Banking

INDUSTRY PROFILE

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

1990–1991

BANKING

FOREWORD

In a rapidly changing global trade environment, the international competitiveness of Canadian industry is the key to growth and prosperity. Promoting improved performance by Canadian firms in the global marketplace is a central element of the mandates of Industry, Science and Technology Canada and International Trade Canada. This Industry Profile is one of a series of papers in which Industry, Science and Technology Canada assesses, in a summary form, the current competitiveness of Canada's industrial sectors, taking into account technological, human resource and other critical factors. Industry, Science and Technology Canada and International Trade Canada assess the most recent changes in access to markets, including the implications of the Canada-U.S. Free Trade Agreement. Industry participants were consulted in the preparation of the profiles.

Ensuring that Canada remains prosperous over the next decade and into the next century is a challenge that affects us all. These profiles are intended to be informative and to serve as a basis for discussion of industrial prospects, strategic directions and the need for new approaches. This 1990–1991 series represents an updating and revision of the series published in 1988–1989. The Government will continue to update the series on a regular basis.

Michael Wilson

Michael H. Wilson
Minister of Industry, Science and Technology
and Minister for International Trade

Introduction

Canadians are served by a well-developed financial system in which a variety of institutions provide a diverse selection of financial services. Increasingly, institutions have been expanding the range of services that they provide to business and the public. This industry profile on *Banking* focuses specifically on the activities of banks chartered under the federal *Bank Act*. The profile examines three broad market segments that encompass banking operations: retail (personal), domestic-commercial and international-commercial.

Financial institutions now offer many competitive services, and the traditional boundaries among them are becoming blurred. Other financial intermediaries also accept deposits and provide personal loans and mortgages, but they generally differ from banks in that they have limited commercial lending powers. These "near banks"— trust and mortgage loan companies, credit unions and *caisses populaires* — are not covered in this profile. Industry profiles describing other financial services are available on

- *Life and Health Insurance*
- *Property and Casualty Insurance*
- *Venture Capital*

Structure and Performance

Structure

Banks are the main sources of financial services in Canada and provide over 100 retail financial services. These services normally include savings and checking accounts, loans with or without security, lines of credit, credit cards, financial leasing and banking-related data processing services. Banks also handle foreign trade-related transactions, maintain safe-deposit facilities and accept deposits.

Canadian banks are chartered under the *Bank Act*, which is subject to regular parliamentary review. Banking is one of the most heavily regulated industries in Canada; the goals of such legislation are to ensure bank solvency, to help banks remain effective, efficient and competitive and to maintain public confidence in the banking system. While the federal government has sole jurisdiction over banks and the banking system, provincial governments can influence banking activities through their securities law, contract law and consumer protection legislation.

The *Bank Act* lists banks under its Schedule I or Schedule II, according to the diversity of the public distribution of their shares. Schedule I banks are widely held; no individual investor can own more than 10 percent. Moreover, no group of non-resident investors, except U.S. investors, can own more than 25 percent of any class of shares. Therefore, the Schedule I banks are Canadian-owned. Most Schedule II banks are closely held subsidiaries of foreign banks. In March 1991, there were eight domestic banks (seven Schedule I and one Schedule II) and 58 foreign bank subsidiaries (Schedule II banks).

The banking industry in Canada consists of a few large banks and many smaller banks. As of 31 October 1990 the six largest banks held almost 90 percent of total Canadian bank assets of $584 billion. (Figure 1 shows assets for the calendar year.) Known as the "Big Six," these banks, ranked by asset size, are the Royal Bank of Canada, Canadian Imperial Bank of Commerce, Bank of Montreal, Bank of Nova Scotia, Toronto-Dominion Bank and the National Bank of Canada. Their total assets were $517 billion, ranging from $126 billion for the Royal to $36 billion for the National. The smallest Schedule I bank, the Canadian Western Bank, held less than 1 percent of total banking assets. Schedule II banks, including the Canadian-owned Laurentian Bank of Canada, held assets of $65 billion. In 1990, Schedule I banks employed more than 181 000 people in Canada and Schedule II banks another 7 600.

Retail banking traditionally requires a local presence. Schedule I banks operate nation-wide branch systems in a diverse range of markets, from very small villages to large metropolitan areas. At the end of 1990, there were about 7 400 branches serving 2 800 communities in all provinces and territories. These branches represent over 60 percent of the retail outlets provided by all financial institutions.

Chartered banks are the major suppliers of consumer and commercial credit in Canada. Business loans constitute the largest element of their asset holdings, followed by mortgage loans and consumer loans.

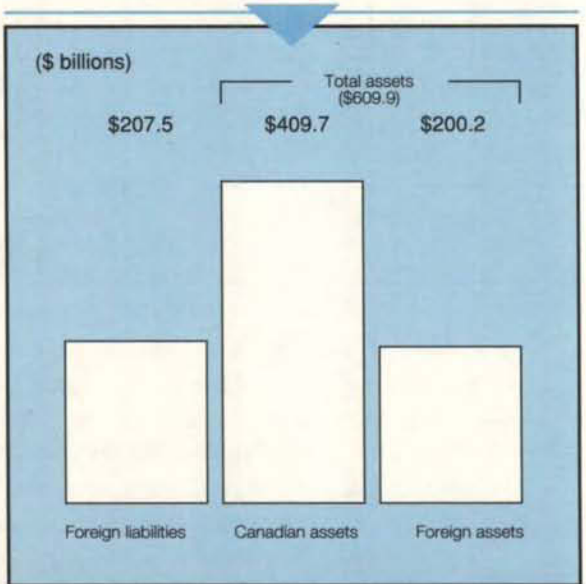

Figure 1 — Assets and Liabilities, 1990

The banks' retail and commercial credit markets are distinct, but the competition in both remains intense as new competitors continue to appear. A major difference between these markets is the relative size of the borrowers. In the 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 corporations and governments also have the option of raising funds outside Canada.

The banks' domestic commercial credit operations encompass a wide range of borrowers, including small businesses, large firms operating across Canada and different levels of government. Banks are the primary source of financing to small businesses and provide a range of support services. Larger Canadian companies rely on banks for short-term working capital and a number of other services such as treasury, cash management, trade finance services and the 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.

Banks face intense competition in commercial markets, as trust companies, life insurance companies and securities dealers also seek to expand their share of commercial financing. With the slower growth in commercial lending, Schedule I banks have focused their efforts further on the small business market. While the intense competition is beneficial for corporations seeking funds, it has put pressure

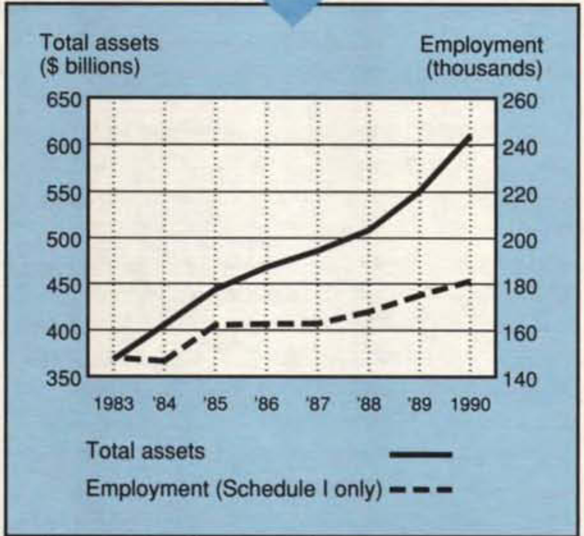

Figure 2 — Total Assets and Employment

on the earnings of several Schedule II banks. Schedule I banks also have an advantage in that their retail deposit bases often provide funds at lower costs than the wholesale money markets upon which the Schedule II banks rely.

While Schedule I 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 their influence and the increased competition that their operations have provided in the Canadian commercial credit markets. In allowing them to operate in Canada, the *Bank Act* requires the foreign banks to establish subsidiaries (Schedule II banks) or representative offices. Foreign bank subsidiaries can be closely held indefinitely, but their combined Canadian dollar assets, excluding those held by U.S.-controlled Schedule II banks, cannot exceed 12 percent of the domestic assets of the Canadian banking system. The size of individual banks is controlled through regulatory approval of their capital bases. Schedule II banks are small relative to domestic banks because of competition from Schedule I banks and other sources of commercial financing in addition to the limitations outlined above.

To compete with Schedule I banks, Schedule II banks tend to seek niche markets. Many focus on wholesale banking operations and try to attract Canadian customers by providing services that are not generally available at local banks. For example, one major Schedule II bank uses its home market expertise in factoring to purchase accounts receivable at a discount in return for assuming the risk of default. Schedule II banks are also oriented towards commercial banking services because of the practical difficulties involved in establishing large retail branch networks. Some Schedule II banks are in the Canadian market to better serve their international clients rather than to seek a share of the Canadian market. Not all Schedule II banks have succeeded in Canada, and some have withdrawn.

Canadian-owned banks are very active abroad. They operate through more than 200 foreign branches and many subsidiary and agency offices. They also have correspondent relationships with more than 5 000 financial institutions worldwide. 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. At the end of 1990, these banks' foreign currency assets were $200.2 billion, about 33 percent of total assets. Their foreign currency liabilities are approximately equal to their foreign currency assets. Canadian banks refer customers to their correspondent banks when they cannot provide a service in other countries.

Performance

The relative importance of banks as sources of financing and other financial services for Canadian businesses and consumers varies with changing economic and financial conditions. The growth rate of the banks' assets is closely related to the growth rate of credit demand, as loans are their primary asset. Total bank assets in Canada rose from $368.6 billion in 1983 to $609.9 billion in 1990 (Figure 2). Employment growth over the period has increasingly occurred in the more skilled positions.

Over the past decade, bank profitability has been lower than that of other financial institutions and a number of other corporate sectors in Canada. In 1989, the banks' rate of return was 8.08 percent, compared with 11.12 percent for the overall financial services industry. Over the period from 1980 to 1989, the average return on equity for domestic banks was 10.29 percent, compared with 11.99 percent for the other segments of the financial services industry. This rate of return placed the banks in 18th place among 34 corporate sectors.

Whereas in the early 1980s four of the Big Six banks consistently ranked among the 50 largest banks in the world in terms of assets, by the end of the decade their rankings had slipped to between 54th and 160th.

Worldwide banking pressures during the 1980s progressively pared the capital strength and profitability of the world's biggest banks. In response, Canadian banks reduced their emphasis on total asset holdings as a measure of success, strengthened their capital base and focused more on the profitability of each of their activities. Canadian banks also reduced their assets to capital ratios, increased their reserves against problem loans and sought to maintain relatively constant rates of return. As a result of these efforts, they now rank among the best-capitalized banks in the world. As measured by shareholders' equity, their rankings improve to between 32nd and 144th place.

In their retail operations, banks traditionally have dominated the Canadian marketplace for deposits. Throughout the 1960s and 1970s, the banks had about 68 percent of the deposit market. However, their market share has been gradually eroded by aggressive competition and marketing techniques from near banks, such as trust and mortgage loan companies, credit unions and *caisses populaires*, which expanded their range of deposit accounts and broadened their number of branches and hours of operation. The 1967 extension of deposit insurance coverage to near banks also helped to increase public acceptance of these institutions. This increased competition caused the banks' market share to decline to 62 percent by the end of 1989. Trust companies increased their market share from 18 percent in 1967 to 25 percent in 1989. Over the same period, credit unions and *caisses populaires* experienced a slight decline in their relative share from 14 to 13 percent.

The banks responded to the competition in a number of ways, including altering their hours of operation and using automated banking machines (ABMs) and multi-branch banking. The banks have also taken the initiative in some rapidly growing areas. For example, banks greatly increased their activity in promoting Registered Retirement Savings Plans (RRSPs), and their market share of RRSP dollar deposits now is approximately equal to that of the trust companies. Canadians annually invest about \$10 billion to \$12 billion in RRSPs, with total investment amounting to more than \$75 billion by the end of 1989. Banks account for \$27.6 billion or 37 percent of this market, while trust companies hold \$25.5 billion or about 34 percent.

The demand for credit financing by the household sector has been relatively stable, with consumer and mortgage loans assuming an increasingly important role in the banks' lending activities during the 1980s. However, by the end of 1989, the demand for consumer loans had started to slow as the ratio of consumer debt to disposable income increased to record levels, mainly to finance house purchases. This has resulted in intense competition in the residential mortgage market. The banks have been able to increase their share of the mortgage market by narrowing lending spreads, by adopting aggressive marketing and promotion tactics and by developing new products. The banks' share of the residential mortgage market increased from 37.5 percent in 1984 to 41 percent by the end of 1989, while that of trust companies increased by 2 percent to 32 percent. These gains in market share have been at the expense of the credit unions and *caisses populaires* as well as life insurance companies and other lenders such as pension funds.

The competition for consumer loans continues to remain strong. The entry of banks into direct personal lending in the 1950s resulted in greater availability of credit, which brought about a gradual lowering of personal loan rates. Subsequently, the share of the personal credit market of small-loan companies was substantially reduced. While the banks' share of consumer credit was about 67 percent during the 1980s, the sales finance companies' share has been as low as 5 percent. Recently, however, the market share of the sales finance companies increased to 8 percent, reflecting the use of discount financing by automobile companies and furniture retailers as a sales promotional tool.

Exchange rate and interest rate instability over the past 20 years has contributed to the growth of the international financial markets and the development of a wide range of new financial instruments, such as interest rate and foreign exchange swaps. These new products have resulted in a greater integration of individual financial markets and in increased local competitive pressures. The strong international links of the Canadian banks keep them abreast of these developments and help to ensure these new services are readily available in the Canadian financial markets.

While traditionally banks in most industrialized countries have had a comparative advantage over financial market competitors in extending loans because of their expertise in assessing the credit worthiness of borrowers, they now face common new pressures. First, increasing market sophistication now allows many institutional investors to perform their own risk assessments. Investors with large portfolios are able to establish direct contact with low-risk corporate borrowers to avoid using banks as intermediaries, as they once did. This process of "disintermediation" has put pressure on banks by depressing both their profit margins, as a result of the foregone low-risk business, and the quality of risk in their loan portfolios.

Second, there is a general worldwide trend towards decreasing reliance on bank loans as a major source of corporate funding. During the early to mid-1980s, many corporations found it cost-efficient to raise funds on equity markets instead. In addition, the development of a number of new financial instruments has replaced corporations' reliance on traditional bank loans.

These changes have caused the financial industry to experience substantial variations in the volume and nature of the financing it provides. For example, following a sharp decline in equity markets in October 1987, many corporations experienced difficulty in placing new share issues. Therefore, they returned to using bank loans and other short-term instruments such as bankers' acceptances and commercial paper. In Canada, funds raised by new share issues have still not returned to 1987 levels. However, corporate treasurers and government borrowers in particular want the extra flexibility provided by the newer debt instruments. The Big Six banks, except for the Toronto-Dominion Bank, have responded by purchasing interests in Canadian securities firms. These domestic acquisitions complement the existing range of commercial financing services that the banks already offer their clients.

In the early 1980s, the consensus among the major players in the international financial community was that they should be all things to all markets. However, the rapidly changing international financial markets of the 1980s forced all banks, not just Canadian banks, to review their role in the global marketplace. The Canadian banks re-examined their international operations in general, a process that resulted in some rationalization of their international operations, with associated closing or consolidation of branches and offices.

Recessions always have a negative impact on banks and their customers. Banks are the major creditors for the Canadian economy, and recessions usually result in a reduced demand for loans. All banks have had to increase their provisions for loan losses, and there have been increases in the number of loans on which interest is not being paid. However, the broad and diverse customer base provided in the national branch networks of Canadian banks affords an element of stability when problems emerge in individual regions or industries.

The banking sector in North America has been subject to a number of problems, the most recent being the weak performance of the real estate and energy sectors, especially in the United States. The Canadian banks are relatively well capitalized: the largest Canadian bank is the third largest bank in North America. The collapse of the real estate market in the United States has placed pressures on the capital bases of U.S. banks, and many have had to curtail their lending operations accordingly. For the well-capitalized Canadian banks, this represents an opportunity to expand their U.S. operations, as many companies with worthwhile credit ratings are having some difficulties in raising the financing they require.

Similarly, falling equity and real estate prices in Japan have put pressure on Japanese banks to raise more capital or reduce their scale of operations. As a result, there has been some retrenching in their international operations.

Strengths and Weaknesses

Structural Factors

For a service industry such as banking, strengths and weaknesses can be assessed in terms of a firm's profitability relative to risks, the efficiency and effectiveness of its domestic performance and its efficiency relative to counterparts abroad. Key factors that determine a bank's effectiveness are its marketing skills and its ability to meet consumer (commercial and retail) demands with respect to price, service, convenience and product.

A number of structural and regulatory changes have influenced competition in the financial industry. The growing competition from near banks has been an important determinant of industry efficiency. Changes in ownership of some trust companies during the early 1980s often resulted in new management and corporate strategies as well as in more aggressive pursuit of new business at the expense of the chartered banks. The banks responded by expanding outside their traditional markets. They were able to do so in part because of sunset provisions in the *Bank Act* that ensure a regular review of Canadian banking legislation. This periodic adjustment to bring the banks' business powers in line with current market trends and opportunities, a provision not currently available to other federal financial intermediaries, gives the banks a competitive advantage over non-bank financial institutions. However, the federal government is currently proposing to place all financial sector legislation on the same review cycle.

Changing technology is allowing banks and other financial institutions to develop more individualized service packages to suit the special needs of their customers. As a result, banks have been "unbundling" their service packages and pricing many services individually.

Banks are also placing greater emphasis on fee income as competitive pressures have reduced interest rate spreads on their loans. Banks rely on fee income to increase corporate profits because fee-generating activities exert little pressure on their capital base and diversify their revenue streams. The fee income of several banks has been growing rapidly and is currently about one-third of their total revenue (net interest income plus fee income), compared with about 22 percent of total revenue 10 years ago.

The performance of international financial markets also has an important bearing on Canadian banks' competitive positions. Like many other financial intermediaries during the 1970s, Canadian banks were active in the recycling of petrodollars, a significant proportion of which were placed as loans to foreign governments, in particular the less developed countries (LDCs). The recession, high fossil fuel prices and high interest rates of the late 1970s and early 1980s led several sovereign borrowers to announce that they could not cope with their debt loads.

Banks in Canada, the United States and several other countries, with the encouragement of their regulatory authorities, increased their reserves against these doubtful loans. Since 1986, Canadian banks' loan provisions have increased from $3 billion to $10 billion; in 1990 they represented about 71 percent of gross loan exposure. The loan loss provisions of Canadian banks at the end of 1989, as a percentage of total loan exposure, were the highest in the world.

For the industry worldwide, net exposure (gross exposure minus loan loss provisions) to LDC loans has declined from 134 percent of equity to 27 percent, with the range for individual banks being negligible to 58 percent. By comparison, the 10 largest U.S. banks had an average loan loss reserve ratio of 39 percent, with their net exposure representing 95 percent of common equity. Similarly, the five largest British banks had an average loan loss ratio of 46 percent, with their net exposure equal to 47 percent of their common equity. While the LDC debt situation will confront the international financial markets for many more years, Canadian banks have effectively placed this problem behind them.

The portfolio problems arising from the LDC crisis were followed by severe financial difficulties and problems faced by domestic and foreign borrowers in such sectors as energy, resources and real estate in making their loan payments. While problem loans were increasing, some international banks attempted to expand their market share at the expense of profits. This increase in international competition created an international marketplace characterized by overcapacity, low returns and pressures for market corrections.

All financial institutions, not just banks, are considering expanding their lines of business. A major regulatory concern is the adequacy of the capital base to support these expansion plans. Bank regulators in a number of countries have agreed to apply universal capital standards, the Bank for International Settlements (BIS) common capital requirements, to all banks. These requirements stipulate that riskier assets require greater capital reserves. This weighting scheme will give banks an incentive to engage in activities that generate fees but do not tie up large amounts of capital.

Although the regulations are not due to be fully implemented until 1992, most banks are already adhering to them. Canadian banks are already close to meeting their 1992 BIS capital requirements, as they have been steadily increasing their capitalization over the past few years. However, for some international banks, the higher BIS capital requirements will mean that they will have to raise new capital to grow or to maintain their present size, because these requirements are being implemented during a period of overcapacity and relatively poor profits in the international banking business.

Over the next few years, banks in several countries, including the United States and Japan, will be seeking additional capital as the full effects of the BIS capital requirements are felt. This capital will be used in part to strengthen capital bases that have been weakened by a marked deterioration in the values of their loan portfolios due to declining real estate and offshore equity prices. Given that investors have already expressed some reluctance to purchase new issues of bank equities, this quest for capital suggests that some banks may have to place greater reliance on profits and retained earnings as a source of new capital. While banks from some countries may be experiencing some difficulties, the relatively well capitalized Canadian banks should have an easier time raising funds and should be in a better position to take advantage of new opportunities as they arise.

In implementing their new strategies, the Canadian banks have adopted a policy of looking for niches in the international markets best suited for their particular skills. However, the Canadian banks have not acted in unison in this endeavour. Each bank has developed its own strategy, based on its perceptions of the opportunities available in foreign markets and on its strengths and weaknesses. As a result, some banks have increased their activities in the Far East and Pacific Rim countries. Other banks have decided to place a greater priority on North America and have been broadening and strengthening U.S. and Canadian operations. In addition, some banks have been seeking to expand existing business relationships in South and Central America, Mexico and other LDCs where they believe there are opportunities for new business.

The competitive conditions in the international financial markets have led most banks to place greater focus on their domestic marketplace. Canadian banks are probably concentrating more on domestic markets now than they were in the first half of the 1980s. This reflects the fact that one of the strengths of the Canadian banking system is its branch networks, as the domestic banking side has helped to maintain the banks' profitability over the past few years.

Trade-Related Factors

Tariff barriers and the usual trade remedies do not generally apply to services and the trade impediments that do exist are often regulatory in nature. As a result, the main issues for 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 information on such measures is readily accessible and is 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 with respect to government measures affecting the service sector in question. Right of establishment allows foreign investors to establish branches, agencies, subsidiaries or representative offices.

The Canada-U.S. Free Trade Agreement (FTA) provides that financial institutions of the other country are governed by the same rules as comparable domestic institutions. Canada exempts U.S.-owned Schedule II banks from the 12 percent ceiling on ownership of total domestic assets and the associated restrictions on the size of individual banks and also exempts them from the requirement that the Minister of Finance approve new branches. The United States guarantees the same rights to the U.S. operations of Canadian banks as U.S. banks in the event that legislative provisions (the "Glass-Steagall Act") preventing banks from engaging in activities in the U.S. securities markets are amended. Meanwhile, Canadian and other banks are able to trade and distribute, in the United States, securities issued or guaranteed by Canadian governments or their agencies. Canadian banks are also allowed to continue indefinitely their interstate banking operations established prior to 1978, when foreign banks in the United States became subject to the same legislation as domestic banks.

The FTA provides more immediate benefits to the U.S.-owned Schedule II banks, since they have enhanced access to the Canadian marketplace. In addition, the easing of the restrictions on opening new branches makes it easier for U.S. banks to pursue retail banking in Canada. The FTA retains the current *Bank Act* provisions limiting individual shareholdings of Schedule I banks to a maximum of 10 percent of outstanding shares; however, it exempts U.S. shareholders from the 25 percent limit on foreign shareholdings.

Technological Factors

Banking is an information-based industry, and modern banking techniques depend on technology to deliver services quickly, efficiently and at a reasonable cost. Technology has become an integral part of banking operations, and banks could be placed at a competitive disadvantage if their technical support systems are not up to industry norms.

Since computers first made their way into banking in the 1960s, many banks have tried to keep themselves in the forefront of technology in terms of its installation and application to widely distributed branch networks. Initial applications in banking were backroom processing of repetitive and voluminous activities such as cheque processing and clearing. Over time, technology has spread throughout banking operations, and computers no longer play a solely administrative role. Now banks have data processing departments, which often employ thousands of highly paid, highly trained staff.

Technological growth presents a significant potential market expansion for banks to meet their customers' ever-changing needs and demands. Many of these applications have been directed to business clients only and therefore are not well known at the consumer level. For example, many Canadian companies, both large and small, are actively involved in electronic data interchange (EDI), electronic funds transfer (EFT) and other automated business systems. 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 via links between the banks' computers and the clients' computers.

Services such as EDI and EFT could also play an important role in technology diffusion and general skills upgrading of Canadian business. The acceptance of such technology by business implies that firms have a commitment to use advanced information and management systems and may then be willing to accept, or at least to consider, additional technology-based services that banks may develop. However, the current legislative environment restricts the activities of the banks in non-payments-related data processing services. The proposed information services corporations should allow the banks to expand the range of business-related services they can provide their customers.

Consumers also have benefited from the use of technology in product design. A partial list of computer-based products would include daily interest on deposits, any-branch banking, on-line customer records, ABMs, debit cards, point-of-sale terminals, fast information retrieval and fast credit authorization. With the introduction of ABMs, large banks initially developed their own networks. However, as Canadians became more receptive to using them and in response to increasing consumer demand and rising costs, banks and other financial institutions expanded and 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 3 900 machines. By December 1990, Interac members had expanded the network to 11 500 machines.

While the application of technology brings significant gains by reducing paper burden, investments in technology are costly and expensive to maintain. Technology expenditures are one of the fastest-rising, non-interest expenditures categories on banks' balance sheets. Moreover, Canadian banks are some of the largest private sector purchasers of telecommunications services in Canada. In 1989, the Big Six banks spent over $385 million on telecommunications services.

As a result of their ongoing involvement with information technology industries, the Canadian banks are well placed to respond to technological innovations. While Canadian banks are major users, rather than developers, of new technological products such as personal computers and telecommunication networks, they are heavily involved in software development as it relates to the development and delivery of new products and services. Every year, banks spend heavily on technological products in order to improve the speed and efficiency of such operations as credit card and cheque processing. These expenditures represent a large market, the importance of which is often not recognized by the Canadian public. Acceptance of their products by the banks provides a major incentive for high-technology firms to improve their services and products to the benefit of other firms and the public in general.

Evolving Environment

Financial intermediaries worldwide have undergone a number of changes in their methods of meeting the needs of client corporations, governments and individuals to the point that traditional distinctions between them are blurring. All competitors are being forced to react more quickly to market pressures. Increasingly, financial institutions must devote more resources to strategic planning and to the development of new products and technology to remain competitive.

The Canadian government is reviewing its legislation governing federally regulated financial institutions. Federal policy proposals would further break down traditional barriers among banks, trust companies, insurance companies and securities firms by allowing them to compete more freely for shares of the financial services market. For example, banks and insurance companies would be able to sell fiduciary services through a trust company subsidiary or affiliate. Trust and loan companies would have full consumer and commercial lending powers. Insurance companies would have enhanced powers to engage in consumer and commercial lending. Federal financial institutions and their subsidiaries would be able to offer a full range of investment and portfolio management services.

The proposals would also allow all federally incorporated financial institutions to own ancillary corporations in a number of prescribed areas, such as information services, real property holdings and brokerage corporations. The information services companies should be of special interest to the banks. They would be able to provide software and hardware related services, and they would allow banks to make more effective use of their large computer capabilities and to offer more customer-tailored services. Ownership of information services companies would represent a significant change from the current *Bank Act* restrictions on the banks' data processing services.

The federal policy proposals also deal with the possible emergence of financial supermarkets that are able to provide one-stop shopping for advice on a range of services, including deposits, loans, pensions and tax planning. While there may be potential benefits, attempts so far at developing financial supermarkets have had mixed results due to less-than-enthusiastic public acceptance. Under the proposals, banks and other federal deposit-taking financial institutions would be prohibited from retailing insurance through their branches. This measure may curtail involvement of some financial institutions in financial supermarkets, as the inability to sell insurance products reduces the attractiveness of the concept. Nevertheless, some attempts at developing financial supermarkets will no doubt be successful, although most participants can be expected to stick to their core business, with some selling of complementary financial services.

A challenge facing the financial industry generally is the influence of increased competition and technology on its delivery mechanisms. Banks have traditionally relied on branch networks, whereas insurance companies have used sales forces of agents and brokers. On the one hand, branch offices can provide a focal point for networking a number of interrelated services, thereby providing preferred access to consumers. On the other hand, changing computer and telecommunications technology allows for more flexible ways of delivering services, even directly into the consumer's home.

Another challenge arising from the proliferation of computer technology in the industry is the choice that banks are being forced to make between viewing their relations with customers in the context of the more personal, long-term relationships that can be developed, or on a service or volume-of-transactions basis.

Computer technology allows banks to be very creative in repackaging or custom tailoring their services to meet clients' needs through individualized, value-added services. This could be an important marketing tool, especially as the baby boomers become older and start to accumulate assets for retirement years. The recent shifts in service offerings and marketing campaigns suggest that the banks are already placing considerable emphasis on these future long-term relationships with their clients.

The dilemma for the banks is to balance the push-and-pull influences of the technology on their customers at the branch level. The technology that speeds up delivery of customer service, such as automated payrolls or ABM networks, also depersonalizes branch office relationships with clients. Routine financial services are becoming almost generic, with many consumers using the lowest-cost provider. Customer loyalty is thereby weakened, and many clients already boast that they do not visit a branch office, except for more detailed financial matters such as arranging mortgages or loans. Even the loan relationship is being eroded with pre-authorized lines of credit.

Regardless of the approach adopted — long-term or low-cost service provider — financial institutions will be faced with the challenge of how to price their service offerings. While deposit-taking institutions have traditionally relied on interest rate spreads, many of the new areas of activities are not suited to this type of pricing structure. This change is already evident in banks, where non-interest revenues have been increasing as a percentage of their total revenues throughout the 1980s.

A related challenge is the adaptation of technology to business management. For example, as use of electronic payments expands, banks will have to alter manual methods of handling high-volume business such as credit card and cheque processing, which currently involve much paperwork. Even for large banks, their ability to manage the process of change in their business practices will be a key factor in future success.

Competitiveness Assessment

The increased competition and uncertain policy environment facing the Canadian financial services sector during the 1980s have been influencing the way in which the banks operate. In the provision of retail banking services, Canadian banks have been challenged in the pursuit of new business by other financial institutions. The result has been increased efforts to develop new products and services. While several products, such as weekly pay mortgages and daily interest savings accounts, had their origins with other financial institutions, the banks have been quick to develop similar products and often extend the choice available to consumers. The banks also benefit from their large size and associated financial resources, which provide them with the ability to implement new products and technologies quickly. One example is the important role that the banks have played in the spread of ABMs.

Another challenge facing the banks is differentiation of their retail product lines. From the consumers' point of view, banks and near banks provide virtually identical retail services. Even with the increased competition, as the performance in the mortgage and consumer credit markets indicates, the banks have been successful in protecting their interests and will likely continue to do so.

The banks also face a significant challenge from major commercial corporations that are moving into such financial service businesses as consumer lending, leasing and credit card operations. In addition, numerous non-bank organizations such as telephone companies, cable networks, airlines, retailers, electronic data processing (EDP) network operators and others are eager to compete in banking and are entering the financial services business on the strength of their global electronic networks. Many of these firms feel that, after exchanging financial data for the banks, they can bypass the banking system and handle financial transactions themselves. The outcome of this trend is difficult to predict at present, but many of the commercial firms examining the possible provision of financial services are some of the largest corporations in the world.

Commercial loans are another area of large potential impact on banking operations. All banks, Canadian as well as international, were experiencing declining demand for commercial loans during the 1980s. As a result, the banks have experienced substantial variations in the volume and nature of their financing of corporate Canada. While commercial loans volumes have been increasing over the past few years, all of the major Canadian-owned banks except the Toronto-Dominion Bank have been diversifying the financing services they provide through the acquisition of securities industry affiliates.

Canadian banks have made considerable progress over the past few years in increasing their provisions for handling doubtful loans and reducing the total value of the non-performing LDC loans held in their portfolios. While the outstanding loans are still a concern, the negative effects are gradually being reduced. In this regard, the Canadian banks have much higher reserves, as a percentage of equity, than most of their foreign counterparts.

The presence of foreign banks in Canada for many years has added an extra dimension to the competition in the commercial credit market. While this competition has been beneficial for corporations seeking funds as well as for smaller borrowers, the competition has been intense, and several of the Schedule II banks involved have often displayed poor earnings. The federal policy proposals to admit trust and life insurance companies into the market for commercial lending would add to this competitive challenge.

The federal government's financial sector reform proposals would also continue the current trend of forcing all financial industry participants to react more quickly to market pressures. As new products are developed, competitors must respond quickly with similar products. Competition in the financial industry is increasingly focusing on ways to differentiate product lines.

The presence of Schedule II banks has added an extra dimension to the competition in Canadian financial markets. However, from the Schedule I banks' perspective, the extra competition from U.S. banks due to the FTA is very limited, and relatively minor, compared with the much broader effects of the current deregulation process.

Opportunities for Canadian banks to operate in the United States have not changed significantly since the implementation of the FTA on 1 January 1989, as they already enjoy virtually all the benefits of national treatment in the United States. While the U.S. operations of Canadian banks are not at a competitive disadvantage vis-à-vis their U.S. counterparts, the potential benefits arising from free trade have been delayed because of the slow pace of the U.S. reform process. However, the U.S. Federal Reserve Board recently changed some of its regulations, thereby restoring some of the underwriting powers that Canadian securities firms operating in the United States had lost after they were purchased by Canadian banks.

The Canadian banks support the current efforts to develop a North American free trade agreement involving Canada, the United States and Mexico. Foreign banks are currently prohibited under Mexican law from operating in that country, although at least one Canadian bank had a major commercial presence there earlier in the century. Canadian banks are already familiar with Mexico through their sovereign loans and their operations in neighbouring countries. The removal of the existing barriers will provide opportunities to offer enhanced services to exporters, importers and investors.

The banking community in Canada and abroad has been confronted with a number of challenges and issues. During the 1980s, banks have had to deal with problem loans, falling real estate and equity prices in several national markets, BIS capital requirements and a rapidly changing international marketplace where new products and competitors can quickly appear. The Canadian banks have responded to these challenges by improving their capital base, refocusing their strategic directions and improving their franchise through upgrading the skills of their staff and through investment in technology.

Canadian banks have been relatively unaffected by the developments that have presented problems for banks in other countries, and their world rankings based on equity and capital have been increasing steadily. The improved capital bases and refined business strategies should allow the Canadian banks to maintain their strong position in the domestic marketplace and to expand their foreign operations selectively.

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PRINCIPAL STATISTICS[a]

	1983	1984	1985	1986	1987	1988	1989	1990
Domestic banks	13	14	12	8	9	8	8	8
Foreign bank subsidiaries	58	58	57	59	59	58	58	58
Employment[b]	148 184	146 746	162 163	162 667	162 850	167 999	175 035	181 153
Total assets[c] ($ billions)	368.6	405.6	443.8	468.0	486.0	508.7	550.9	609.9
Canadian assets[c] ($ billions)	211.9	222.8	241.8	260.7	294.5	339.8	379.1	409.7
Foreign assets[c] ($ billions)	156.7	182.8	202.0	207.3	191.5	168.9	171.8	200.2
(% of total assets)	42.5	45.1	45.5	44.4	39.4	33.2	31.2	32.8
Foreign liabilities[c] ($ billions)	160.2	187.3	205.0	207.7	200.4	180.2	179.7	207.5

[a]Based on Canadian Bankers' Association, *Bank Facts 90* (Toronto: CBA, 1990).
[b]Schedule I banks only.
[c]Schedule I and II banks.

REGIONAL DISTRIBUTION[a] (average over the period 1987 to 1989)

	Atlantic	Quebec	Ontario	Prairies	British Columbia
Branches (% of total)	8.4	19.4	40.1	20.4	11.7
Employment[b] (% of total)	6.2	17.9	48.9	15.8	11.2
Canadian assets (% of total)	6.1	20.6	47.6	14.3	11.4

[a]Based on Canadian Bankers' Association, *Bank Facts 90* (Toronto: CBA, 1990).
[b]Schedule I banks only.

MAJOR FIRMS

Name	Country of ownership	Location of head office
Domestic Banks		
Bank of Montreal	Canada	Montreal, Quebec
Bank of Nova Scotia	Canada	Toronto, Ontario
Canadian Imperial Bank of Commerce	Canada	Toronto, Ontario
Canadian Western Bank	Canada	Edmonton, Alberta
Laurentian Bank of Canada	Canada	Montreal, Quebec
National Bank of Canada	Canada	Montreal, Quebec
Royal Bank of Canada	Canada	Montreal, Quebec
Toronto-Dominion Bank	Canada	Toronto, Ontario
Foreign Bank Subsidiaries		
Banque Nationale de Paris (Canada)	France	Montreal, Quebec
Barclays Bank of Canada	United Kingdom	Toronto, Ontario
Citibank Canada	United States	Toronto, Ontario
Crédit Suisse Canada	Switzerland	Toronto, Ontario
Deutsche Bank (Canada)	Germany	Toronto, Ontario
Hongkong Bank of Canada	Hong Kong	Vancouver, British Columbia
Industrial Bank of Japan (Canada)	Japan	Toronto, Ontario
National Westminster Bank of Canada	United Kingdom	Toronto, Ontario
Swiss Bank Corporation (Canada)	Switzerland	Toronto, Ontario
Union Bank of Switzerland (Canada)	Switzerland	Toronto, Ontario

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