Is Competition Dying in the Canadian Equipment Finance Market?

By Hugh Swandel

Canada's banking system is one of the strongest in the world. But domestic and international regulations that helped preserve the strength of Canadian banks during the financial crisis of 2008 and 2009 have since worked to create an alarming dominance by a handful of banks. Will this work against Canada's equipment leasing and finance industry?

Competition for market share is the key to innovation and improved choice for customers, but the playing field must be at least reasonably level to sustain competition. The current system of determining capital adequacy for Canadian banks gives the largest advantage to a small group of six domestic banks. The advantage is so great that these banks have the ability to outprice or profitably acquire any domestic competitor that is of interest or a threat to these dominant players.

Canadian regulators have been trying for many years to improve competition without adding risk to the banking system in Canada. The efforts of regulators, while preserving the strength of the main Canadian banks, have significantly reduced competition and created a concentration of market share that is unhealthy.

The dominant banks are now among the largest and strongest in the world, but this success has come at a price. The Canadian domestic economy is heavily reliant on the six largest banks. The Big Six are Royal Bank of Canada, Toronto-Dominion Bank, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Bank of Montreal, and National Bank of Canada, and their success has become a threat to innovation and competition in the Canadian banking sector.

This problem is not new in Canada: in 1999 the Department of Finance introduced measures intended to reform Canada's financial services sector.[1] As a result of reforms, the number of domestic banks in Canada increased from eight to 30 between 1999 and 2016. However, during the same period the market share of the largest six banks has grown.

According to the Department of Finance Canada (1999),

> The six largest banks continue to hold most of the market share in the banking sub-sector. Together, they hold $4.6 trillion in assets. The large banks' share of all assets in the banking sub-sector has increased since the financial crisis, and they now represent 93% of all banking assets, compared with about 90% in 2007.[2]

Part of the gain in market share came from the changes forced on U.S. and other global financial institutions that found themselves with much less capital to lend. U.S. lessors including GE Capital, Key Equipment Finance, and CIT rapidly, and in some cases completely, reduced their funding activity in Canada. The merger and acquisition activity that followed the 2008 financial crisis led to Canadian banks acquiring Canadian entities and assets from GE Capital, CIT, and others. Between the years 2000 and 2013, the percentage of Canada's financial industry assets under foreign control dropped from a high of 17% to 12%.[3]

CAUSE FOR CONCERN?

Is there reason to be concerned? The incredible market share of the Big Six is alarming; however, consumers and businesses appear to have sufficient access to capital, and the financial sector was tested in 2008 and passed with flying colors. There would appear to be enough domestic competition in the market to give good access to diverse products, low rates, and sufficient capital. However, a deeper look at the competitive advantages of the Big Six gives insights into some of the domestic consequences of the different capital requirements of banks operating in Canada and how this limits the ability of small and medium-sized banks to gain meaningful market share.

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On the surface, the Canadian banking sector is the envy of the world. Canadian banks were relatively unscathed by the 2008 global credit crisis and the regulatory regime in Canada was praised for keeping the banks strong and stable. The Canadian banks had been operating under domestic regulation that required higher levels of capital than their foreign competitors and higher than levels recommended by the Basel committee on banking supervision. At a time when most banks operating globally were in need of additional capital, the six largest Canadian banks were healthy and had the capacity to grow.

The Big Six banks, like most publicly traded banks, must grow profits and market share to meet their shareholders' expectations. Growth has been achieved organically but also through acquisitions across a range of product lines including deposits, mortgage lending, wealth management, securities dealing, commercial equipment finance, and auto loans. The Big Six have also increased their geographic reach, with expansion to many countries around the world.

The expansion domestically has increased the power of the Big Six to influence the domestic economy dramatically. By 2013 the Office of the Superintendent of Financial Institutions (OSFI) designated the Big Six as domestic systematically important banks (D-SIB). These banks now carried the added risks of international operations, such that if foreign performance impacted the viability of one of the Big Six it would affect the Canadian economy.

The Canadian financial industry, while considered healthy, has become less competitive and is now dominated by a small group of domestic banks with the strength and competitive advantage to dominate any financial sector in Canada. The very systems that keep the banking community healthy have also led to dominance by a small group of Canadian Banks.

GAP IN COMPETITIVE ADVANTAGE

The gap in competitive advantage is well illustrated in the commercial equipment finance sector. A group of smaller Canadian financial institutions have chosen to focus expansion efforts in the commercial equipment finance market. The group includes Laurentian Bank, Canadian Western Bank (CWB), and Meridian OneCap, which are three smaller domestic financial institutions that have made acquisitions and investment in the commercial equipment finance sector over the past several years. These companies are growing their commercial equipment finance market share significantly, although a deeper understanding of the system of determining risk and capital adequacy reveals some significant competitive hurdles for smaller Canadian financial institutions.

The Canadian commercial equipment finance market has shown fundamental changes in market share since 2008. There have been well over 30 merger and acquisition transactions, with several of the most significant transactions involving banks acquiring the largest and most profitable independents. The consolidation has changed the dynamic of who is fighting for origination and profit in the market.

Most independents of size have been acquired by financial institutions (banks, credit unions), and now the main battle for market share is mainly between foreign and domestic banks with strong liquidity, low cost of capital, and a desire for growth. However, some banks are stronger than others. This article explores the issue of how competition in Canada is impacted by domestic and global banking capital requirements. There is a large discrepancy in the leverage available to different financial institutions, and this gap impacts competition in Canada.

The Basel Committee on Banking Supervision (Basel) is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters.[4] Basel is made up of central bank governors from numerous countries who cooperate on bank supervisory matters.

Before and since the financial crisis, Basel has been providing information on the recommended minimum capital requirements for banks operating internationally. These recommendations have evolved over time with the most recent recommendations being derived from lessons learned since 2008. Basel has struggled to maintain a consensus on the best methods to determine risk and whether the same approach for international banks is effective for banks operating only domestically.

RISK RATIOS AND CAPITAL REQUIREMENTS

In Canada, the Big Six gain a significant advantage from regulators because these banks, and only these banks, are allowed to use the advanced internal ratings-based (AIRB) method of determining capital requirements. The other, smaller banks are required to use the standardized rates set forth in Basel, causing the smaller banks to hold significantly more capital.

In addition, the Basel approach deems business loans to have significantly higher risk than residential mortgages and other retail loans. A smaller bank specializing in commercial lending faces a much higher capital requirement. Table 1 shows a comparison of the risk ratings used to calculate capital requirements. The table shows the enormous discrepancy between the capital required by a small bank and the Big Six.

The risk weightings shown above are used to calculate capital that the bank must hold to offset the risk of each type of lending. The weighted amount is then multiplied by the common equity Tier 1 (CET1) ratio established by Basel III. When the Big Six were designated D-SIB, their Tier 1 capital ratios were increased by 1% but the net amount of calculated capital is still much lower than for CWB and Laurentian.

Canadian banks have also had the ability to offload much of the risk of underwriting mortgages onto taxpayers through a unique insurance program. Homebuyers with down payments of less than 20% require insurance. This insurance provides the banks with ironclad government support and is unique to Canada. Mortgages with government insurance are risk weighted "0" for the purposes of calculating capital adequacy.

More than 50% of Canada's $1.4 trillion home loan market is made up of insured home mortgages.[5] The Department of Finance has acknowledged that the level of government insurance protection is too high and is contemplating changes that will transfer a greater portion of the risk back to the banks originating the transactions.

There are multiple issues with the current risk weighting system including concerns about shifts in lending toward lower risk-rated residential mortgages and a movement away from business lending. Table 1 illustrates that current risk weighting gives banks a greater leverage if they pursue residential mortgages and retail loans over commercial lending. The larger banks have been historically connected to retail customers through a network of branches and now a dominant internet presence.

Smaller banks lacking a retail presence often pursue commercial lending because it is more suited to their resources and capabilities. Available data illustrates that the distribution of bank credit to individuals has grown enormously in the residential mortgage sector. Figure 1 illustrates the massive shift by lenders over the past 40 years to a more residential mortgage based portfolio.

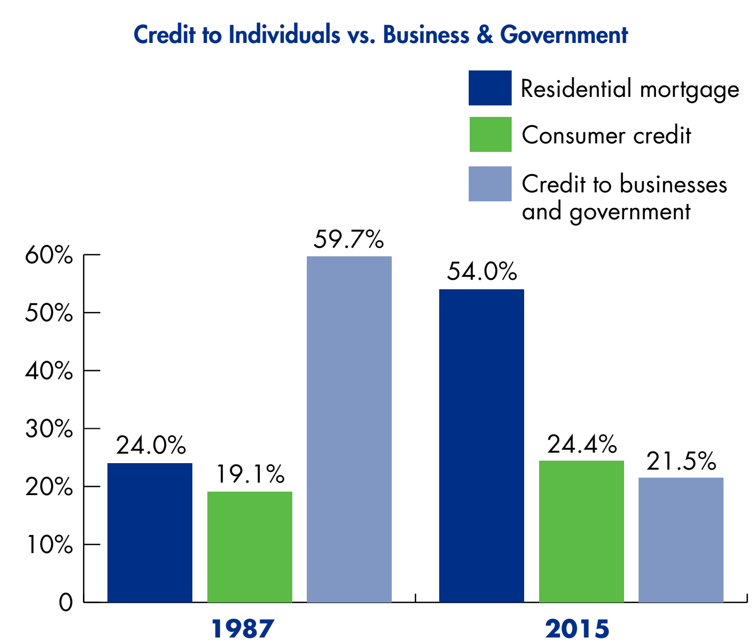
Table 1. Risk Weighting by Category

	Standardized		Advanced internal rating based (AIRB)					
Category	**CWB**	**LB**	**BMO**	**BNS**	**CIBC**	**NB**	**RBC**	**TD**
Residential mortgage	30.4%	17.2%	8.0%	11.3%	6.4%	11.7%	7.5%	8.8%
Other retail loans	76.6%	66.3%	25.2%	41.7%	31.9%	37.9%	22.6%	34.3%
Business loans	99.9%	100.1%	42%	58.1%	35.2%	47.0%	58.4%	44.6%
Avg. equity required	9.2%	8.0%	10.1%	11.0%	11.3%	10.1%	10.8%	10.4%

Note: Category Abbreviations – Canadian Western Bank (CWB), Laurentian Bank (LB), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce (CIBC), National Bank of Canada (NB), Royal Bank of Canada (RBC), Toronto-Dominion Bank (TD).

Source: CWB Financial Group, corporate presentation, 1st quarter 2017. Used with permission.

Figure 1. Distribution of Bank Credit in Canada



Source: Chris Fowler, Western Bank of Canada. (See endnote 2.)

The Big Six have grown their residential mortgage books with cheap capital and high leverage. They have a substantial advantage over smaller financial institutions in every category of lending.

EXPOSURE FROM RESIDENTIAL MORTGAGES

The shift away from business credit is clear. In recent times, the exposure of the banks to residential mortgages in general and to residential mortgages in certain provinces specifically has been identified as an area of concern for the Office of the Superintendent of Financial Institutions. The Big Six have grown their residential mortgage books with cheap capital and high leverage. They have a substantial advantage over smaller financial institutions in every category of lending. Moreover, the impact of their ability to use the internal ratings-based approach has led to a dramatic shift in lending activity.

Canada has 23 small and medium-sized domestically owned banks that collectively make up 2% of all the assets of all banks in Canada. This is but one example of the many challenges facing those who regulate and monitor the financial services sector in Canada. Although the health of the banking sector is not in doubt, the long-term ramifications of such a concentration of market share continue to be a concern for policy-makers and regulators.

An effective capital regime is intended to provide confidence in the banking system. In theory, the regime dissuades banks from taking riskier credit because these deals will require higher capital. In negative credit cycles, the intention is that effective levels of adequate capital will not require the sale of assets or reduced lending activities when times are tough.

Two smaller Canadian banks have made significant efforts to expand their commercial equipment financing operations. Canadian Western Bank and Laurentian Bank have been actively acquiring equipment finance firms and increasing their originations post-acquisition. The smaller banks have had to stay away from the hypercompetitive residential mortgage space and have pursued commercial lending (including equipment). Their capital requirements for all forms of lending are significantly higher than the Big Six, creating an unlevel playing field in the domestic lending market.

Smaller financial institutions are less profitable because of their higher capital requirements and resulting thinner margins. Table 2 shows a simplified calculation of Tier 1 capital required to offset business loan risk for two smaller financial institutions compared to the average required for the Big Six. The premise of the regulation is to ensure these banks have adequate capital to sustain themselves in periods of economic strain and loan stress.

The impact of the gap in risk weighting is well stated by Chris Fowler, president and CEO of Canadian Western Bank, in his submission for the Consultation Paper on Review of the Federal Financial Sector Framework[6]:

> Non-AIRB banks that specialize in servicing the financial needs of small to medium sized businesses are at a competitive disadvantage in terms of the higher capital that they have to hold relative to the large dominant Canadian Banks. This is because commercial loans represent a higher percentage of their overall portfolio as well as the fact non-AIRB banks currently utilize the standardized method of calculating risk weighted assets and therefore carry more capital compared to AIRB banks for the same credit risk. This limits the ability of smaller banks to focus on the business segment. Notwithstanding the significant impact of capital requirements on competition, products offered and the potential systemic risk associated with federal banks all incentivized to offer the same types of credit, there is no mention in the Consultation Paper of the need to examine the effects of capital requirements on the policy objectives of the Government.

COMPETITION FOR THE BIG SIX

Can domestic financial institutions and foreign financial entities compete with the dominance of the Big Six? The data presented above shows that the six largest Canadian banks have a considerable advantage over their competition. There is no doubt that the advantage is significant and the difference in capital requirements materially impacts the profits of smaller banks. Under the current system of risk weightings, it remains

Table 2. Simplified Tier 1 Capital Calculation

Tier 1 %	Business loan total	Weighted calculation	Weighted loan amount	Tier I capital required
Big Six Avg 10.6%	$100 Million	$100 Million × 47.6%	$47.6 Million	$5.0 Million
CWB 9.2%	$100 Million	$100 Million × 99.9%	$99.9 Million	$9.1 Million
Laurentian 8.0%	$100 Million	$100 Million × 100.1%	$100.1 Million	$8.0 Million

Source: Alta Canada. Derived from CWB Financial Group, corporate presentation, 1st quarter 2017. Used with permission.

more difficult for smaller financial institutions to attract capital and generate comparable return on equity to the Big Six.

For U.S. lessors there are opportunities in Canada in spite of the competitive advantage of the Big Six. Thus, U.S. lessors with strong vendor and manufacturer programs should consider expanding their offerings to include the Canadian market. Many Canadian dealers want the same finance options as their U.S. dealer counterparts but often the U.S. equipment finance firm is not active in Canada.

Entering Canada to support existing relationships would bring additional volume as well as protect from competitors trying to enter the United States by leveraging Canadian relationships. U.S. firms would also find opportunity offering residual based financing where the Big Six banks face some regulatory restrictions.

The Big Six banks have a pricing and leverage advantage, but this does not mean there is not room for U.S. firms with a value proposition that distinguishes themselves from low-priced competitors. Many U.S. firms are thriving in Canada (Wells Fargo, Key Equipment Finance, Bank of America, PNC Bank) and these firms exemplify companies with strong value propositions and mature sales strategies.

Even with the advantages described in this article, the Big Six face stiff competition in the Canadian commercial equipment finance sector. The industry has a diverse group of competitors including captives, foreign banks, and independents in addition to the domestic financial institutions. The Big Six are a presence in the industry and have significant market share, but there does not appear to be a concerted effort to dominate the industry.

Banks and credit unions represent an estimated 70% market share,[7] and the Big Six are estimated to hold 43.6% of the Canadian commercial equipment finance portfolio. The commercial equipment market share of the Big Six is considerably smaller than their overall 93% share of Canadian banking activity including retail and commercial banking, wealth management services, wholesale banking operations, and insurance services.

Although the smaller market share is encouraging, it indicates a market segment that may become a target of the Big Six to add origination. Given the considerable competitive advantages of the Big Six and the historical effort to grow through acquisitions, there is the potential for further industry consolidation.

CONCLUSION

The Canadian banking system, while often praised as among the strongest in the world, has in some ways become a victim of its own success. The six largest banks now represent 93% of banking assets and because of current Basel regulations have an incredible competitive advantage. Canadian governments and financial service regulators acknowledge that the dominance of the Big Six needs to be addressed but have not yet articulated or scheduled clear actions. At the root of the problem is the use of the risk-weighting system recommended by Basel and used, in part, as the basis for bank capital requirement calculations in Canada.

In recent remarks, the superintendent of OSFI, Jeremy Rudin, made it clear that the internal ratings based approach is an area of concern[8]:

> If we turn to the internal ratings based approach, we find that risk weights vary too much across banks. This is seen most clearly when banks using the internal ratings based method are asked to determine the risk weight that they would assign to a common, specific portfolio of assets.

The comments of Mr. Rudin include additional statements that neither the standardized approach used by small and mid-sized banks nor the internal ratings based approach used by the global banks (including the Big Six) is a satisfactory solution[9]:

> The underlying problem in each approach is the mirror image of the problem in the other. In the standardized approach, the problem itself is risk weights that do not vary enough from bank to bank. In the internal ratings based approach, risk weights vary too much from bank to bank.

If it is true that the first step toward finding a solution is identifying the problem, it would appear that Canadian regulators are making some progress. Unfortunately, finding a solution that works for domestic banks, the Big Six, and Basel is complicated and further hampered by a lack of consensus among the 27 jurisdictions represented on the Basel committee. Any solution to risk weightings involves the commercial lending segment, and Basel is struggling to find consensus about how to treat commercial lending in general and equipment finance specifically.

> U.S. lessors with strong vendor and manufacturer programs should consider expanding their offerings to include the Canadian market. Many Canadian dealers want the same finance options as their U.S. dealer counterparts but often the U.S. equipment finance firm is not active in Canada.

Trade associations including the Canadian Finance and Leasing Association, Equipment Finance and Leasing Association, and Leaseurope have all made submissions to Basel articulating how default rates for commercial transactions need to reflect lower default rates and accurate risk weights.[10] The efforts of the commercial equipment finance industry associations are only a small example of the challenges faced by Basel at this time.

The concentration of market share is of concern to policymakers in general but the threat to the number and volume of financing choices for small and medium-size enterprises (SMEs) is a serious concern. The Big Six have historically been passive pursuers of SME business and have evolved consumer origination strategies with more priority than SME solutions. SMEs in Canada are looking for more options and would be receptive to additional providers of commercial equipment finance.

The Big Six banks have proven over many decades that they have the ability to dominate any sector of the domestic banking system in Canada including the commercial equipment finance business. The Canadian government has the responsibility to ensure the stability of the domestic banking community, and the performance of the banks during events like the global financial crisis of 2008 shows Canadian measures were among the few that were adequate.

The unintended consequence of Canadian regulatory policy is a concentration of market share in the banking sector that is a threat to competition. The banking system is in good health, but the concentration of assets among the Big Six is cause for concern. The risk weightings used to determine capital adequacy for all Canadian banks do not adequately reflect the risk profile of smaller financial institutions. It appears that the Department of Finance is aware of this issue but has yet to propose a viable solution.

Until the gap in capital requirements between the Big Six and other small and medium-sized domestic banks can be closed, the ability to close the competitive gap between financial institutions will be limited.

Endnotes

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