The Financial Services Sector: An Update on Recent Developments

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An updated review of the Canadian financial industry shows that it continues to experience significant changes.[1] In an earlier Bank of Canada technical report, the driving forces behind the developments that had been taking place over the previous decade or so were examined, and some of the challenges that these forces would pose for financial service providers (FSPs) were indicated. The key factors identified were technological change, the changing nature of competition in the financial services sector, and changes in household demographics. The challenges facing the financial services industry were discussed under two main headings—the importance of size and the choice of the range of services and products that an FSP would provide.

This update builds on the previous work and, in particular, highlights the role of economies of scale and scope,[2] mergers and concentration, the strategies being followed by FSPs, and the role of changes in information technology on service delivery. Developments in these areas continue to pose significant challenges for FSPs as they attempt to develop strategies to maintain their profitability and long-run viability. While change in the financial sector is not new, the current period is noteworthy because of the pace and the scope of change, which appear to be greater than ever.

Canadian financial service providers continue to search for ways to operate at an efficient scale in their back-office activities. They are following three different strategies to achieve this scale: (i) creating or building it; (ii) buying it; or (iii) borrowing it. Because of technological change, the optimum scale of activities in many back-office operations has increased. As a result, some FSPs are trying to gain the largest market share in Canada in particular activities (for example, transactions processing). Other FSPs are exiting these same areas, having decided that they will not be able to achieve a sufficient size of operations to be efficient. They are then purchasing these services from low-cost providers. Specific examples of back-office activities where technological change has significantly increased the scale at which FSPs must operate to be efficient include credit card processing and payment processing activities, such as debit card acceptance services.

With regard to involvement in existing and new financial instruments, FSPs continue to emphasize the need for each product or service to be profitable. Some FSPs have rigorously assessed the profitability of each business activity in an attempt to allocate balance sheet resources towards activities of high strategic value and sustainable profitability. A consequence of such assessments is that the FSP will exit areas that do not meet the test; for example, selling non-core subsidiaries or getting out of certain lending activities. This development has been facilitated and accompanied by an unbundling of activities. One example of unbundling is the further separation of loan-origination activities from the ongoing credit-risk exposure to the borrower, resulting from the development and spread of various credit-risk-transfer arrangements.

At the same time, some FSPs have announced strategies that involve the rebundling of products and services, particularly where economies of scope are significant. This can be seen in the areas of consumer lending and corporate lending. For example, some banks are linking their willingness to extend corporate loans to

1. This note summarizes the recently published Bank of Canada Technical Report No. 91, Freedman and Goodlet (2002), which updates Technical Report No. 82, published in 1998.
2. Economies of scale and scope refer to the possibility that a firm will realize a reduction in the cost of producing goods and services as a result of an increase in the size or breadth of its activities.

customers to the readiness of those customers to undertake their capital market business (such as underwriting) with the bank.

Electronic money, which was introduced a number of years ago with great fanfare, has been shown to be technically feasible but not economically viable at this time. The potential revenues from a fully functioning arrangement appear to be insufficient to offset the high costs of establishing a national infrastructure capable of supporting such a scheme. Expectations of a rapid deployment of electronic money schemes, either using stored-value cards or network money, have all but disappeared.

Mechanisms used to deliver financial services and products continue to evolve. A broader range of delivery channels has been developed, including expanded use of Automated Banking Machines, computer banking, and the use of the Internet, to handle routine, low-margin financial transactions. Nevertheless, branches continue to play a very central role in the plans of FSPs, but their nature is changing (a strategy characterized as “bricks and clicks”). Branch staff must now have different qualifications, be better trained, and have access to much better information technology. Branches are also being opened on the premises of non-financial companies. Some FSPs are placing increasing emphasis on the revenues to be earned from the distribution of financial services or products (their own and others) and from the development and operation of Web-based auction sites. But there continue to be significant barriers to the use of information technology by FSPs in the innovation of products and services and their delivery channels.

With regard to the size of institutions, it is important to distinguish between the business lines of FSPs and the size of a financial institution as a whole. The recent literature seems to suggest that economies of scale in a number of business lines extend further than previous empirical work had indicated. Evidence of this is seen in the growth of financial firms that specialize in a small number of product areas (the so-called “monolines”). These firms exploit scale economies in process-intensive or information-intensive areas such as credit card processing. The growing importance of outsourcing in certain areas is also in part a recognition that significant scale economies exist. The benefits from the overall size of a financial institution come from somewhat different sources, such as an increased possibility of economies of scope in institutions with multiple business lines and the ability to engage in activities that require more capital. In addition, diversification across business lines can lead to smoother revenue flows.

The prevalent view is that Canadian markets for financial services are too small for even the largest FSPs to operate in at an efficient scale in certain lines of business. Large Canadian FSPs believe that they must operate as North American entities. Indeed, there are a number of recent examples of Canadian FSPs implementing such a strategy. The key questions for these FSPs are the extent of the economies of scale in their various areas of specialization and, where the economies of scale are important, whether the FSPs can achieve the size necessary to realize them and to be competitive with the very large FSPs in the United States. Regulatory restrictions may limit the ability of FSPs to realize these economies. Finally, there continue to be questions regarding the importance of economies of scope or synergies. In the non-financial sector, there have been waves of conglomeration and divestiture as views about the benefits and costs of size change. It will be interesting to see whether the financial sector experiences a similar pattern.

References

Freedman, C. and C. Goodlet. 2002. *The Financial Services Sector: An Update on Recent Developments*. Bank of Canada Technical Report No. 91.