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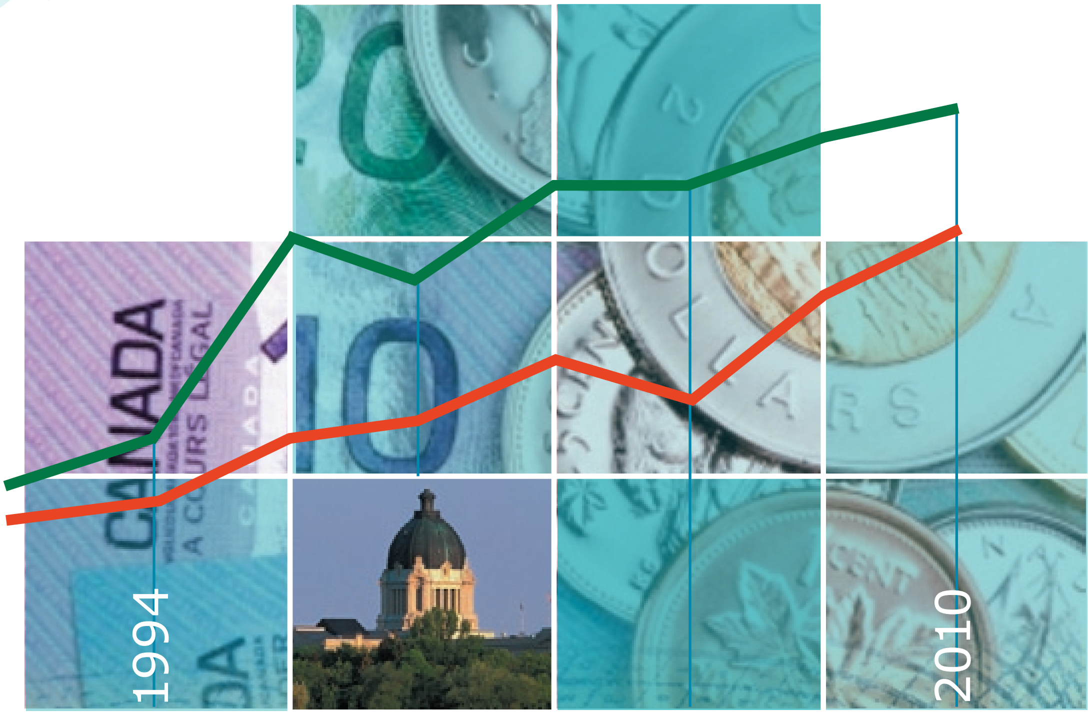

The Role of Alberta Treasury Branches in the Alberta Financial Market

Analysis By Frank J. Atkins

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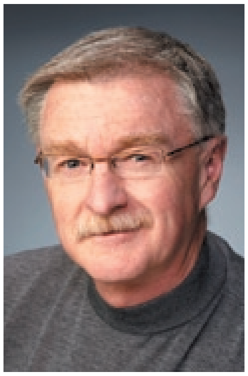

About the Author

Dr. Frank Atkins is an Associate Professor of Economics at the University of Calgary. Frank attended the University of Guelph and received an Honours B.A. in 1977, and an M.A. in 1979. Upon graduation, Frank spent two years at the Bank of Canada as an Economic Analyst, where he gained a deep appreciation for the difficulties associated with monetary policy formation. In 1981, Frank left the Bank of Canada to further his studies in economics at Queen's University at Kingston. Frank graduated in 1985, with a Ph.D. in economics, and joined the faculty at the University of Calgary. Frank's main academic areas of interest are monetary policy and the application of time series analysis to macroeconomic data. Frank had the privilege of supervising the Master of Arts (Economics) thesis of Stephen Harper. In addition, Frank served as a mentor for Danielle Smith while she was completing a Bachelor of Arts degree at the University of Calgary. As well as publishing many articles in leading economic journals, Frank is a frequent commentator on macroeconomics and policy issues for the major national networks.

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1. Executive summary

In its original incarnation, Alberta Treasury Branches (ATB) was envisioned as an institution that would provide financing to areas of Alberta that were having difficulty raising money from traditional Eastern banks in the time of the Great Depression. There was a belief that this need was especially strong in the rural areas. It is clear that ATB has grown beyond this mandate, as it now competes in Alberta as a full-service bank and has grown aggressively in large urban centres. Of the market share that does not include chartered banks in Alberta, ATB has a 60 per cent share, while credit unions collectively have a 40 per cent share. There is evidence that the Alberta government not only recognizes this, but that it also encourages ATB to compete with other financial institutions "in all areas of the province." This is a very curious situation, especially in the province of Alberta. ATB seems to have escaped the Klein-era dictum that the government should not be in the business of doing business.

By the mid 1990s, there was a growing recognition that ATB was operating with certain competitive advantages that were bestowed upon it by financial regulations created by the government of Alberta. For instance, as noted in the Flynn Report, ATB paid no deposit insurance, yet the government of Alberta guaranteed all deposits. Further, ATB paid no income tax to the federal or provincial governments and operated with very lax capital requirements.

As a result of the Flynn Report, the Treasury Branches Working Group was formed. This group provided several policy recommendations to the Alberta government. In response, the government moved to correct the competitive imbalances noted in the Flynn Report. In spite of this move to change the rules under which ATB operates, ATB still has several competitive advantages in Alberta financial markets. ATB now pays deposit insurance but at a rate that is lower than that paid by, for instance, credit unions in Alberta. Moreover, this rate can vary from year to year at the discretion of the government of Alberta. ATB now makes a payment to the government in lieu of taxes. However, this tax arrangement should be questioned. ATB does not pay taxes *per se,* but rather issues subordinated debentures to the government of Alberta. For no apparent reason, these debentures can be used in partial fulfillment of Tier 2 capital requirements.

The essential problem with ATB in the 1990s was not that it had competitive advantages per se but rather that it faced lax capital controls combined with a full government guarantee. This gave rise to a rather perverse incentive structure. That is, ATB had no incentive to maintain any fiscal discipline. Financial institutions are required to limit asset growth to what can be accommodated within the existing capital base of the institution. For ATB, this constraint was not present and caused it to take on more risk than it could easily absorb. As a result of this, subsequent to the downturn in the early 1980s, the balance sheet of ATB deteriorated considerably. The reason for this was that ATB had no incentive to behave in a financially prudent manner. In economics, this is known as a moral hazard problem. As soon as the downturn started, ATB went into a negative equity position and remained in that position until 1999.

As a result of the Flynn Report and the Treasury Branches Working Group recommendations, the government instituted a system of capital controls. In spite of this change, when another financial downturn began in late 2008, ATB's balance sheet began to deteriorate once again. It is apparent that the capital control changes did not remove the moral hazard problem. ATB still seems to be able to operate in a fiscally prudent manner only when the economy of Alberta is growing. This suggests that either the capital control changes did not impose sufficient discipline on ATB or that the moral hazard problem lies largely in the full government guarantee.

The answer to this lies in the behaviour of the government in response to the latest deterioration of ATB's balance sheet. It seems clear that ATB was having difficulty meeting its capital requirements in 2009 and 2010. In response to this, the government stepped in and issued $600-million in notional capital in 2009 and authorized ATB to include $568-million in "capital investment deposits" as Tier 2 capital. The Alberta government is obviously willing to step in and shore up the balance sheet of ATB when needed. It seems that the moral hazard problem that existed in the 1990s is still a problem today. If the government is willing to issue notional capital in order for ATB to meet its capital requirements, this serves to make capital controls irrelevant and ATB will continue to have very few, if any, constraints on its behaviour.

It appears that, in spite of the fact that ATB is still operating with some competitive advantages in Alberta's financial markets, it is only able to operate efficiently when the economy of Alberta is performing well, as it is crippled by the incentives put in place by some combination of lax capital controls and government guarantees.

> ***The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design.***
>
> ***– Friedrich Hayek***

It must be remembered that the shareholders of ATB are the taxpayers of Alberta. However, ATB has remitted no dividends to the government since 1982, when it became virtually insolvent. Therefore, the taxpayers are absorbing some non-trivial risk while getting no return. This is a poor business model.

The general conclusion that emerges from this study is that there is a sense in which the existence of ATB represents poor public policy. Even if the government were capable of designing capital control rules with proper incentives, the full government guarantee would also have to be removed in order for ATB to face proper fiscal discipline. The problem here is that, in this situation, the government would then be simply duplicating what is already being accomplished by the private sector. Given that Alberta now seems to be adequately served by private sector financial institutions, this represents a misallocation of resources.

It would appear that, given all of the above, one sensible conclusion is that the government of Alberta should consider privatizing ATB.

2. ATB in Alberta's financial markets

2.1 The beginnings of the ATB

It is well know that the Social Credit government of William Aberhart created the Alberta Treasury Branches in the 1930s. Mr. Aberhart appeared to be concerned that the Eastern-based chartered banks were not serving the interests of Alberta. That is, given the economic climate of the Great Depression, chartered banks based in Eastern Canada were somewhat reluctant to lend money in Alberta and especially in rural Alberta. According to Mr. Aberhart, the solution to this problem was for the Alberta government to take the responsibility of providing financial services to Albertans through the Alberta Treasury. Mr. Aberhart's Social Credit government created ATB through an order-in-council on August 29, 1938, and on November 22, 1938, the *Treasury Branches Act* was passed in the legislature, and ATB was started with an initial seed grant of $200,000. This was a considerable sum of money during the Great Depression.[1] It is interesting that, also in 1938, the Social Credit government passed legislation that permitted the establishment of credit unions in Alberta. Today, credit unions compete for market share with ATB.

The original idea for the organizational structure of ATB was to appoint a superintendent who reported directly to the Provincial Treasurer. Notice that this structure differs significantly from that of a traditional financial institution, where there is a board of directors that represents shareholders. The corporate structure of ATB remained mostly unchanged until 1997, when ATB was made a Crown corporation and a board of directors was created. The creation of a board of directors was part of a large package of reforms at ATB, which will be discussed below.

It appears to be accepted historical fact that the impetus for the creation of ATB was tied to dissatisfaction with the behaviour of the Eastern financial institutions toward Alberta. However, what is less well known is that the creation of ATB was also tied up in the arcane beliefs of the original Social Credit teachings of Major C.H. Douglas. The formation of ATB can be thought of as essentially an attempt to create an Alberta currency. Once the government controlled the currency, it would only be a short step to implementing the original monetary ideas of the Social Credit Party. Consider some of the details of how ATB was originally intended to fit into Alberta's perceived need for home-grown financing. At the outset, ATB accepted deposits that were guaranteed by the provincial government. Mr. Aberhart then created a voucher system that was implemented through the ATB. If a person had an account at ATB, he or she could use these vouchers to purchase goods. These vouchers were much like cheques. However, merchants could only redeem these vouchers if they also had an ATB account. ATB imposed a 2 per cent penalty on cash withdrawals and offered a 3 per cent bonus to ATB customers who used the vouchers to purchase a certain amount of goods and services from Alberta merchants. The 3 per cent bonus was apparently supposed to be the "social credit" promised in Major Douglas' teachings.

This was clearly an attempt to create money through ATB accounts. Apparently, Mr. Aberhart may have thought of ATB as some a type of central bank for Alberta, much in the same manner that the Bank of Canada is a central bank for Canada.

Whatever Mr. Aberhart's noble intentions concerning Albertan's access to financial services may have been, it appears that he hoped that ATB could be used to create an Alberta currency that would eventually replace the Canadian currency in Alberta. This would then allow the Alberta government to create money, much in the same manner that a central bank can create money. This would be the manner in which the "social credit" would be paid. It seems that no one explained the relationship between money creation and the potential for inflation to Mr. Aberhart.

Of course, the establishment of an Alberta currency clearly did not (and clearly could not) transpire. Once this portion of the goals of creating ATB was abandoned, ATB went on to become the large financial institution that it is today. In today's financial markets in Alberta, ATB competes with the credit unions (and, to a lesser extent, the chartered banks) for market share. As noted above, the original reasons for creating ATB were to provide financial services to Albertans during the Great Depression when no financing was available from traditional sources. As will be shown in the next two sections, ATB has now evolved into a rather large player in Alberta financial markets, and it has clearly outgrown its original mandate.

2.2 ATB's recent growth

In its initial years, ATB was not particularly profitable. In its first 12 years in business, ATB had accumulated a deficit of nearly $1-million. Eventually ATB began to operate profitably. From the initial government seed grant of $200,000, ATB's equity position grew to greater than $50-million in 1982. However, the downturn in Alberta in the early 1980s hit ATB particularly hard. One of the standard explanations for this is that, given that ATB only operated in Alberta, it was unable to diversify enough to avoid the worst effects of the National Energy Program and the collapse of the world price of oil.[2] This caused ATB's equity position to turn negative in 1983, and it remained in this position until 1999. Once ATB entered into a recovery phase, its equity position began to grow rapidly (see Chart 1, next page). Helped by the recovery in the Alberta economy, which in turn was buoyed by robust resource prices, ATB was able to build its equity to approximately $1.6-billion by 2008.

> ***Once ATB entered into a recovery phase,* its equity position began to grow rapidly...**

Chart 1. ATB Equity 1994-2010

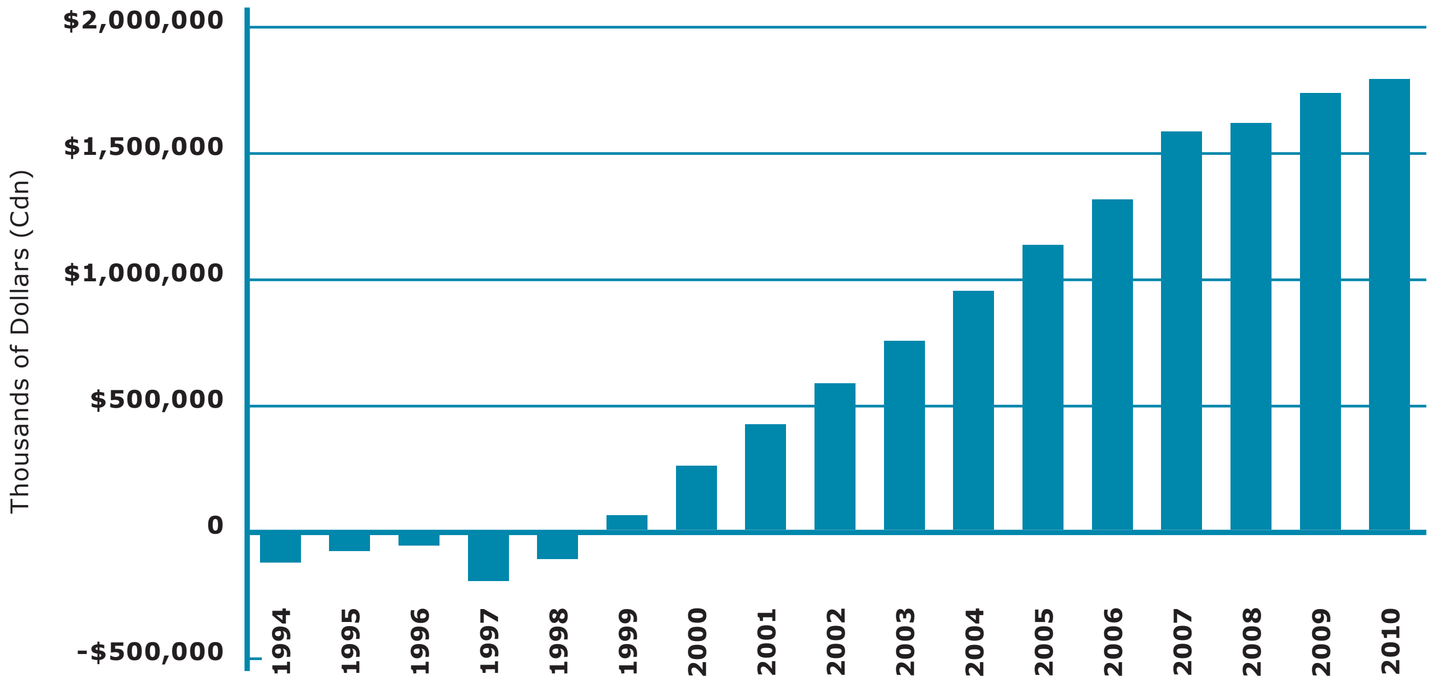


Chart 2. ATB Assets 1994-2010

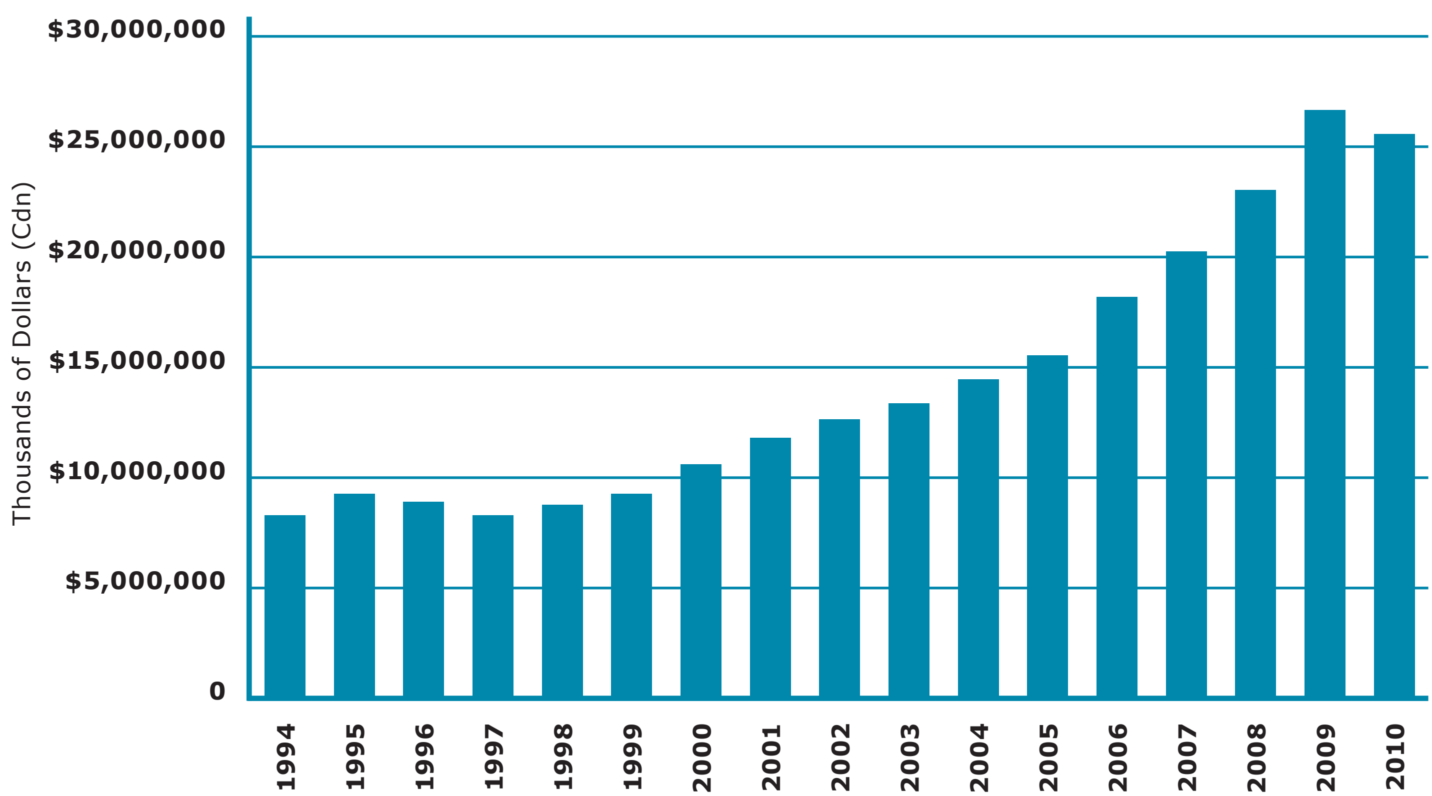


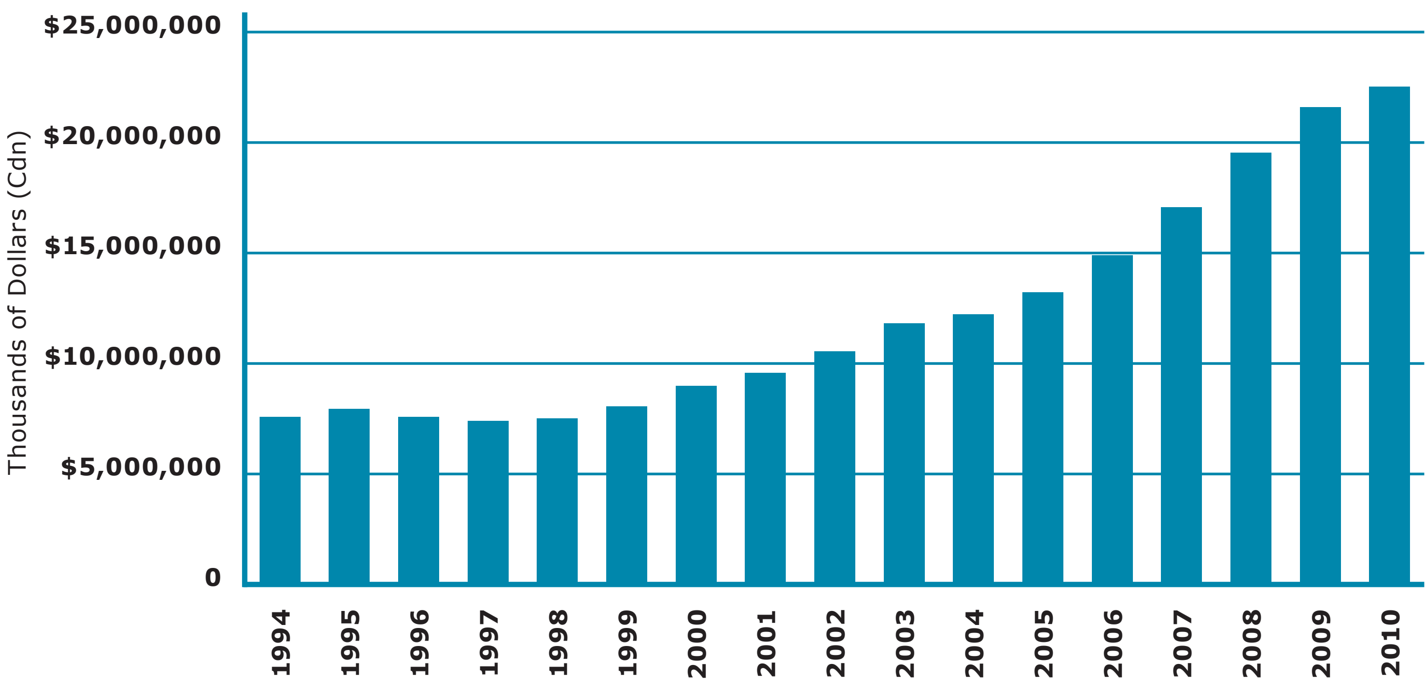
Chart 1 shows the equity position of ATB from 1994-2010. The stock of assets at ATB exhibits a similar pattern to that of its equity position. This is illustrated in Chart 2.

Notice that, as ATB was struggling with the aftermath of the devastating downturn of the early 1980s and the early 1990s, asset growth was stagnant. However, once the economy began to improve, the asset position of ATB began to improve as well. Notice also the rapid expansion in the stock of assets between 2006 and 2009.[3]

This, of course, roughly corresponds to the boom period in the Alberta economy. Starting in approximately 2000, ATB took advantage of the boom to enter a phase of rapid expansion.

Notice that the pattern of ATB lending behaviour is very similar to the pattern of ATB asset accumulation over the period 1994-2010. That is, loans showed stagnant growth in response to the downturn of the early 1990s. However, by the early 2000s, ATB began to pursue aggressive growth in the loan market (see Chart 3).

Chart 3. ATB Loans 1994-2010



2.3 ATB and market share

Generally, we can think of the market for financial services as consisting of institutions that provide interest-bearing deposits, investment services and products, and personal and business loans. Given this, there are three broad players in the financial market in Alberta: chartered banks; Alberta Treasury Branches; and credit unions. Unfortunately, finding a consistent breakdown of chartered bank activity at the provincial level is somewhat problematic. Therefore, most of what follows entails a comparison of the activities of ATB and the credit unions.

Relative market shares: locational presence

Given the original mandate that ATB was to operate in order to give Albertans access to financial services in areas where these services did not exist, one would assume that ATB branches would be primarily in rural Alberta communities where there is little or no access to alternative financial services. ATB does have a presence in remote locations throughout Alberta; however, ATB also has a strong presence in medium-sized urban centres such as Red Deer, Grande Prairie, Lethbridge and Medicine Hat, along with a significant number of branches in both Calgary and Edmonton. It is noteworthy that of 152 locations where ATB has branches, all but 12 of these locations contain either a credit union or a chartered bank or both. Interestingly, there are a large number of rural locations that have chartered banks and/or credit unions but no ATB branches.[5]

Further to the above, it is also noteworthy that the recent aggressive expansion of ATB noted above indicates that it is now emphasizing expansion and competition in large urban centres.

Between 2005 and 2009, 18 new ATB branches opened in Alberta. Of these, 10 were in Calgary, five in Edmonton and only three in rural Alberta.

Clearly, ATB has expanded beyond its original mandate and is now in direct competition with other financial institutions in Alberta. Further, ATB appears to have recently emphasized competition in large urban centres, something that was not in its original mandate.[6]

It is important to realize that the Alberta government is directly condoning this ATB behaviour of operating outside of its original mandate. In 2003, Pat Nelson, who was minister of finance at the time, signed a *Memorandum of Understanding* that contains the statement that ATB should "continue to focus on providing financial services in all areas of the province."[7] It appears that the provincial government is encouraging this aggressive expansion into urban markets and, by implication, the government appears to be condoning the increased competition between ATB and other financial institutions. One possible interpretation is that the *Memorandum of Understanding* actually represents an updated mandate for ATB.

Relative market share: financial statements of ATB and Credit Unions

It is instructive to consider relative market shares of ATB and credit unions in Alberta. Table 1 shows relative market shares over the period 2002 to 2009 for ATB and credit unions based on four criteria: net loans; total assets; total deposits; and equity.[8]

A consistent scenario emerges from the data in Table 3 (pg. 13). The data reveal that ATB has a larger market share in all four measures.

Table 1. Measure of Relative Market Share 2002-2009

	2002	2003	2004	2005	2006	2007	2008	2009
Net Loans								
CU	6,568,059,726	7,467,024,850	8,153,026,231	9,086,446,984	10,647,999,028	12,672,092,816	13,947,539,541	14,762,285,154
ATB	10,400,563,000	11,691,482,000	12,131,053,000	13,137,917,000	14,846,694,000	16,994,329,000	19,443,517,000	21,602,235,000
Total	16,968,622,726	19,158,506,850	20,284,079,231	22,224,363,984	25,494,693,028	29,666,421,816	33,391,056,541	36,364,520,154
CCU share	0.39	0.39	0.40	0.41	0.42	0.43	0.42	0.41
ATB share	0.61	0.61	0.60	0.59	0.58	0.57	0.58	0.59
Total Assets								
CCU	8,189,218,391	9,030,674,663	9,841,796,238	10,928,207,297	12,773,935,606	14,787,091,047	16,486,946,364	17,492,066,123
ATB	12,353,810,000	13,183,995,000	14,305,810,000	15,381,232,000	17,647,815,000	20,294,718,000	23,343,153,000	26,514,143,000
Total	20,543,028,391	22,214,669,663	24,147,606,238	26,309,439,297	30,421,750,606	35,081,809,047	39,830,099,364	44,006,209,123
CCU share	0.40	0.41	0.41	0.42	0.42	0.42	0.41	0.40
ATB share	0.60	0.59	0.59	0.58	0.58	0.58	0.59	0.60
Total Deposits								
CCU	7,581,893,019	8,237,303,364	8,963,106,403	9,986,775,328	11,697,692,738	13,197,173,146	15,068,354,096	15,983,897,956
ATB	11,425,210,000	12,096,911,000	13,035,120,000	15,840,032,000	15,870,308,000	18,252,838,000	21,175,716,000	23,881,246,000
Total	19,007,103,019	20,334,214,364	21,998,226,403	25,826,807,328	27,568,000,738	31,450,011,146	36,244,070,096	39,865,143,956
CCU share	0.40	0.41	0.41	0.39	0.42	0.42	0.42	0.40
ATB share	0.60	0.59	0.59	0.61	0.58	0.58	0.58	0.60
Equity								
CCU	562,501,385	658,733,056	736,952,793	847,870,625	919,534,803	1,044,465,601	1,184,937,427	1,311,380,989
ATB	592,033,000	790,937,000	962,961,000	1,150,274,000	1,348,995,000	1,623,383,000	1,668,452,000	1,758,684,000
Total	1,154,534,385	1,449,670,056	1,699,913,793	1,998,144,625	2,268,529,803	2,667,848,601	2,853,389,427	3,070,064,989
CCU share	0.49	0.45	0.43	0.42	0.41	0.39	0.42	0.43
ATB share	0.51	0.55	0.57	0.58	0.59	0.61	0.58	0.57

Of the market share that does not include chartered banks, ATB appears to control approximately 60 per cent of the market for financial services, with approximately 40 per cent controlled by credit unions.[9]

Table 2 lists the services provided by ATB. It is important to note that, out of this list, the only services that credit unions do not provide are payroll services and derivatives. Therefore, ATB does not have a larger market share relative to that of credit unions due to a larger product offering (as many might assume) given that credit unions and ATB offer essentially the same services. Rather, it appears that the larger market share arises because of the competitive advantages afforded by government such as capital and liquidity support that permits ATB to unfairly capture market share from private sector financial institutions such as credit unions.

Table 2. Services Provided by ATB

1. **Personal Services**
   a. Personal Loans
   b. Deposit Accounts
   c. MasterCard
   d. Mortgage Services
   e. Personal Investments
   f. Insurance
2. **Business Services**
   a. Business Financing
   b. Business Accounts
   c. Business MasterCard
   d. Payroll Services
   e. Merchant Payment Services
   f. Investments
   g. Loan Insurance
3. **Agri-industry Services**
   a. Loans
   b. Deposit Accounts
   c. MasterCard
   d. Investments
   e. Financing Services
   f. Payroll Services
4. **Corporate Financial Services**
   a. Financing
   b. Corporate Accounts
   c. Investments
   d. Employee Banking Packages
   e. Derivatives
5. **Investing**
   a. Tax Free Savings Accounts
   b. RRSPs
   c. GICs/Mutual Funds

3. ATB and the Financial Regulatory Framework

3.1 Competitive advantages in the 1990s

There does not appear to be a great deal of academic literature directly studying ATB and its role in the Alberta financial markets. However, in the mid 1990s, there emerged a growing consensus that ATB was competing with unfair advantages in Alberta's financial markets. There was a belief that these competitive advantages had been conferred on ATB by the fact that the Alberta government controlled ATB and set its own financial regulations for ATB. These regulations were clearly different from the regulations that were imposed upon chartered banks by the Office of the Superintendent of Financial Institutions and credit unions by Credit Union Deposit Guarantee Corporation. For instance, ATB did not pay deposit insurance, did not pay income tax and appeared to operate with somewhat lax regulatory control. Three studies published in the mid 1990s discussed these competitive advantages.

The Flynn Report

In December 1994, Gordon Flynn presented a report on the Alberta Treasury Branches to the Provincial Treasurer. Mr. Flynn laid out a three-stage program for the future direction of ATB. Stage 1 recommendations were measures that suggested changes to the manner in which ATB was run on a day-to-day basis. It is important that, in spite of the competitive advantages that arose from different financial regulations, Mr. Flynn appeared to be concerned that ATB was not in a competitive position. Two of the recommendations from Stage 1 were:

> "Management is to continue to automate some services to remain on par or ahead of competition in providing financial services"; and,

> "Management continue to monitor and assess the desirability of ATB offering additional services to the pubic which may be necessary to remain competitive."

In Stage 2 Mr. Flynn recommended that the *Treasury Branches Act* be amended to establish a board of directors and that the government consider converting ATB into a Crown corporation. These two recommendations were implemented by 1997. Mr. Flynn thought these changes could facilitate eventual privatization. In Stage 3, Mr. Flynn offered a future choice for ATB: Either it could operate as a Crown corporation or privatization could be considered.

Mr. Flynn appeared to be the first person to point out that ATB was operating in the Alberta financial markets with some distinct advantages. At the time, ATB enjoyed full government guarantee, while simultaneously not paying deposit insurance. Mr. Flynn also noted that ATB did not pay income tax, and it operated with rather lax regulatory controls.[10] These points raised by Mr. Flynn eventually formed the basis for some changes in the financial regulations that governed how ATB operated.

Treasury Branches Working Group

The Provincial Treasurer mandated this working group in response to the Flynn Report. This group made 10 proposals, which are summarized in Table 3.

Of particular importance is the recommendation that steps should be taken to move ATB to a level playing field with other financial institutions in Alberta. This, of course, is in reference to the Flynn Report citing advantages in the areas of deposit insurance, taxes and lax capital controls.

Notice that the Treasury Branches Working Group ignored Mr. Flynn's proposal of privatization as one option for the Treasury Branches.[11] The emphasis appeared to be on making ATB competitive. In both the Flynn Report and the Treasury Branches Working Group document, the notion of competitive appears to have two meanings. First, ATB was noted to have certain competitive advantages in the financial marketplace that were conferred by regulations designed by the Alberta government, and second, ATB should remain competitive within Alberta's financial marketplace. Apparently, it was feared that removing the former might have an adverse effect on the latter.

Table 3. Proposals of the Treasury Branches Working Group

1. Government should identify the public policy goals of the ATB, and its performance in achieving the goals should be measured and benchmarked.
2. A governance framework involving a board of directors should be implemented as soon as practicable.
3. The operations and management of ATB should be at arm's-length from the government.
4. There should be a step-by-step plan over a specified period to move the ATB to a level playing field with other financial institutions, particularly with respect to capital, deposit insurance and capital taxes.
5. ATB should provide modern, innovative products and services that customers are entitled to expect from a progressive financial institution in a very competitive marketplace.
6. To the greatest extent possible and particularly with respect to entering new financial businesses, the ATB should form alliances with private sector institutions.
7. Emphasis and attention should be placed on operating on a cost-conscious, profit motivated basis.
8. ATB should be subject to an accountability regime equivalent to that of private sector financial institutions.
9. The operations of ATB should be separate and apart from government operations, including areas of human resources, physical plant, systems, telecommunications, etc. Services provided to or used by ATB should reflect the full cost of doing business.
10. Government should consider whether government programs, and particularly financial service programs, could be delivered via the ATB, on a profit basis by the ATB, at reduced cost for the government.

University of Alberta Faculty of Business Report

In March 1997, the University of Alberta Faculty of Business produced a report under the auspices of the Western Centre for Economic Research.[12] This paper is an exhaustive attempt to investigate whether ATB operated (prior to 1997) under any competitive advantages. The authors noted the aforementioned competitive advantages of lack of payment of deposit insurance and income tax and lax regulatory controls. However, the major contribution of this paper may well be that the authors applied financial analysis to balance sheet data to conclude:

> The data showed that, during the period of study [1981 to 1995], the variability of ATB's risk premiums was approximately equal to that of chartered banks. Therefore, one would expect the risk premium for the ATB to be equal to that of the banks. In fact it was considerably less. The ATB risk premium averaged 0.05% of assets, while the banks averaged 0.39% of assets. This is a very large difference in the low margin world of banking. For ATB, this amounted to an annual average subsidy of approximately 0.34% of assets or nearly $20-million per year over 15 years, based on the average assets of the ATB over the study period.

"Therefore, the taxpayers of Alberta provided a subsidy to ATB, at least over this period of negative equity."

One of the technical reasons for this conclusion may have been due to the fact that ATB operated with negative equity between 1983 and 1999. This does not, however, negate the essence of the findings that the authors presented. It appears to be correct that, for some reason, the Alberta government was willing to accept a low (and/or negative) rate of return from ATB. Therefore, the taxpayers of Alberta provided a subsidy to ATB, at least over this period of negative equity.

These findings led the authors to conclude that this subsidy was "bound to have a negative impact on overall competitiveness in the banking industry in this province." The recommendation of the authors was that "…the situation could easily be eliminated if the government imposed realistic earnings targets on the ATB that are correspondent to its risk position."[13] Notice that, once again, there appears to be no strong recommendation for privatization but rather a call to remove any artificial competitive advantages.

General comments on the above reports

It is apparent that the importance of the above reports lies in the consensus that, at least by the mid 1990s, ATB was operating with certain competitive advantage within Alberta financial markets. ATB did not pay deposit or income tax and appeared to operate with lax regulatory controls compared with other financial institutions. There also appeared to be some concern that if these competitive advantages were removed, ATB might not have been able to adequately compete in Alberta's financial marketplace.

As a result of the Flynn Report and the recommendations of the Treasury Branches Working Group, the government moved toward changing the financial regulations that governed how ATB operated.

However, as will be shown in the next section, the changes that were made by the Alberta government did not appear to completely remove these competitive advantages, and in 2011, these competitive advantages still exist, albeit in slightly different forms.

One important omission in the above studies is the failure to consider the relationship between the period of negative equity and the lax capital requirements that existed at the time. The standard story for the deterioration of the ATB balance sheet in 1983 is its inability to diversify beyond the oil and gas sector. However, the fact that the actions of ATB were guaranteed by the government, combined with lax capital requirements, provided the wrong incentives for sound financial management. That is, ATB appeared to take on more risk than it could easily absorb. Therefore, when the downturn came in the early 1980s, the equity position of ATB deteriorated rapidly. This was likely caused by the lax capital controls.[14] The next section discusses how this may still be the case in 2011.

One final point is worth noting. Apparently, no one at the time questioned why a government-run institution was allowed to compete with private sector companies, especially since these recommendations were made during Ralph Klein's tenure as premier of Alberta. It is important to recall one of the political mantras of the Klein-era government: "The government should not be in the business of doing business." Not only was ATB competing with the private sector, it was competing with a government-granted competitive advantage in several areas.

3.2. Current financial regulation

As a result of the recommendations of the Treasury Branches Working Group, ATB underwent a number of changes. As noted above, in the late 1990s, ATB became a Crown corporation, and a board of directors was established. In addition, changes were made to the regulations that governed how ATB was to operate. This was an attempt to address the competitive advantages in the areas of deposit insurance, income tax and capital requirements. The current regulatory environment under each of these headings will be discussed in this section.

In terms of general financial regulation, it is important to recall that the rules that pertain to ATB are somewhat different from the rules governing credit unions and chartered banks. ATB operates under rules created by the government of Alberta, while credit unions are governed by the Credit Union Deposit Guarantee Corporation and chartered banks operate under the rules of the Office of the Superintendent of Financial Institutions. In some cases, the regulatory environment is so completely different as to make direct comparisons extremely difficult. For instance, the definitions of Tier 1 and Tier 2 capital are completely different for ATB than for the credit unions or chartered banks. There is no rationale for this from a regulatory perspective, and it arouses the suspicion that ATB operates under a set of rules that the government gives it out of the fear that ATB would not be able to compete in financial markets in Alberta if these competitive advantages were removed.

Deposit insurance

Recall that originally ATB did not pay deposit insurance, which afforded it a competitive advantage through lower operating costs. ATB now pays the government a fee in respect of this deposit guarantee. The current rules governing ATB deposit insurance are summarized in Table 4.

Over the period 2002-2010, the above rules resulted in ATB paying an average of approximately 11 basis points of their deposits to the province in terms of deposit insurance premiums.[15] In contrast, credit unions pay into the Credit Union Deposit Guarantee Corporation. The rate paid by credit unions is 0.17 per cent of all deposits. Apparently, even though the rules have been changed, ATB may still have a competitive advantage in terms of the cost of deposit insurance.

The 2010 ATB Financial Report contains the following paragraph:

> ATB pays a deposit guarantee fee to the Government of Alberta in compensation for the unlimited principal and interest guarantee it provides to our depositors. The fee is assessed on total deposits outstanding as at the end of each fiscal year, both retail and wholesale. The fee payable on deposits is consistent with the Canada Deposit Insurance Corporation's (CDIC's) risk-based premium methodology. In fiscal 2009–10, ATB recognized a $23.7-million deposit guarantee expense, a decrease of $5.7-million that is related to the decrease in deposits and a reduction in the premium.[16]

In 2009, the deposit premium was approximately 0.12 per cent of deposits, while in 2010 this decreased to approximately 0.10 per cent of deposits.[17] It seems clear that, if required by the ATB financial position at any point in time, the deposit insurance rate can be adjusted downward.

Table 4. Rules Governing ATB Deposit Insurance

For deposits of less than $100,000 and for the first $100,000 of deposits exceeding $100,000, ATB pays the lesser of

> An amount equal to the total of relevant deposits multiplied by the CDIC's rate for a deposit-taking institution with a similar risk profile, as determined by the Alberta Minister of the Treasury;
>
> An amount equal to 1/6 of 1% of all relevant deposits.

For the portion of deposits exceeding $100,000, ATB pays 1/6 of 1% of all those excess portions.

There is a perception created that the government of Alberta has moved to make ATB pay deposit insurance in the same manner as other financial institutions. Notice that the 2010 *ATB Financial Report* quoted above claims that ATB's deposit insurance is consistent with CDIC's risk-premium methodology. This is a correct statement, but it misses some crucial distinctions. First, the average rate is lower than that paid by the credit unions. Second, and somewhat more importantly, the deposit insurance rate is variable at the discretion of the government of Alberta. Given this, it is not at all obvious that the changes that have been made to the deposit insurance rules for ATB have removed the competitive advantage that ATB has in this area.

Table 5. Capital Requirements Rules Faced by ATB

- Tier 1 capital refers to retained earnings.
- Tier 2 capital is the aggregate of
  - i. The amount of general allowances against loan losses (subject to a maximum of 0.875 per cent of risk-weighted assets).
  - ii. An amount equal to the greater of zero and the formula $600-million—25 per cent (R1-R0+L, where R1 is retained earnings as of March 31, R0 is retained earnings at the end of the fiscal year and L is the absolute value of the sum of all net losses.
- ATB shall maintain its assets so that its capital equals or exceeds the greater of
  - i. 8 per cent of risk-weighted assets.
  - ii. 5 per cent of its assets.
  - iii. The amount specified by the minister.
- The maximum amount of subordinated debt that can be taken into account in determining capital is the total issue value of subordinated debt, modified by the remaining term to maturity/repurchase.
- As of March 31, 2009, ATB is required to maintain
  - i. A total Tier 1 capital ratio of at least 7 per cent,
  - ii. A total capital ratio of at least 10 per cent of risk-weighted assets.

Capital requirements

Financial institutions are required to limit asset growth to what can be accommodated within the existing capital base of the institution. For reasons that are not transparent, ATB operates under different capital requirement rules than those imposed on credit unions and chartered banks. The Office of the Superintendent of Financial Institutions regulates the chartered banks and rules set by the Credit Union Deposit Guarantee Corporation apply to the credit unions. ATB's capital requirements are simply mandated by the Alberta government. This gives rise to a myriad of complicated rules. Generally speaking, capital consists of Tier 1 and Tier 2 capital. However, the definitions of Tier 1 and Tier 2 capital are different for ATB and credit unions. Table 5 outlines the capital requirements faced by ATB.

"For reasons that are not transparent, ATB operates under different capital requirement rules than those imposed on credit unions and chartered banks."

Table 6. Capital Requirements Rules Chartered Banks

- **Tier 1 Capital:**
  - Common shareholders' equity: common/member shares, contributed surplus, retained earnings
  - Qualifying non-cumulative perpetual preferred shares
  - Qualifying innovative instruments
  - Qualifying non-controlling instruments arising on consolidation from Tier 1 capital instruments
  - Accumulated net after-tax foreign currency translation adjustment reported in Other Comprehensive Income (OCI)
  - Accumulated net after-tax unrealized loss on available-for-sale equity securities reported in OCI
- **Tier 2 Capital:**
  - Hybrid capital instruments
  - General allowances
  - Limited life instruments

Table 6 shows the capital requirements rules faced by chartered banks. The capital requirement rules faced by credit unions are very similar to those listed in Table 6.

The capital requirements for credit unions are 4 per cent of total assets and 8 per cent of risk-weighted assets and the capital requirements for chartered banks are 7 per cent of Tier 1 assets and 10 per cent of total capital.

Given the differences in the definitions of Tier 1 and Tier 2 capital, there would appear to be no straightforward manner in which to directly compare the capital requirements of ATB and the other financial institutions. However, the important difference lies in the manner in which the rules are applied. It seems that when ATB is faced with financial difficulty, as it was in the financial turmoil of late 2008-2009, the government is prepared to change the rules rather than make ATB face any real capital requirements.

This can be seen by examining the actual regulatory capital assets of ATB in 2009 and 2010. This is shown in Table 7.[18]

Given the data in Table 7, ATB is correct in stating, "As at March 31, 2010, ATB has exceeded both the total capital requirements and the Tier 1 capital requirement of the Capital Adequacy."[19] However, this statement is only true in a strict technical sense. From a financial balance sheet perspective, the statement is actually misleading.

In order to see this, consider three important items in Table 7. First, notice the 2010 item under Tier 2 capital, Subordinated Debentures. This item due to the fact that, starting in fiscal 2010, ATB was required to make a payment to the Alberta government in lieu of paying tax.[20] Under the new rules, ATB is to settle its tax liability by issuing subordinated debentures to the government of Alberta.

Table 7. Regulatory Capital ATB , 2009 and 2010

As at March 31		
($ in thousands)	2010	2009
Tier 1 capital		
Retained earnings	$1,777,223	$1,649,753
Tier 2 capital		
Eligible portions of:		
Subordinated debentures	9,076	-
Capital investment notes	179,995	-
General allowance for credit losses	172,657	164,238
Notional capital	568,133	600,000
929,861	764,238	
Total regulatory capital	$2,707,084	$2,413,991
Total risk-weighted assets	$19,732,223	$18,770,083
Risk-weighted capital ratios		
Tier 1 capital ratio	9.0%	8.8%
Total regulatory capital ratio	13.7%	12.9%

A portion of these debentures can be used as Tier 2 capital. Therefore, ATB's tax liability can be used to meet its Tier 2 capital requirements.

Second, notice the item Capital Investment Notes. Capital investment notes are five year non-redeemable guaranteed notes issued to the general public. In fiscal 2010, ATB's capital requirements were amended to expand the definition of Tier 2 capital to include these notes to a maximum of $50-million. Under rules of the Office of the Superintendant of Financial Institutions they would not qualify as capital due to the term and possibly the guarantee yield. Notice that these notes are guaranteed by the Alberta government. Other financial institutions can issue shares to raise capital. However, these are subject to market risk. The capital investment notes issued by ATB are guaranteed and therefore are not subject to any risk. Consequently, ATB is able to take advantage of a lower cost of capital at the expense of the taxpayer.

Finally, notice the item Notional Capital. In 2008 and 2009, the balance sheet position of ATB deteriorated considerably due to large losses from ATB holdings of Asset Backed Commercial Paper (ABCP). The provision for loss on ABCP was $253-million in 2008 and $224-million in 2009.[21] Given this, ATB was unable to meet its capital requirements in 2009. This prompted the government to grant ATB $600-million in notional capital in 2009 and authorize ATB to include $568-million in "capital investment deposits" as Tier 2 capital. Obviously, the Alberta government is willing to step in and shore up the balance sheet of ATB when needed.

Given the above discussion, it appears that ATB is under no real pressure to meet its capital requirements, as the government is willing to change the rules when needed. This is an important point from a risk-taking perspective. For instance, ATB was overexposed in its holdings of ABCP. If it were not, the failure of the ABCP market would not have had such a large effect on the balance sheet position at ATB. The fact that the government guarantees all ATB decisions simply means that ATB is willing to take risks that it is not prepared to absorb. Put another way, the regulatory changes that were brought about by the Flynn Report and the Treasury Branches Working Group did not alter the perverse incentives that were in place prior to the changes. ATB still has no incentive to operate in a fiscally prudent manner.

Income tax

Until 2010, ATB paid no provincial income tax. As of 2010, ATB makes a payment in lieu of taxes. With respect to these taxes, note 27 of the *ATB 2010 Financial Report* states:[22]

> 27. Payment in Lieu of Tax
>
> Pursuant to the ATB Act, the Government of Alberta has the ability to assess a charge to ATB as prescribed by the ATB Regulation. The ATB Regulation defines the charge to be an amount equal to 23% of ATB's consolidated net income as reported in its audited annual financial statements. As at March 31, 2010, ATB accrued a total of $38,075 (2009: nil) for payment in lieu of tax.
>
> This amount must be settled before July 1, 2010, by ATB issuing a subordinated debenture to the Government of Alberta. The payment in lieu of tax will continue to be settled by issuing subordinated debentures until ATB's Tier 2 notional capital is eliminated.

Table 7 shows that just over $9-million of these subordinated debentures qualified as Tier 2 capital. Therefore, a portion of the payment in lieu of taxes can be used to satisfy ATB's Tier 2 capital requirements.

This all appears to be a very convoluted set of rules. Notice that this arrangement will continue until ATB's notional capital is eliminated. It is not immediately apparent from the above whether ATB actually pays tax. Further, why the ATB tax liability should be allowed to form a portion of Tier 2 capital is somewhat questionable.

Return on equity and assets

It was noted above that ATB operated with negative equity between 1983 and 1999. It is apparent that the downturn of the early 1980s had a devastating effect on the balance sheet of ATB, and it did not recover before the downturn of the early 1990s. During this period, ATB operated under what the Flynn Report referred to as "lax capital requirements." These lax capital requirements, combined with the fact that the government guarantees everything that ATB does, create a situation of moral hazard. That is, ATB has no incentive to operate in a fiscally prudent manner. This is likely why ATB suffered so badly in the downturns of the early 1980s and early 1990s: there was no incentive to operate in a financially prudent manner due to the nature of the capital requirements. Subsequently, the government allowed ATB to operate with negative equity.

It appears that the effects of lax regulatory requirements have not vanished in 2010, even though the regulatory environment has changed. ATB was overexposed to ABCP, and its balance sheet position suffered in the most recent financial turmoil. This can be seen by comparing the return on equity and the return on assets to those of the credit unions. This is shown in Charts 4 and 5.[23]

Chart 4. **Return on Equity ATB and Credit Unions, 2002-2009**

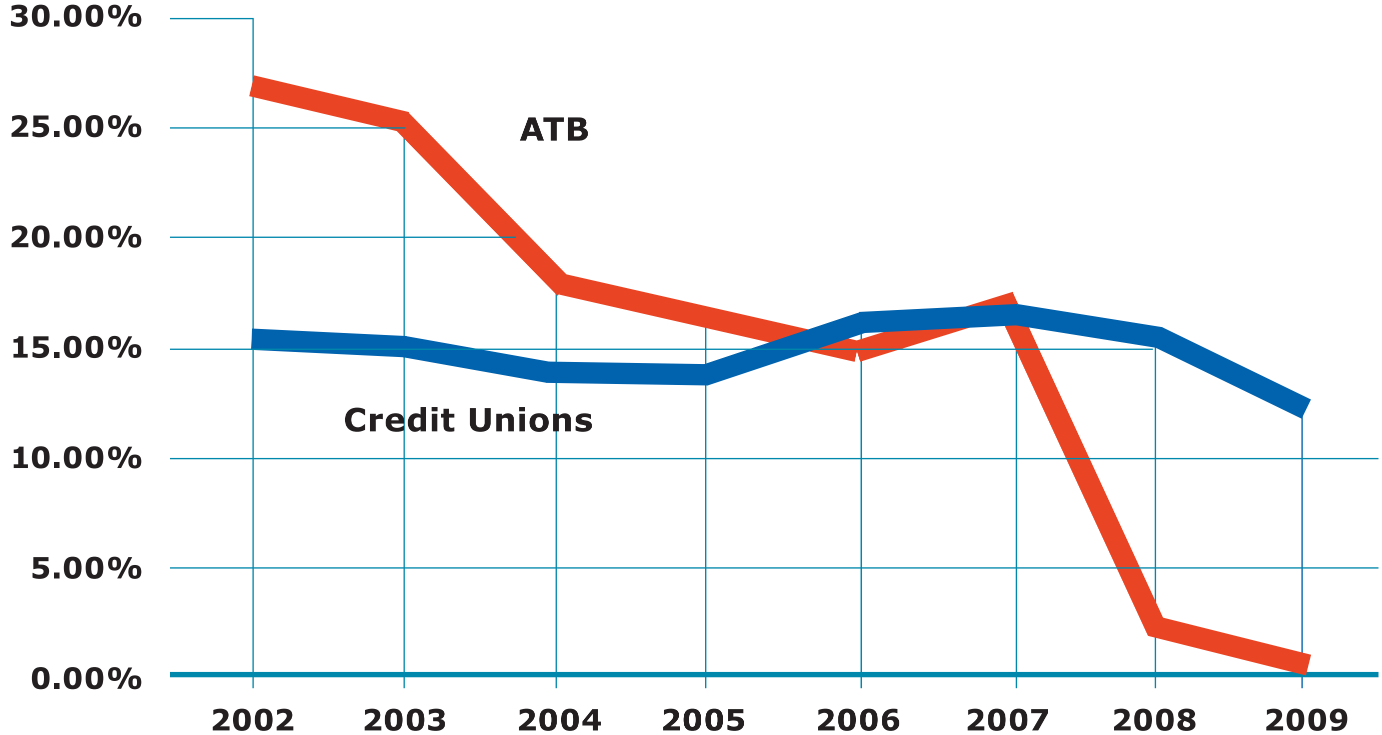
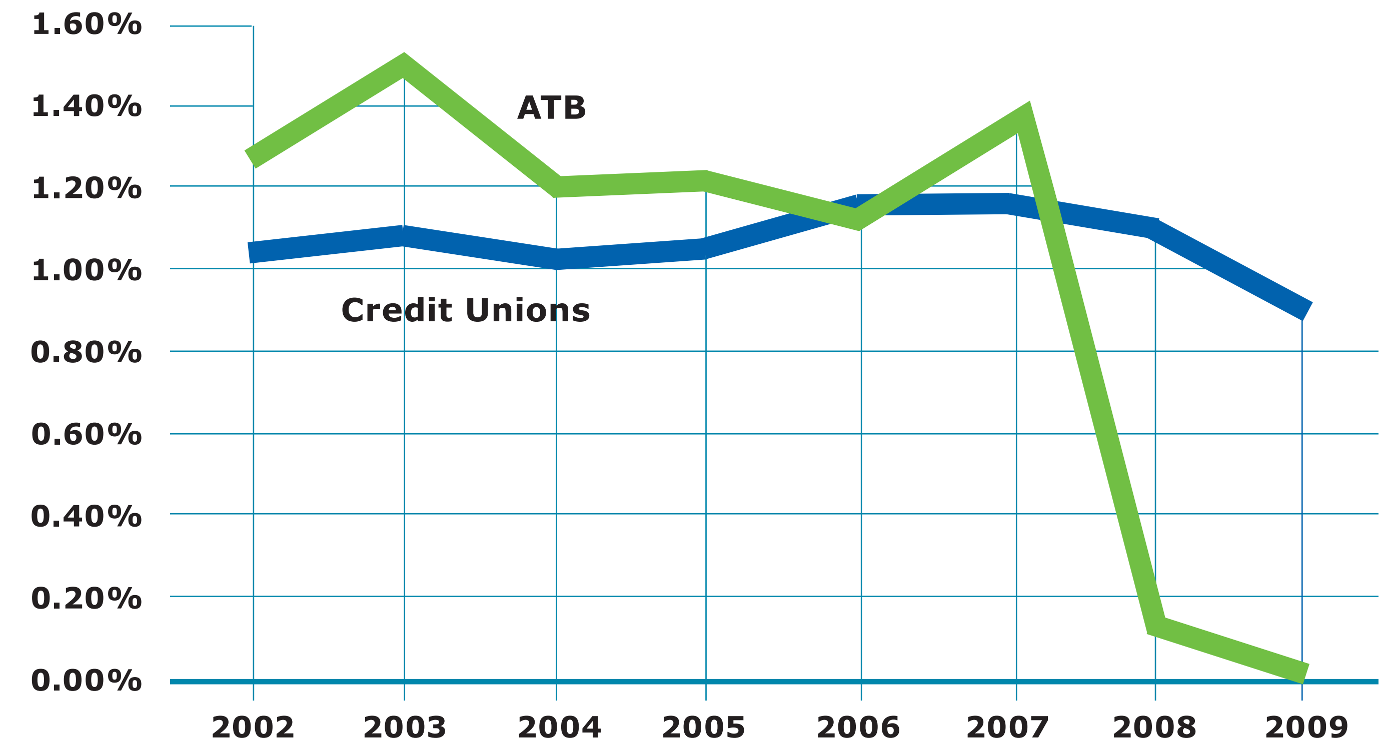


Chart 5. **Return on Assets ATB and Credit Unions, 2002-2009**



Notice that initially the return on equity and the return on assets at ATB were somewhat higher than at the credit unions. However, ATB's return on equity and assets fell reasonably steadily over the period 2002-2007. Recall that this is roughly consistent with the period of aggressive expansion at ATB. However, the real drop in these financial measures began in 2008 with the onset of the recent financial crisis. This recent drop in both of these measures is directly attributable to ATB's exposure to ABCP.

"It would appear that ATB is able to maintain a healthy balance sheet only when the economy of Alberta is performing well..."

It would appear that ATB is able to maintain a healthy balance sheet only when the economy of Alberta is performing well. When faced with a downturn in economic activity, ATB appears to be vulnerable. This would seem to be directly attributable to the regulatory environment in which ATB operates.

During the downturns of the early 1980s and 1990s, it operated with a full guarantee and lax capital requirements. During the most recent downturn, it is still operating with full government guarantee and lax capital requirements. This leads ATB to take on more risk than it can easily absorb. Note that the return on equity and assets for the credit unions decreased moderately during this recent financial crisis. One has to assume that because the credit unions faced more stringent capital requirements, they were more easily able to absorb the risks associated with the financial crisis.

4. Conclusions

Originally, ATB was envisioned as an institution that would provide financing to areas of Alberta that were having difficulty raising money from traditional Eastern banks during the Great Depression. It is clear that ATB has grown beyond this mandate, as it now competes in Alberta as a full-service bank, and it has grown aggressively in large urban centres. Of the market share that does not include chartered banks in Alberta, ATB has a 60 per cent share, while credit unions have a 40 per cent share. There is evidence that the Alberta government recognizes this and encourages ATB to compete with other financial institutions "in all areas of the province." This is a very curious situation, especially in the province of Alberta. ATB seems to have escaped the Klein-era dictum that governments should not be in the business of doing business.

It is obvious that since the publication of the Flynn Report in the mid 1990s and the resultant Treasury Branches Working Group policy recommendations that the government understood that ATB was operating with several competitive advantages that were conferred by the government.

Originally, ATB paid no deposit insurance, yet the government of Alberta guaranteed all its deposits. Further, ATB paid no income tax to the government of Alberta and operated with very lax capital requirements that resulted from rules designed by the government of Alberta.

As a result of the Treasury Branches Working Group policy recommendations, the government moved to correct these imbalances. The problem here is that the new rules did not result in a level playing field. ATB now pays deposit insurance but at a rate that is less than that paid by credit unions in Alberta. Further, this rate can vary from year to year at the discretion of the government of Alberta. Originally, ATB paid no taxes to the government of Alberta. ATB now makes a payment to the government in lieu of taxes. However, this tax arrangement needs to be questioned. ATB does not pay taxes per se but rather issues subordinated debentures to the government of Alberta. For no apparent reason, these debentures can be used in partial fulfillment of Tier 2 capital requirements.

What the Flynn Report and the Treasury Branches Working Group failed to recognize is that the lax capital controls, combined with the government guarantee of ATB, provided incentives for ATB to take on risk that it would not normally take on in the presence of adequate capital controls. Because of this, each time the economy went into a downturn, the balance sheet of ATB deteriorated considerably due to the incentives that were put in place by the government.

It appears that in spite of the fact that ATB is still operating with some competitive advantages in Alberta's financial markets, it is only able to operate efficiently when the economy of Alberta is performing well, as it is crippled by the incentives put in place by a combination of lax capital controls and government guarantees.

It must be remembered that the shareholders of ATB are the taxpayers of Alberta. However, ATB has remitted no dividends to the government of Alberta since 1982, when it became virtually insolvent. Therefore, the taxpayers are absorbing some non-trivial risk while getting no return. This is a poor business model.

> ***The problem is that, in this situation,* the government would then be simply duplicating what is already being accomplished by the private sector...**

The conclusion that emerges from this study is that there is a sense in which the existence of ATB represents poor public policy. Even if the government were capable of designing capital control rules with proper incentives, the full government guarantee would also have to be removed in order for ATB to face proper fiscal discipline. The problem is that, in this situation, the government would then be simply duplicating what is already being accomplished by the private sector. Given that Alberta now seems to be adequately served by private sector financial institutions, this represents a misallocation of resources.

It would appear that, given all of the above, one sensible conclusion is that the government of Alberta should consider privatizing ATB.

Endnotes

1. In today's dollars, this is equivalent to just over $3-million.
2. In Section 3, an alternative explanation involving risk incentives is discussed.
3. Over the period 2006-2009, the asset growth rate was above 10 per cent in each year.
5. Individuals may have access to ATB agencies (as opposed to branches) in these communities.
6. This turns out to be consistent with the recommendations of the Treasury Branches Working Group in the late 1990s. These recommendations are discussed below.
7. Quoted from the document *Memorandum of Understanding,* dated November 24, 2003, and signed by the Honourable Patricia L. Nelson, Minister of Finance, and Ron P. Triffo, Chair, ATB Board of Directors.
8. Recall that it is somewhat difficult to obtain data concerning chartered bank balance sheet data at the provincial level. Consolidated credit union data are not available prior to 2002.
9. To put the overall market share in perspective, chartered banks in Alberta have an approximate overall market share of 79 per cent, when measured by the size of the loan market.
10. For instance, Mr. Flynn noted that ATB should have had a capital base of approximately $500-million when the equity position of ATB was actually negative.
11. With respect to the question of privatization, it is not clear what meaning should be attributed to recommendation 6 that ATB "form alliances with private sector institutions."
12. Randy Otto and Glen Murray, *Competitive Advantages and the Alberta Treasury Branches,* Number 45, March 1997, Western Centre for Economic Research, University of Alberta.
13. Quoted from page 38 of the report.
14. The University of Alberta report appears to hint at this in several places.
15. This is calculated by dividing the Deposit Guarantee Fee by Total Deposits in each year over the period 2002-2010.
16. Quoted from page 53 of the *2010 ATB Financial Report*.
17. Derived from ATB financial statements and confirmed in note 16 in the *2010 ATB Financial Report*.
18. See note 7, page 108 of the *2010 ATB Financial Report*.
19. Quoted from page 108 of the *2010 ATB Financial Report*.
20. The issue of ATB paying taxes is discussed in the next sub-section.
21. Adapted from the Consolidated Balance Sheet, page 92 of the *2010 ATB Financial Report*.
22. See note 27 on page 134 of the *2010 ATB Financial Report*.
23. Several points should be noted in making this comparison. Return on equity and return on assets are calculated by dividing net income by equity and assets respectively. Net income is generally calculated as after-tax net income for the full fiscal year. The issue with this calculation is that ATB did not start paying taxes until 2010. Therefore, there is no concept of after-tax income, as there would be with the credit unions. Therefore, in the graphs below, pre-tax income is used. It is somewhat difficult to obtain these sorts of financial measures at the provincial level for chartered banks. Therefore, a comparison between ATB and chartered banks is not presented. Finally, information on credit unions' consolidated balance sheets is not available prior to 2002.

Further Reading

January 2009

Why Ontario and Alberta Should Not Pay Much Longer

By David MacKinnon

http://www.fcpp.org/event.php/226

January 1999

Can Small Governments Secure Economic and Social Well-being?

By Vito Tanzi and Ludger Schuknecht

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