Research Department
Federal Reserve
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FRBSF Weekly Letter

Nationwide Branching: the Canadian Case

The prospect of interstate banking in the United States has stirred popular debate recently. Opponents of interstate banking fear that the net result of such a practice will be tremendous consolidation with, eventually, only a few large banks remaining. They feel this will cause a deterioration in the quality of banking services along with disadvantageous changes in prices. As evidence to support their argument, the opponents often cite the structure of Canadian banking.

On the surface, the comparison seems reasonable. Nationwide branching is allowed in Canada and branches are abundant. The banks, however, number only eleven, compared to a U.S. total of over 14,500—a difference that cannot be explained by population alone. This seems to support the argument that economies of scale will ensure that a group of a few, powerful banks will ultimately result from a more liberal branching policy in this country. However, a closer look reveals several differences between the banking environments of the U.S. and Canada that suggest this conclusion may be premature.

The Canadian regulatory environment, rather than economies of scale, may be the better explanation for the evolution of Canada's banking structure.

Canadian banking structure

The eleven chartered banks in Canada together have approximately 7,000 branches, each branch serving on average about 3,300 people. They are large banks by most standards, having an average of over $25 billion in total assets, with the average among the top five roughly twice that amount. In fact, five of Canada's banks rank among the largest sixty-five banks in the world in terms of both assets and deposits, a claim probably unmatched by any other country of comparable size.

The "Big Five", as they are called, are national in scope, while the six smaller banks are primarily provincial with one metropolitan-oriented. All banks are federally-chartered by law and governed by the Bank Act. Nevertheless, Canadian statutes do not clearly define the business of banking, and, as a result, the activities of chartered banks overlap those of other financial institutions.

Commercial banking is primarily the domain of the chartered banks but these banks also compete in most retail or consumer product markets with "near banks"—over sixty trust and mortgage loan companies, and over 3,500 credit unions and "caisses populaires" (cooperative institutions similar to credit unions). Over the years, near banks have gained in market share, but banks remain dominant, holding approximately 75 percent of the assets and 63 percent of the deposits of all major depository institutions in Canada.

The near banks are comparable to U.S. savings and loan assocations, credit unions and consumer finance companies. They hold a similar market share of deposits at about 37 percent and focus mainly on the retail banking markets, primarily deposit-taking and consumer loans, especially mortgages. These institutions also enjoy some privileges not accorded to banks. Interest rate differentials, for example, existed in both countries until 1967 when Canada lifted its maximum of 6 percent on bank loans. Near banks in both countries also were not required to hold reserves until 1980 when the U.S. removed this exemption. Some near banks in the U.S. and Canada still enjoy certain tax advantages.

These similarities in banking structure belie the major differences in banking regulations between the two countries. One of these differences is branching law. While Canada has

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always allowed nationwide branching, individual states make their own branching laws in the U.S. Many of these laws still allow only unit banking, and in most of the U.S., they restrict interstate branching.

Regulatory history in Canada

Canada has not always had as few banks. In 1875, it had 51 despite nationwide branching and a much smaller population. There is evidence that changes in government policy toward banking contributed to the later reduction.

Until 1900, Canada had a strict merger policy that required applicants to obtain approval from Parliament. This process was simplified in 1900 when, many Canadian analysts conclude, the government began actively to *encourage* mergers. There were more mergers (28) among Canadian banks between 1900 and 1930 than in all of the rest of Canadian banking history combined.

At approximately the same time, new bank charters became more difficult to obtain. In 1890, the paid-in capital requirements for a new bank almost tripled from $100,000 to $250,000. In addition, investors were allowed only one year from the time the charter was granted to the time operations had to begin with full capital. This change in chartering policy seems to have greatly reduced new entry. Before 1890, an average of over eleven banks entered the banking market each decade. In the following ten years, there was not one new entrant. Moreover, the number of charters received but not used increased after 1890. All these changes combined to create a more restrictive entry policy.

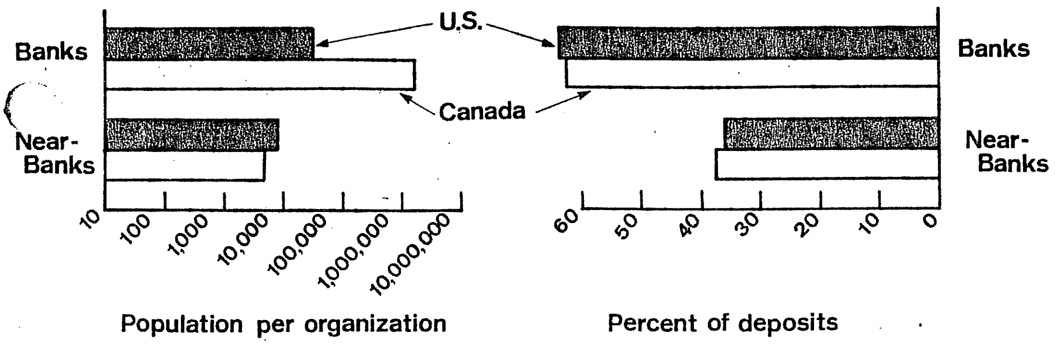
Economist Dale Orr, in a study on entry into Canadian banking markets, estimated that there should have been two new bank entries per year in the period 1963-67 when there had actually been only one entrant in those four years. Indeed, Canada has had only five new banks in the past fifty years. He concluded that this low rate of entry cannot be explained by natural economic barriers.

Policy or economics?

The economic evidence linking the Canadian banking structure mainly to its regulatory environment is not conclusive, but it does suggest that Canadian banks enjoy protection from fully-effective competition. A study by the Economic Council of Canada in 1976 revealed that the profits of Canadian banks were much higher than those of other Canadian industries examined in the same 1968-1973 period. The additional findings that Canadian banks were less cost-efficient and Canadian bank profits (even after adjusting for differing tax structures) higher than those of their U.S. counterparts implied the existence of substantial market power.

Several other institutional factors reinforce the idea that the chartered banks of Canada enjoy an environment different from their U.S. counterparts. First, the absence of a central, publicly-operated check-clearing system allows the few chartered banks to operate this portion of the payment mechanism and to play a role that may give them market advantages over potential competitors. Second, as a recent report of the Royal Commission on Banking and Finance observed, the banks tend to act as a group rather than as individuals in response to near bank competition and they tend to compete among themselves through services rather than prices. Both are classic indications that they operate in a less than competitive environment. Third, foreign banks have always found the Canadian banking market attractive but their full-fledged entry into that market has been legislatively restricted. This, too, suggests that the existing banking structure may not be the natural one generated by economics alone.

Canadian concern about these effects of government policy has already prompted regulators to re-examine some banking regulations. The Bank Act of 1967 began to place chartered banks and near banks on more equal footing. This process has continued with the Bank Act of 1980 which removed more of the protective policies.



The new laws allow near banks and foreign banking offices to become operating banks, but we know of no near bank that has made the conversion. While this would seem to indicate that the economies associated with large size are crucial to profitable Canadian banking, some additional facts must be kept in mind.

Near banks may be slow to convert because they have established expertise in certain banking areas and, particularly in the current environment, would incur large costs if they were to provide full banking services. In addition, the provincial charter near banks usually must hold in addition to any Federal charter can further restrict their activities. Some near banks also enjoy certain tax advantages and reserves exemptions which they would have to relinquish if they were to become chartered banks. In sum, there remain specific barriers to the entry of near banks into the chartered banking market.

The California contrast

The experience of California's banking market raises more questions about the relevance of the Canadian case to the branching debate in the U.S. California is similar to Canada in population (23 million) and has a gross state product of $250 billion versus Canada's GNP of $290 billion. California also allows statewide branching, which is analogous to Canada's nationwide branching albeit in a smaller geographic area.

In California, however, there are 260 commercial banks compared to Canada's eleven. Moreover, there are numerous new entrants in the California banking market each year. In 1980 alone, 47 new banks entered the market.

The relative abundance of banks in this State is due largely to a liberal entry policy for newly formed banks reinforced by a more restrictive merger policy. It is true that the California banking market is fairly concentrated, with the top five banks having over seventy percent of the market share of deposits, but this share is shrinking and numerous smaller banks offer major competition in local markets. In Marin county, for example, the Bank of Marin, a small organization on a statewide scale, has the largest share of the county market. In addition, the largest California banks are drawing significant deposits from outside the State, so their simple deposit share overstates their dominance in the State and local markets.

The combined evidence suggests that natural economies of scale do not necessarily dictate low levels of bank competition.

Implications for U.S. banking structure

It is impossible to predict from the available evidence in Canada how the U.S. banking structure would evolve if nationwide branching were allowed. There have been enough legislative barriers in Canada to alert us to the possibility that Canada is not necessarily a good model. We can, however, conclude from the Canadian and Californian experiences that interstate branching, if allowed in the United States, would not necessarily lead to market dominance by a few banking giants.

Randall Pozdena and Alane Sullivan

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/25/82	Change from 8/18/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	159,865	−1,184	8,015	5.3
Loans (gross, adjusted) — total#	139,955	−1,024	9,242	7.1
Commercial and industrial	44,002	− 331	4,612	11.7
Real estate	57,306	9	3,215	5.9
Loans to individuals	23,459	50	467	2.0
Securities loans	2,340	− 382	859	58.0
U.S. Treasury securities*	6,334	− 120	365	6.1
Other securities*	13,576	− 40	− 1,592	− 10.5
Demand deposits — total#	37,716	− 917	− 1,066	− 2.7
Demand deposits — adjusted	26,816	− 85	− 438	− 1.6
Savings deposits — total	30,779	− 22	1,170	4.0
Time deposits — total#	99,717	− 217	13,641	15.8
Individuals, part. & corp.	90,019	− 193	12,114	15.5
(Large negotiable CD's)	37,715	− 209	2,325	6.6

Weekly Averages of Daily Figures	Week ended 8/25/82	Week ended 8/18/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	192	28	102
Borrowings	87	4	195
Net free reserves (+)/Net borrowed(−)	105	24	− 93

* Excludes trading account securities.
# Includes items not shown separately.

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