



Chapter 15: The Banking System and the Money Supply

Learning Objectives

After studying this chapter, you should be able to

- 15.1** Describe the structure of the Canadian banking system
- 15.2** State the objectives and functions of the Bank of Canada
- 15.3** Identify the major items on the balance sheet of the Bank of Canada
- 15.4** Discuss the origins of modern banking and the role of chartered banks
- 15.5** Identify the main items on the balance sheets of chartered banks
- 15.6** Explain what is meant by the “creation” of money by the chartered banks
- 15.7** Discuss practical constraints on deposit creation and deposit destruction
- 15.8** Discuss the role of near banks in the financial system

Assess Your Knowledge

Indicate whether each of the following is true (T) or false (F).

- 1.** In Canada, the central bank is a network of chartered banks.
- 2.** The Bank of Canada is the largest commercial bank in Canada.
- 3.** Credit unions and caisses populaires are commercial banks.
- 4.** Chartered banks create money.

The Canadian Banking System

LO 15.1 Describe the structure of the Canadian banking system

© 2025 Addison Publishing. All rights reserved.

The Banking System

The **banking system** refers to the institutional relationship between the **Bank of Canada** and the country's **chartered banks**, which together provide core banking services—deposit-taking, lending, and payment processing—to households and businesses. It operates as a key component of the broader **financial system**, which includes a range of institutions that support savings, investment, and credit.

Banking system: the interaction between the central bank and chartered banks as part of a wider financial system.

Canada's financial system consists of the following main institutional categories:

1. **The Bank of Canada** – the central bank responsible for **monetary policy, issuing currency, and maintaining financial stability**.
2. **Chartered Banks** – federally regulated institutions that offer **deposit and loan services**, operate payment systems, and provide access to the credit market.
3. **Near Banks** – institutions like **credit unions, caisses populaires, trust and mortgage loan companies**, which also accept deposits and make loans but under a different regulatory framework.
4. **Other Financial Institutions** – investment firms, insurance companies, pension funds, and fintech firms that provide specialized financial services.

Together, these entities form a **highly integrated financial system**, supporting economic activity by allocating capital, facilitating payments, and managing risk.

What Is a Central Bank?

A **central bank** is the **monetary authority of a country**, responsible for **issuing currency, regulating the money supply, managing interest rates, and promoting financial stability**. It typically serves as a **lender of last resort to commercial banks**, oversees **payment systems**, and maintains **price stability**, often by targeting a specific rate of inflation. Central banks are **independent institutions** operating at arm's length from the government to protect their decisions from short-term political pressure.

The Bank of Canada

Canada's central bank—the **Bank of Canada**—was established in **1935** to manage the country's monetary system and ensure financial stability. Prior to its creation, **central banking functions were carried out by the Department of Finance**, and private banks issued their own currency. The **Bank of Montreal**, the country's largest bank at the time, acted as the government's fiscal agent, and regulatory oversight rested with the **Canadian Bankers Association**.

© 2025 Addison Publishing. All rights reserved.

The **Great Depression** revealed the limitations of this decentralized system. Many believed that the lack of coordinated monetary policy worsened the crisis, leading to widespread unemployment and financial instability. In response, the government created the **Royal Commission on Banking and Finance in 1933**, chaired by **Lord Macmillan**, to examine the case for a central bank.

Following the commission's recommendation, the **Bank of Canada was founded in 1935** as an independent institution. Its core functions today include:

1. **Issuing Canada's banknotes**
2. **Targeting inflation (currently 2 percent)**
3. **Conducting monetary policy by adjusting interest rates**
4. **Acting as lender of last resort**
5. **Overseeing the national payments system**
6. **Advising the government on financial and economic matters**

The **Bank of Canada Act** ensures that the central bank operates independently, with a clear mandate to promote **price stability, sustainable economic growth, and confidence in the financial system**.

The Establishment and Governance of the Bank of Canada

In the **fall of 1933**, the **Macmillan Commission** submitted its report recommending the creation of a central bank to stabilize Canada's monetary system. While **chartered banks opposed the proposal**, the **Bank of Canada Act was passed in 1934**, and the **Bank of Canada began operations in 1935** as a **privately owned institution**.

This changed in **1938**, when the Bank became a **Crown corporation**, fully owned by the federal government—in effect, **by Canadian taxpayers**. The **governor is appointed by the federal Cabinet**, giving the institution operational independence but public accountability. The Bank also became the **sole issuer of Canadian currency**, absorbing responsibilities from the Department of Finance. Private banks, which had previously issued their own notes, were required to **withdraw their currency by 1949**.

The Bank of Canada was founded to bring **professional, centralized control to monetary policy**, replacing a fragmented and bank-led system that had failed to respond effectively during the Great Depression.

Who Manages the Bank of Canada?

The Bank of Canada is governed by a **Board of Directors**, which includes:

- The **Governor**
- The **Senior Deputy Governor**
- **Twelve external directors**
- The **Deputy Minister of Finance** (non-voting member)

The **Governor and Senior Deputy Governor** are appointed by the Board of Directors, subject to Cabinet approval, for **seven-year terms**. The **external directors** are appointed by the **Minister of Finance** for **three-year renewable terms**. All directors must:

- Be **Canadian citizens**
- Be **under the age of 75**
- Not be **employees or officers of any government**
- Not be **affiliated with financial institutions that deal directly with the Bank**

The Bank's **Executive Committee**, composed of the Governor, Senior Deputy Governor, and two to four directors, **meets weekly** and acts on behalf of the full board. The Deputy Minister of Finance participates in board meetings but **does not hold voting rights**, maintaining a formal link to government while preserving the Bank's operational independence.

Chartered Banks and the Broader Financial System

While the **Bank of Canada** serves as the country's **central bank**, it operates within a **larger financial system** that includes **chartered banks, near banks, and other financial institutions**. This system provides the infrastructure for **saving, borrowing, investing, and making payments**, supporting both economic growth and financial stability.

Chartered banks—also called **commercial banks**—are **federally regulated financial institutions** that offer a wide range of services, including **deposit-taking, lending, investment products, and payment processing**. According to the Department of Finance, Canada's chartered banks operate **more than 8,000 branches and over 17,000 automated banking machines (ABMs)** across the country. Canada continues to rank among the global leaders in **per capita access to electronic banking channels**, including **debit cards, online banking, and mobile apps** (Department of Finance Canada, <https://www.canada.ca/en/department-finance.html>).

Chartered banks are classified into three categories under the **Bank Act**.

Schedule I Banks

These are **domestically owned banks** that are **not subsidiaries of foreign institutions** and are authorized to **accept deposits**. They include Canada’s “**Big Five**”:

- Royal Bank of Canada (RBC)
- TD Bank Group (TD)
- Scotiabank
- Bank of Montreal (BMO)
- Canadian Imperial Bank of Commerce (CIBC)

As well as the **National Bank of Canada**.

Table 15.1

Table 15.1 Revenues of Shcedule Bank in 2024
(\$ billions)

Schedule I Bank	Revenue
Royal Bank of Canada (RBC)	53.66
Toronto-Dominion Bank (TD)	49.20
Bank of Montreal (BMO)	32.8
Scotiabank (BNS)	29.25
Canadian Imperial Bank of Commerce (CIBC)	21.31
National Bank of Canada	11.40

Source: (Bank of Canada

Schedule I banks must be widely held, meaning no single shareholder may control more than 10 percent of voting shares, and foreign ownership is limited to 25 percent.

Below is Table 15.1 with 2024 revenues for Canada’s Schedule I banks, based on Bank of Canada classification and corporate reports:

Table 15.1 shows the 2024 revenues of Canada’s six largest Schedule I banks, institutions that are domestically owned and federally regulated. The Royal Bank of Canada leads the sector with revenues exceeding \$53 billion, followed by TD Bank at \$49 billion and BMO at \$32.8 billion. Scotiabank, CIBC, and National Bank report lower revenues but

remain major players, together generating over \$60 billion. The wide revenue gap reflects differences in market share, international exposure, and business mix. The concentration of revenue among the top three banks underscores the oligopolistic structure of Canada’s banking system.

Schedule II Banks

These are **subsidiaries of foreign banks** operating in Canada. They are permitted to **accept deposits** and typically **focus on commercial lending, international banking, or specialized financial services**.

Examples include:

- Bank of China (Canada)
- Citibank Canada
- Amex Bank of Canada
- ICICI Bank Canada

Schedule III Banks

These are **foreign banks not incorporated under the Bank Act** but permitted to conduct certain banking operations in Canada under **strict regulatory conditions**. They do not accept retail deposits and typically operate in major financial centres. Examples include:

- **Barclays Bank PLC (Canada Branch)**
- **JPMorgan Chase Bank N.A.**
- **Capital One Bank (Canada Branch)**
- **Deutsche Bank AG (Canada Branch)**

In addition to chartered banks, Canada's financial system includes credit unions, caisses populaires, trust companies, insurance firms, pension funds, and investment dealers—collectively referred to as near banks and other financial institutions. These organizations offer overlapping services and operate under various regulatory frameworks at the federal and provincial levels.

Together, these institutions form a highly integrated and regulated financial system, where the Bank of Canada maintains monetary and financial stability, and private financial institutions provide services, allocate capital, and facilitate the flow of funds across the economy.

Near Banks and Other Financial Institutions

Near banks are financial institutions other than chartered banks that accept deposits from the public. They include credit unions, caisses populaires, trust companies, and mortgage loan companies. Although regulated primarily at the provincial level, these institutions perform core financial functions—deposit-taking, personal and small business lending, and wealth management services—similar to those of chartered banks.

© 2025 Addison Publishing. All rights reserved.

Near banks: financial institutions, other than chartered banks, that accept deposits from the public.

In 2023, credit unions and caisses populaires in Canada generated approximately C\$21.6 billion in revenue, serving over 10 million members nationwide (Canadian Credit Union Association, <https://ccua.com>). While their operations remain more regionally concentrated, particularly in Quebec and Western Canada, they play a central role in the financial lives of millions, offering services that closely parallel those of commercial banks.

In contrast, non-depository financial institutions—formerly grouped as “other” financial institutions—do not accept deposits. This category includes mutual funds, insurance companies, pension funds, leasing firms, and consumer finance companies. These institutions contribute significantly to financial intermediation, but fall outside the scope of this chapter.

Reading Comprehension

1. What constitutes the Canadian banking system?
2. Distinguish between the banking system and the financial system.
3. What circumstances led to the establishment of the Bank of Canada?

The Canadian banking system, the primary subject here, consists of the Bank of Canada (the central bank) and the chartered banks. Because near banks offer overlapping services and compete in many of the same markets, their operations warrant attention, even if non-depository institutions remain beyond our present discussion.

Table 15.1 presents the 2023 revenue levels for the Big Five Schedule I banks,

highlighting the financial scale of Canada’s core deposit-taking institutions.

The Objectives and Functions of the Bank of Canada

LO 15.2 State the objectives and functions of the Bank of Canada

Objectives of the Bank of Canada

The Bank of Canada Act (1934) defines the Bank’s mandate as follows:

“... to regulate credit in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit, to mitigate fluctuations in production, trade, prices and employment, and to promote the economic and financial welfare of the Dominion.”

Restated, the Bank of Canada is responsible for conducting monetary policy to achieve:

1. **Price stability**
2. **Sustainable economic growth**
3. **A stable external value of the currency**
4. **A viable balance of payments**
5. **Financial and economic welfare**

These objectives often require trade-offs, as measures to achieve one goal may complicate the achievement of another—for example, curbing inflation may temporarily raise unemployment.

The functions of the Bank of Canada—which support these objectives—will be discussed in detail in the following section.

Functions of the Bank of Canada

The Bank of Canada performs five central functions to meet its statutory objectives. These responsibilities are essential to maintaining economic stability, price control, and financial system resilience in Canada.

1. Controller of the Money Supply

The Bank of Canada regulates the quantity of money in circulation to influence **aggregate demand (AD)**, production, employment, and the price level. According to the **AD–AS model** (introduced in Chapter 7), if the money supply grows too quickly, **aggregate demand shifts right**, creating upward pressure on prices—**inflation**. This is the classic situation of “*too much money chasing too few goods*.” Conversely, when the money supply is insufficient, **aggregate demand falls**, leading to **lower output and higher unemployment**.

In Canada, the **Bank of Canada is the only institution authorized to issue banknotes**. However, there is an important distinction between **issuing money**—done exclusively by the central bank—and **creating money**, which is largely performed by **commercial banks**. Through deposit-taking and lending, commercial banks engage in **multiple deposit creation**, resulting in the expansion of the money supply. As of 2024, **more than 95 percent of Canada’s money supply** exists in the form of **deposit money** created by commercial banks, while **less than 5 percent** exists as physical currency issued by the Bank of Canada.

2. Banker to the Commercial Banks

The Bank of Canada holds **settlement accounts** for all chartered banks, where they keep **reserves** for clearing transactions. These reserves are liabilities of the Bank of Canada and are used to settle interbank payments through the **Lynx system**, Canada's high-value payment platform.

The Bank also serves as **lender of last resort**, providing liquidity support if a chartered bank encounters a short-term funding shortfall. This backstop increases **public confidence** in the safety of the banking system.

The Bank works alongside other regulatory agencies—the **Canada Deposit Insurance Corporation (CDIC)**, the **Office of the Superintendent of Financial Institutions (OSFI)**, and the **Department of Finance**—to conduct **regular financial stability assessments**. These joint efforts aim to prevent institutional failures and safeguard the overall financial system. In international rankings, Canada's banking system continues to be recognized as among the **most stable and resilient**, consistently ranking near the top in measures of **soundness and efficiency**.

3. Fiscal Agent and Financial Adviser to the Government

The Bank of Canada acts as the **fiscal agent and financial adviser to the federal government**. The **governor** and **senior management** are appointed by the Cabinet for seven-year terms, providing continuity and minimizing political interference in monetary decisions. The Bank collaborates closely with the **Minister of Finance** to coordinate fiscal and monetary policies.

As fiscal agent, the Bank:

- **Manages the Government of Canada's main account**, through which federal payments are processed.
- **Oversees public borrowing** by organizing bond and treasury bill auctions.
- **Provides short-term credit to the government**, primarily through the purchase of government securities, which are credited as deposits in the government's account.

Historically, the Bank played a key role in:

- Financing the **Second World War**
- Supporting **postwar economic expansion**
- Creating the **Industrial Development Bank** (now the **Business Development Bank of Canada**)

The Bank's current mission is:

"To promote the economic and financial welfare of Canada through low and stable inflation, a safe

© 2025 Addisan Publishing. All rights reserved.

and secure currency, financial system stability, and efficient management of government funds and public debt.”

4. Manager of Monetary Policy

In coordination with the federal government, the Bank of Canada sets and implements the country’s **monetary policy**. While the Bank is operationally independent, the **Minister of Finance** retains the legal authority to issue a directive if there is a policy disagreement. Under the **amended Bank of Canada Act (1967)**:

1. The Bank must **consult regularly** with the government.
2. The government may issue a **written directive**, with Cabinet approval, instructing the Bank to adopt a specific policy.
3. Any directive must be **time-limited**, and the Bank is **required to comply**.

The central goal of monetary policy has evolved. Historically, it aimed to achieve **full employment and price stability**. Since 1991, the Bank has adopted an **explicit inflation-targeting framework**, with a target of **2 percent inflation**, measured by the **Consumer Price Index (CPI)**—midway between a 1–3 percent control range.

The Bank monitors **core inflation** (which excludes volatile items like food and energy) as a guide for short-term interest rate decisions. The CPI is compiled by **Statistics Canada**, using a weighted basket of goods and services representing typical household consumption.

Designing effective monetary policy remains a complex task, requiring the Bank to balance **short-term trade-offs** between inflation, output, and employment while maintaining **long-term price stability**.

Headline vs. Core Inflation

Headline inflation refers to the total **Consumer Price Index (CPI)**, which tracks the average price change of all goods and services purchased by households. This measure includes volatile components like **gasoline, fresh produce, and energy**, which can cause large month-to-month fluctuations.

Core CPI, by contrast, excludes these volatile items—specifically **fresh fruits and vegetables, gasoline, fuel oil, natural gas, mortgage interest costs, and tobacco products**—to provide a smoother measure of price trends. The **core inflation rate** derived from this index offers a better view of the persistent movement in prices and is widely used by the **Bank of Canada** to inform its interest rate decisions.

By focusing on core inflation, policymakers aim to respond to sustained price pressures rather than temporary shocks, making it a more reliable guide for monetary policy.

Supporter of the Financial System

The Canadian monetary system functions as a **fiduciary monetary system**—one based on **trust and confidence** rather than intrinsic value. **Paper currency and deposit balances** are accepted as money not because they are backed by physical commodities, but because **everyone trusts that others will also accept them in exchange**.

Fiduciary monetary system: a monetary system based on trust that others will accept the currency or deposits as payment.

Maintaining this trust is essential. If confidence in the monetary system eroded—causing individuals to withdraw deposits en masse—the result could be widespread instability. The Bank of Canada supports the financial system by **acting as lender of last resort, providing liquidity**, and **monitoring systemic risk**, all to ensure that confidence in Canada's financial institutions remains strong.

Through regulation, risk oversight, and emergency lending mechanisms, the Bank of Canada plays a critical role in sustaining a **secure, stable, and trusted financial environment**. The Bank of Canada supports the financial system and prevents the loss of confidence that might cause panic and ensuing bank failures.

Figure 15.1 the rate of inflation between 2003 and 2023

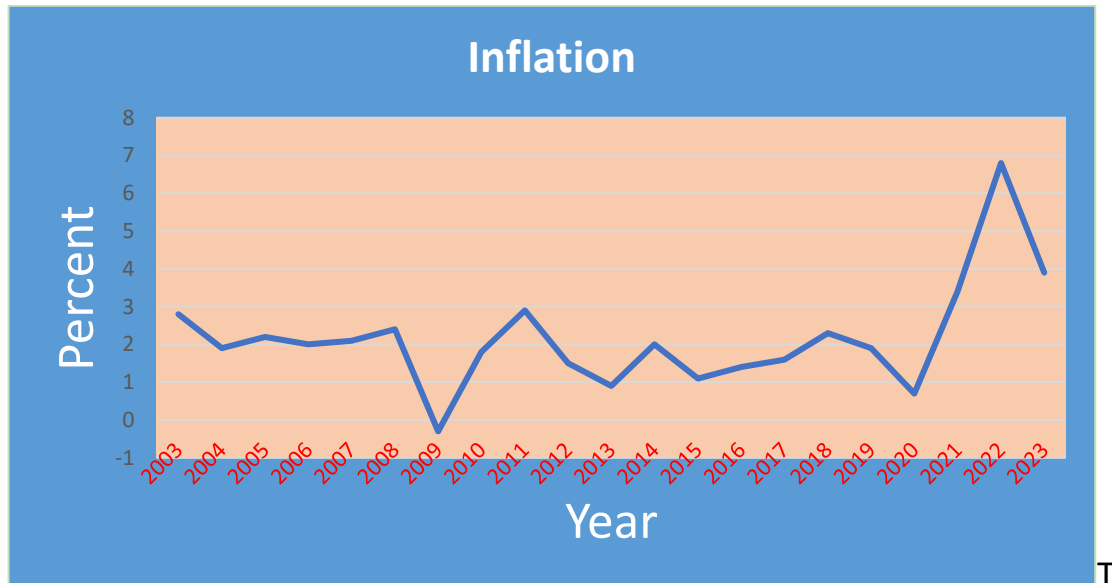


Figure 15.1 presents Canada's annual inflation rates, measured by the **Consumer Price Index (CPI)**, from **2003 to 2023**, based on data from **Statistics Canada**. The table reveals several important trends in the country's price stability over two decades.

© 2025 Addisan Publishing. All rights reserved.

Between **2003 and 2008**, inflation rates remained relatively stable, fluctuating between **1.9% and 2.8%**, reflecting moderate price growth in a period of steady economic expansion. In **2009**, the CPI declined slightly to **-0.3%**, marking a brief period of deflation triggered by the global financial crisis and the resulting contraction in demand.

From **2010 to 2019**, inflation remained subdued and well within the **Bank of Canada's target range of 1% to 3%**, averaging around **1.6%** annually. This stability reflects a period of low interest rates, modest wage growth, and well-anchored inflation expectations.

In **2020**, inflation dropped to **0.7%** due to the economic disruptions caused by the COVID-19 pandemic. Demand fell sharply, oil prices collapsed, and consumer activity contracted.

This trend reversed sharply in **2021**, when inflation rose to **3.4%**, followed by a surge to **6.8% in 2022**—the highest rate in over 40 years. This spike was driven by **global supply chain disruptions, energy price shocks**, and **expansionary monetary and fiscal policies** enacted during the pandemic.

In **2023**, inflation moderated to **3.9%**, reflecting tighter monetary policy, including **interest rate hikes** by the Bank of Canada, which aimed to bring inflation back within the target range. While still above the 2% goal, the decline signals a shift toward price stabilization.

Overall, the data show that while inflation was largely stable for much of the 2003–2019 period, **recent volatility has tested the Bank of Canada's inflation control framework**, highlighting the delicate balance between stimulating growth and maintaining price stability.

The Balance Sheet of the Bank of Canada

LO 15.3 Identify the major items on the balance sheet of the Bank of Canada

Reading Comprehension

1. What are the main objectives and functions of the Bank of Canada?
2. Give a brief account of the organization and management of the Bank of Canada.
3. Distinguish between the *Bank Act* and the *Bank of Canada Act*.
4. Distinguish between the following sets of terms: (a) inflation and core inflation (b) total CPI and core CPI.

Understanding a Balance Sheet

A **balance sheet** is a financial statement that provides a snapshot of an entity's financial position at a specific point in time. It details:

- **Assets:** Resources owned by the entity.
- **Liabilities:** Obligations owed to external parties.

- **Owner's Equity (Capital):** The residual interest in the assets after deducting liabilities.

The fundamental accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

This equation ensures that the balance sheet remains balanced, reflecting the entity's financial stability.

The Bank of Canada's Balance Sheet

The composition of the Bank of Canada's balance sheet reflects its unique role and responsibilities as the nation's central bank. Below is a summary of the Bank's financial position as of **December 31, 2023**:

Key Components Explained

1. **Investments:** The largest asset category, primarily consisting of Government of Canada securities. These investments decreased by 23% from the previous year due to the Bank's

Table 15.2: Bank of Canada Balance Sheet as of December 31, 2023
(in millions of dollars)

Assets	Millions
Investments	292,341
Derivatives—indemnity agreements	23,406
All other assets	1,043
Total Assets	316,776
Liabilities and Deficiency	Millions)
Bank notes in circulation	119,430
Deposits	196,212
Securities sold under repurchase agreements	6,638
Other liabilities	342
Deficiency	-5,846
Total Liabilities and Deficiency	316,776

quantitative tightening measures, which involved not replacing maturing bonds to reduce the balance sheet size.

2. **Derivatives—Indemnity Agreements:** These represent agreements with the Government of Canada to indemnify the Bank for losses related to specific asset purchase programs. The balance of \$23,406 million reflects the fair value of these derivatives as of December 31, 2023.

3. **Bank Notes in Circulation:** Physical currency issued by the Bank, totaling \$119,430 million. This figure remained relatively stable compared to the previous year.

4. **Deposits:** Funds

deposited by the Government of Canada, financial institutions, and others, amounting to \$196,212 million. The 28% decrease from the prior year aligns with the reduction in the Bank's asset holdings.

© 2025 Addisan Publishing. All rights reserved.

5. **Deficiency:** The Bank reported a deficiency of \$5,846 million, primarily due to net losses incurred during the year. These losses were mainly because the interest expenses on deposits exceeded the interest revenue from investments, a situation influenced by the Bank's policy rate adjustments.

Understanding the Bank of Canada's balance sheet provides insight into how its financial activities support its mandate to promote the economic and financial welfare of Canada.

Main Liabilities of the Bank of Canada

The **primary liabilities** of the **Bank of Canada** are:

1. **Bank Notes in Circulation**
2. **Canadian Dollar Deposits**

These two categories represent the largest obligations of the central bank and reflect its core monetary functions.

1. Bank Notes in Circulation

The **Bank of Canada has exclusive authority to issue Canadian banknotes**, making it the sole supplier of paper currency in the country. These notes are a liability because they represent a claim on the central bank—accepted as legal tender in all transactions.

As of **December 31, 2023**, the total value of **bank notes in circulation** stood at **\$119.4 billion**, nearly **38 percent** of the Bank's total liabilities (Bank of Canada, [Annual Report 2023](#)). This figure nearly doubled compared to **\$57.9 billion in 2010**, reflecting both population growth and increased demand for cash, particularly during periods of economic uncertainty such as the COVID-19 pandemic.

2. Canadian Dollar Deposits

Deposits held at the Bank of Canada are liabilities owed to a range of stakeholders:

- The **Government of Canada**, which uses its deposit account at the Bank for making payments and receiving revenues.
- **Chartered banks** and **members of the Canadian Payments Association**, which hold reserves to settle daily transactions.

- **Foreign central banks**, which may maintain balances for exchange operations or institutional convenience.

As of **December 2023**, total **Canadian dollar deposits** amounted to **\$196.2 billion**. This is significantly higher than the **\$47.5 million** held in 2010, reflecting expanded balance sheet operations following the Bank's quantitative easing programs and the shift toward interest-bearing settlement balances in the post-pandemic environment.

Together, these two liability categories—**currency and deposits**—represent over **99 percent** of the Bank's obligations and are fundamental to its roles in **monetary policy, payment system stability, and government financing**.

The Origins of Modern Banking and the Role of the Chartered Banks

LO 15.4 Discuss the origins of modern banking and the role of chartered banks

The Origin of Modern Banking

Reading Comprehension

1. What are the major components on the asset side of the balance sheet for the Bank of Canada?
2. On the asset side, which component is the most significant?
3. What are the main liabilities on the balance sheet for

The roots of modern banking can be traced to **seventeenth-century England**, where **goldsmiths** played a crucial role in the early development of financial institutions. These goldsmiths, known for their secure vaults, began to **accept gold deposits for safekeeping**. In return, they issued **receipts** that certified the amount of gold deposited. These receipts were **redeemable on**

demand, meaning the holder could return at any time and exchange them for the corresponding quantity of gold. As such, goldsmiths needed to maintain adequate reserves to meet withdrawal requests at all times.

Initially, if a depositor—say, **Alexandra**—wished to purchase an item, she would **withdraw gold** and use it directly to make a payment. The recipient, **Bonita**, would then deposit the gold at her own goldsmith. Over time, people began to **bypass the physical transfer of gold** and simply **exchange the goldsmiths' receipts**. These receipts gradually became accepted as a **medium of exchange**, provided the issuing goldsmith was reputable.

To facilitate smaller transactions, depositors began requesting **receipts in smaller denominations**—for example, ten £1 receipts instead of a single £10 receipt. The goldsmiths thus evolved into **early issuers**

of **paper money**. While this function was later taken over by **commercial banks**, today it is carried out exclusively by **central banks**, such as the Bank of Canada.

An important development followed: goldsmiths noticed that **most depositors did not redeem their gold immediately**, allowing them to **lend out receipts instead of gold**. These loans were issued in the form of **additional receipts**, increasing the number of claims on the same quantity of gold. This practice gave rise to a system in which the **total value of circulating paper exceeded the physical reserves**—a direct predecessor to the **modern fractional reserve banking system**, where banks maintain only a fraction of their deposits as reserves and lend out the rest.

The Role of Chartered (Commercial) Banks

The original function of **chartered banks**—historically called **commercial banks**—was to support commerce by issuing **short-term loans** to merchants and traders. These loans were typically used to finance **inventory purchases and raw materials**, with repayment expected within a year from the proceeds of sales. The risk of default was low because the goods were generally sold quickly. Although bank lending today extends far beyond commercial loans, the term **commercial bank** remains in use.

In Canada, these institutions are referred to as **chartered banks** because, prior to 1980, banks could only be created through a **federal charter granted by Parliament**. Today, they operate under a **universal banking model**, offering a full range of services—including personal banking, business lending, wealth management, and investment services.

Structure of the Canadian Banking System

Canada's banking system has evolved significantly. In the decades following Confederation, the country had over 50 banks. That number has since consolidated into a small number of large, **Canadian-owned financial institutions** with extensive national branch networks. This structure is known as a **branch banking system**.

Branch banking system: a system characterized by **a few large banks operating many branches** across the country.

This model contrasts sharply with that of the United States, where thousands of smaller, **independent banks** operate, often with limited geographic reach. The branch system in Canada has helped foster **efficiency, stability, and uniform regulation**.

The operations of chartered banks in Canada are governed by the **Bank Act**, the central piece of federal legislation that regulates their activities. The Act undergoes **mandatory legislative review every 10**

years, with the most recent comprehensive review completed in **2023**, ensuring that Canada's regulatory framework remains current with market developments.

The Art of Banking

Although chartered banks are **privately owned and profit-seeking**, they also serve a **public utility function** by maintaining confidence in the financial system. This dual responsibility creates a fundamental tension between **profitability** and **liquidity**:

- Assets that **maximize earnings**—like long-term loans or high-yield securities—are **less liquid**.
- Assets that maintain **liquidity**, such as cash or central bank reserves, **generate little or no return**.

For example, if a bank held all its assets in cash, it would be fully liquid but earn no income. If it invested entirely in long-term loans, it could earn higher returns but face **serious liquidity risks** during unexpected withdrawals or shocks.

The art of banking, then, lies in **balancing these two goals**—generating returns for shareholders while maintaining sufficient liquidity to meet customer needs and regulatory requirements. Sound banking depends on prudent **asset management, liquidity planning, and risk control**.

Services Offered by Commercial Banks and How They Make Money

Commercial banks provide a wide range of financial services to individuals, businesses, and governments. These services include:

- **Personal banking**: chequing and savings accounts, debit and credit card services, and safe deposit boxes
- **Lending**: personal loans, mortgages, auto loans, and business credit
- **Digital and remote banking**: online and mobile banking, ATM access, and telephone banking
- **Payments and transfers**: bill payments, e-transfers, wire transfers, and foreign exchange
- **Advisory and investment services**: financial planning, registered accounts (RRSPs, TFSAs), and wealth management

Banks charge **service fees** for many of these offerings, such as account maintenance, ATM use outside the network, and foreign currency conversions. These fees generate a portion of bank income.

However, the **primary source of revenue** for commercial banks is **interest income from loans**. Banks operate by accepting deposits at relatively low interest rates and lending those funds at higher rates. For example, a bank might:

- **Pay 3% interest** to a depositor
- **Charge 9% interest** to a borrower

The difference between these rates—known as the **interest spread**—is retained by the bank as income.

Interest spread: the difference between the interest rate banks charge on loans and the interest rate they pay on deposits.

Banks also incur operating costs, including **wages, rent, technology infrastructure, regulatory compliance, and marketing**. After subtracting these expenses from total revenue, the remainder constitutes the bank's **net profit**.

In short, commercial banks **combine service-based fee income with interest-based revenue**, managing risks and operational costs to generate **profit while ensuring liquidity and trust within the financial system**.

The Balance Sheets of Chartered Banks

LO 15.5 Identify the main items on the balance sheets of chartered banks

Assets, Liabilities, and Sources of Funds for Chartered Banks

Main Assets of Chartered Banks

Chartered banks in Canada hold a diverse mix of assets designed to maintain liquidity, generate returns, and manage risk. These include:

Reading Comprehension

1. Why is the Canadian banking system called a fractional reserve banking system?
2. “The banker must walk a tightrope between profitability and safety.” Discuss.
3. What is a chartered (commercial) bank? What services do chartered banks provide?

- **Notes and deposits with the Bank of Canada** – used to meet reserve requirements and facilitate interbank transactions.

- **Foreign currency deposits** – held with other banks to support international transactions and foreign exchange services.

- **Cheques and items in transit** – funds in the process of being cleared

through the payments system.

- **Government of Canada Treasury bills** – short-term, low-risk securities used for liquidity management.
- **Loans and mortgages** – the largest category of assets, representing funds lent to households, businesses, and governments.

Loans and mortgages remain the most important assets of chartered banks, generating the majority of their interest income.

Main Liabilities of Chartered Banks

Bank liabilities represent **claims against the bank's assets** and reveal how the bank finances its operations. Key liabilities include:

- **Customer deposits** – chequing, savings, and term deposits. These typically account for over **30%** of total liabilities and are the primary source of bank funding.
- **Advances from the Bank of Canada** – short-term borrowing by banks, usually accessed during liquidity shortages.
- **Bankers' acceptances and guarantees** – commitments by the bank to make payments on behalf of clients, often used in trade finance.
- **Letters of credit** – contractual promises to pay under specified conditions, supporting international trade.

Table 15.3

Table 15.3

The assets and liabilities of the Royal Bank as of October 31st, 2023

Category	Billions)
Assets	
Cash and deposits	56.4
Securities	338.2
Loans (net)	841
Derivative assets	96.5
Other assets	98.9
Total Assets	1,430.90
Liabilities and Equity	
Deposits	1,006.60
Derivative liabilities	101.4
Debt securities issued	160.8
Other liabilities	61.2
Subordinated debentures	9.6
Shareholders' equity	91.3
Total Liabilities & Equity	1,430.90

© 2025 Addison Publishing. All rights reserved.

- **Shareholders' equity** – the bank's capital base, which provides a cushion against losses and supports regulatory compliance.

Sources and Uses of Funds

The balance sheet of a commercial bank provides a detailed view of its **sources and uses of funds**.

Main Sources of Funds

Reflected on the **liability side**, the main sources include:

- **Customer deposits** – personal, business, and institutional deposits.
- **Foreign currency deposits** – held by international clients or Canadian residents transacting in foreign currencies.
- **Borrowing from financial markets** – through bonds, commercial paper, and interbank loans.
- **Shareholder capital** – equity raised through stock issuance.

Main Uses of Funds

Reflected on the **asset side**, these include:

- **Loans and mortgages** – extended to consumers and businesses.
- **Investments** – primarily in **government securities** and other low-risk financial instruments.

- **Reserves** – cash balances and deposits with the Bank of Canada to meet settlement and liquidity needs.

Together, the asset and liability structure reflects a bank's central function: **transforming short-term deposits into longer-term loans**, managing risk while maintaining liquidity and profitability.

Table 15.3 shows a snapshot of the **financial position** of the Royal Bank of Canada (RBC) at the end of its 2023 fiscal year. It lists what the bank **owns (assets)** and what it **owes (liabilities)**, along with the value owned by shareholders (equity). The numbers are shown in **billions of dollars**.

Assets: What the Bank Owns

- **Loans (\$841.0 billion)** are the bank's biggest asset. These are amounts lent to individuals, businesses, and governments. RBC earns interest from these loans, which is a major source of income.
- **Securities (\$338.2 billion)** include investments like government and corporate bonds.
- **Cash and deposits (\$56.4 billion)** are funds kept with the Bank of Canada or in other highly liquid forms to meet day-to-day needs.
- **Derivative assets (\$96.5 billion)** are financial contracts whose value depends on things like interest rates or exchange rates.
- **Other assets (\$98.9 billion)** include buildings, equipment, and other investments.

The **total assets** of RBC are **\$1,430.9 billion**, or over **1.4 trillion dollars**, showing just how large and complex the bank is.

Liabilities and Equity: How the Bank Finances Its Operations

- **Deposits (\$1,006.6 billion)** are the bank's largest liability. These are funds held by customers in savings, chequing, and other accounts. The bank must be ready to return this money when customers withdraw it.
- **Debt securities issued (\$160.8 billion)** are funds the bank borrows from financial markets by selling bonds.
- **Derivative liabilities (\$101.4 billion)** are related to financial contracts the bank owes others.
- **Other liabilities (\$61.2 billion)** include accounts payable and other short-term obligations.
- **Subordinated debentures (\$9.6 billion)** are a form of long-term debt with lower repayment priority.

- **Shareholders' equity (\$91.3 billion)** represents the owners' share of the bank—what's left if all debts are paid off.

Key Takeaway

RBC's balance sheet shows that it is a **deposit-based bank**: most of its funding comes from customers' deposits. It uses that money mainly to **provide loans** and **invest in securities**, which generate income. The bank is financially strong, with a healthy amount of equity to absorb any potential losses.

This table gives a clear picture of how a commercial bank operates: **taking in deposits, making loans, investing funds**, and keeping enough cash on hand to meet withdrawal needs.

BUSINESS SITUATION	15.1
Suppose that you are the owner of a medium-sized production company making cardboard boxes. You are interested in expanding your operations but realize that in order to do so you will require some steep loans provided by your local chartered bank branch. You have just read in the paper that your branch is over-reserved. How might this affect the likelihood that you will get a loan? The answer to this Business Situation can be found in Appendix A.	

The Creation of Money by Chartered Banks: **Fundamentals of Deposit Creation**

LO 15.6 Explain what is meant by the “creation” of money by the chartered banks

The Process of Deposit Creation

To understand how banks create money, we can use a simple model of deposit creation based on the following assumptions:

1. Chartered banks keep 10% of deposits as cash reserves.
2. All deposits are demand deposits.
3. Banks invest only in loans.

© 2025 Addison Publishing. All rights reserved.

4. Banks lend out all of their excess reserves.

Assume that Mr. Deslauriers deposits \$1000 in cash into his chequing account at Atlantic Bank. This is called a **primary deposit**—a deposit made in exchange for cash.

Atlantic Bank must keep 10% of this deposit (\$100) as reserves. The remaining \$900 is **excess reserves**, which the bank lends to a borrower. The borrower spends the \$900, and the recipient deposits it into another bank, say Central Bank. Central Bank keeps 10% (\$90) and lends the remaining \$810. This \$810 is deposited in another bank, which then keeps 10% (\$81) and lends \$729, and so on.

Reading Comprehension

1. What is the most important asset of a chartered bank? What is its most important liability?
2. What are the main sources of funds for chartered banks? What are the main uses of funds?

Each bank in the system holds 10% of the new deposit and lends out the rest. The process continues across multiple banks, and the total amount of money created is a multiple of the original deposit.

The process can be summarized with the formula:

$$\text{Total Deposits Created} = \text{Initial Deposit} \times (1 / \text{Reserve Ratio})$$

In this example:

$$\text{Total Deposits} = \$1000 \times (1 / 0.10) = \$10,000$$

Through this process, an initial cash deposit of \$1000 leads to \$10,000 in total demand deposits in the banking system. This is how banks expand the money supply through fractional reserve lending.

Table 15.6 Balance Sheet Changes at Atlantic Bank

Atlantic Bank			
Assets			Liabilities
Desired reserves	+\$ 100	Demand deposits:	
Excess reserves	+ 900	Mr. Deslauriers	+\$1000
TOTAL	+\$ 1000	TOTAL	+\$1000

Derivative Deposits and Loan Creation

Let’s assume that another customer, **Mr. Ephraim**, applies for a **\$900 loan** at Atlantic Bank to purchase a new laptop. The bank approves the loan—not by handing over physical cash—but by **crediting \$900 to Mr. Ephraim’s chequing account**.

At this point, the bank has not transferred any of its existing reserves. Instead, it has **created a new deposit**—a process known as **deposit creation**. The \$900 now appearing in Mr. Ephraim’s account did not exist in the banking system before. It was **created electronically** when the loan was approved.

This \$900 is called a **derivative deposit** (or **secondary deposit**), because it arises **as a result of the bank’s lending activity**, not from a cash deposit by a customer. Unlike the **primary deposit**, which the bank receives passively from a depositor, the **derivative deposit is actively created** by the bank through its decision to extend credit.

Derivative deposit or secondary deposit: a deposit created by a bank when it grants a loan.

This mechanism is fundamental to how commercial banks expand the money supply. While the bank must still hold reserves to support its deposit base, **the act of lending itself results in the creation of new money** in the form of demand deposits.

Effect of the Loan on Atlantic Bank’s Balance Sheet

When Atlantic Bank grants a loan of **\$900** to Mr. Ephraim, it **adds \$900 to his chequing account**. This increases the bank’s assets (through loans) and simultaneously increases its liabilities (through deposits). The balance sheet expands, even though no cash leaves the bank.

Banks increase the money supply by creating deposits.

Table 15.7 Balance Sheet Changes after the Loan Transaction

Atlantic Bank			
Assets		Liabilities	
Cash:		Demand deposits:	
Desired reserves	+\$190	Mr. Deslauriers	+\$1000
Excess reserves	+ 810	Mr. Ephraim	+ 900
Loans	+ 900		
TOTAL	+1900	TOTAL	+ 1900

Here’s what changed:

- The bank's **assets** increased by \$900 due to the new loan.
- The bank's **liabilities** increased by \$900 because it credited that amount to Mr. Ephraim's account.
- The bank still holds \$100 in reserves to support its \$1,900 in total deposits, maintaining its 10% reserve ratio.

The **initial deposit** of \$1,000 from Mr. Deslauriers did **not** affect the total money supply—it simply converted **cash into demand deposits**, which are both counted as part of the money supply.

But the **loan to Mr. Ephraim increased the money supply**. The \$900 credited to his account **did not exist before**. It is a **new deposit created by the bank**, and it adds to the total volume of demand deposits in the economy.

In short:

- **Primary deposit:** no change to total money supply.
- **Derivative deposit:** increases total money supply.

This illustrates the basic process of **money creation in a fractional reserve banking system**.

Summary of the Process of Money Creation

1. Initial Deposit

Mr. Deslauriers deposits **\$1,000** in cash into his account at Atlantic Bank. This changes the form of money from **cash to demand deposits**, but it **does not increase the money supply**.

2. Loan Creation

Atlantic Bank keeps **10% (\$100)** as reserves and lends **\$900** to Mr. Ephraim. The bank **credits \$900 to Mr. Ephraim's account**, creating a **new deposit**. This **\$900 is new money**—it increases the money supply.

3. Spending the Loan

Mr. Ephraim uses the **\$900** to **buy a product**, say a laptop. The seller deposits the \$900 into their own bank account—possibly at another bank.

4. Further Rounds of Lending

The second bank keeps **10% (\$90)** and lends **\$810** to a new borrower, who spends it. That money is deposited again, and the process continues.

5. Cumulative Effect

Each new loan creates a new deposit. Over time, the original \$1,000 in cash can lead to up to **\$10,000 in total deposits**, assuming a 10% reserve ratio.

Mr. Ephraim's **purchase** sets in motion a chain of deposits and loans that **multiplies the original deposit**, expanding the **money supply** through the banking system.

Deposit expansion

The process of deposit expansion continues **as long as banks have excess reserves** to lend. Each time a loan is made, new money is created through a **derivative deposit**, and the deposit is used, re-deposited, and re-lent by another bank. But this chain does not go on forever.

Deposit creation **stops when all of the original deposit becomes desired reserves** across the entire banking system. In our example, with a **reserve ratio of 10%**, the initial **\$1,000 in reserves** can support up to **\$10,000 in total deposits**.

The Deposit Expansion Multiplier

The total amount of deposits that can be created is calculated using the **deposit expansion multiplier**, also known as the **money multiplier**. It is the **reciprocal of the reserve ratio**:

$$\text{Money Multiplier (MM)} = 1 / \text{Reserve Ratio (rr)}$$

- If **rr = 10%**, then **MM = 1 / 0.10 = 10**
- If **rr = 20%**, then **MM = 1 / 0.20 = 5**

This means that:

- An initial deposit of **\$1,000** with a **10% reserve ratio** can support **\$10,000 in total deposits**
- An initial deposit of **\$1,000** with a **20% reserve ratio** can support **\$5,000 in total deposits**

Conclusion

The process of deposit expansion comes to an end when **banks collectively hold no excess reserves**. At that point, the system has reached its **maximum deposit capacity**, determined by the size of the initial deposit and the reserve ratio. The **money multiplier** provides a simple way to estimate this maximum expansion of the money supply.

Table 15.5 The Deposit Expansion Process

Steps	Deposits (\$)	Desired Reserves (\$)	Loans = Excess Reserves (\$)
1	1000.00	100.00	900.00
2	900.00	90.00	810.00
3	810.00	81.00	729.00
4	729.00	72.90	656.10
5	656.10	65.61	590.49
6	590.49	59.05	531.44
.	.	.	.
.	.	.	.
.	.	.	.
Sum (all steps)	10 000.00	1000.00	9 000.00

Deposit Expansion in a Monopoly Bank System

The process of money creation works the same way in a **monopoly bank system** as it does in a multi-bank system. Even if only one bank exists in the economy, the act of receiving deposits, holding a fraction as reserves, and lending the rest would still lead to **multiple rounds of deposit creation**. The money supply expands as long as **loans remain in the form of deposits** and are not withdrawn as cash. The total potential increase in deposits is still determined by the **money multiplier**, based on the reserve ratio.

BUSINESS SITUATION 15.2

You are the manager of a bank. Your bank has excess reserves. The economy is in a depressed state.

How would you utilize your bank's excess reserves?

The answer to this Business Situation can be found in Appendix A.

LO 15.7 Discuss practical constraints on deposit creation and deposit destruction

Practical Limits to Deposit Expansion

In theory, the banking system can expand deposits up to a maximum determined by the **money multiplier**. In practice, however, banks rarely reach this limit. The model we used assumed ideal conditions to illustrate the basic mechanism of deposit creation. But in the real world, several factors restrict the full expansion of deposits. The most important constraints are **excess reserves**, **limited demand for loans**, and **currency drain**.

Excess Reserves

Our earlier model assumed that banks lend all of their excess reserves. In reality, banks often hold more reserves than required. This is a **precautionary measure**—a buffer to guard against uncertainty in customer withdrawals. Banks manage what is known as **bankers' risk**: the risk that they will not be able

to meet withdrawal demands promptly. Holding excess reserves reduces the funds available for lending and therefore **slows down deposit creation**.

Reading Comprehension

1. "Only the central bank can create money. Chartered banks merely lend out funds deposited with them and earn a return by charging interest on their loans." Discuss.
2. Briefly explain the process of money (deposit) expansion by commercial banks.
3. Describe the relationship between the reserve ratio

Limited Demand for Loans

We also assumed that borrowers are always ready and willing to take out loans. In reality, **creditworthy borrowers may be scarce**, especially during periods of economic slowdown

or rising interest rates. Even when banks are willing to lend, households and businesses may be unwilling to borrow. A lack of borrowing **limits the creation of new deposits**.

Currency Drain

Finally, the model assumed that all money received by the public would be deposited in banks. In practice, **people often withdraw a portion of their funds in cash** to use for transactions. This is known as a **currency drain**. When people hold cash instead of depositing it, banks lose potential reserves. This

weakens the system's ability to **support further rounds of deposit creation**. Even a small currency drain can lead to a **larger reduction in total money supply** than the amount withdrawn.

Together, these constraints—excess reserves, weak loan demand, and currency withdrawal—prevent banks from reaching the **theoretical maximum** level of deposit expansion predicted by the money multiplier.

Deposit Contraction: The Reverse of Money Creation

Just as the banking system can create money through lending, it can also **reduce the money supply** through a process called **deposit contraction**. This occurs when banks destroy deposits, either directly or indirectly. The two main causes are **loan repayments** and **currency drain**.

Loan Repayment

When borrowers repay loans, money is **removed from circulation**. Suppose bank clients repay **\$150,000** of their loans by drawing on their deposit accounts. The bank's **loan assets decrease by \$150,000**, and its **deposit liabilities fall by the same amount**, since the repayments are made using funds already in the bank.

The result is a **direct reduction in the money supply**. If there are no new loans to offset the repayment, the supply of demand deposits shrinks. In this case, a **\$150,000 repayment reduces the money supply by \$150,000**. Additionally, if the repayment leaves the bank with **excess reserves**, these funds may or may not be re-lent, depending on demand and risk conditions.

Currency Drain

Now suppose some depositors **withdraw \$50,000 in cash** from their accounts. This appears to be a simple switch from deposits to currency, which are both counted in the money supply. But the effect is larger than it seems.

Here's why: the **withdrawn cash leaves the banking system**, reducing **the reserves available for lending**. In our example, if the bank originally had \$300,000 in reserves and \$3 million in deposits, the withdrawal reduces reserves to **\$250,000**. To maintain a **10% reserve ratio**, the bank must now reduce its deposits to **\$2.5 million**. It must do this by **calling in loans, refusing renewals, or restricting new credit**.

The result: a **\$50,000 currency withdrawal** triggers a **contraction of deposits** potentially many times greater, depending on the reserve ratio. The **money supply contracts** not just by the amount withdrawn, but by a **multiple** of it—just as it expands by a multiple when deposits grow.

Conclusion

Deposit destruction is the mirror image of deposit creation. **Loan repayments shrink deposits directly**, while **cash withdrawals reduce reserves**, forcing banks to limit credit and thereby reduce the supply of money. In both cases, the contraction in deposits leads to a decline in the **overall money supply**.

The Role of Near Banks

LO 15.8 Discuss the role of near banks in the financial system

Description of a Near Bank

Near banks are financial institutions whose liabilities function as close substitutes for the **deposit liabilities of chartered banks**. These institutions participate in the financial system by accepting deposits and issuing loans, although they typically operate under **different regulatory frameworks** than federally chartered banks.

In Canada, near banks include:

- **Caisses populaires**

Reading Comprehension

1. Is it possible that banks keep excess reserves? Under what conditions is this likely? What effect will this have on their ability to create money?
2. What are the factors that limit the number of deposits that commercial banks can create?
3. Describe how a loan repayment can lead to deposit destruction.

- **Credit unions**
- **Trust companies**
- **Mortgage loan companies**

These institutions serve many of the same functions as commercial banks, particularly in local and community-based settings.

Caisses Populaires and Credit Unions

Caisses populaires and **credit unions** play a vital role in Canada's financial sector, especially in Quebec. The **credit union movement originated in Lévis, Quebec, in 1900**, when **Alphonse Desjardins** founded the first caisse populaire. Since then, the movement has grown across the country, although it remains strongest in Quebec.

Unlike chartered banks, which are federally regulated, **credit unions and caisses populaires operate under provincial legislation**. Each province oversees its own network of local credit unions, which are typically members of a **provincial central credit union**. These organizations provide services such as clearing and settlement, liquidity management, and regulatory coordination for their member institutions.

Sources and Uses of Funds

The **balance sheets** of caisses populaires and credit unions reveal that their operations are remarkably similar to those of chartered banks in terms of structure.

- **Main sources of funds:**
 - **Deposits** – roughly **85% of total liabilities**
 - **Members' equity** – about **7% of liabilities**

These institutions use their funds primarily to make **loans to members**, invest in **safe securities**, and maintain **liquidity reserves**. The structure of their liabilities makes them important components of the deposit-taking sector, particularly in **rural and cooperative communities**, where they often operate as accessible alternatives to large commercial banks.

In summary, near banks such as credit unions and caisses populaires **perform banking functions**, are **locally embedded**, and **support financial inclusion**, especially in **provincial and community-based economies**.

Caisses populaires and credit unions obtain most of their funds from customers' deposits.

Trust and Mortgage Loan Companies

Trust and mortgage loan companies are non-bank financial institutions that perform many of the same functions as chartered banks, although they typically serve **niche markets** or **specific financial needs**. These two types of institutions are closely related and often operate under a **combined business structure**, especially in provinces where regulatory frameworks permit it.

Both institutions accept deposits, provide loans, and offer investment services, but they differ slightly in focus:

- **Trust companies** offer a wide range of financial services, including **estate administration, trustee services, asset management, and custodial services**. They also issue loans and accept deposits and have increasingly moved into areas traditionally dominated by banks.
- **Mortgage loan companies**, by contrast, focus primarily on **mortgage lending**. They specialize in issuing **residential and commercial real estate loans**, and as a result, a **larger share of their assets** is held in the form of mortgages compared to trust companies.

Although they are distinct in function, the overlap between trust and mortgage loan companies means they are often **regulated together** and may operate **under a shared license**. In Canada, most are now part of larger financial groups or are subsidiaries of banks, credit unions, or insurance firms, making their services widely accessible across the country. What are the main sources and uses of funds for trust and mortgage loan companies?

Reading Comprehension

1. Why is the credit union movement of particular significance to Quebec?
2. What are the main sources and uses of funds for caisses populaires and credit unions?
3. What are the main sources and uses of funds for trust and mortgage loan companies?

Review

1. Review the learning objectives listed at the beginning of the chapter.
2. Have you accomplished all the objectives? One way to determine this is to answer the Reading Comprehension questions at the end of each section. These will help you assess your understanding of the learning objectives.
3. If you have not accomplished an objective, review the relevant material before proceeding.

© 2025 Addisan Publishing. All rights reserved.

Key Points to Remember

1. **LO 15.1** The Bank of Canada and a number of chartered banks make up the Canadian banking system.
2. **LO 15.2** The main functions of the Bank of Canada are to issue currency in adequate quantities, to act as banker to the chartered banks, to act as fiscal agent and financial adviser to the government, to conduct the country's monetary policy, and to support the financial system.
3. **LO 15.3** The main asset of the Bank of Canada is Government of Canada securities. The main liability of the Bank of Canada is Bank of Canada notes in circulation.
4. **LO 15.4** Origins of modern banking can be traced back to the seventeenth century when the role of goldsmiths was prominent. The banking system has evolved greatly since that time. Today our banking system is described as a branch banking system. The operations of chartered banks in Canada are governed by the provisions of the *Bank Act*. Banks must try to strike a balance between profitability on the one hand and liquidity and safety on the other. They make a profit by charging a higher rate of interest on money they lend out than the rate they pay their depositors.
5. **LO 15.5** The assets of the chartered banks include deposits at the central bank, foreign currency deposits, cheques in transit, government T-bills, loans, and mortgages. Liabilities include deposits, advances from the Bank of Canada, acceptances, guarantees, and letters of credit.
6. **LO 15.6** Chartered banks increase the money supply by extending loans to borrowers and by crediting the amount of the loan to their deposit accounts. Borrowers are not given cash. The reciprocal of the desired reserve ratio gives the maximum money expansion multiplier.
7. **LO 15.7** A variety of circumstances can prevent a bank from realizing its maximum deposit expansion. There are practical constraints on deposit creation which include excess reserves, limited demand for loans, and currency drain. In the same way that banks can create deposits and thus increase the money supply, they can also destroy deposits and thus reduce the money supply. Two factors that lead to the destruction of deposits are the repayment of a loan and a currency drain.
8. **LO 15.8** The main sources of funds for credit unions and caisses populaires are deposits and members' equity. Fund share is allocated mainly to mortgage lending and cash loans to members. Term deposits constitute the major source of funds for trust companies and mortgage loan companies. The main use of their funds is mortgage lending.