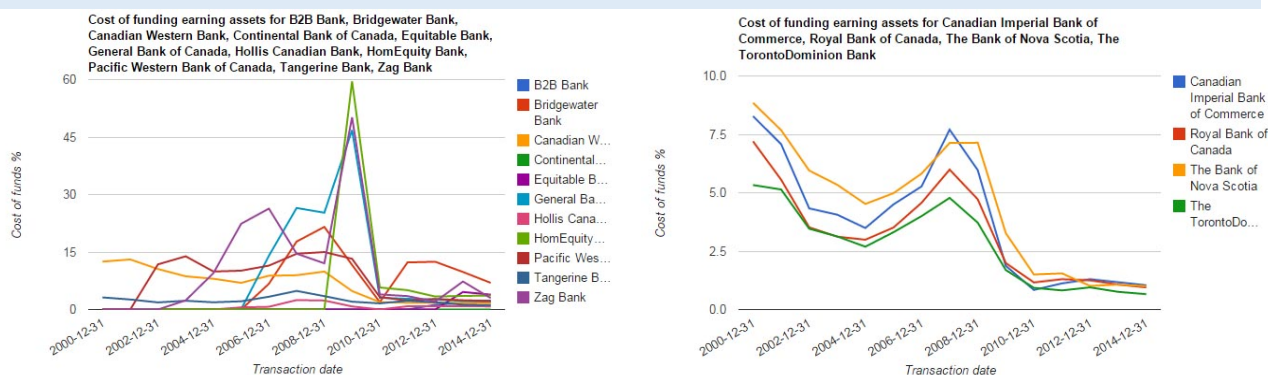


This report looks at Canadian challenger banks (apart from merchant led banks) and explains why they have not threatened larger institutions. It also looks at ways in which these upstarts have achieved success.

These days it is common to hear talk about challenger banks being able to provide the same or better services. For example Stephane Dubois, CEO and founder, Xignite, says that “the biggest premise underneath Wall Street is also being challenged: that it has to be run by a set of gigantic highly leveraged, highly centralised, too-big-to-fail, century-old institutions to even work. New technologies have simply shattered that assumption with the unbundling of the bank as obviously the first step.” (Dubois, 2015)

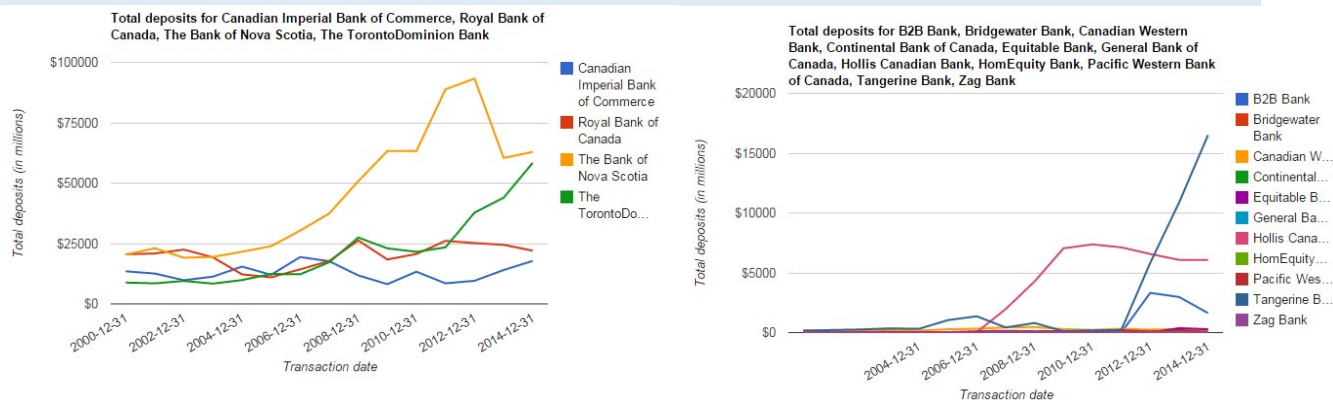
A problem with Dubois’ statements is that data from a selection of small Canadian banks comparing them to larger FIs do not support Dubois statements. Here is what the data has to say:

COST OF FUNDS SIGNIFICANTLY HIGHER FOR CHALLENGER BANKS



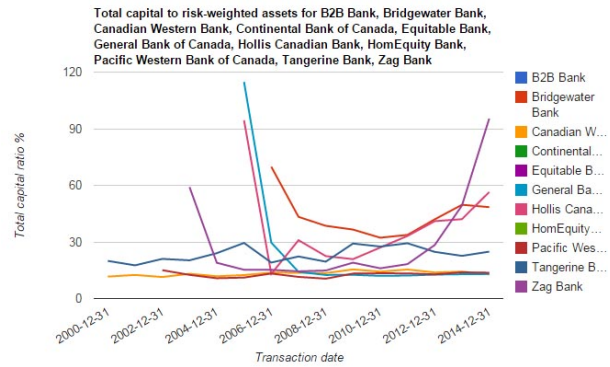
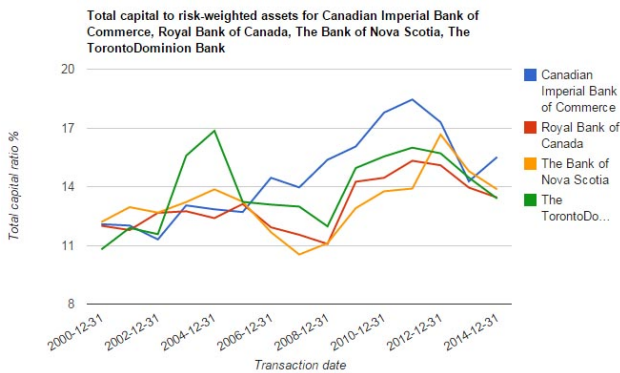
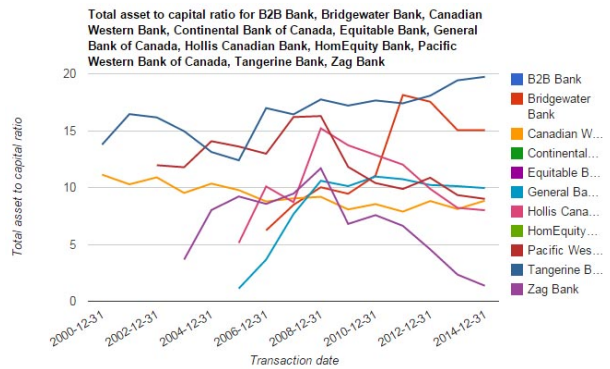
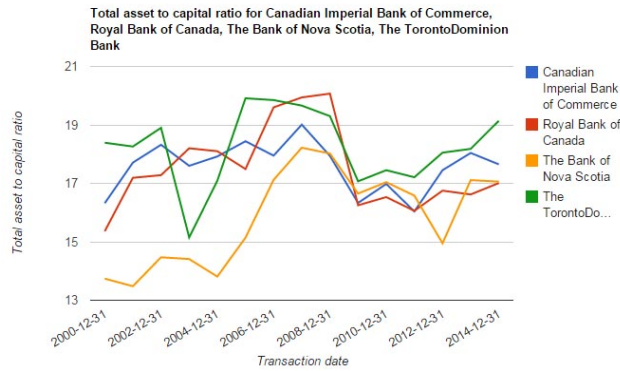
The exceptions being small banks owned by larger ones. Tangerine bank for example, enjoyed a cost of funds of 1.13% versus Pacific Western Bank, an independent bank, which paid 2.22% on average for its deposits in 2014.

DEPOSIT GROWTH GENERALLY LOWER FOR CHALLENGERS

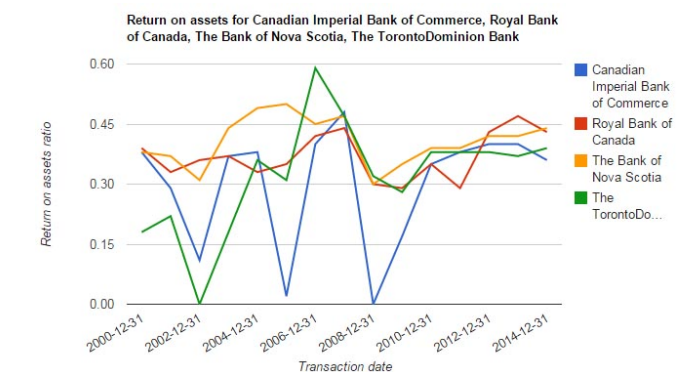
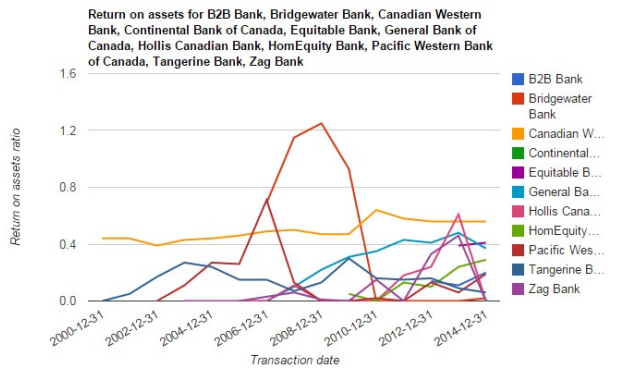


CHALLENGER BANKS NOT A THREAT TO BIG BANKS

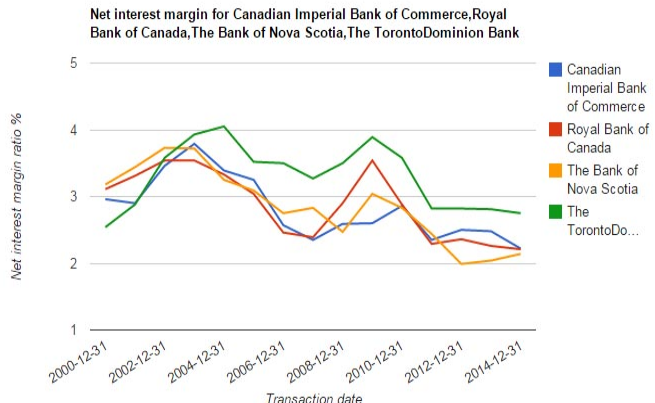
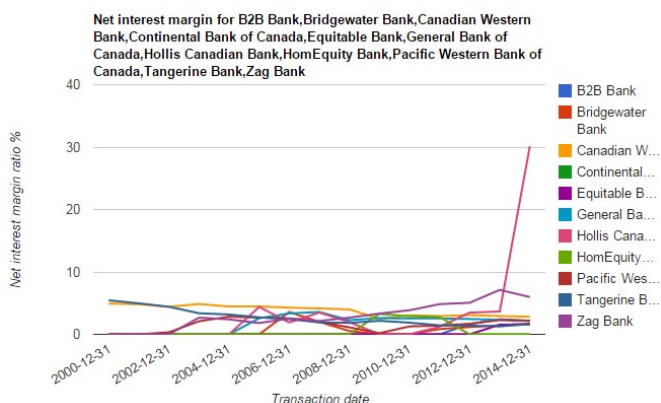
CAPITAL ADEQUACY RATIOS HIGH FOR BOTH



RETURN ON ASSETS (ROA) AND RETURN ON EQUITY (ROE) SIMILAR BUT LOWER FOR CHALLENGERS

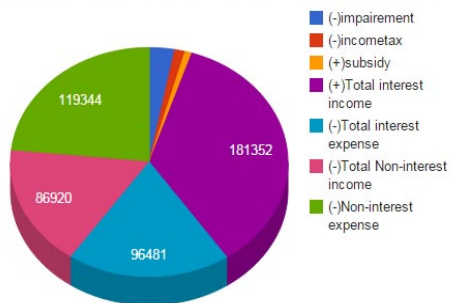


NET INTEREST MARGINS (NIM) LOWER FOR CHALLENGERS

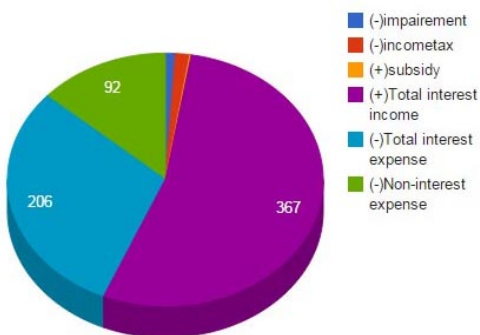


INCOME DISTRIBUTION EXAMPLE

Net income distribution for Canadian Imperial Bank of Commerce



Net income distribution for HomEquity Bank

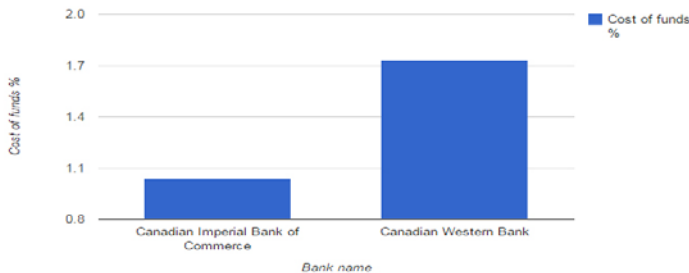


The pie charts to the left offer a visual representation of the impact of interest expense versus interest income.

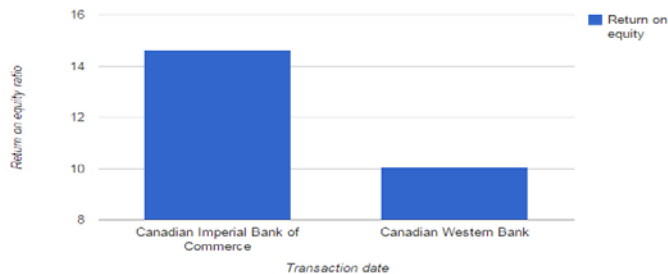
COMPETITIVE ADVANTAGE IMPACT

The impact of this can be seen in the income distribution comparison between a lower performing large bank (CIBC) and a higher performing small bank (Canadian Western Bank).

Cost of funding earning assets for Canadian Imperial Bank of Commerce, Canadian Western Bank



Return on equity for Canadian Imperial Bank of Commerce, Canadian Western Bank



COMPETITIVE ISSUES

One argument assumed by people like Dubois is that technology and more compelling product offerings can allow challengers to level the playing field: to open the door for competition. For

Net Interest margin for Canadian Imperial Bank of Commerce, Canadian Western Bank

example, a common perception is that virtual banks automatically reduce costs or offer consumers better services or a better deal. The [facts, as argued in a previous report](#), demonstrate that this has not worked in practice. For example, in a recent report examining the impact of bank fees on account switching, challenger banks in the UK had not made a significant impact on the market. Research shows that challenger banks have a combined market share short of 10%, despite favourable switching offers. Meanwhile, in Canada, evidence from J.D. Power indicates that competitive fees are not required to keep existing clients. (Sibthorpe, 2015)

It seems clear that challenger banks must overcome two fundamental problems in order to compete:

1. People do not switch banks easily;
2. Challengers must find a way to reduce their costs of funds.

CHALLENGER SUCCESS

With respect to the 2nd challenge, Pacific Western Bank (PW Bank) has made inroads with insolvency practices (IPs) that now total 45. IPs use PW's services to improve efficiency and, in exchange provide low cost deposits. PW are also currently exploring other niche deposit markets that may also prove to be attractive deposit sources. These kinds of initiatives are bearing results, as indicated (in part) by net income increasing 22% over the previous quarter and 70% over the same quarter last year.

SUMMARY

Attractive switching offers and technology are not enough to threaten large banks. Therefore, in order to out maneuver the large banks, challenger banks must have innovative strategies as shown by PW Bank.

Data and charts provided by www.banknews.tv analytic services

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Dubois, S. (2015, July 15). The Now, The Cloud and the Crowd: What is Shaking Wall Street to Its Core? Part 2. *Bobsguide*.

Sibthorpe. (2015, June). OVERVIEW OF BANK FEES IN CANADA, THE U.S. AND UK MARKETS. *BankNews.TV*.