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**SOME PERSPECTIVES
ON THE
FUTURE OF BANKING**

by

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I: INTRODUCTION

For well over a year now, proposals for reforming the Canadian financial system have made the headlines -- the federal government's Green Paper on the regulation of financial institutions, the Wyman Report on Deposit Insurance, the House of Commons' report Canadian Financial Institutions, the interim and final reports of the Ontario Task Force on Financial Institutions, and the Senate reports Deposit Insurance and Towards a More Competitive Financial Environment. And the process is not completed: Justice Estey still has to report and, of course, the federal government has yet to table its proposed legislation. Except for the Estey enquiry which is focusing on the spectacular failures of the Canadian Commercial Bank and the Northland Bank, the thrust of these reports relates principally to the operations and powers of financial intermediaries other than banks.

The present paper reverses this emphasis by focusing on the likely future developments in the banking sector and, more generally, on the role of banking in the evolution of the overall financial services sector. The first clue to the probable future of banking in Canada comes from the series of developments that are occurring in the international banking arena. These will be detailed in Part II. Briefly, international banking is moving away from the provision of loans and towards investment banking or merchant banking, with a corresponding increased emphasis on off-balance-sheet activities. These initiatives will surely influence domestic financial services operations, but the degree that they will be undertaken by Canadian chartered banks rather than, say, by financial conglomerates, by securities firms or by foreign financial institutions will depend in part on the process

of financial deregulation within Canada. Hence, Part III of the paper will attempt to render some assessment of the likely evolution of banking powers within the Canadian financial services industry. However, even if banks remain somewhat constrained by their regulatory authorities, the nature of banking domestically will nonetheless undergo considerable alteration, with greater emphasis being placed on activities that generate management and fee income relative to those that generate only interest income. These considerations will be the subject of Part IV. A short conclusion completes the paper.

II: THE INTERNATIONAL BANKING REVOLUTION

Driven by technology, deregulation, competition and innovation, the international financial services sector is undergoing a rather dramatic transformation. Not surprisingly, the world's leading commercial banks are in the forefront of this financial revolution. But what is surprising is that in the process the very nature of banking is undergoing an equally dramatic transformation. What follows is a brief overview of recent developments as they affect the international financial system in general and commercial banking in particular.

The Trend Toward Disintermediation and Securitization¹

Leading the way in terms of structural change has been the trend for the highest quality borrowers to turn to the capital markets and away from bank credit as the source for their funding. The economics underlying this shift is that many of the high-quality corporate borrowers can access the capital

markets at rates below those available to the international financial institutions. To a certain degree this reflects the tarnished credit ratings of many of the world's large financial institutions, in turn reflecting their over-exposure to third-world debtors and to the oil patch. For example, in 1980, nine North American banks received triple-A ratings from Standard and Poor's for their long-term debt; now there is only one top-rated bank.²

One result of this dramatic change is that some of the large corporations can now raise money in the capital markets, lend it to the banks, and turn a profit in the process. Indeed, in a recent Euromoney listing of the top 50 lead managers of Euronotes and syndicated loans, the corporate financial arm of British Petroleum ranked seventh overall. To be sure, most or all of this related to the provision of a borrowing facility for the parent company. But it may well be a harbinger of what the future holds -- the emergence of "corporate" banks. While I shall not focus further on these corporate banks in what follows, it is worth noting that there are several areas where even middle-sized corporations can engage in "banking" activities.³ First, they can develop the expertise and systems to replace financial advice bought previously from banks or, at the very least, to deal with the banks from a position of strength. Second, given that all of them have treasury departments, the computers and brainpower already in place can be turned into a profitable asset and liability management activity at very little additional cost. And, third, a growing number of these corporations have "mountains" of cash on their hands. Therefore, several years from now, the likes of G.E., Toyota, G.M., Ford, Sumitomo, Mitsubishi, Exxon, and IBM may join the "Sears Revolution" in making substantial inroads into the financial sector.

In any event, the comparative advantage in funding high-grade corporate borrowers has shifted from commercial-bank credit and towards the international securities markets. Effectively, this is a move in the direction of financial disintermediation -- a move away from intermediated credit and toward direct credit. More generally, it is part of a much larger process referred to as the "securitization" of bank credit, that is the increasing tendency for credit to take the form of negotiable instruments (e.g., securities) rather than non-negotiable instruments (loans).

The reaction of the banks to this trend has been two-fold. First, they have joined the march toward securitization in the sense of becoming major issuers and purchasers of securities as well as arrangers and managers of these new securities issues. Table 1 presents some data relating to the magnitude of these developments. Euro-bank loans have fallen by more than a factor of four over the 1981-1985 period -- from \$96.5 billion U.S. to \$21.6 billion U.S., while international bond and note issues increased by a similar factor -- from \$44 billion U.S. to \$162.8 billion U.S. As panel B of Table 1 indicates, the banks have replaced these loans by adding securities to their asset portfolios. Even more interesting, the banks have become very important issuers of securities, so much so that in 1985 their total issues (\$43.0 billion U.S.) exceeded their gross syndicated lending (\$21.6 billion U.S. from row panel B.2)! The BIS report summarizes this move towards securitization as follows:

"Firstly, the gradual decline of long-term interest rates from abnormally high levels of several years ago and the restoration of positively-sloped yield curves have clearly enhanced the appeal of long-term marketable instruments and facilitated the recovery of bond markets. Secondly, the impact on banks' portfolios of the international debt problems has stimulated banks to improve the liquidity and

marketability of their other assets and has encouraged them to strengthen their balance sheets by funding themselves through longer-term bond issues. Thirdly, the highly publicized problem of a few banks in various countries and the weakening of banks' balance sheets more generally...have impaired banks' comparative advantage as a channel for lending, at least to prime borrowers with recourse to securities markets."⁴

The banks have also reacted to securitization in a second, more aggressive, manner by assuming a prominent role in the development of a sophisticated range of financial innovations which, on the one hand, facilitate securitization across a much wider array of financial instruments and national currencies and, on the other, serve to shift banks' income sources away from interest income and toward fee income, reflecting their new comparative advantage. Moreover, some of the banks' increased borrowing activity, as reflected in row panel B.2 of Table 1, is most easily explained in terms of allowing the banks greater opportunities to benefit from these new innovations. I shall now turn briefly to a description of some of these innovations and how they allow the banks to transfer their activities to "off-balance-sheet" or "fee-generating" rather than "interest-generating" activities.

Selected Financial Innovations in the Euro-Market

Note Issuance Facilities (NIFs)

Note issuance facility is a generic term to describe medium-term arrangements provided by banks under which borrowers can issue short-term paper in their own name. This facility "unbundles" the traditional syndicated-credit provision and allows these functions to be performed by separate institutions. As the BIS report notes, the function of funding the

borrower's requirements is transformed from one of lending money into one of setting up a borrowing mechanism, so that the borrower can access the credit markets directly, and the function of maturity transformation is turned into one of underwriting.⁵

NIFs allow borrowers to issue successive series of short-term notes over a medium-term period, say five to seven years. At any point in time, the credit risk falls to those who actually hold the notes. The risk to the underwriter is one of accepting the notes of a borrower in whom investors have lost confidence. If the banks end up holding these notes they will obviously appear on their balance sheet. However, the underwriting commitment, by itself, is an off-balance-sheet item. The attraction to banks of NIFs is that they offer a replacement for their disappearing loan business and they also offer flexibility in terms of income -- interest income if the banks acquire these notes, fee income for placing these notes with other institutions and, of course, fee income for underwriting and arranging the NIF. Unlike the U.S. commercial paper market, which is dominated by the U.S. securities firms (e.g., Merrill Lynch, Goldman Sachs, Salomon Bros. and Lehman Bros.), commercial banks play a much greater role in this Euronote market.

The advantage to borrowers, apart from the lower cost, is that NIFs provide great flexibility in sourcing funds. Despite the dramatic increase in this market (a ten-fold increase over the last two years) there is still substantial unrealized potential. Thus far, \$U.S. and Ecus are effectively the only denominations utilized, but with the advent of currency swaps (elaborated below) the longer term implications of NIFs and similar innovations will likely be to integrate not only the Euro and U.S. commercial paper markets but as well the global markets for money. It is possible, of

course, that this short-term market may evolve for the quality borrowers from a Euronote market (which is backstopped by NIFs) to a true commercial paper market (which is not so backstopped), but in this case the banks will presumably react by providing NIF to the next rung of potential corporate borrowers.

Currency and Interest-Rate Swaps

Whereas NIF-type provisions enhance the shift toward securitization of the credit markets and indirectly serve to integrate selected international markets, the real thrust toward global capital markets has arisen from the development of interest rate and currency swaps. Essentially, swaps are financial transactions in which two parties agree to exchange payment streams over time according to predetermined rules. While there appears to be no limit to the variations possible, there are basically two types of swaps -- those that convert floating-rate obligations to fixed-rate ones and vice versa (interest-rate swaps) and those that convert debt raised in one currency into a fully-hedged liability in another currency.

In general the demand for swaps arises because of market peculiarities or inefficiencies. For example, some parties would prefer fixed-rate obligations but find that they have a comparative advantage borrowing floating rate obligations. Therefore, they can gain a cost advantage by borrowing in floating and swapping into fixed. In effect, interest-rate swaps allow these borrowers to arbitrage across these markets. Likewise some borrowers desiring, say, U.S. dollar liabilities find that they have a comparative advantage in borrowing in their own currency and then swapping the proceeds and interest payments into U.S. currency with a counterparty, thereby

acquiring a fully-hedged U.S. dollar liability at a rate below that which they could obtain if they attempted to access the U.S. dollar market directly.

In terms of interest-rate swaps, the driving force is frequently that investors in fixed-rate instruments are more sensitive to credit quality than are floating rate investors. This situation is elaborated in Appendix A which presents the details of a typical interest-rate swap. Company A, the better credit risk, can access funds more cheaply than company B in both the floating-rate and fixed-rate markets. However, company A's cost advantage is 1.20% in the fixed-rate market but only .50% in the floating-rate market. Assuming company A desires floating-rate obligations and company B fixed-rate debt, both companies can gain by accessing funds where they have a comparative advantage and then swapping the obligations. As a result both companies achieve substantial cost savings in their preferred obligations compared to what they would pay in accessing these markets directly.

While I shall not present a comparable example of a currency swap, the following three basic steps are typical.⁶ First, the parties exchange the principal amount of the swap at an agreed upon exchange rate. Second, the parties exchange interest payments on the outstanding principal at the respective interest and exchange rates agreed upon at the outset. Third, on the maturity date the parties re-exchange the principal, again at the agreed-upon exchange rate. In effect, the currency swap transforms a debt raised in one currency into a fully-hedged liability in another currency.

It is also possible to combine currency and interest swaps to transform a floating rate obligation in one currency to a fixed-rate liability in another.

Again, one driving force behind currency swaps is the cost savings they

provide. For example, a strong borrower in the Swiss market desiring U.S. dollars may find it much cheaper to raise funds directly in the Swiss market and then swap them with a counterparty into U.S. dollars. Or, in a real-life example provided in the January, 1986, Supplement to Euromoney, the use of swaps allowed a large U.S. multinational to discreetly provide Deutschmark financing to its German subsidiary by using its U.S. dollar funding pool. The swap allowed a perfect matching of payment dates, no foreign currency risk, a minimum of administrative problems and eventual access to Deutschmarks at a preferential borrowing rate.⁷

There are, of course, other reasons that make swaps very attractive. They enable corporations to access markets and currencies which would otherwise not be available or, if so, only at substantial premia. Moreover, they allow a corporation continued access to a particular currency, even if the domestic investors' view is that the corporation has already borrowed up to its "limit".

Therefore, currency and interest-rate swaps, by essentially arbitraging over market or currency niches and over national regulatory provisions, serve to internationalize national capital markets. As part of this process of integration, currency swaps have increased substantially the numbers of currencies participating in the market. Moreover, swaps have allowed potential issuers in all countries to capitalize quickly on "windows" which exist from time to time in the various national capital markets.

The role of the financial intermediaries in the swap process is rather obvious. They can either play the role of broker in bringing two parties together or, more commonly in the case of a currency swap, they can interpose themselves as counterparties to each of the end parties in arranging a

fully-hedged swap. By matching exactly the needs of the end-user both in terms of principal and payment dates, either by finding an appropriate counterparty or by acting as counterparty, the intermediaries have provided such immense utility and flexibility to swap transactions that swaps are destined to continue to play a growing role in the financial services arena. (In mid-1985 the outstanding amounts of interest-rate swaps were estimated to be between \$100 and \$150 billion U.S. of notional principal. Currency swaps are not as large but are growing very rapidly.)⁸ Not surprisingly, swaps are an attractive source of off-balance-sheet earnings (fee income as well as trading profits) and a substantial portion of the banks' new securities issues (row B.2 of Table 1) are related to these activities.

However, as the BIS report points out, commercial banks and merchant banks take somewhat different approaches to the swap markets. The latter tend rather naturally to view swaps as tradable securities. They are in the forefront of efforts to standardize swap contracts and market practices in order to improve the liquidity of the swap market. One result has been the development of a secondary market in swaps. Another result has been that a few of the largest end-users with high credit ratings have begun entering into swap transactions directly with other comparable end users, eliminating the need for an intermediary.

Commercial banks, on the other hand,

"tend to view swaps as an extension of more conventional banking business. For example, when a bank combines a floating-rate loan with an [interest-rate] swap, it is creating the equivalent of a fixed-rate loan for a borrower. In the past, banks have found it difficult to extend fixed-rate loans outright because their fixed-rate funding costs have been high, sometimes as high as those faced by some of the customers...By unbundling the components -- the floating-rate loan and the swap -- banks

can price each more efficiently. Commercial banks stress that as swap-market intermediaries they offer a large customer base and expertise in assessing long-term market and credit risks.⁹

By way of summary, it is hardly surprising that swaps have attracted an incredible broad range of end-users -- banks, corporations, thrifts, insurance companies, international agencies, and sovereign states. Their appeal is that they can be utilized for one or more of five basic reasons: to obtain low-cost financing; to obtain high-yielding assets; to hedge interest-rate or currency exposure; to implement and enhance short-run asset/liability management strategies; and to speculate.¹⁰

In general terms, then, there are three broad trends emanating from the recent evolution of the international financial markets:

- . a trend towards the securitization of markets, and a corresponding blurring of distinctions between bank credits and capital markets and between the roles of commercial bankers and securities dealers;
- . a trend for commercial banks to focus on off-balance-sheet business;
- . a resulting trend toward the global integration of financial markets.

Underlying Determinants of the International Financial Revolution

To note that prime corporate borrowers can now access funds more cheaply than some of the world's large financial institutions explains the direction of recent innovations in international financial markets. The underlying determinants of this creativity and innovation are rooted in more-lasting developments.

The Supply Side

Underlying these developments on the "supply" side, as it were, has been the dramatic revolution in the technology relating to computerization and telecommunications. There are, however, other important developments which operate on the supply side. One of these is the increasing ability of the major international financial intermediaries, whether banks, merchant banks or securities firms, to operate on a global scale, by which is meant the ability to trade in the domestic assets of each of the world's key financial markets -- Tokyo, London, and New York. For all intents and purposes, the geographical location of these key markets, along with the international trading linkages among the various national stock exchanges, means that the trading books of the major international financial players are always open. Combined with the networks of branches and agencies within each of these three time zones, the world's financial leading international commercial and merchant bankers provide a degree of global integration heretofore unknown. And the financial innovations referred to above, along with scores of others, imply that windows of opportunity that exist virtually anywhere in the world can be brought to the attention of would-be borrowers or lenders almost instantaneously.

A further significant development contributing to the integration of international markets has been the wave of liberalization in financial regulations in various countries. Actually, the relationship between financial deregulation and the efficiency of international markets is one of both cause and effect. Countries with restrictive regulatory provisions will not only put their financial institutions at a comparative disadvantage because these institutions will not be able to utilize the home currency

market as a launching pad for their international banking activities but will, as well, probably find that both domestic clients and market trading will move offshore. Hence, the tendency has been for national authorities to move towards deregulation which, in turn, serves to increase the internationalization of financial markets, thereby placing even greater pressure on those remaining countries with more conservative regulatory approaches to the financial sector. One indicator of the difficulty in bucking this international tide is the degree to which foreign banks have increased their presence in various countries over the last three decades. Table 2 presents data on this trend for eleven countries.

In terms, therefore, of the "supply" side as it relates to international banking, it would appear that the developments are irreversable and, indeed, will likely intensify. The one initiative that might have substantial counter influence is that some national authorities appear to be about to develop a set of capital requirements applicable to the banks' off-balance-sheet activities. Such a move would presumably tilt the balance in favour of the securities firms and away from commercial banks. However, in order for such a provision to become binding on the international activities of commercial banks it would have to be adopted by most of the host countries -- an unlikely event in my view.

The Demand Side

On the demand side of these new banking developments, there is more reason to argue that some of the recent activity may be a temporary blip. Some of the demand for currency and interest-rate swaps presumably arose as a consequence of the immense volatility in international money markets -- for

example, the inflation-deflation cycle, the volatility in interest-rate and exchange markets and the dramatic shift in current account balances. If this volatility were to lessen substantially and if, in the process, the banks were to strengthen their capital base and their perceived credit worthiness, then it is not impossible that some of the movement toward securitization might in fact be reversed.

Nonetheless, the creativity and innovativeness of international banking are here to stay. This is even more so the case since many of the large financial institutions have recently put in place research and development divisions responsible for devising "new products", which will obviously be designed to exploit major profit opportunities and, with the increasing degree of competition in international banking, minor profit opportunities as well. In particular, making the innovations available to the next rung of companies on the credit-rating scale and/or bringing these innovations to domestic markets will guarantee substantial further growth.

Impact on Monetary Policy

Finally, as an important aside, the increasing integration of world financial markets is likely to pose problems for national monetary authorities or at least alter some traditional methods of monetary control. This is particularly the case for countries that have tended to conduct monetary policy via changes in the availability of credit. With financial deregulation and heightened capital mobility, changes in monetary policy will have their impact more and more through price channels (interest rates and exchange rates) rather than through availability channels. This implication applies not so much to Canada as it does to those nations which have, until recently

at least, frequently relied upon instruments such as interest-rate ceilings and non-market channels to influence internal flows of credit.

However, there are implications even for Canada. Henceforth, tight monetary policy is unlikely to have as immediate an impact as was hitherto the case, at least not on those corporations that have full access to the international market. Not only can such corporations take advantage of interest rate and currency swaps to reduce their borrowing rates, but the range of financial instruments available to them has been greatly enhanced. For example, as the BIS study points out, a short-term hike in interest rates need not deter a corporate treasurer needing funds. If rates are expected to fall back, the treasurer can borrow fixed now and swap to pay floating. As rates later fall, he/she can reverse the swap and lock in the benefits from the lower fixed rate. Thus, the proliferation of new instruments available to market participants may make the timing and incidence of monetary policy less certain than has previously been the case.¹¹

The implications of recent developments in the international financial arena that are of most interest for present purposes, however, are those that are likely to influence the evolution of domestic banking. To these I now turn.

Implications for Canadian Commercial Banking

International and Domestic Linkages

The financial regulatory structures of several countries, particularly those of continental Europe, tend not to differentiate between commercial banking and investment banking. The German universal banks are probably the

best example. Generally speaking, the range of powers or at least the range of activities available to these banks in their international operations are not that different from the powers they have on the domestic front. Hence, financial innovations in the international financial arena can in principle be transferred relatively easily to the domestic front. Phrased differently, the trend in international markets toward securitization and investment banking will pose much greater problems for countries which attempt a clear separation, domestically, between commercial banking and investment banking. And Canada probably qualifies as the country, par excellence, where this division or separation is most apparent.

There can be little doubt that the integrated nature of world financial markets and the enhanced mobility of capital will ensure that Canadians will eventually have access to these recent financial innovations. What is at issue, however, is whether the chartered banks will be the principal vehicles for bringing these innovations to Canadians. This latter question relates to the likely evolution of provincial and federal regulations in the financial sector and will be the focus of part III. The remainder of this section will focus on the various national-international linkages and, more generally, on the avenues through which pressure for financial deregulation will be brought to bear on the Canadian regulatory authorities.

Chartered Banks

The obvious first link is the chartered banks themselves. While some of the larger banks are only beginning to develop their international networks, it is nonetheless the case that Canadian banks have already achieved a substantial international presence in some important niches of the

international market place. For example, in terms of underwriting or backstopping Euronotes, Table 3 reveals that, of the top-20 Euronote underwriters, Orion Royal Bank ranks second, T-D Bank seventh, Bank of Montreal fourteenth, and CIBC seventeenth.

To be sure, underwriting of Euronotes is more a banking function than a securities industry function so that almost all of the institutions in Table 3 are banks. Were one to focus on the top "arrangers" of Euronotes, the list of institutions would be dominated more by the large securities firms like Merrill Lynch, Goldman Sachs, and Salomon Bros. Even here, however, Orion Royal Bank ranks twentieth. None of the Canadian securities firms makes any of these rankings.

In terms of the longer-term Eurobond market, Orion Royal ranks eleventh among the fifty bookrunners in 1985, up from seventeenth in 1984.¹² The Canadian securities firm, Wood Gundy, ranks a respectable thirty-sixth, but this is down from its twenty-eighth place ranking in 1984.

What this implies is that the chartered banks have substantial, and growing, investment banking expertise that they will surely attempt to utilize within Canada. Indeed, the pressures that led to securitization and the resort to off-balance-sheet activities in the Euro-markets are also very much evident within Canada. Most of the Canadian banks have been active in either or both of third-world lending and the oil patch, so that their capital bases have been weakened. Large domestic corporations are also moving to meet their short-term borrowing needs in direct markets rather than intermediated markets, so that banks are having to fall back on their innovativeness to skirt the regulatory authorities in following their customers in this trend.

Moreover, the process of intermediation has become substantially more

competitive. The advent of schedule B banks has intensified the competition in the commercial loan market. In the personal loan and deposit market the trust companies and the caisses populaires (unincumbered by loan losses in overseas or energy markets) are challenging the chartered banks. Finally, the financial conglomerates like Power Corporation and Edper Investments, along with the Canadian securities firms, are developing expertise in the investment banking field.

Thus, while the incentives for moving toward investment banking and for substituting fee income for interest income are substantial, the chartered banks are currently reeling under both competitive and regulatory pressures.

However, they are also faced with a further problem, namely that the traditional commercial banking culture is quite far removed from the investment banking culture. The conception of corporations having long-standing relationships with particular banks and of bank officers waiting for customers to show up at their branches runs counter to the aggressive nature of investment banking. But these conceptions die slowly. Having separate international subsidiaries clearly allows the two cultures to co-exist more easily, particularly since the international transactions originating within Canada are largely handled by their off-shore merchant banking subsidiaries. However, the challenge remains to shift the philosophy and culture of the domestic operations more into the merchant banking direction.

Schedule B Banks

For the most part, this cultural contradiction does not afflict the schedule B banks. In the first place, many of them, like Deutschebank, are

full merchant bankers in their country of origin. And in the second place, they are operating off-shore so that even if they are restricted to commercial banking domestically their off-shore operations tend to be in the investment banking area (just as are Orion Royal Bank and CIBC Ltd in their European operations). There are several other reasons why merchant banking comes more naturally to schedule B banks than to the schedule A banks. Basically, they are wholesale banks and do not bother very much with the retail side of banking. As important, their capital (or asset base) is limited so that they have a substantial incentive to continuously "cycle" their capital by focusing on fee income rather than tying it up in interest income.

Hence, relative to schedule A banks, the schedule B's (or at least some of them), appear to have a mission that is substantially more oriented toward investment banking. Although evidence is hard to come by, they appear to rival, if not exceed, the schedule A's in terms of engaging in swap transactions with Canadian borrowers. Thus, it is not really that surprising that the first full-blown Canadian attempt to securitize mortgages (i.e., mortgage-backed securities) is a joint venture between a trust company subsidiary and a schedule B bank.

While the advent of schedule B banks has intensified the competition in the wholesale loan market, it is probably as important to recognize the degree of competition that they have brought into the merchant banking area and to those areas of securities trading that come under the rubric of the "exempt markets".¹³ The latter is particularly significant, since the schedule B's can target their capital and expertise to selected niches of the exempt market and out-perform the relatively low-capitalized Canadian securities firms. Now that I have broached the area of securities firms, it is instructive to focus on their operations.

Securities Firms

For the most part, the 100 or so registered Canadian securities firms are in the opposite position from the off-shore merchant banking subsidiaries of the schedule A banks. The latter would like to be able to free-wheel domestically while the securities firms would like to be able to expand their international operations. What holds the banking subsidiaries from operating domestically are the various federal and provincial regulatory strictures. No such regulatory restrictions prevent the securities firms from expanding their international operations. However, what does effectively constrain them is their limited capital base -- no industry outsider can own more than 10% of a securities firm (again, Quebec is an exception). The entire Canadian securities industry has roughly one billion dollars of capital. Compare this to Merrill Lynch which, by itself, has capital of \$4 billion U.S. Although the registered (protected) markets serve to provide these Canadian firms with an above-average return on capital (particularly in the recent buoyant stock markets), the history over the last decade or so is one of a whittling away of the Canadian firms' market share of overall Canadian securities trading. This whittling away will surely continue, since one characteristic of the recent financial innovations is that they require both adequate capital and the ability to trade in all three "time-zone" markets -- New York, Tokyo and London. Both the "bought deal" (where the investment banker buys the issue outright and assumes all future risk) and the role of a counterparty to a currency swap, for example, imply that the investment dealer is acting as principal rather than as agent. And to operate as principal requires substantially more capital than to operate in the capacity of an agent. Obviously, it is highly risky for securities firms with, say, \$150 million of

capital (which would exceed the capital of any Canadian securities firm) to attempt to act as principal in bought deals where the amounts are in the hundreds of millions of dollars.

While the Canadian firms will probably always have a stranglehold on the domestic retail market, if they want to enhance their ability to become meaningful players in the international arena they are going to have to be able to trade in the domestic issues of all three of the world's key markets (Tokyo, London and New York). In turn, this will require that the current ownership restrictions (10%) be liberalized substantially. Moreover, there will likely be another requirement imposed from the outside, namely reciprocal treatment for Japanese and British securities houses.

Herein lies a problem for the chartered banks. The environment surrounding the Canadian securities industry has for some time now been very protectionist. If, in order to give Canadian firms enhanced access to foreign markets, the quid quo pro will likely be to allow foreign securities firms some (limited?) access to the hitherto protected domestic market, it is highly likely that the industry will lobby hard and long to attempt to limit the amount of such competition. That is, the industry will lobby to keep the chartered banks out of the domestic market. Or, as the industry would probably put it, it is necessary to maintain the distinction between market intermediaries and financial intermediaries (more on this later).

Financial Conglomerates

The final set of institutions that can act as conduits for bringing international financial developments to Canadian corporations are the financial conglomerates. And in many ways they are likely to be the most

successful. One reason for this is that they appear to be operating in a regulatory "vacuum" and they are moving quickly to take advantage of the situation. The obvious example here is the combination of Great Lakes and Hees International, both part of Edper Investments. The stated objective of the group is to create a "vital fifth pillar -- a pillar consisting of entrepreneurial institutions providing merchant banking services and capable of assuming financial risk."¹⁴ Lest one tend to downplay this development, it is important to note that the combined capital of Great Lakes and Hees is roughly \$1.2 billion -- more than that of the entire Canadian securities industry!

What I find somewhat surprising is that none of the financial conglomerates has as yet undertaken to buy or to start up a securities firm based in Quebec. As I understand the regulations, this does not run counter to the policies of the Quebec Securities Commission, although the Commission reserves the right to approve any such initiative. To be sure, the Ontario rules would prevent such a firm from establishing an office in Ontario and from accessing directly the Toronto Stock Exchange. (It is for this latter reason that established firms in Quebec would be reticent to allow an outsider to own more than 10% of its voting shares, so that the likely route would be to start up a new Quebec-based firm.)

This meshing together, in a financial conglomerate, of a merchant banking arm and a securities firm to engage in underwriting would seem to be a potent combination and one that must surely be about to appear.

The Corporations

It is not only the financial intermediaries that will be lobbying to ensure that the range and type of credit instruments available elsewhere will come to Canada. Canadian corporations will increasingly insist on a level of services at least on par with that available to their competition in other countries. This is really of no concern to the large corporations like Bell Canada Enterprises since they can and do already access the full range of services offered by the international community. But it is of importance to the next rung of corporations. As a result of the recent innovations and the international access provided by the schedule B's and the schedule A merchant banking arms, many of these corporations have realized the value of a bought deal or have experienced the savings arising from an interest-rate or currency swap, and for them there is no turning back. Now the next rung of corporations will desire equivalent treatment.

More to the point they deserve it. The role of the financial services industry is not to provide comfortable niches for the various industry players. Rather it is to develop markets for credit and capital so that Canadian firms have access to funds at the best possible terms. It is this consideration, above all, that ought to, and in the final analysis will, provide the underlying rationale for increasing the degree of competition in domestic financial markets.

Summary

The thrust of the analysis in this section has been that the integration of the world's financial markets and the corresponding enhanced mobility of capital is such that financial innovations will indeed find their way into

domestic capital markets. However, there exist a great many avenues by which these innovations can be imported into Canada. Thus, despite the fact that, off-shore, the Canadian chartered banks are among the world's top merchant bankers, it is far from pre-ordained that it is they who will be allowed to patriate this expertise to the domestic market. Much will depend on the manner in which financial regulation will evolve, which is the subject of the following section.

III: THE REGULATORY MAZE

As noted in the introductory paragraph, Canada is in the midst of regulatory reform. The purpose of this section is not to elaborate on the details of the various reform proposals but rather to focus on the underlying philosophical positions toward the evolution of the financial sector and, in particular, on the positions with respect to the relationship between financial intermediaries (banks, trusts, credit unions, life companies) and market intermediaries (securities firms). As background, however, two observations are pertinent.

First, as with most other aspects of Canadian life, the regulation of the financial sector is shared between the federal government and the provinces. Ottawa has sole responsibility for the chartered banks and the provinces essentially have sole responsibility for credit unions and the securities industry (including the stock exchanges). Insurance companies and trust companies can be chartered and regulated at either the federal or provincial level.

The second observation is that, from the vantage point of the consumer,

Canada essentially has two parallel banking systems -- one chartered federally (the banks) and one chartered provincially (the credit unions, caisses populaires and the trusts, although as noted above the trusts can also be federally chartered). Both systems have access to deposit insurance, both provide a similar range of services (e.g., automated tellers) and both have direct access to the Canadian Payments Association for clearing purposes. Therefore, the Canadian consumer in his/her deposit and chequing roles probably views these systems as rather perfect substitutes.

Some important implications derive from viewing these two observations in tandem. Suppose, for example, that the provinces were to open up the market intermediary sector to financial intermediaries. This would open up the securities area to the "provincially-run" banking system, but not to the chartered banks. To open this opportunity to chartered banks would also require an amendment of the federal banking legislation.

The intriguing question is whether the regulatory authorities will allow the chartered banks into the domestic investment banking business.

Three Models of the Financial Sector

One can distinguish three general approaches to the financial sector and, more particularly, to the relationship between market intermediaries and financial intermediaries.

The Ontario approach has come to be referred to as the four-pillar approach. Not only should each of the pillars (banks, trusts, insurance and securities) remain distinct, but there should be ownership separation as well. In terms of the securities industry, no industry outsider (whether a financial intermediary or an individual) can own more than 10% of a securities

firm. Moreover, the TSE monitors this provision by denying direct access to the exchange to securities firms that do not abide by Ontario's ownership restrictions, even if they are legitimately incorporated in other provinces.

Quebec's approach is exactly the opposite. Excluding banking (over which Quebec has no jurisdiction), for all intents and purposes there is only one pillar. Quebec allows both upstream and downstream holding companies as a means of ownership diversification across the pillars. It also permits institutions a somewhat wider range of in-house powers than does Ontario. Moreover, subject to approval by the Quebec Securities Commission, financial intermediaries can acquire (i.e., wholly own) securities firms.

Ottawa as yet has no official approach to financial sector reform. However, the federal government's Green Paper took an intermediate position between Ontario and Quebec, but in its essence it leaned toward the Quebec approach. It endorsed ownership integration across the pillars but required that this be done via a federally regulated financial holding company. However, in terms of expanding the commercial lending powers of financial intermediaries, it argued that this had to be carried out through a new institution -- a schedule C bank.

Over the last year or so there have been several further position papers. In terms of Ontario, the Ontario Securities Commission report (frequently referred to as the Dey Report) recommended that ownership restrictions in the securities industry be eased -- the so-called 30-30 provision. A financial institution, domestic or foreign, would be able to own up to 30% per cent of a securities firm. Foreign dealers could either access this option or register under a new category, the foreign dealer registrant. Each such registrant would be allowed a maximum capital base of 1.5% of the

total industry capital and these new registrants, as a group, would be limited to 30% of industry capital. Hence, the 30-30 designation. One peculiar feature of the Dey Report is that all of the chartered banks' main competitors in international markets would be allowed to register as foreign dealer registrants (or as schedule B's) but neither the banks themselves nor their merchant banking subsidiaries would qualify. It is hard to rationalize, on grounds either of efficiency, equity, or nationalism, why the likes of Salomon Bros., Goldman Sachs and Deutschebank should be favoured over, say, Orion Royal Bank.

More recently, the report of the Ontario Task Force on Financial Institutions (The Dupré report) backpeddled on this issue, recommending that the ownership limits be expanded only to 20% and that foreign dealers not be allowed foreign-dealer-registrant status to operate in the registered market. However, the Dupré report did give its blessing to the continued existence of the exempt markets.

Thus far the Ontario government has not introduced any legislation. However, this has not meant that the securities environment in Ontario is remaining static. Prior to these reports, many foreign firms probably felt that moving aggressively into Ontario might trigger restrictive legislation. This no longer would appear to be the case and some foreign firms appear to be ready to establish operations in Ontario. The rationale must be that, if the Dey report is adopted, then they will become foreign dealer registrants and, if the Dupré report is adopted, then at least they would be welcome to operate in the exempt markets. In any event, word appears to be out that Goldman Sachs is coming to Toronto this fall.

At the federal level, both the Senate and House reports on the Green

Paper appear to be falling behind the Quebec approach to the financial sector. Both would permit ownership integration across the pillars either in terms of direct subsidiaries or via holding companies. And while these reports recognize that the securities industry is under provincial jurisdiction, both recommend that financial intermediaries be allowed to acquire securities firms, if the provinces are willing. The Senate report goes further by noting that it would seem appropriate that securities firms also be able to diversify across the pillars in terms of acquiring subsidiaries or establishing financial holding companies.

Perhaps most importantly, both these reports express the view that, when the Bank Act next comes up for review, the chartered banks be given diversification powers similar to those being recommended for trust and insurance companies, which would include the ability to acquire securities firms provided the provinces are willing.

Finally, the designation of Montreal and Vancouver as international banking centres in Finance Minister Wilson's recent budget adds a further wrinkle to the relationship between financial intermediaries and market intermediaries. Quebec is already in the process of passing enabling legislation for such centres, which encompasseses the purchase, sale and underwriting of any capital issue where there is a non-resident on either side of the transaction. Presumably, Quebec would welcome the chartered banks as participants in the Montreal international banking centre. For its part, British Columbia is about to publish a position paper on the financial sector designed to attract financial institutions to Vancouver. One feature of this position paper is reported to be that the B.C. government will not impose any ownership requirements on new institutions establishing in Vancouver. Again

this might accommodate financial institutions owning securities firms.

Prior to rendering an assessment on how all of this may eventually be resolved, it is instructive to note that Ontario's rules are clearly offside with respect to the rest of the world. In continental Europe, there is frequently only one pillar. Australia has now opened up its financial sector. Japan appears about ready to do the same. It is true that Glass-Steagall in the U.S. prohibits banks from owning securities firms. But the U.S. does not prohibit other financial intermediaries or even non-financial corporations from doing so -- Prudential Insurance owns Prudential Bache, American Express is associated with Lehman, and Sears owns Dean Witter. Hence, it is Quebec, not Ontario, that is closer to the international norm.

It may well be that Ontario's policies are "right" in some underlying philosophical sense. However, markets are now so integrated and financial technology so sophisticated that the system will simply pass Ontario by. This is even moreso the case, given that Quebec has a much more liberalized financial environment. Thus, I see little risk of being wrong in predicting that major changes are about to take place in the Canadian securities industry. Moreover, it is also my belief that the securities industry will be opened up to domestic financial institutions, including chartered banks or at least their merchant banking subsidiaries. To do otherwise would not make any sense: why allow entry to giant foreign firms like Daiwa and Goldman Sachs (which will probably be the price for Canadian access to Tokyo and New York) and deny entry to Canadian-owned intermediaries? And if Canadian intermediaries or conglomerates can get access, why would one shut out the only financial intermediary that, by law, must be widely held, namely the

chartered banks.

Hence, it is my view that the chartered banks will eventually be allowed to enter the securities industry and, as such, operate their merchant banking or investment banking activities domestically. Moreover, this is something that ought to be of considerable value to the banks. My advice to the banks would be to accept, if not welcome, the additional commercial lending ability currently being recommended for the near banks and to begin right now to lobby for equivalent powers to diversify across the pillars.

But even if I am wrong in this prediction, chartered banking in Canada is going to undergo a rather dramatic transformation. Part of this relates to the fact that money is so inherently fungible and financial technology so pervasive that the regulatory authorities will have immense difficulty in maintaining the separation of the pillars. Part also relates to the fact that all financial institutions, not only chartered banks, are going to summon all their creativity and innovation to maintain their customers' base. If their customers are moving in other directions, the institutions will follow them either by adjusting their traditional operating methods or by designing new financial instruments that will contribute further to the already-blurred distinctions that exist among the financial offerings of the various pillars.

IV: CHANGING THE FACE OF DOMESTIC BANKING

Challenges and Opportunities

The challenges faced by the chartered banks domestically are not all that dissimilar to those that they face internationally:

- . prime corporate borrowers are increasingly finding attractive alternatives to banks as a source of funding. These alternatives include direct access to capital markets and increased access to the flow of savings through institutional channels;
- . the return on the traditional deposit-taking, loan-making function has fallen substantially. Increased competition has narrowed considerably the spread between loan and deposit rates. In terms of wholesale banking the schedule B banks have made life difficult for the schedule As. On the retail side, where spreads are typically larger, effective competition has come from the trust companies -- institutions whose capital bases are not affected by over-exposure to the third world and the oil patch, nor subjected to the provision of holding non-interest-bearing reserves with the Bank of Canada;¹⁵
- . the nature of the market for financial activities has changed considerably. Customers are increasingly interested in paying for only those services that they want. The traditional "package" of services available from a customer relationship has given way to "unbundling" or marginal-cost pricing of the various services which, in turn, has greatly increased the flexibility of customers to pick and choose across intermediaries for their services.
- . the on-going erosion of the four pillars and, in particular, the emergence of financial conglomerates means that banks are facing competition from institutions able to offer a wider variety of financial services.

However, the reality is that the ability of the banks to respond to these

challenges domestically is more limited than their ability to respond internationally.

One obvious solution, therefore, is for the banks to take their clients overseas, i.e., to make full use of the internationalization of financial markets, of the advantage over their domestic competitors (except perhaps for the schedule B's) in terms of a global presence, and of their freedom to operate in all pillars off-shore. This, too, is among the implications that arise from an increasingly integrated world capital market: if domestic regulatory authorities do not allow the banks to bring their international expertise home to domestic clients, the banks can always bring their clients overseas. This represents a rather peculiar turnabout. The traditional argument is that institutions need a strong and successful domestic base in order to carve out a meaningful international presence, whereas the above argument suggests that it is the strong international presence that may be necessary to maintain the domestic base. Thus, one can expect that the banks will move to enhance their international presence both because it is more profitable in its own right and because it is essential to maintain and perhaps even expand their prime-borrower clients. One would also expect that the banks will make innovations such as currency and interest-rate swaps available to a progressively larger set of domestic corporations. Indeed, this is already occurring.

The banks' second general response, again modelled after their international experience, will be to move in the direction of focusing on off-balance-sheet activities, i.e., following the markets toward the marginal pricing of existing services and offering a broader range of services than has been traditional. Obviously, initiatives in this direction would be

facilitated greatly if the regulators were to allow banks greater cross-pillar powers. But money and ideas are so inherently fungible and technology is so readily available that the banks will make substantial inroads in this direction regardless of the evolution of financial regulation. Providing NIF-type backstopping to facilitate their customers increased direct lending, and moving loans of cramped balance sheets by bundling up car, mortgage, commercial and consumer loans and issuing securities backed by these loans are obvious sorts of financial innovations that may appeal to some banks. The securities industry may well object to these developments since the securitization of loans tends to convert the original loan contract into a prospectus of sorts. But with the securitization of loans now playing such a major role in U.S. banking circles, these protests will probably come to naught.

More generally, securitization represents just one more avenue that is serving to erode the four-pillar philosophy and that, in practice if not in principle, will eventually lead to the integration of the pillars. Faced with the potential loss of customers or traditional revenue sources, all financial institutions can be expected to exercise creativity in designing financial instruments and techniques to skirt existing regulatory barriers.

The third general way in which the banks will likely respond to these challenges is to strategically focus, or perhaps more correctly refocus, their efforts on serving the needs of consumers and small businesses. In general, the two previous approaches to the challenges facing the banks represented alterations in their corporate strategy or philosophy. Efforts to focus more on consumers and small business involve, in addition, a rethinking of what the branch network is all about.

Restructuring the Branch

Much of the discussion and analysis thus far has tended to focus on the "high flyers" in the system -- prime borrowers, globally present investment and commercial bankers, and the latest wave of sophisticated financial instruments. However, the impact of the application of computer and telecommunications technology to the financial sector and of the move towards integrated financial markets has been far greater, relatively, on the average Canadian than it has been in the various elites in the system. Canadian consumers, investors and small entrepreneurs have acquired access to information, to financial services, and to markets and in general have a degree of financial sophistication that frequently ranks them with the so-called high flyers. One obvious result of all this is that the traditional bank branch has become outmoded.

It is resorting only slightly to exaggeration to note, as does a recent feature in The Economist, that the first wave of technology essentially knocked off the back part of the branch. The second wave -- the advent of machines dispensing cash, taking deposits, answering questions about balances, accepting loan applications and the like -- is knocking off the front part.¹⁶ The question is: What to do with the middle?

The issue is complicated further by the fact that rapid spread of plastic has made banking increasingly impersonal, thereby eroding the loyalty that customers once had with their banks or trust companies. And technology is now taking banking into the office and the home: some highly-valued bank customers already have the ability to access their accounts and shift money instantaneously from one account to another or to clear non-interest or low-interest accounts overnight into higher-yielding accounts. Thus one

aspect of the dilemma facing the branch network is that there is little reason for customers to come to the branch.

Yet another complicating factor for the branch is the unbundling of the traditional dual relationship where customers typically availed themselves of services on both sides of the balance sheet. In the halcyon days of banking, not only would firms and individuals be associated with a particular bank, but loans essentially implied deposits if not because of geographical necessity then because of package arrangements (compensating balances and the like). With increasing competition, information and customer sophistication, this link is becoming progressively more tenuous -- consumers feel no compunction to ensure that the financial institution utilized for their deposit activities coincides with the institution where they hold their mortgage or their line of credit.

What this implies for the banks, and for other financial institutions as well, is a much greater separation between their liability and asset activities than was heretofore the case. Indeed, the banks' principal competitors in terms of their deposit business are quite different from their competitors on the asset side, particularly as this relates to corporate business. In turn, this poses further problems for the branch network since the degree of specialization now required in marketing the banks' full range of services is not consistent with the traditional customer-initiated model of service.

Changing the Underlying Philosophy

Thus, it is not surprising that we are witnessing a transition in banking from a "production" mentality to a "retailing" mentality:

"As a retail banker, you will have to be more retailer than banker in the future. The difference is primarily one of mind-set. The retailer identifies a market, determines the level of quality and variety and the degree of price sensitivity customers demand, stocks shelves with the merchandise most likely to optimize volume and profits, and reaches out to sell in a manner appropriate to consumers....The banker has traditionally identified a market, offered what was allowed by law and custom under terms that fit personal attitudes and systems, and awaited the customer."¹⁷

One potential advantage that the chartered banks have in adjusting to this new environment is that there is a lot of room to experiment across the branch network in terms of products, hours, and even such things as decor. Presumably, much experimentation is currently underway. Nonetheless, the dilemma for the branch system arising from the market-driven requirement that banks shift their mentality more towards "retailing" than "production" remains. In the remainder of this section I want to focus on two important areas where the banks have both opportunities and challenges -- catering to small business and to selected niches of the consumer market.

Small Business

Maintaining small business contacts is probably the easier of the two since banks are still a very significant source of funds for small business, particularly in non-metropolitan areas. Simply put, the "middle" of the branch could become a small-business financial-services boutique. Essentially, the branch would offer the services of a small-business merchant banker, striving to finance, service, and advise over the entire capital and financial needs of small businesses, rather than merely being the source of loan financing. Clearly, one advantage of such a boutique to the company is that the bank would become a one-stop financial supermarket for the company's

present and future overall financial needs. As a small businessman remarked recently about the range of services he wants from his U.S. bank:

"...many of us tend to seek a cluster of financial services. Those include combinations of such products as payroll services, cash management, business trust services, and personal loans. Some banks may make available to us computer software that will give us general financial data, including forecasts and rates, and information on our own accounts, perhaps sending us daily updates on our positions, so we can make optimal use of our cash. Seminars designed to assist small business owners, especially those seminars dealing with tax planning, business trends, and personal financial advice, are appreciated. By providing several of these services, a bank can become familiar with its customers quickly, and we can become comfortable with the bank.¹⁸

To this set of services, Canadian banks would presumably also attempt to deliver as much of the firms overall financing needs as possible, not just the loan component of any financing.

The advantage from the banks' point of view, in addition to retaining customers, would be that the provision of such a bundle of financial services would match what the competition is offering. In the process, these activities would generate management fees and off-balance-sheet items rather than the current reliance on interest income.

There are of course several barriers to hurdle. First of all, the provision of small-business investment banking requires human capital of a sort quite different from that typically associated with account managers. The very nature of this full-service package requires much greater financial sophistication on the part of the account manager and, also, much greater discretion and decentralization of operations.

It is not within my expertise to suggest how the head office would structure these "branches" in order that they combine some optimal combination

of incentive and control, nor to suggest the manner in which these small business "profit centres" would interface with the back-up services provided by the head office. At the very least, however, it would seem apparent that head office should either restrict the capital available to these various small business centres or specify minimum rates of return on capital. Otherwise, account managers will not have appropriate incentives to alter their long-standing tradition of viewing their role primarily as one of providing loans. As noted earlier, it is precisely this sort of capital or asset limitation (dictated by the regulatory authorities) that has provided the incentive for many schedule B banks to focus on investment banking or off-balance-sheet activities.

Secondly, while this small-business boutique was depicted as a solution as to what to do with the "middle" of the branch, it is unlikely that these operations could meaningfully be housed, except peripherally, within the traditional branch network. Rather, it is more likely that such a boutique would occupy a small office in a commercial high-rise building, with a mobile, insurance-type sales force retailing the range of products and services directly to the small businesses in the area.

Finally, the banks will probably once again run into the regulatory system. Full investment banking would require the provision of services such as insurance and underwriting -- functions that under existing regulations may more easily be obtainable from a financial conglomerate than from a bank. Recently, however, some banks have begun to offer loans that appear to incorporate an element of insurance. This is further evidence that the pillars are crumbling. One alternative avenue that appears to be opening up in some provinces is multiple licensing of agents of financial institutions

for the distribution of a variety of financial services. In the technical jargon this is referred to as "networking", i.e., arrangements between financial institutions under which one of the institutions provides the public with access to the products or services issued by the other. This provides institutions with the ability to offer a broader range of financial services than they could otherwise offer on their own account. It is interesting to note that all of the various reports on financial sector reform were unanimous in favouring networking. Obviously, the preferable alternative from the point of view of some of the banks would be for the regulatory system to allow enhanced cross-pillar activities.

Targetting Consumer Niches

Maintaining profitable ties with consumers is likely to be more challenging for the banks. At the same time, it likely to be critically important since more and more the formation of assets is taking place in private households rather than in corporations or governments. Thanks to increased competition and increased consumer awareness, financial institutions can no longer view retail deposits as the source of inexpensive funds that they once were. But even with the move toward more competitive rates, a retail deposit base is still of immense value to banks, particularly if the alternative is to access the volatile wholesale market. What is emerging, however, is that individuals and households are an increasingly valuable market for the full array of financial services. In such an environment, those institutions that are able to deliver their financial services may also acquire the associated deposit base. Phrased somewhat differently, while it is clear that Canadians need banking services, it is far from clear that they

need the services of a bank.

While one-stop financial shopping centres or financial supermarkets might not be everyone's cup of tea, it seems to me that they are motivated by exactly these incentives -- to provide a full range of financial services to consumers and in the process to capture the deposit business. The next application of technology in the financial arena will probably be in the direction of "home banking". In the comfort of one's own home a personal computer will be able to access the full range of existing accounts, replete with information on investment opportunities and the latest market quotes. Initially, it would appear that the financial conglomerates would be favoured in this race. Indeed, they may even be able to sell the necessary computer software to their customers. As recently as a decade ago, the safe assumption would have been that the banks would have captured this business. This is far from obvious now and part of the reason is the explosion of plastic money, since the credit card is becoming the key to the banking relationship.

Actually, the Canadian banks are thus far in a much better position in this regard than are the American banks because the banking system in Canada has a much tighter control over credit cards than is the case for the U.S. banks. Sears Roebuck is America's biggest issuer of plastic with more than 60 million card-carrying customers. Now Sears is sending 25 million Discover cards to its cardholders, allowing them to access a network of 5,000 ATMs as well as to use more sophisticated savings accounts.¹⁹ Moreover, Visa has allowed firms like Merrill Lynch to issue credit cards. Given the restrictions on out-of-state banking in the U.S., Merrill Lynch can already lay claim to being the first truly national "bank". To some bankers, these are ominous developments: "once banks lose control of the payments system,

they are in danger of losing the deposits that come because of it and thus of losing the retail business altogether."²⁰

Actually, an equally bleak scenario is that banks specialize in providing their customers a place to store their money and to process their transfers since, in most countries, the charges for such transfers are lower than the cost. For example, the U.S. Federal Reserve reported that for 1983 the cost of providing a personal chequing account averaged between \$5.47 and \$8.60 per month while customers paid between \$2.84 and \$3.35 in fees.²¹ Presumably the situation in Canada is roughly similar. The banks are going to be in serious trouble if they cannot capitalize on the fee and management income that will arise from the new generation of consumers and, hence, they become relegated to processing transfers for the financial institutions that are the innovators in the system.

However, as noted above, the banks have more control at present over issuance of credit cards than their counterparts in the U.S. Moreover, the Canadian securities firms are currently in a very weak position relative to the chartered banks, particularly if a comparison is made with these institutions south of the border. Nonetheless, the Canadian securities firms will move in the U.S. direction. Already Merrill Lynch Canada has inaugurated a version of the cash management account that allows chequing via a networking relationship with a chartered bank. And the so-called "free-credit balances" (i.e., deposits) kept with securities firms earn a rate of interest above that available in chartered banks, largely because the securities firms are subject to neither reserve requirements nor deposit insurance premiums on these deposits. Thankfully, from the chartered banks point of view, the very restrictive ownership regulations pertaining to securities firms and their

resulting limited capital base implies that they cannot yet mount a serious challenge to the banks in terms of competing for consumer business.

At this juncture, an important aside is warranted. Earlier in the paper I argued that it was critical to the future of banking in Canada that the banks be allowed to diversify across the pillars and, in particular, to be able to deploy their merchant banking expertise domestically. In my view, it is even more important that the securities firms embrace the Senate report's recommendation that they too be allowed to diversify into other areas of the financial sector. The proven appeal of the cash-management-account approach would be enhanced dramatically if securities firms had also trust and life companies under their wing.

Presumably, in designing their strategy for enhancing the provision of services to consumers, the banks will zero in on particular market niches, e.g., the upwardly mobile yuppies, career women and students. However, I want to focus on an emerging client group that will obviously represent an important market -- the "golden agers". The next generation of retirees will be incredibly wealthy, at least with respect to their predecessors. In addition to any accumulated wealth, most will have generous pensions and many will have taken ample advantage of tax-assisted savings devices like RRSPs. A year ago, I would have hazarded a guess that the life companies would be a natural home for the financial needs of these individuals. However, with the provision in the proposed pension legislation that individuals be granted much greater latitude in managing their own pensions (as well they ought to!), the securities firms may well be the intermediary with the best chance of capturing these customers since they are likely to play a prominent role in managing, or co-managing, the retirees' pensions.

But this group might also be won by the banks. What would be required is again a financial-services boutique that would need to be every bit as sophisticated as that for small business. The recent moves by the T-D Bank (Green Line Investor Services and the TSE mutual fund) go some way toward this end, but the range of services and expertise again run the gamut from investment advice, estate planning, trust facilities, tax planning, insurance, trading capability through to the traditional banking activities. I need not dwell again on the obvious -- that the regulatory process will play a role in determining whether the banks are successful and that the nature of the expertise needed to provide this range of services is quite different that of the archetypical branch banker. However, it would appear that the existing branch network is more amenable to being converted into specialized consumer boutiques than it is to servicing corporate and small business needs.

The general point is a simple one. Banks no longer enjoy the privileged position they once did. To be successful in the current environment they are going to have to market their services in a way that runs counter to tradition. There are, of course, many options open to them. For example, Bankers Trust in the U.S. abandoned the retail market, sold more than 200 branches and concentrated on merchant banking. Citicorp, on the other hand, completely revised its corporate structure and effectively established three more or less autonomous units handling consumers, corporate and institutional customers, and capital markets.²² Both strategies appear to have succeeded.

In the Canadian context, it is highly unlikely that the established chartered banks will relinquish their reliance on retail markets. The presence of the schedule Bs, which are essentially wholesale banks, and the domestic penetration of foreign securities firms, again at the wholesale or

corporate level, does not leave much room for a schedule A bank geared solely to the wholesale market. In part, this is the message to be derived from the failures of the CCB and Northland. Rather, the likelihood is that the chartered banks will attempt to develop strategies that will maximize their ability to generate a low-cost retail deposit base. However, it is also likely that this deposit-taking function will become more specialized, in the sense that it will be less integrated than previously with the function of "placing" this money. Consumers and small businesses desire a range of financial services well beyond that which was associated with chartered banking in Canada only a decade ago. The onus is on the banks to respond to this challenge. They are not pre-ordained to continue to play the dominant role that they have played in the financial history of our country.

V: CONCLUSION

Probably for the first time in our history it is possible to conceive of Canada without chartered banks. The rise of the trusts and credit unions and the march of technology have created a situation where most Canadian consumers now have access to alternative institutions for storing and transferring money. In terms of corporate finance, the securities firms, the schedule B banks, the financial conglomerates and the large pools of institutional capital provide alternative sources of business financing. This is particularly the case if the on-going financial reform process enhances the commercial lending powers of the life companies, the trusts and the credit unions.

However, a purely domestic view of the role of banks is far too narrow a

perspective. In a world where financial technology and financial instruments are rapidly evolving and where markets for capital and credit are increasingly becoming global, the chartered banks are effectively the only Canadian financial institutions giving us a meaningful international presence. Moreover, in a world where all countries appear to be restructuring their economies, it is absolutely essential that Canadian enterprises have full access to the range of financing sources and techniques available to their competitors in other countries.

To be sure, financial sector reform ought to encourage all Canadian institutions to attain world-class status. However, it is also the case that such reform ought to ensure that the chartered banks can maintain their current world-class status. In my view this requires that the banks be allowed much greater leeway to conduct their operations domestically. The fear of some is that allowing the pillars to integrate will result in large financial conglomerates. It probably will. But so will the status quo. The next downturn in economic activity will likely see a new wave of mergers among Canadian securities firms and a further strengthening of the financial conglomerates. More to the point, to make it on the global scene in the 1980s firms of necessity must be large. Hence, the choice essentially comes down to the issue of whether Canada will have large domestic or large foreign firms dominating its domestic-international financial linkages. In this sense the chartered banks would appear to have much appeal, especially given that they are widely held and, therefore, will not increase the concentration of ownership in the financial sector.

However, the thrust of this paper is that even if the banks are granted greater investment banking powers within Canada, they may still face very

rough competition. Traditionally, they have not been effective retailers of their products. Their original strength lay in a far-flung network of branches combined with an effective monopoly power over the payments system. Technology and competition have substantially eroded this advantage. And this erosion will continue unless the banks alter their underlying operating philosophy to recognize, as noted above, that while Canadians need banking services, they do not necessarily need the services of a bank.

TABLE 1

The International Credit and Capital Markets
 (\$ Billion U.S.)

	1981	1982	1983	1984	1985
A: <u>New Issues in International Markets</u>					
1. International bonds and notes	44.0	71.7	72.1	108.1	162.8
2. Syndicated Euro-bank loans	96.5	100.5	51.8	36.6	21.6
3. Total	141.5	174.5	127.2	163.8	233.8
B: <u>Banks Holdings and Issues of Securities</u>					
1. Holdings of bonds and securities (new and existing)	46.7	59.2	76.7	99.5	157.7
2. Securities issued by banks	6.6	11.0	11.9	23.1	43.0

Source: Bank of International Settlements, Recent Innovations in International Banking, April 1986, Tables 5.1, 5.4, and 5.5.

TABLE 2

Foreign Banking Presence in Selected Countries
(at end-period)

Host Country	1960	1970	1980	end-June 1985
Number of institutions ¹				
Belgium	14	26	51	57
Canada	0	0	0	57
Italy	1	4	26	36
Netherlands	-	23	39	40
Switzerland	8	97	99	119
United Kingdom	51	95	214	293 ²
Number of banking offices ³				
France	33	58	122	147
Germany	24	77	213	287 ⁴
Japan ⁵	34	38	85	112
Luxembourg	3	23	96	106
United States	-	- 6	579	783 ⁷

1 Number of foreign banking institutions ("families") operating in the country through branches or majority-owned subsidiaries unless otherwise specified.

2 At end-June 1985, 357 if joint ventures and consortium banks are included.

3 Foreign banking organisations represented by more than one entity are doubled-counted.

4 At end-June 1985 these offices represent 95 different banking organisations.

5 Branches only; at end-June 1985 there were 76 different foreign banks operating in Japan.

6 In the early 1970s there were about 50 foreign banking offices.

7 At end-June 1985 these offices represented approximately 350 institutions.

Source: Bank of International Settlements, Recent Innovations in International Banking, April 1986, Table 7.4.

TABLE 3

Euronotes Top 20 Underwriters - By Volume
(January to September 1985)

Rank	Bank	Amount (\$m)	Number of Transactions
1	Banque Nationale de Paris	765.6	44
2	Orion Royal Bank/RBC	695.8	43
3	Credit Suisse	617.7	36
4	IBJ	612.1	46
5	Sumitomo Bank/Sumitomo Finance	576.8	37
6	Bank America Capital Markets Group	560.5	28
7	Bankers Trust	553.7	34
7	Toronto Dominion	531.7	24
9	Crédit Lyonnais	491.7	39
10	Swiss Bank Corp/SBCI	489.7	25
11	Banque Paribas	450.2	39
12	Amsterdam-Rotterdam Bank NV	448.7	24
13	Algemene Bank Nederland	493.3	24
14	Bank of Montreal	420.7	18
15	Westpac Banking Corp	401.4	30
16	First Interstate	392.9	16
17	CIBC Ltd	389.6	26
18	Citicorp	378.4	34
19	Bank of Tokyo	368.6	24
20	Nat West/County Bank	357.6	19

Source: Supplement to Euromoney, January 1986, p. 1.

ENDNOTES

*An earlier version of this paper was presented to the National Bank of Canada, May 29, 1986, Montreal.

¹The source for much of the information in this section comes from Recent Innovations in International Banking: April, 1986, a Bank of International Settlements (BIS) publication.

²"Inside the New In-House Banks," Euromoney, February 1986, p. 24.

³The information in the remainder of this paragraph comes from the article referenced in the previous footnote.

⁴"Recent Innovations in International Banking, op.cit., pp. 12-13.

⁵Ibid., p. 9.

⁶Bankers Trust Company, "The International Swap Market," Euromoney: January 1986 (Supplement), p. 97.

⁷Ibid.

⁸"Recent Innovations in International Banking," op.cit., p. 39.

⁹Ibid., p. 45.

¹⁰ Ibid., p. 43.

¹¹ Ibid., p. 4.

¹² Euromoney: Annual Financing Report, 1986 (March 1986), pp. 10-12.

¹³ As will be emphasized later, full-service brokerage in Canada requires registration with the respective provincial securities commissions which in turn entails (except for Quebec) ownership requirements. However, certain aspects of the securities markets are "exempt" and, hence, open to all domestic financial institutions and foreigners alike. In general, there are two sorts of exempt markets -- those that are exempt because of the nature of the securities themselves (e.g., government bonds and bills and debt instruments of financial institutions) and those that are exempt because of the nature of the transactions (e.g., transactions above \$100,000 in value). In addition, all securities-related transactions destined for foreign markets are exempt. Together, these exemptions actually account for the majority of securities-related transactions in Canada.

¹⁴ Barry Critchley, "Edpers Offspring: Great Lakes Leads the Big Push Against Financial Barriers," The Financial Post (May 24, 1986), Section 2, p. 1.

¹⁵ I assume, along with the Senate and House reports, that the next round of financial legislation will "level" the playing field between banks and trusts in terms of the "tax" on banks arising from the requirement to hold

non-interest-bearing reserves with the Bank of Canada. My preferred solution would be to have the Bank of Canada pay interest on these reserves..

¹⁶"A Survey of International Banking: The Consumer is Sovereign," The Economist, March 22, 1986, p. 46.

¹⁷Ibid, p. 30. The original source of this quotation is an 1984 Peat, Marwick, Mitchell report for the American Bankers Association.

¹⁸George Morris, "What a Small Business Wants from Its Bank -- and its Loan Officer," The Journal of Commercial Bank Lending, February 1986, p. 21.

¹⁹"A Survey of International Banking: The Consumer is Sovereign," op.cit., p. 50.

²⁰Ibid, p. 55.

²¹Ibid., p. 42.

²²Ibid., p. 29.

APPENDIX¹The Mechanics of Interest-Rate Swaps

Table A1 presents the borrowing profiles of two companies. Company A, with the better credit rating, can borrow more cheaply than company B in either the fixed or floating markets. However, company A can borrow 1.20% cheaper than company B in fixed rates but only .50% cheaper in floating. (LIBOR is the London Interbank Offered Rate.) Since company A wants floating rate funds and company B wants fixed rate funds, an interest-rate swap can arbitrage over the relative comparative advantages.

Panel B of the table has each company borrow funds where it has the comparative advantage. Panel C demonstrates the swap process. Company A pays company B the LIBOR floating rate while company B agrees to pay a fixed rate of 10.90% to company A. (The amount of the principal and the payment dates are identical.)

The net position for company A is as follows. It has borrowed at 10.80% fixed but receives 10.90% fixed. And in return it is paying floating LIBOR. Hence, the net result of the swap is that it is paying LIBOR minus 1/10%. Company B has borrowed at LIBOR plus 3.4% and receives LIBOR from company A for a net cost of 3/4%. In addition, it is paying a fixed 10.90% to A, for an overall cost of 11.65%, fixed.

Rows E and F show the effective savings, both at 35 basis points in the example used.

¹The text and the table are adapted from Bankers Trust Company, "The International Swap Market," Euromoney (January 1986, Supplement), pp. 94-95.

This need not be the end of the story. If interest rates float down, then company A will obviously leave the swap in place since it now has a floating contract. At the end of the interest rate decline, company A could enter into another swap to "lock in" the low rate, i.e., it could now go from floating to fixed. This would be the obvious strategy if interest rates were expected to rise again. If interest rates were expected to remain at their lower levels, then company A may simply stay put, since it has already benefited from the fall in LIBOR.

The arrangement of swaps is a straightforward process, often conducted by telephone and subsequently confirmed by telex subject only to agreement on acceptable documentation.

TABLE A1
The Mechanics of an Interest-Rate Swap

	Company A	Company B	Comparative Advantage
<u>A. Company Profiles</u>			
1. Credit Rating	AAA	BBB	
2. Cost of Raising Direct Fixed Rate Funds	10.80%	12.00%	1.20%
3. Cost of Raising Direct Floating Rate Funds	6-month LIBOR plus 1/4%	6-month LIBOR plus 3/4%	.50%
<u>B. Direct Funding Cost</u>			
1. Fixed Rate Funds Raised Directly by Company A	(10.80%)		
2. Floating Rate Funds Raised Directly by Company B		(6-month LIBOR plus 3/4%)	
<u>C. Swap Payments</u>			
1. Company A Pays Company B Floating Rate Interest	(LIBOR)	LIBOR	
2. Company B Pays Company A Fixed Rate Interest	10.90%	(10.90%)	
<u>D. All-in Cost of Funding</u>	LIBOR - 1/10%	11.65%	
<u>E. Comparable Cost of Equivalent Direct Funding</u>	LIBOR + 1/4%	12.00%	
<u>F. Saving</u>	35 Basis Points	35 Basis Points	

Source: Euromoney (January 1986, Supplement), p. 95.



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