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# I N D U S T R Y P R O F I L E

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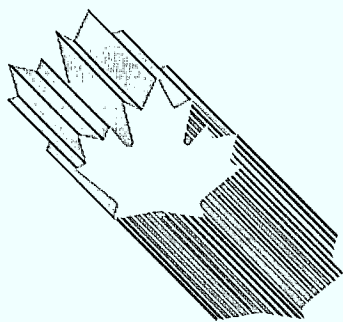


Industry, Science and  
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## Banking

Canada



# I N D U S T R Y P R O F I L E B A N K I N G

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## FOREWORD

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In a rapidly changing global trade environment, the international competitiveness of Canadian industry is the key to survival and growth. This Industry Profile is one of a series of papers which assess, in a summary form, the current competitiveness of Canada's industrial sectors, taking into account technological and other key factors, and changes anticipated under the Canada-U.S. Free Trade Agreement. Industry participants were consulted in the preparation of the papers.

The series is being published as steps are being taken to create the new Department of Industry, Science and Technology from the consolidation of the Department of Regional Industrial Expansion and the Ministry of State for Science and Technology. It is my intention that the series will be updated on a regular basis and continue to be a product of the new department. I sincerely hope that these profiles will be informative to those interested in Canadian industrial development and serve as a basis for discussion of industrial trends, prospects and strategic directions.

Minister

## Introduction

Canada has a sophisticated and well-developed financial system composed of a variety of institutions that provide diverse financial services. Increasingly, the different types of financial institutions are expanding the range of services they provide to business and the public. As a result, many competitive services are now being offered by these institutions and traditional boundaries among the financial sub-sectors are becoming blurred. This profile focuses specifically on the activities of commercial banks regulated under the federal *Bank Act*.

Banks are financial intermediaries. There are, however, other financial intermediaries, including trust and mortgage loan companies, credit unions and caisses populaires, which are often called near banks. Although banks share many functions with other intermediaries, such as accepting deposits and providing personal loans and mortgages, they generally differ in that they are empowered to provide short-term commercial financing, including loans and letters of credit. Most other financial institutions have limited commercial lending powers.

While market definitions are blurring, banks are still the main sources of financial services. Banks normally offer: chequing accounts; loans, with or without security; credit cards; financial leasing; and banking-related data processing services. They also handle foreign trade-related financial transactions, maintain safe-deposit facilities and accept deposits. This profile will selectively examine three broad market segments that encompass most banking activities — retail (personal); domestic-commercial operations; and international-commercial operations.

## 1. Structure and Performance

### Structure

Banking is one of the most heavily regulated industries of the economy and plays a central role in transmitting monetary policy. Banks are in a unique position of trust in handling the public's funds and their stability depends highly on consumer confidence. Banking regulations, therefore, seek to ensure bank solvency and maintain public confidence in the banking system. Jurisdiction over banks and the banking system is the sole responsibility of the federal government, although provincial governments have jurisdiction over certain matters, such as securities law, contract law and consumer-protection issues. Federal banking legislation, called the *Bank Act*, is subject to parliamentary review and revision every 10 years.

Canadian banks are chartered under the *Bank Act* and listed in Schedule A or B of that Act. The distinction between Schedule A and B banks is based on the diversity of the public distribution of their shares. Schedule A banks are widely held — no investor can own more than 10 percent, and no group of non-resident investors can own more than 25 percent. As a result, Schedule A banks are Canadian-owned. Schedule B banks are, with one exception, closely held subsidiaries of foreign banks. There is virtually no difference in the services Schedule A and B banks may offer. As of July 1988, there were eight domestically owned banks (seven Schedule A and one Schedule B) and 58 foreign bank subsidiaries (Schedule B only).

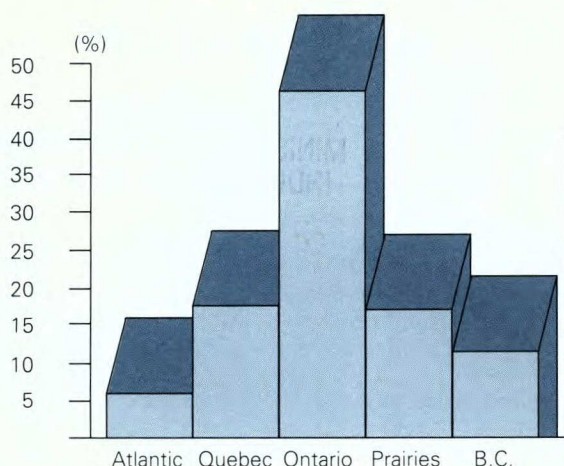
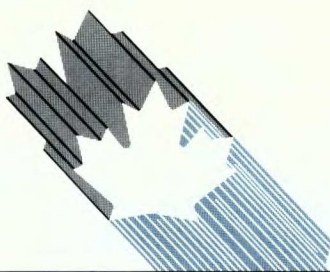
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**Employment by Region  
1987**

(Total 162 850 — Schedule A banks only)

The 1980 *Bank Act* allowed foreign banks to operate in Canada but required them to establish subsidiaries (Schedule B banks) or representative offices. Foreign bank subsidiaries can be closely held indefinitely, but their combined domestic assets cannot exceed 16 percent of the total domestic assets of the Canadian banking system. The size of individual banks is controlled through regulatory approval of their capital bases. Schedule B banks are small compared to domestic banks, due to competition from Schedule A (domestically controlled) banks and other sources of commercial financing, together with the regulations outlined above.

The banking industry in Canada is characterized by a few very large banks and a number of smaller ones. The six largest banks (the "Big Six") held total assets (domestic plus foreign) of \$437 billion at the end of 1987, or almost 90 percent of the total assets of all Canadian banks (\$486 billion) — ranging from \$104 billion for the Royal Bank to \$31 billion for the National Bank. Schedule B banks held assets of \$44 billion (nine percent), while the small Schedule A bank held the remaining one percent. In 1987, Schedule A banks employed 162 850 people in Canada and Schedule B banks another 4400 people. Schedule A banks are large even by international standards.

Asset holdings are often used as indicators of the relative positions of the different financial institutions. Banks account for 38 percent of the assets held by Canadian financial institutions; other deposit-taking institutions, 18 percent; contractual-savings institutions, 26 percent; and other financial institutions, 18 percent.

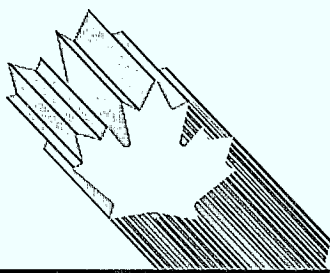
Retail banking has traditionally required a local presence. Thus, Schedule A banks operate nationwide branch systems which provide a full range of services over a large geographical area. At the end of 1986, there were almost 7000 branches serving 1700 communities in all provinces and territories. The distribution of banking reflects the population and economic activity, with headquarters concentrated mainly in Ontario, Quebec and British Columbia. The dominant position of banks is also reflected in the fact that branches represent about 57 percent of retail outlets provided by all financial institutions.

Fluctuations in exchange rates, inflation and interest rates, which were characteristic of the last 15 years, complicate cross-border comparisons of banks. Nevertheless, Schedule A banks are large even by international standards and the "Big Six" have consistently placed among the largest worldwide in terms of assets. In 1985, the "Big six" ranged in rank from 32nd (Royal Bank) to 144th (National Bank). Two years later, Canadian and American banks declined in rank relative to Japanese and German banks, due to changes in relative currency values. Canadian banks now rank from 57th to 168th worldwide. However, Canadian Schedule A banks are better capitalized than many of their international counterparts.

### Performance

The relative importance of banks as a source of financing and other financial services for Canadian businesses and consumers varies with changing economic and financial conditions. In general, the growth of banks and deposit-taking near banks is closely related to the growth rate of credit demand. This is because loans are their primary asset.

A recent study by a Canadian securities firm showed that bank profitability, measured as an average return on shareholders' equity, is low compared to other financial institutions such as trust companies, life insurance companies and investment dealers. Over the last six years, the profitability of domestic banks, at 11.6 percent, is several percentage points below that of large trust companies. In general, bank profitability, as a return on equity, falls within the middle range for selected Canadian industries.



Canadian banks have been subject to the same market pressures as their counterparts in other countries. A recent survey by *Banker* magazine examined the capital strength and profitability, since 1970, of the world's biggest banks. The main findings were as follows. First, profitability and capital strength have been progressively reduced. Second, increased leverage (lower ratios of capital to assets) helped to maintain pre-tax profitability at relatively high levels. Third, the rate of deterioration in profitability and capital strength has slowed down in the mid-1980s. Fourth, the "biggest" banks operate on thinner margins than smaller banks. Canadian banks also experienced many of these trends. However, since 1981, Canadian banks have increased their capital bases, reduced their leverage ratios, increased reserves against problem loans and maintained relatively constant rates of return.

### Retail Operations

#### *Deposits*

While banks dominate the Canadian marketplace, the general trend has been for near banks to intrude into traditional banking markets. Throughout the 1960s and 1970s, the banks' share of the deposit market held at around 68 percent. In the 1980s, increased competition from near banks drove the banks' market share down to 62 percent by the end of 1987. Over the same period, trust companies increased their market share from 18 percent in 1967 to 24 percent in 1987. Credit unions and caisses populaires remained relatively constant at around 14 percent.

Through aggressive competition, near banks have increased their deposit business a number of ways. They have expanded the range of deposit accounts and broadened the availability of branches and hours of operation. Extended hours offered to the public by near banks, beyond the traditional "banker's" hours of 10 to three, have forced banks to respond by altering their hours of operation. Multi-branch banking has allowed banks to provide services outside traditional core hours, with only a proportion of a bank's branches open. Banks have also made more automated banking machines available to help them meet the competition.

The extension of deposit-insurance coverage, in 1967, to trust and mortgage loan companies has also helped increase public acceptance of the near banks and smaller institutions. Co-operatives also provide insurance on deposits in credit unions and caisses populaires.

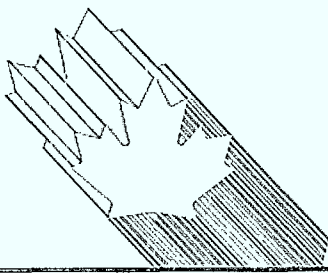
While their relative share of the deposit market has declined, banks have been highly successful in certain other areas. For example, Registered Retirement Savings Plans (RRSPs) have been available since the mid-1950s, but the public did not show much interest in this investment option until the mid-1970s when more favourable income tax treatment was introduced. This market has been growing rapidly, with Canadians investing approximately \$7 billion to \$10 billion in RRSPs each year. Banks used to play a relatively minor role in the RRSP market, but amendments to the *Income Tax Act* have allowed them to become more directly involved. In the past few years, the banks' share of the market has been increasing and their RRSP dollar deposits are approximately equal to those of the trust companies.

#### *Credit*

Chartered banks are the major suppliers of consumer and commercial credit in Canada. While business loans constitute the largest item in their asset holdings, mortgage loans have been the fastest growing asset on their balance sheet since 1967 — rising to become the second largest balance-sheet component. Consumer loans, meanwhile, have increased only marginally as a share of bank assets, although banking has significantly increased its share of that market. Consumer loans now rank behind mortgage loans as a balance-sheet component. Most financial institutions report consumer loans and mortgage loans separately, even though most mortgage loans are to consumers for home purchases.

Consumer loan demand has remained relatively stable and, given the lack of growth in the banks' commercial lending, consumer loans have assumed an increasingly important role in the banks' lending activities. During the current business cycle, mortgage loans have been a growth market and competition has been intense. At the end of 1986, the banks' share of the residential mortgage market was 37 percent, up from 33 percent two years before. The market share of the trust companies remained at 31 percent. Over this period, credit unions also maintained a steady 15 percent of the market, while life insurance companies and other lenders (i.e., pension funds) lost market share. Institutional mortgage lenders must also compete with informal lending arrangements in which residential mortgages are provided on a private basis. While the size of the informal market is difficult to estimate, the absolute dollar amount is believed to be significant.





The banks have been able to increase their share of the mortgage market by narrowing lending spreads, aggressive marketing and promotion, and new product development. Competition in this market has given consumers much greater choice than they had 10 years ago. Whereas the standard mortgage typically involved monthly payments, consumers now have the option of weekly, biweekly and monthly payments.

The entry of banks into the personal lending market through direct lending has resulted in more readily available credit and in lower personal loan rates. The outcome has been the virtual elimination of small loan companies from this market. At the end of 1986, the banks supplied 63 percent of consumer credit, while the finance companies' share was six percent.

### **Commercial Operations Overview**

While retail and commercial credit markets are distinct for banks, competition in both is intense and new entrants in financial services continue to appear. One difference between these markets is the relative size of some of the borrowers. In commercial credit markets, also called wholesale markets, the large size of many borrowers allows them to use alternative methods of raising funds, such as share issues. Large borrowers also have the option of raising funds outside Canada.

Changing economic conditions of the past decade have resulted in the appearance of new products and services (such as interest rate and foreign exchange swaps) in international capital markets. Close links with international markets ensure that these new services will be introduced into domestic markets.

Banks in most of the industrialized countries have faced a number of common trends. Traditionally, they have had a comparative advantage in extending loans because of their expertise in assessing the credit worthiness of borrowers and in enforcing the terms and conditions of outstanding loans. However, many institutional investors with large portfolios are now performing their own risk assessments and placing their funds directly with corporate borrowers.

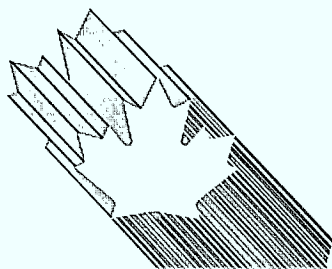
A second major trend has been a shift by borrowers away from bank loans. During the late 1970s and early 1980s, many large corporations increased their debt/equity ratios to finance takeovers and additions to capacity. Much of this increased debt load was financed through bank loans. Since the recession, there has been almost continuous improvement in corporate capitalization, with the proceeds of new share issues often being used to pay off outstanding debt. At the same time, the complexity of lending arrangements increased as corporations indicated a growing preference for marketable short-term debt. This migration from bank loans to the commercial paper and bankers' acceptance market, as well as other short-term debt, reflects, in part, the results of banks increasing their interest rate spreads to provide more prudence for potential loan losses. Although direct lending declined, banks were increasingly able to earn income from such fee-generating activities as bankers' acceptances.

While banks worldwide were experiencing declining demands for commercial loans, changing economic conditions, such as the sharp decline in equity markets in October 1987, can quickly change comparative advantages. Since that time, corporations have been reviewing their financing options and often have returned to such traditional means of financing as bank loans.

Changing conditions in world financial markets have slowed the global drift towards the securing of debt (corporations moving away from bank loans and toward debt instruments that can be traded). Corporate treasurers and government borrowers will still want the extra flexibility provided by these newer instruments. Banks have sought ways to expand their commercial financing activities outside of traditional banking. As a result of regulatory changes introduced in June 1987, four large Schedule A banks purchased interests in four of the largest Canadian securities firms. These domestic acquisitions complement their foreign investment activities.

### **Domestic-Commercial Operations**

Domestic-commercial credit markets cover a wide range of borrowers — local, small businesses, large firms operating across Canada and different levels of government. Financial institutions in Canada have responded to new financial products and services developed internationally by providing similar services to their large corporate customers. Banks offer similar services to their domestic and foreign customers. However, the *Bank Act* allows them to engage in a wider range of activities in foreign markets than domestically.



Banks are the primary source of financing for small businesses and provide them with a range of support services. Larger Canadian companies rely on the banks for short-term working capital and a broad range of other services, such as treasury, cash management and trade finance services. The regulatory changes of June 1987 permit banks to expand their commercial services to include underwriting and distribution of corporate securities. Banks also underwrite and distribute the debt issues of Canadian governments and Crown corporations and invest their surplus funds in government and corporate securities.

While Schedule A banks are the main suppliers of commercial credit, foreign banks have had a presence in this market in Canada for many years. The 1980 *Bank Act* acknowledged the influence of foreign financial corporations (which subsequently became Schedule B banks) and the increased competition that their operations have successfully provided in the commercial credit markets. Schedule B banks have focused on wholesale banking operations, in part due to their market share and capital restrictions, and the practical difficulties involved in establishing retail branch networks. Also, many Schedule B banks are oriented towards investment banking services, which generate fee income and often do not commit capital for long periods. Several Schedule B banks and foreign securities dealers have been active in the large dollar-value transactions of the securities market in an attempt to gain a foothold before anticipated deregulation in the other market segments.

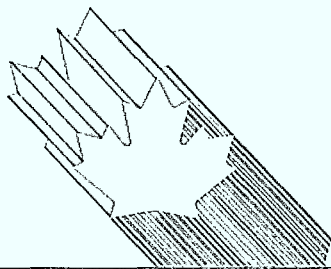
Competition in commercial markets has been intense as trust companies, life insurance companies and securities dealers have also been seeking to expand their share of commercial financing. With slower growth in commercial lending, Schedule A banks have focused their efforts further on the small business market. While beneficial for corporations seeking funds, the intense competition has been a factor in the poor earnings of several Schedule B banks. In 1987, aggregate profits of Schedule B banks dropped 72 percent to \$19.8 million from \$73 million in 1986. The 1987 results follow a 34 percent decline in the previous year from the 1985 peak of \$110 million. Schedule A banks have an advantage in that their retail deposit bases provide them with stable sources of funds, often at lower costs than the wholesale money markets upon which the Schedule B banks rely.

### International-Commercial Operations

Canadian-owned banks are very active abroad. They accept deposits, extend loans, participate in the underwriting of corporate securities and loan syndications, and provide new products such as interest rate and foreign exchange swaps. Schedule B banks can hold foreign currency assets, but are prohibited by the *Bank Act* from establishing branches abroad. In 1987, the banks' foreign currency assets were \$192 billion (39 percent of total assets) — more than a fourfold increase over 10 years. The importance of their international operations varies from bank to bank, from a low of 33 percent at the National Bank to a high of 55 percent at the Bank of Nova Scotia. The banks' foreign currency liabilities are approximately equal to their foreign currency assets. Canadian banks operate through more than 200 foreign branches and many subsidiary and agency offices. They also have correspondent relationships with more than 5000 financial institutions worldwide. Banks refer customers to their correspondent banks when they cannot provide a service in other countries.

The consensus among the major players in the international financial community during the 1980s was that a good way to do business was to be all things to all markets. The significant increase in competition in international financial markets over the past two or three years and the October 1987 crash have forced financial institutions to re-examine their business strategies. As a result, the banks are retrenching and looking for market niches. Some Canadian banks have withdrawn or reduced operations in a number of European markets. For example, Canadian banks have earned meager profit margins in the highly competitive London market and have found it very difficult to establish more than a token presence in the Japanese market. Thus, they are now reducing or re-assessing their market presence in these countries. Banks in the United States, the United Kingdom (U.K.) and other countries have had similar experiences in various markets.

Canadian banks are combining the operations of their recently acquired investment dealers with their remaining international operations. All banks, not just those in Canada, are also sharpening their international thrusts towards specific markets where they feel they have an edge. The competitive conditions in the international financial markets have also resulted in most banks placing a greater focus on their domestic marketplace. Canadian banks are probably concentrating more on domestic markets now than they have in the past five to six years. This reflects the fact that the strength of the Canadian banking system is in its branch networks and that it is the domestic banking side which has helped to maintain the banks' profitability over the last five years.



## 2. Strengths and Weaknesses

### Structural Factors

For a service industry such as banking, strengths and weaknesses can be assessed in terms of the efficiency and effectiveness of its performance and of its efficiency relative to counterparts abroad. Key factors that determine a bank's effectiveness are marketing skills and the ability to meet consumer (commercial and retail) demands with respect to price, service, convenience and product. As mentioned earlier, competition from near banks has been an important determinant of industry efficiency.

A number of structural and regulatory changes have influenced competition in the financial industry. During the early 1980s, changes in ownership of independent trust companies often resulted in new management and corporate strategies, and more aggressive pursuit of new business. Non-bank financial institutions may now become part of a financial holding company. The federal and provincial governments also propose to enhance greatly the trust companies' ability to enter the commercial lending market. These regulatory changes can be expected to increase competitive pressures on the banks.

All competitors, not just banks, have been forced by the current environment to react more quickly to market pressures. When competitors developed new products, banks usually responded quickly with similar products. As a result, competition is now strongly characterized by product differentiation.

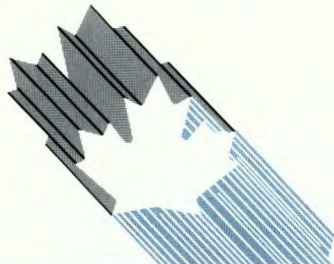
While inroads have been made by near banks into traditional banking markets, banks themselves have also been quite successful in expanding into other markets. They have benefited from the sunset provisions of the *Bank Act* which ensure a regular parliamentary review of Canadian banking legislation every 10 years. As a result, the business powers of banks have been adjusted periodically in response to developments in financial markets to bring them in line with current market opportunities. The legislation governing other federally regulated financial institutions has not been regularly viewed in the same manner, and this has given banks a competitive advantage relative to these institutions.

Many customers do not want or need the entire package of services offered by financial institutions. In response to competitive pressures, many have re-examined their pricing practices, unbundled their service packages and now price many services individually. Increased competition in most markets has also resulted in banks looking towards fee income to increase their corporate profits. "Other income" of Canadian-owned banks increased from \$1822 million in 1981 to \$3601 million in 1986, an annual growth rate of 14.6 percent. Over the same period, net interest income (before loan-loss provisions) increased from \$6993 million to \$10 962 million, an annual growth rate of 6.1 percent. Prices for bank services are generally not regulated and at least part of the increase in revenues over the period is due to higher fees for services. The rapid rise in some service fees has, in the past, resulted in public criticism and reviews by parliamentary committees.

International financial markets played an important role in the 1970s in the recycling of petrodollars, with a significant proportion of the funds placed with loans to foreign governments, particularly less-developed countries (LDCs). The recession and high interest rates of the late 1970s and early 1980s resulted in increasingly difficult problems for many of these sovereign borrowers. In the early 1980s, several countries announced that they could not cope with their debt loads.

The reaction in Canada, the United States and several other countries has been to increase reserves against doubtful loans. For 1988, the Canadian Office of the Superintendent of Financial Institutions (OSFI) has asked banks to increase their reserves to between 35 percent and 45 percent of outstanding LDC loans. The 1987 level was between 30 percent and 40 percent. By the middle of the 1988 fiscal year, the banks had attained an average of 40 percent. This figure compares favourably with the performance of major U.S. banks which have established reserves of between 20 percent and 30 percent of their LDC exposure. Canadian banks have also been reducing their total LDC exposure through loan sales for cash to other banks and corporations and/or debt-for-equity swaps. Nevertheless, the LDC debt situation will confront the financial community for many more years.





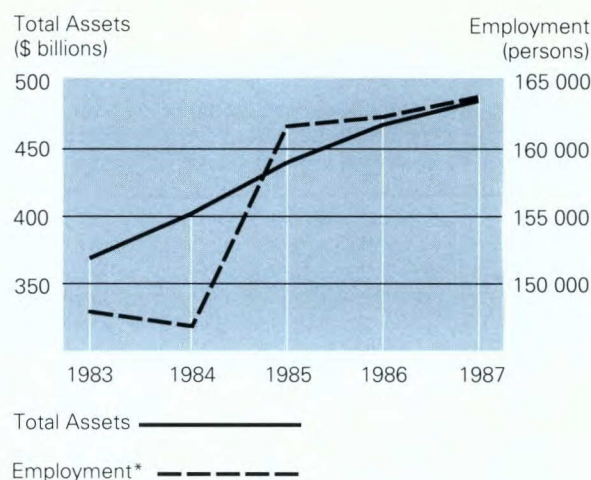
As part of the general trend toward a revised regulatory regime in the financial industry, all financial institutions, not just banks, are considering expanding their business lines. However, one of the major regulatory concerns is the adequacy of the capital base which will support the expansion of the financial institutions' activities. This concern is worldwide and bank regulators in a number of countries recently signed an agreement that will apply universal capital standards to all banks (the Bank for International Settlements (BIS) Common Capital requirements) by 1992. Canadian banks are in the process of raising additional capital and are well positioned to meet the 1992 deadline. The BIS requirements will also ensure that major financial centres do not use more lenient supervisory practices as a factor in competing for banking business.

Banks wishing to exploit the new opportunities presented by the revised regulatory regime will have to raise more capital. They must also raise additional capital to deal with LDC debt loads and other financial risks. In the near future, most Canadian and foreign banks will have to rely on their own profits as their main source of capital. This trend comes at a time when banks will need increased capital if they are going to realize their expansion plans.

#### Trade-related Factors

Tariff barriers and the usual trade remedies do not generally apply to services, while the trade impediments that do exist are often regulatory in nature. As a result, the main issues for banks, as for all service industries, are transparency, national treatment, right of establishment, non-discriminatory accreditation procedures and labour mobility.

In a general services framework, transparency ensures that government measures affecting service industries are developed and maintained in a clear and predictable manner, and that information on such measures is readily accessible and made known to all interested parties on an equal basis. National treatment generally requires that foreign service providers receive treatment no less favourable in like circumstances than that accorded to domestic service providers. Right of establishment allows foreign investors to establish branches, agencies, subsidiaries or representative offices, subject to regulatory and prudential approval.



**Total Assets and Employment**

\* Schedule A banks only.

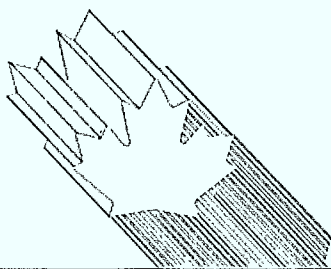
The provisions of the Canada-U.S. Free Trade Agreement (FTA) preserve the access that financial institutions have to each other's markets. Both countries have agreed to continue liberalizing the rules governing their respective financial markets and to extend the benefits of such liberalization to institutions controlled by the other country. The commitments made under the Financial Services chapter of the FTA affect only the federal legislation of the two countries. Under the FTA, U.S. operations of Canadian banks will be guaranteed the same rights as U.S. banks in the event of an amendment to the *Glass-Steagall Act*, which now prevents banks in the United States from engaging in some activities in the securities markets. Canadian banks will be able to trade and distribute, in the United States, securities issued or guaranteed by Canadian governments or their agencies. Canadian banks will also be allowed to continue their interstate banking operations indefinitely, which would be subject to review in the absence of the FTA.

Under the terms of the FTA, Canada will exempt U.S.-owned Schedule B banks from the 16-percent market share ceiling and associated restrictions on the size of individual banks. Also, under the agreement, U.S.-owned Schedule B banks will be exempt from the requirement that the Minister of Finance approve new branches.

The current *Bank Act* provisions that limit individual shareholdings of Schedule A banks to a maximum of 10 percent of outstanding shares will be retained under the FTA. However, U.S. shareholders would be exempt from the 25-percent limit on foreign shareholdings.

Financial services, other than insurance, will not be subject to the agreement's dispute-settlement mechanisms. Rather, there will be a consultative mechanism between Canada's Department of Finance and the U.S. Treasury.





### Technological Factors

Banking is an information-based industry that depends on technology to deliver services quickly, efficiently and at a reasonable cost. Banks could be placed at a competitive disadvantage if their technical support systems are not up to date. Canadian banks have made extensive investments in technical systems that are equal or superior to those of their domestic and international competitors.

Since computers first made their way into banking in the 1960s, banks have kept themselves in the forefront of technology. Initially, bank automation was to help the backroom operations (especially the cheque-clearing system) cope with the growing volume of paper. Over time, technology has spread through the banks, and computers no longer play a solely administrative role. Banks now have massive data-processing departments, often employing thousands of highly paid and trained staff.

Canada's financial institutions use computer technology in a vast array of new services to meet their customers' ever-changing needs and demands. Companies, large and small, are increasingly computerizing their day-to-day operations. Banks have responded to this trend by providing their corporate clients with products such as electronic cash management, automated payroll processing, capital-markets financing, and foreign exchange and money market services. Many of these products are available to corporations and governments through computer links between banks and clients.

Consumers have also benefited from the use of technology in product design. A partial list of computer-based products would include: daily interest on deposits; multi-branch banking; on-line customer records; automated banking machines; point-of-sale terminals; fast information retrieval; and fast credit authorization.

As Canadians have become more receptive to using automated banking machines (ABMs), financial institutions have expanded their ABM networks. Initially, the large banks developed their own ABM networks. However, in response to increasing consumer demand and rising costs, banks and other financial institutions integrated their networks in the mid-1980s. Bank customers now have access to several shared ABM networks. For example, Interac, a network of ABMs shared with other financial institutions, became operational in 1986 with about 3900 machines. Some Canadian bank customers may also have access to over 10 000 machines in the United States through the Plus System, Inc., and 19 000 machines through the CIRRUS network.

There is no doubt that technological innovations, such as ABM networks, have enhanced customer convenience and have made the system more efficient by reducing paper burden. While there are significant gains from the application of such innovations, investments in technology are costly and expensive to maintain. In this regard, technology-related costs are at, or close to, the top of the banks' capital-goods expenditures, with data-processing systems accounting for as much as 11 percent to 12 percent of their non-interest expenses.

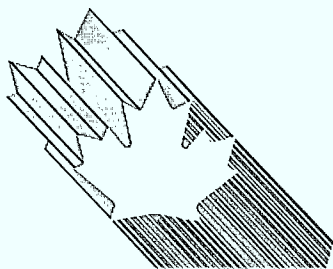
Banks in Canada have been major users of new technological products such as personal computers and telecommunications networks. They have become heavily involved in software development because of its key role in the development and delivery of many new products and services. Banks' expenditures represent a large market. This provides the incentive for high-technology firms to improve their products for both financial institutions and the public.

The spread of ABMs illustrates the important role banks have played in the dissemination of technology within the financial community and the economy. This ongoing involvement with information technologies industries places the banks in a good position to respond to technological innovations.

### 3. Evolving Environment

World financial markets have changed in the ways they meet the needs of corporations, governments and individuals. The blurring of functions and markets has had an impact on all financial institutions, not only banks. Increasingly, financial institutions must devote more resources to strategic planning, new product development and technology in order to maintain their market shares. In addition, a recent trend has been noted that banks diversify their operations outside their "traditional" services into new activities -- off-balance sheet lending, Euro-market bond and equity underwriting, and corporate investment and management advice.

The federal government has initiated a review of legislation governing federally regulated financial institutions to help ensure that the Canadian financial system remains effective, efficient and competitive. On December 18, 1986, the Minister of State for Finance issued a policy paper entitled *New Directions for the Financial Sector*. The proposals it contains would allow banks, trust companies, insurance companies and securities firms to compete much more freely for shares of the financial services market. While giving far broader powers to financial institutions, the federal proposals recognize the need for greater regulatory clout and tougher rules for corporate self-government.



These proposals would break down traditional barriers among financial institutions and allow the development of diversified financial companies. Large institutions, like banks, would be required to expand into new businesses by setting up subsidiaries rather than acquiring existing institutions. The Minister of Finance would review mergers and acquisitions in the interest of the financial system.

Federal financial institutions would be given expanded business powers. Proposals to allow trust, loan and insurance companies to engage in consumer lending and, with regulatory approval, commercial lending, are of particular concern to banks. On the other hand, banks and insurance companies would be able to sell fiduciary services through a trust company subsidiary or affiliate. Federal financial institutions and their subsidiaries would be able to offer a full range of investment services.

Provincial governments also play a role in financial sector reform as they have jurisdiction over provincially incorporated trust companies, insurance companies and credit unions. Several provinces plan to review their legislation. There appears to be a general trend towards expanding the business powers of provincially incorporated financial institutions.

Banks face several challenges including increased competition from domestic and international sources; changes in the regulatory environment; doubtful loans to less-developed countries and resource-based firms; keeping abreast of changing technology; and the progress of the federal policy reform. Key elements for the banks will be the timing of the reform proposals, and changes in their business powers and the business powers of their competitors. While the complete legislative package has not been introduced, it will probably result in increased competition in all markets.

Canadian banks already enjoy virtually all the benefits of national treatment in the United States. The Canada-U.S. Free Trade Agreement (FTA) will help to preserve this situation. The U.S. operations of Canadian banks will retain their competitive position regarding their U.S. counterparts, and will receive the same powers and privileges as those granted U.S. financial institutions when the U.S. *Glass-Steagall Act* is amended. The slower pace of U.S. reform may delay some of the potential benefits from freer trade for banks.

The agreement will provide more immediate benefits to U.S. Schedule B banks as they will gain enhanced access to the Canadian marketplace. Attempts to increase their market share could result in increased competition. Also, the easing of the branch restrictions will make it easier for U.S. banks to pursue retail banking in Canada.

The presence of Schedule B banks has added an extra dimension to competition in Canadian financial markets. However, the extra competition from U.S. banks due to the FTA will be limited for Schedule A banks.

The banks will benefit from the general impact of the FTA on the economy. The stronger performance of Canada's economy will benefit banks as the volume of their business is closely linked to economic activity. Improvements in employment, real wages and production will increase the demand for banking services. The expansion of Canadian companies will also provide the banks with more business opportunities. This could include financing investments in new plants and equipment, and financing new trade opportunities and expansions of U.S. operations by Canadian businesses. For all these reasons, the FTA means more opportunities for banks.

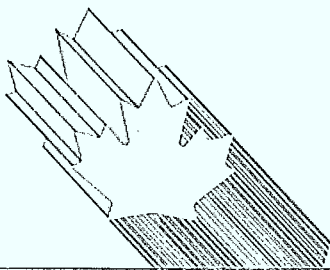
#### **4. Competitiveness Assessment**

In the market for retail banking services, banks and non-banks provide virtually identical services and competition has been keen. Banks will have to make their retail product lines different. As their performance in the mortgage and consumer credit markets indicates, banks have been successful in developing and protecting new markets and will likely continue to do so. Several new products, such as weekly-pay mortgages and daily-interest savings accounts, had their origins with other financial institutions. Banks, however, quickly developed similar products which were rapidly diffused throughout the market.

Banks also benefit from their large size and associated financial resources which allow them to implement new products and technologies quickly. This is illustrated by the important role banks played in the spreading of automated banking machines and technology within the financial community and the economy.

With the recent weakening of equity markets, the banks' traditional commercial lending and risk assessment activities have again become of key importance. The re-examination of financial options by business firms represents an opportunity over the next few years for banks to recoup some of the business they had lost through the securing of debt.





Foreign banks have had a presence in Canada for many years. They have successfully increased competition in commercial credit markets, especially commercial paper and bankers' acceptances, and lowered the cost of funds for corporations. In addition, after policy reforms are implemented, trust companies and life insurance companies may also be competing directly in this area. However, banks should be able to retain their competitive position, as their additional powers to own securities firms and provide trustee services will allow them to offer more comprehensive packages to their corporate clients.

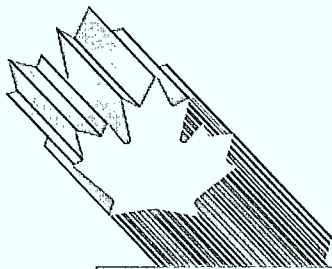
Canadian banks are also well positioned to respond to the challenges of intense competition in international credit markets and LDC debt problems. They already have the size, financial resources and international networks to compete abroad. Also, they have substantially increased their reserves against their LDC loans, and LDC debtors appear to be honouring their obligations, at least for the foreseeable future. Canadian banks have also strengthened their capital bases in order to compete for international business. Unlike the banks of several countries, Canadians already meet the 1992 BIS capital requirements for core capital.

Canadian banks face a number of challenges and issues. A partial list would include problem loans to less-developed countries and energy-related companies; new financial products that have shifted the commercial credit markets; and uncertainties in the Euro-markets and in regulatory environments. These challenges and issues are universal and all banks, not just Canadian, must face them to varying degrees. Canadian banks are well positioned to respond positively to these challenges.

For further information concerning the subject matter contained in this profile, contact:

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**PRINCIPAL STATISTICS**

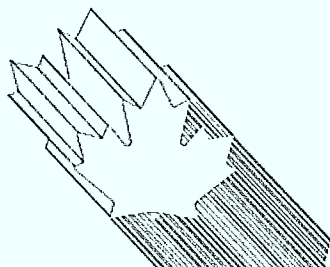
	1983	1984	1985	1986	1987
Canadian-owned banks	13	14	12	8	9
Foreign-owned banks	58	58	57	59	59
Employment (A banks only)	148 184	146 746	162 163	162 667	162 850
Total assets (\$ billions)	368.6	405.6	443.8	468.0	486.0
Canadian \$ assets (\$ billions)	211.9	222.8	241.8	260.7	294.5
Foreign \$ assets (\$ billions)	156.7	182.8	202.0	207.3	191.5
as % of total assets	42.5	45.1	45.5	44.3	39.4
Foreign \$ liabilities (\$ billions)	160.2	187.3	205.0	207.7	200.4

**REGIONAL DISTRIBUTION — 1987**

	Atlantic	Quebec	Ontario	Prairies	B.C.
Branches — % of total	8.4	18.3	40.2	20.9	11.8
Canadian \$ assets — % of total	5.6	17.6	48.4	17.4	11.0
Canadian \$ assets (\$ billions)	16.4	51.6	142.2	51.4	32.4
Employment — % of total	6.3	18.2	48.0	16.4	11.1
Employment — ('000)	10.3	29.5	78.0	26.6	18.1

(continued)



**MAJOR BANKS**

Name	Ownership	Employment (1987)	Location
<b>Schedule A Banks</b>			
Royal Bank of Canada	Canadian	42 839	Nationwide
Bank of Montreal	Canadian	34 482	Nationwide
Canadian Imperial Bank of Commerce	Canadian	33 874	Nationwide
Bank of Nova Scotia	Canadian	26 187	Nationwide
Toronto Dominion Bank	Canadian	21 710	Nationwide
National Bank of Canada	Canadian	11 550	Nationwide
<b>Schedule B Banks</b>			
Lloyd's Bank of Canada	British	1 565	Nationwide
Citibank Canada	American	680	Ontario British Columbia
HongKong Bank of Canada	Hong Kong	1 453	Western Canada Ontario
Barclay's Bank of Canada	British	N/A	Nationwide

N/A Not available

Note: Statistics Canada and Bank of Canada data were used in compiling the above figures.

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