Introduction

With its high salaries, absence of pollution and enduring nature, there is little wonder that the financial services sector is attractive to governments all over the world. From Dubai to Dublin, cities and regions are competing to entice financial firms to settle. In this race, Toronto is luckier than most. To start, it is a safe, livable and efficient city. Further, it has a long history of being a financial and economic hub both for Canada and, in certain instances, the world. That it is at the heart of a prosperous national economy while at the same time being only an hour’s flight from New York makes it a natural site for businesses and the financiers who serve them.

Few would suggest that Toronto’s financial services cluster is a failure. The banks are profitable and the city’s insurance firms are among the best in the world. Yet it is not clear that the cluster is realizing its full potential, or that it is growing as quickly and as dynamically as it could be. This paper examines the cluster’s national and regional context; its most salient characteristics using the diamond approach; the barriers that it faces to growth; and recommendations to move it forward in a fiercely competitive global industry.

I. Overview of Ontario, Canada: History, Performance, Business Environment, and Policy

History

Ontario traces its origins to the beginnings of Canada. Prior to contact with Europeans, the area that would become Ontario was inhabited by Algonquian and Iroquoian tribes. In the 17th century, Europeans arrived in significant numbers: explorers first, followed by fur traders, missionaries and, eventually, settlers. From the outset, as in much of North America, the English and French staked rival claims. These were settled by war, with the English (and their Iroquoian allies) defeating the French in
1763. The region quickly became a magnet for British loyalists fleeing the newly independent US, particularly as each arriving family was granted 200 acres of land.¹

Toronto (then called York) was founded in 1793. Forty years later, its population numbered 9,000, including a number of African Americans who had fled slavery in the US South.² As the population grew, an extensive sewage system was built and gas lights lit the streets. The city’s position on Lake Ontario made it a natural site for a port, and it soon became a railway hub and an important gateway to the interior of the continent. The railways carried streams of European immigrants to the city, confirming it as the leading destination for new immigrants to Canada, a role it continues to play to this day. By the end of the 19th Century, horse-drawn carriages had given way to electric street cars. From this beginning arose the Toronto Transit Commission, the city’s highly successful public transit system, which now enjoys the third highest ridership of any in North America.³

As Toronto’s population swelled, so too did those of Ontario and Canada. From 1870, three years after Confederation, to 1939, the country’s population tripled to 11.3 million, of which about a third lived in Ontario.⁴ The opening of the Ford car manufacturing company,⁵ the discovery of a rich silver vein and the development of Ontario’s hydro-electric company marked the beginning of the manufacturing era. The Second World War brought another wave of immigrants fleeing Europe, many of whom made their home in Toronto and other parts of the province. Not only were they offered personal and political freedom, but Ontario’s economy was also growing robustly, bolstered by cheap hydroelectric power and increasing industrialization. Following the war, the 1950s and 1960s were a

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period of infrastructure development and economic growth, as well as heavy investment in education and health. As early as 1934, the Toronto Stock Exchange was the country’s largest, but though the city was an important economic center, it stood second in significance to Montreal. By the 1980s, this had changed, as Toronto surpassed Montreal in population and economic importance. Commentators argue that the growing separatist movement in Quebec was a catalyst, leading many national and multinational businesses to decamp to the relative stability of Toronto. Even the Bank of Montreal, one of Canada’s five large banks, moved its head office to Toronto in 1977, joining scores of other financial institutions headquartered in the city.

By the early years of the 21st century, Ontario had solidified its position as a manufacturing and transportation hub. Toronto has grown to be North America’s 5th largest city and, by some measures, its most diverse, with 49.9% of the population foreign-born. Its broader economic region, called “the Golden Horseshoe”, stretches south and west around Lake Ontario, and is home to 8.1 million residents.

**Political System**

Canada is a constitutional monarchy with a federal system of parliamentary government. The federal government has constitutional responsibility for “peace, order and good government”, including criminal law, national defense and foreign affairs. Provinces have broad responsibility over property and civil rights, health, education and cities. Jurisdictional disputes between levels of government are common.

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The federal parliament is bicameral, with a Prime Minister elected as head of government through a Westminster-style first-past-the-post electoral system. Each of the ten provinces and three territories has a provincial parliament or assembly. Ontario’s is unicameral, headed by a Provincial Premier (equivalent to a US State Governor), and housed at Queen’s Park in Toronto, the provincial capital.

Ontario’s government, like its federal counterpart, is considered to be efficient, capable and responsive by global standards. The country was recently ranked 9th out of 179 countries on the Corruption Perception Index by Transparency International.\(^\text{12}\)

**Social Indicators**

Canada and Ontario do well in international comparisons of human development. Canada placed first among G7 members in the most recent UN ranking using the Human Development Index, which scores countries on their educational, health and economic achievements\(^\text{13}\). Ontario, in particular, has a strong primary and secondary system of public education, and the province’s network of over forty universities and colleges is strong. However, by some measures, Ontario lacks high educational institutions that are regarded as best-of-class. The Times Higher Education Supplement, for example, lists The University of Toronto as 45th best in the world, and as the only Ontario university in the top 80.\(^\text{14}\)

**Economy**

Canada’s economy has been growing robustly. It has outperformed the G7 average in seven of the past ten years (see Exhibit 1). Its composition is similar to that of other G7 nations, with services accounting for 69% of GDP, industry for 29% and the balance from agriculture (see Exhibit 2). More


than most G7 countries, Canada is very outwardly-focused, with exports accounting for 33.6% of GDP.\textsuperscript{15}

Various experts have praised Canada for its strong macroeconomic policies and performance. Calling Canada a “Northern Star”, the IMF recently noted: “Robust GDP growth, declining unemployment, low and stable inflation, and a string of fiscal and current account surpluses -- it's a record to be envied. These outcomes in Canada owe much to sound macroeconomic policies, as well as to a favorable external environment.”\textsuperscript{16}

Canada has a diverse mix of clusters, among which the financial cluster plays a significant role in terms of size and employment, and less of a role in terms of exports (see Exhibits 3 and 4).

Ontario remains the economic engine of Canada, accounting for about 40% of Canada's total employment, about 40% of its GDP, 45% of total exports and 50% of international immigration.\textsuperscript{17} Ontario has a diversified economy, with relatively high employment in manufacturing and financial and business services, and relatively less employment in agriculture, forestry and mining. Services account for 72% of employment, with exports contributing to about 60% of Ontario’s GDP.\textsuperscript{18}

\textit{Business Environment and Policy}

Overall, according to a number of international rankings Canada has a very strong business environment. In 2008, the Economist ranked Canada 1\textsuperscript{st} among G7 countries and 4\textsuperscript{th} overall as the best place to do business in the world.\textsuperscript{19} Out of 178 economies on the World Bank Doing Business index, Canada ranked 7th on ease of doing business, and 5th on protecting investors.\textsuperscript{20} Canada scored worse on the labor and tax indices, but still well ahead of its European competitors. According to the World Bank,

\textsuperscript{15} Economist Intelligence Unit.
\textsuperscript{19} The Economist, April 22, 2008. The Economist ranking includes the political and institutional environment, macroeconomic stability, policy towards private enterprise, foreign investment policy, financing and infrastructure. Canada is behind Denmark, Finland and Singapore.
\textsuperscript{20} World Bank, Doing Business in Canada (2008).
contract enforcement was one of the main weaknesses. Due to an average of 570 days that it takes to enforce a contract, Canada ranked 43rd, well behind UK (24), France (15) and Germany (14).

Canada also performed relatively well on the World Economic Forum’s Global Competitiveness Index. In 2008, Canada moved up to 14th from 15th place on the Business Competitiveness Index and fell to 13th from 12th position on Global Competitiveness Index.

Canada’s effective tax rate is among the highest in its peer group. At 36.4% for services, it is almost 16% higher than the OECD average. Federal corporate income tax is scheduled to decrease from 21% to 15% by 2012. Federal government has also advised the provinces to reduce their corporate income tax to reach a goal of 25% combined federal-provincial statutory tax rate. However, Ontario continues to have an unfavorable tax regime. Due to tax rate increases in 2004 and other provinces’ reductions, by 2012 Ontario will have the third highest corporate income tax rate in Canada at 14%.

Another criticism of Canadian policy often mentioned is that a number of sectors, including the financial sectors, are still sheltered from the effects of foreign competition and investment. The Canadian economy may benefit from more openness to foreign entry.

**Challenges Ahead**

The key challenge for Canada in general and Ontario specifically is how to improve an already prosperous economy. Among countries with a population that is similar or greater than Canada’s, no country outside North America outperforms Canada (or Ontario) in GDP per capita. However, when compared to the US, the GDP per capita is lower by some $8,000 for Canada, and $6,000 for Ontario.

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21 Contract enforcement ranking takes into account duration, number of procedures and cost of enforcing contracts. World Bank, Doing Business in Canada (2008).
22 From number 6 in 1998 in the ranking on business competitiveness Canada fell to 11th place in 2001, as other countries improved their rankings. Statement by Roger Martin, Chairman of the Institute for Competitiveness & Prosperity Canada, Competitiveness Standing up in One Index, Down in Another.
24 2008 Pre-Budget Consultations Commission, Canadian Banks Association (January 2008).
25 Ibid.
There is a concern that not only does this gap represent unmet potential, but that the gap will also continue to grow in the future.

The success of Canada and Ontario in relation to all other countries has been explained by a combination of highly skilled and culturally diverse work force, mix of productive industries, and macroeconomic strengths.\textsuperscript{28} The gap with the US, on the other hand, has two sources according to the Institute for Prosperity and Competitiveness (IPAC). A large portion of the gap – about $4,500 in 2006 – is due to a different set of choices. An average worker in Canada works five weeks less than his/her US counterpart each year, due to both more vacation and less hours worked (intensity gap).\textsuperscript{29} The other source of the prosperity gap is lower productivity. The IPAC’s analyses concludes that Canada has an excellent mix of clusters, but that the cluster effectiveness is lower than in the US, due to lower urbanization, lower educational attainment and underinvestment in capital.\textsuperscript{30}

**II. Canadian Financial Sector**

*Short History*

Canada has a long history of nation-wide banking. Almost all of big Canadian banks trace their roots to the 19\textsuperscript{th} century. Unlike their US counterparts, Canadian banks have never been prohibited from conducting nationwide branching and banking. By 1920, the full-fledged Canadian nationwide branching banking system was in place. Over the subsequent decades a few domestic banks became the dominant players in the financial market as the Canadian government prohibited foreign competition, encouraged national mergers and removed restrictions for banks to participate in other financial activities.\textsuperscript{31} Canada’s

\textsuperscript{28} Path to the 2020 Prosperity Agenda: Ontario, Institute for Prosperity and Competitiveness (2007).

\textsuperscript{29} See Time on the Job: Intensity and Ontario’s Prosperity Gap, Institute for Prosperity and Competitiveness (2006); and Setting our Sights on Canada’s 2020 Prosperity Agenda: Report on Canada 2008, Institute for Prosperity and Competitiveness. In addition to less hours worked voluntarily, about a quarter of the intensity gap is involuntary: half-time workers who cannot find full-time jobs.

\textsuperscript{30} Setting our Sights on Canada’s 2020 Prosperity Agenda: Report on Canada 2008, Institute for Prosperity and Competitiveness.

\textsuperscript{31} For good overview of the history of Canadian banking see Bordo et al (1994) and Nichols et al (1997).
system of national banks differs significantly from the US model of thousands of local banks, which resulted from a number of restrictions placed on nationwide banking.

**Financial Cluster Performance**

The financial cluster of Toronto is vibrant but lags other global financial centers. According to a London-based consulting company that ranks global financial centers, Toronto is 13th, excluded from the top ten “alpha world cities”.  

There are many reasons for that ranking. While Canadian financial services companies are on average more profitable than their U.S. counterparts, there are concerns about productivity of labor. IPAC’s study uses wages as an indicator of productivity, finding that the Canadian financial firms lag behind US financial firm productivity levels (more details bellow).

When it comes to individual companies, Canadian banks and life insurance companies are performing better than the industry average. Canadian banks have outperformed the market on total shareholder returns for the last five years, and on average have higher net profit margins and return on equity (see Exhibit 5).

Canadian life insurance companies have also performed well when measured on return on equity. Two of Canada’s largest life insurers, Great-West Lifeco and Manulife Financial, outperformed the five largest US life insurers on return on equity. The three biggest insurers also outperformed the industry average in terms of RoE, RoA and net profit margin (see Exhibit 6):

The lion’s share of Canada’s financial sector and cluster is located in Ontario. According to the US Department of Commerce, Ontario ranks sixth among states and provinces as centers of leading

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34 Ibid
37 Financial Data obtained from OneSource database (2008).
financial services clusters in North America, contributing approximately 8% to GDP.\(^{38}\) Toronto is the home of the headquarters of the overwhelming majority of the Canadian financial sector players, including the two Canadian banks that are listed among the Top 50 World Banks by *The Banker*.\(^{39}\) Canada’s biggest stock exchange and the heart of Toronto’s financial infrastructure is the Toronto Stock Exchange, the 7\(^{th}\) largest stock exchange in the world by market capitalization.\(^{40}\)

**The Financial Cluster Diamond (see Exhibit 10)**

Financial services is a sophisticated, labor-intensive and capital-intensive industry. The use of available resources, strategic positioning, and managerial know-how are key for the competitiveness of the cluster.

**Factor Conditions**

The main factor inputs for financial services are capital and labor.

**Capital Input Factors.** Canada’s share of the global financial industry is approximately 3% of the global assets.\(^{41}\) This is modest compared to 37%, 22%, and 15% of U.S., Eurozone, and UK shares, respectively.\(^{42}\) In terms of market depth (280% of bank, tradable debt, and equity capital as % of GDP in 2006), the Canadian financial services cluster ranks among the mature markets. However, it still lags the financial depth of the U.S., UK, Japan, and Eurozone countries.\(^{43}\) The lower level of financial depth of the Canadian industry compared to market leaders can be explained in part by logistical difficulty in serving a vast territory with relatively complex services, where developing a relationship with a client is critical.

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38 Quebec, ranks 16\(^{th}\), with approximately 5.5% of contribution to GDP. TO Business, http://www.toronto.ca/tobusiness/2007-august.htm.
42 Ibid.
43 Ibid.
In terms of financial depth of the subsectors, Canada ranks 8th in equity capitalization ratio and 9th in corporate debt (as a % of GDP).  

**Human Capital Factors.** Financial services represent one of the core employment areas in Toronto. More than 11% of Toronto’s employed residents work in the cluster; three percentage points more than in the New York City area and two percentage points more than in Boston. Because of the significance of the commercial banking segment in the overall industry, the majority of those finance professionals employed in the Toronto area work in depository institutions (49%), while 34% engage in securities and brokerage. Only 14% of Toronto labor force is in the insurance business, compared to 56% in Hartford, CT, and 33% in Los Angeles.

Employees with high educational attainment appear to be thinly distributed, with only 13% earning a Master’s or Ph.D. degree; 51% of the workforce in financial services has a pre-bachelor background. This compares unfavorably to other North American financial services clusters. For example, in Boston, only 32% of financial service professionals hold less than a bachelor degree.

One of the explanations for this fact is a higher need for managing retail client relationships, given the necessity to outreach across vast distances of Canada, which suggests a lower ratio of highly educated financial professionals to clients than in markets where clients are more concentrated. Another explanation is a relatively high importance of specialized courses. Toronto has a higher percentage of CFA charter holders than any of the peer cities, 2.5%. Further, 40,000 short courses were offered to Canadian financial services professionals through Canadian Securities Institute in 2006, which is just one of many similar training centers in Toronto.

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44 Ibid.
45 2005 Canada Country Business Patterns.
47 Ibid.
48 Ibid.
49 Ibid.
50 Ibid.
51 Ibid; CFA Institute.
IPAC takes wages as an indicator of productivity, and finds that in certain sub-clusters they are lower than in some other leading North American markets. Comparing Toronto’s wage level to top ten US financial centers, it is clear that the wages converge in the banking segment. However, in more value adding segments, the difference is large. For example, in risk capital, professionals are paid, on average, close to $200,000 in the US and only $75,000 in Canada (see Exhibit 7). One way to realize benefits of less expensive labor is to attract foreign labor, which Ontario and Canada indeed explore: nearly 50% of Toronto residents are foreign-born:

Firm Strategy, Structure and Rivalry

The financial cluster is dominated by banks. 56% of all financial services assets are under the control of the banks. The banking assets themselves are very concentrated. There are 73 banks in Canada, but only six control 90% of all banking assets. The “Big Six” are Royal Bank of Canada, TD Bank, Bank of Nova Scotia, Bank of Montreal, CIBC and National Bank of Canada. Five of the six banks (all except NBC) are headquartered in Toronto. In addition to retail and commercial banking, the Big Six are also major players in the securities, trust and mutual fund segment of the market. The banks own three out of ten largest mutual fund companies, all large integrated securities are bank-owned and finally, the largest trust companies are also subsidiaries of banks. The only exception to the dominance of banks is the insurance, where some legal restrictions still remain in place.

Banks

As mentioned, the banking sector is highly concentrated. A number of empirical studies show that concentration by itself does not reduce competition in the banking sector, and that contestability rather than competition is crucial in the banking sector (Bikker & Haaf, 2002). A number of empirical studies, examining Canadian banking sector, confirm that there is a high level of competition despite the

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However, the protection from foreign competition and the focus on the domestic market has reduced Canadian banks’ incentives to develop world beating strategies that can translate to greater innovation and global leaderships. Until 1980, foreign banks were not allowed to operate in Canada, and until 1999 they were only allowed to enter if they incorporated under the Canadian laws and subject to the same capital requirements and regulatory oversight as domestic banks. Since 1999, foreign banks are allowed to open branches, but their retailing activities are limited. Currently, a foreign take-over of one of the big six is still not possible due to “widely-held” rules which prohibit concentration of ownership.\textsuperscript{55}

While there are now 24 foreign banks subsidiaries and 29 foreign bank branches, given the entrenched position of the Big Six and their highly developed national branching network, their effect on the competition is limited. At the same time, since 1989 the government has not allowed additional mergers between domestic banks.

While the Canadian banks compete intensely in the domestic market, this competition is based more on operational effectiveness than on differentiated competitive strategies. IPAC’s assessment of the Toronto financial services cluster has found a low level of product differentiation between the banks\textsuperscript{56}; a view confirmed by various analysts. At the same time, despite this strong performance, Canadian banks are being forced to expand internationally due to limited opportunities for growth on the local market and increased competition from global players and non-traditional competitors. While 33\% of the net income reported by Canadian banks comes from foreign sources,\textsuperscript{57} and they all cite extensive presence in various international markets, the significance of their global presence has not been great. None of the Canadian banks feature on top 25 banks by any measure (tier 1 capital, assets or market capitalization).\textsuperscript{58}

\textsuperscript{55} No person or entity can own more than 20\% of voting rights. Department of Finance, Canada, http://www.fin.gc.ca/fin-eng.html.
\textsuperscript{56} Assessing Toronto’s Financial Services Cluster, Institute for Prosperity and Competitiveness (2007).
The US, UK, France, Netherlands, Spain, Italy and Switzerland all have at least one or more banks listed under top 25.\(^{59}\) In addition, 30% of income derived from international operations is low when compared to top international banks. ABN Amro (Netherlands) derives close to 50% if its net income from foreign operations.\(^{60}\) The same is true for ING (Netherlands), Credit Agricole (France) and Banco Santander (Spain).\(^{61}\)

Canadian banks have had some success in the English-speaking Caribbean, where the Canadian banks now control the three largest banks.\(^{62}\) They have also started expanding into the US market (e.g., TD acquisition of Banknorth), with limited impact so far.

The Canadian banks face two problems in their international expansion. First, they lack the size to compete on the global market against the big players. It takes the combined assets of the six banks to reach the level of assets of the largest global bank.\(^{63}\) Second, as discussed by various analyst reports, the Canadian banks suffer from weak differentiating strategic position.\(^{64}\)

**Securities**

The number of securities firms has increased over the last two decades, however, integrated firms, mostly owned by banks, still account for over 65% of revenues.\(^{65}\) Being dominated by domestic banks, securities firms have not developed strategies that position them as global leaders. The segment of the market not dominated by the banks is focused on domestic niches, focusing either on institutional or retail customers. Out of 200, six leading securities firms accounted for 73 % of revenue in 2003.\(^{66}\)

An additional regulatory barrier is that contrary to the banking regulation which is in the hands of the federal government, securities regulation is passed on the provincial level. This means that there are

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\(^{59}\) Ibid.
\(^{60}\) Annual Report 2007, ABN Amro. ABN Amro was recently acquired by a consortium of banks: Banco Santander, Royal Bank of Scotland and Fortis. Annual Report 2007, Banco Santander.
\(^{62}\) The Economist, March 27, 2008.
\(^{63}\) PWC, Canadian Banks in 2007.
\(^{64}\) See PWC Canadian Banks in 2007 and Credit Suisse analyst reports.
13 different securities systems in Canada, increasing the transactional costs, and leading to inconsistent investor protection. The last decade has seen a number of initiatives to harmonize the provincial regulation. At the same time, over the time the Toronto Stock Exchange has become the dominant stock exchange in the country, reducing the importance of other provinces and the need for harmonization. While the differences are not that great, the system would benefit from consistent regulation.

**Insurance**

Leading life insurance firms in Canada have developed more differentiated strategies, leading to several of them becoming global players. The life insurance firms have benefited significantly from changes in Canada’s regulations, which allowed them to convert into stock companies from policyholder ownership. In addition, large banks are not permitted to acquire or merge with large insurance companies.

The competition in the life insurance sector is strong, and includes a number of foreign players. Eight of the ten largest life insurers in Canada, ranked by total assets, are however, Canadian firms. 70% of them, when measured by total assets, are headquartered in Ontario.

From their strong domestic market presence and excellent financial performance, Canada’s largest life insurers have started expanding into the global market. Three Canadian life insurers are among the top ten in the world by market capitalization. Manulife Financial ranked 2nd by market value in 2006, Sun Life Financial, 8th, and Great-West Lifeco, 9th.

The domestic property and casualty (P&C) industry is less well developed, and has faced strong competition from foreign companies. The largest P&C insurer in Canada by 2005 net premium income is a foreign company. While shareholder returns are good, Canada has no internationally dominant P&C firms.

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70 Ibid.
71 Ibid.
**Demand Conditions**

Because the financial services industry relies heavily on local client-agent relationships, it is significantly influenced by the home demand conditions. In Canada, about a third of total wealth is invested in financial assets, and half of that goes into pension plans.\(^72\) Distribution of portfolios of assets and debt in Ontario tracked closely the same distribution in Canada.

Pension plans are major investment vehicles for Canadians. In 2006, they stood at approximately 100% to GDP (Burgess & Fried, 2004).\(^73\) The majority of pension plans are managed by banks. Until 1990, only 10% of pension plans could be invested in foreign assets. This cap was gradually increased to 30% in 2005, after which the cap was removed.\(^74\) The rational for such restrictions was to have tax-deferred savings invested in Canada.

Canadians spent C$360 per annum on financial services in 2006.\(^75\) This amount includes commissions and premiums that financial firms charged clients, rather than amounts of investments, which were given in the table above. Spending on financial services has been steadily growing since 1997.\(^76\) One of the key drivers for this was growing sophistication in using financial services on the part of customers.

For example, in 2003, Canadians made C$2.6 billion and C$1.5 billion debit and credit purchases, respectively, on approximately 30 billion transactions.\(^77\) Compared to other similar markets, the Canadians use debit card more frequently.\(^78\) The use of internet banking and online bank payments are particularly widespread in Canada as well.\(^79\)

**Related and Supporting Industries**

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\(^{74}\) Ibid.

\(^{75}\) Statistics Canada, http://www40.statcan.ca.

\(^{76}\) Ibid.

\(^{77}\) Ibid.

\(^{78}\) Ibid.

\(^{79}\) Ibid.
While financial firms are the heart of the financial services cluster in Toronto, they are intertwined in a network with other firms and organization, crucial for the cluster performance (see Exhibit 8). Particularly important are two groups of supporting industries – IT infrastructure, and knowledge and training.

The financial services industry relies heavily on the services of the IT infrastructure sub-sector, particularly for data routing across many networks, databases, and terminals, owned by multiple clients and operated by clients and agents with many levels of authorization. Additionally, this data routing needs to comply with data security standards set by the regulator and by industry’s client-agent requirements. Toronto’s financial cluster benefits from a very developed local IT cluster, especially in data processing, software development, and telecom. Toronto’s IT cluster is the third largest concentration of IT companies in North America, employing 100,000 people.80

As mentioned earlier, the presence of firms and organizations related to knowledge creation and management is crucial for financial services. Ontario is home to a number of leading universities, but also to industry associations and think-tanks, many of which provide training programs.

*Institutions for Collaboration*

A part of the cluster diamond, institutions for collaboration provide a self-regulating environment for managing many aspects of the industry. For example, the Canadian Payment Association is responsible for developing inter-bank payment standards, a common industry standard for transaction routing.81 Investment Dealers Association of Canada provides mandatory professional certification for securities brokers.82 Toronto Financial Services Alliance took on the role to promote Toronto’s financial services cluster and be a liaison with the legislator.83

A partial list of the most important industry associations in Toronto include: Association of Canadian Pension Management; Canada’s Venture Capital and Private Equity Association; Canadian

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80 Greater Toronto Information and Communication Technologies Industry Profile 2004, E&B Data.
81 http://www.cdnpay.ca/
82 http://www.ida.ca/
83 http://www.tfsa.ca/
Bankers Association; Canadian Institute of Chartered Accountants; Canadian Payments Association; Canadian Securities Institute; Certified Management Accountants of Toronto; Institute of Canadian Bankers; Investment Dealers Association of Canada; Investment Funds Institute of Canada; Pension Investment Association of Canada; and Toronto Financial Services Alliance.

III. Identification of Strategic Issues

Summary of Cluster Diamond

The analysis above has clearly detailed the issues facing Ontario’s financial services cluster, related to each of the four “corners of the diamond”. Before attempting to synthesize the issues, it is useful to summarize them:

Factor Conditions

+/- An exceptionally high proportion of workers in Toronto are in the financial services sector, many of whom have advanced professional certification. However, Toronto trails its competitors in terms of advanced university programs dedicated to finance.

+ Canada, and Toronto in particular, is an extremely attractive destination for immigrants.

- The tax regime in Ontario may present a barrier to attracting new financial services firms.

Strategy, Structure, and Rivalry

+/- The six major national banks compete intensely with each other. However, they are focused primarily on domestic markets, and are somewhat protected by regulation. This may account for higher profit margins, but may stifle true innovation. Analysts express the view that the lack of innovation manifests itself in low levels of product differentiation.

+/- There are a numerous new small securities firms appearing, but the securities sub-segment is still dominated by the major banks.

+ Ontario has several major life insurance companies, which rank among the largest in North America, especially after recent consolidation activity.
- Foreign competitors do not drive further intensity of competition, due to the many restrictions on foreign ownership of financial firms.

+/- Canadian banks have made some, albeit limited, inroads in entering foreign markets through acquisition, especially in the United States and the Caribbean.

Demand Conditions

+ The capital markets are very developed and rank among the best in the world. There is a long history of securities firms, and a long period of high growth of investment in Canadian assets driven by former rules requiring pension assets to be invested within Canada.

+ Stock market performance has been strong, and nearly all stock exchange activity in Canada is now centered on Toronto.

+/- The financial markets are “deep” but slightly less so than in the United States, both in terms of corporate debt and equities; consumer credit is also slightly lower.

+/- Overall, demand in all major financial products categories is high, but driven almost exclusively by local (and therefore limited) businesses and consumers.

Related and Supporting Industries

+ Most Canadian business and professional services, along with IT services, are concentrated in Ontario, whose quality of innovation and reliability is world-class.

+ Dozens of associations promote the needs of nearly every sub-segment of the financial services industry.

Synthesis of Strategic Issues

Clearly, Ontario’s financial services market is highly developed. The cluster has had solid but unspectacular performance for many years. However, with the increasing intensification of worldwide financial markets competition, it is critical for the industry to take strides that will allow it to compete more effectively on the global stage. Most of the specific issues identified above can be consolidated into
six major strategic areas. Recommendations to address these strategic issues can be found in Section IV (“Recommendations”).

i) **Competing Globally rather than Locally**

The Canadian financial services industry has been dominated by the six major banks. These banks not only dominate retail and commercial banking, but also securities and investment banking activity and trusts. Only the insurance sub-cluster has avoided the banks’ reach. The historically protective regulation has allowed the banks to earn large profits year after year, without a great need to consider whether they are particularly innovative compared to global financial firms.

The Canadian banks have made a few small acquisitions abroad, but have mostly avoided global competition. Banks have competed mostly in non-traded sub-sectors of the industry. In order for the cluster to be on the “technological frontier” – defining technology broadly to include products, distribution channels, processes, etc. – action must be taken to create an environment of innovation.

ii) **Win in Particular Sub-Segments**

While overall quality, depth and skills are excellent in Canada, comparable to the other G7 countries, Ontario’s financial sector is simply not large enough to realistically be an overall global leader (like New York or London). More manageably, Ontario’s financial services firms could “win” by focusing on specific sub-clusters, or certain types of services. Ontario could build on its excellent factor conditions and reputation to build an international competitive advantage in particular niches; firms (and supporting industries) could then focus on becoming globally competitive through targeted cost reduction and product differentiation. For example, one potential sub-segment where Ontario seems to be competitive is life insurance. Section IV (“Recommendations”) suggests additional potential niches.

When determining which niches to focus on, the government should be fairly agnostic; in other words, firms should be the ones driving better strategic differentiation. Firms should consider factors including underlying factor strengths and the competitive landscape when choosing sub-segments to prioritize.
iii) **Use Policy to Spur Innovation**

People often think of high-tech firms when they consider the importance of innovation, but success in the global financial services market is indeed driven largely by innovation. The top investment banks of New York, venture capitalists of San Francisco, and international retail banks of London all use financial innovation to secure their global prominence.

Defining the role of the government in driving innovation in the financial securities industry is difficult. Many industry observers focus exclusively on government’s regulatory role; in fact, the public debate in Canada about regulation has often been couched in a discussion about how the banks are too profitable! Instead, the driving force of financial market policy should be to encourage true innovation.

iv) **Scale**

All of the banks have been involved in some consolidation activity over recent years. However, the major six banks have not been able to merge with each other, and they have claimed that scale is a strategic priority. The obvious question is that if they require scale, why they would necessarily need to achieve it through domestic consolidation rather than acquisitions of foreign financial institutions.

v) **New Competitors**

New competition to Ontario’s financial services firms has come in two forms. First, there is an increased presence of non-traditional firms, such as Internet banks and non-banking lenders, which have very competitive cost structures. Second, many cities that have more recently risen to global prominence are attempting to become financial centers as well. Examples include Dubai, Singapore, Shanghai, and Kuala Lampur. Ontario/Toronto will need to be more aggressive than in the past if it hopes to be competitive beyond domestic borders.

vi) **National Conditions**

The analysis above demonstrated that the policy environment in Ontario is generally very strong, but the one major exception appears to be tax policy. An uncompetitive tax regime could undermine the rest of the region’s economic strengths if it deters entry and lowers margins.
IV. Policy Recommendations

The policy recommendations proposed here are intended to directly address the strategic priorities identified above.

TYPE I: Address general weaknesses in national diamond

The main policy recommendation for the government is to improve the environment by lowering taxes. Harmonizing securities regulation for all provinces may also lead to greater efficiency, but this is not a binding constraint.

TYPE II: Address specific weaknesses in financial services cluster diamond

i) Build on strength of specialized skills with university programs and recruiting campaign

Ontario should fund more specialized, advanced degree programs at Ontario colleges and universities. The provincial government, to whom the responsibility for education funding and policy falls, should work with industry to fund the types of programs that are most practically relevant and in demand.

Canada should use its “points-based” immigration system to attract immigrants with specialized skills in the financial sector. Again, business should have strong input so that government can be responsive to their needs. Canada can stress the high quality of life and lower cost of living than New York or London to potential financial professional recruits. Canada should also adopt an automatic visa program for graduates of MBA/finance programs of certain top universities abroad.84 This recommendation has particular urgency now, with the US cap on H1B visas forcing many highly skilled global professionals to seek employment elsewhere. Canada should aggressively target those who are denied H1B visas—it is a lottery system, so a denial does not speak to a lack of desirability.

84 The United Kingdom has a similar program in place.
ii) **Encourage innovation by supporting research and by exposing firms to foreign competition**

Innovation will clearly be a key to any global aspirations of Canadian financial services firms. Competitiveness is driven, in the end, by firms, and Canadian financial sector firms need to develop more unique positioning to compete globally.

The federal government should endow new research chairs in Canadian universities dedicated to financial sector innovation. Private sector players should take part in the selection and direction-setting advisory board.

Finally, innovation can be spurred by allowing more foreign entry. Indeed, the federal government has already begun to ease foreign entry restrictions, and should continue to do so going forward.

iii) **Continue to take strides to improve the general business environment**

Tax rates have been identified as the major negative factor in the business environment. The federal and provincial governments should fund a benchmarking project to see which parts of the tax code are uncompetitive versus other rival financial services centers, then lower taxes accordingly.

iv) **Demand sophistication**

Demand is fairly sophisticated today, but true sophistication will only come if financial firms have the courage to expand abroad and compete internationally. There is only so much demand that Canada’s small population and business community can ever provide.

Government procurement may be able to play a minor role as well.

**TYPE III: Improve strategic competitive positioning**

v) **Support industry-led sub-cluster “niche” initiatives**

The analysis above showed that focusing on particular sub-clusters is necessary if Toronto (and Ontario) wishes to be a true global leader in financial services. Differentiation and specialization are clearly lacking. The government should avoid “picking winners”; instead, it should help sub-segments of
the cluster identified by the firms that will need to implement the competitive strategies. More specifically, the government should create a new program whereby it commits to research funding, export promotion, and university program funding for a certain number of sub-segments, and have a clear, transparent process to choose from the applications submitted. Niches may be traditional sub-segments of the financial services sector, such as life insurance, or more creative areas, such as financial services for energy and natural resources (see below).

A task force should also be created to explore the idea of Toronto as a hub for outsourced financial services. The combination of high skills and lower costs (relative to the US and UK) might make Toronto a natural place for less “glamorous” financial services functions that other firms can “outsource”.

vi) **Consider question of scale, and what firms truly need**

The federal government should reconsider its stance towards bank mergers. If the banks are repeatedly expressing the view that they need more scale to compete globally, then it is hard to argue that the government should continue to block their strategies. On the other hand, domestic industry consolidation has extremely limited scope; at most, two major mergers may be possible. Firms would have a much greater chance to achieve scale, and true global competitiveness, by increasing acquisition activity abroad.

vii) **Develop specialized products for energy, natural resources**

Just as financial intuitions in California were at the forefront of the development of oenological financial products, so should the Canadian financial sector develop specialty products designed for the company’s energy and natural resources industries. The Toronto Stock Exchange (TSX) and TSX Venture Exchange have already moved in this direction, with more than half of the 3,800 listed companies in natural resources industries (especially mining, oil & gas, forestry). With the enormously growing demand for both energy and natural resources, especially in developing countries, this may be a
high-growth niche particularly well-suited for Ontario’s financial sector firms. The absence of a Sarbanes-Oxley equivalent makes Toronto’s stock exchange even more attractive to foreign firms.

\textit{viii) Life insurance}

Given their size and importance to the financial sector, most of the effort on how to improve the competitiveness of Ontario’s financial cluster has been traditionally focused on large banks. Meanwhile, two of Canadian life insurance companies have made it to the top 10 companies worldwide. More focus should be given to building on this strength. The insurance sector lacks studies on competitiveness and benchmarking. This can be done through an industry association or through cooperation with the provincial government. The goal would be to determine best practices, disseminate the knowledge and address weaknesses that are holding the rest of the insurance sector behind.

\textbf{V. Conclusion}

Ontario, as the largest province in one of the world’s richest countries, is well suited to being a center of financial activity. Ontario has a long history of successful financial firms, a highly skilled and specialized labor force, a strong business environment, world-class infrastructure and numerous supporting industries and institutions. However, while Ontario’s financial services industry is strong globally by nearly any metric, it is not a leader in any sub-segment. By adopting some of the recommendations presented in this paper, the industry may be able to improve its competitiveness over time and realize its full potential as a global financial hub.
EXHIBITS

Exhibit 1

Real GDP growth per person (%pa)
Source: Economist Intelligence Unit

Exhibit 2

Origins of GDP
Source: Economist Intelligence Unit
Exhibit 3

Canada Cluster Map, by Employment, 2007


Exhibit 4

Canada Cluster Map, by Exports, 2005

Exhibit 5

Total Shareholder Return, Banks, 2001 - 2005 p.a. (%)


Exhibit 6

ROE for life insurers, by company, 2001-2005 average

Net Profit Margin, RoA and RoE, 2008

Exhibit 7

Source: Assessing Toronto's Financial Services Cluster, Institute for Prosperity and Competitiveness, 2007; Institute for Competitiveness and Prosperity; CFA Institute; Institute for Strategy and Competitiveness.

Exhibit 8: Cluster Map
Exhibit 9. Ontario’s Financial Services Cluster Diamond

Factor Conditions

+ High proportion of employment
+ High number of industry-certified workers
+ Attractive for immigrants
- Insufficient specialized graduate university programs
- High marginal tax rates

Demand Conditions

+ Highly-developed capital markets, especially due to pension assets
+ Strong stock market
- Lower level of corporate debt and equity issuance
- Pension asset deregulation is a threat
- Lower credit card penetration

Related and Supporting Industries

+ Business and IT services are concentrated in Ontario
+ Developed university and research systems and facilities

Demand Conditions

+ Very strong rivalry between six major banks
+ Proliferation of small securities firms
- Little foreign competition
- Domestic competition focused on retail products
- Low level of product differentiation

Firm Strategy, Structure, and Rivalry
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