Executive Summary

Prudent lending, borrowing and risk management practices, as well as regulatory compliance, have helped the Canadian banking industry wade through prolonged recessionary tides fairly unscathed. As such, Canada’s banks are consistently lauded and rated as sound and safe, and — unlike financial institutions in other portions of the developed world — they are seen as strongly positioned to grow. Canada’s Big Six banks operate under a government charter, with a national presence and in various business lines. They are well capitalized, well managed and deeply entrenched in the nation’s economy, contributing significantly to its growth.

The Big Six overall turned in a solid performance in 2010 compared with 2009, reporting increases in revenues, net income and return on equity, and have reported strong results through the third quarter of 2011.

Because they operate in a saturated market, Canada’s banks need to work aggressively to grow, and many are turning to emerging market economies to do so. Stringent regulatory reforms, as well as the pace at which these are unfolding, could dampen growth. As a result, Canada’s banks still need to invest additional resources, especially technology, to not only remain competitive but also outmaneuver the competition. Increasing regulatory pressures call for additional reporting capabilities that existing legacy systems will be hard-pressed to accommodate. For now, we believe Canadian banks should take a middle path by gradually upgrading their systems and adding new technology to help comply with evolving regulations.

Going forward, the Canadian banking industry will face challenges on a multiplicity of fronts, including regulatory requirements, economic conditions, changing demographics and new technologies (see Figure 1, next page). Canada’s banks can rely on the experience they gained through successful navigation of the global financial meltdown, as well as extending operational strategies that have kept them solvent in times of turmoil. This will help them maintain consumer confidence in an industry whose reputation worldwide has been tarnished by questionable tactics and decisions.

Forces Shaping the Industry

Canadian banks are enjoying relatively strong growth and stability compared with financial institutions in many developed markets. The industry continues to be influenced by economic challenges, new growth strategies, changing consumer behavior and the need for technology upgrades.
Canada’s banking industry survived the global financial crisis largely intact. The industry, which contributed 3.4% of the nation’s GDP in 2010, faces a scenario in which customer deleveraging and continuing global turmoil in the financial markets could affect lending volume and profitability.

According to the Royal Bank of Canada’s Economic and Financial Market Outlook for September 2011, the country’s GDP growth is forecast to decline from 3.2% in 2010 to 2.4% in 2011 and remain at that level for the next few years (see Figure 2). The unemployment rate, which peaked just above 8% during the global economic crisis, now hovers below 7.5% (see Figure 3, next page). Canada’s economy recovered quickly compared with the U.S., whose unemployment rate has plateaued at 9%; however, as the report cautions, consumer
spending on goods and services is likely to decrease to 2.1% year over year in 2011 before improving slightly in 2012 to 2.4%.

The overnight rate, Canada’s key policy-setting interest rate set by the Bank of Canada, has been at 1% or below since January 2009 (see Figure 4). This low interest rate regime has kept the cost of servicing debt low for consumers; however, fluctuation in interest rates due to uncertain market and economic conditions will force consumers to deal with a very high cost to service their debt. The debt service ratio of Canadian households, which decreased after the crisis, has increased in 2010 (see Figure 5, next page).

Unlike the U.S., Canada’s housing market has been relatively strong. It grew in 2010, although the market is showing signs of cooling, with flat sales expected in 2011 and 2012 due to the economic uncertainty prevailing in global markets (see Figure 6, next page). Sales declined by 3.9% in 2010 and are forecast to grow marginally by 0.9% in 2011 and remain at that level in 2012. Motor vehicle sales are also forecast to remain stagnant at the 1.6 million mark for the period from 2010 to 2012.

**Industry Landscape**

The Canadian banking system was rated as first in the world for financial strength by Moody’s Investors Service for the past two years, and the World Economic Forum rated it as the soundest for the last four years. Canada’s banking industry comprises 77 domestic and foreign banks (see Figure 7, page 5). Bank of Canada, the central bank of Canada, is the sole issuer of currency and is responsible for monetary policy, providing...
central banking services, promoting a safe and sound financial system and managing funds. It uses its ability to set the interest rate for borrowed money to achieve the goal of containing inflation below the 3% mark.

The banking industry is dominated by the Big Six banks, which account for 90% of the country’s banking business. In 2010, the Big Six had a combined net income of $20.4 billion, an increase of $6 billion from 2009. Interest income accounts for a major portion of Canadian banking income. Five of the six banks (not including Royal Bank of Canada) reported an increase in revenues in 2010 over 2009. However, all the banks in the Big Six recorded increased net incomes and return on equity over 2009. Personal and commercial lending contributes more than half of their revenues.

The banking industry currently employs more than 260,000 people from diverse backgrounds and accounts for 1.5% of total employment in the country. Many Canadians hold shares in banks. Operating in a limited domestic market,
banks compete aggressively to acquire customers and market share. This has led to a plethora of affordable consumer product offerings. Banks are also a key source of credit to Canadian business, representing 58% of all commercial lending.

Canadian banks emerged stronger from the financial crisis due to strong retail deposit flows, conservative risk appetites and diversification across regions and business lines, as well as low exposure to risky markets. The capital ratios, mandated by Canadian banking regulators and higher than those of Basel II, also helped them maintain greater liquidity levels. The ability of banks to raise high-quality capital from private markets, riding on the confidence in the Canadian banking sector, ensured they were sufficiently capitalized to deal with unexpected losses.

Canada’s Financial Consumer Agency, charged with protecting consumer interests, largely restricted subprime-type lending by banks and helped them avoid the crisis that befell their brethren in the U.S. Other factors, such as leverage restrictions and incentives that discouraged risky securitization products, also helped Canadian banks avoid toxic assets.

With limited growth opportunities at home, many Canadian banks are expanding into emerging economies with solid growth potential. International expansion, while somewhat risky, is seen as complementary to a conservative domestic stance. Some Canadian banks are employing diverse growth strategies that combine international acquisitions with improving core domestic operations through enhanced offerings as a way to boost revenues and sustain growth levels.

**Consumer Behavior**

The quick recovery of Canada’s housing industry has played an important role in limiting the recession’s impact. In the past 25 years, national house prices have been 3.5 times the average household disposable income; today, that number has increased to 4.5. This has resulted, for the first time in 12 years, in a debt-to-income ratio (148.1%) that surpasses that of the U.S. (147.2%), according to Statistics Canada. This is largely due to the increase in mortgage debt. Homeowners have also maintained a healthy amount of equity (72%) compared with debt in their home investments. As of July 2011, the percentage of arrears to total number of mortgages was just 0.4%, which is one-tenth the mortgage arrears in the U.S.

Consumers understand that global economic uncertainty and disruptions in key industries can leave them exposed to high debt with low income. A survey by the Certified General Accountants Association of Canada says, “Canadians are more likely to gauge their debt as decreasing, whereas the level of concern over increasing debt has declined: 37% of indebted respondents reported their debt as decreasing, while 35% as
increasing; the proportion of those concerned with increasing debt declined from 86% in 2010 to 78% in 2011; 82% of respondents are confident that they can either manage their debt well or take on more debt; the proportion of those who think they have too much debt and have trouble managing it declined from 21% in 2008 to 18% in 2011."

Meanwhile, Canadian consumers have a very positive opinion about their banks. Eighty-one percent believe Canadian banks are more stable and secure than other banks around the world, while 75% have a favorable impression of their banks. A total of 76% believe that banks in Canada do an important job of contributing to the economic recovery, according to the Canadian Bankers Association (CBA).

Regulatory Challenges
Banks in Canada come under the purview of two regulators: The Office of the Superintendent of Financial Institutions (OSFI) for prudential regulation and the Financial Consumer Agency of Canada (FCAC) for consumer matters. Every five years, Canada’s Bank Act is reviewed and updated to stay abreast of industry changes.

Regulations and regulatory compliance have been key to the Canadian banking industry, enabling it to remain strong and stable. However, the move-forward impact of regulatory changes worldwide is a big concern for banks in Canada. As they enter international markets, Canadian banks will be more exposed to global turmoil and conditions that are in a state of flux due to economic troubles, worries of sovereign debt and stringent regulations. Adjusting to the regulatory changes will require transformation of business operations that could slow growth and cause tradeoffs to be made between risk and profitability.

The key for Canadian banks will be to navigate changes that will have an impact on their business operations, models, systems and profitability, as regulators continue to introduce and implement new measures to ensure transparency and stability to the banking system. Banks, therefore, must effectively manage their resources while complying with regulations, which calls for retooling and investing in IT systems to ensure compliance and competitive advantage. Moving forward, this type of investment will put additional pressure on profitability and operational efficiencies.

Technology Challenges
The sound business practices of Canadian banks helped them weather the global financial storm effectively compared with banks from other nations. Going forward, technology will play a key role for these banks to achieve the balance between compliance and growth.

The Big Six have invested $55.8 billion between 1996 and 2009 in technology to provide their customers with secure, accessible and convenient banking systems. Investments, especially on the compliance and reporting front, can be expected to grow as Canadian banking regulators mandate early adherence with new regulations. Basel III will require banks to pay more attention to integrating data sources and using newer data modeling techniques. Liquidity reporting is another area in which banks will need to invest significantly. They will also need to ensure they have a robust IT infrastructure to deal with data integrity and usability.

Legacy modernization is a major challenge for the Canadian banking industry. Newer banks are using IT to attract new customers and improve their level of service. More established institutions face a difficult time deploying new technologies, as a major portion of their businesses is supported and run on legacy systems. Celent, a prominent research house, predicts that a significant percentage of IT budgets in the future will be allocated to maintaining legacy systems.

Modern-day innovations such as service-oriented architecture-based systems and cloud-based technologies can help alleviate upgrade expenditure challenges. Recently, Scotiabank signed up for a cloud-based software as a service (SaaS) solution to replace its multiple legacy trade and supply chain applications for its global trade services. These kinds of systems provide an efficient way of allocating capital, in which the bank pays only for computing resources that are actually used, while providing a means to quickly enter new markets and offer new and innovative services.

The call for replacing legacy systems is a longstanding need. Canadian banks need to address
this with a slow and steady, incremental approach, since these heritage systems are pervasive across business lines; it is too risky to replace them all at once. Competition for customers in the ultra-competitive Canadian banking market also calls for newer technologies to achieve market and mind share. Given the state of banking and the economy, taking a middle path is the best approach for banks that want to conserve capital and maintain operating margins over the short term.

Preparing For The Future
For all the recognition that the Canadian banking industry receives, it operates in a limited and insular market. The industry’s move outside Canada for growth will expose banks to global economic challenges, as well as a slew of regulatory compliance challenges. The industry can overcome these obstacles by leveraging its strong banking system, built on plain-vanilla products, limited exposure to riskier businesses and products, as well as a strong focus on long-term returns and customer service.

Another strength is that the government offers no incentives for consumers to take on higher debt, resulting in prudent borrowing. The Dodd-Frank Act began mandating stress-testing to measure the health of banks following the global economic crisis, but OSFI, the Canadian banking regulator, has been administering stress tests even before the crisis took place. This places Canadian banks in a strong position to contend with new challenges and opportunities.

Emerging technologies such as analytics, social media, mobile devices and cloud computing will play a greater role in the coming years. As the millennial generation grows in size and influence, demand for services that make use of these tools and techniques will play a significant role in determining growth and pecking order. Social media is already proving to be a critical platform to appeal to various segments of customers. According to the JD Power 2011 Canadian Retail Banking Customer Satisfaction Study, more than 60% of retail banking customers use social media, and among those who use social media for banking purposes, 24% say they do so to discuss their banking experience or inform their bank of a customer service issue. As more and more consumers use online and mobile banking services, it will be imperative for banks to consider how they can integrate these technologies and tap into their power to support and grow their businesses.

Regulations and economic conditions worldwide remain a cause for concern. Banks today are required to deal with more stringent capital, liquidity and risk management requirements. In such a scenario, improving operational efficiencies and gaining additional ground by utilizing their existing competitive advantages will determine which banks will succeed in the future.

Canadian banks will do well by:
- Maintaining the fine balance of meeting growth targets while complying with more stringent regulatory requirements.
- Diversifying into markets and related businesses with strong growth potential, while applying the experience gained in their home markets.
- Effectively dealing with the economic, political, cultural and regulatory hurdles in markets where they operate.
- Developing and providing innovative products and solutions. A recent Global CEO survey by PricewaterhouseCoopers says that 87% of banking and capital market CEOs believe that innovation will lead to operational efficiencies; 64% believe that IT investments will help them tap into new marketing and transactional opportunities.
- Achieving operational efficiencies with smart use of technology and third-party services to keep focused on acquiring, retaining and delighting customers.

The Canadian banking industry weathered the global financial storm. In fact, no Canadian financial institution required a government bailout. Given their strong fundamentals, track record and operational strategies, Canadian banks are well positioned to tap into new growth opportunities. But this can only happen if they can quickly and cost-effectively upgrade their legacy systems and apply historically solid risk mitigation strategies to expand into new geographies and offer ancillary products that will enable them to incrementally improve their top and bottom lines.
Footnotes

1 Big Six refers to the six biggest banks that dominate banking in Canada. They include Royal Bank of Canada, Toronto-Dominion Bank, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Bank of Montreal and National Bank of Canada.


3 “Royal Bank of Canada: Annual Report 2010,” www.rbc.com/investorrelations/pdf/ar_2010_e.pdf. Total revenue decreased $776 million, due to significantly lower total trading revenue. Also contributing to the decrease were lower securitization gains and reduced revenues, to the tune of $1.2 billion on account of a strong Canadian dollar.


Bibliography


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