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An Engine for Growth.

2015 Report Card on Canada and Toronto's Financial Services Sector

TFSA | TORONTO FINANCIAL SERVICES ALLIANCE

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An Engine for Growth: 2015 Report Card on Canada's and Toronto's Financial Services Sector
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Preface

Financial services are a critical component of the Canadian economy. The sector directly accounted for 4.4 per cent of Canadian employment in 2014, at 780,000 jobs, and 6.8 per cent of Canadian GDP. This report discusses the performance of Canada's financial services sector versus its peers in other countries and versus other sectors within Canada. The metrics considered in the report include the sector's financial performance, its productivity and innovation performance, and its international trade and investment performance. The report also assesses Toronto's role in Canada's financial services sector. This includes examining the sector's importance to Toronto's economy, as well as how Toronto compares with other international financial centres.

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CONTENTS

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About the Toronto Financial Services Alliance

The Toronto Financial Services Alliance (TFSA) is a unique, public–private partnership dedicated to growing Toronto region's financial services cluster and building it as a "top ten" global financial services centre. Established in 2001, TFSA is a collaboration involving three levels of government, the financial services industry and academia.

EXECUTIVE SUMMARY

An Engine for Growth: 2015 Report Card on Canada's and Toronto's Financial Services Sector

At a Glance

- Financial services have been a major source of growth for Canada over the past decade, with the sector's employment, financial results, and international trade and investment performance outpacing the average for all sectors.
- Financial institutions account for one-quarter of the profits generated by Canada's private sector and have high profit margins. However, returns relative to equity or capital employed are slightly below average.
- Compared with their international peers, Canadian deposit-taking institutions have healthy levels of capital adequacy and liquidity, with high rates of return and low levels of non-performing loans.
- Canada's financial services sector is innovative; 73.6 per cent of financial services firms had undertaken some form of innovation in the previous year versus 63.5 per cent for all sectors.
- Toronto is an important part of Canada's financial sector, with the metro area accoutning for 32.3 per cent of national employment.

The financial services sector is a critical component of the Canadian economy. The sector directly accounted for 4.4 per cent of Canadian employment in 2014 (at 780,000 jobs) and for 6.8 per cent of Canadian GDP. Also, the sector has been a source of growth for Canada in recent years. For example, sector employment has risen by 15.4 per cent since 2004. Only a handful of sectors—such as mining, oil and gas; health care; and professional services—have experienced stronger growth.

But the sector's role goes well beyond the jobs it supports and the GDP it generates. A well-functioning financial services sector is a critical ingredient in a successful economy, as it links the economy together in a unique way. Financial services are a necessary input for every single business across the country and are used by essentially every adult individual. Only a handful of other sectors, such as telecommunications or transportation, have the same impact on the day-to-day functioning of the economy.

Given the importance of the sector, the purpose of this report is twofold. First, we discuss the performance of Canada's financial services sector versus its peers in other countries and versus other sectors within Canada. The metrics we consider include the sector's financial performance, its productivity and innovation performance, and its international trade and investment performance. The second objective is to assess Toronto's role in Canada's financial services sector. This includes examining the sector's importance to Toronto's economy, as well as how Toronto compares with other international financial centres.

Within the sector, key sources of revenue growth included the banking, securities, and life and health insurance industries.

Financial Performance

Financial services experienced revenue growth of 4.3 per cent over the past decade—above the average of 3.8 per cent for the entire private sector. Furthermore, this growth occurred despite the fact that the sector experienced a large decline in revenues during the 2008–09 recession. Within the sector, key sources of revenue growth included the banking, securities, and life and health insurance industries.

In terms of profitability, financial services stand out in two ways. First, the sector accounted for 26.3 per cent of the net profits generated by the private sector in 2014. Second, the sector has a very high profit margin of 19.4 per cent, versus 7.1 per cent for the entire private sector. Among major sectors, only the real estate and leasing sector has a higher profit margin. However, the financial services' high profit margin is partially attributable to the sector's high degree of capital intensity. Once financial services' profitability is compared relative to its invested capital, returns are slightly below the average for all sectors. That said, there is considerable variation within the sector, with property and casualty insurance, back office operations, and other insurance operations (such as brokers and independent adjusters) reporting above-average rates or return on equity (ROE) and capital employed.

When compared with their international peers, Canadian financial institutions generally also fare well. Deposit-taking institutions in Canada have healthy levels of capital adequacy and liquidity, with high rates of return and low levels of non-performing loans. This contributes to Canada consistently being listed as having the soundest financial system in the world. In fact, Canadian ROE for deposit-taking institutions is among the highest for countries that contain one or more major global financial centres. At the same time, non-performing loans as a share of all loans in Canada are among the lowest for the same group of countries. Canadian insurance firms also report above-average ROE, compared with their international peers, despite the challenges of limited premium growth and the impact of low interest rates on investment returns.

The most common forms of innovation undertaken by the sector include organizational and marketing innovations.

Productivity and Innovation Performance

Although the financial services sector does not score highly on common measures of innovation, such as research and development spending or patents, the sector is innovative. For example, according to Statistics Canada's Survey of Innovation and Business Strategy, 73.6 per cent of financial services firms had undertaken some form of innovation in the previous year, versus 63.5 per cent for all sectors. The most common forms of innovation undertaken by the sector include organizational and marketing innovations.

Within the sector, it is difficult to say which industry is the most innovative, as each one innovates in different ways. However, banking tends to take the lead in developing new marketing channels and promotional strategies, while securities firms are the most likely to undertake innovations in product design and pricing. Finally, insurance firms are the most likely to undertake organizational innovation. Regionally, the most innovative financial services firms are found in Ontario and British Columbia, while innovation is lowest in Alberta and Atlantic Canada.

However, the sector's innovations have only partially translated into productivity growth. Labour productivity gains in the sector averaged 0.5 per cent per year between 2007 and 2014. This was below the average of 1.0 per cent over the same period for all sectors in Canada. As well, labour productivity growth in Canada's financial services sector is only moderate when compared with peer countries. Even so, growth in Canada did outpace some countries that host major global financial centres, such as the United Kingdom (–1.5 per cent) and Germany (0.3 per cent). One potential factor may be that Canada already has an above-average level of productivity, and it is harder to grow from a high level.

Trade and Investment Performance

Financial services are a large and growing part of Canada's international trade and investment profile. The principle means by which Canadian financial institutions expand their international footprint is by undertaking investments to establish foreign affiliates. In fact, 52 per cent of Canada's stock of outward foreign direct investments (FDI) is attributable to the financial services sector, up from 35 per cent in 2000. At $435 billion in 2014, Canada's stock of financial services outward FDI has quadrupled since 2000, and it is now twice as large as its inward stock. In other words, Canada is a large and growing net exporter of financial services capital.

As a result of these investments, Canada's financial services foreign affiliate sales have doubled since 2000. They now account for 20 per cent of Canada's total foreign affiliate sales, up from 13 per cent in 2000. At $100 billion in 2012, the sector's foreign affiliate sales are 10 times the size of its exports. However, the sector's exports have also grown significantly—tripling since the turn of the century. This growth is largely driven by "other financial services," which include items such as securities issuance and trading, and asset management services. In fact, financial services is Canada's largest and fastest-growing services category internationally.

Toronto's Role in Canada's Financial Services Sector

Toronto is the major hub for financial services in Canada. For example, the metro area accounts for 32.3 per cent of Canada's financial services employment and 43 per cent of the sector's headquarters employment. As well, the sector has become more concentrated in Toronto over the past decade. As a result, at 251,375 employees, the sector directly accounts for 8.1 per cent of the metro area's employment, and 13.3 per cent of its GDP. In terms of GDP, only the public services sector is larger in Toronto.

In addition to the direct impacts on Toronto's economy, the financial services sector generates secondary (or indirect) impacts, as well as fiscal impacts. For example, the sector supports another 209,371 indirect jobs, with 106,290 of those occurring in Toronto and the rest occurring elsewhere in Canada. Key industries that indirectly benefit Toronto include consulting, accounting, legal services, and computer services. As well, Toronto's financial services sector generated a combined $15.7 billion in fiscal benefits in 2014 for the Canadian, Ontario, and City of Toronto governments.

Toronto's role as Canada's major financial services hub is reinforced by the results of global rankings such as *The Banker* magazine's list of top global financial centres. The magazine ranks Toronto 7th in the world, and the Global Financial Centres Index (GFCI) ranks Toronto 8th. Toronto's ranking in the GFCI improved from 11th, and the improvement appears to be largely tied to an improved reputation for the city. In fact, Toronto now ranks 15th among the cities covered in the GFCI in terms of "reputational advantage." This means that opinions about Toronto are significantly stronger than the quantitative data would suggest.

CHAPTER 1

Introduction

Chapter Summary

- Canada's financial services sector has been a source of growth for the economy over the past decade, and it now directly accounts for 780,000 jobs and 6.8 per cent of GDP in Canada.
- In addition, a well-functioning financial services sector is a critical ingredient in a successful economy. It links the economy together in a unique way.
- Toronto is Canada's largest and most dominant financial centre. The metro area accounts for one-third of the sector's employment and more than 40 per cent of its headquarters employment.

The financial services sector is a critical component of the Canadian economy. For example, the sector directly accounted for 4.4 per cent of Canadian employment in 2014 (at 780,000 jobs[1]) and 6.8 per cent of Canadian GDP.[2] Furthermore, the sector has been a source of growth for Canada in recent years. For example, sector employment has risen by 15.4 per cent since 2004. Only a handful of sectors—such as mining, oil and gas, health care, and professional services—have experienced stronger growth.

But the sector's role goes well beyond the jobs it supports and the GDP it generates. A well-functioning financial services sector is a critical ingredient in a successful economy. Key functions that the sector provides which, essentially, all consumers and business require, include access to credit, transaction processing, and risk management services. Without these services, a modern, dynamic, and resilient economy is impossible.

Thus, the financial services sector links the economy together in a unique way. Financial services are a necessary input for every single business across the country and are essentially used by every adult individual. Only a handful of other sectors, such as telecommunications or transportation, have the same impact on the day-to-day functioning of the economy.

Within Canada's financial services sector, Toronto plays an important role. This is reflected in the fact that the metro area accounts for 32.3 per cent of Canada's financial services employment and 43 per cent of

1 See CANSIM table 282-0008. In this report, the financial services sector is defined as NAICS 52 unless otherwise noted.

2 See CANSIM table 379-0031.

The depth and diversity of Toronto's financial sector and its international success is reflected in its high ranking on international league tables for financial centres.

headquarters employment. For both measures, these shares are more than double those of the second-ranked metro area in Canada. Financial services are also an integral part of Toronto's economy: the sector directly accounts for about 1 out of every 12 jobs in the Toronto metro area. As well, the sector indirectly supports activity in a variety of other sectors—locally and across Canada.

The depth and diversity of Toronto's financial sector and its international success is reflected in its high ranking on international league tables for financial centres, such as those produced by *The Banker*, and on the Global Financial Centres Index. As well, among all of the industries that make up the sector, Toronto accounts for an above-average share of Canada's total employment in that industry, except in the case of credit unions. As such, Toronto remains Canada's largest and most dominant financial centre.

This report updates and supplements two previous reports published by The Conference Board of Canada about Toronto's financial sector: *Performance and Potential: Toronto's Financial Services Sector—2014*[3] and *Ensuring the Future: Understanding the Importance of Toronto's Financial Services Sector*.[4] The purpose of this report is twofold. First, we discuss the performance of Canada's financial services sector versus its peers in other countries and versus other sectors within Canada. The metrics we consider include the sector's financial performance, its productivity and innovation performance, and its international trade and investment performance. The second objective of the report is to update our annual scorecard on the performance of Toronto's financial services sector. The scorecard looks at the role of the sector in Toronto's economy, as well as at how Toronto compares with other international financial centres.

3 Sutherland, *Performance and Potential*.

4 Burt, Audet, and Sutherland, *Ensuring the Future*.

CHAPTER 2

The Financial Performance of Canada's Financial Services Sector

Chapter Summary

- Compared with other Canadian sectors, financial services has experienced above-average revenue growth over the past decade, driven by the banking, securities, and life and health insurance industries.
- Financial services account for one-quarter of the profits generated by the private sector in Canada.
- Compared with their international peers, Canadian deposit-taking institutions have healthy levels of capital adequacy and liquidity, with high rates of return and low levels of non-performing loans. This contributes to Canada consistently being listed as having the soundest financial system in the world.
- Despite the challenges of limited premium growth and the impact of low interest rates on investment returns, Canadian insurers generate above-average returns compared with their international peers.

There are many different financial indicators that can be examined to assess the performance of a business or sector.

Common categories for these indicators include the following:

- **Profitability** (including return on capital employed, profit margins, and asset turnover)
- **Liquidity** (including the current ratio, inventory turnover, and receivables turnover)
- **Gearing** (including the debt-to-equity ratio, and the interest coverage ratio)
- **Investor ratios** (including earnings per share, and dividend yields)

Each of these ratios has different purposes, as well as dissimilar strengths and weaknesses. For our purposes, we focus on the profitability metrics when comparing Canada's financial sector with other sectors in the Canadian economy, as well as when comparing individual industries within the sector. Many of the other indicators are more pertinent to a particular business, such as measuring the riskiness or the return to investing in that business.

Revenue Growth

The financial services sector is a significant contributor to the revenues generated by all businesses in Canada. In 2014, the sector accounted for 9.6 per cent of total private sector[1] revenues generated in Canada. Furthermore, this share has increased over the past decade: in 2004, the sector's share of business revenues was 9.1 per cent. Other sectors that account for a large share of business revenues include manufacturing (20.4 per cent), wholesale trade (17.4 per cent), retail trade (13.9 per cent), and construction (8.2 per cent).

1 Note: Private sector revenues exclude government-related activities such as public administration, and much of the health and education sectors.

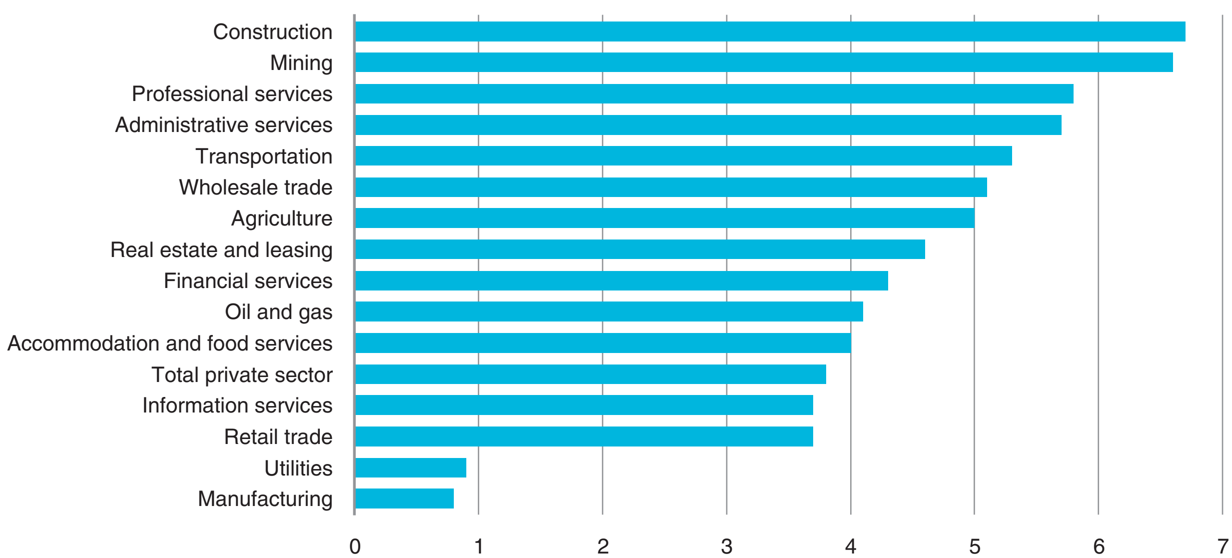
The rise in the financial services' share of total private sector revenues over time indicates that the sector's revenues have experienced slightly above-average growth. Since 2004, financial services revenues have averaged gains of 4.3 per cent per year, versus 3.8 per cent for the entire private sector. (See Chart 1.) Some sectors, such as construction and mining, have experienced strong revenue growth while others, like manufacturing and utilities, have experienced very weak growth. Many of the sectors with above-average revenue growth either directly (such as agriculture, mining, and oil and gas) or indirectly (such as construction) benefited from the general rise in commodity prices over the 2000s. Now that commodity prices have weakened, so too has their growth.

Another factor contributing to the revenue growth performance of different sectors over the past decade is volatility. This is one reason why most of the service sectors have experienced above-average growth. For example, after experiencing strong growth prior to the recession, the

Chart 1

Financial Services Have Experienced Above-Average Revenue Growth Over the Past Decade

(average annual revenue growth, 2004–14, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

Although financial services revenues have more than fully recovered from the effects of the recession, the recession-related decline limited the sector's revenue growth over the past decade.

financial services sector saw revenues shrink by 7.5 per cent between 2007 and 2009. This was the largest decline in revenues during the recessionary period among service sectors. Although financial services revenues have subsequently more than fully recovered from the effects of the recession, the recession-related decline limited the sector's revenue growth over the past decade. In addition, the recessionary dip in financial services revenues highlights the fact that the sector is more sensitive to economic conditions than most service industries.

However, nearly all of the goods-producing sectors experienced much more volatility during the recession. For example, oil and gas, mining, utilities, and manufacturing all experienced double-digit declines in sales between 2007 and 2009. Because of the dip in commodity prices during the recession, the oil and gas and mining sectors saw revenue declines of 20 per cent. Some other service sectors, such as transportation and wholesale trade, also experienced sizable declines in revenues during the recession, as they are more closely linked to activity in the goods-producing sectors.

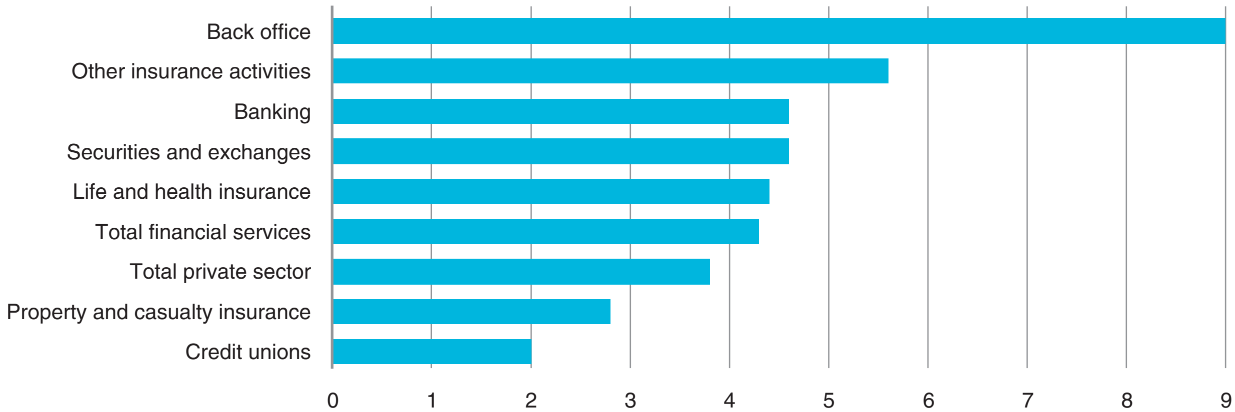
Within the broad financial services sector, there are a number of industries, such as banking, insurance, and securities. Each of these industries has also experienced different paces of revenue growth over the past decade. The strongest growth has occurred in the back office industry, where revenues have risen by an average of 9 per cent per year since 2004. (See Chart 2.) However, the back office industry accounted for only a small share of sales, at 1.9 per cent, in 2014. Thus, the strong back office gains have had a minimal impact on sales growth in the broad financial services sector. (See Chart 3.)

Among the larger industries within the financial services sector, banking (4.6 per cent), securities (4.6 per cent), and life and health insurance (4.4 per cent) have all experienced similar revenue growth over the past decade. But property and casualty insurance has experienced weaker growth (2.8 per cent). Over this period, the property and casualty insurance industry has generally experienced slow, but steady, growth. This is indicative of a mature industry, with the Canadian market generally well-insured.

Chart 2

Back Office Operations Experienced the Strongest Revenue Growth in Canada's Financial Services Sector

(average annual revenue growth, 2004–14, per cent)

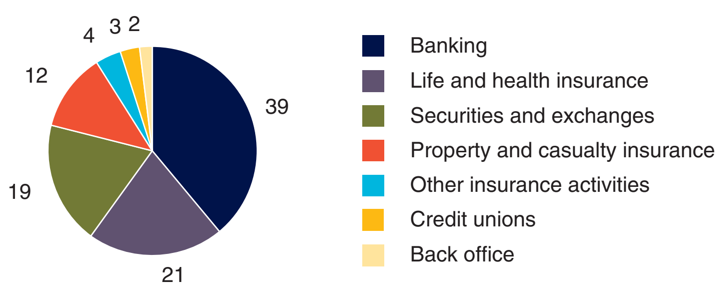


Sources: Statistics Canada; The Conference Board of Canada.

Chart 3

Banking, Securities and Insurance Account for Most Financial Services Revenues

(share of financial services revenue, 2014, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

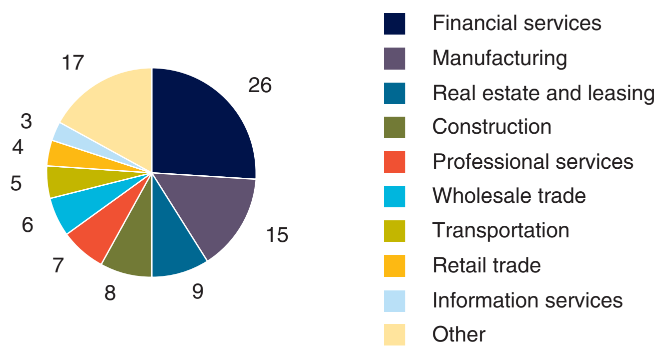
Profit Measures

There are multiple measures that one can use when assessing the profitability of a business or sector. However, the two most common ones are operating profits (or profits before interest and taxes) and net profits (after all expenses have been deducted). In both cases, the financial services sector plays a large role in generating the profits of Canada's private sector. In fact, the financial services sector accounted for 25.3 per cent of operating profits and 26.3 per cent of the net profits generated by Canada's private sector in 2014. (See Chart 4.) These shares have been fairly consistent over the past decade.

Chart 4

Financial Services Account for One-Quarter of the Profits Generated in Canada

(share of total private sector net profits, 2014, per cent)

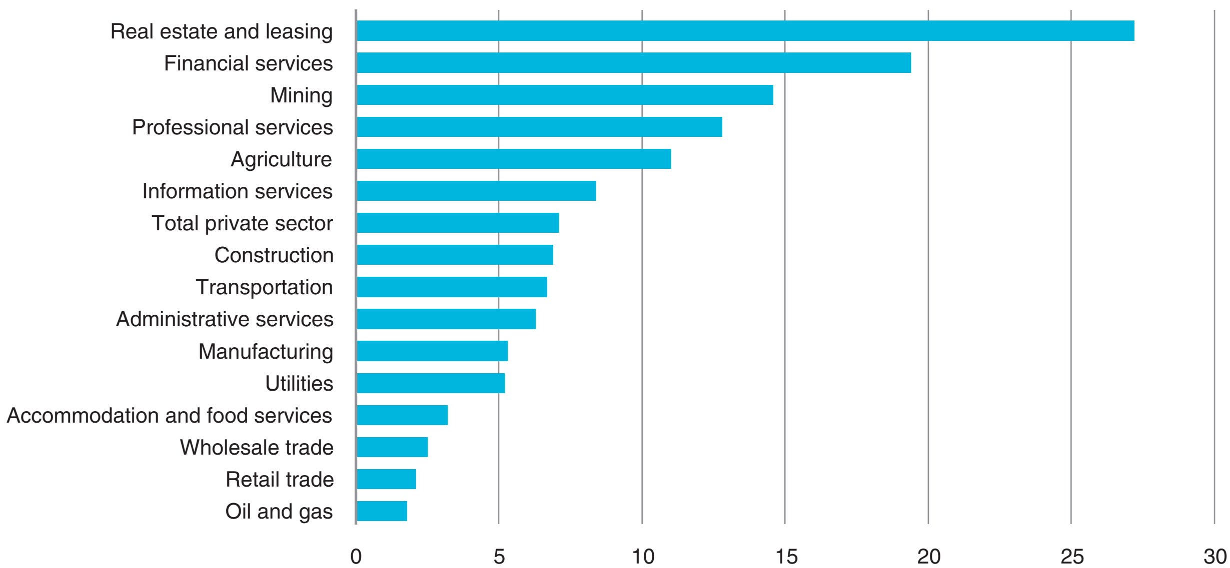


Sources: Statistics Canada; The Conference Board of Canada.

The high profits at Canada's financial institutions are used in a variety of ways. For example, more than half is traditionally paid out as dividends to shareholders. Profits are also one of the ways that the sector pays for the investments it undertakes. Finally, profits are the key component of building capital against which any future losses can be charged. As we will discuss later in this chapter, insufficient capital at financial institutions was a key contributor to the 2008–09 financial crisis in many countries outside of Canada. Therefore, the profitability of the Canadian financial sector assists with building its capital base, thus improving its capital adequacy and safety.

It is also useful to look at profits relative to revenues, or as a margin, to assess how efficiently a sector is translating its revenues into profits. By these measures, the financial services sector is also a strong performer. Both in terms of net profit margin (19.4 per cent) and operating profit margin (23.8 per cent), the financial services sector ranked second only to real estate and leasing among major sectors in 2014. (See Chart 5.) Also, financial services has consistently ranked first or second among sectors in terms of profit margins over the past decade. This was true even during the recession, when margins reached their lowest point.

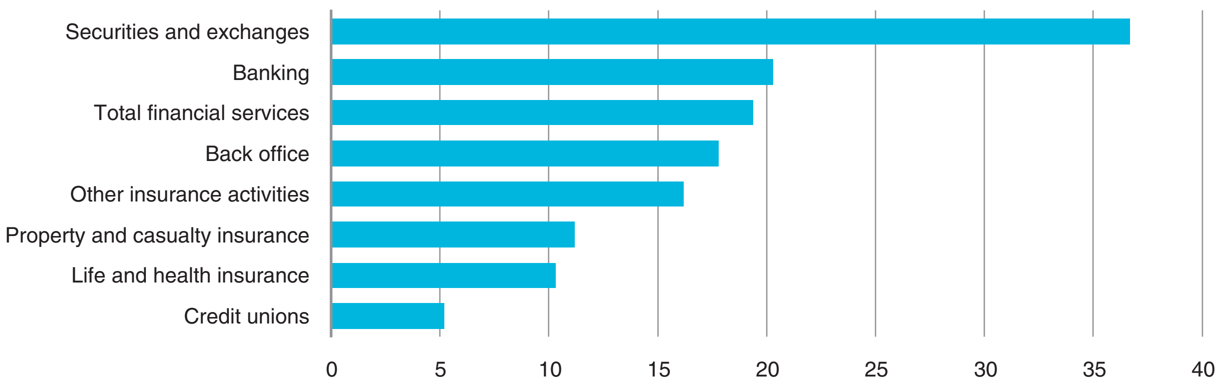
Chart 5
Financial Services Has High Profit Margins
(net profit margin by sector, 2014, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

Within the financial services sector, double-digit profit margins are nearly universal. In 2014, only the credit union industry had a net profit margin below 10 per cent, and that was unusually low. Profit margins at credit unions have deteriorated in recent years. This is likely the result of credit unions' heavy reliance on residential mortgage lending at a time of unusually low mortgage rates.[2] The securities and banking industries have particularly high margins. (See Chart 6.) And, because of their large size, they are the key contributors to the sector's profitability. In fact, between them, the industries accounted for three-quarters of the financial services sector's profits in 2014.

Chart 6
Securities and Banking Have the Highest Margins in Financial Services
(net profit margin by segment, 2014, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

The high margins at financial institutions are consistent with the fact that the sector is highly capital intensive. In general, capital-intensive sectors, such as utilities and transportation, have above-average margins. Other examples of capital-intensive sectors include real estate and leasing, oil and gas, and telecommunications (which is part of the broader information services sector). The high margins of capital-intensive

2 Crawford, *Canadian Credit Unions: Different by Design.*

industries reflect the need for these sectors to generate strong cash flows to cover their large, upfront investments. Although the financial services sector does not hold large amounts of physical assets, its capital is often tied up in long-term assets such as loans or illiquid investments. Because of the correlation between margins and capital intensity, it is also useful to look at profitability relative to a sector's invested capital, which we do in the next section.

Measures of Return

Two common measures of profitability that take into account the capital structure of a sector are return on equity (ROE) and return on capital employed (ROCE). The key difference between the two measures is that ROE looks only at the efficiency of generating profits on equity, while ROCE considers both debt and equity as a source of capital. For our purposes, ROE is defined as net profits as a share of equity, while ROCE is defined as operating profits divided by the sum of equity and debt.

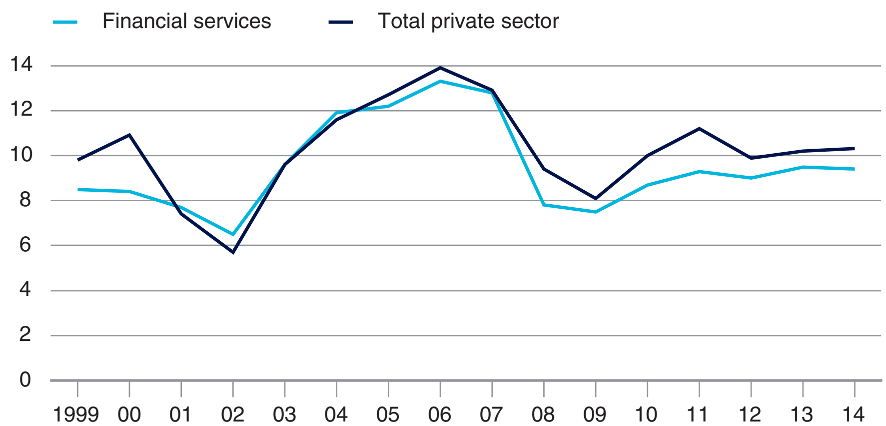
Both of these measures show similar trends for the financial services sector. First, the sector has slightly below-average ROE (9.4 per cent) and ROCE (7.6 per cent) when compared with the total private sector: 10.3 per cent and 8.5 per cent, respectively. Second, returns in the financial sector were significantly higher prior to the recession. They fell considerably during the recession, and the returns have subsequently only partially recovered. Finally, these changes in ROE and ROCE for the financial services sector over time closely mimic those for the private sector as a whole. (See Chart 7.) This similarity may be because financial services account for a sizable share of total private sector profits.

The limited recovery in both ROE and ROCE since 2009 for the financial services sector is likely partially attributable to changes in regulatory requirements for financial institutions in the wake of the financial crisis. Financial institutions around the world have been required to increase their capital holdings so that they have a larger buffer against which they can write off losses. The intent of these regulatory changes is to reduce systemic risk in the financial services sector, but it does have the side effect of reducing returns on capital. In essence, the profits of each financial institution are now being compared against a larger capital base, reducing ROE and ROCE.

Chart 7

Financial Services ROE Has Lagged Since the Recession

(return on equity, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

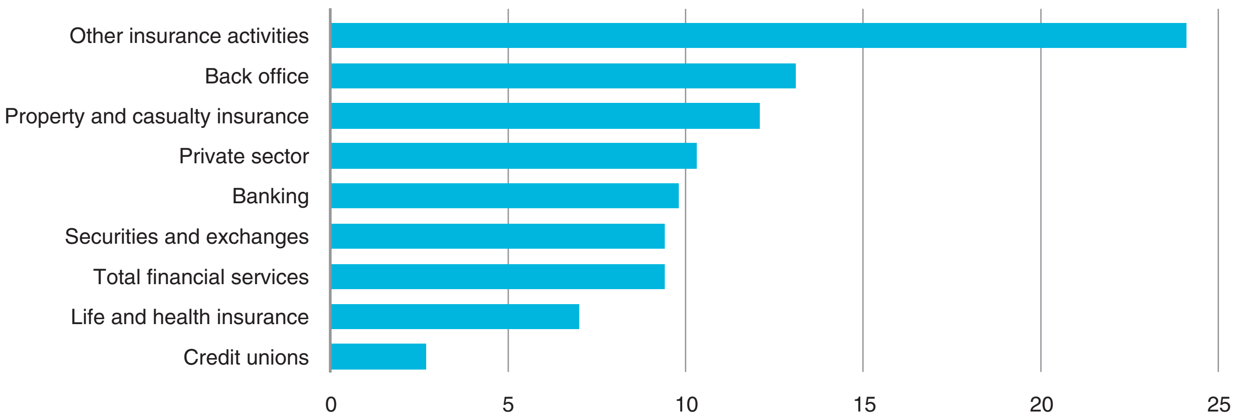
Within the financial services sector, the largest rates of return are actually found in the least capital-intensive industries, namely other insurance activities and back office operations. (See Chart 8.) Both industries have had consistently high rates of return both before and after the 2008–09 financial crisis. Other industries have struggled to recover from the effects of the recession. For example, the securities industry used to have one of the highest rates of return in the financial services sector but, after experiencing a large drop during the recession, it has struggled to recover. Rates of return in the property and casualty insurance industry are currently high relative to the rest of the sector and the private sector as a whole. However, rates of return did drop during the recession and have also struggled to recover since then.

The weakest performers in terms of ROE for the financial services sector are credit unions, and life and health insurance. Both industries historically had higher ROEs, but they have trended down over the past 10 years. This trend is most prominent in the credit union industry, where the ROE has fallen from 14.1 per cent in 2004 to 2.7 per cent in 2014. As previously mentioned, the industry's high dependence on residential mortgages for revenues, combined with a prolonged period of low interest rates, is likely the major factor contributing to this change.

Chart 8

ROE Is Highest in the Least Capital-Intensive Industries

(return on equity, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

Financial Stability Indicators

The Canadian financial system is often cited as being one of the soundest in the world.[3] A key reason for this is the strong financial performance of the Canadian sector compared with its international peers. One of the ways this performance can be assessed is by examining the Financial Stability Indicators (FSIs) for deposit-taking

3 World Economic Forum, *The Global Competitiveness Repor, 2014–2015*.

institutions that are set out by the International Monetary Fund (IMF).[4] FSIs provide a snapshot of how well prepared deposit-taking institutions are to meet unexpected external shocks and how they have increased in prominence since the financial crisis of 2007–08.

Some of the FSIs listed in the current IMF *Compilation Guide on Financial Soundness Indicators* predate the financial crisis, while others have been added only recently through amendments to the guide.[5] FSIs are listed as either a “core” or “encouraged” indicator of financial soundness and are a key source of information for those who wish to conduct macroprudential analysis. (See Table 1.) In theory, an analysis conducted using FSIs raises the probability of detecting trends that threaten financial systems or increase systemic risk. These risks can then be mitigated before reaching crisis levels as they did in the U.S. housing crash and leading into the sovereign debt crisis in Western Europe. For our purposes, we will focus on the core indicators.

Measures of Capital Adequacy

One of the principal causes of the 2007–08 financial crisis was the lack of high-quality capital to support excessive on- and off-balance sheet leverage.[6] Consequently, commercial banks in many countries outside of Canada were unable to absorb the systemic trading and credit losses that ensued from the crisis. Therefore, to address the lack of available capital during the financial crisis, regulators on the Basel Committee on Banking Supervision strengthened the capital requirements in December 2010 under the Third Basel Accord (commonly known as Basel III).

Basel III requirements sought to increase “the quality, consistency, and transparency of the capital base.”[7] To meet the objective of increasing the quality of the capital base, Basel III defined two forms of capital. Tier 1 capital is defined as the principal source of bank capital and is

4 International Monetary Fund, *Financial Soundness Indicators: Compilation Guide*.

5 Ibid.

6 Bank of International Settlements, *Basel III*.

7 Ibid.

Table 1
Financial Stability Indicators

Financial Soundness Indicators for Deposit Takers		
Capital based	**Asset based**	**Income/expense based**
Regulatory capital to risk-weighted assets	**Liquid assets to total assets**	**Interest margin to gross income**
Regulatory Tier 1 capital to risk-weighted assets	**Liquid assets to short-term liabilities**	Trading income to total income
Capital to assets	Customer deposits to total loans	**Non-interest expense to gross income**
Non-performing loans net of provisions to capital	**Return on assets**	Personal expenses to non-interest expenses
Return on equity	**Non-performing loans to total gross loans**	
Large exposures to capital	**Sectoral distribution of loans to total loans**	
Net open position in foreign exchange to capital	Residential real estate loans to total loans	
Gross asset and liability in financial derivations to capital	Commercial real estate loans to total loans	
Net open position in equities to capital	Geographical distribution of loans to total loans	
	Foreign currency denominated loans to total loans	
	Foreign currency denominated liabilities to total liabilities	

Note: Bold indicates "core" indicator.
Source: International Monetary Fund.

primarily composed of common shares and retained earnings. The remainder of Tier 1 capital includes instruments that are subordinated, have fully discretionary non-cumulative payments, and have neither a maturity date nor an incentive to redeem. Tier 2 capital is added to Tier 1

Canadian deposit-taking institutions perform well on measures of capital adequacy.

capital to produce Total Regulatory Capital, with Tier 3 capital phased-out under Basel III. Tier 2 capital includes items such as subordinated debt instruments.[8]

The capital measures under Basel III are often measured against risk-weighted assets (RWA). Under the RWA, assets are weighted according to their relative riskiness. Safe assets, such as cash and highly rated government debt, have a weight of zero per cent. This suggests that the bank does not need to hold capital against these assets because it is very unlikely that these assets will deteriorate in value.[9] Those assets that are secured by residential real estate, such as residential mortgages, typically have a weight of 35 per cent with higher weights applied to loans with a high loan-to-value ratio. Past-due loans and securities that are below investment grade can be weighted in excess of 100 per cent.

Broadly speaking, Canadian deposit-taking institutions perform well on measures of capital adequacy. For example, the Tier 1 to RWA ratio in Canada was 11.9 per cent at the end of 2014. This is similar to the ratio in peer countries and well above the current guidelines set out by both the Basel III (6 per cent) and Office of the Superintendent of Financial Institutions (OSFI) (8.5 per cent). (See Chart 9.) Similarly, the total regulatory capital to RWA ratio in Canada, at 14.2 per cent, is well above Basel III (8 per cent) and OSFI (10.5 per cent) guidance.

Measures of Profitability

Canadian deposit-taking institutions rank very highly compared with their international peers when it comes to measures of profitability. For example, the ROE, at 22.5 per cent in Canada, is among the highest for

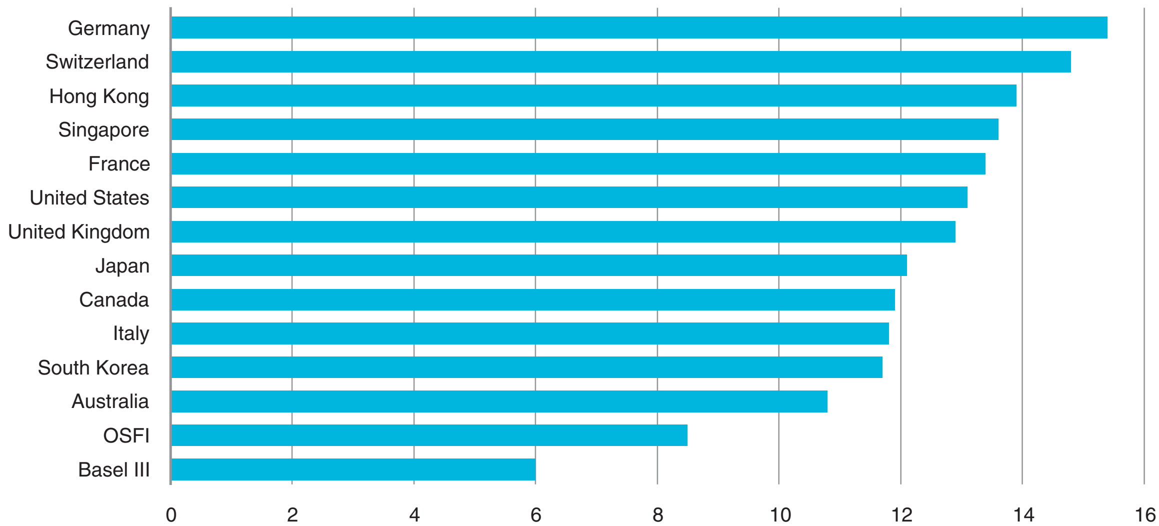
8 Subordinated debt is any instrument that ranks below other debts if a company falls into bankruptcy. Since subordinated debt is only repayable after other debts have been fully repaid, it is considered more risky than senior debt.

9 Office of the Superintendent of Financial Institutions, *Capital Adequacy Requirements.*

Chart 9

Deposit-Taking Institutions in Canada Have More Than Sufficient Capital

(Tier 1 capital to RWA for selected countries, 2014 Q4 or most recent, per cent)



Source: International Monetary Fund.

countries that contain one or more major global financial centres.[10] (See Chart 10.) Similarly, the return on assets (ROA) in Canada stood at 1.1 per cent at the end of 2014; among the countries shown in Chart 10, only Australia and Singapore are higher. The high level of ROE and ROA for Canadian deposit-taking institutions, in combination with their healthy level of capital adequacy, suggests that they are using their capital very efficiently. As well, the healthy level of profitability has the added benefit of generating additional capital in the form of retained earnings for use against any future losses.

One measure of profitability where Canadian deposit-taking institutions compare less favourably to their peers is interest margin as a share of gross income. At 51.3 per cent, the ratio in Canada is generally lower

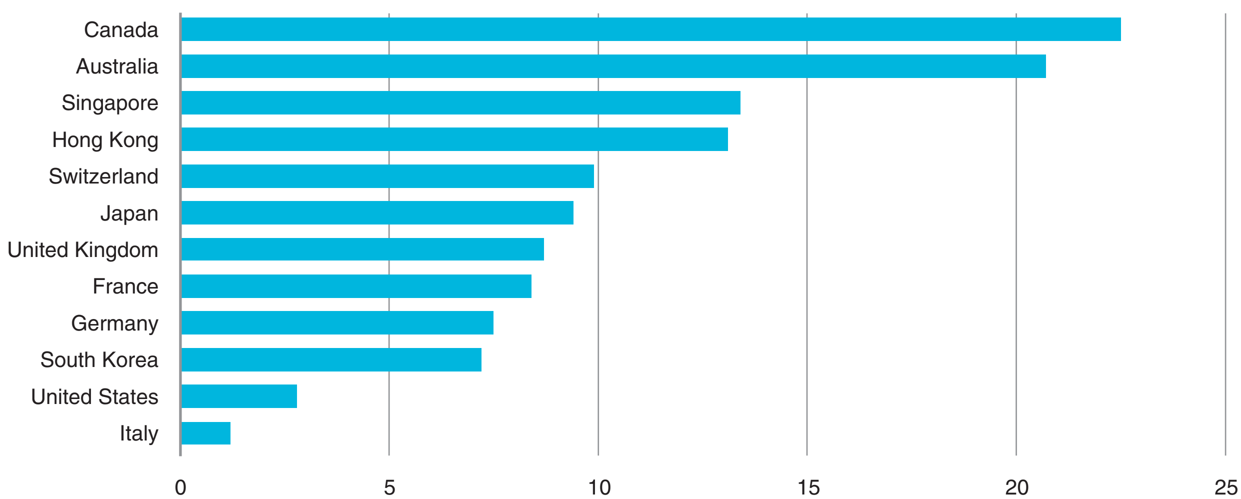
10 The IMF measure of ROE uses operating income rather than net income. That is why it is significantly higher than the ROE for Canadian financial institutions reported in the previous section.

than what we see in most other developed countries. However, this ratio can be impacted by many things, such as the asset mix of the reporting firms. If a firm's asset mix is less concentrated on loans and instead more focused on other financial activities, all else being equal, this ratio will be lower. The loans to deposits ratio is also a very important determinant of the interest margin ratio, but this can vary considerably over time and across countries. As such, given its strong performance for other measures of profitability, a low-interest margin ratio in Canada likely reflects different structural characteristics among its deposit-taking institutions rather than a cause for concern.

Chart 10

Deposit-Taking Institutions in Canada Have a High ROE

(ROE for selected countries, 2014 Q4 or most recent, per cent)



Source: International Monetary Fund.

Since profitability is impacted not only by revenues but also by costs, it is equally important to look at the expense performance for deposit-taking institutions. Non-interest expense as a share of gross income is one measure identified by the IMF that helps to determine the amount of administrative expenses (i.e., expenses accrued that are not related to lending or borrowing activities). Thus, it is a measure by which we can judge how efficiently deposit-taking institutions deliver their services.

By this measure, Canadian financial institutions generally compare favourably to many of their peers. At 62.8 per cent, Canadian firms generally have a higher non-interest expense ratio than we see in Asian countries such as Singapore (44.5 per cent), Hong Kong (48.9 per cent), and South Korea (59.9 per cent). However, Canada compares favourably with the U.S. (64.7 per cent) and many European countries such as the U.K. (67.0 per cent), Germany (69.1 per cent), and Switzerland (69.4 per cent).

Measures of Liquidity

Liquidity metrics are designed to measure to what extent financial institutions can meet expected, and unexpected, demands for cash. Low levels of liquidity could indicate that an institution, or the system in aggregate, is vulnerable to external shocks that cause a rapid withdrawal of funds (or a rapid slowdown in deposit growth). Conversely, higher liquidity ratios provide the system a higher margin of safety. The IMF considers two measures of liquidity to be core measures of financial soundness: the ratio of liquid assets to total assets (liquidity ratio) and the ratio of liquid assets to short-term liabilities (liability coverage ratio).

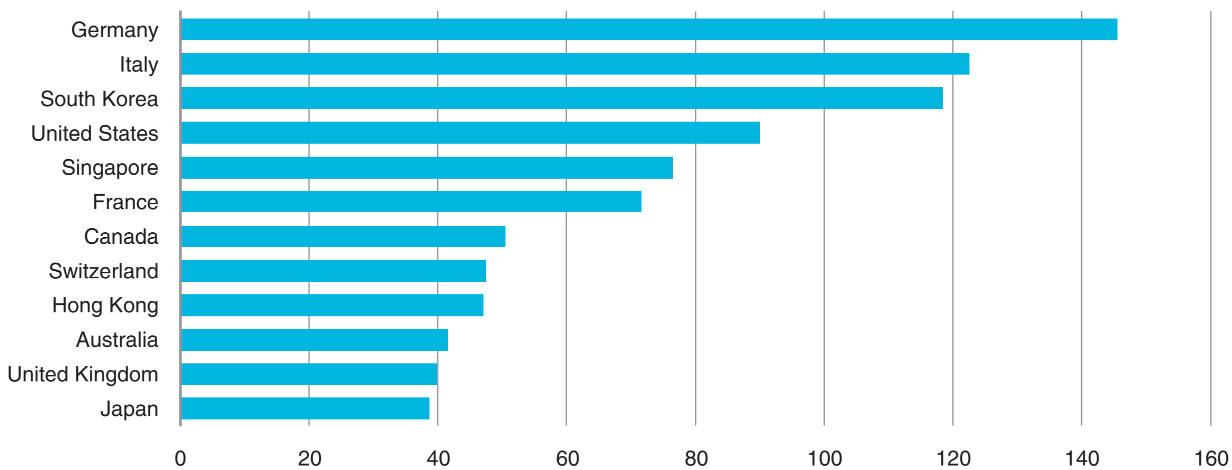
At 11 per cent, the liquidity ratio for Canadian deposit-taking institutions is currently low; only a few small developed countries (such as Sweden and Norway) have a lower ratio. By way of comparison, the liquidity ratio is 14.5 per cent in the United States and 25.5 per cent in the United Kingdom. On the surface, this would suggest that Canadian institutions are less able to deal with shocks to liquidity. However, Canada's liabilities coverage ratio is less concerning.

At 50.5 per cent, Canada's liabilities coverage ratio is higher than some peer countries, and lower than others. (See Chart 11.) The liabilities coverage ratio "is intended to capture the liquidity mismatch of assets and liabilities."[11] In other words, it assesses the degree to which an institution has liquid or short-term assets matched with short-term liabilities, such as demand deposits. As such, it likely better represents the ability of deposit-taking institutions to manage unexpected and significant withdrawals of cash without creating a liquidity crisis.

Chart 11

Liquidity Is Adequate for Deposit-Taking Institutions in Canada

(liabilities' coverage ratio for selected countries, 2014 Q4 or most recent, per cent)



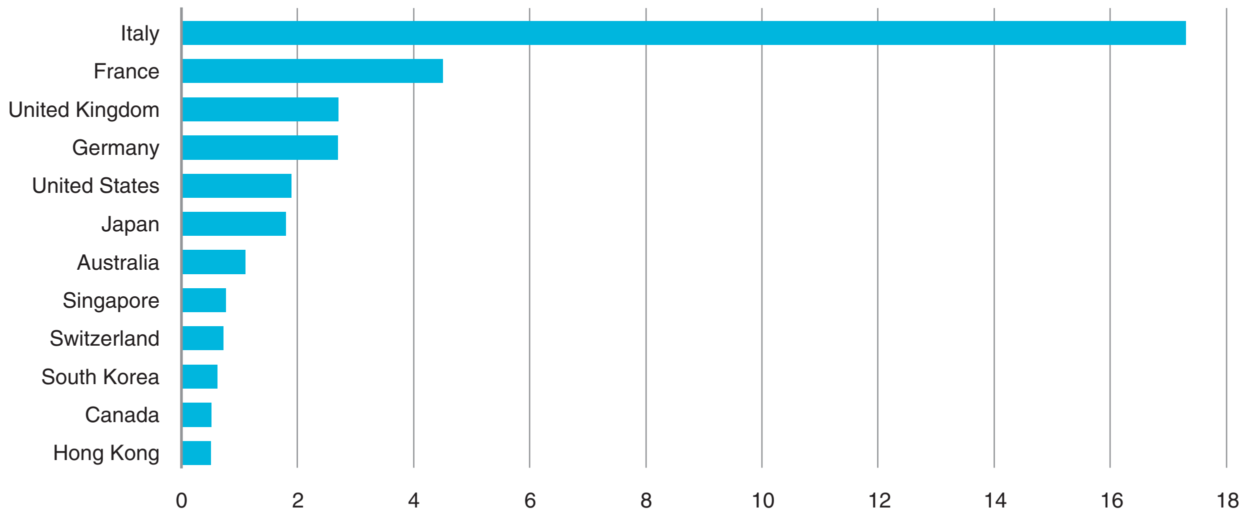
Source: International Monetary Fund.

Measures of Loan Performance

The other major type of indicator included in the FSI measures loan performance, which assesses the relative size of non-performing loans (NPLs). Since NPLs are a major source of losses for deposit-taking institutions, the purpose of these metrics is to assess the capacity of the institution to absorb such losses. In general, Canada has a very low level of NPL; its share of total loans is only 0.5 per cent, the lowest among peer countries. (See Chart 12.)

11 International Monetary Fund, *Financial Soundness Indicators: Compilation Guide*, 83.

Chart 12
Non-Performing Loans Are Very Low in Canada
(NPL as a share of total loans for selected countries, 2014 Q4 or most recent, per cent)



Source: International Monetary Fund.

Given the low level of NPL in Canada, it is not surprising that Canadian deposit-taking institutions also currently have a low level of NPL relative to capital. At 5.5 per cent in Canada, only a handful of peers—including Hong Kong (1.3 per cent), Switzerland (3.7 per cent), and Singapore (4.5 per cent)—have lower ratios. In comparison, this ratio is very high in many countries, such as the United States (8.8 per cent) and the United Kingdom (8.5 per cent), where the global financial crisis was most acute. This ratio has fallen in many of these countries as they recover from the financial crisis, but it remains elevated.

International Comparisons for Insurance

Given that the FSI's reported by the IMF are focused on deposit-taking institutions (which include banks and credit unions/caisse populaires), it is also useful to examine how Canada compares with its peers for other industries within the financial services sector. Data comparing the financial performance of industries like securities, asset

Insurance premium growth is generally much stronger in emerging markets—a key reason why Canadian insurance firms are expanding overseas.

management, and back offices across countries is scarce. However, the OECD does publish financial indicators for the insurance industry by country. This section of the report examines these statistics.

Insurance premium growth across different countries is driven by three factors. The first is broad economic growth, with premium growth generally being weak in countries with poor economic conditions, and vice versa. The second factor is the penetration rate of insurance products: where penetration rates are low, growth tends to be stronger. This is why emerging markets generally see much stronger premium growth than developed countries. Finally, regulatory changes, such as changes in what is mandatory coverage for automobile insurance, can also have an impact on premium growth in specific countries.

Broadly speaking, Canadian insurance companies are experiencing weak premium growth, with both life and non-life insurers reporting real (price-adjusted) gains of less than 1 per cent in 2013.[12] However, in the case of life insurers, this is above the weighted average for all OECD countries (–2.9 per cent), and only slightly below average for non-life insurers (1.9 per cent). (See Chart 13.) In short, insurance premium growth is very weak across much of the developed world, while it is generally much stronger in emerging markets. This is a key reason why Canadian insurance firms are expanding overseas, as we'll discuss in Chapter 4.

At the same time, claims growth in Canada was above average in 2013. The life segment saw claims payments rise by 4.8 per cent, while they rose by 12.9 per cent for the non-life segment—the fifth highest among OECD countries. One-time events, including the 2013 flood in Calgary, were a major contributor to the strong increase in claims payments. The net result is that the non-life insurers in Canada experienced an underwriting loss in 2013 before reinsurance was taken into account.[13]

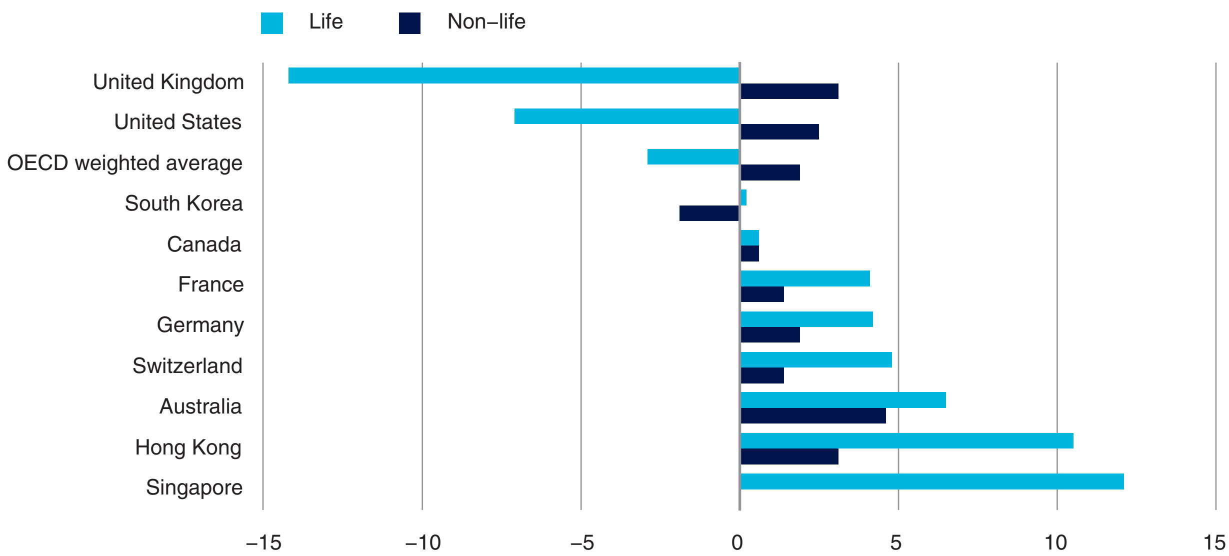
12 Organisation for Economic Co-operation and Development, *Global Insurance Market Trends 2014*.

13 Ibid.

Chart 13

Real Premium Growth for Canadian Insurers is Weak

(real premium growth for selected countries, 2013, per cent)



Source: OECD.

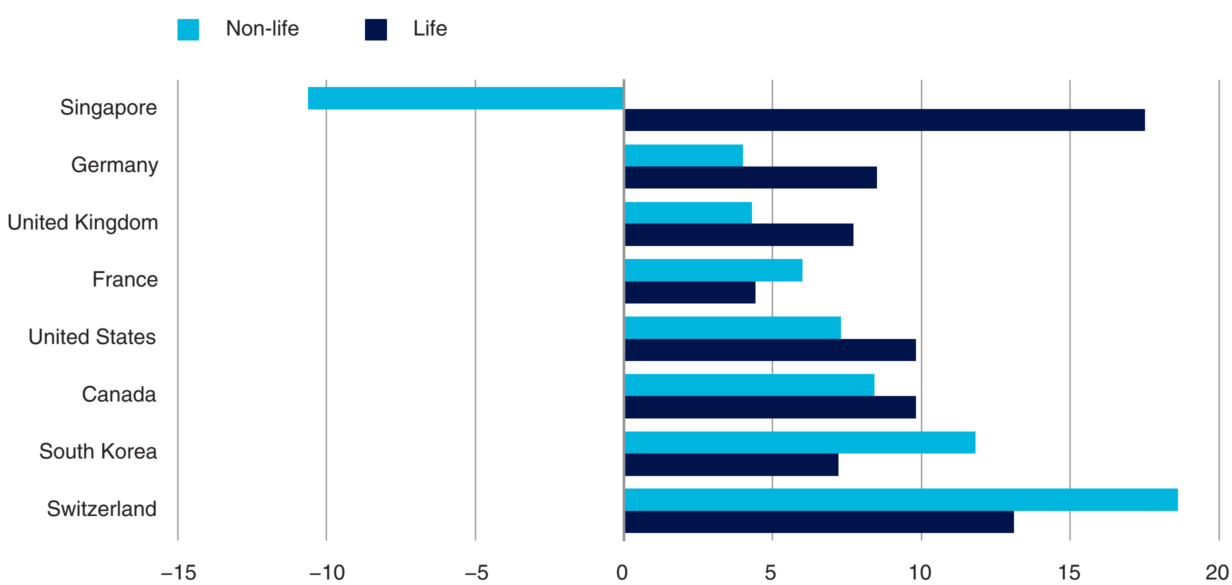
However, the reported underwriting loss for Canadian non-life insurers highlights a couple of issues that are specific to the industry. First, profitability in the industry can be volatile from year to year depending on the frequency and severity of the very events the industry is designed to protect policy-holders from. Second, premiums are not the only source of revenues for insurers; they derive a significant share of their earnings from their investments. Although the low interest rate environment has made it more challenging for insurers to generate revenues from their investments, they can be used to smooth the impacts of volatility in claims on profitability.

This is why, when all these factors are taken into account, Canadian insurance firms tend to have healthy levels of ROE relative to other OECD countries. (See Chart 14.) Between 2011 and 2013, the ROE for non-life insurers in Canada averaged 8.4 per cent, and it was 9.8 per cent for life insurers.[14] This is above the average for many peer countries, such as the United States and the United Kingdom. As such, Canadian insurance providers have been able to maintain their profitability relative to their peers in other countries despite the challenges they have faced.

Chart 14

Canadian Insurers Have Above-Average ROE Relative to Their Peers

(average ROE for insurance providers for selected countries, 2011–13, per cent)



Source: OECD.

14 The Canadian life ROE figures used here are reported as “composite” rather than “life” in the OECD data. This is because most Canadian life insurers are categorized as composite in the OECD data.

CHAPTER 3

The Productivity and Innovation Performance of the Financial Services Sector

Chapter Summary

- Canada's financial services sector is innovative. According to Statistics Canada's Survey of Innovation and Business Strategy, 73.6 per cent of financial services firms had undertaken some form of innovation in the previous year versus 63.5 per cent for all sectors.

- The most common forms of innovation undertaken by the sector include organizational and marketing innovations.

- The sector's innovations have only partially translated into labour productivity growth. Gains in the sector have been below average versus other sectors in Canada, and moderate when compared with the financial services sectors of peer countries. However, Canada has outperformed some countries that host major global financial centres, such as the United Kingdom and Germany.

- One potential factor limiting productivity growth in the sector is that it already has an above- average level of productivity, and it is harder to grow from a high level.

Productivity is the single most important determinant of a country's per capita income over the longer term. Countries that are innovative and able to adapt to the ebb and flow of the new global economy boast high productivity, and thus a superior standard of living. As such, understanding Canada's productivity performance and the factors influencing i, is a key part of keeping Canada on the path of long-term economic growth.

Productivity is a measure of how efficiently goods and services are produced, and the productivity of an economy or a sector can be measured in different ways. For our purposes, we assess the labour productivity of different sectors and countries. Labour productivity is defined as the amount of output (or GDP) produced for every hour of work. Labour productivity levels can be influenced by a variety of factors such as the skill level and educational attainment of the workforce, as well as the quality of the capital assets (such as machinery and equipment, and information technology) that is available for workers.

Broadly speaking, Canada's labour productivity performance has been poor for many years. For example, among the 34 OECD countries, Canada ranked 23rd in terms of labour productivity performance over the period 2000 to 2014.[1] A key factor limiting Canada's productivity performance has been a low rate of investment in machinery and equipment, particularly in information and communications technology. Low rates of investment in research and development, poor performance on measures of innovation, and limited inward foreign direct investment also contribute to Canada's weak labour productivity performance.[2]

1 Based on calculations from the OECD productivity statistics database.

2 The Conference Board of Canada, *How Canada Performs: Labour Productivity Growth.*

International Comparisons of Financial Services Productivity Performance

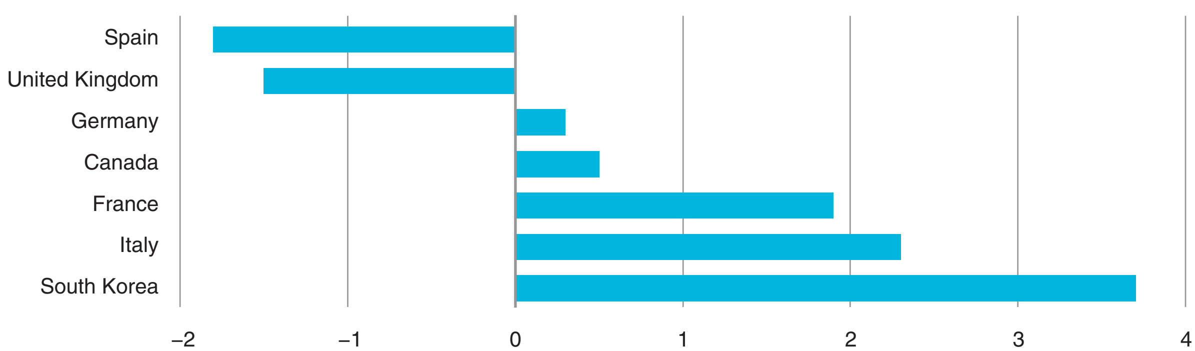
Productivity growth can be volatile from one year to the next. As well, it is a long-term indicator of economic health. As such, it is best practice to look at productivity growth over extended periods of time. Unfortunately, data on the labour productivity performance of Canada's financial services sector specifically have only been published since 2007, limiting our ability to assess its performance prior to this period. However, over this limited time period, Canada's financial services sector has exhibited a similar trend to the economy as a whole—specifically, Canadian growth has lagged behind the growth exhibited in many peer countries.

Between 2007 and 2014, Canada's financial services sector has experienced average annual growth in labour productivity of 0.5 per cent.[3] This is a better performance than some countries that host major global financial centres, such as the United Kingdom, where productivity actually declined over this period, and Germany. (See Chart 15.)

Chart 15

Canada Is Middle of the Pack When It Comes to Financial Services Productivity Growth

(average annual labour productivity growth in financial services for selected countries, 2007–14, per cent)



Sources: OECD; Statistics Canada; The Conference Board of Canada.

3 The available productivity figures for Canada include the financial services (NAICS 52) and holding companies (NAICS 55) sectors, and we refer to them here as the financial services sector.

However, it is below the growth exhibited in other countries, such as France and South Korea. Canada's performance was also essentially on par with that of the broader European Union (0.6 per cent).

The exact cause for Canada's middle of the pack performance in financial services labour productivity growth is not easy to identify. One potential factor may be that Canada already has an above-average level of productivity, and it is harder to grow from a high level. However, this should not lead to complacency, as continued weak relative growth in Canada could allow other countries to catch up.

Another potential factor influencing the relative growth rates in labour productivity across countries for the financial services sector is the mix of activities undertaken in each country and how they may be changing. For example, higher average wages per employee are an indicator of higher productivity. This would imply that activities such as investment banking are more productive than back office operations or retail banking, for example. If a country has high relative concentrations in high-productivity activities like investment banking, it will tend to have high levels of productivity. Similarly, a country that is experiencing strong growth in high-productivity activities will contribute to robust productivity growth in that country. Thus, if much of the financial services growth in Canada is occurring in less productive activities, productivity growth for the whole sector would be limited.

However, limited investment in machinery and equipment in the Canadian financial services sector in recent years is likely a contributing factor to the slow productivity growth. On a price-adjusted basis, total financial services investment in Canada plunged by 40 per cent between 2007 and 2009, with nearly all of that decline occurring in machinery and equipment investment.[4] This is not surprising, as the decline occurred during the financial crisis. What is surprising is that the recovery in the sector's investment spending has subsequently been very modest. Total investment is still 35 per cent below its pre-recession peak—even though

4 See CANSIM table 031-0005.

the sector's finances have recovered from the effects of the financial crisis. Thus, the limited pace of investment is likely limiting the sector's productivity growth.

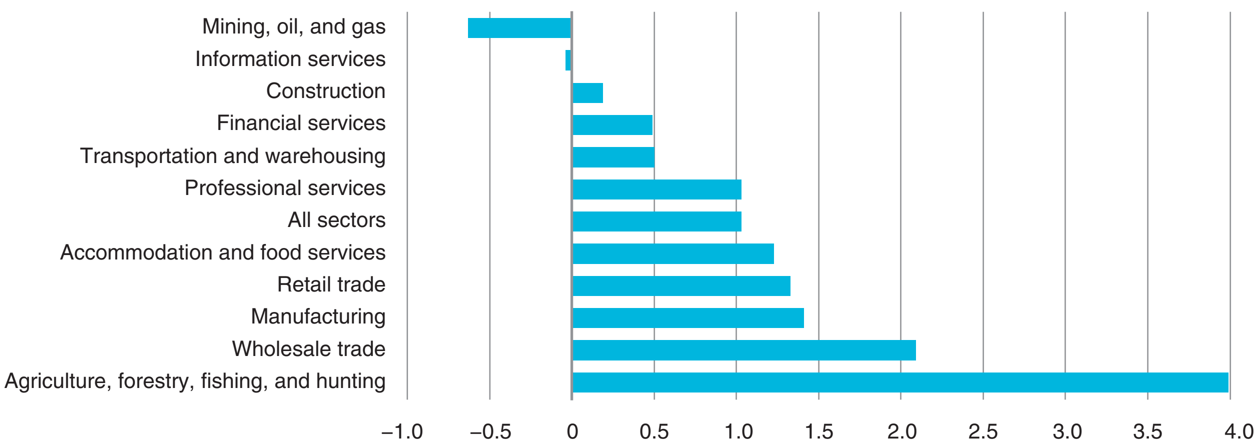
Canadian Comparisons of Financial Services Productivity Performance

Canada's financial services sector has also been a moderate performer in terms of labour productivity growth versus other sectors within the country. Between 2007 and 2014, annual growth in labour productivity averaged 0.5 per cent in the financial services sector, versus 1.0 per cent for all sectors. (See Chart 16.) The strongest performers in Canada have included the agriculture, wholesale trade, and manufacturing sectors.

Chart 16

Financial Services Is Middle of the Pack When It Comes to Productivity Growth

(average annual growth in labour productivity for selected sectors, 2007–14, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

A high degree of international competition has been one of the factors driving productivity growth among the strong performers. For example, both agriculture and manufacturing are generally export-intensive

The largest decline in labour productivity occurred in the mining, oil and gas sector, despite heavy investment.

and had to increase productivity to maintain their competitiveness. As well, agriculture, in particular, has benefited from robust investment in machinery equipment, with the capital stock per worker rising strongly in this sector.

At the opposite end of the spectrum, the largest decline in labour productivity occurred in the mining, oil and gas sector. Despite heavy investment in the sector, productivity has been in decline as a result of two things. The first is the changing mix in production, with products like the oil sands requiring many more inputs to produce a given level of output. As well, extraction sectors, such as mining, are impacted by the fact that the most economical to exploit resources are extracted first, before companies move on to second or third best options. Over time, this means the sector needs to work harder to produce each unit of production, even if production is not rising.

Financial Services Productivity Performance Across Provinces

Within Canada, there is considerable variation across the provinces in terms of labour productivity growth for the financial services sector. Some provinces, such as Newfoundland and Labrador, Alberta, and Saskatchewan, experienced very strong growth, while others saw declines. (See Chart 17.) One factor that likely contributed to the strong productivity growth in specific provinces is the strong wage growth experienced over the period examined in all three of those provinces. Strong wage appreciation likely leads financial services firms in those provinces to find ways to produce more with fewer people.

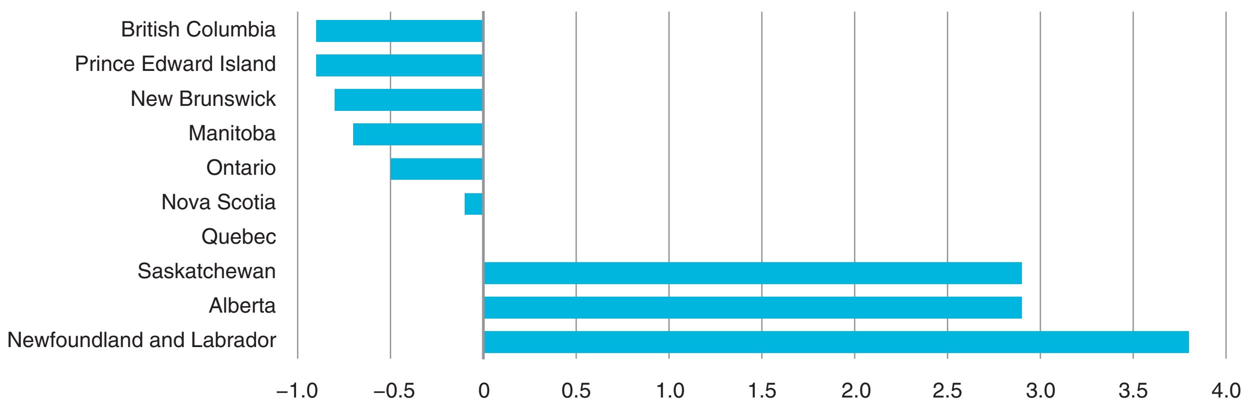
Innovation Performance

Given the sector's moderate productivity performance, it would be useful to understand more about innovation in the sector. Innovation is key to maintaining and improving the competitiveness of any business, and productivity improvement is one of the measurable outcomes of successful innovation. In any conversation about innovation, it is also

Chart 17

Financial Services Productivity Growth Has Varied Widely by Province

(average annual labour productivity growth in financial services by province, 2007–13, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

important to note that it is not just about creating new products or services, as is sometimes thought. Innovation is also about improving business processes, or how a business carries out its day-to-day activities. In fact, the OECD identifies four types of innovation:

- product innovation (new or improved products);
- process innovation (new or improved production or delivery methods);
- organizational innovation (usually related to reducing administrative or transaction costs);
- marketing innovation (product design, placement, promotion, or pricing).

Since the financial crisis, a debate about innovation in the financial services sector has sprung up. Innovation will always bring change, but the disruptions caused by that change may be difficult to predict or manage. In theory, innovation in the financial services sector should provide positive outcomes for an economy, such as better pricing of risk, a more efficient allocation of capital, and better access to capital. However, the development of innovative financial products, such as asset-backed securities and credit derivatives, coupled with an inadequate regulatory environment for these products, contributed to the financial crisis.[5] The result was not good for the financial services sector in much of the world, nor for the broader economies in which the crisis unfolded.

Indeed, the two-sided nature of financial innovation was highlighted in one recent study.[6] The authors found that high levels of financial innovation in a country lead to positive outcomes, such as higher levels of capital invested per employee and stronger per capita GDP growth. However, high levels of financial innovation were also linked with bank fragility, economic volatility, and higher bank losses during the financial crisis. As such, a measured pace to financial innovation—with a focus on customer benefits and in cooperation with regulators in order to reduce systemic risk—may be the best approach.

That said, a key challenge for anyone wishing to understand the impacts of innovation must first overcome the difficulties of measuring it. Researchers often use indicators like research and development spending, or patents, as a proxy for innovation. But, these may be more pertinent for some sectors than others. For example, the financial services sector rarely takes out patents for its innovative business practices, nor generally is the sector a major spender on formal R&D. However, this does not mean that the sector is not innovative.

This is apparent when we examine the results of Statistics Canada's Survey of Innovation and Business Strategy, a periodic survey that looks at the innovation practices of Canadian businesses. For example, according to the survey, 73.6 per cent of financial services firms had undertaken some form of innovation in the previous year, versus 63.5 per cent for all sectors. (See Chart 18.) Only the manufacturing and professional services sectors reported a higher share of innovative firms. Within financial services, the most innovative firms are found in Ontario and British Columbia, while innovation was lowest in Alberta and Atlantic

5 World Economic Forum, *Rethinking Financial Innovation*.

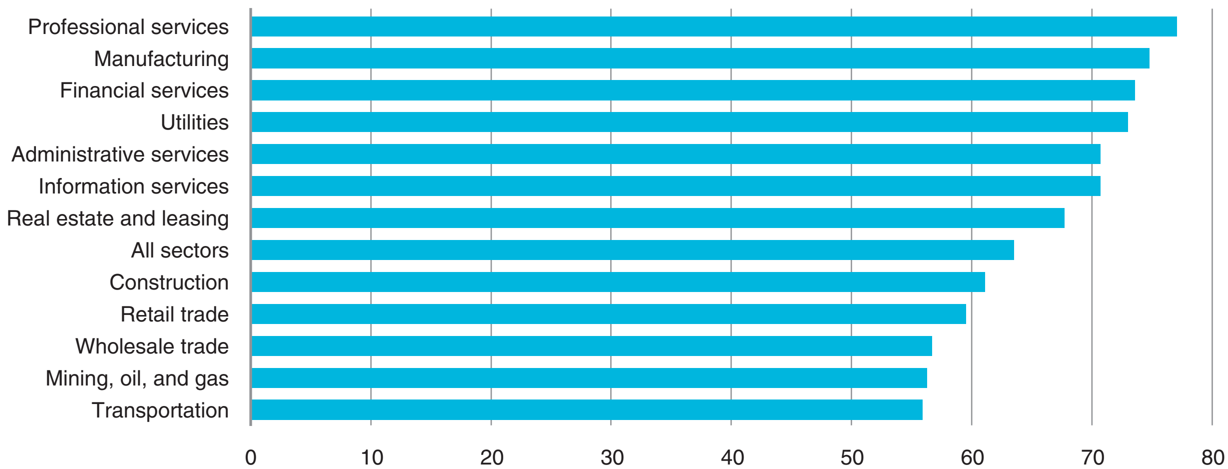
6 Beck and others, *Financial Innovation: The Bright and Dark Sides*.

Canada. However, in every region of the country except Alberta, the share of firms in the financial services sector that are innovative is above average.

Chart 18

Financial Services Is Among the Most Innovative Sectors

(share of firms that have innovated, 2012, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

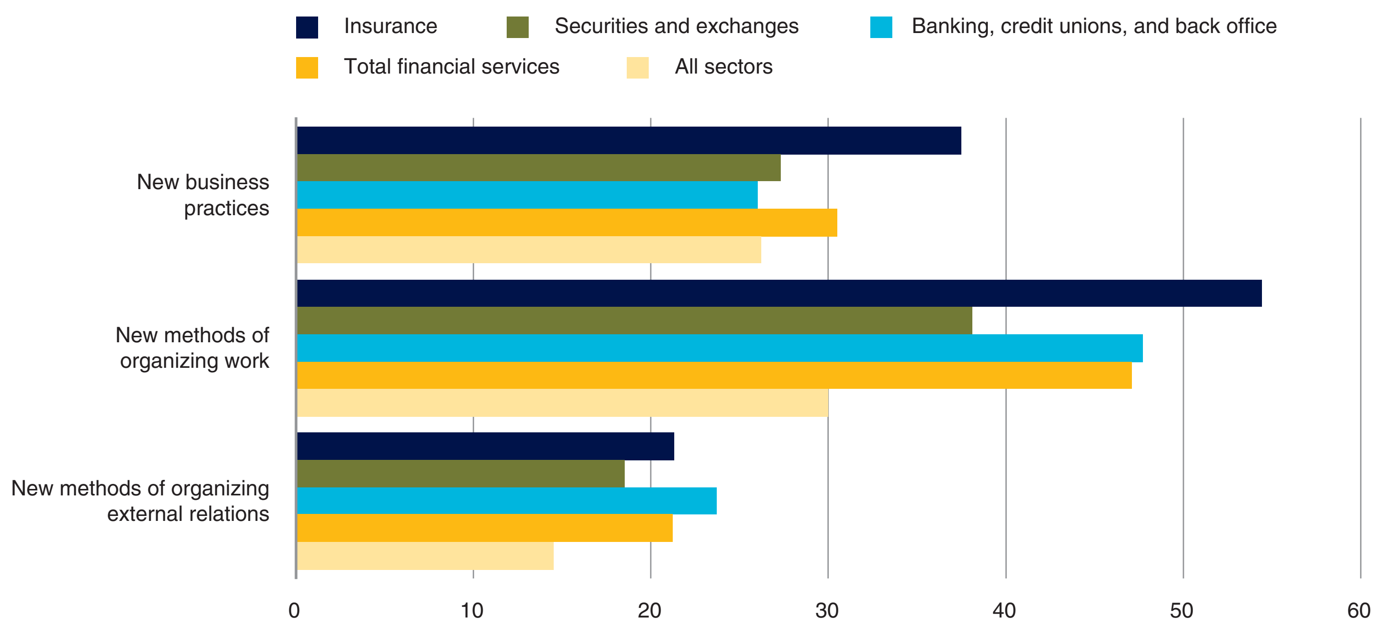
Among the major forms of innovation, organizational and marketing innovation are where the financial services sector stands out. For example, 50.1 per cent of financial services firms reported undertaking some form of organizational innovation, versus 37.9 per cent for all sectors. The most common organizational innovation undertaken was new methods of organizing work. (See Chart 19.) As well, within the sector, it was generally insurance firms that undertook the most organizational innovation. Finally, Ontario was the province where the most organizational innovations took place with financial services.

In the case of marketing innovation, 37.3 per cent of financial services firms reported undertaking new innovative practices, versus 33.3 per cent for all sectors. The most common way that financial services firms

Chart 19

Employing New Organizational Methods Is a Major Way That Financial Services Firms Have Innovated

(share of firms that have undertaken specific innovations, 2012, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

undertook marketing promotion was using new promotional techniques. (See Chart 20.) However, the firms also made above-average use of new methods for product pricing and product placement. Among the provinces, British Columbia was the leader in Canada in terms of marketing innovation within the financial services sector.

Beyond the types of innovation that the sector has undertaken, its innovation practices are apparent in other indicators. For example, the sector makes above-average use of advanced technologies, such as communication, and integration and control technologies.[7] The sector also makes above-average use of modern human resources practices, such as formal training and appraisals, as well as incentive programs.[8]

7 See CANSIM table 358-0223.

8 See CANSIM table 358-0323.

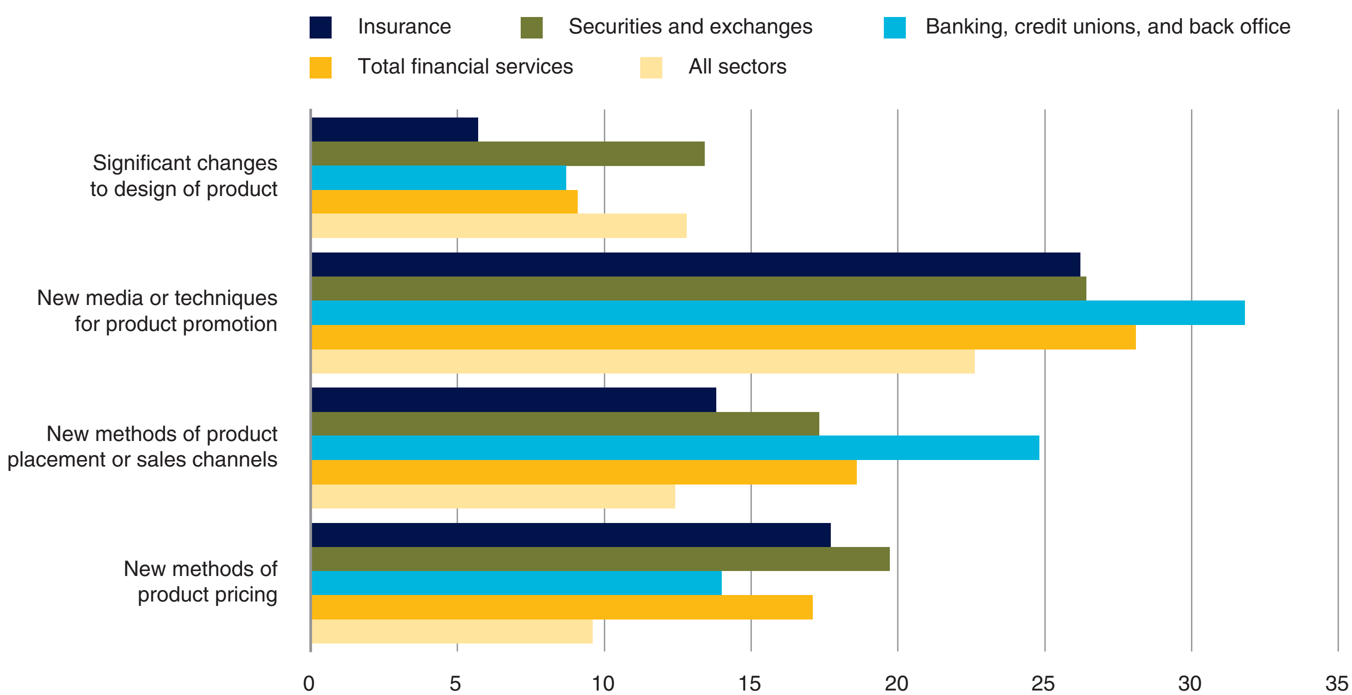
Finally, financial services firms are more likely to use performance indicators (such as sales growth, market share, customer satisfaction, and share of sales from new products) to monitor their achievement of long-term strategic objectives.[9]

Thus, although the financial services sector makes limited use of patents and formal R&D spending, both common measures of innovation, it would be inaccurate to characterize the sector as not being innovative. Instead, the sector's innovations tend to occur in ways that are harder to

Chart 20

New Promotional Techniques Is a Major Way That Financial Services Firms Have Innovated

(share of firms that have undertaken specific innovations, 2012, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

9 See CANSIM table 358-0307.

observe, such as how their businesses are organized. The challenge for this sector going forward will be to translate these innovative business practices into even stronger productivity growth.

CHAPTER 4

Canada's Financial Sector in a Global Context

Chapter Summary

- Foreign affiliates are the principal avenue by which Canadian financial institutions provide financial services to overseas customers. Foreign affiliate sales have been consistently more than 10 times the size of exports.
- Establishing overseas presence has been made possible thanks to foreign direct investment. Canada's stock of direct investment abroad in the financial services sector has more than quadrupled in the past 15 years, reaching $435 billion in 2014—twice the amount of financial services' FDI in Canada.
- Canadian exports of financial services have more than tripled since 1999, one of the strongest growth profiles among Canadian sectors. In large part, growth has been driven by the significant increase in exports of "other financial services," which include items such as securities issuance and trading, and asset management services.

Having a local presence in foreign markets is the principal avenue for Canadian financial institutions to provide financial services to international customers.

Canadian financial institutions are serving the financial needs of Canadians, but also those of international customers. In the past decade, Canada's financial sector has significantly increased its footprint in global markets. This has been accomplished by selling directly to international customers from the sector's Canadian offices and through establishing a physical presence in foreign countries. In fact, having a local presence in foreign markets is the principal avenue for Canadian financial institutions to provide financial services to international customers. Sales through foreign affiliates are, on average, nine times greater than the value of financial services exports.

This chapter looks at the latest trends in Canada's financial services trade through foreign affiliate sales and exports—the two main channels used to reach international customers. Exporting financial services directly contributes to economic growth and job creation in Canada, and foreign affiliate sales raise the revenues and profits of the parent companies—thus benefiting all Canadians holding shares in those institutions. Having a presence abroad also contributes to the international reputation of Canadian financial institutions and of the Canadian financial system.

Building a Global Presence Through Foreign Affiliates

Canadian financial firms have a significant out-of-country presence, as measured by foreign affiliate sales data from Statistics Canada.[1] Foreign affiliates are the principal avenue for Canadian financial institutions to provide financial services to overseas customers. As such, foreign affiliate sales are much larger than financial services exports. For example, financial services exports have been equivalent to less than 10 per cent of foreign affiliate sales since 1999, when data were first published. In other words, the value of services supplied by affiliates abroad of Canadian financial institutions has been, on average, more than 10 times the value of financial services exports.

There are many benefits to doing business through foreign affiliates; for example, profits generated through sales by foreign affiliates directly benefit Canada by contributing to the gross national income. In addition, through establishing a local presence abroad, Canadian firms can expand market share, provide better service for their foreign customers, and improve their competitiveness within global value chains.

Foreign affiliate sales in the financial services sector have experienced robust growth over the past decade, more than doubling between 1999 and 2012 and reaching close to $100 billion. In comparison, foreign affiliate sales for *all* Canadian companies rose by 60 per cent and for all service-oriented companies by 83 per cent over the same period. (See Chart 21.) As a result, the financial services sector represents a steadily growing segment of Canada's foreign affiliate sales, rising from 13 to 20 per cent between 1999 and 2012.

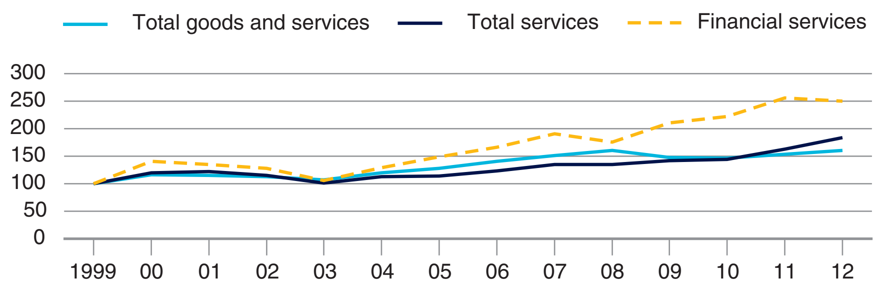
The increasing volume of foreign affiliate sales attests to the fact that Canadian financial institutions have been developing their commercial presence around the world, and that presence has been growing by

1 For our purposes, we combine the data for the financial services (NAICS 52) and holding companies (NAICS 55) sectors, and refer to them as the financial services sector. We do this because financial institutions often use holding companies to set up and operate their foreign affiliates.

Chart 21

Canadian Financial Services Sales Through Foreign Affiliates Have Outperformed Those of the Services Sector in General

(foreign affiliate sales index, 1999 = 100)



Sources: Statistics Canada, CANSIM table 376-0060; The Conference Board of Canada.

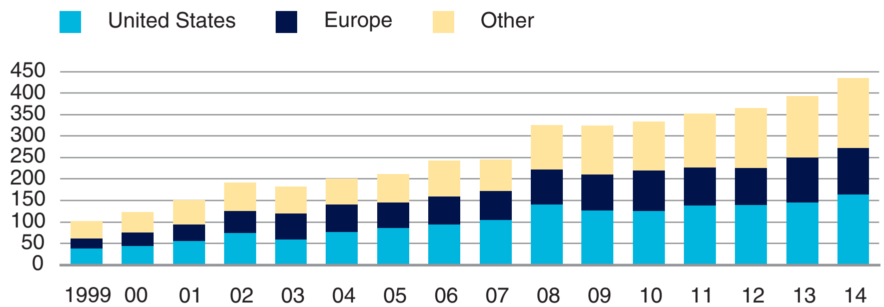
means of foreign direct investment (FDI) into the host countries. The IMF defines FDI as any direct investment into a business in a host country by an individual or company of a foreign country. Investors and companies can undertake FDI in two ways: by establishing a new company in the host country or by investing in an existing business through merger and acquisition. FDI enables an investor to have a significant voice in the management of an enterprise operating outside the investor's home country. The phrase "significant voice" usually means ownership of 10 per cent or more of the ordinary shares, voting power, or the equivalent.

Canada is a large net exporter of financial services FDI. Between 1999 and 2014, our stock of direct investment abroad in the financial services sector has consistently been close to twice the amount of foreign direct investment in Canada. And during this period, Canadian financial services institutions' stock of foreign direct investment more than quadrupled. (See Chart 22.) In 2014, Canada's financial services FDI increased 11 per cent over the previous year, reaching $435 billion. In addition, financial services now account for more than half of Canada's total foreign direct investment abroad, up from 35 per cent 15 years ago.

Chart 22

Financial Services Direct Investment Abroad Has More Than Quadrupled Since 1999

($ billions)



Sources: Statistics Canada, CANSIM table 376-0052; The Conference Board of Canada.

The U.S. remains the primary destination for Canadian financial services FDI, accounting for just under 40 per cent of the total outward stock of investments in 2014. This is followed by "Other Americas" (31 per cent) and Europe (25 per cent). These shares have remained largely static over the past 15 years. Thus, Canadian financial institutions have taken a broad approach to investing across a number of regions, instead of focusing on any particular area.

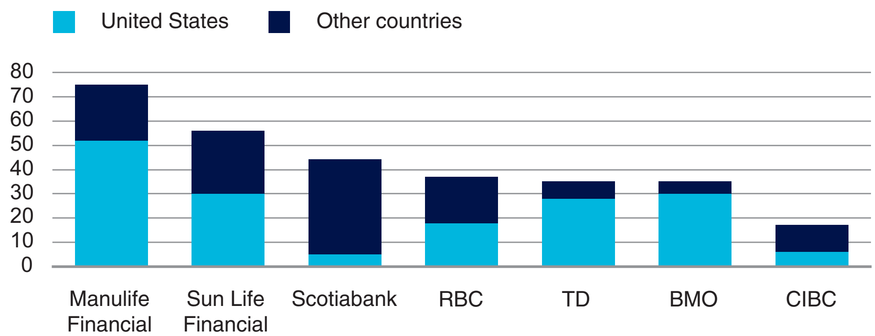
The great expansion of FDI has enabled Canadian financial institutions to extend their international footprint. For example, in 2014, more than a third of the revenues from Canada's five largest banks combined was from the U.S. and other international markets. And as for Toronto's largest life insurance companies, Manulife Financial and Sun Life Financial, they generated 76 and 56 per cent of their revenues, respectively, from countries other than Canada. (See Chart 23.) According to a 2014 Conference Board survey, the most common market entry strategies used by Canadian financial institutions to build a presence in foreign markets are foreign acquisitions, establishing a subsidiary, and setting up joint ventures or local partnerships.[2]

2 Ai and Burt, *Going Abroad.*

Chart 23

Canada's Banks and Insurance Companies Generated a Large Share of Their Revenues From International Operations in 2014

(share of revenues from the U.S. and other countries, 2014, per cent)



Sources: Banks and insurance companies' 2014 financial reports; The Conference Board of Canada.
Note: The revenue breakdown for Sun Life Financial attributes revenues from MFS Investment Management to "other countries," MFS is headquartered in the U.S. And operates internationally (including the U.S.).

The international footprint for Canadian financial institutions other than banks and insurance firms is also significant. For example, Canada has some of the largest pension funds in the world, with the Canada Pension Plan Investment Board (8th) and Ontario Teachers' Pension Plan (17th) ranked among the top 50 largest pension funds in terms of assets under management.[3] Canada's pension funds continue to expand their international presence. Foreign investments accounted for 31.5 per cent of the total portfolio in 2014, up from 18.8 per cent in 2000.[4] Portfolio diversification by geography helps to explain the investment strategy of large Canadian pension funds. The strategy diversifies risk exposure beyond the relatively small Canadian economy. As well, greater global diversification allows income from foreign investments to flow back into Canada to support future pension payments.

3 Pensions and Investments, and Towers Watson, *Pensions and Investments*.

4 See CANSIM table 280-0003.

Canada's largest exchange operator, TMX Group Limited, also has a significant foreign presence, with about 30 per cent of revenues coming from international business.[5] Key factors driving these foreign revenues include international listings of the TMX Group's exchanges and transactions originating from foreign-based brokers.

Building a Global Presence Through Exports

The second channel by which Canada's financial institutions can serve foreign customers is through cross-border trade, also known as exports. When a Canadian financial institution provides services to non-residents through its Canadian operations, it is engaging in an export activity, which is a source of income and job creation for Canada. Exports of financial services can be split into three broad categories: banking, insurance, and other financial services, which are composed of items such as securities issuance and trading, and asset management services.

Canadian financial services exports are much smaller than sales of foreign affiliates. However, they have been growing at a faster pace than foreign affiliate sales. Between 1999 and 2014, total exports of financial services more than tripled, surpassing the $10 billion mark. In fact, financial services are Canada's largest and fastest-growing source of services exports.[6] (See Chart 24.) While banking and insurance exports have both grown substantially over this period, other financial services have experienced the strongest growth and now account for half of Canada's financial services exports. (See Chart 25.)

Similarly, with foreign affiliate sales, the U.S. is also the number one market for Canadian exports of financial services, accounting for 50 per cent of the total—a share that has remained relatively unchanged over time. (See Chart 26.) There are a variety of reasons for the strong growth in financial services exports to the United States. The reasons include

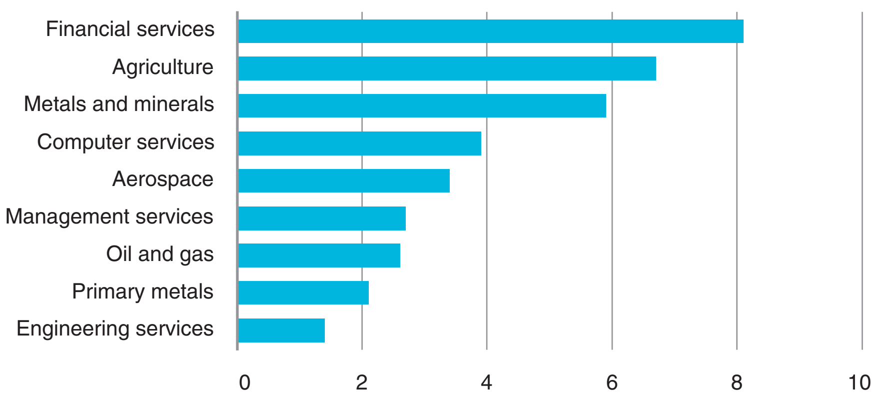
5 Ai and Burt, *Going Abroad*.

6 Palladini, *Spotlight on Services in Canada's Global Commerce*.

Chart 24

Financial Services Have Led Canada's Export Growth

(average annual growth in real exports for selected industries, 2004–14, per cent)

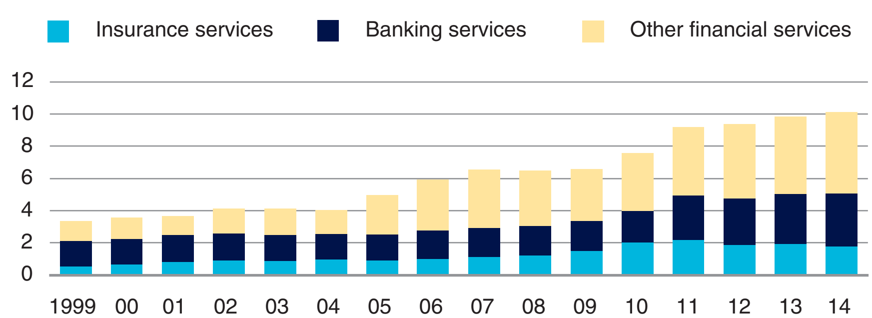


Sources: The Conference Board of Canada; Statistics Canada.

Chart 25

Growth in Financial Services Exports Driven by Other Financial Services

($ billions)



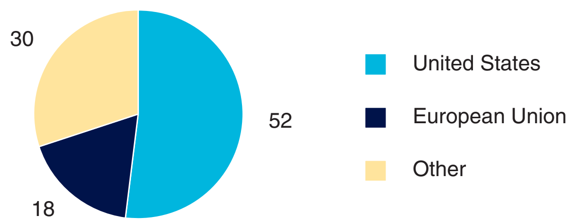
Sources: Statistics Canada CANSIM tables 376-0033 and 376-0108; The Conference Board of Canada.

the need to facilitate the large volume of trade transactions between the two countries, and the use of Canadian equity, debt, and derivative markets by U.S.-based businesses. Moreover, Canadian financial institutions have "followed" clients from Canada into the U.S. market, to provide financing and other financial products, as their customers engaged in a growing volume of international investment activities.

Chart 26

The U.S. Is the Largest Market for Financial Services Exports

(share of financial services exports by region, 2013, per cent)



Sources: Statistics Canada CANSIM table 376-0033; The Conference Board of Canada.

CHAPTER 5

Toronto's Role in Canada's Financial Services Sector

Chapter Summary

- Financial services directly employed 251,375 people in Toronto in 2014. This represents 8.1 per cent of the metro area's total employment, up from 7.1 per cent in 2004. In addition, the sector indirectly employed another 106,290 people in the metro area.
- Toronto accounts for a growing share of Canada's financial services sector. Toronto's share of the sector's employment rose from 28.2 per cent in 2004 to 32.3 per cent in 2014.
- The sector directly accounts for 13.3 per cent of metro Toronto's GDP. Only the public services sector is larger.
- In total, Toronto's financial services sector generated a combined $15.7 billion in fiscal benefits in 2014 for the Canadian, Ontario, and City of Toronto governments.

Toronto is the major hub for financial services headquarters in Canada; 43 per cent of financial services headquarters employment is found in Toronto, compared with 12.4 per cent in Montréal, its nearest competitor.

The trends in the financial services sector that we have discussed thus far pertain broadly to Canada. We now turn our attention to Toronto's role in the sector, as well as its contribution to the Canadian economy.

Toronto is the major hub for financial services headquarters in Canada. For example, 31 per cent of all financial services headquarters are located in Toronto, which is more than double the proportion in Vancouver (13.2 per cent), its closest Canadian competitor.[1] The concentration of financial services headquarters activity is even more apparent when we look at employment—43 per cent of financial services headquarters employment is found in Toronto. This is more than triple its nearest competitor, Montréal, at 12.4 per cent.

In addition, Canada's financial services sector is becoming more concentrated in Toronto, as the share of the sector's employment in Toronto has risen over the past decade. In 2004, Toronto accounted for 28.2 per cent of Canadian financial services employment: this share had risen to 32.3 per cent by 2014. By way of comparison, Toronto's share of total Canadian employment changed by only a small amount over that period, rising from 16.9 per cent to 17.4 per cent. This indicates that Toronto has solidified its position as Canada's leading financial centre.

Economic and Fiscal Impacts of the Sector in Toronto

When assessing the economic footprint of a sector, one can consider a variety of effects. In this report, we consider the following three economic effects associated with Toronto's financial sector:

1. **Direct effects.** These are the economic effects directly associated with the day-to-day operations of Toronto's financial services sector. Essentially, they include all of the sector's economic activity in Toronto.

1 Ai, *A Head for Finance*.

2. **Indirect effects.** The indirect or supply-chain effects are the economic effects associated with the financial services sector's use of intermediate inputs or other support services, both in Toronto and in the rest of the country.
3. **Fiscal effects.** The fiscal impacts include all of the federal, provincial, and municipal revenues associated with the direct and indirect economic effects of the sector in Toronto.

Direct Effects

The financial services sector is one of Toronto's major clusters. It directly employed 251,375 people in 2014, which included everyone from tellers and insurance agents in local offices to the headquarters' staff of multinationals in the metro area. This is of sufficient size to make the sector the fifth largest in the metro area in terms of employment, accounting for 8.1 per cent of the total. (See Table 2.) This share is even higher in the City of Toronto, at 11.4 per cent.

Table 2
Breakdown of Major Sectors in Toronto

	2014 Employment		2014 GDP	
	Number	Share (%)	2007 $ millions	Share (%)
Financial services	251,375	8.1	40,891	13.3
Manufacturing	323,790	10.5	37,867	12.4
Public services	627,590	20.3	45,306	14.8
Professional services	332,375	10.8	24,733	8.1
Information services	89,205	2.9	14,890	4.9
Retail trade	334,775	10.8	15,827	5.2
Transportation	152,802	4.9	13,570	4.4
Construction	186,001	6.0	14,174	4.6
Accommodation and food services	191,300	6.2	5,249	1.7
Other sectors	597,754	19.4	93,941	30.7
Total	3,086,969	100.0	306,449	100.0

Sources: The Conference Board of Canada; Statistics Canada.

Toronto's financial services industry has also been a significant source of growth in recent years. In 2004, the sector employed 192,025 people in Toronto. This represents an average annual growth of 2.7 per cent over the past decade, which compares favourably with 1.4 per cent for all sectors in the Toronto metro area over the same period.

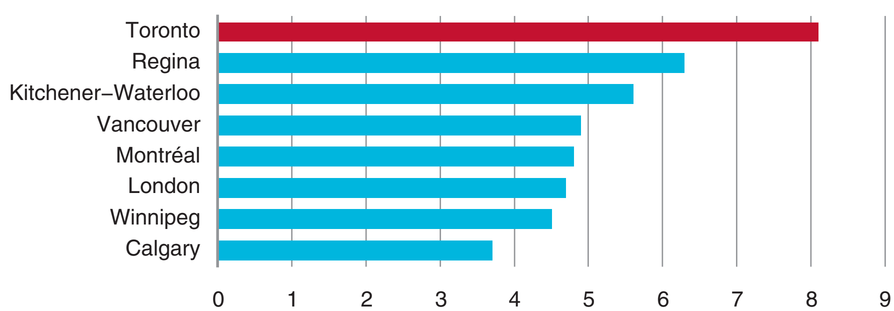
Because employment growth in the sector has outpaced the average for all sectors, financial services have grown as a share of Toronto's economy. Between 2004 and 2014, the sector's share of the metro area's employment rose from 7.1 per cent to 8.1 per cent. In fact, the concentration of financial services employment in 2014 was higher in Toronto than in any other metro area across the country. (See Chart 27.)

As large as the employment impacts are, it is important to note that the GDP impacts of Toronto's financial services sector are even larger. On a GDP basis, financial services accounted for 13.3 per cent of the metro area's economy in 2014; this was second only to public services. Financial services account for a larger share of Toronto's GDP than its employment because GDP per employee in the sector is significantly above average. Several factors determine a sector's GDP, including the

Chart 27

Concentration of Financial Services Employment Is Highest in Toronto Among Canadian Metro Areas

(share of employment in financial services for selected metro areas, 2014, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

wages and salaries that it pays, the amount of depreciation of its assets, and the profits that it earns. For all three factors, the financial services sector's numbers are above average.

For example, in Ontario, the sector's average weekly earnings per employee in 2014 were $1,218, versus the overall industrial average of $938.[2] As well, the sector's depreciation expense per employee in Canada was $11,100, versus $8,400 for all industries in 2014.[3] Although the sector's capital stock per employee is below average, much of what it consists of is information technology equipment and software, which depreciates quickly. The result is an ongoing need for a high rate of investment per employee in the sector. Finally, nationally, the sector's profit margin was 19.4 per cent in 2014, versus 7.1 per cent for all industries.[4] Ultimately, the high level of GDP per employee in the financial services sector reflects the fact that, in general, it generates a high degree of value-added for the economy.

Indirect Effects

In addition to employing people directly, the financial services sector also generates secondary or indirect effects in the economy. Indirect effects measure the economic benefits associated with the financial services sector's use of intermediate inputs or other support services. Thus, the indirect effects describe a sector's supply chain, highlighting all of the inputs necessary to conduct financial activity.

In aggregate, Toronto's financial services sector supported an additional 209,371 jobs in 2014. Thus, the sector accounted for a total of 460,538 jobs once the direct effects were added to the indirect effects. The indirect effects occurred largely in Toronto, but benefits did accrue across the country. Of the 209,545 indirect jobs, 106,378 occurred in Toronto; 69,589 occurred in the rest of Ontario; and 33,578 occurred in the rest of Canada. (See Table 3.)

2 Derived from Statistics Canada's CANSIM table 281-0026.

3 Derived from Statistics Canada's CANSIM table 187-0001 and *Labour Force Survey.*

4 Derived from Statistics Canada's CANSIM table 187-0001.

Table 3
Financial Services Employment and GDP Effects, by Region

	Toronto				Rest of Ontario		Rest of Canada		Total	
	Direct		Indirect		Indirect		Indirect			
	Value	Share of effects (%)	Value	Share of effects (%)	Value	Share of effects (%)	Value	Share of effects (%)	Value	Share of effects (%)
Employment	251,375	54.5	106,378	23.1	69,589	15.1	33,578	7.3	460,920	100
GDP (2002 $ millions)	40,891	65.6	9,322	15	8,554	13.7	3,560	5.7	62,327	100

Sources: Statistics Canada; The Conference Board of Canada.

The indirect effects of a sector are often expressed as a multiplier, which is the ratio of the combined direct and indirect effects to the direct effects. In this case, the financial services sector had a multiplier of 1.83. This means that for every direct job in the sector, it supported another 0.83 jobs through supply-chain impacts. We can break those results down further by region. Thus, for every direct job in Toronto, there were another 0.42 indirect jobs in Toronto; 0.28 indirect jobs in the rest of Ontario; and 0.13 indirect jobs in the rest of Canada.

The sector also has indirect GDP effects across Canada. In fact, for every $100 of GDP that the sector directly generated in Toronto, it indirectly generated an additional $23 in Toronto; $21 in the rest of Ontario; and $9 in the rest of Canada. This resulted in a total GDP multiplier of 1.52 for the sector.

The GDP multiplier for the sector was lower than its employment multiplier because the sector has a high level of GDP per employee. Essentially, since the sector's direct GDP effects were above average, a large denominator was used to calculate the multiplier. As a result, the GDP multiplier was smaller than the employment multiplier. Other sectors with high GDP per employee ratios, such as mining and utilities, experience a similar effect.

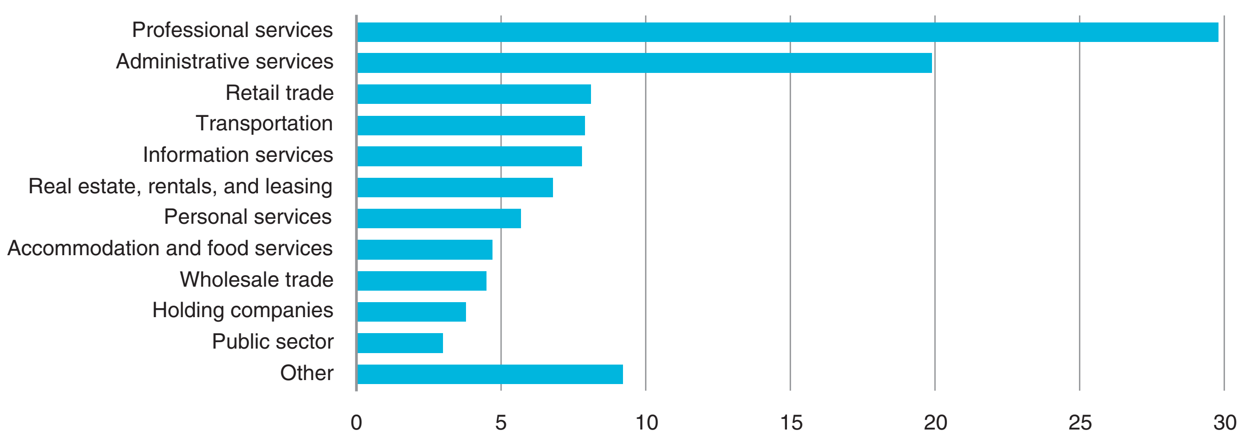
Indirect Effects on Professional Services in Toronto

If we turn our focus to the indirect effects in Toronto, we can gain some additional insights into which industries are supported by activity in the financial services sector. In 2014, the single largest impact was in the professional services industry, where financial services activity supported 29,834 jobs. (See Chart 28.) Indeed, the relationship is so strong that some professional services, such as legal and accounting services, are sometimes considered to be part of the financial services sector. If we add the direct effects of the financial services sector and its indirect effects in the professional services sector, the total of 281,209 jobs equates to 9.1 per cent of Toronto's total employment.

Chart 28

Professional Services Experienced the Largest Indirect Employment Effects in Toronto

(indirect employment effects in Toronto by sector, 2014, 000s of jobs)



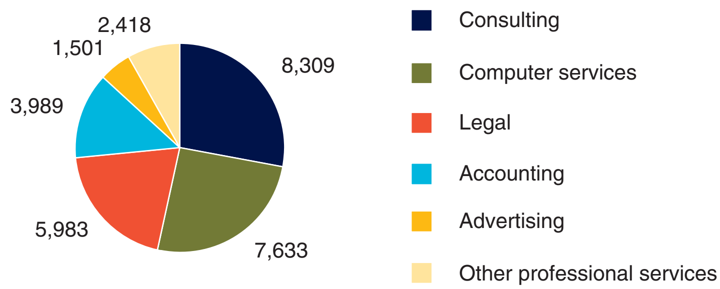
Sources: Statistics Canada; The Conference Board of Canada.

Within the professional services sector, the consulting industry experienced the largest impact: financial services activity supported 8,309 jobs in this industry. (See Chart 29.) Significantly, the financial services sector also supported 5,983 legal services jobs (17.2 per cent of local industry employment) and 3,989 accounting services jobs (12.0 per cent of local industry employment).

Chart 29

Financial Services Support a Variety of Professional Services Industries

(professional services employment effects in Toronto by industry, 2014, number of jobs)



Sources: Statistics Canada; The Conference Board of Canada.

The financial services sector also had a sizable effect on the computer services industry, supporting 7,633 jobs or 8.4 per cent of local industry employment. This reflected the sector's heavy use of information technology. Indeed, 51.8 per cent of total financial sector investment in Canada was related to information technology equipment and services in 2013.[5]

Indirect Effects on Administrative Services in Toronto

Professional services were not the only sector where financial services activity had a major impact. The second-largest indirect effects in Toronto occurred in the administrative services sector. This sector is primarily engaged in activities that support the day-to-day operations of other organizations. Financial services activity supported 19,881 administrative services jobs in Toronto in 2014.

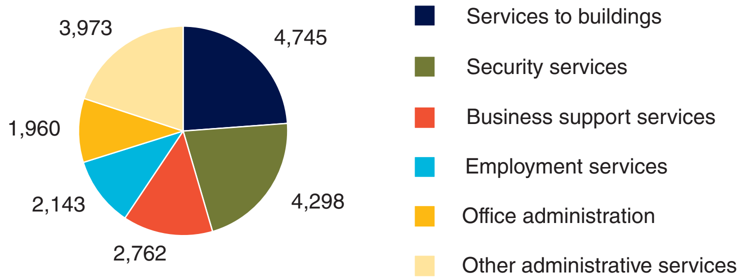
The industry that provides services to buildings was the single largest beneficiary, with 4,140 jobs being supported by the financial services sector—equivalent to 7.3 per cent of the industry's total local employment. (See Chart 30.) This industry provides services such as janitorial, cleaning, pest control, and landscaping services. The

5 Derived from Statistics Canada's CANSIM table 031-0003.

The single largest effect in the manufacturing sector in 2014 occurred in the printing industry, at 1,845 jobs, or 12.6 per cent of total printing industry employment in Toronto.

large impact of financial services on this industry reflects the sector's heavy use of office and retail space, and the outsourcing of activities needed to maintain this space. Other areas of major impacts in the administrative services sector include security services (e.g., armoured cars and security guards), business support (e.g., call centres and collection agencies), employment (e.g., temporary help providers and placement agencies), and office administration services (e.g., billing, and record-keeping).

Chart 30
Administrative Services Employment Effects in Toronto, by Industry
(2014, number of jobs)



Sources: Statistics Canada; The Conference Board of Canada.

Indirect Effects on Other Sectors in Toronto

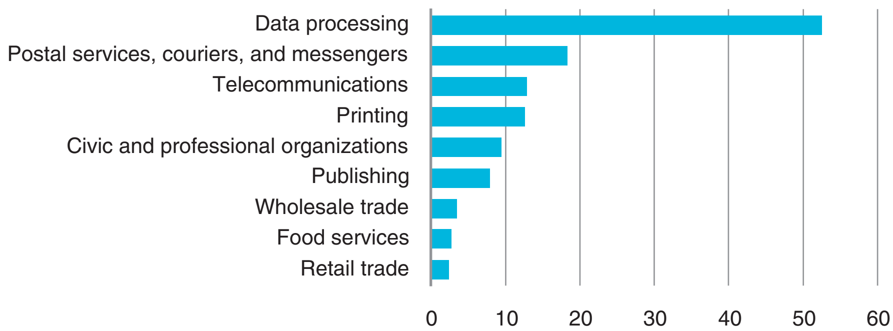
Beyond the professional and administrative services sectors, a variety of other industries benefit significantly from financial services activities. For example, the single largest effect in the manufacturing sector in 2014 occurred in the printing industry, at 1,845 jobs, or 12.6 per cent of total printing industry employment in Toronto. (See Chart 31.) Financial services firms print a wide variety of materials, from advertising materials to cheques and bills.

Within the transportation sector, the postal service, courier, and messenger industry was the most affected industry in 2014. In fact, financial services activity supported 5,776 jobs, or 18.3 per cent of the industry's local employment. This partly reflects the importance

Chart 31

Financial Services Were a Key Customer for Some Industries

(indirect employment effects' share of Toronto employment for selected industries, 2014, per cent)



Sources: Statistics Canada; The Conference Board of Canada.

of direct mail advertising to the financial services sector. We estimate that about one-quarter of the sector's ad spending was directed toward direct mail—well above the average of 8.4 per cent for all industries.[6] As well, although there is an ongoing shift toward electronic billing and correspondence, mailings of items such as bank and investment statements, proxy statements, bills, and payments affected this result. Finally, the sector makes significant use of couriers to deliver time- and security-sensitive documents.

In the information services sector, telecommunications companies were the largest beneficiaries of financial services activity, which in 2014 supported 4,126 jobs, or 12.9 per cent of the industry's total local employment. The financial services sector is a major user of IT equipment and services, and telecom operators are major providers of these services. Other information services industries with significant effects include publishing (1,616 jobs) and data processing (1,582 jobs). In publishing, this reflects the importance of information as an input into sector activities such as asset management, investing, and trading. The

6 Burt, Audet, and Armstrong, *Marketing's Influence in Canada.*

effects in the data processing industry reflect the data-intensive nature of the financial services sector, particularly those segments that are transaction-oriented, such as exchanges and banking.

Although the financial services sector accounted for a smaller share of their total employment, sectors such as retail and wholesale trade also experienced significant employment effects, at 8,126 and 4,504 jobs, respectively. These industries experience economic impacts from activity in most industries because they connect businesses and consumers across the economy.

Fiscal Effects

The direct and indirect effects associated with Toronto's financial services sector also have significant fiscal implications for the City of Toronto, for Ontario, and for the federal government. The sector affects federal and provincial government revenues in several key areas, including the personal income taxes that employees pay on their wages and salaries; corporate taxes on the profits that financial services firms generate; and indirect taxes, which include things such as sales taxes and fuel taxes. At the municipal level, the employees of financial services firms require office space, and property taxes are paid on this space. In total, we estimate that Toronto's financial services sector generated a combined $15.7 billion in fiscal benefits in 2014 for the Canadian, Ontario, and City of Toronto governments. (See Chart 32.)

Federal

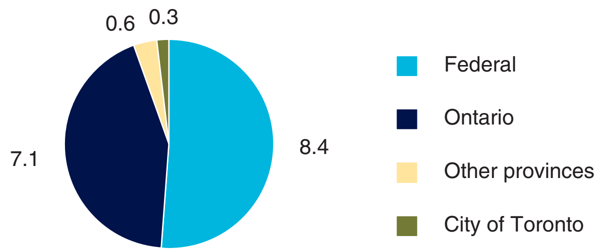
Among the different levels of government, Toronto's financial services sector had the largest impact on the federal government. The sector was equivalent to 3 per cent of the federal government's $279.3 billion in reported revenues for fiscal 2014–15.[7] Personal income taxes were the single largest source of these revenues, accounting for $3.2 billion or 37.8 per cent of the total. The second-largest source of federal tax revenues—at $2.3 billion, or 27 per cent of the total—was the GST on

7 Government of Canada, *Strong Leadership.*

Chart 32

Toronto's Financial Services Sector Generates Billions in Government Revenues

(government revenues by level, $ billions)



Source: The Conference Board of Canada.

sales transactions in the financial services sector's supply chain. The last major source of federal government revenues was corporate profits taxes, which amounted to $2 billion or 23.5 per cent of the total.

Provincial

The fiscal impact of Toronto's financial sector in Ontario was smaller than the national impact, but it was more significant as a share of the province's budget. We estimate that the province received $7.1 billion in revenues in 2014 as a result of economic activity supported by the sector. This was equivalent to 6 per cent of the province's total planned revenues of $118.9 billion in fiscal 2014–15.[8] The single largest benefit came from sales taxes ($3.5 billion), followed by personal income taxes ($2.0 billion), and corporate income taxes ($1.2 billion).

Although the vast majority of the economic effects associated with Toronto's financial sector occurred in Ontario, another $552 million in fiscal effects did accrue in other provinces. Quebec was the single largest beneficiary outside of Ontario, garnering $255 million in fiscal benefits, followed by British Columbia and Alberta. As well, depending

8 Government of Ontario, *Building Opportunity.*

on how the federal fiscal effects were spread across the country, the other provinces would receive additional benefits associated with federal spending.

Municipal

The final fiscal impact associated with the financial services sector comes from the office space that its employees occupy. We found that the sector supported 357,450 jobs in the Toronto metro area in 2012, both directly and indirectly. However, not all of these jobs were in the City of Toronto, nor did all of them require office space. In fact, we estimate that 166,800 of those jobs were in the City of Toronto and required some form of commercial space (office or retail space). This was equivalent to 20.7 per cent of the total employment in the City of Toronto that used commercial space.

Using these employment figures and City of Toronto data on property tax collections, we estimate that $277 million in municipal taxes in 2013 can be directly and indirectly linked to Toronto's financial services sector. That was equivalent to 7.5 per cent of Toronto's total property taxes and 2.5 per cent of the city's total revenues of $11.2 billion in 2013.[9] Of course, the other municipalities that make up the Toronto metro area—such as Mississauga, Oakville, and Markham—would have also received fiscal benefits.

9 City of Toronto, *2013 Consolidated Financial Statements.*

Three industries—banking, insurance, and securities—accounted for a combined total of 92.8 per cent of Toronto's financial services employment in 2014.

The Structure of Toronto's Sector

Toronto's financial services sector is made up of many constituent parts that offer a variety of services. The key industries within the sector include the following:

- banking
- credit unions
- insurance
- asset management
- securities
- exchanges
- back office operations

However, the distinctions between these industries have blurred over time. In 1991, regulatory changes ended the policy of separating the sector into "four pillars" (banks, insurance, trusts, and investment dealers). As a result, different industries in the sector offer many similar products and services. For example, many of the largest banks in Canada offer insurance and asset management services. As well, some large insurance providers offer asset management or banking services.

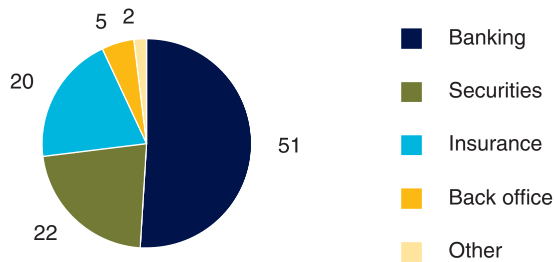
Because of the way industry statistics are compiled, the blurring of the lines between industries can make cross-industry comparisons difficult. Employees of an organization that earns most of its revenues from banking would generally be recorded as banking industry employees, even if the services they provide might be better classified under a different industry. This problem affects the asset management industry the most. With this caveat in mind, it is still instructive to look at the structure of the industries that make up the financial services sector.

In terms of employment, three industries—banking, insurance, and securities—accounted for a combined total of 92.8 per cent of Toronto's financial services employment in 2014. (See Chart 33.) This share has declined modestly over the past decade. Although banking employment experienced above-average growth, insurance and securities employment did not. As a result, these two industries now account for

Chart 33

Banking, Insurance, and Securities Account for Much of Toronto's Financial Sector Employment

(Toronto's financial sector employment by industry, per cent)



Source: The Conference Board of Canada.

a smaller share of Toronto's financial services sector. In their place, the banking and back office operations industries now account for a growing share of the sector. A detailed table of sector employment by industry can be found in Appendix B.

Despite the predominance of the banking, insurance, and securities industries in terms of the sector's employment, the sector is well-diversified in Toronto. In fact, Toronto's share of Canadian employment is above average in every industry except credit unions. Toronto accounted for 17.4 per cent of Canadian employment in 2014. Yet, for most financial services industries, Toronto's share was higher. For example, Toronto accounted for 48.7 per cent of Canadian employment in the back office industry, 38.6 per cent of securities employment, and 34.1 per cent of banking employment. This highlights Toronto's role as Canada's financial centre.

We see somewhat different patterns when we look at the number of financial services businesses. According to Statistics Canada's business registry, 8,586 financial services businesses were operating in Toronto at the end of 2014. Nearly half of these were in the securities industry (42.9 per cent), followed by insurance (25.2 per cent), and banking (21.6 per cent). Because the securities industry is sizable and includes many small businesses, it has a high share of the sector's businesses.

In fact, in 2014, 86 per cent of securities enterprises in Toronto had fewer than 20 employees. A detailed table of financial services establishments by employment can be found in Appendix B.

Small businesses are common in most of the industries that make up Toronto's financial sector. In 2014, 75.4 per cent of enterprises had fewer than 20 employees, versus 87.1 per cent for all industries. However, some segments have more large businesses than others. For example, nearly 10 per cent of life and health insurers had more than 200 employees. This may sound like a small share, but it is actually well above average. In fact, only 1.1 per cent of all businesses across all industries in Toronto had more than 200 employees.

Within the financial services sector, large businesses are most common in segments such as retail and commercial banking, insurance carriers, credit card issuance, and exchanges, where larger businesses are most likely to incur significant benefits. For example, capital-intensive businesses can benefit from economies of scale. As well, size can improve the perceived safety of a financial institution. This can lead to real benefits, such as lower borrowing costs and reduced counterparty risk premiums when dealing with other financial institutions. Finally, some segments, such as retail banking, can benefit from the network effects that come with scale. Larger banks generally have more locations where customers can conduct transactions, improving customer convenience and service.

CHAPTER 6

Toronto as a Global Financial Centre

Chapter Summary

- Toronto is highly ranked among global financial centres. It is ranked 7th by *The Banker* and its rank in the Global Financial Centres Index (GFCI) rose from 11th to 8th in the most recent survey. The improvement appears to be largely tied to an improved reputation for the city.
- According to the GFCI, key areas where Toronto stands out include its business environment, infrastructure, human capital, and reputation.
- According to *The Banker*, key areas of strength for Toronto include high levels of outward foreign direct investment (FDI), pre-tax profits, business friendliness, cost factors, and total bank assets.
- With financial services accounting for 8.1 per cent of the metro area's employment, Toronto's proportional reliance on financial services is even higher than that in major global financial centres such as London and New York.

Not only is Toronto the largest financial centre in Canada, it generally ranks well compared with other global financial centres. For example, *The Banker* magazine ranked Toronto 7th, behind cities like New York, London, and Singapore.[1] As well, Toronto ranked 8th in the most recent *Global Financial Centres Index* (GFCI) report, an improvement of three positions from the previous version of that report.[2] The improvement appears to be largely tied to an improved reputation for the city. In fact, Toronto now ranks 15th among the cities covered in the GFCI in terms of "reputational advantage"—meaning opinions about Toronto are significantly stronger than the quantitative data would suggest.

According to the most recent version of the GFCI, New York, London, Hong Kong, and Singapore are the most attractive financial centres in the world. Toronto improves to 8th position, behind the top four, as well as behind Tokyo, Seoul, and Zurich.[3] Toronto's high ranking in the GFCI is complemented by the fact that the report lists only 11 cities as having financial sectors that are both broad and deep. (See Table 4.) It is also worth noting that both surveys rank Toronto as the second most important financial centre in North America.

The GFCI uses a combination of "instrumental factors" from other reports and its own survey to generate its rankings. The categories of instrumental factors include business environment, financial sector development, infrastructure, human capital, and reputation. According

1 Pavoni, "London Stays Top of IFC Tree: S Rankings."

2 Yeandle, *The Global Financial Centres Index 18.*

3 Ibid.

Table 4
Ranking of Broad and Deep Global Financial Centres

London	1
New York	2
Hong Kong	3
Singapore	4
Seoul	6
Zurich	7
Toronto	8
Frankfurt	14
Amsterdam	36
Paris	37
Dublin	46

Source: GFCI.

to the GFCI methodology, Toronto ranks among the top global cities in four of these categories: business environment (9th), infrastructure (9th), human capital (11th), and reputation (8th).

The GFCI survey also presents sub-indices based on its surveys, where rankings are created using the responses of professionals working in the relevant industry sectors. These five industry sectors are investment management, banking, government and regulatory, insurance, and professional services. Toronto is well-represented within these five industry sectors, scoring a top 10 ranking in investment management, as well as government and regulatory. (See Table 5.) As expected, the large financial centres dominate each subsector.

In *The Banker* magazine's survey,[4] Toronto fared slightly better, ranking 7th globally. Key areas of identified strength for Toronto included high levels of outward foreign direct investment (FDI), pre-tax profits, business friendliness, cost factors, and total bank assets. As well, Toronto ranked

4 Pavoni, *London Stays Top of IFC Tree.*

Table 5
Rankings for Sub-Indices Within the GFCI

Survey Based				Instrument Based							
Investment Management		Government and Regulatory		Business Environment		Infrastructure		Human Capital		Reputation	
London	1	London	1	London	1	London	1	New York	1	London	1
New York	2	New York	2	New York	2	New York	2	London	2	New York	2
Hong Kong	3	Hong Kong	3	Hong Kong	3	Hong Kong	3	Hong Kong	3	Hong Kong	3
Singapore	4	Singapore	4	Singapore	4	Singapore	4	Singapore	4	Singapore	4
Toronto	**5**	Tokyo	5	Tokyo	5	Tokyo	5	Tokyo	5	Tokyo	5
Tokyo	6	Seoul	6	Seoul	6	Seoul	6	San Francisco	6	Sydney	6
Chicago	7	Chicago	7	Zurich	7	Zurich	7	Zurich	7	Chicago	7
San Francisco	8	Sydney	8	Luxembourg	8	Luxembourg	8	Chicago	8	**Toronto**	**8**
Boston	9	**Toronto**	**9**	**Toronto**	**9**	**Toronto**	**9**	Washington, D.C.	9	San Francisco	9
Zurich	10	Zurich	10	Chicago	10	Chicago	10	Boston	10	Boston	10
				Sydney	11	Sydney	11	**Toronto**	**11**	Zurich	11
				Dubai	12	Dubai	12	Seoul	12	Vancouver	12

Source: GFCI.

highly in terms of stock market capitalization, financial markets, and international debt securities. Toronto ranked in the top 10 globally for all of these factors. (See Table 6.)

Although it places well on all of these measures, Toronto generally lagged well behind the major global financial centres. For example, total assets were $6.9 trillion in London, $6.7 trillion in New York, and only $2.8 trillion in Toronto.[5] As well, there were about $3.1 trillion worth of international debt securities issued in London, which far exceeds the Toronto value of $777 billion. However, if we compare Toronto with

5 Ibid.

other cities, the gap is smaller. For example, in terms of total assets, Toronto was on par with Zurich. In terms of the value of international debt securities, Toronto was closer to Milan.

Table 6
Activities Where Toronto Ranks Among the Top 10 Globally

Outward FDI		International Debt Securities		Cost Factors		Financial Markets	
London	1	London	1	Copenhagen	1	New York	1
New York	2	New York	2	Johannesburg	2	London	2
Paris	3	Amsterdam	3	Manama	3	Tokyo	3
Tokyo	4	Paris	4	Wellington	4	Luxembourg	4
Zurich	5	Frankfurt	5	Bangkok	5	Amsterdam	5
Toronto	**6**	**Toronto**	**6**	Montréal	6	Paris	6
Beijing	7	Milan	7	Manila	7	Osaka	7
Mumbai	8	Dublin	8	**Toronto**	**8**	Frankfurt	8
Seoul	9	Sydney	9	Chicago	9	**Toronto**	**8**
Frankfurt	10	Madrid	10	Jakarta	10	Hong Kong	10
Stock Market Capitalization		**Total Bank Assets**		**Bank Pre-Tax Profits**		**Business Friendliness**	
New York	1	Beijing	1	Beijing	1	London	1
Tokyo	2	Tokyo	2	New York	2	Singapore	2
Osaka	2	London	3	Tokyo	3	Amsterdam	3
London	4	Paris	4	San Francisco	4	Seoul	4
Shanghai	5	New York	5	London	5	Dubai	5
Hong Kong	6	Frankfurt	6	**Toronto**	**6**	Moscow	6
Mumbai	7	**Toronto**	**7**	Shanghai	7	**Toronto**	**7**
Paris	8	Zurich	8	Sydney	8	Wellington	7
Toronto	**9**	Shanghai	9	Paris	9	Paris	9
Shenzhen	10	Madrid	10	São Paulo	10	Oslo	10

Source: *The Banker.*

Toronto ranks above Singapore and Hong Kong when it comes to outward FDI, financial markets, and international debt security issuance.

In short, London and New York are clearly the largest global financial centres. They remain in a league of their own, and they consistently vie for first or second place in the global rankings. Similarly, Singapore and Hong Kong generally compete for the third and fourth rankings. Toronto is part of a group of cities that compete below these four large centres.

That said, on the measures where Toronto ranked the highest, it often does better than some of the larger centres. For instance, Toronto ranks above Singapore and Hong Kong when it comes to outward FDI, financial markets, and international debt security issuance. Toronto can even compete with London and New York on some measures. Toronto outranks both cities in terms of cost factors, is more business friendly than New York, and is essentially tied with London in the case of bank profitability.

Given the difference in the results, it is clear that *The Banker* and GFCI rankings are not completely comparable. For instance, the GFCI combines quantitative results in five broad categories with its own survey of global finance industry professionals to create an overall ranking. Alternatively, *The Banker* compiles financial data in areas ranging from economic potential to business environment.[6] All in all, the rankings provided by *The Banker* are more data-driven, while the GFCI's also reflect survey responses.

Employment in Global Financial Centres

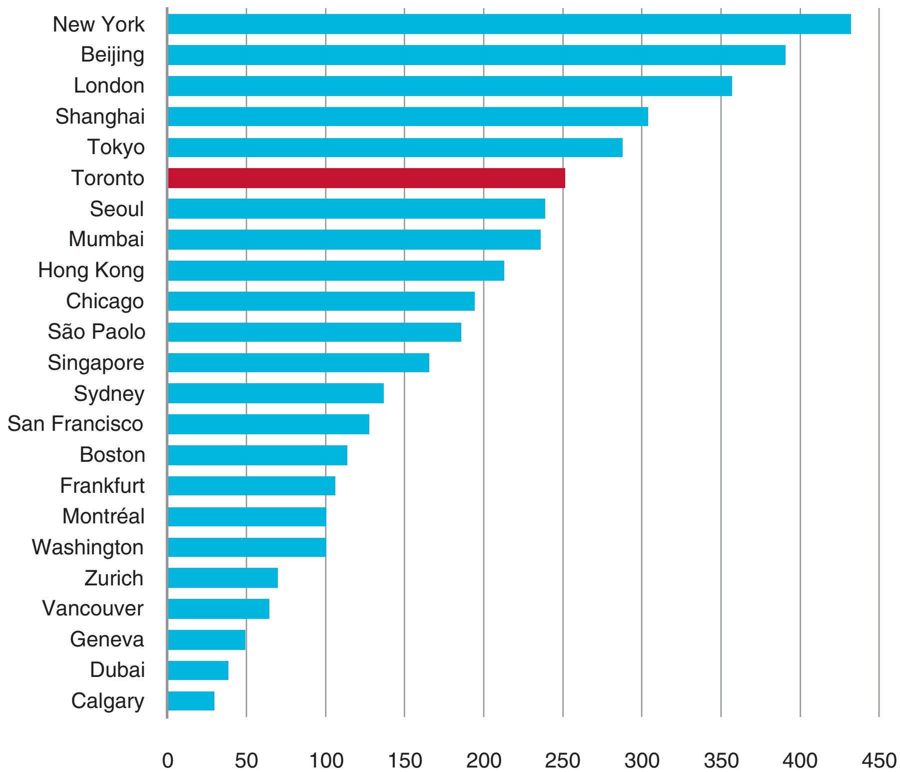
Beyond these surveys, Toronto ranked highly compared with other global financial centres in terms of employment. Indeed, 251,000 people were employed in Toronto's financial services sector in 2014, meaning the city ranked 6th among the global financial centres we consider here. (See Chart 34.) However, Zurich is the only city that is more dependent than Toronto on the financial services sector. (See Chart 35.) With financial services accounting for 8.1 per cent of the metro area's employment,

6 Ibid.

Chart 34

Toronto Had a Significant Number of Financial Services Employees

(000s, 2014 or most recent data available)



Sources: Various national statistical agencies.

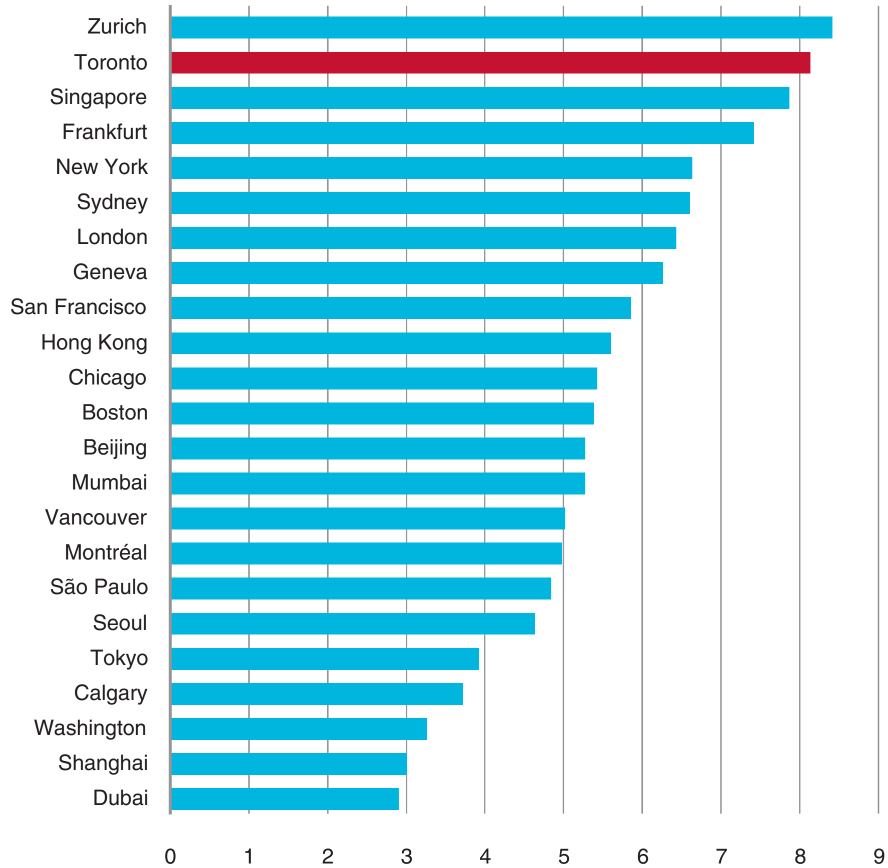
Toronto's proportional reliance on financial services is even higher than that in major global financial centres such as London and New York, which have much larger populations.

It is also interesting to note how Toronto's financial services sector has grown over the past decade in comparison with some of the other financial centres. For example, while all major Canadian centres have posted significant increases in employment since 2002, Toronto's financial services sector increased by 36.5 per cent, generating about 67,200 new financial services positions. (See Chart 36.)

Chart 35

Financial Services Employment Was More Important to Toronto Than to Other Financial Centres

(share of total local employment, per cent, 2014 or most recent data available)



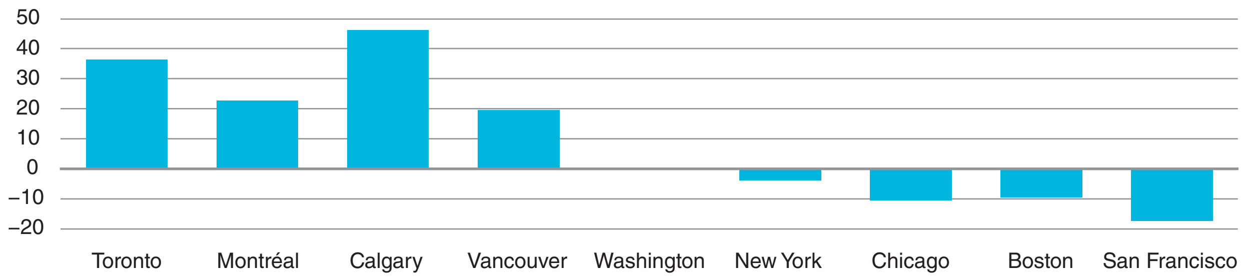
Sources: Various national statistical agencies.

Conversely, the major U.S. financial centres have all seen their employment shrink, due entirely to the financial crisis in 2008–09. In all of the U.S. metro areas we included, financial services employment fell drastically in 2008. What is more, a recovery has not transpired. In fact, in all of the U.S. metro areas profiled, financial services employment in 2014 was less than it was in 2002.

Chart 36

Employment Growth in Financial Services

(selected North American cities, percentage change, 2002–14)



Sources: Statistics Canada; Bureau of Labour Statistics.

CHAPTER 7

Conclusion

Chapter Summary

- Looking only at employment understates the importance of the financial services sector to Canada's economy. For example, the sector accounts for 26 per cent of private sector profits and 52 per cent of the stock of outward FDI.
- Financial services have been a major source of growth for the Canadian economy over the past decade. The sector's employment, financial results, and international trade and investment performance outpaced the average for all sectors.
- Key areas of strength for the sector include its financial and international trade and investment performance, but its productivity performance has been more modest.
- Toronto's role as Canada's largest financial hub has grown domestically and internationally. The sector's share of domestic activity has increased, while its ranking among international financial centres has improved.

Our analysis has shown that the financial services sector is a critical part of the Canadian economy, and this is apparent in a myriad of ways. For example, the sector directly accounts for 4.4 per cent of Canadian employment, but this figure understates the impact of the sector in many ways. At the same time, it accounts for 20 per cent of Canada's foreign affiliate sales, 26 per cent of the net profits generated by the private sector, and 52 per cent of the stock of outward FDI undertaken by Canadian firms.

Furthermore, the sector's importance is growing. For most of the indicators we looked at in this report—including employment, GDP, private sector sales and profitability, and international trade and investment—the sector's share of Canadian activity has grown over the past decade.

Beyond the direct footprint of the sector, it plays an important role as a facilitator in the economy. Key functions that the financial services sector provides, which essentially all consumers and business require, include access to credit, transaction processing, and risk management services. Without these services, a modern, dynamic, and resilient economy is impossible.

Thus, the financial services sector links the economy together in a unique way. Financial services are a necessary input for every single business across the country and are used by essentially every adult individual. Only a handful of other sectors, such as telecommunications and transportation, have the same impact on the day-to-day functioning of the economy.

Given the size and growing importance of the sector, as well as its facilitator role, assessing its performance is critical. In this report, we have examined how financial services compare with other sectors domestically, and with its peers internationally, in terms of financial performance, innovation/productivity performance, and international trade and investment performance. Broadly speaking, the sector is well-positioned for future growth.

In terms of financial performance, the sector generally does well. It has high profit margins but slightly below-average rates of return on equity compared with other Canadian sectors. But, when compared with financial institutions in other jurisdictions, Canadian firms fair considerably better. Deposit-taking institutions and insurers in Canada both have ROE that is above those found in most countries with major global financial centres. As well, Canadian deposit-taking institutions stand out for having very low rates of non-performing loans, which is a positive indicator for their future profitability.

The sector also outperforms when it comes to international trade and investment. Growth in exports, investment, and foreign affiliate sales for Canadian financial institutions have all been considerably stronger than average. For example, financial services are Canada's largest and fastest-growing source of services exports. In fact, the size of the sector's international footprint means that it is now one of the most common ways that foreigners interact with Canadian businesses.

Among the indicators we examined here, productivity is where the sector could most improve its performance. Although financial institutions reported a high rate of innovation compared with other sectors in Canada, these innovations have been slow to materialize into labour productivity growth. Canada's financial services sector underperforms the average for all domestic sectors—as well as some international—peers on this measure.

It is in this environment that we focus on Toronto's role in Canada's financial sector. Toronto has accounted for a growing share of the sector domestically, and its ranking relative to other global financial centres is high and improving. Given its status as Canada's largest financial hub, Toronto has a key role to play in the further development of the sector. As well, given the growing importance of the sector to both Canada's and Toronto's economies, we need to get the policy environment right, balancing risks with the opportunities at home and abroad. If successful, the sector will continue to be a source of growth for both Toronto and Canada.

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APPENDIX A

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APPENDIX B

Additional Data Tables

Table 1
Toronto Financial Services Employment, by Industry
(number of jobs)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Average annual growth (2004–14, %)	Share of Toronto's financial services employment (%) 2004	2014
Total financial services	190,025	207,475	217,700	209,450	217,725	218,425	212,875	219,350	219,325	240,025	251,375	2.6	100.0	100.0
Banking	86,209	98,593	111,848	102,753	11,294	109,261	112,174	107,959	112,104	112,072	128,940	3.3	45.4	51.3
Credit unions	928	962	1,003	1,053	1,083	1,077	1,123	1,152	1,200	1,236	1,273	3.6	0.5	0.5
Insurance	51,400	54,200	55,500	54,100	56,700	55,800	50,800	56,500	51,600	56,600	50,200	0.2	27.0	20.0
Property and casualty insurers	25,535	22,113	23,242	25,872	25,949	26,215	25,416	26,875	21,706	25,155	20,608	–1.6	13.4	8.2
Life and health insurers	10,875	9,417	9,898	11,018	11,051	11,165	10,824	11,445	9,244	10,713	8,777	–1.6	5.7	3.5
Other insurance	14,990	22,670	22,360	17,210	19,700	18,420	14,560	18,180	20,650	20,733	20,816	3.9	7.9	8.3
Asset management	2,008	2,134	2,180	2,244	2,476	2,620	2,680	2,884	2,865	3,115	3,241	3.9	1.1	1.3
Securities	44,140	44,887	39,131	41,336	35,474	40,519	36,436	41,166	40,832	55,598	54,204	2.3	23.2	21.6
Securities intermediation and brokerage	20,704	20,807	17,923	18,256	15,069	16,510	14,195	15,280	14,909	19,964	19,134	–0.3	10.9	10.0
Other financial investment activities	23,436	24,080	21,208	23,080	20,404	24,009	22,241	25,886	25,923	356,345	35,070	4.2	12.3	11.6
Exchanges	760	713	569	664	626	781	764	934	868	1,102	996	1.7	0.4	0.4
Back office	4,580	5,986	7,469	7,300	8,417	8,367	8,898	8,755	9,856	10,302	12,521	11.9	2.4	5.0

Sources: Statistics Canada, Labour Force Survey; The Conference Board of Canada.

Table 2
Number of Financial Services Sector Firms Operating in Toronto, by Employment Size

	Number of enterprises						Share of enterprises (%)				
Number of employees	**Total**	**1–9**	**10–19**	**20–99**	**100–199**	**200+**	**1–9**	**10–19**	**20–99**	**100–199**	**200+**
All industries	201,973	154,951	21,029	21,044	2,774	2,175	76.7	10.4	10.4	1.4	1.1
All financial services	8,586	5,648	829	1,749	155	205	65.8	9.7	20.4	1.8	2.4
Banking	1,829	405	260	1,109	21	34	22.1	14.2	60.6	1.1	1.9
Depository credit intermediation	1,374	68	221	1,053	12	20	4.9	16.1	76.6	0.9	1.5
Credit card issuers, sales financing, consumer lending	177	113	18	33	3	10	63.8	10.2	18.6	1.7	5.6
All other banking	278	224	21	23	6	4	80.6	7.6	8.3	2.2	1.4
Credit unions	78	30	23	22	2	1	38.5	29.5	28.2	2.6	1.3
Insurance	2,160	1,635	191	258	36	40	75.7	8.8	11.9	1.7	1.9
Life and health insurers	158	79	16	37	11	15	50.0	10.1	23.4	7.0	9.5
Property and casualty insurers	168	74	13	49	16	16	44.0	7.7	29.2	9.5	9.5
Other insurers	1,834	1,482	162	172	9	9	80.8	8.8	9.4	0.5	0.5
Asset management	198	161	13	15	3	6	81.3	6.6	7.6	1.5	3.0
Securities	3,682	2,871	302	320	90	99	78.0	8.2	8.7	2.4	2.7
Securities intermediation and brokerage	623	382	104	89	28	20	61.3	16.7	14.3	4.5	3.2
Other financial investment activities	3,059	2,489	198	231	62	79	81.4	6.5	7.6	2.0	2.6
Exchanges	18	10	2	1	1	4	55.6	11.1	5.6	5.6	22.2
Back office	621	536	38	24	2	21	86.3	6.1	3.9	0.3	3.4

Source: Statistics Canada, Canadian Business Patterns.

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