BANKING ON REFORM

The Banks Have a Crucial Role in Economic Recovery—Let's See That They Play It

by Susan Bellan

Editor's Note: This article is based on the author's presentation to the Standing Committee on Industry regarding access to capital for small and medium-sized business on March 22, 1994, on behalf of the Canadian Organization of Small Business. It complements an earlier critique of the banks ("The Mission of the Banks," Making Waves*, Vol. 5, No. 1, pp. 11-15) with recommendations for radical reform.*

Like its social programs, Canada's banking system is in need of a major overhaul. While the chartered banks are presenting record profits to shareholders and large bonuses to top management, they are failing the Canadian people. Since 1990, tens of thousands of Canadian small and medium-sized businesses—responsible borrowers that were servicing their debts—have been seriously injured or destroyed by their banks through the abrupt and arbitrary withdrawal of credit.

Canada's banks are incredibly hypocritical. On the one hand they continually lambast the government about the deficit. On the other hand, their lending policies are largely responsible for the creation of the deficit. For each viable company injured or destroyed by its bank, government loses twice. The employees who used to earn their livelihoods through the company must receive UIC (and welfare, eventually, if they cannot find work). The owner of the company, if he or she has no savings, immediately goes on welfare. Unnecessary bankruptcies thus trigger huge, sustained social assistance costs for government. At the same time, the government loses all the tax revenue that employees and the owner paid when they were working in the company. This "double whammy" adds to government annual deficits and eventually becomes part of the national debt.

FRIDA CRAFT STORES VS THE TD

Take my company for example. In 1991 the Toronto Dominion threatened to halve or eliminate its credit line of $65,000. I had been in business since 1979, and even though 1991 was a terrible year for me, my business still made a $80,000 profit. I had a good track record and had paid on time $110,000 of $130,000 of a loan made under the Small Business Loan Assistance program. However, my bank tried to call the balance of this government-guaranteed loan that was in good standing. If I had been forced to pull an additional $20,000 out of my business to immediately pay off the loan, it would have caused tremendous problems.

At the moment, Canada's banks are not exactly "on-side" in the effort to create jobs. It's time the people of Canada started giving orders to the banks instead of constantly taking orders.

The Office of the Superintendent of Financial Institutions said that they could do nothing about it. My husband and I managed to save ourselves by calling the *Toronto Star* to publicize our situation. An article on the front page of the Saturday edition of that newspaper (December 14, 1991) was profoundly embarrassing to my bank. Fortunately for us, the public was very interested in our situation and very annoyed at the bank. We received many telephone calls of support from our customers, the general public, and from many business people having similar problems in Ontario and other parts of Canada. In the end, our credit line was increased from $65,000 to $100,000. That has certainly helped us weather the stormy and deteriorating Ontario economy.

But many thousands of small and medium-sized businesses have not been so lucky. They do not have the same high profile and have quietly gone under, when their loans have been called and their credit lines eliminated or sharply reduced.

Consider the consequences for the national community if the bank had succeeded in pushing me under. My business employs four people, so there would have been a UIC cost of about $50,000 in the first year. My company generates $250,000 in provincial sales tax, GST, and business and realty tax as well as all the income tax paid by my family and my employees. All this would also have been lost. We were easily able to pay the additional $250 a month in interest for the higher credit line. Yet here was this bank claiming that it was safer to shut us down and get its depositors' money back, at a cost to the taxpayers (who, coincidentally, are the same people as shareholders) of over $350,000 annually in lost taxes and additional social assistance expenditures.

THE MISUSE OF PRIVILEGE

Canadian banks are in a position of privilege matched by no other private corporations. By government legislation they have sole access to $400 billion in Canadian deposits that represent 96% of their inventory. Bank shareholders only provide 4% of this inventory, a minuscule proportion relative to the contributions shareholders make to other private corporations. The sad truth is that Canada's money supply, much of which sits as deposits in the chartered banks, is being used to maximize shareholders' short-term profits and justify large bonuses for bank top management. The banks lend themselves vast sums to finance their own acquisitions and expansion, while denying Canadian small and medium-sized business the capital they need to survive, to expand, or to start up. The banks tell us how lucky we are that they are so wildly profitable.

Meanwhile, their shortsighted, self-serving lending policies are making Canadians go bankrupt, individually and collectively.

A good example of this double standard and utter hypocrisy is the recent bank financing of the takeover of McLean Hunter by Rogers Cable. Since 1990, the banks have withdrawn more than $4 billion of credit from Canadian small and medium-sized business. They have justified this massive withdrawal on the grounds that these companies are part of risky industrial sectors, or because some companies might have lost some money for the first time due to the recession. In the mean time, the banks casually lend $2 billion to one company that lost $55 million last year. This deal was set up in a matter of days and is risky indeed if cable does not prove the way of the future. The merger of Rogers and McLean Hunter will likely result in 1) unemployment, due to the firing of redundant staff, and 2) inflation, as the debt-laden Rogers tries to increase revenue (through rate increases, most likely) to pay back its creditors.

So why are Canadian banks giving 50% of the capital that they took away from over 900,000 smaller companies to one company owned by one individual? Because they will get 2.13% in up-front commissions for putting the $2 billion loan together.

COSBI RECOMMENDATIONS FOR REAL ECONOMIC “RECOVERY”

The current situation is no longer tolerable. The Canadian economy continues to go down hill, yet analysts still talk about a “recovery” we are supposedly experiencing. Continuing high unemployment, no job prospects for school graduates, high government deficits, increasing foreign debt, and declining public services—plus higher taxes—are not my idea of “recovery,” no matter how GNP and exports may be rising.

An economic recovery that does not feature significant job creation is as good as no recovery at all for Canadians and their government.

In the period 1946-1974, the Canadian government had 17 budget surpluses and 12 budget deficits. The total surpluses were three times the total deficits. Unemployment averaged 4.6%. Since 1974, by contrast, unemployment has averaged over 9% and the government has had an unbroken record of deficits.

There is a message in these figures: persistent and increasing unemployment prevents governments from balancing their books and causes growing indebtedness. To really reduce the deficit and the national debt (especially the foreign debt), we must tackle head-on Canada’s growing long-term unemployment and the lack of job opportunities for recent school graduates.

Through a partnership of small and medium-sized businesses, banks, & government, we must vastly increase commercial lending to create a million new private sector jobs.

At the moment, however, Canada’s banks are not exactly “on-side” in the effort to create jobs. It’s time the people of Canada, via their federal representatives, started giving orders to the banks instead of constantly taking orders. The Canadian Organization of Small Business (COSBI) has six recommendations to that effect. The sixth and most important one I explain in detail at the end of this article.

1. Pass a Canadian version of the American Community Reinvestment Act (CRA), which has been in force for more than twenty years. Under this legislation, all deposit-taking institutions would be required to earmark a minimum of 20% for loans to small and medium-sized business and for the economic development of the community of origin of the deposits.
2. Establish an ombudsman system whereby small businesses in conflict with their bank can involve an outside party to make sure they are being fairly treated. There is no way that a small or medium-sized business can successfully survive a legal onslaught financed by a bank with billions of dollars of assets and expensive lawyers on retainer.
3. Use legislation to oblige banks’ boards of directors to become more representative of the general public, as in Denmark. Currently these boards are comprised mostly of the banks’ largest corporate borrowers. This fosters a big-corporate perspective in institutions that should be very concerned about the welfare of the overall community—current lending policies being a case in point.
4. Foreign loans should not be tax deductible or insured via the CDIC. Why should the Canadian people underwrite these vast risks? If the project goes well, Canadians get no benefit in terms of economic multiplier effect and employment. If the project goes badly, the average depositor pays for it. Higher service charges nickel and dime him or her to death for years to come. Ultimately, we underwrite 50-100% of the risk through generous tax deductions and at times outright payments to depositors through the Canadian Deposit Insurance Corporation.
5. Bank charters should be reviewed every five years, staggered in such a way that each of the big five’s charters comes up for review in a different year. We are the banks’ masters, not their servants. The immensely valuable monopoly privileges that we have conferred we can also take away or curtail as we so choose.

   This is what we do in granting broadcasting licenses. Before we renew these licenses, the companies must prove that they have been meeting Canadian content guidelines and other public objectives.

   We should also consider charging annual charter fees, commensurate with the tremendously valuable concession we have conferred on these few corporations with their monopoly access to Canadian deposits.
6. Through a constructive partnership of small and medium-sized businesses, banks, and government, we must vastly increase commercial lending to the level required to create a million new private sector jobs. Extensive government guarantees must encourage banks to take much greater risks in the financing of existing companies and start-ups (including the provision of working capital), increasing loans to this sector initially by about $15 billion.

USING COMMERCIAL LENDING TO CREATE A JOB-ORIENTED RECOVERY

The Key Role of Small/Medium-Sized Business

One million is a lot of jobs to create. To achieve such an ambitious objective, we need a strategy of the same scale. Instead of spending over $20 billion year after year to finance social assistance that accomplishes nothing permanent and training programs that often lead nowhere—instead of this, we make a one-time investment in tens of thousands of Canadian businesses that can create permanent jobs for the unemployed.

There is no point in looking to the corporate sector for assistance. Its recurrent "downsizing" is in truth a dehiring process. Small business is currently the only creator of net new jobs. But the small business sector is currently denied the capital it requires to absorb such numbers of unemployed Canadians.

What is needed is a lending program that serves existing small and medium-sized companies as well as those starting up. By increasing loans to this sector by $15 billion, a million jobs can be created, assuming an average investment of $15,000 per new job.

This should be done by expanding our current Small Business Loans program (SBLA) to cover working capital, which the program specifically excludes right now. Most Canadian small companies need more working capital to hire additional employees and to finance production before it qualifies as a bankable receivable. (Under the current legislation, the government guarantees loans to buy such things as Japanese computers and American equipment whose purchase contributes virtually nothing to the Canadian economy.) If all this seems unprecedented, think again. The Dutch commercial lending system has been operating successfully on these principles for over forty years.

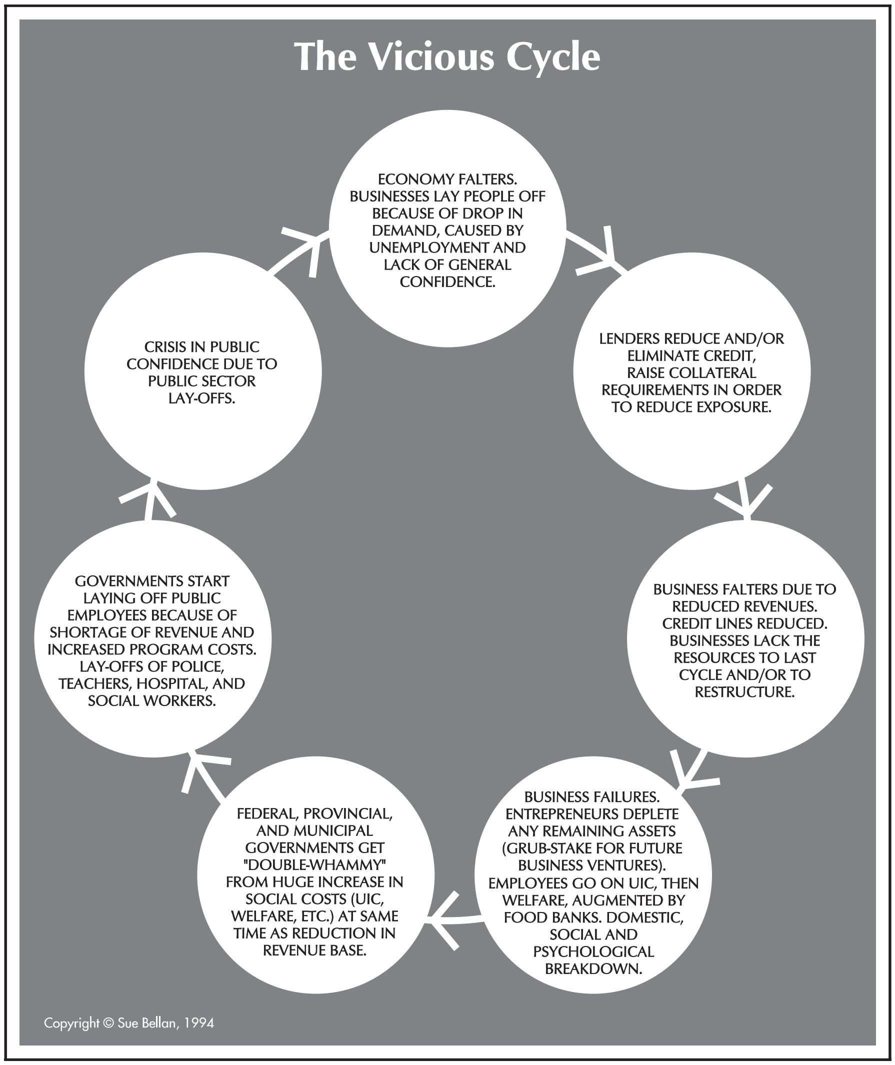
A "Worst-Case" Scenario

It is crucial to understand at the outset that all these businesses will not succeed. Lending to these companies at an adequate level is relatively risky and time-consuming. But factor in the huge cost of not doing so—the value of social assistance and lost tax revenues. The government can actually benefit from the creation of businesses that eventually fail in so far as they relieve the public of some social assistance expenditure and generate tax revenue during their term of operation.

Let's assume the most risk-laden scenario: the investment of $15 billion in SBLA money in new companies. If we invest $15 billion in start-ups, initially we are likely to create one million new jobs. An additional million people working means 1 million x $12,000 average social assistance not paid out, totaling a win for the government of $12 billion annually. Similarly, one million additional taxpayers contributing a minimum of $5000 each in income tax would yield a win for government of 1 million x $5000 or $5 billion in new tax revenue. In one year, Canada could thus get a "double win" of $17 billion from a single $15 billion investment, much of which eventually would be repaid.

One could endlessly conjecture how many of these one million new jobs would be permanent. According to bank statistics, 75% of new companies survive their first year, while by their third year, 50% are left. Assuming that $15 billion is lent out to start-ups, the government would get 75% of the $15 billion double win in Year One, which is $11.25 billion. In Year Two, with 62.5% of new companies still operating, it would get 62.5% of the $15 billion double win, which is $9.375 billion. In Year Three, the government would get 50% of $15 billion, which is $7.5 billion. Totaling the double win for the three years, the combined benefit to government is $28.125 billion.

At the end of this period, the government would compensate the banks for



their total 50% one-time losses on the $15 billion investment, which would come to $7.5 billion. It is generally acknowledged that once a company has survived for three years, it is likely to keep going and is on a solid footing. Hence we would also have created 500,000 permanent jobs, which is no mean achievement.

If we add in the cost of social assistance paid out to those who lose their jobs within the three years, on the basis of 25% of $12 billion of social assistance in Year I, 37.5% in Year II, and 50% in Year III, the total costs of a $15 billion job-oriented SBLA investment would be $7.5 billion paid to the banks and $16.875 billion eventually paid out for social assistance, totaling $24.37 billion. Once we subtract even this high figure from the double win of $28.125, however, a $3.75 billion profit remains for government.

What is the alternative? A $12 billion annual investment in social assistance, plus the loss of $5 billion in potential tax revenue annually, totaling $17 billion each year. Over three years this comes to a certain double loss of $51 billion to government which ultimately becomes part of the debt. Inaction and timidity thus net a $51 billion cash loss, when a $15 billion SBLA investment—even under the worst possible circumstances—can generate $3.75 billion and spare the national debt an additional $47.25 billion.

Realistically, the success rate of the assisted businesses will be much higher. A considerable proportion of the $15 billion will go towards companies that have already proved their viability. So the $3.75 billion positive win is more likely to be higher, in the realm of a $10-15 billion net double win after subtracting loan losses and social assistance payments.

Breaking the Vicious Cycle of Recession

Furthermore, once the general public sees a lot of jobs being created, especially well-paying jobs with career potential, it will begin to loosen its purse strings and start spending again. A major reason for the persistence of this economic downturn is that people with jobs are understandably terrified that they too will join the ranks of the long-term unemployed. They consequently have been reining in their spending so drastically that the economy has been still further weakened. The economy, after all, is 60% dependent on consumer spending. The constriction of consumer spending has contributed to an unending negative chain reaction of high deficits, higher taxes, and continuing public sector cutbacks (see chart, p. 9).

Restoring consumer confidence will in itself will give a massive boost to the economy. Existing companies that have suffered from the collapse in consumer confidence will see their sales firm up; they may then begin to hire again. Government revenues from sales taxes will increase with consumer spending.

In closing, I am both optimistic and pessimistic. If we act boldly, there is good reason for optimism. By changing the basis of our banking system so that our banks only succeed if Canadians truly succeed, our future can again be very bright. That requires a new definition of success, however. We must see it in terms of a prosperous, equitable economy with low unemployment, and not be satisfied with a few dramatically wealthy people and corporations. We can take a big step in the direction of true recovery through a new, constructive partnership of small and medium-sized business, banks, and government that massively increases our system of commercial lending. If we are timid and passive, however, the future is bleak indeed. If we allow the banks to use our money to further their own agendas to the detriment of the public good, and consequently to underinvest in the very organizations that can create jobs in abundance, we can only expect more of the same "spiral of growth": downwards.

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