements are extended to bank transactions; little disruption could be expected to occur in the capital markets with the introduction of our proposal. Indeed, we foresee a potential drop in the cost of equity capital which would be most noticeable for the small-business sector. This gain alone, with its ramifications for our economy's long-term performance may make the process worthwhile.

#### IV. POTENTIAL POWER ABUSES

##### 4.1 Introduction

Aside from concerns about banking system stability, the other major motivation for restricting bank ownership of common equities stemmed from fears that banks would abuse their new powers. Simply put, the concern is that as banks increase their holdings of common equities, they will come to exert undue influence over the operations of non-financial sector firms. The power behind such influence is derived from the voting power over corporate affairs that is normally attached to common equity securities. Critics claim that by allowing banks to own common equities, the banks will use the voting power to pursue objectives which may not be in Society's best interest. For example, competition between bank-owned and non-bank owned companies could be stifled if the former receive preferential treatment by parent-banks. Banks could also intervene in client operations to control the credit-risk on outstanding loans by minimizing management's ability to pursue risky ventures. Therefore if banks are allowed to own common equities, other mechanisms must be found to ensure that the associated increase in bank power is used in society's best interest.

##### 4.2 German Perspective

Since Canadian restrictions on bank ownership of common equities have always existed, analysis of the above claims within the Canadian economic context is impossible. However, we can gain some insights by reviewing the German situation where banks have always been active investors in common equity.

Throughout the 1970's, German banks directly held approximately

10% of non-bank equities. In addition, they held greater than 50% interests in 30 of the 100 largest German companies.<sup>8</sup> Here too, concerns have been raised about the potential for abuses of bank power.

To date, this potential has yet to be realized. According to the Gessler Commission, three factors appear to be responsible for the banks' apparent good behaviour. First of all, German banks do not have access to corporate management boards. This limits their ability to affect daily operational decisions. Banks, through their Supervisory Board representation, must content themselves with influencing long-term strategy. Secondly, the German banking system is extremely competitive. The competition limits the amount of monopoly power available to banks. Therefore they are unable to give their clients any real operational advantage. Two, it gives the companies a ready source of alternative funding should the parent-bank prove difficult. Finally, the banks wish to protect their reputations; thus preventing the subsequent government intervention that would result were they found to be acting contrary to their country's best interests.

#### 4.3 Summary

The German experience appears to have been quite favourable. They too, have been cognizant of the potential for bank power abuses. However, instead of banning the practice of bank investments in common equities, Germany seems to have initiated other safeguards to forestall problems. Thus perhaps we can learn from their experience.

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<sup>8</sup> Gessler Commission: Summary.

## V. OTHER ISSUES

### 5.1 Bankruptcy Costs

As mentioned earlier, a reduction in bankruptcy costs can be expected to follow from bank investments in common equities. In this section, we propose to examine the cause of this phenomenon.

Traditionally, when granting credit, a bank's major concern is naturally with the credit-risk of a company. As such, the bank will concern itself with a client's ability to meet scheduled loan-repayments or failing that, with the ability to be repaid from the proceeds of a liquidation of the client's assets. This leads to a potential conflict between bank and shareholder interests in times of financial distress. The bank is only concerned with the asset values to the extent that its loans are repaid. In contrast, the shareholders wish to receive maximum value for their assets. Historically in Canada, in times of financial distress, the bank's interests have been dominant because they are the preferred creditor.

The potential bank-shareholder dispute might prove irrelevant, except that there are strong reasons to believe that in times of financial distress, assets need not necessarily receive fair-market value upon disposition. Theoretical support for this claim can be found in macro-economic disequilibrium theory. According to A. Drazen in his survey of macro economic disequilibrium theory, agents' actions can be guided by factors other than price signals.<sup>9</sup> Therefore, potential buyers of a distressed firm's assets can be expected to take into account the vendor's

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<sup>9</sup> A. Drazen, "Recent Developments in Macroeconomic Disequilibrium Theory," Econometrica, March 1980.

financial position when formulating bids for assets. On the other side, pressure from creditors can force the vendor to accept bids which while below fair-market value, are sufficient to pay-off the creditors' claims. Thus, the bank-shareholder dispute can lead to significant bankruptcy costs which are solely borne by the shareholders.

Unfortunately, empirical evidence to support such claims is lacking due to lack of research. However, during the past recession, media reports were full of articles about farmers and other small businessmen who had felt unfairly treated by their creditors. Thus there is reason to believe that the problem does indeed exist in Canada.

A side-benefit of allowing banks to own common equities is that the conflict with corporate shareholders is reduced by the greater alignment of their interests. Owning common equities gives the banks a vested interest in ensuring that fair-market value is obtained for client assets. Evidence to support this claim can be found in Germany. According to Business Week and the Anglo-German Foundation, German banks are more likely to assist their clients in working out their problems, or failing that, obtain fair value for the assets through an orderly liquidation process.<sup>10</sup> Examples of client companies where this approach has been implemented are: AEG Telefunken, Köckner Werke, and the German optical industry. It should also be pointed out that as a result, German banks

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<sup>10</sup> "The German Example: 3 Rich Powerful Banks Dominate the Economy," Business Week, April 19, 1976, p. 89.

Economists Advisory Group Ltd., The British and German Banking Systems: A Comparative Study, Anglo German Foundation (London, England: 1981), pp. 43-57, 210-235.

enjoy lower loan-losses than their American counterparts; and are held in greater esteem by their respective public. Therefore allowing Canadian banks to invest in common equities may serve a dual purpose of reducing bankruptcy costs as well as enhance the banking industry's reputation in the eyes of the Canadian public.

## 5.2 Managerial Expertise

A potential long-term hidden benefit of permitting banks to own common equities would be an upgrading of managerial expertise, most notably in the small business sector. Since banks would now be working with existing management in a true partnership, it will be in the bank's best interest to monitor corporate management performance, and help it enhance its skills to the fullest.

According to The Economist, this situation prevails in West Germany.<sup>11</sup> With their large corporate shareholdings and voting power, German banks can ensure that management is accountable to shareholder interests. The banks also maintain advisory departments to assist industry, and thus are able to play the role of efficiency-auditor. Therefore, one may well find banks assuming the role of management consultant by providing services to help corporate management make best use of its resources. Furthermore, the bank can reap economies-of-scale benefits by utilizing its management pool continuously to help small companies which are unable to attract such help by themselves.

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<sup>11</sup> "Role of the Banks: The German Lesson," The Economist, October 15, 1966 (Supplement).

## VI. CONCLUSION

Throughout this paper, we have sought to challenge the conventional wisdom which dictates that allowing chartered banks to invest in common equities is necessarily bad. As shown in Section II, our simulation studies reveal that concerns about banking system instability are exaggerated. The remainder of the paper sought to distinguish fact from fiction with regards to conventional thought, and outline some of the potential benefits that could be expected to arise from our proposal.

Section III outlined the potential impact on the existing financial markets, as well as examining potential benefits to those corporations in need of common equity capital. Section IV discussed the fears surrounding the potential abuses by banks of their new-found powers. Using Germany as a back-drop, it strove to prove that the abuses are controllable by other mechanisms. Finally, Section V discussed two major socio-economic issues: bankruptcy costs and managerial expertise, where significant benefits can be expected when banks invest in common equities.

In summary, there are many advantages to be gained by allowing Canadian A banks to follow their German counterparts. However, in order to ensure that abuses of the new environment are kept to a minimum, several safeguards should be adopted concurrently:

1. The process should be adopted over a time-frame of 5-10 years.

This will minimize the disruption to existing operations and institutions; allow time for current participants to become familiar with their new roles; and enable reversal of the process if insurmountable problems arise.



2. Deregulation of current banking operations.

Competition should be enhanced in current banking operations by allowing near-banks and B banks greater access to the banking system. This will prevent A banks from transferring any monopoly power now enjoyed, into their new role as venture capitalists. It will also ensure that the lending market is not disrupted by the A banks' reallocation of funds into the common equity market.

3. A ceiling on bank common equity investments.

A ceiling of 10% of a bank's domestic agri-commercial portfolio should be set as a limit for common equity holdings. This will help ensure banking system stability.

4. Limitations on bank voting power.

Voting of bank-owned common stock should be limited to times of corporate financial distress. This will minimize the bank's ability to interfere in the daily operational activities of client companies.

5. Banks should be made subject to current stock market insider-trading disclosure requirements.

This provision will ensure that a bank's ability to manipulate stock prices will be no greater than any other corporate insider.

6. Government willingness to police the system.

To help ensure that bank abuses of their new powers are kept to a minimum, governments should declare and enforce a willingness to intervene if necessary, to prevent banks from abusing their powers. This will give tangible value to bank reputations, and encourage banks to protect them.

7. Enlargement of bank venture-capital operations.

The A banks may find it advantageous to enlarge their venture capital

operations to manage their new investments. These people are already trained in the necessary skills needed to manage the new types of investments.

As the Toronto Stock Exchange recently noted, Canada has always been a nation whose citizens are reluctant to consider common equity investments. By allowing Canadian A banks to fill this void, we can lessen the need to continuously sell-off our nation's resources to foreign investors whose priorities are not necessarily our own.

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