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Swimming with Whales: How to Encourage Competition from Small Banks

by
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- Successive federal governments have sought to promote competition in the banking sector with initiatives to increase the entry and market share of smaller financial institutions.
- Since 1999, the number of domestic banks in Canada has increased from eight to 30. However, the market share of the largest six banks has grown. Since 2007, the share of all banking assets controlled by the largest six banks grew from 90 percent to 93 percent.
- This may reflect consumers' satisfaction with the services they receive from the largest banks, or their preference, since the 2008 recession, for more established banks.
- Nevertheless, in the face of this dominance, Ottawa should consider new regulatory approaches to bolster the role of smaller financial institutions if it is to achieve its goals of enhancing quality, price and innovation in the sector.

In 1999, the federal government set out its vision for the financial services sector. Strong competition, the government said, was essential for quality, price and innovation in the sector. While the government expressed the view that there was generally strong competition across the financial services sector, the lack of new domestic entrants in banking was identified as a source of

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concern.[1] The government stated its intention to address this concern by introducing initiatives to strengthen the "second tier" of smaller financial institutions that provide an alternative to the larger financial institutions.[2] Since 1999, this has remained an objective of each successive government.[3]

In one sense, these efforts have been successful. Since 1999, the number of domestic banks in Canada has increased from eight to 30. However, despite the growth in the number of domestic banks, there continues to be concern about the ability of these new entrants to thrive and survive in the sector. For example, the 2016 consultation paper recently released by the Department of Finance (2016 Consultation), noted that since 2007 the share of all banking assets controlled by the largest six banks grew from 90 percent to 93 percent. Further the share of all banking assets controlled by the largest three banks grew from 54 percent in 2002 to 65 percent in 2015. The growing level of concentration prompted the Department to request comment from the public on how to promote competition, including by encouraging new entrants and fostering the growth of small entities and other players.[4]

The data from the credit union sector, another potential source of domestic competition for banking assets, tell a similar story. Data from Statistics Canada indicate that the national market share of credit unions has declined by 1.4 percent over the past 10 years.[5]

Given that there are now many more competitors in the market, why have we not seen a greater redistribution of market share? It is possible that consumers are entirely satisfied with the service that they receive from the large banks and that the latter compete aggressively to maintain their market shares. Additionally, since the financial crisis of 2008, consumers may prefer to maintain their banking relationships with more established banks that demonstrated their ability to weather a severe economic downturn.

However, as the government continues to indicate that it is concerned about the level of competition in the banking sector, it may be necessary to consider what other measures could be taken to bolster the role of smaller banks.

1 The government's proposed framework followed the release in 1998 of the Report of the Task Force on the Future of the Financial Services Sector that had recommended that the government enhance competition in the sector.

2 In June 1999, the government released "Canada's Financial Services Sector, A Framework for the Future," which outlined this new policy framework. Coming shortly on the heels of the decisions disallowing proposed mergers among the big banks, the government argued that strong competition was both essential and necessary if financial institutions were to serve Canadians well and succeed in the international marketplace. The paper noted, however, that between 1987 and 1999 only two new Schedule I banks were chartered in Canada, compared with 207 new US banking charters in 1997 alone. To address this lack of new competition in the sector, the government stated that it would take steps to facilitate new bank entry and introduce initiatives to strengthen the "second tier" of smaller "community-based" financial institutions.

3 In its 2016 Budget Plan, the government stated that the strength of the financial services sector should not "stand in the way of measures to reinforce its soundness, enhance competition and better serve users' needs."

4 It should be noted that these are not the only, nor necessarily the best, measures of competition. As discussed by Northcott (2004) "Other factors play a strong role, including regulatory policies that promote competition, a well-developed financial system, the effects of branch networks, and the effect and uptake of technological advancements.

5 Statistics Canada, Tables 176-0015 and 176-0026.

In 2016 Consultation, the Department of Finance stated that its financial sector policy seeks to balance three objectives, stability, efficiency and utility.

Stability is safety, soundness and resiliency in the face of stress.

Efficiency refers to whether the sector is providing competitively priced products and services, and passes efficiency gains to customers, accommodates innovation, and effectively contributes to economic growth.

Utility is providing the services and products that customers need.

Currently, it appears that these objectives are not appropriately balanced, arguably with too much emphasis on stability. Regulatory tightening has imposed significant expectations for the resources that are dedicated to risk management, adding a commensurate financial burden. Although the government has acknowledged that this burden may be impeding the ability of smaller institutions to compete, its attempts to address the imbalance have not resulted in meaningful relief. Such relief is unlikely to occur without new regulatory approaches that better balance Ottawa's three objectives and reflect a willingness by regulators to tolerate more risk at smaller institutions.

Another topic that warrants consideration is whether the current regulatory framework, which was largely established in legislative changes to the *Bank Act* in 1992, will allow smaller banks to succeed in the current environment. The business powers afforded to the banks and the restrictions imposed on those powers reflected a time when there were few competitors to the large banks. The internet as a vehicle for commerce did not exist. Competition from the emerging Fintech sector was not even conceived. A modernization of the legislation may enhance the ability of all banks large and small to better address the needs of customers and provide them greater scope to meet their competition.

The balance of this paper will elaborate on these possibilities and suggest areas of policy that could be reconsidered.

Overburden from the Regulatory Framework

As mentioned above, the government understands the need to balance competing objectives in the regulatory framework. In fact, the need to balance these objectives is recognized in the legislative mandate of the Superintendent of Financial Institutions. The *Office of the Superintendent of Financial Institutions Act* instructs OSFI to protect the rights and interests of depositors, policyholders and creditors of financial institutions, having due regard to the need to allow financial institutions to compete effectively and take reasonable risk. While the Act acknowledges that OSFI can reduce the risk of failure, it instructs OSFI to approach regulation and supervision of institutions having regard to the fact that "boards are responsible for the management of financial institutions, financial institutions carry on business in a competitive environment that necessitates the management of risk and financial institutions can experience financial difficulties that lead to their failure."[6]

In the 2014 federal budget, the government recognized that the current regulatory framework could have a negative impact on the ability of smaller banks to compete. One of the government's three stated goals in respect of the financial sector was to address the interests of smaller banks in the regulatory framework. At the

6 *Office of the Superintendent of Financial Institutions Act* section 4.

time, OSFI had already appointed an advisor to reach out to small banks and trusts and address the challenges faced by these institutions where feasible. While the resource demands posed by the vast number of regulatory requirements can be difficult for a large bank to accommodate, for smaller banks, they can mean the difference between profitability and loss leading to non-viability.

In a speech delivered at the C.D. Howe Institute in April 2014, OSFI Deputy Superintendent Mark Zelmer noted that, in addition to appointing the small bank advisor, OSFI had established a Guidance Review Committee to consider the burden of new guidelines on institutions, particularly smaller and mid-sized institutions which he acknowledged "may have limited resources."[7]

Since the financial crisis, OSFI has updated and supplemented much of its risk management guidance. This includes its Corporate Governance, Regulatory Compliance Management and Operational Risk Guidelines. While these Guidelines contain a general instruction for smaller institutions to account for their nature, size and complexity in addressing the expectations that are expressed therein, the guidance provided by the Guidelines does not otherwise distinguish between large and small institutions.

OSFI has taken some steps to provide relief with respect to its reporting requirements for smaller banks, but most smaller banks would argue that they remain largely subject to the same requirements as their much larger competitors. Essentially, OSFI's analysis is directed at finding instances where smaller banks are exposed to lower risk than what might be the case with a larger bank.

However, this misses the main point. The issue is not whether a small bank is exposed to risks but that risk in a small, systemically unimportant bank is more tolerable. It is the calibration of the response to the risk that must be adjusted. Looking for the absence of risk will never result in any meaningful relief for the smaller bank community.

This suggests that it is time to rethink our approach to the calibration of regulatory expectations for smaller banks. However, relying on a prudential regulator to find new ways to promote competition seems flawed by definition. New institutions are by their nature often more risky than large, long-established competitors. Prudential regulators are, therefore, more cautious with start-up banks. Asking them to abandon their carefully crafted prudential guidance to accommodate a new entrant that is unproven and untested may simply be asking too much.

One solution would be to develop a set of criteria to determine whether a particular financial institution could qualify for regulatory relief. In a recent speech, Vice Chairman Thomas M. Hoenig of the U.S. Federal Deposit Insurance Corporation provided some examples of potential qualifying requirements for regulatory relief in the U.S. context.[8]

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7 Mark Zelmer, Deputy Superintendent, Office of the Superintendent of Financial Institutions, Speech at C.D. Howe Institute, April 3, 2014.

8 Vice Chairman Hoenig suggested that a bank that met the following criteria could be eligible for regulatory relief: (i) it holds no trading assets or liabilities, (ii) it holds no derivative positions, other than interest rate and foreign exchange derivatives, (iii) the total notional value of its derivative positions is less than $8 billion, and (iv) it maintains a GAAP ratio of tangible equity to assets of 10 percent. Thomas M. Hoenig, Vice Chairman of the FDIC and the former President of the Federal Reserve Bank of Kansas City, (https://www.fdic.gov/news/news/speeches/spapr0616b.html).

Capital Requirements

The rules respecting regulatory capital are another aspect of the prudential regulatory framework that has important implications for new entrants. One of the steps the government took in 2001 to encourage new entrants into the banking sector was to reduce the minimum amount of capital required to establish a bank from $10 million to $5 million. Clearly, the hope was that lowering the threshold would provide smaller investors an opportunity to establish a bank. In addition to lowering the threshold for investment, it also reduced the pressure for a newly minted bank to earn sufficient profits to justify the size of the investment made by its investors.

However, a new entrant's initial capital requirements are no longer determined by the statutory minimum but rather by the projection of risk-based capital over the initial three years of operations.[9] This is reflected in OSFI's Guide for Incorporating Banks and Federally Regulated Trust and Loan Companies that states that despite the stated statutory minimum of $5 million, the initial capital of a new bank must both meet the requirements of OSFI's current Capital Adequacy Requirements (CAR) Guideline and be sufficient, at all times, for the institution to remain above its target risk-based capital ratios and leverage ratio for the longer of the first three years of operations, or until it is profitable under a base case scenario. In addition, the Guide requires that these capital projections be fully stress-tested against adverse scenarios.

By replacing a fixed mandatory minimum with a minimum based on a risk-based capital ratio, applicants are incented to pursue low-risk business strategies that reduce their start-up capital. This raises an obvious inconsistency with the stated goal of encouraging innovative competition for products and services. Instead of acting as an innovator, a new bank is incented to offer the same products and services in the same manner as every other bank.

While there is plenty of rationale for strengthening the capital rules for banks, the Basel rules were designed for large internationally active banks.[10] Applying them for even the smallest start-up seems unduly conservative and is discouraging new entrants into the market.

Reconsidering the Framework

Most of Canada's regulatory framework for the financial sector was developed with the largest banks in mind, and for good reason. Until fairly recently, Canada's domestic banks were mostly large. In 1998, when the government first announced its intention to review the banking sector, Canada had only eight domestic banks.

Of the 24 small and medium-sized domestic banks now in existence many are monolines or offer only limited services. Most offer their services electronically with only limited bricks and mortar locations. As a group,

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9 The amount of regulatory capital that is required is highly dependent on the business lines that the bank will engage in, how profitable those business lines will be, how much scale is required in those business lines for the bank to achieve profitability, and how quickly the capital turns over.

10 "It should be stressed that the revised Framework is designed to establish minimum levels of capital for internationally active banks." International Convergence of Capital Measurement and Capital Standards A Revised Framework Comprehensive Version (Basel II).

11 For example, the province of British Columbia guarantees 100 percent of deposits made with a BC credit union regardless of their amount.

according to the 2016 Consultation, these banks control just 2 percent of the banking assets of all banks in Canada. The question is whether the current regulatory framework, designed when Canadian domestic banks were primarily large, is inhibiting smaller banks from being successful.

The government's attempt to encourage existing provincial credit unions to come under the national regulatory regime tells an interesting story regarding the burdens of that regime. Although enabling legislation came into effect in 2012, to date, only one federal credit union has been established. In January 2014, the Department of Finance announced transitional measures to assist provincial credit unions to convert to federal credit unions. In particular, the government offered to extend the scope of the federal deposit insurance to cover certain deposits that might lose the coverage they currently benefit from under certain provincial deposit insurance schemes.[11] In addition, the federal government offered to make short-term funding available to address the potential loss of these deposits. Finally, transferring credit unions would be given an extended period to comply with the more restrictive federal insurance networking rules.

Without these transitional measures, credit unions would lose an important source of revenue and an important business relationship with their customers. Further, converting credit unions could also lose an important source of funding if the newly uninsured depositors moved those deposits to other provincial credit unions. Does this mean that the provincial regulatory models are better? Not necessarily, but from the perspective of many credit unions, they cannot afford economically to convert.

The emergence of a financial technology or Fintech industry is another concern for new entrants. Although many of these Fintech companies offer products that compete with the regulated sector, not only are they free from the regulatory burden, they are also unconstrained by the confines of the regulatory framework. For example, while a bank may not offer "goods, wares and merchandise" a Fintech company is not subject to this constraint.

The fundamental question is whether our regulatory framework is too narrow, thereby limiting the ability of new entrants (and transitioning credit unions) to provide the services that today's consumer demand and inhibiting their ability to become economically viable. If the answer is yes, the Government will have to consider whether to continue with transitional relief to assist new entrants or, more fundamentally, review the framework for the entire sector.

Conclusion

This E-Brief has identified a set of actions to create improved competition in the financial sector, including increasing risk tolerance for new entrants, reducing the start-up capital burden, and creating greater flexibility for institutions to offer a broader array of products. If the government continues to believe that a level playing field is required, then it may be time to reconsider the regulatory model across the industry. At a time when the industry is under pressure from the developing Fintech sector, taking a harder look at the confines of banks and banking is warranted.

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