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DEPOSIT-ACCEPTING INSTITUTIONS IN 1996: THE STRUCTURE AND ECONOMIC PERFORMANCE OF THEIR ACTIVITIES

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Résumé de l'article

Le marché des services financiers est en profonde mutation. La combinaison du progrès dans les technologies de l'information, les changements législatifs ainsi que les forces du marché sont autant de facteurs qui ont réduits la ligne de démarcation traditionnelle entre les institutions de dépôts et de retraits (banques à charte, sociétés de fiducie, caisses d'épargne et de crédit) et les autres institutions financières. Des concurrents domestiques et étrangers, y compris des institutions de type « virtuel », font leur entrée sur le marché. Les firmes se restructurent par le biais de fusions ou d'acquisitions, de partenariats d'affaires et de localisation dans des niches afin de faire face à la concurrence issue de joueurs à vocation mondiale et fortement capitalisés. Utilisant des données inexploitées jusqu'ici, cette étude examine les activités, les structures de marché et la performance économique des institutions de dépôts au Canada, à la lumière des différents changements ayant affecté leur environnement.

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RÉSUMÉ

Le marché des services financiers est en profonde mutation. La combinaison du progrès dans les technologies de l'information, les changements législatifs ainsi que les forces du marché sont autant de facteurs qui ont réduits la ligne de démarcation traditionnelle entre les institutions de dépôts et de retraits (banques à charte, sociétés de fiducie, caisses d'épargne et de crédit) et les autres institutions financières. Des concurrents domestiques et étrangers, y compris des institutions de type «virtuel», font leur entrée sur le marché. Les firmes se restructurent par le biais de fusions ou d'acquisitions, de partenariats d'affaires et de localisation dans des niches afin de faire face à la concurrence issue de joueurs à vocation mondiale et fortement capitalisés. Utilisant des données inexploitées jusqu'ici, cette étude examine les activités, les structures de marché et la performance économique des institutions de dépôts au Canada, à la lumière des différents changements ayant affecté leur environnement.

ABSTRACT

The financial service market place is being dramatically redrawn. Progress in information-processing technology, legislative changes, and market forces have combined to blur the traditional distinctions between deposit-taking institutions (chartered banks, trust companies and credit unions) and other financial institutions. New domestic and foreign competitors are entering the market, some doing so as 'virtual' institutions. Businesses are being reorganized through mergers and acquisitions, joint ventures and niche market positioning to compete with well-capitalized global players. Using an, as yet, untapped dataset, this paper provides an analysis of the activities, market structures and economic performance of deposit-accepting institutions in Canada, in light of the various changes that affected their environment.

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THE CONTEXT

In 1996, the value of production for deposit-accepting institutions (chartered banks, trust companies and credit unions) was $33 billion. This represents a 38% increase since the 1992, the year of the most recent revision to *The Bank Act*.

In recent years, foreign activities and trade in financial services have become increasingly prominent elements of the activities of financial institutions. Chartered banks, in general, are more integrated to the world economy in comparison to other deposit accepting institutions. In 1996, 20% of Chartered banks' production was outside Canada, while roughly 90% of the employment was based in Canada. With $2 billion in exports in 1996, representing roughly 7% of Canada's exports in services, Canadian chartered banks contribute significantly to Canada's global competitiveness.

BANKS, TRUST COMPANIES AND CREDIT UNIONS HAVE BROADENED THEIR OPERATIONS, BUT THEIR CORE BUSINESS IS STILL THEIR DEPOSIT-ACCEPTING ACTIVITY

Significant changes have occurred in the financial sector in Canada over the last few decades as a result of domestic and international factors. The globalisation of financial markets, technological innovation (information technology), financial innovation (derivatives and securitization), demographic changes (aging baby boomers) and the revision of the regulatory environment have blurred the distinctions between the traditional financial institutions. As a result, the four pillars of the Canadian financial sector (chartered banks, trust companies, insurance companies and investment dealers) have gradually merged, with much greater overlap of business lines and direct competition between each traditional financial institution.

The product lines of deposit-accepting institutions have broadened considerably beyond the core activity of lending, deposit-accepting, and traditional service functions. A notable feature has been their entry into the trust, mutual fund, insurance, and retail brokerage activities. Although there are variations in structure among the deposit accepting institutions, their activities can conveniently be reviewed by dividing their operations into retail banking, commercial and institutional finance, electronic financial services, and treasury and investment banking.

In spite of these changes, the traditional activities of retail banking and corporate and institutional finance accounted for 90% of their overall production in 1996 (Table 1). Retail banking remains prominent because these institutions have expanded their lending to households (mortgage loans in particular) and more recently have moved into personal wealth management. This reflects the changing needs of the baby boom generation, first as home-buyers and, more recently, as middle-aged investors.

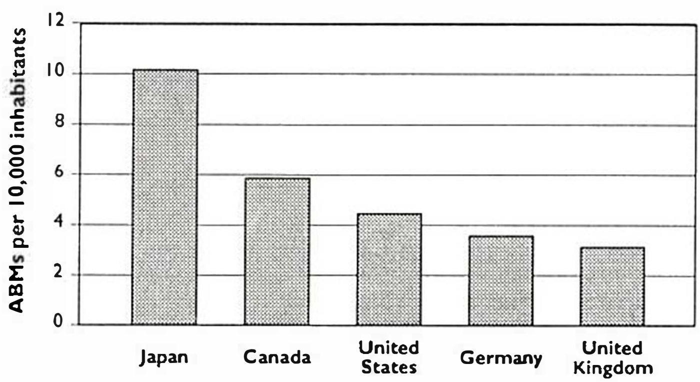
TABLE 1
In 1996, deposit-accepting remains the most significant activity of chartered banks, trust companies and credit unions

	Production in Current Prices		Components of Production			
			Service Fees		Net Interest Income	
	$million	%	$million	%	$million	%
Retail banking	26,208	80.0	7,417	28.3	18,791	71.7
Corporate and institutional finance	3,285	10.0	1,760	53.6	1,525	46.4
Treasury and investment banking	2,176	6.6	1,325	60.9	851	39.1
Electronic financial services	1,075	3.3	621	57.8	454	42.2
All Activities	**32,744**	**100.0**	**11,123**	**34.0**	**21,621**	**66.0**

The 1987 financial reforms allowed banks to purchase and create securities dealer subsidiaries, and the 1992 *Bank Act* granted banks additional powers, such as the right to engage in trust activities. Through their treasury and investment banking activities, banks have become increasingly active distributors and sponsors of mutual funds. Marketing their own mutual funds has helped the banks to maintain their share of household assets during periods when the banks might have lost deposits to higher yielding mutual funds. The banks have also established a major presence in the rapidly growing discount brokerage business, where clients pay low commissions but receive no investment advice. In spite of these changes to the legislation, treasury and investment banking activity accounted in 1996 for only a modest share of deposit-accepting institutions overall activities (6.6%).

Although still in its infancy (3.3% of the overall activity), electronic banking has been driven by deposit accepting institutions seeking more cost-effective delivery alternatives to expensive in-branch banking and by retail clients seeking improved service and choice. Electronic banking has revolutionised the delivery of financial services enabling consumers, where ever they are, to access their financial institutions by telephone, personal computer or automated banking machines (ABMs). In 1996, with 14,000 deposit-accepting institutions branches, 18,426 ABMs and 253,089 *Interac* direct payment terminals, consumers have access to a significant network of banking services in Canada. With 6 ABMs for every 10,000 people, Canada has more ABMs per capita than most major industrialised countries, except for Japan (Chart 1).

CHART 1
CANADA IS SECOND ONLY TO JAPAN IN PER CAPITA AVAILABILITY OF ABMS



Source: Bank of International Settlements, 1996.

THE NEW ACTIVITIES OF THE DEPOSIT ACCEPTING INSTITUTIONS RELY MORE ON NON-INTEREST INCOME

The net interest income of deposit-accepting institutions amounted to $21.6 billion in 1996, while income from service fees was $11.1 billion (Table 1). Although two-thirds of the value of production are in the form of net interest income, service fees have increased rapidly during the 1992-1996 period (an increase of 52% compared to 7% for interest revenue). The rapid increase in service fees is directly attributable to corporate and institutional finance and new activities such as treasury and investment banking and electronic financial services. In these activities service fees are the main contributors to the value of production. In contrast, retail banking, which primarily provides services to individuals and small businesses, derives the bulk of the value of production from net interest income.

Activities of banks have been characterised by the rising importance of off-balance-sheet items which are broadly categorised as derivatives transactions. Dealing in derivatives provides revenues in the form of transactions fees, dealing spreads, and trading profits and has become essential for the six largest banks who want to offer full service to their corporate and investment banking clients. With $193.5 billion[1] in 1996 from their world-wide activities, off-balance sheet positions represented almost 20% of their total balance sheet positions.

IN 1996, PROFITS ACCOUNTED FOR LESS THAN LABOUR COMPENSATION IN THE TOTAL PRODUCTION

The retail banking activity, usually performed at the customers' location, is labour intensive. The collection of retail deposits from households is carried out traditionally through local branches, where most of the banks' labour is employed. Similarly, lending to consumers and small businesses usually requires face-to-face meetings at a branch location. Other activities, such as the collection of large deposits and lending to medium and large businesses, which are centralised at regional or even national offices, are less intensive in labour.

Of the $33 billion of financial services produced in 1996, the deposit accepting institutions posted profits of $9.5 billion and paid $11.5 billion in labour compensation (Table 2). In retail banking, profits accounted for less than the revenue distributed to employees. In other areas, including corporate and institutional finance, electronic financial services and treasury and investment banking, the level of profits was significantly greater than labour compensation. This reflects the greater application of labour saving technologies in these type of activities.

TABLE 2
In 1996, the share of profits in the total production accounted for less than the revenue paid to employees

	Production in Current Prices ($ million)	Labour compensation		Non-interest expenses		Profit before income tax	
		$ million	%	$ million	%	$ million	%
Retail banking	26,208	9,776	37.3	9,835	37.5	6,597	25.2
Corporate and institutional banking	3,285	751	22.9	1,104	33.6	1,430	43.5
Treasury and investment banking	2,176	667	30.6	563	25.9	946	43.5
Electronic financial services	1,075	263	24.5	311	29.0	501	46.6
All Activities	**32,744**	**11,457**	**35.0**	**11,813**	**36.1**	**9,474**	**28.9**

SMALL AND MEDIUM-SIZED INSTITUTIONS FOUND THEIR NICHE

The deposit-accepting business in Canada is marked by a high degree of market concentration, the coexistence of firms of various sizes and the presence of a number of foreign institutions. Except for treasury and investment banking where both small and medium sized institutions control 22% of the market, the markets for all other activities are almost exclusively under the control of large institutions (Table 3). While large institutions are under Canadian control, nearly 70% of small and medium sized institutions' production is under foreign control. This proportion is even higher than 90% for the corporate and institutional finance activity (Table 4).

Large and medium-sized deposit-accepting institutions tend to specialise in retail banking (roughly 80% of their overall activities). In contrast, their small-sized counterparts are oriented more towards investment banking and corporate and institutional finance, both of which account for 53% of their total activities (Table 5). These small-sized deposit-accepting institutions are composed mainly of foreign banks that are established in Canada mainly to service the financing needs of their foreign corporate clients established in Canada. The investment activities of some of these small

TABLE 3
The market share of small and medium-sized institutions is significant in treasury and investment banking

	Market share by size of institutions (%)		
	Large	Medium	Small
Retail banking	93.5	5.5	1.0
Treasury and investment banking	77.7	16.2	6.1
Electronic financial services	98.9	—	—
Corporate and institutional finance	92.7	2.1	5.1
All activities	**92.5**	**5.7**	**1.7**

foreign banks include acting as portfolio managers for some large mutual funds companies.

In 1996, the profit margin ratio was 29 cents per $1 of all services produced. It increased with the deposit-accepting institutions' size, albeit not significantly (Table 6). With more than 40 cents per $1 of services produced, electronic financial services, treasury and investment banking and corporate and financial institutional finance were the activities that posted the highest profit margin ratio in 1996 for all institutions.

The profit margin ratio of corporate and institutional finance significantly increases with institutions' size, thus suggesting the

TABLE 4
More than $^2/_3$ of small and medium sized deposit accepting institutions' production is under foreign control

	Percentage of small and medium-sized institutions' output under foreign control	
	Medium	Small
Retail banking	69.5	44.8
Treasury and investment banking	58.4	91.2
Electronic financial services	—	—
Corporate and institutional finance	95.2	90.2
All activities	**67.9**	**69.1**

TABLE 5
Large and medium-sized institutions are specialised in retail banking whereas their small-sized counterparts are mainly engaged in treasury and investment banking and corporate and institutional finance activities

	Share of the different activities (%)		
	Large	Medium	Small
Retail banking	80.9	76.9	47.2
Treasury and investment banking	5.6	18.8	23.3
Electronic financial services	3.5	—	—
Corporate and institutional finance	10.1	3.7	29.6
All activities	**100.0**	**100.0**	**100.0**

existence of important cost savings in the case of this activity performed by large institutions. Medium-sized institutions seem to have a competitive advantage in the treasury and investment banking activity, where they posted the highest profit margin ratio in the industry (50 cents per $1 of services produced).

In conclusion, changes in the economic and institutional environment have broadened the activities of the traditional deposit-accepting institutions into areas once exclusively reserved to investment dealers and trust companies. Electronic banking, an

TABLE 6
Medium-sized institutions have the highest profit margin ratio in treasury and investment banking activity

	Profit margin ratio			
	All deposit-accepting institutions	Small	Medium	Large
Retail banking	0.25	0.21	0.18	0.26
Treasury and investment banking	0.44	0.18	0.50	0.44
Electronic financial services	0.47	—	—	0.47
Corporate and institutional finance	0.44	0.31	0.35	0.45
All activities	**0.29**	**0.23**	**0.24**	**0.29**

activity prompted by the development of the information technology, has revolutionised the delivery of financial services, allowing customers to have anytime and anywhere access to their deposit-taking institution by telephone or personal computer.

Institutions of small and medium size coexist alongside large ones who control 93% of the whole deposit-taking services. While large institutions are under Canadian control, nearly 70% of small and medium sized institutions' total production is under foreign control. This proportion is as high as 90% in activities such as corporate and institutional finance. The coexistence of firms of different size may be explained by the existence of niches where medium sized institutions are more profitable than their large counterparts.

NOTE TO READERS

This release provides information on production statistics of deposit-accepting institutions in Canada for reference year 1996. It is based on a new survey of chartered banks and trust companies (Segmented Reporting on Banks and Trust Companies) supplemented by data from Statistics Canada's Quarterly Financial Statistics for Enterprise Survey on Credit Unions and other sources of information (1996 data from the Office of the Superintendent of Financial Institutions, 1996 annual reports of the Bank of International Settlements and Interac).

This new survey, which provides a breakdown of banks and trust companies consolidated operations (in Canada only) by type of activities, reflects the broadening of activities of these institutions as a result of the reforms that affected the financial sector in Canada since 1987. It is also based on the 1997 North American Industrial Classification System (NAICS), an activity based industrial classification which allows the business sector data from Canada, Mexico and the United States to be compared.

CONCEPTS

The activities performed by Banks, credit unions and trust companies are defined as follows:

• Retail banking: Provides financial services to individuals and small and medium sized commercial businesses in Canada through a branch network. Included in this group are private client services, branch banking and banking for small and medium sized businesses. Fiduciary services, i.e. activities of acting as a trustee or agent by providing record keeping, custodial and performance evaluation services for personal trusts, pension funds, corporate and institutional investments and group RSPs, are also included in retail banking.

• Corporate and Institutional Finance: Provides financing and operating services to institutional and large corporate customers. Examples of activities that may be included in this group, if they are not already included in Electronic Funds Services, are trade and export financing, project financing and syndicated lending.

• Electronic Financial Services: Includes services provided by automated banking machines and telephone banking centres.

• Treasury and Investment Banking: Treasury manages the funds of the consolidated operations of the firm, ensures that regulatory requirements are followed, establishes the spread thresholds applicable to particular operating units based on performance indicators, manages the cash flow for consolidated banking operations, and performs risk management services. Investment banking covers only the operations of securities brokerage, mutual fund management, investment management, discount securities brokerage, financial planning and financial advisory services to corporate, government, institutional and private clients.

These activities belong to the following industries delineated under the 1997 NAICS:

- 522111 Personal and commercial banking (retail banking activity)
- 522112 Corporate and Institutional banking (corporate and institutional finance activity)
- 52232 Financial transactions processing, reserve and clearing house activities (electronic financial services activity)
- 523110 Investment banking and securities dealing (treasury and investment banking)

The following definitions are used:

Production in current prices is the sum of net interest income and explicit service fees.

Labour compensation is the sum of wages and salaries, pension contributions by the employer and other paid benefits;

Non-interest expenses include purchased goods and services, depreciation and amortization, provisions for credit losses;

Profit margin ratio is profit before income tax over the value of production;

Securitization is a transaction in which certain assets, such as mortgages, are sold to an entity that finances their acquisition by issuing negotiable securities;

Derivatives are financial futures or options whose value is derived from interest rates, foreign exchange rates or equity prices. Derivatives are used in treasury operations as well as for hedging regular financial instruments. The most common types of derivatives include foreign currency, interest rate futures, swaps and options;

Off-balance sheet items represent a variety of commercial arrangements that are not reported on the balance sheet of chartered banks but that involve the same types of business risks as reported assets and liabilities (i.e., credit risk, interest rate risk, etc.);

The following *size breakdown* is defined in terms of production: large institutions produced more than $1 billion, medium-sized institutions produced between $50 million and $1 billion and small ones produced less than $50 million.

Note

1. These figures are in credit-equivalent values, that is, they are put on the same basis as balance sheet items by calculating the actual credit exposure of the off-balance sheet items.