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Foreign Banks in the Canadian Market

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Foreign Banks in the Canadian Market

Christine Hinchley
Industrial Organization and Finance Division

Summary

In Canada these days, it's almost as easy to do business at a foreign bank as it is at one of the major domestic chartered banks.

Financial institutions are stretching over national boundaries. Canadian banks are investing abroad, while foreign banks are increasing their presence in Canada.

In 1999, the federal government allowed foreign-owned banks to establish full service branches in Canada, rather than restricting them to forming subsidiary companies as in the past.

Between 1997 and 2004, foreign bank operations slowly increased their market share in the Canadian deposit-taking industry. In 1997, foreign bank subsidiaries and full-service branches accounted for 5.7% of the value of services produced in this industry. By 2004, this proportion had edged up to 7.9%.

This increase in market share can be attributed largely to the rapid 7.0% average annual growth in the real value of services produced by these foreign operators during this seven-year period.

The fastest growing foreign bank operations concentrated on specific niches such as corporate and institutional finance, credit card issuing and online banking. As a group the foreign bank operations gained market share in the business line of corporate and institutional finance and in retail banking and electronic financial services.

Large domestic banks continued to dominate the services offered by banks, trust companies, credit unions and caisses populaires. The market share gains of the foreign operators meant relatively small losses in market share by the domestic banks and trust companies.

The domestic banks have also been actively growing by acquiring other financial service providers in Canada and expanding their business abroad. Between 1997 and 2004, the total real value of services produced by the domestic banks rose at an annual average rate of 1.8% in Canada. Worldwide, however, the gain was more than double that pace, 4.8%.

This study examines the evolution of foreign bank subsidiaries and full-service branches in Canada from 1997 to 2004. It focuses on the real value of services produced, that is, adjusted for inflation. Value of services produced (not adjusted for inflation) is similar to total revenue reported by some banks and includes both net interest income and non-interest income. This study also examines assets held by Canadian financial institutions abroad.

Definitions

Deposit-taking Institutions (DTIs) (or deposit-accepting intermediaries) are financial institutions that are federally or provincially regulated to accept deposits in Canada. They include domestic banks, foreign bank subsidiaries, full-service foreign bank branches, local and central credit unions (including caisses populaires) and trust companies. These institutions act as intermediaries moving funds between lenders (depositors) and borrowers and provide many other financial services.

Foreign bank subsidiaries and **full-service foreign bank branches** are the only two types of **foreign bank institutions** in Canada that can accept deposits. This article refers to them together as foreign banks or foreign bank operations.

Foreign bank subsidiaries are full banks in Canada that are owned by foreign parent companies as subsidiaries.

Foreign bank branches are branches in Canada of foreign banks operating abroad. They have been allowed to operate since 1999, following an announcement in 1997. They do not have all the powers of a bank subsidiary, but have other advantages. For example, they have tax advantages and are regulated differently from subsidiaries. The full-service foreign bank branches included in this article differ from "lending only" branches in that they can accept deposits. Unlike subsidiaries, however, they are not allowed to accept deposits of less than \$150,000. This discourages retail banking operations. A foreign bank branch is not the same as what we commonly refer to as a "branch" of a domestic bank.

Canadian and foreign-owned trust companies, that are not owned by other institutions in the Canadian deposit-taking industry, are grouped together in this article with domestic banks. Trust companies make up a very small share of the industry, and the country of control is not readily available in the dataset used.

Value of services produced is calculated by summing net interest income and non-interest income, the two main categories of income for deposit-taking institutions. It is similar to total revenue reported by some banks. Value of services produced does not equal profit, since non-interest income is not net of expenses. Value of services produced does not remove amounts for provisions for credit losses or expenses for tax. It is analogous to gross output in economic terms.

Net interest income is the income that remains after all interest income has been collected from borrowers and all interest expenses are paid to depositors.

Non-interest income or "other income" includes all other types of income such as fees for different kinds of services, commissions, trading income, and foreign exchange revenue.

Financial data in this paper are primarily derived from Statistics Canada's Survey of Deposit-accepting Intermediaries from 1997 to 2004, and only include results from operations in Canada. Data for 2004 are available in *The Daily*, November 17, 2004, <http://www.statcan.ca/Daily/English/051117/d051117b.htm>. Industry level data are available in Statistics Canada CANSIM Table 182-0001.

While non-deposit-taking financial service providers also provide some overlapping services with those provided by DTIs, such as lending, corporate finance, insurance, and investment management, they are not included in the survey or in this article.

All financial data in this article are expressed in "real" or constant 1997 Canadian dollars to remove the effect of inflation. The All-items Consumer Price Index (CPI) was used as a deflator. CPI data come from CANSIM Table 326-0002. Rates of growth are compound annual rates.

Canadian financial services industry in context

Legislative and regulatory changes over the last two decades in Canada have been designed to encourage competition among the various types of financial service providers. They have allowed new ownership combinations and permitted broader activities for the different institutions.

In 1999, the Federal government allowed foreign-owned banks to establish full service branches in Canada, rather than restricting them to establishing subsidiary companies as in the past. Since 1999, many foreign bank subsidiaries have converted to become foreign bank branches. Some foreign banks without previous Canadian subsidiaries have also established branches in Canada.

New domestic banks have also emerged, particularly servicing credit card business, online banking or industry niches. Technological change has contributed to the development of new financial services such as “virtual” banking. At the same time, the number of credit unions in the country has fallen by about half since the end of 1997, mainly due to amalgamations.

Today, the domestic industry includes 21 domestic banks, 26 foreign bank subsidiaries and 19 full-service foreign bank branches operating in Canada, around 1,200 credit unions and caisses populaires as well as over 20 deposit-accepting trust companies which are independent of the other institutions.¹

Deposit-taking institutions kept pace with national GDP

Deposit-taking institutions represented 3.2% of the total gross domestic product (GDP) for Canada in 2005.² To put this in perspective, this is more than the whole transportation equipment and motor vehicle manufacturing industry.

This proportion has changed little since 1997. This means that the GDP contributed by these institutions generally grew along with real GDP for Canada. In 2005, deposit-taking institutions contributed about one-half (53%) of GDP in the finance and insurance industry.

Balance sheet assets of the deposit-taking sector expanded from \$1.1 trillion in 1997 to \$1.4 trillion in 2004,³ an annual average growth rate of 3.3% in real terms.

1. Bank data from: Office of the Superintendent of Financial Institutions, *Who We Regulate*, <http://www.osfi-bsif.gc.ca> (accessed April 6, 2006). Credit union data from: Bank for International Settlements, *Statistics on payment and settlement systems in selected countries, Figures for 2004*, Preliminary release January 2006, p. 16, Table 5, <http://www.bis.org/publ/cpss72.pdf> (accessed April 6, 2006) and Bank for International Settlements, *Statistics on payment systems in the group of ten countries, Figures for 1997*, December 1998, p. 16, Table 5, <http://www.bis.org/publ/cpss29.pdf> (accessed April 6, 2006).

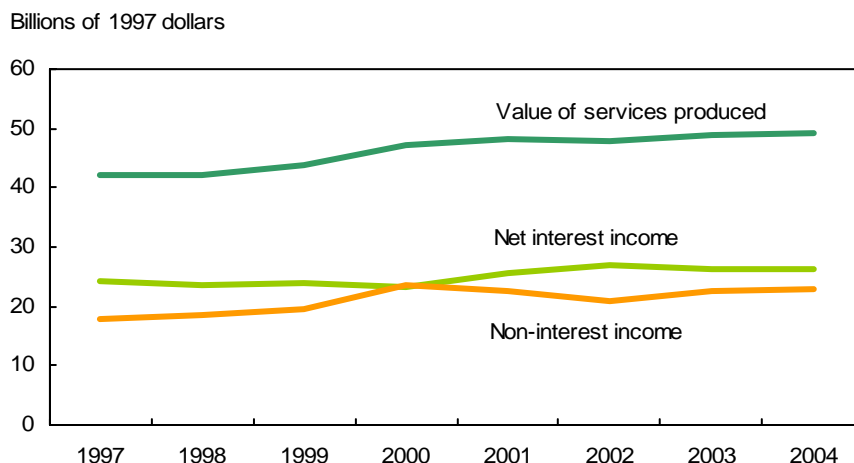
2. Statistics Canada, CANSIM Table 379-0017—Gross Domestic Product (GDP) at basic prices, by North American Industry Classification System (NAICS), annual, Canada, 1997 constant dollars (accessed April 6, 2006). This calculation used the industry group of “Monetary authorities and depository credit intermediation” (NAICS 521 and 5221) which is very similar to, but not exactly the same as, that covered by the Survey of Deposit-accepting Intermediaries.

3. Statistics Canada, CANSIM Table 187-0001—Balance sheet and income statement, by North American Industry Classification System (NAICS), quarterly. NAICS 5221 (Depository Credit Intermediation) was combined with NAICS 5223 (Activities related to credit intermediation). This combined industry is very similar to, but not exactly the same as that covered by the Survey of Deposit-accepting Intermediaries. December amounts were converted to 1997 constant prices.

In addition, during this seven-year period, the value of real services produced by the deposit-taking sector increased at an annual average rate of 2.3%, rising every year except in 2002. These services amounted to just under \$49.2 billion in 2004.

Non-interest income recorded a higher average rate of growth during this time frame (+3.6% annually), than net interest income (+1.2%). However, growth in net interest income offset weaker non-interest income results in 2001 and 2002.

Steady growth in real value of services produced by deposit-taking sector



Source: Statistics Canada CANSIM Table 182-0001, Statistics Canada, Survey of Deposit-accepting Intermediaries: Chartered Banks, Trust Companies, Caisses Populaires and Credit Unions, annual. Data were converted to 1997 constant dollars using the All-items CPI, CANSIM Table 326-0002.

Foreign bank operations grew fastest

The real value of services produced in Canada by foreign bank subsidiaries and branches has grown at a much faster pace than the value of services produced by domestic deposit-taking institutions. In fact, foreign bank operations accounted for one-fifth of the growth in these services between 1997 and 2004, even though they represented only 5.7% of the value of these services in 1997.

In 2004, the value of services produced by foreign bank operations reached nearly \$3.9 billion, an average annual growth rate of 7.0% from 1997. This was triple the growth rate of only 2.3% for all deposit-taking institutions combined.

The growth in foreign bank operations was led by services earning non-interest income, which increased on average 8.7% per year during this seven-year period. On the other hand, those services earning net interest income grew by 5.2%.

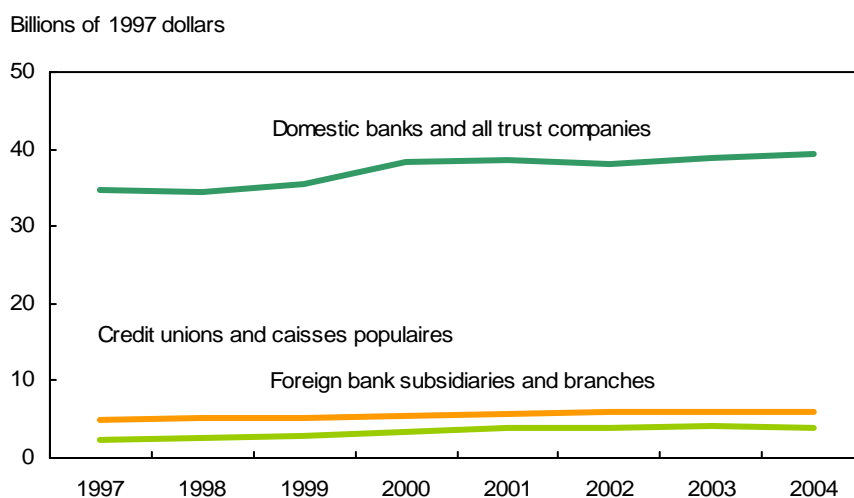
Real value of services produced (VSP) by type of institution

Type of institution	VSP		Absolute change	Compounded annual growth rate
	1997	2004	1997 to 2004	1997 to 2004
	\$ millions			%
Domestic banks and all trust companies	34,609	39,330	4,721	1.8
Credit unions and caisses populaires	4,994	5,972	977	2.6
Foreign bank subsidiaries and branches	2,412	3,862	1,450	7.0
Total	42,015	49,163	7,148	2.3

Source: Statistics Canada, Survey of Deposit-accepting Intermediaries: Chartered Banks, Trust Companies, Caisses Populaires and Credit Unions.

Credit unions and caisses populaires produced services worth nearly \$6.0 billion in 2004, a 2.6% annual average increase from 1997. These services rose consistently during this period.

Domestic banks and trust companies together recorded the slowest rate of growth in services produced, only 1.8% on average. However, in 2004, the value of their services surpassed \$39.3 billion, so the increase in real dollar value amounted to more than \$4.7 billion. Their services earning non-interest income increased 3.2% a year on average, five times the growth rate of only 0.6% in net interest income. These increases mainly came from the domestic banks.

Domestic banks and trust companies continued to dominate the Canadian market

Source: Statistics Canada, Survey of Deposit-accepting Intermediaries: Chartered Banks, Trust Companies, Caisses Populaires and Credit Unions. Data were converted to 1997 constant prices using the All-items CPI, CANSIM Table 326-0002.

Since the early 1990s, many trust companies have sold or converted all or part of their business to other deposit-taking institutions, such as domestic banks or in some cases, outside the deposit-taking sector. The real value of services produced by independent trust companies (not owned by other deposit-taking institutions) declined since 1997. By 2004, it made up only about 1% of value of services produced by all deposit-taking intermediaries combined. The domestic banks gained market share from the trust companies through these mergers and acquisitions. This article groups independent trust companies with the domestic banks.

Foreign competitors gained market share

The domestic banks and trust companies continue to dominate the industry, accounting for 80.0% of the real value of services in 2004, down slightly from 82.4% in 1997.

The market share of credit unions and caisses populaires held steady at about 12% over the seven-year period. The market share lost by the domestic banks and trust companies went to foreign bank operations.

In 1997, foreign bank subsidiaries and full-service branches accounted for 5.7% of the real value of all services; by 2004, this had increased to 7.9%.

Foreign bank operations gained market share in services producing both net interest income (+1.6 percentage points) and non-interest income (+2.6 percentage points). These gains are sizeable compared to their total shares in 1997.

Market share by type of institution, Canada

Type of institution	Net interest income			Non-interest income			Value of services produced		
	Market share		Change 1997– 2004 ²	Market share		Change 1997– 2004 ²	Market share		Change 1997– 2004 ²
	1997	2004		1997	2004		1997	2004	
	%								
Domestic banks and all trust companies	79.6	76.5	-3.1	86.1	84.0	-2.1	82.4	80.0	-2.4
Credit unions and caisses populaires	15.3	16.8	1.5	7.3	6.8	-0.5	11.9	12.1	0.3
Foreign bank subsidiaries and branches	5.1	6.7	1.6	6.5	9.1	2.6	5.7	7.9	2.1
Total¹	100.0	100.0	0.0	100.0	100.0	0.0	100.0	100.0	0.0

1. Components might not add up to the total due to rounding.

2. The variation between 1997 and 2004 might differ from the number presented in this column due to rounding.

Source: Statistics Canada, Survey of Deposit-accepting Intermediaries: Chartered Banks, Trust Companies, Caisses Populaires and Credit Unions.

Small number of foreign banks led the growth

The gain in market share by the foreign bank operations is even more significant when we consider that only a handful of foreign bank subsidiaries and branches dominate the group in terms of size.

Six of these bank operations accounted for over 80% of the value of services produced among the foreign subsidiaries and branches in Canada in 2004, compared to just over one-half in 1997. Most of them have grown by an annual average of 10% or more from 1997 to 2004 in terms of value of services produced.

Foreign operations with credit card and other electronic financial services offerings as well as some specializing in corporate and institutional finance grew the most notably. Mergers and acquisitions have helped others to grow.

The low interest rate environment in recent years has helped to fuel consumer lending, of which credit cards are a part. Most of the credit card operations are considered to be in electronic financial services for which the value (for the deposit-taking sector overall) has soared, increasing 8.7% a year on average since 1997.

Some foreign participants are relatively small, but are becoming more prominent through consistent and rapid growth.

Biggest gains in corporate and institutional finance

The Survey of Deposit-accepting Intermediaries collects financial data according to five common lines of business. This article combines these lines of business into three groups.

During the seven-year period, foreign bank subsidiaries and branches gained market shares in corporate and institutional finance and in the combined group of retail banking and electronic financial services. Their market share in the remaining group—treasury and investment banking and fiduciary services—was relatively unchanged from 1997 levels.

Foreign bank operations made the biggest gains in market share in the value of corporate and institutional finance services. In 2004, they captured nearly one-quarter (24.6%) of this market, up from 18.4% in 1997 (excluding credit unions and caisses populaires from the calculation).⁴ By definition, this 6.2 percentage point was gained from the domestic banks and trust companies, whose market share fell from 81.6% to 75.4%.

This gain was consistent with the creation of new foreign bank branches that specialized in corporate and institutional finance during the seven-year period. It also coincided with the general shift observed in corporate finance from traditional loans to a greater use of financing instruments

4. This section on market share by line of business omits credit unions and caisses populaires because estimates of their data by business line are less reliable. The market share for credit unions and caisses populaires overall is expected to be relatively small and stable relative to the rest of the industry. Most of their business is in retail banking and electronic financial services.

traded on financial markets.⁵ Niche players with expertise in these markets may have been able to expand their Canadian business.

Foreign bank operations also increased their market share in the value of retail banking and electronic financial services. They captured 8.7% of the value of these services in 2004, up from 5.7% in 1997.

This 3.0 percentage point gain was driven mainly by the foreign bank subsidiaries as a group. The increased market share of foreign bank operations seen in retail banking and electronic financial services has not generally arisen from the establishment of new foreign bank branches in Canada since 1999. Deposit restrictions mean that foreign bank branches generally do not offer retail banking services to individuals, although a small number provide credit card services. At this time, few branches report other separate electronic financial services.

**Market share of real value of services produced by business line,
Canada, 1997 and 2004¹**

Type of institution	Retail banking and electronic financial services			Corporate and institutional finance			Treasury, investment banking and fiduciary services		
	1997	2004	1997–2004	1997	2004	1997–2004	1997	2004	1997–2004
	%								
Domestic banks and all trust companies	94.3	91.3	-3.0	81.6	75.4	-6.2	94.6	94.8	0.2
Foreign bank subsidiaries and branches	5.7	8.7	3.0	18.4	24.6	6.2	5.4	5.2	-0.2
Sum²	100.0	100.0	0.0	100.0	100.0	0.0	100.0	100.0	0.0

1. This table omits credit unions and caisses populaires from the market totals because their data by business line are less reliable.

2. Components might not add up to the total due to rounding.

Source: Statistics Canada, Survey of Deposit-accepting Intermediaries: Chartered Banks, Trust Companies, Caisses Populaires and Credit Unions.

5. See Christian Calmes, "Regulatory Changes and Financial Structure: The Case of Canada," Bank of Canada, *Working Paper 2004-26*, 2004, pp. 4-5; and Charles Freedman and Engert Walter, "Financial Developments in Canada: Past Trends and Future Challenges," *Bank of Canada Review*, Summer 2003, pp 3-16.

Business line definitions

The Survey of Deposit-accepting Intermediaries collects financial data broken out by five common lines of business. Some of these business segments have been combined in this article.

Retail banking services (chartered banks, trust companies, credit unions and caisses populaires) cover all financial services to individuals and to small- and medium-sized businesses through a traditional branch network.

Electronic financial services cover services to individuals, businesses and institutions through networks of banking machines, debit and credit cards, telephone banking, and the Internet.

Corporate and institutional finance services cover financing and operating services for institutions and large corporations. They include trade, export, and project financing and syndicated lending.

Treasury and investment banking services: Treasury banking manages the funds of the deposit-accepting intermediary, itself. Investment banking covers services to individuals, corporations and institutions such as securities brokerage, mutual fund management, corporate financing and other investment services.

Fiduciary services refers to all services provided when acting as a trustee or agent such as record-keeping, custodial and performance evaluation services for personal trusts, pension funds, corporate and institutional investments and group Registered Retirement Savings Plans.

Subsidiaries and branches do not target the same markets

Foreign bank subsidiaries generally derive the greatest share of their income from retail banking and electronic financial services. Foreign bank branches tend to focus on corporate and institutional finance and investment banking.

There are also differences in activities among the foreign subsidiaries. Some of the largest subsidiaries provide services in all business lines, while others focus on niche markets related to products and services (such as credit cards, online banking, low fees) or related to customer segments. For example, many of the smaller Asian bank subsidiaries specialize in retail banking and appeal to individual customers through links with their family's country of origin, or countries with which they do business.

The subsidiaries of Japanese, French and German banks appear to place more emphasis on corporate and institutional finance, with some interest in treasury and investment banking. Most of the American subsidiaries that specialized in these areas have converted to branch operations only.

Domestic banks also offer a variety of services. The larger ones usually provide many types of services, while the smaller and newer banks focus on service or industry niches along the lines of the foreign banks.

Local credit unions and caisses populaires mainly serve retail banking clients. However, some of the central credit unions and caisses populaires provide other services such as corporate and institutional finance and treasury and investment banking services, especially to their related network of local institutions.

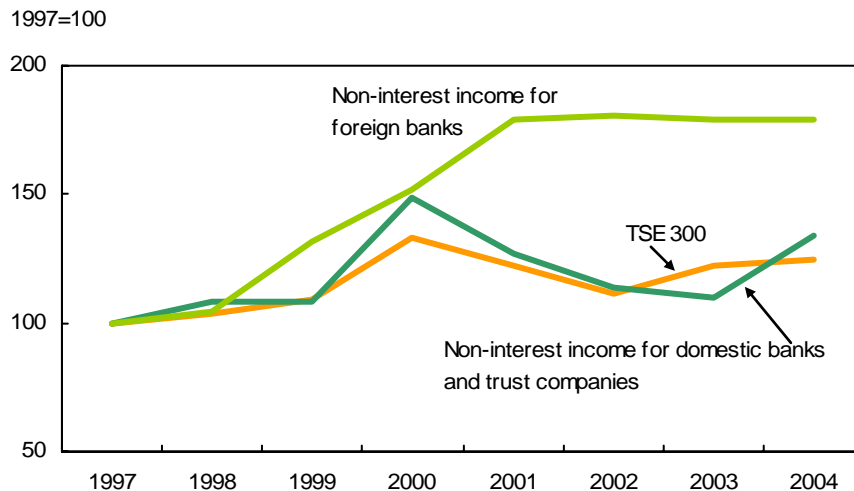
Domestic bank results align more with Canadian stock indexes

Net interest income for both domestic and foreign bank operations rose during the seven-year period, with the foreign bank operations growing fastest.

Non-interest income for foreign bank operations rose between 1997 and 2001 and then flattened. In contrast, the non-interest income of the domestic banks and the trust companies appears to have followed a similar trend to the Canadian stock markets from 1997 to 2004. They experienced more fluctuation and less overall growth in non-interest income than the foreign bank operations.

About half of the deposit-taking sector's non-interest income in 2004 came from corporate finance, treasury, and investment banking services. These services include activities that depend on equity markets.

Non-interest income of Canadian deposit-taking institutions are more closely related to the Canadian stock market than their foreign counterparts



Source: Statistics Canada, Survey of Deposit-accepting Intermediaries: Chartered Banks, Trust Companies, Caisses Populaires and Credit Unions and data adapted from CANSIM Table 377-0003, TSE 300 (smoothed index, 1975=1000).

Canadian financial institutions also going global

Canadian financial institutions have also been going global. Their share of activities abroad has been increasing along with foreign direct investment in other countries.

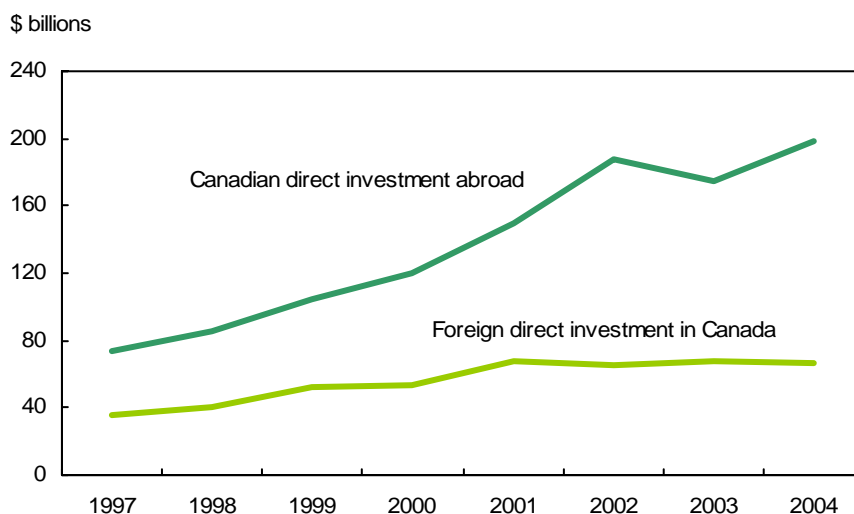
Between 1997 and 2004, the total real value of services produced by the domestic banks rose at an annual average rate of 1.8% in Canada. Worldwide, however, the gain was more than double that pace, 4.8%.⁶

Moreover, the larger finance and insurance industry in Canada holds more assets (direct investment position) abroad than their foreign counterparts do in Canada. In 2004, this Canadian industry held three times as much abroad as foreign investors held in the same economic sector in Canada. (As noted before, the deposit-accepting intermediaries accounted for about half of the overall GDP for the finance and insurance industry).

Direct investment abroad by those in the Canadian finance and insurance industry grew 15.2% a year on average between 1997 and 2004, while direct investment by foreign investors in the finance and insurance industry in Canada increased more slowly at 9.1% annually.

Historically, foreign direct investments in the finance and insurance industry within Canada have been affected by ownership regulations as well as minimum capital requirements for establishing new financial institutions in Canada. Over the past two decades these regulations have been evolving to allow more competition from foreign-owned financial service providers in Canada.

Canadian financial institutions hold more assets (direct investment position) abroad than their foreign counterparts in Canada



Source: Statistics Canada, CANSIM Table 376-0038, data for the Finance and Insurance Industry.

6. International consolidated financial data for the domestic banks are from the Office of the Superintendent of Financial Institutions, <http://www.osfi-bsif.gc.ca> (accessed November 11, 2005) and were used to calculate the international value of services produced. The Consumer Price Index was used to derive real growth.