CANADA

BANKING

SUMMARY

Canada has a large and highly-developed banking industry that included over 8,140 branches at the end of 1997. However, the industry continues to be dominated by the six largest "Schedule I" banks which are widely-held and Canadian-owned institutions with aggregate assets in excess of C$1.2 trillion. These six banks controlled over 90 percent of total banking assets at year-end 1997.

In December 1996, the government created a Task Force on the Future of the Canadian Financial Services Sector to develop a framework for the sector in the 21st century. The Task Force, chaired by Harold MacKay, reported its findings in September 1998. Early in 1998, two proposed mergers of major Canadian banks were announced. If approved and completed, these mergers will increase the level of concentration in the Canadian banking industry.

At year-end 1997, 10 U.S. bank subsidiaries were operating in Canada compared to 16 in 1990. The decline was due to bank mergers in the United States and to strategic business decisions by some institutions to withdraw from the Canadian market. Most U.S. banks in Canada concentrate on the corporate sector, capital market transactions, and cross-border financial activities. They generally have not attempted to compete with Canadian financial institutions in the retail market.

The Bank Act and other financial services laws in Canada are mandated for review every five years. Amendments to the Bank Act in 1992 and 1997 removed some obstacles to doing business in Canada for U.S. and other foreign banks. Foreign banks can now "opt out" of the Canada Deposit Insurance Corporation, and the federal government has agreed to allow direct foreign-bank branching. Legislation to implement branching has been postponed, but Canada has committed to modify its GATS offer in the WTO financial services negotiations by June 30, 1999, to incorporate results of implementing a new direct branching regime for foreign banks.

The financial services chapter of the NAFTA, which entered into force on January 1, 1994, established a comprehensive set of rules to govern trade and investment in financial services among the three signatory countries (U.S., Canada, and Mexico). As a result, U.S. banks now enjoy a right of establishment and a guarantee of national treatment in Canada.

DESCRIPTION OF THE MARKET

Commercial Banking Market Structure

At the end of 1997, the Canadian banking industry included 54 commercial banks employing more

than 221,400 people and managing over C$1.3 trillion in assets. However, the industry is highly concentrated and is dominated by the six largest "Schedule I" banks. In descending order of asset size, these banks are the Royal Bank of Canada, Canadian Imperial Bank of Commerce (CIBC), Bank of Montreal, Bank of Nova Scotia (Scotiabank), Toronto-Dominion Bank, and National Bank of Canada. These institutions accounted for over 90 percent of total banking system assets at the end of 1997. The remaining 48 banks are "Schedule II" banks which are closely-held institutions with capital not exceeding C$750 million. The Schedule II banks include five Canadian institutions and 43 foreign-bank subsidiaries, of which 10 are U.S. bank subsidiaries.[1]

Total bank assets increased 62 percent between 1993 and 1997. Strong business investment, recovery in the housing market, and growing consumption fueled loan demand. The assets of Canada's domestic banks increased 63 percent, while asset growth of foreign-bank subsidiaries was 51 percent. U.S. bank subsidiaries achieved an 81 percent increase in assets between 1993 and 1997.

Balance Sheet Data for the Canadian Banking Industry
(C$ billions, year-end)
1993

	Shareholders' Equity	Liabilities	Assets
All Banks	39.2	716.8	756.0
Domestic Banks	35.4	659.7	695.2
Foreign Banks	3.8	57.0	60.8
U.S. Banks	*1.1*	*11.1*	*12.2*

Balance Sheet Data for the Canadian Banking Industry
(C$ billions, year-end)
1997

	Shareholders' Equity	Liabilities	Assets
All Banks	54.7	1169.6	1224.3
Domestic Banks	49.8	1082.7	1132.4
Foreign Banks	4.9	86.9	91.9
U.S. Banks	*1.6*	*22.1*	*23.7*

Source: Chartered Bank Assets & Liabilities, Canada Gazette, Part I. www.canada.gc.ca

[1]Schedule I banks are publicly-traded, majority-owned Canadian institutions with capital in excess of C$750 million. Schedule II banks are closely-held institutions with capital not exceeding C$750 million.

In the first half of the period 1993-1997, interest rates were volatile due in part to the Mexican financial crisis. Short-term rates declined from over 8 percent in early 1995 to a little over 3 percent by mid-1997 and climbed back to near 5 percent by the end of 1997. Given this interest-rate environment and the overall growth of the Canadian economy, the period of 1993-1997 was very good for the financial services sector and the banking industry in Canada. The six largest Canadian banks recorded net income of C$7.5 billion in FY97 (ending October 31, 1997), compared with C$2.9 billion in FY93. Return on common shareholders' equity increased to 15.3 percent in FY97 from 9 percent in FY93. Income from the securities subsidiaries of Schedule I banks played a major role in this rise in earnings. Non-interest income of the top six banks contributed 47.5 percent of the total net interest and non-interest income in FY97, up from 38 percent two years earlier.

Canadian banks are federally-chartered and regulated. They may operate in all ten Canadian provinces and two territories, as well as overseas. At the end of 1997, about 8,140 branches were located throughout Canada. The Schedule I banks operated the majority of the branches and employed the majority of the 221,400 employees working in the banking sector at year-end 1997. Schedule II banks had 157 branches at year-end 1997, of which 99 belonged to the Hongkong Bank of Canada, a subsidiary of Hongkong Shanghai Bank Corporation. NAFTA-country Schedule II bank subsidiaries can establish inter-provincial branches under the same terms as Schedule I banks. However, non-NAFTA country Schedule II bank subsidiaries must secure approval from the Minister of Finance to open more than one branch. As part of its WTO financial services offer, Canada has committed to removing this requirement by June 30, 1999.

Canadian banks, both Schedule I and Schedule II, can engage in a wide range of financial activities in addition to traditional banking services. A bank may provide financial services (including financial planning), investment counseling and portfolio management services, and merchandise promotion and payment services to credit and charge-card holders. In addition, a bank may create subsidiaries to undertake other financial activities, including securities dealing, mortgage lending, trust services, insurance, mutual fund sales and management, merchant banking, venture capital, real estate brokerage and investment, leasing (except automobile leasing), and factoring.

A number of "near-banks" in Canada compete for the deposit and lending business of the commercial banks. These include trust and loan companies (similar to U.S. savings and loans), credit unions, consumer loan and finance companies, and several public-sector housing and financial agencies (i.e., Canada Mortgage and Housing Corporation, Export Development Corporation, various provincial savings banks, and the federal Farm Credit Corporation). Other types of financial institutions include life and health insurance companies, property and casualty insurance companies, investment dealers, and merchant banks.

Foreign banks were not permitted to operate in Canada until 1980. After that, foreign-bank operations were authorized as separately-capitalized subsidiaries. Generally, foreign banks have

concentrated on wholesale banking and capital markets activities; this approach reflects the significant investment in facilities and marketing needed to compete in the retail sector. However, Hongkong Bank of Canada is an exception. It is the largest Schedule II bank and the seventh-largest bank in Canada in terms of assets, and it is the only Schedule II bank with an extensive retail branch network. Hongkong Bank's growth results from its acquisition of several other institutions and its cultivation of Canada's rapidly-growing Chinese community. (Foreign Schedule II banks can undertake the same banking activities as domestic banks.)

In December 1996, the government created a Task Force on the Future of the Canadian Financial Services Sector to develop a framework for the sector in the 21st century. The Task Force, chaired by Harold Mac Kay, issued its report on September 15, 1998. The report addressed banking, leasing, and insurance financial services in the context of increasing globalization and mergers. Overall, the report concluded that the government has a role to play in supervising the financial services sector, but recognizes that the sector must be shaped by market forces. Priority was given to consumer interest as the criteria by which to judge government policy in the sector. To this end, the Task Force Report recommended passing legislation to permit foreign bank branching (not ruling out mergers among Canada's largest banks) and liberalizing the insurance and leasing markets. As of November 1, 1998, the government of Canada is undertaking hearings in further consideration of these recommendations.

Early in 1998, two proposed mergers of major Canadian banks were announced. In January the Royal Bank of Canada and the Bank of Montreal announced that they planned to merge and, a few months later, the Canadian Imperial Bank of Commerce and Toronto-Dominion Bank announced that they intended to merge. Both of these mergers require approval from shareholders, regulators, and the Minister of Finance. If approved and completed, these mergers will increase the high level of concentration in the Canadian banking industry.

Bank Supervision and Regulation

Banks are regulated by the Office of the Superintendent of Financial Institutions (OSFI), which also regulates federally-chartered trust and loan companies and insurance companies. OSFI is an independent regulatory agency of the Canadian federal government. The Superintendent is appointed by the Finance Minister and confirmed by the Cabinet for a seven-year term. On matters requiring the attention of the Cabinet, the Finance Minister represents OSFI. Federal government policy regarding financial institutions is established by the Department of Finance.

Banks are required to join the Canada Deposit Insurance Corporation (CDIC), a federal entity (a Crown corporation) that insures depositors up to C$60,000. Banks and trust and loan companies currently pay a CDIC insurance premium set at 0.167 percent of assets. Due to failures of insured institutions since the mid-1980s, the CDIC had a cumulative deficit of C$1.5 billion at the end of 1993. These failures prompted new legislation in 1996 to strengthen the regulatory regime for

financial institutions. Since 1993, the CDIC has steadily reduced its deficit and plans to eliminate it entirely by March 1999. A 1997 revision of the Bank Act includes an "opt out" clause for foreign banks with respect to membership in CDIC, since it is oriented toward the protection of retail depositors and most foreign-bank subsidiaries do not accept retail deposits. Those banks opting out are effectively limited to taking deposits over C$150,000 (the level below which the retail banking regulations apply).

Since 1987, banks have been allowed to own securities firms in Canada. Each of the six largest Schedule I banks has either acquired a securities firm or started one *de novo* since then. Consequently, bank-owned securities firms dominate the Canadian securities market. Banks may also own trust and loan companies and insurance companies. They may set up "networking" arrangements with other financial institutions and distribute those institutions' products and services in their branches to their customers. Banks also have the right to own "specialized financing corporations," which allow them to undertake broad venture capital and merchant banking activities.

Banks may offer investment counseling and portfolio management services directly or through securities subsidiaries, and financial planning services are also permitted as part of the business of banking. Banks may offer real estate services (property development, management and brokerage), and they are also allowed to offer some non-financial services such as information management. Over the past few years, banks' movement into the trust area has been significant; however, banks' movement into the insurance area has been cautious largely because of a restriction on their ability to network most traditional insurance products within their branches to their customers.

Payments and Electronic Banking

Payments in the Canadian banking system are transacted through the Canadian Payments Association (CPA), created by the Canadian Payments Association Act. The CPA is chaired by the Bank of Canada, the central bank, and representatives of banks and other deposit-taking financial institutions sit on its board of directors. The CPA had 145 members at year-end 1997. Clearing is handled through regional settlement points of the CPA located in seven major cities across Canada. The Bank of Canada, unlike the U.S. Federal Reserve System, does not have a direct role in the clearing process. Although the CPA cleared 3.2 billion items worth C$16 trillion by year-end 1997, the smaller number of financial institutions in Canada reduces the complexity of the clearing process as compared to the United States.

Canada has an extensive network of automated teller machines (ATMs), with 14,484 bank-owned ATMs at year-end 1997, compared to 12,000 in 1994 and 6,000 in 1990. Additional ATMs owned by other financial institutions are connected through the electronic banking network run by the "Interac" association, a consortium of Canada's "big six" banks, Canada Trustco, and credit unions. This network brings total ATMs to about 19,200. Most Canadian ATMs allow access to the U.S.-based Cirrus and Plus ATM networks. The CPA requires that transactions between member

institutions in Canada on any ATM network be routed and settled entirely within Canada. All the major deposit-taking institutions now provide telephone banking services, as well as some type of computer-based banking. Citizens Bank, owned by the Canadian VanCity Savings Credit Union, and ING Direct, a subsidiary of the Dutch financial group ING, began operating in 1997 as branchless "virtual banks" in the retail sector.

U.S. PRESENCE IN THE MARKET

At year-end 1997, 10 U.S. bank subsidiaries were operating in Canada, two fewer than at the end of 1993. The decline in the number of U.S. bank subsidiaries in Canada is due both to the mergers of U.S. parent banks and to strategic business decisions by U.S. organizations to withdraw from the Canadian market. U.S. banks had C$23.7 billion in total assets at year-end 1997, up from C$12.2 billion at the end of 1993. They accounted for 1.9 percent of banking assets and 1.0 percent of loans at the end of 1997, compared with 1.6 and 1.3 percent respectively in 1993, and 2.2 and 2.1 percent respectively at the end of 1990.

U.S. banks in Canada focus on the corporate sector and capital market activities. Generally, they have not attempted to compete with Canadian financial institutions in the retail market. (Only two U.S. banks have retail branches in more than one Canadian city.) Given their small capital base relative to their much larger Canadian competitors, U.S. banks have been successful in Canada by emphasizing their expertise in capital markets activity. They offer specific off-balance sheet products, foreign exchange swaps, and other financial services through which the U.S. bank can serve clients on both sides of the border.

Among the non-lending activities currently conducted by U.S. banks in Canada are cash management, investment banking, government bond sales and trading, and dealing in derivative products. Since 1989, three U.S. banks have been authorized by the Department of Finance to function as primary distributors of Canadian government securities. One of the U.S. banks is the second largest dealer in the government bond market in Canada. Although it is permitted, only one U.S. bank has entered into a joint venture with a Canadian trust company to form a limited-purpose trust company that engages in stock transfer and corporate trust services.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Until 1980, foreign banks were permitted to operate in Canada only as representative offices. An amendment to the Bank Act in that year authorized the establishment of foreign-bank subsidiaries, but foreign-bank operations were subjected to administrative controls on their growth in the form of rules regarding "deemed authorized capital" and market share limits. The U.S.-Canada Free Trade Agreement (FTA), which entered into force on January 1, 1989, exempted U.S. banks from

the system of deemed authorized capital and market share limits. In addition, U.S. bank subsidiaries were exempted from the requirement to obtain approval from the Finance Minister prior to opening branches and from the regulatory constraints on loan transfers to their parent banks. All U.S. investors were exempted from the 25 percent limit on aggregate foreign ownership of widely-held (Schedule I) Canadian banks.

The financial services chapter of the NAFTA, which entered into force on January 1, 1994, established a comprehensive set of rules to govern trade and investment in financial services among the three signatory countries (U.S., Canada, and Mexico). As a result, U.S. banks now enjoy a right of establishment and a guarantee of national treatment in Canada. NAFTA also established a Financial Services Committee to supervise implementation of the chapter and to address financial services issues that are referred to it by any of the three countries. If differences of interpretation cannot be resolved by this committee, formal dispute settlement mechanisms are available.

In early 1997 the government announced that it would "make public" legislation to allow direct foreign-bank branching in Canada by the end of 1997. This legislation has been delayed both by the discussion of two proposed mergers among the largest Canadian banks and by the government's desire to review the Task Force Report on the Financial Services Sector. Until a law is enacted to amend the Bank Act, foreign banks in Canada will continue to be prohibited from operating as direct branches of their parent institutions. Therefore, these banks remain at a competitive disadvantage with respect to Canadian banks. Due to their relatively small capitalization and legal lending limits, U.S. and foreign-bank subsidiaries are precluded from competing for large corporate loans. (They are prohibited from extending loans to a single borrower in excess of 100 percent of the subsidiary's capital. Furthermore, bank subsidiaries may only reach the 100 percent limit in exceptional cases, and they must notify OSFI when they exceed the 50 percent level.) Foreign-bank subsidiaries also face the added expense of maintaining a separate board of directors, half of whom must be Canadian residents.

U.S. and other foreign banks are also disadvantaged by Canada's Income Tax Act, which imposes a nonresident withholding tax on funds borrowed by the foreign-bank subsidiary from its nonresident parent bank and nonresident related companies. Although 1995 amendments to the U.S.-Canada tax treaty reduced the rate of withholding from 15 percent to 10 percent, this tax provision makes it uneconomical for foreign-bank subsidiaries in Canada to lower their funding costs by borrowing from their parent banks.

The conditions for foreign-bank branching that the Canadian government has proposed thus far (and which may be part of the final legislation) would remove some disadvantages that foreign institutions face due to the subsidiary requirement, but other restrictions would continue. For example, the ability to operate branches in Canada would generally apply to foreign banks with at least C$25 billion in assets on a worldwide basis; however, the branches of foreign banks would not be allowed to take retail deposits (defined as under C$150,000). According to the Department of

Finance, most foreign banks operating subsidiaries in Canada at present would be able to operate branches in the future. However, the ability of regional and/or special-purpose U.S. banks to set up branches would be limited.

Bank Act revisions in 1992 loosened the previous requirement that banks operating in Canada must maintain and process all their customer data in Canada. Banks must request approval from OSFI for offshore data processing, but reportedly all such requests by U.S. banks have been approved. A prohibition precluding banks from offering data processing services to outside parties is still in effect. However, exemptions from the prohibition can be requested and all banks (both Schedule I and Schedule II) may apply to OSFI for an exemption. To date, no U.S. bank that has applied for an exemption has been turned down.

In addition to the CDIC opt-out provision for foreign banks noted above, a few other changes to the Bank Act in 1997 improved the treatment of U.S. financial services companies in Canada. Regulated foreign banks that own a Schedule II bank will no longer be required to own other financial services subsidiaries through the Schedule II bank. This change means that a U.S. bank with a Schedule II bank in Canada could operate its other Canadian subsidiaries, performing nonbank operations such as securities brokerage and investment banking, directly under the U.S. parent.

In addition to wholesale banking operations, U.S. banks and financial services companies engage in a range of activities in Canada, including consumer finance, leasing, credit-card issuance, and mortgage insurance. The government has distinguished between two types of foreign companies that offer limited financial services in Canada, or "near banks," depending on how they are regulated in their home jurisdiction. In general, both types are defined as entities that do not take deposits, that provide one or more banking-type services, and that have received approval under the Bank Act to enter the Canadian market.

The 1997 banking legislation specifies regulations for near banks that are not regulated as banks in their home jurisdiction, such as GE Capital, the "big three" auto company finance subsidiaries, and key U.S. consumer finance companies. However, the government places in a separate category, and treats differently, those foreign providers of limited financial services that are regulated as banks in their home jurisdiction. The government proposed in 1996 that these companies be required to become bank subsidiaries to operate in Canada. This requirement would have created a significant burden for U.S. companies already in operation, and it met with opposition in Parliament. The government, therefore, decided to address these foreign companies when it issues the foreign branching legislation. Until then, those foreign companies offering a limited range of financial services and now operating unregulated in Canada, as well as new entrants that meet certain criteria, will be allowed to conduct their activities without being regulated as financial institutions.

Exchange Rates:

1994 period average	1.37 C$/US$
1995 period average	1.37 C$/US$
1996 period average	1.36 C$/US$
1997 period average	1.38 C$/US$