

C A S E S T U D Y

The Forgotten Credit Crisis of 1907

Canadian Business History
Professor Joe Martin

This case was prepared by Darren Karn under the direction of Professor Joe Martin as the basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation.

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The Forgotten Credit Crisis of 1907

Introduction

Media outlets in the United States and Canada have devoted a great deal of attention to what they call the Great Recession of 2008. After the Dow Jones Industrial Average fell by over 40 per cent, comparisons to the stock market crash of 1929 and the subsequent Great Depression frequently appeared in the popular media. These comparisons, however, are disproportionate, since no financial crisis has been as damaging as the Great Depression, and certainly not the financial events of 2008.

As the initial panic passed in America, more thoughtful analysis revealed that the crisis of 2008 actually resembled another period more closely: the credit crisis known as the Banker's Panic of 1907. The details of that event are relatively well known. J.P. Morgan was said to have "saved the street" after a botched attempt to corner the copper market and the subsequent default of the Knickerbocker Trust led to a run on the city's financial institutions.

In the aftermath to the 1907 panic, the United States appointed the National Monetary Commission to study global banking systems, including those of England and France, as well as that of Canada. The commission released its report in 1912. Its conclusions led to the passage of the Federal Reserve Act in 1913, and it was this act that created the modern Federal Reserve System, America's central bank.¹

Although the financial events of 1907 are well documented in the United States, little reference to the Canadian experience is available. Canadian business history refers to the event as 'a brief downturn in 1907' or 'a mere hiccup'. This case serves to fill the historical void by providing an overview of the economic and political situation in Canada before, during and after the credit crisis of 1907.

While the drama of the U.S. Banker's Panic did not play out to the same degree here in Canada, this country did not emerge unscathed. Canada's per capita GDP growth fell by 7.8 per cent in 1908 as a result of the crisis, still significant but less than the 10 per cent drop in the United States.² The financial sector also felt the impact of the crisis acutely. Trading volume on the New York and Montreal Stock Exchanges fell by 31 per cent and 45 per cent, respectively.³

The 1907 credit crisis fuelled a high level of distrust among members of the public towards financiers of the time. This suspicion began after reports were made public outlining some of the actions taken by providers of life insurance.

¹ The creation of the Federal Reserve Act allegedly took place at a secret location on Jekyll Island, Georgia. The details of this event are provided at the end of this case.

² This decline in per capita GDP ranks among the worst in Canada's history. In the fallout of the 2008 crisis, Canada's decline in per capita GDP of 2.1 per cent pales in comparison.

³ Armstrong, Christopher. 1997. *Blue Skies and Boiler Rooms: Buying and Selling Securities in Canada, 1870–1940*. Toronto: University of Toronto Press.

Life Insurance and the Ontario Bank: The Seeds of Public Discontent

Prior to the turn of the century, life insurance had evolved as a major financial industry. In the early 1900s in the United States, insurance firms were among the largest companies in the country. The biggest three life insurance companies (The Equitable, The Mutual and New York Life — all based in New York) had amassed assets in excess of \$1.2 billion, about 5 per cent of U.S. national income.⁴ In 1905, Canadian life insurers, led by Canada Life, which had recently moved its head office from Hamilton to Toronto, had assets of more than \$100 million and enjoyed strong growth. With the value of policies exceeding \$400 million, life insurance companies had become important players in the financial market.⁵ These impressive market positions brought with them greater public scrutiny on both sides of the border.

The Armstrong Investigation

Complaints from policy holders about a lack of transparency related to investments and the inner workings of life insurance companies had surfaced from time to time. In the late 1880s, a spate of complaints in the United States arose. A group of policy holders complained that their share of profits from investing, and the value of their policies at maturity, were not as high as the companies advertised. An 1888 court decision, however, favoured the life insurance companies with its ruling that policy holders did not have the right to such transparency, given the nature of their policies.⁶

That court decision largely silenced disgruntled policy holders until 1904, when popular journals of the day published stories claiming that the life insurance companies misrepresented their policies and were irresponsible in the investment of policy holder funds.⁷ It is important to note that in 1892, laws had been relaxed to allow insurance companies to invest in the stocks, bonds or other debts of any company incorporated in the United States⁸ — and as a result, accusations of insider trading and conflicts of interest arose.

In the wake of these allegations, the media then began reporting on the extravagant lifestyles of insurance executives — in particular Equitable vice-president James Hazen Hyde, son of company founder Henry Hyde. Media reports revealed that James threw a costume party in January 1905 estimated to cost \$2 million (in 2000 dollars) that was paid for by the company. An investigation of The Equitable concluded on May 31, 1905. It was followed by a New York State-sponsored investigation in July into life insurance company practices in the state.

The findings of this initiative, known as the Armstrong Investigation, cut across many facets of the life insurance industry. The investigation revealed exorbitant executive compensation, nepotism, inappropriate influence on public officials and unethical investigation practices. For instance, many life insurance companies controlled trust companies, as well. The trust companies, by virtue of their status as large financial institutions, could often buy large blocks of initial and secondary stock offerings at discounted prices. Since the directors of the life insurance companies were also directors of the trust companies, they then issued themselves options to buy the stock at cost. While the

⁴ Moss and Kintgen, p. 1.

⁵ *Canada Year Book*, 1905, pp. 241 and 251.

⁶ Moss and Kintgen, p. 8.

⁷ *Ibid.*, p. 8.

⁸ *Ibid.*, p. 5.

life insurance executives declared (correctly) that their investments also made money for the policy holders, the investigation nevertheless concluded that these investment practices (among others) “weakened the sense of official responsibility, multiplying the opportunities for gains, both direct and indirect, to officers and directors through the use of the company’s funds, and making easy the exercise of official discretion at the promotion of self-interest.”⁹

In the end, several of the investigation’s recommendations were enacted, including the idea to limit the growth and size of life insurance companies, as well as the nature of their investments. Insurance companies were no longer permitted to hold bank stocks or act as securities underwriters. In 1906, insurance companies held about six per cent of their assets in stocks — by 1922, this amount had dropped to one per cent.¹⁰

The Federal Royal Commission on Life Insurance

William (Billy) Findlay Maclean was a journalist and politician, serving as an independent Conservative Member of Parliament for 34 years from 1892 to 1926. In 1880, he founded the *Toronto World*, a tabloid-style newspaper modelled after the *New York Herald*. His style was populist and sensationalist; while readers of *The Globe* looked down on the *World*, the latter was also widely considered “editorially boldest” and was popular right from its inception. The paper claimed many political victories in its early years, including inciting an 1887 referendum on Sunday streetcar service in Toronto.¹¹

As the Armstrong Investigation concluded,¹² Maclean must have smelled an opportunity for another one of his populist press campaigns when he focused on insurance. The abuse of policy holder funds by New York life insurance companies was well-known by this point — Maclean picked up on that theme while presenting evidence suggesting that the financial games played in Canada were worse than those of its southern neighbour.

On Feb. 14, 1906, the *Toronto World* launched a two-week attack on the Canadian life insurance industry with the following headline: “Can the Canada Life explain? Policy holders are much worse off than those who hold policies in the corrupt New York companies, whose presidents have been driven from office.”¹³ The story included a detailed table listing the percentage of profits paid out to policy holders by prominent New York life insurers. Despite rampant corruption in New York, the *World* contended that New York policy holders nevertheless reaped three to seven times the returns over their Canada Life counterparts.

For two subsequent weeks, the *World* published stories with a similar theme. The articles demanded transparency on executive salaries, expenses and investing practices in order to restore confidence among the premium-paying public. On Feb. 20, 1906, Supreme Court Justice Sir Louis Davies issued a letter of regret over his actions seven years earlier when he was part of the government that approved amendments to laws allowing insurance companies to invest in stocks and

⁹ Moss and Kintgen, p. 12.

¹⁰ Markham, p. 20.

¹¹ *Dictionary of Canadian Biography*.

¹² Following the results of the Armstrong Investigation, the UK also launched a Royal Commission on the practices of life insurance companies. The actions of the UK, combined with the local media pressure from sources such as Billy Maclean, played an important role in Canada’s decision to launch a Royal Commission to investigate the same.

¹³ *Toronto World*, p. 1, Feb. 16, 1906.

bonds — and therefore more speculative activities.¹⁴ On Feb. 28, Ottawa announced a Federal Royal Commission on Life Insurance.¹⁵

The industry, predictably, was not in favour of the investigation. One executive was quoted at the time saying, “the public mind has been so excited by sensation mongers that people are ready to give credence to any innuendo or charge disparaging to the management of a life insurance company.”¹⁶

The Royal Commission took a broad approach, investigating politicians, lawyers, financiers, judges and public officials. Although the commission discovered investments made by the life insurance executives that it alleged were illegal, the companies countered that these activities were indeed legitimate. As was the case in the Armstrong Investigation, while these investments blurred the conflict of interest boundaries, no policy holder appeared to have actually lost money.¹⁷

Although the Royal Commission shed light on some of these investments, it discovered little impropriety while sullyng many reputations in the process.¹⁸ The Royal Commission made recommendations similar to those of the Armstrong Investigation. These suggestions largely highlighted the need for greater transparency on investments, director interests and compensation, and restrictions on classes of allowable investments. The legislation acted on some of these recommendations, while extending more supervisory power to the government.¹⁹

Against this backdrop, the world economy began to slow. The investments that had been made by insurance executives for personal gain did not lose money, but they nevertheless exposed the funds of policy holders to undue risk. A compliant stock market enabled the executives to argue that they were making more money for policy holders than would otherwise have been possible.

The Ontario Bank Fraud

The Toronto-based Ontario Bank failed in 1906, beginning a series of bank failures. In October 1906, the Royal Bank of Canada opened negotiations to purchase the Ontario Bank. After reviewing financial statements, the Royal noticed that the Ontario Bank had sustained significant losses the previous year.²⁰ Otherwise occupied with foreign business at the time, the Royal opted against restructuring the Ontario Bank and instead advised the latter bank’s directors to consult with The Bank of Montreal to arrange a buy-out.²¹ This reasoned approach by the Royal permitted a quick, smooth takeover, which preserved confidence in the banking community.

On Friday, Oct. 12, the first signs of trouble at the Ontario Bank were revealed by the stock market. Although it closed the day before at \$132.50 per share, a large block of the same stock was offered that morning at only \$125. Despite this low price, no bid was made — the financial community must have sensed that something was wrong.²² No bids were submitted at that price on the

¹⁴ *Canadian Annual Review*, 1906, p. 216.

¹⁵ The commission was chaired by Judge D.B. MacTavish and commissioners J.W. Langmuir and A.L. Kent.

¹⁶ *Canadian Annual Review*, 1906, p. 219.

¹⁷ *Canadian Annual Review*, 1906, p. 222.

¹⁸ A quote from the memoirs of Robert Laird Borden offered some perspective on the process. “Some criticism of the personnel of the commission was made; and from time to time there were comments upon the character of the investigation and upon the attitude of the commissioners and counsel engaged by the Government.” Borden, p. 169.

¹⁹ Norman, p. 25.

²⁰ *The Monetary Times*, Oct. 20, 1906, p. 565.

²¹ *Ibid.*, p. 565.

²² *The Globe*, Oct. 13, 1906, p. 1.

Toronto Stock Exchange, but reports indicated that private offers had been made to sell shares at much lower prices.²³ That evening, as it became apparent that the Ontario Bank had significant financial problems, its bank directors held a conference with managers of the major banks in Toronto. It was agreed that the Bank of Montreal would take over the Ontario Bank and guarantee depositors against the losses. In turn, the other banks — in proportion to their size — then supported the Bank of Montreal, thereby spreading the risk across the banking community.²⁴ A representative from the Bank of Montreal arrived in Toronto on the night train and finalized the agreement before 9 a.m. on Oct. 13, 1906. Signs were posted that day on all Ontario Bank branches declaring “This is the Bank of Montreal” and business continued as usual.²⁵

The subsequent investigation into the reasons behind the collapse of the Ontario Bank revealed a long trail of fraud perpetrated almost entirely by the general manager, Charles McGill. The investigation revealed that McGill had invested in New York securities for his own benefit using bank funds.²⁶ Furthermore, he was found to have deliberately misled investors and the government in his reports, claiming that the bank was in good financial standing, when the exact opposite was the case. Quoted in an interview on Oct. 15 following the collapse, McGill offered the following telling insights:

“I said that the Ontario Bank assets were good; not because they were good, but because I did not want the institution to tumble. I watched and nursed Ontario Bank stock daily — now buying, now selling. I was building up the Bank from the outside, increasing and improving the branches. [...] As I have told you, my stock investments yielded returns for a while. Then came reverses.”

McGill was subsequently arrested on Oct. 16 on charges of making false government returns about the state of the Ontario Bank.²⁷ Although McGill was the only one jailed for fraud, the trial revealed that the other directors demonstrated a surprising degree of negligence and ineptitude in their oversight of the bank and in their protection of shareholders.²⁸ One week after the collapse, an editorial in *The Monetary Times* lamented, that “the day is waning when a man’s name is accepted as guaranteeing the final stability of a business to which he lends it, but with which he cannot be closely acquainted. Inattention is incompetence... directors must direct, or get out.”²⁹

A palpable sense of frustration with the financial community existed among consumers in the lead-up to the credit crisis of 1907. Investigations into the practices of life insurance in Canada, New York and the UK reinforced the general perception that those in finance sought to enrich themselves first, at the expense of the general public. The failure of the Ontario Bank, while the result of criminal acts, highlighted the lack of oversight in the financial sector — neither directors nor the public (there were no bank regulators at this time)³⁰ knew the workings of the organizations entrusted to manage the public’s finances.

23 *The Globe*, Oct. 13, 1906, p. 7.

24 *The Monetary Times*, Oct. 20, 1906, p. 568.

25 Johnson, p. 560.

26 *Canadian Annual Review*, 1906, p. 240, and Ferrier, p. 40.

27 *Canadian Annual Review*, 1906, p. 240.

28 Ferrier, p. 41.

29 *The Monetary Times*, Oct. 20, 1906, p. 566.

30 Oddly, from the late 1800s there existed an Office of the Superintendent of Insurance, which oversaw federally-licensed insurers.

The Credit Crisis

The credit crisis of 1907 came at the end of a period of great economic growth. In his closing remarks to the 1906 Session of Parliament, the Governor General was in high spirits. “It is very gratifying to note,” he said, “that Canada continues to enjoy a prosperity rarely equalled in the history of nations.”³¹ The previous year, 1906, had indeed been a prosperous one. It was said that during this economic boom, the railroads did not have enough cars to transport the freight being purchased and could not build them quickly enough. Canadian manufacturers withdrew their salesmen from the field because orders had already been placed for the upcoming year.³² The *Canadian Annual Review* reported on this growth and prosperity in 1906. “In the current development of Canada, money, and lots of it, is required.”³³

In 1906, lending in Canada grew 25 per cent from \$450 million to \$550 million.³⁴ Loans increased to \$590 million in May 1907, but this active period was followed by steady contraction and subsequent increases in cash reserves. By September 1907, current loans decreased by \$10 million to \$580 million — the slowdown had begun.³⁵ As the crisis reached its peak in the United States in October and November, loans declined by another \$25 million.³⁶

The economic boom created an unusual demand for money, forcing interest rates upward. Canadian bankers began to urge their customers to use caution, claiming that the profits and growth of the preceding years should not be expected to continue unabated. A general feeling was shared among all bankers they should begin to retrench in preparation for an eventual crash.³⁷

It did not come as a surprise, therefore, when at the annual general meeting of the Canadian Bank of Commerce in early 1907, Byron Edmund Walker, the general manager and soon-to-be president, commented warily upon the state of the economy.

In Walker’s view, the fact that Europe was still bearing the cost of a war in South Africa and the conflict between Russia and Japan — coupled with more recent fires and earthquakes in San Francisco — meant that global capital had vanished or been destroyed. Further, the quickly growing Canadian economy added to the existing strain on the global money supply and indicated an upcoming crisis.

Throughout 1907, Bank of Commerce managers were informed by Walker and senior management that they should no longer advance loans unless they were of “a class that would lead to permanent and profitable connections” — a first effort to reduce lending and preserve cash.³⁸ By April 1907, the bank had already received more requests for credit than it was willing to extend — branch managers were directed to limit credit to 1906 levels. Interestingly, managers were also told that loans of “moderate amounts to responsible farmers” should not be declined.³⁹

Because other banks were also tightening their credit, more and more businesses looked to the Commerce for credit, but they were also being turned away. As a result, the bank raised rates on loans to try to reduce demand and trim the portfolio of borrowers. By July, Commerce managers

³¹ *Canada Year Book*, 1906, p. 25.

³² Johnson, p. 553.

³³ *Canadian Annual Review*, 1906, p. 196.

³⁴ Johnson, p. 555.

³⁵ *Ibid.*, p. 555.

³⁶ *Ibid.*, p. 557.

³⁷ *Ibid.*, p. 554.

³⁸ Ross, p. 235.

³⁹ *Ibid.*, p. 236.

were informed that any requests to extend credit beyond pre-set limits would have to be approved by head office, indicating further credit restriction and reflecting a heightened sense of unease in the financial markets.

The Panic of 1907 — New York at a Standstill

The Panic of 1907, as it is called in the United States, is a story that begins with speculation and ends with financial heroism.

The Dow Jones Industrial Average enjoyed great success between 1904 and 1906, doubling in value. As with any stock bubble, the rise in prices sparked even more market activity and broad speculation as those looking for quick profits entered the market and pushed prices higher. Jacob Schiff, head of the prestigious investment firm of Kuhn, Loeb & Co., was nervous about the market and the speculation, claiming that another panic was imminent, “compared with which the three that have preceded would be only child’s play.”⁴⁰

Early chinks in America’s financial armor began to show in March 1907, when securities prices dropped precipitously. Companies and municipalities (in particular, New York City)⁴¹ had difficulty raising funds in the bond market — the money supply was tightening.

In August 1907, George Cortelyou, Secretary of the Treasury, deposited \$28 million in national banks across the United States, in advance of the fall harvest. Additional funds were required every fall to move the crop, as was the case in Canada. Despite this infusion of cash into the system, the American economy began to seize as major corporations announced drops in earnings and other concerns failed.

The panic began, however, when an effort by a group of speculators to corner the copper market unravelled in October 1907. A group of New York banks and trust companies controlled by the Heinze brothers, in association with Charles Barney and C.F. Morse, incorrectly judged the market. These investors believed they held enough of the outstanding shares in United Copper. As short-sellers flooded the market on the overpriced security, shares in United Copper dropped dramatically — exposing the Heinze position. The associated banking concerns quickly became insolvent as positions could not be covered, and the public immediately lost confidence in the banks and trust companies. Bank runs were in full swing.

In the ensuing panic, depositors started to withdraw as much cash as possible, depleting bank cash reserves. The financial system of the United States ground to a halt from this lack of liquidity. At this point, esteemed financier J.P. Morgan stepped into the picture. He engineered a series of events that saved the financial system, acting as a “one man Federal Reserve Bank.”⁴²

Throughout late October, Morgan organized a series of meetings in his library — sometimes locking groups of bankers in the room until agreements were arranged. He raised money to save various financial companies in New York, convincing both Secretary Cortelyou and the New York financial leaders to provide millions in liquidity in a matter of hours after each new emergency.

In the end, the panic lasted from Oct. 16 (the failure of the copper cornering scheme) to Nov. 7, 1907, when US Steel took over Tennessee Coal, Iron & Railroad in a deal that saved one of

⁴⁰ Markham, p. 29.

⁴¹ Some might be puzzled that New York City had difficulty raising funds in the capital markets, but in 1907 the modern city had only been in existence for 10 years; the five boroughs amalgamated in 1898.

⁴² Markham, p. 32.

Wall Street's major brokerage houses.⁴³ Dramatic in course, the panic prompted a thorough investigation and review of the country's financial system and resulted in the creation of a central banking system in the United States.

The Canadian Experience: Discomfort and Measured Response

As the panic in the United States reached its peak in October and November, additional restrictions⁴⁴ were imposed to address the question of how to deal with American business, in light of the fact that it was impossible to find U.S. currency.

In Canada, the situation was not yet extreme. Cash became tight,⁴⁵ but there was no panic. The most vocal Canadian constituency during this period was a group of wheat farmers. Cash was needed in greater quantities each fall as farmers looked to sell their crops, especially since the annual crop output increased every year. Grain farming in Canada was booming during this period. Farmed acres in Canada grew more than 60 per cent from 1901 to 1911 (from 30 to 48.5 million acres), while wheat production increased several hundred per cent. The intermediary industries — shipping, milling and speculating concerns — all required cash to pay the farmers so that further profits could be made on the crop. The flow of cash followed this path, as described by *The Monetary Times* in 1907:

1. The farmer delivers his wheat to a nearby elevator, or he orders grain cars and ships the wheat to Winnipeg for inspection and sale.
2. At Winnipeg, the grain is either purchased by the milling companies and stored by them for future use, or it is sold to large dealers who carry wheat over from month to month, hoping to profit on the difference between the cash article and the price of futures.
 - a. It is this latter class who are not being assisted by the banks in their speculations just now, and many of the complaints against the bankers emanate from this fraternity.
3. Regarding the export business, those who send the wheat eastward are often the same firms who speculate in grain futures. The two functions of these houses are entirely distinct. As exporters, these firms enter the Winnipeg market and buy wheat on the track and in elevators.
4. When shipment time comes, they forward down the lakes from Port Arthur or Fort William.
5. Next, with the help of the Canadian bank, an “inland draft”⁴⁶ is drawn on a New York or other export house.⁴⁷

⁴³ The takeover, facilitated by Morgan, also required President Roosevelt to personally agree to waive antitrust concerns over the size of the merged entity.

⁴⁴ The stringency — at least on the part of the Bank of Commerce — was relaxed in February 1908, when branch managers were informed that all previous restrictions on lending were lifted, and business could return to normal. Unfortunately, 1908 would prove to be a difficult year as the country slipped into recession (Ross, p. 238).

⁴⁵ It was speculated that one of the reasons for this tightness is that Canadian banks had deposited gold in New York banks at the time to take advantage of exceptionally high interest rates (Rich, p. 142).

⁴⁶ An inland draft is a written order for a sum of money to be transferred at a certain time. The draft allows the shipper to pay for shipment of the grain, for which he will be paid upon receipt and shipment by the New York (or other) export house. (*Investopedia*).

⁴⁷ That is, the bank is willing to loan the shipper the funds to finance the shipment to the export house — provided a contract to purchase the wheat and ship it overseas is negotiated.

6. This draft, with the inland bill of lading⁴⁸ attached, is handed to the buyer of the draft, who sees the shipment made and negotiates a sterling or continental bill of exchange, to which is attached the bill of lading.⁴⁹ When the grain is on the high seas *en route* to Europe, Canadian banks which financed the shipment at Winnipeg get their money back.
 - a. The Canadian banks thus advance the requisite funds to the shipper in Winnipeg. Their money is returned to them when the cargo is in the Atlantic. The funds thus released go back to Winnipeg and then finance more shipments.⁵⁰

As the Canadian banks tightened lending practices throughout 1907, the bigger players in the grain trade were having difficulty raising funds to pay to purchase the wheat and finance shipment. While J.P. Morgan was the most prominent figure in resolving the U.S. panic, William Stevens Fielding, the Canadian Finance Minister, was the key player to tackle this country's credit issues. Fielding, in response to the plight of farmers and grain speculators, was quoted at the time:

"The matter is represented to us as one of extreme gravity; indeed, this is generally admitted. We have received deputations and telegrams from Winnipeg urging upon the seriousness of the matter. There is, undoubtedly, a crisis.

"We can assure the farmers of the West that they need not have any anxiety. There are from twenty to twenty-five millions of bushels of feed wheat⁵¹ in Western Canada. There are thirty days in which to ship this down the lakes (before freeze-up). Unless this is moved within that time, the farmers will not have, in exchange, good hard cash. The situation is one of gravity and the Government have adopted certain methods by which they believe that what would otherwise be a crisis, will be averted."⁵²

In fall 1907, the tight money supply was approaching a crisis level for farmers. Government officials knew that wheat was Canada's biggest export by a significant margin, and it therefore deserved special attention. Although banks experienced this demand for funds every year — and always made funds available to farmers — the state of credit markets in fall 1907 was different. The banks had been restricting lending for months leading up to the harvest, and were still unwilling to provide loans above what they considered a safe level. Following the collapse in confidence of the banking community in New York in October, Canadian banks had taken measures to strengthen their positions in the event that this lack of confidence spread north.

Grain speculators also lacked access to credit, and this group was also deprived of business during the 1907 harvest season. Between the challenges expressed by Winnipeg's financial community and prairie farmers, there was great pressure on the banks and government to intervene with a solution. The oncoming winter and the knowledge that this crop was prone to spoilage added more tension to an already-taught credit environment.

⁴⁸ A bill of lading is a legal document between the shipper and the carrier of a particular good detailing the type, quantity and destination of the good being carried. The bill of lading also serves as a receipt of shipment when the good is delivered to the predetermined destination. This document must accompany the shipped goods, no matter the form of transportation, and must be signed by an authorized representative from the carrier, shipper and receiver. (*Investopedia*).

⁴⁹ The export house — often located in New York — negotiates this overseas sales contract for the wheat.

⁵⁰ *The Monetary Times*, Nov. 16., 1907, p. 798.

⁵¹ Feed wheat: The 1907 harvest yielded a significant amount of lower-quality feed wheat. This wheat could not be stored for as long a period and had to be shipped soon after harvest. Due to its lower quality — and therefore lower price — it was only profitable to ship it by boat through the Great Lakes — and therefore the immediate need for financing was greater due to the approaching winter.

⁵² *The Monetary Times*, Nov. 16, 1907, p. 798.

Fielding and the Government Quietly Save the Day

In interviews and statements made in fall 1907, particularly announcements about his plans to make funds available to move the crop, Fielding was a man of few words. His only comment was that farmers and exporters need not be anxious about obtaining funds for shipments. However, he would not explain exactly how these funds would be made available. Following the pressure of the cash squeeze in fall and early winter, Fielding eventually revealed those details several months later when he made his budget speech on March 17, 1908, in the House of Commons.

In these comments, Fielding reiterated a sense of urgency — the lines of credit ordinarily offered by banks were limited. Since the crop had suffered frost damage, it could not be stored over the winter in grain elevators and therefore required immediate shipment by boat.

Although the banks had initially told the government that they did not believe the situation required outside assistance, other stakeholders convinced the government otherwise. Fielding therefore made up to \$10 million in special funds available to banks involved in crop financing. In order for banks to access these funds, loans could only be given for a short term and required that the banks pledge securities for them.

The banks were hesitant to make use of these funds for two reasons. First, they found the terms from the government overly stringent (including the seven per cent interest rate), which left them little room for profit. Fielding relented and offered the funds at a lower rate of interest — four per cent for 60 days, five per cent for the next 60 days, and six per cent for any time beyond.⁵³

Second, the banks worried that by making use of these funds, their reputations would suffer. They felt that the need for a loan would reflect poorly on bank management. As a result of the \$10 million advance, global markets immediately became suspicious. Much to the chagrin of the Canadian Banker's Association, which lamented the Finance Minister's interference, the *London Economist* quickly published "if Government assistance was really necessary the strain on Canadian credit must be more serious than most people in England have believed." However, all was not lost, as the same publication also commented that "the success of the Canadian bankers so far in dealing with the difficulties of this autumn is a remarkable proof of the soundness of the Dominion's banking and currency system."⁵⁴

Under the new terms, money moved more freely. In fact, it was observed that the simple announcement that the government would offer assistance allowed the banks themselves to loosen their lending to farmers. In stark contrast to the insatiable thirst for credit in the United States, only \$5.1 million of the \$10 million pool was accessed by the Canadian banks. However, this gentle intervention appeared to be all that was required to re-establish the flow of credit. The potential crisis in the West was averted.⁵⁵

Fielding explained that the government did not have \$10 million sitting idle in the treasury to loan to banks and that it would not have been able to raise that total amount from England in such a short period of time. Canada had legislation in place that put a reserve requirement of gold on the government for the total amount of currency that the government could release. Releasing the full \$10 million would have exceeded this reserve requirement.

⁵³ Hansard, p. 5153.

⁵⁴ *Journal of the Canadian Banking Association*, 1908, Vol. 15, p.146.

⁵⁵ Hansard, p. 5154.

However, since the Bank of Montreal acted as the agent for the government during this transaction, Fielding required that the bank guarantee the full amount of the loan. That guarantee, plus the securities posted as security by other banks availing themselves of the emergency loans, was treated by Fielding as equivalent to gold for the purposes of the reserve requirement calculation.⁵⁶ Fielding defended his actions in his speech:

“The effect of the issue was to reduce our percentage of reserve to 56%, a difference of 5%. For this 5% reduction in reserve we had the securities put up by all the banks to which money was advanced, and we had, in addition to that, the guarantee of the Bank of Montreal. Thus I think it will be found that while there was a technical departure from the law governing our Dominion notes, which calls for ratification by the parliament of Canada if parliament shall so approve, still the occasion was a very exceptional one and one upon which we were justified in adopting exceptional methods.”

The approval for a \$10 million loan pool to the banks was passed through order in council⁵⁷ on Nov. 12, with loans being given later in the month.

Fielding went on to state that in future years, greater currency elasticity on the part of the banks would be required to move the wheat crop. He offered to amend the Bank Act to authorize banks to issue “emergency currency” for a limited time during the crop-moving season, subject to the amount of a bank’s paid up capital and reserve.⁵⁸

Post-Crisis: Bank Failures, Legislative Amendments and The Federal Reserve

The loosening of credit in the United States and Canada in early 1908 did not spell the end of the crisis. Both countries slipped into recession that year as GDP growth collectively plunged dramatically. The consequences of the panic of October and November were broad and affected more than just the players involved. In Canada, five banks failed between 1905 and 1908, as bad debts accumulated (see Figure 1 on the following page). The largest and most significant of these failures was the Sovereign Bank.

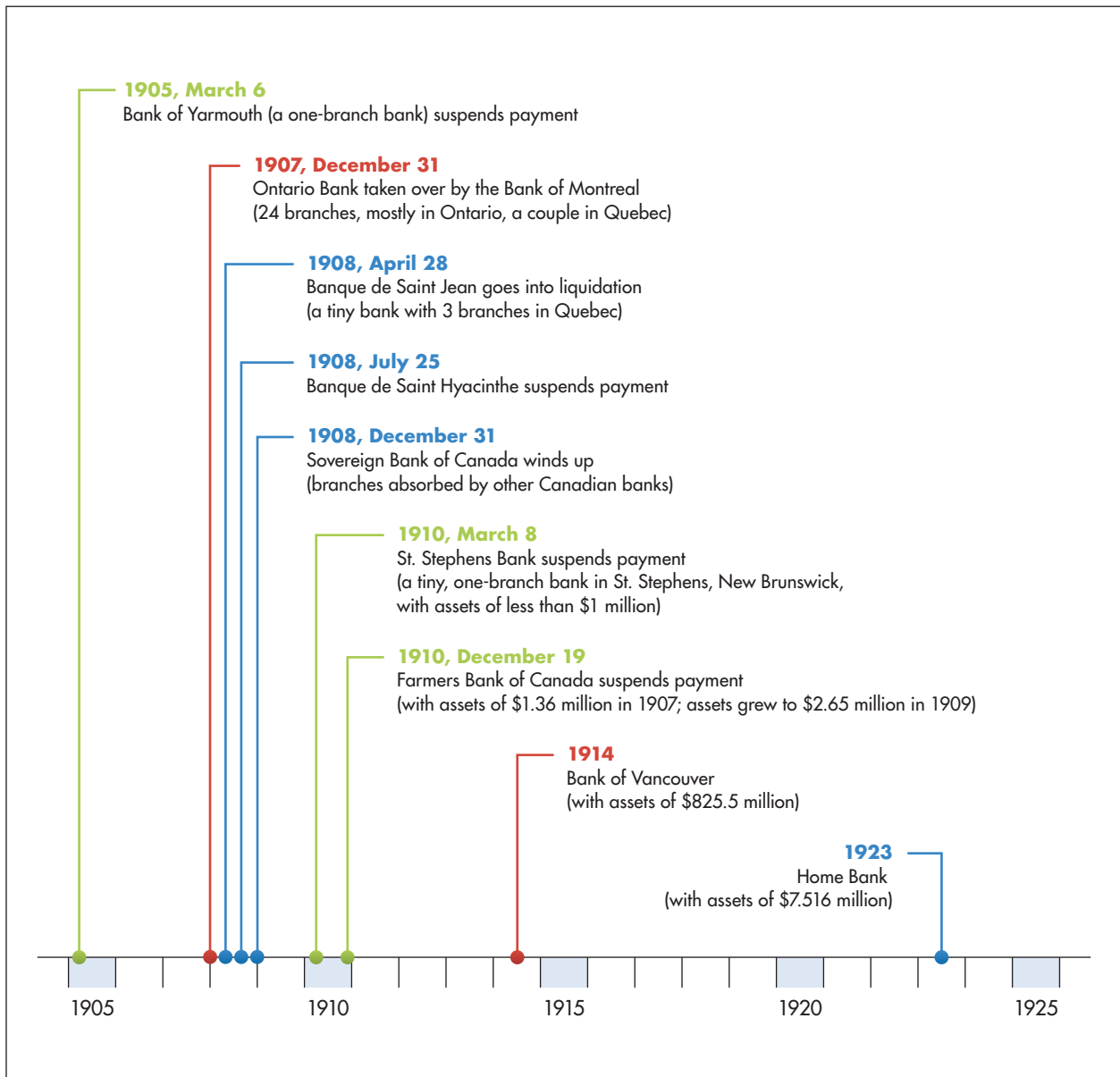
In both countries, the public demanded action to prevent future crises of the sort just experienced. As with the aftermath of the panic, the Canadian response was less dramatic than that of the United States. At home, a small amendment was made to the Bank Act. In the United States, the crisis led to the creation of the Federal Reserve System, which represented a complete restructuring of that country’s financial system.

⁵⁶ Hansard, p. 5155.

⁵⁷ An Order-in-Council, at the federal level, is technically an order of the Governor General by and with the advice and consent of the Queen’s Privy Council for Canada. In fact, it is formulated by Cabinet or a committee of Cabinet and formally approved by the Governor General. Some orders simply make appointments. About a third are legislative, forming part of the law and enforceable by the courts. Most legislative orders are made under authority expressly conferred by an Act of Parliament.

⁵⁸ Hansard, p. 5156.

Figure 1:
Canadian Bank Mergers, Failures and Rescues



The Sovereign Bank: Canada’s Banking Problem Child

D.M. Stewart founded the Sovereign Bank on Aug. 23, 1902, with capital supplied by J.P. Morgan and Company and the Dresdner Bank of Germany.⁵⁹ D.M. Stewart became known as an “artist in high finance.” His approach was different from most of his counterparts, and he broke the trend in the Canadian banking community where executives tended to be a cautious and conservative lot. Stewart took a bold approach and led what appeared to be dramatic growth at the new bank — increasing the number of branches far more quickly than other banks, taking in significant new business, and

⁵⁹ Ferrier, p. 49.

establishing the first quarterly dividend in Canadian banking.⁶⁰ The bank made significant loans to the Alaska Central Railroad and the Chicago and Milwaukee Electric Company, the latter of which appeared to secure loans from Stewart with little-to-no due diligence.⁶¹

In June 1907, both Stewart and the Sovereign Bank's president resigned, evidently aware that they had run the institution into difficulty — making large loans without the knowledge of the directors. Stewart fled to Alaska. Although new management worked diligently to correct the situation and return the bank's books to good standing, the credit crisis in October 1907 hobbled these efforts.

In Canada, the biggest effects of the panic were felt in November and December. The Sovereign Bank's notes were increasingly presented for redemption since customers needed cash. Deposits therefore declined, requiring the bank to liquidate loans to maintain solvency. However, with the credit crisis then in full swing, the Sovereign could not sell its loans. With only a few days of cash left on hand, the bank's president, Emilius Jarvis, took an urgent trip to New York on Jan. 8, 1908. He travelled there to meet with J.P. Morgan and Company to ask for an emergency infusion of cash and negotiate plans to liquidate the bank's holdings.⁶²

On Jan. 17, a consortium of Canadian banks was approached to take over the Sovereign's operations. The next day, all branches of the Sovereign opened under new names. Sixteen banks assumed the Sovereign's liabilities and branches. It took some time to locate all of the branches that the other banks had been allotted due to the fact that some communities in which they were located were not yet shown on maps or in the post office register.⁶³ In hindsight, this confusion is an amusing testament that reveals the speed and aggressiveness of Stewart's pursuit of growth.

Following the failure of The Sovereign Bank on Jan. 18, 1908, its president, Emilius Jarvis made the following comments:

“For some time there has been a constant strain on the bank's resources, caused by the unnatural conditions of the last four months, which have created a still greater drain upon the deposits and made it correspondingly difficult to liquidate our loans. These conditions, which in many ways have been far more stringent than have been experienced in the memory of this generation, could not possibly have been foreseen, and they were rapidly bringing out a state of affairs under which the business, if continued, would have been sufficiently profitable.

When this conclusion was reached, we at once conferred with the leading bankers of the country and asked them to verify our statements. These bankers have expressed their opinion that the assets of the Sovereign Bank of Canada are sufficient to pay all liabilities and an agreement has been made... by which all the branches of this bank will open this morning as branches of other banks.”⁶⁴

At the Sovereign Bank's annual general meeting a few months earlier, General Manager F.G. Jemmet had expressed a similar feeling of helplessness. He attributed the situation to the moves made by the bank's previous management:

⁶⁰ Ferrier, p. 49.

⁶¹ *Ibid.*, p. 55.

⁶² *Ibid.*, p. 52.

⁶³ Johnson, p. 561.

⁶⁴ *The Monetary Times*, Jan. 25, 1908, p. 1214.

*“The bank in the past has been too ambitious. . . in many cases loans have been made for which sound banking principles offer no apparent justification and under methods directly contrary to those which will be allowed by the present management.”*⁶⁵

The ambition and aggressive growth over the lifetime of the Sovereign Bank did not go unnoticed in the banking community. The *Journal of the Canadian Banker’s Association* called the practices of the previous management “injudicious” and labeled those activities as the main contributing factor in its demise.⁶⁶ Meanwhile, the bank’s disappearance was not lamented:

*“The scientific elimination of the Sovereign Bank from the active banking history of Canada illustrates the art of unconsciously getting rid of the unnecessary. . . . It has been a fester upon our banking system. [. . .] the absorption of the institution has been but for a matter of time.”*⁶⁷

In a study of the causes of bank failures, the Canadian Bankers’ Association (CBA) was not apologetic. It chose not to refer to the incident with the Sovereign Bank as a “failure”. Instead, the association argued that improper banking practices and poor management resulted in the need for more appropriate institutions to take over the bank. The study took into account two more bank failures that occurred after the Sovereign — those of the Banque de St. Jean and the Banque de St. Hyacinthe.

Both small, Quebec-based banks, the St. Jean folded as a result of “fraudulence and incompetence”, with the president sentenced to serve time in a Quebec penitentiary.⁶⁸ The St. Hyacinthe, however, folded not only because it was quite small, but also because it had one very large borrower that could no longer service its debt — a casualty of incompetence once more, aided by the credit crisis and subsequent economic downturn.

The CBA continued to state that the Canadian banking system was in sound condition, and did not need any assistance from the federal government. It categorized the spate of Canadian bank failures as follows:

*Thus fraud was present in four cases out of six, but in two of the cases it consisted merely in concealing the position of insolvency; the guilty parties apparently did not rob the stockholders and depositors. . . . Rather it was incompetence, manifested in the making of bad loans, that did the damage. [. . .] [In Canada] bankers are disposed to consider the chief danger besetting a bank is the bad loan.”*⁶⁹

The CBA took the position that a lack of oversight was the source of the problem. The association could also look to the failure of the Ontario Bank and the behaviour of the life insurers to support this conclusion. While the trend of self-regulation and flimsy oversight by weak directors continued, the government took the position that future credit problems could instead be solved by a small amendment to the Bank Act.

⁶⁵ *The Monetary Times*, Jan. 25, 1908, p. 1215.

⁶⁶ *Journal of the Canadian Banking Association*, Vol. 15, p. 49.

⁶⁷ *The Monetary Times*, Jan. 25, 1908, p. 1209.

⁶⁸ *Journal of the Canadian Banking Association*, Vol. 15, p. 49.

⁶⁹ *Ibid.*

Canada's Response: Amendments to the Bank Act

Minister Fielding's emergency loan to Canadian banks in November 1907 was based on questionable legal footing, considering Canada's existing financial laws. His 1908 budget speech made it clear that although the loan technically breached Canada's laws, given the circumstances — and the extensive security supplied by the banks in return for the cash — the risk was deemed acceptable.

Nevertheless, the government did not want to be put in a position of having to defend this kind of decision again in the future. It therefore moved to amend the Bank Act. The amendment, which was passed on July 20, 1908, sought to allow banks to issue their own notes in excess of reserve requirements for the crop moving season. Specifically, the banks were allowed to issue notes up to 15 per cent of their unimpaired paid-up capital and reserve fund, but only during a specific period each year, from Oct. 1 to Jan. 31.

The amendment imposed restrictions on this seasonal exception. The most significant restriction was that a bank's general manager would have to give notice to the Minister of Finance and the president of the Canadian Bankers' Association by registered mail should the bank choose to make use of this exception. Further, the bank would be required to pay interest on these special funds to the Ministry.⁷⁰

The National Monetary Commission, Jekyll Island and The Federal Reserve

Following the Panic of 1907, the U.S. Congress voted to appoint a commission. Its mandate was twofold: to investigate the causes of the crisis and to propose measures to prevent a similar crisis in the future. Senator Nelson Aldrich was appointed chair of the commission — a potentially incendiary choice considering the widely-held belief that Aldrich had profited wildly from his Senate position.⁷¹ Despite the appearance of a lack of integrity by the commission chair, the study nevertheless proved exhaustive.

Four years later, the commission delivered its findings. The 1912 report concluded that the panic was due to the absence of a central banking authority similar to those of other nations. In particular, the commission cited instances when the Bank of England, the Banque de France and Germany's central bank, the Reichsbank, had intervened in the economy to prevent widespread panic and loss of confidence in those countries' financial systems.⁷² As such, Aldrich proposed legislation that the United States develop some manner of central bank.

The public perception was that the National Monetary Commission was responsible for suggesting the creation of a central bank. However, some argue that the actual bill was drafted by an elite group of business executives at a secret meeting at an exclusive club on Jekyll Island — a private island off the coast of Georgia. The club was founded by John D. Rockefeller, J.P. Morgan, William Vanderbilt and Silas McCormick. The secret meeting that took place there has been dubbed the Jekyll Island Conspiracy. Some evidence appears to indicate that a meeting did take place and it is possible that the legislation may first have been conceived there. However, the significance of Jekyll Island remains a point of dispute.

⁷⁰ *Journal of the Canadian Banking Association*, Vol. 16, p. 160.

⁷¹ Markham, p. 42.

⁷² *Ibid.*, p. 43.

It is alleged that the group,⁷³ which met at the club under the guise of a duck hunting expedition, proposed that the new system be set up as a bank for the banks and therefore controlled by private bankers.⁷⁴ Although that provision was watered down with some government oversight, the Federal Reserve Act of 1913 mirrored for the most part the secretly-penned plan from Jekyll Island. Regardless of the origins of the proposed legislation, a key element of the commission's report was that the new U.S. central bank would not be controlled by government.

Conclusion

The bank failures that occurred during this period raise questions about bank regulation in Canada. Between 1908 and 1913, two additional bank failures occurred. The most serious case was the collapse of the Farmers Bank in 1910, when creditors lost nearly \$1.5 million. The failures during these years led to revisions to the Bank Act in 1913. One key change to be implemented included the appointment of individuals as independent auditors. However, the revisions did not include government inspection of banks. That provision was not introduced until after the 1923 failure of the Home Bank.

Although the position of Superintendent of Insurance had existed for many years, no formal bank regulator in Canada was established until 1925. This point was noted by American financial authority Charles Francis Phillips. He stated enviously that banks in Canada “are free from the menace that lies in the interference of the Government with banking.”

This view was clearly shared by the Canadian Bankers Association, which resisted any Crown influence. The association appeared to act as the *de facto* regulator, with banks being required to notify the association president and the Minister of Finance if they made use of the special seasonal liquidity fund available to finance the fall harvest. This arrangement placated the Canadian public, and the period's only lasting impact was a slate of small revisions to the Bank Act. The United States, by contrast, experienced such backlash from the same crisis that the country required a major overhaul of its system culminating in the creation of a central bank.

As recently as the late 1920s, the events of 1907 were described as a “financial crisis” in Canada. Sometime between then and now, these events fell off the public radar. The 1907 credit crisis, with its accompanying sharp decline in GDP per capita and stock market values, has been mostly forgotten. A review of the public records of the time reveals not only that there was a very real crisis, but also that Canadians were protected by the quality of their banking system. Meanwhile, the Americans were required to take much more drastic steps to maintain financial stability.

⁷³ The men were Aldrich, Paul Warburg (Kuhn, Loeb and Co), Henry Davison (Bankers Trust), Frank Vanderlip (National City Bank), Benjamin Strong (Bankers Trust) and Walter Andrews (Assistant Secretary to the Treasury).

⁷⁴ Markham, p. 43.

Questions

While many writers compare the financial events of 2008 to the circumstances of the Great Depression, the events of 2008 actually resemble the Banker's Panic of 1907 more than they do the Depression of the 1930s. Review the case and the article by Peter Dungan ("The Financial Crisis of 2008 and the 'Real' Economy: Damage but Not Disaster," in *The Finance Crisis and Rescue*, Rotman School of Management and University of Toronto Press, 2008, pp. 81–94) and consider the following questions:

1. In an examination of both the 1907 and 2008 crises, explain how the causes and effects of the crises on Canada's economy were similar. How were they different?
2. Dungan describes the positive effects that central banks have on the economy. Why do you think the 1907 crises led to the creation of the US Federal Reserve, but not to the establishment of a central bank in Canada?

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