A COMPARISON OF CANADIAN AND UNITED STATES BANKING SYSTEMS AND CROSS-BORDER BANKING ACTIVITY

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I. Introduction

The past decade has seen tremendous upheavals in international financial markets and institutions. While the Canadian and United States banking systems are structured very differently, banks in the two countries have not been immune to these changes. In the United States, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) set the stage for a series of important changes in the U.S. banking system, including the deregulation of interest rates paid on savings, broadening of the lending and investment powers of savings and loan associations, authorizing interest bearing checking at depository institutions and increasing the Federal Reserve's control over the money supply through uniform reserve requirements at all depository institutions. These changes, along with more competitive economic conditions, created many problems for U.S. financial institution managers, as evidenced by the increase in bank failures as well as the ongoing crisis in the savings and loan industry. Across the border, the Canadian banking system experienced similar upheavals, though perhaps with less dire consequences. While U.S. banks struggled to cope with deregulation, Canadian banks had successfully adjusted to changes such as interest on checking and unlimited branch banking without the raft of failures and mergers which occurred in the U.S. On June 30, 1987, Canada's " Big Bang" took place, when the Canadian government allowed federal financial institutions to establish wholly owned Canadian securities dealer subsidiaries [see (7), (8) and (9)]. While the timing of the entrance of Canadian banks (as well as foreign banks and dealers) into the securities business in Canada was poor, given the crash of international stock markets in October, 1987, banks in Canada moved towards becoming "full-line" institutions, providing customers a wide variety of financial services. In 1988, a new challenge faced both Canadian and U.S. financial institutions in the form of the Free Trade Agreement.

This paper compares current U.S. and Canadian banking systems and explores the issues surrounding foreign banks operating in the U.S. and Canada, as well as foreign ownership of Canadian and American banks. By comparing financial ratios and other characteristics of these banks to domestic banks of similar size, we draw conclusions regarding the performance, liquidity, and safety of foreign vs. domestic banks in the United States and Canada. The possible changes in both systems emerging from the Free Trade Agreement is also discussed. Section II of the paper provides a descriptive overview of Canadian and U.S. banking. The effect of the Free Trade Agreement is discussed in Section III. Ratio analysis of foreign and domestic banks in the U.S. and Canada is contained in Section IV. Section V provides a summary of the results and discusses possible future trends in both U.S. and Canadian banking systems.

II. Canadian and United States Banking Systems

Canadian and United States banking systems are structured very differently. The reasons for these structural differences are primarily historical. [2] Canada's banking system is one of nationwide branching networks, dominated by the so-called "Big Six" chartered banks. These six banks, listed in Table 1, control over 90% of total banking assets in Canada, and operate over 7,000 branches across the country. By contrast, there are over 13,000 individual banks in the United States, many of which operate only one office. To demonstrate the contrast more fully, there are over 1,100 branches per domestic Canadian bank while in the United States, the average is about seven [2]. The lack of widespread branching networks in the United States stems from federal regulations restricting interstate branching and the potpourri of state laws which restrict branching activity in many states. The intent of these restrictions is to foster competition and avoid monopoly power, yet allow banks to operate profitably to insure a safe, solid financial system.

Both Canadian and United States bank regulation is primarily federal, with Canada centralizing its financial institution regulation in 1987, under the Office of the Superintendent of Financial Institutions. The Superintendent has full supervisory responsibilities for not only banks but registered trust, insurance, and loan companies, as well as pension funds. Deposit insurance, however, is separately administered by the Canadian Deposit Insurance Corporation (CDIC). Banks in Canada are chartered by the federal government as either Schedule 1 or 2 banks. The Schedule 1 bank designation is restricted to domestic banks and their shares must be widely held, with over 75% held by Canadians. Schedule 2 designated banks have less ownership restrictions; however, limits are placed on asset size and branching ability, as well as dictating Canadian presence on their boards of directors. Foreign bank subsidiaries exist in Canada as Schedule 2 banks, with 57 foreign-owned banks operating in Canada at year-end 1989, controlling nearly 10% or $54 billion in banking assets out of $550 billion total assets in all banks in Canada. [3] Of those, fourteen are owned by U.S parent banks, with total assets of $12 billion or 2.2% of total bank assets in Canada (see Table 2).

Banking in the United States is often referred to as a "dual banking system", due to the existence of both federal and state bank chartering and parallel regulation. Banks can obtain a charter from either the Comptroller of the Currency (becoming "national" banks) or the relevant state chartering agency. However, federal bank regulation and supervision is of primary importance in the United States and is currently spread out among three major regulators, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. Unlike potential foreign owners of banks in Canada, foreigners wishing to participate in U.S. banking markets have two alternatives: 1) if currently operating a commercial bank, they can open a U.S. subsidiary, branch, or agency; or 2) they can acquire or establish a domestic U.S. bank (alternative #2 would also be open to a non-bank foreign investor). A U.S. branch or agency of a foreign bank operates as part of the parent institution and their activities are often restricted by state law. [4] As a branch of a foreign bank, they are neither insured nor chartered by the U.S. federal regulatory authorities but are subject to some supervisory oversight.

Foreign banks operating in the U.S. have found it valuable, in recent years, to choose

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to operate as a full-service bank. Full service facilities originate as either start-up U.S. subsidiaries or result from acquiring existing U.S. banks (for example, the acquisition of Harris Trust Company by Bank of Montreal in 1985). Foreign ownership status, either by a bank or non-bank investor, does not place any additional burdensome restrictions on the bank's activities. While there has been some regulatory concern over the consistent growth in foreign ownership of U.S. banks, studies have shown no "inherently harmful developments linked to the foreign nationality of the owners" [Haupt(6), p.27].

As of 1989, 180 foreign owned banks operated in the United States, controlling 7.9% of total U.S. banking assets (over $230 billion in assets out of $2,913 billion in all domestically chartered U.S. banks). [5] Twenty three bank entities in the United States were majority owned by Canadians, with four of them being owned by individual Canadian citizens or non-bank corporations, and nineteen owned by Canadian banks (see Table 3). Thirteen of the nineteen Canadian bank-owned institutions are part of the Harris bank holding company owned by Bank of Montreal. Canadian- owned banks in the United States control $13.8 billion in assets (less than 0.5% of total domestic banking assets).

III. The Free Trade Agreement

The Free Trade Agreement (FTA) reached between Canada and the U.S. in 1988, while impacting all areas of trade between the two countries, has added another wrinkle to the increasingly complex international market for financial services in the U.S. and Canada. The FTA has changed procedures in two major areas, securities underwriting and foreign ownership of banks, relative to cross-border banking activities.

Securities Underwriting

Both U.S. and Canadian banks will be allowed to underwrite Canadian government debt obligations in the United States. This puts Canadian government securities on equal footing with U.S. and municipal government securities. However, U.S. and Canadian banks operating in the United States are still prohibited under the Glass Steagall Act from underwriting other types of securities (*e.g.* equity, corporate debt). This tilts the playing field in favor of U.S. banks operating in Canada, as it poses a restriction on Canadian banks operating in the U.S. that is not placed on U.S. banks operating in Canada. While this inequity in treatment has not gone unnoticed by Canadian banks, there is hope on the part of Canadian bankers and regulators that U.S. financial reforms will continue to progress, giving Canadian banks powers to provide the same financial services in the U.S. as they provide in Canada [see (4) and (5)].

Foreign Ownership

The FTA also eliminated restrictions on foreign ownersh00% of a U.S.

bank, but foreign ownership of the aggregate assets of Canadian financial institutions under federal jurisdiction has been restricted to 25% control. The FTA has eliminated the 25% rule. However, the existing Canadian law stating that no more than 10% of a single Schedule 1 Canadian bank can be owned by an individual, corporation, or group

- foreign or domestic - remains in place. So, while foreign ownership may increase (due to the elimination of the 25% rule), foreign control is restricted (by the 10% rule). Other foreign bank provisions in Canada have also changed. American banks operating in Canada would no longer be restricted to owning less than 16% of Canada's total banking assets. This would allow American banks operating in Canada to expand without restriction [5]. However, given the small amount of Canadian banking assets under U.S. bank control (2.2%), this easing of restrictions may be more symbolic in the short run.

IV. Data Analysis

Canadian and United States banks were analyzed relative to their performance, liquidity, and safety. Financial data on foreign and domestic banks operating in Canada were gathered from 1985 and 1989 issues of the Canada Gazette and the 1986 Canadian Banking Review, a publication of the Canadian Bond Rating Service (CBRS). Unfortunately, CBRS did not publish a 1990 issue of the Canadian Banking Review; however, 1989 income statements for foreign banks operating in Canada were obtained from the Office of the Superintendent of Financial Institutions Canada. Financial data for foreign and domestic banks in the United States was available on the FDIC's Report of Income and Condition computer tape for year-end 1985 and 1989. Branches and agencies of foreign banks operating in the United States were omitted; only foreign owned banks or banking subsidiaries were included in the study. The following financial statement information was obtained from the above sources: Total Loans, Total Securities, Total Assets, Total Demand Deposits, Total Equity, Provision for Loan Losses, and Net Income.

U.S. Banks in Canada

Tables 4 and 5 provide various financial ratios and data on U.S. banks operating in Canada in 1985 and 1989. While U.S. banks are significant players among foreign banks operating in Canada, their market share has declined significantly over time. U.S banks controlled 25.26% of all foreign bank assets in Canada in 1989, down from 40.57% in 1985. The average size of U.S. banks has grown somewhat, while the average non-U.S. foreign bank operating in Canada showed a dramatic increase in asset size during this period. In 1985, four of the top ten foreign banks in Canada, in terms of assets, were U.S. banks. In 1989, only two U.S. banks remained in the top ten, Citibank Canada and Morgan Bank of Canada. Over the same time period, the size and importance of non-U.S. foreign banks in Canada increased. This growth was primarily seen in British and Asian banks in Canada. For example, Hong Kong Bank of Canada grew from an asset size of $519 million in 1985 to $3.58 billion in 1989. In contrast, both Citibank Canada and Morgan Bank of Canada were smaller in terms of total assets in 1989 than in 1985. The number of U.S. banks operating in Canada has changed little in this time period, while the number of non-U.S. foreign banks has increased from 38 to 42. On average, U.S. banks operating in Canada are more profitable (based on ROA and ROE) and safer (less leverage) than their non-U.S. counterparts. A measure of the credit quality of the loan portfolio, "Provision for Loan Losses", has increased over the time period for both foreign and domestic banks in Canada, indicative of the international trend of increasing "problem" loans, such as loans

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to developing countries. Loans-to-asset ratios for U.S. banks in Canada declined somewhat from 1985 to 1989 accompanied by an increase in securities-to-asset ratios. [6] The decline in the Loan-to-Asset ratio suggests either a loss of market share in the competitive commercial and consumer loan arena or tighter loan approval criteria in an uncertain Canadian (and world) economy.

Canadian Banks in the U.S.

Canadian presence in the U.S. banking market has been fairly constant from 1985 to 1989 (see Tables 6 and 7). The implementation of the Free Trade Agreement on January 1, 1989 did not seem to cause a sudden, huge influx of Canadian investment in the U.S. banking market. Canadian-owned banks continue to control around 6% of total foreign bank assets in the U.S., with the number of Canadian-owned banks increasing from 20 in 1985 to 23 in 1989. As with U.S. banks in Canada, Canadian-owned U.S. banks are more profitable and safer than their non-Canadian counterparts, with higher return on assets and return on equity than non-Canadian foreign banks in the U.S., while operating with less leverage (a larger capital base per dollar of assets). This may be due to very selective lending criteria, as most foreign banks compete primarily for the loan business of larger, creditworthy, multinational corporations. Loans are a more significant use of funds, and demand deposits (checking accounts) a more significant source of funds for Canadian-owned U.S. banks than for other foreign banks operating in the United States. This probably stems from the nature of the Canadian ownership, as many of the Canadian-owned banks operate in the U.S. market indistinguishable from domestically-owned institutions. This is not true in Canada, where a distinction is made between foreign and domestically owned banks (Schedule 1 and 2). Many citizens might be leery of having a checking account with a foreign bank; however, in the case of Canadian-owned U.S. banks, the potential customer may not be aware that the bank is foreign owned.

V. Summary and Future Trends

This paper has examined performance, safety, and market share of foreign-owned banks in Canada and the United States for 1985 and 1989, focusing particularly on Canadian and U.S. banks operating across the border. Overall, U.S. banks are significant players in the Canadian foreign bank market and are safer, more profitable institutions relative to foreign bank competitors. Canadian-owned banks operating in the U.S. are also safer and more profitable than other foreign banks in the U.S.. However, the U.S. share of the Canadian foreign bank market has declined over time, while Canadian bank holdings in the U.S have been relatively constant. Given the very recent implementation of the Free Trade Agreement, it is difficult to detect changes in banking market conditions that can be attributed to FTA. However, the size and stability of domestic Canadian banks and the legal restrictions in place limiting foreign ownership of domestic Canadian banks makes significant entry by U.S. banks into the Canadian banking market difficult. On the other side of the border, Canadian banks have an easier time entering the U.S. market, given its highly segmented nature; however, control of a large percentage of the market by Canadian-owned institutions seems unlikely because large U.S. banks continue to dominate the market. Initial trends in the data show no immediate, drastic changes in market penetration by the banks of either nation. Only time will tell as to whether the Free Trade Agreement will lead to significant changes to the banking picture in the United States and Canada.

ENDNOTES

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[2] For a history of banking in Canada, see Binhammer (1) and Boreham (3).

[3] Over 270 branches of foreign banks operate in Canada [Boreham (2)].

[4] State banking law can supercede federal law if the state law is more restrictive.

[5] When agencies and branches are included, the number of offices rises to 689.

[6] Loans and securities are both competing uses of funds for a commercial bank, with loans typically being riskier but more profitable.

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Tables 1, 2, and 3

Table 1
"Big Six" Canadian Banks
(year-end 1989)

Bank of Nova Scotia
Bank of Montreal
Canadian Imperial Bank of Commerce
National Bank of Canada
Royal Bank of Canada
Toronto Dominion National Bank

Table 2
U.S. Banks Operating in Canada
(year-end 1989)

BT Bank of Canada
Bank of America Canada
Bank of Boston Canada
Bank of New York Canada
Chase Manhattan Bank of Canada
Chemical Bank of Canada
Citibank Canada
First Interstate Bank of Canada
First National Bank of Chicago Canada
Irving Bank Canada
Manufactureres Hanover Bank of Canada
Mellon Bank Canada
Morgan Bank of Canada
National Bank of Detroit, Canada
Republic National Bank of N. Y. (Canada)
Security Pacific Bank Canada

Table 3
Canadian Owned Banks in the U.S.

	State
Canadian Imperial Bank	NY
Royal Bank & Trust	NY
Royal Bank de Puerto Rico	PR
Scotiabank de Puerto Rico	PR
Harris Bank of Barrington	IL
Harris Bank Batavia	IL
Harris Bank & Savings Bank	IL
Harris Bank Glencoe	IL
Harris Bank Hinsdale	IL
Harris Bank Naperville	IL
Harris Bank Roselle	IL
Harris Bank St Charles	IL
Harris Bank Argo	IL
Harris Bank Wilmette	IL
Harris Bank Winnetka	IL
Alamosa National Bank	CO
Dominion National Bank of Denver	CO
American National Bank	AR
Harris Bank Arizona	AR
Foothill Bank	CA
Harris Trust Company of California	CA
Calif. Imperial Bank of Comm. CA	CA
Commercial Center Bank	CA

TABLE 4

1985 IN CANADA	Loans as a % of assets	Securities as a % of assets	Total Deposits as a % of assets	Demand Deposits as a % of assets	Return on Assets (ROA)%	Return on Equity (ROE)%	Leverage (assets/ equity)	Provision for loan losses as a % of assets
Avg. US Banks	63.37	9.87	79.50	1.39	0.55	8.54	15.6	0.16
Avg. Foreign Banks	61.56	7.75	80.74	1.55	0.38	6.20	16.4	0.17
Avg. non-US foreign banks	60.33	6.30	81.58	1.66	0.26	4.47	16.9	0.18

Number of US banks	16
Average asset size US Banks	741,280 in thousands CAN$
Number of non-U.S foreign banks	38
Average asset size non-U.S. foreign banks	457,126 in thousands CAN$

% foreign bank assets held in US banks	40.57

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TABLE 6

1985 IN UNITED STATES	Loans as a % of assets	Securities as a % of assets	Total Deposits as a % of assets	Demand Deposits as a % of assets	Return on Assets (ROA)%	Return on Equity (ROE)%	Leverage (assets/ equity)	Provision for loan losses as a % of assets
Avg. Canadian Banks	61.09	10.35	72.05	24.62	0.67	8.20	12.2	0.52
Avg. foreign Banks	57.26	12.49	79.08	20.77	0.47	7.72	16.4	0.52
Avg. nonCanadian foreign banks	57.01	12.63	79.54	20.51	0.46	7.68	16.8	0.52

Number of Canadian banks	20
Average asset size Canadian Banks	596,167 in thousands US$
Number of nonCanadian foreign banks	158
Average asset size nonCanadian foreign banks	1,155,520 in thousands US$

% foreign bank assets held in Canadian banks	6.13

TABLE 7

1989 IN UNITED STATES	Loans as a % of assets	Securities as a % of assets	Total Deposits as a % of assets	Demand Deposits as a % of assets	Return on Assets (ROA)%	Return on Equity (ROE)%	Leverage (assets/ equity)	Provision for loan losses as a % of assets
Avg. Canadian Banks	58.84	16.41	71.06	22.91	0.81	10.33	12.8	0.66
Avg. Foreign Banks	59.19	11.66	75.48	18.03	0.42	6.69	16.0	0.87
Avg. nonCanadian foreign banks	59.21	11.35	75.77	17.71	0.39	6.39	16.3	0.88

Number of Canadian banks	23
Average asset size Canadian Banks	637,763 in thousands US$
Number of nonCanadian foreign banks	157
Average asset size nonCanadian foreign banks	1,427,260 in thousands US$

% foreign bank assets held in Canadian banks	6.14

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