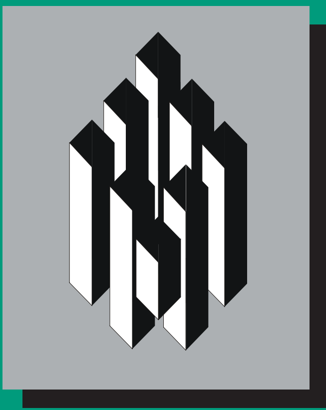

C.D. Howe Institute

Backgrounder

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Bank Mergers

Why We Need Them, How to Get Them

David Bond

The Backgrounder in Brief

The financial services sector, especially banks, is so central to our lives and well-being that any breakdown in its operation can send a tidal wave through the economy. Yet for most of Canada's history, it has been the plaything of governments, intent on using the sector to meet the demands of special interests. In the 21st century, government will have to allow banks and other financial institutions to take actions — including mergers — that are in their shareholders' interest.

About the Author

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It is a service so central to our lives and well being that an interruption in its operations can send a riptide of disruption through the economy. Yet throughout Canada's history, it has been the plaything of governments, concerned less with enhancing its stability than making it dance to the tune of special interests, particularly in the last decade. Now, the financial services sector, especially banks, and the federal government face a time of reckoning. Several of the big banks would like the option to merge to enhance their competitiveness, without the heavy hand of government making the process so cumbersome that it becomes self-defeating. The federal government, however, is still unwilling to let market forces alone determine the feasibility of any merger or takeover proposals, without resort to politicians' special interests. This *Backgrounder* reviews the history of government regulation of the banking sector and recommends that Ottawa adopt a policy that would preserve its public-policy objectives without blocking rationalization of the banking system.

The banking industry plays a vital role in facilitating a prosperous economy. At its core, the sector must be efficient, stable and innovative, enabling payments to be made with ease and at minimal cost, while wealth is held in secure and stable institutions and excess cash balances can be made available to credit-worthy projects to enhance capital investment and economic expansion. Public policy in this area should be consistently aimed at enhancing the system's efficiency, without hindering its ability to innovate in a prudent and consistent fashion when responding to changing market realities.

Moreover, a prosperous and competitive financial sector will generate substantial direct and indirect employment for banks, as well as for lawyers, accountants, software engineers, printers and others. Because of the public-goods nature of the services provided by the sector, devising a public-policy environment that facilitates its growth is critical — but it is not an easy task. To avoid unintended distortions, policy should be even-handed in its treatment of the various component parts of the sector, while focusing on regulations to ensure stability and security.

Policy should avoid loading the sector with additional regulatory burdens that other parts of the economy are not required to meet. Placing arbitrary directives upon all or parts of the financial services sector in response to special interests carries with it an implicit, if not explicit, distortion of the rational allocation of resources. And these distortions can have a far-reaching impact on the development of the system and the national economy.

These are the essential points that the *Backgrounder* takes into consideration when reviewing the reports of the Senate Committee on Banking, Trade and Commerce (Canada 2002) and the House of Commons Finance Committee (Canada 2003a) — prepared after a request from the Minister of Finance to study the public-interest implications of large bank mergers —- as well as the government's response (Canada 2003b).

Both reports — particularly the House committee's study — convey the impression that responding to special interests is more important than enabling

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the banking sub-sector to prosper in a rapidly changing world. The government's response has a similar tone. As well, at first blush it would appear that only the most desperate of bank CEOs would ever attempt a merger because of the various hurdles, which include a requirement to issue a public-interest impact statement to hearings by the House committee, before approval can be granted.

On the face of it, both committees espoused the belief that mergers are a legitimate business strategy. The Commons committee, however, unlike its counterpart in the Senate, recommended for itself an integral part in reviewing any merger proposal, supposedly with the object of protecting the public's interest. This process makes merging a political lottery, not a business strategy.

Mergers Can Enhance Profitability

Because Parliament granted banking charters until 1981, banks have always faced the question of the degree to which political interference would affect their daily business; over the last century that interference has grown relentlessly.

In 1900, banking legislation was almost exclusively focused on what banks could not do, from granting mortgages to providing what we now refer to as consumer loans. The purpose was to protect depositors and the holders of bank notes (the most common form of currency prior to the establishment of the central bank in 1935) from suffering a loss. The prime objective was system stability and liquidity, not the attainment of social objectives.

Politics, too, has long had a major role in banking. Political considerations led Sir Thomas White to reject the proposed merger of the Royal Bank of Canada and the Bank of Hamilton in 1915. In that case, the Hamilton City Council condemned the merger and some of the journalists of the day started a crusade to stop a Montreal firm from acquiring an Ontario-based bank (the Royal Bank's headquarters were in Montreal at the time). Overlooked were the interests of the shareholders whose capital was at risk in both institutions; the future of the Tory government was at stake and no merger took place.

Political considerations also were a significant factor in the decision of then-finance minister Paul Martin to reject out of hand the bank merger proposals of 1998. With an eye on the leadership of his party, he did not wish to alienate the Liberal backbenchers who opposed the mergers for a number of reasons.

Market Solutions Are Preferable

Over time, and most particularly since the revisions to the Bank Act in 1968, banking legislation became ever more directive in what banks were required to do. The traditional lament of agrarian interests that access to credit was inadequate and that credit granters were insensitive to local concerns was augmented by similar complaints from small- and medium-sized businesses, women's groups, aboriginals, the handicapped, those with low incomes and other groups. Government, in responding to these concerns, increasingly decided that market solutions were inappropriate, possibly because using direct government action and spending taxpayers' funds would require justification and engender accountability as to their success.

Consider, as one example, the provision of minimal banking services to those with low incomes. In Canada, moral suasion, in the form of threatened legislation, forced the banks to provide this service at a loss. Constitutional considerations help explain why not all deposit-taking institutions were covered by federal banking legislation. For example, credit unions are provincially chartered. But that is all the more reason for using some alternative, as was done in the U.K., to provide access to the financial system for low-income people.

In the 1990s, the British government asked for bids on the provision of accounts to lower-income earners, assuming that because such accounts would benefit the nation as a whole, the widest possible tax base should be involved in funding the service — in preference to a *de facto* tax on bank shareholders. No bids were forthcoming and, as a result, the government began negotiations with the banks to find some solution to the fact that an estimated 1.4 million households did not have access to a bank account. This was especially problematic when the government proposed to begin direct payment of pensions and other benefits.

The final solution consisted of two options. Individuals can open a basic bank account accessible through a bank branch or the Post Office. These accounts have no overdraft provision, although account holders may have access to direct debit, as well as standing orders. Alternatively, a person can have a Card Account with the Post Office into which benefits will be paid and from which a person can make withdrawals or credit-balance inquiries. No other funds can be paid into the account and cash can only be obtained at a Post Office branch.

The state of New York used yet another approach that, in essence, requires all deposit-taking institutions that are insured by the Federal Deposit Insurance Corporation to offer an account (only one per individual state resident) with a monthly service charge of less than $3.00 for a maximum of eight transactions per month, unless the institution should wish to offer more.

It can be argued that because they are the beneficiaries of federal regulation and deposit insurance, Canadian banks should pay for providing low-cost accounts. That ignores the fact that deposit insurance was not instituted at the request of the banks. Rather, failures in provincially supervised deposit-taking institutions in connection with the Atlantic Acceptance scandal in 1964–65 pushed the federal government into providing such a facility, with the banks paying the majority share of the costs for such a system.

Contrary to widespread belief, providing a minimal banking service is not without costs. Funds allocated to providing it are not available to other sectors — rural Canadians, the handicapped, small business, women, and others — and that usually means either higher costs or a smaller supply than might be the case without such constraints. Some of the costs will be borne by the shareholders, but the exact split is, of course, a function of the bargaining power of the banks *vis-à-vis* their clients. (Evidence as to which alternative strategy is the most efficient has not been gathered and this task certainly lies beyond the scope of this *Backgrounder*.)

Top Heavy with Conditions

This trend toward mandated activity might have reached its zenith with the revisions to banking legislation in 2001. But the special interests continue to increase in

number and in their demands. Some groups appearing before the House committee hearings, for example, expressed concern that mergers would lessen the support banks provided to charities. Others said they feared that any divestitures to foreign or non-deposit-taking institutions would diminish the ability of the government to compel the banks to respond to their demands. The dominant theme was that there should be a free lunch for these special interests and that it should be paid for by bank shareholders as a condition of being allowed to merge.

Whether it is maintenance of rural branches, access to credit for small business or maintenance of current employment levels in the banking industry, the House committee made clear that it will attempt to ensure that a procession of social goods is accommodated in any merger. In short, maintenance of the status quo at a minimum, and preferably the provision of greater numbers of socially desirable services at a net cost to bank shareholders, will be a condition of approval of any merger. The committee saw no inconsistency in setting conditions on a merger which, to all intents and purposes, offset any economic benefit from such an action. Like an over-loaded cargo plane freighted with something for everyone, such mergers may just be too heavy to take off.

Overcoming Barriers to Entering the 21st Century

Nearly everybody appearing before the committees declared in favour of increased competition in banking services and nearly everyone felt that new entrants would build or acquire extensive branch networks. The implicit assumption was that branch networks are essential to gaining market share for new entrants and hence for increased competition. Most chose to ignore the technological advances that have occurred in the past 30 years.

In the period between 1900 and 1920, the number of branches per 10,000 people rose steadily to 5.46. Many communities of less than 100 had a branch and scores of only modestly greater size had two or more branches. That made entry by new competitors extremely difficult since the ability to attract new business was limited. For a new firm, tying up capital in opening a sizable branch network almost guaranteed low earnings for a considerable number of years, and investors willing to wait that long were few and far between.

While the number of branches per 10,000 has been declining (it is now 2.8), the fact that Canada still has a high number of branches per capita compared to any other jurisdiction — except perhaps Scotland — has been the trump card for the established banks in protecting their turf from new entrants. Overcoming this barrier to entry costs money and takes a long time. That is why new banks have not rushed to enter the industry, even when the regulatory environment was favourable. This was amply demonstrated when the Canadian market was opened to foreign banks in 1981: the foreigners stuck to the cities and devoted little effort to building branch networks. Today, HSBC is the lone overseas-based bank with an extensive branch network and the bulk of that was acquired when it purchased first the assets of the Bank of British Columbia and then Lloyds Bank (previously Continental Bank).

Since 1981, the costs of building a physical branch network have not diminished: if anything, the start-up costs per branch have risen. A full-service

branch now costs around $800,000 or more to open, and even converting an existing branch to a new owner costs more than $500,000. (One big expense is integrating the computer systems.) There may be some institutions with sufficiently patient owners willing to invest large amounts of capital in building or acquiring a branch network, but one would have to be exceedingly optimistic to base government policy on such an assumption. If Ottawa wants to ensure widespread competition, the federal government must find new entrants that can compete on a more level playing field with the established institutions. Encouraging further investment in an already exceptionally dense branch system is surely not the answer. In fact, some disinvestment in branch networks is now essential to a healthy financial services industry.

The quandary for the large nationwide institutions is that the trump card which has precluded entry of new competitors for more than 80 years is now very expensive to maintain. There is a misallocation of capital in that too much of it is devoted to the branching effort relative to the returns the networks yield. But if any one bank were to unilaterally reduce the number of its branches, it would be giving up market share. Reduced market share could well lead to rising costs of overhead per dollar of assets, squeezed margins and a potential lower rate of return on capital. These, in turn, would make it all the harder for the bank to raise additional capital.

Banking sector advocates of mergers, such as the Bank of Nova Scotia's CEO, Peter Godsoe, say that the reason for merging is to create a platform from which "to diversify and grow outside of Canada." Yet surely there is more to the story. Banks want to merge to rationalize the domestic market by reducing the number of branches and, inevitably, the number of employees. This does not mean, however, that new entrants would or should rush in to occupy abandoned branches since the capital costs are so high. Moreover, in the event of a merger where duplicate branches are sold to other institutions there would still be no change in the total capital tied up in the branch network. Instead, there would be a redistribution of capital, with no efficiencies for the system as a whole.

The special interest groups are, of course, opposed to rationalization. The 20 percent of the population living in rural Canada appears to believe its banking services should be subsidized.[1] Many labour groups still believe the problem facing Canada is a labour surplus, rather than a labour shortage and, as a result, any reduction of employment in the banking sector is anathema. In short, many groups say bank shareholders should accept a lower rate of return, and the House committee seemed to agree with this philosophy. Put another way, the politicians and interest groups enjoy spending other people's money, especially when they are not required to justify the expenditure rigorously or be accountable for the results. It is worth noting that by mandating such activity the beneficiaries have no choice.

What to Do?

In the current political situation, it appears that frustration will be the lot of both the consumer seeking better and lower-cost financial services and the bank shareholder

1 See, for example, Task Force on the Future of the Canadian Financial Services Sector (1998, 165); and Federation of Canadian Municipalities (2002).

seeking an improved return on investment. It is unlikely that new bank competition will appear to provide a wider range of choice to consumers, though other existing financial institutions may well enter new markets. Economically sensible bank mergers will be precluded because they are almost sure to result in costs to some special interest group. What is the board of directors of a major bank to do in these circumstances?

One would expect the banks to limit investment in Canada, where returns are distorted and concentrate investment abroad, in the U.S. particularly, where the expected return on capital is higher. While head offices will remain legally in Canada, increasingly the cutting-edge portion of the business will move to the U.S. Within 15 years, Toronto will have roughly the same importance in the North American financial firmament as Des Moines, Iowa, now enjoys. As a result, much of the business generated by head offices, from legal services to accounting, and from printing to software development, will increasingly go elsewhere. The ripple effect on the economy of Toronto will be negative — and enormously so.

There is, however, an alternative policy prescription that will achieve a more rational allocation of capital and costs, while at the same time promoting increased competition.

First, Let the Government Purchase Social Goods

All of those groups that have pushed so ardently for the interests of their members must believe that a redistribution of income from bank shareholders to them is of benefit to the entire nation. Why, then, do they see fit to put the bulk of the cost of meeting those demands upon one particular group — bank shareholders — rather than on the widest possible tax base?

Socially desirable special services could be put out for bid by the government, with the taxpayers funding whatever the net cost may be; or the government could provide direct payments to particular groups, allowing a choice as to how the benefit could be spent. Such a course of action would require strict accountability to the public as a condition of subsidy, and there would be public pressure to forego the provision of a service if costs proved to be unjustifiable. Additional benefits to a broad section of the population would result from a more efficient allocation of capital as hidden subsidies in the form of higher costs and reduced output of other types of banking services were discontinued.

An added advantage of having government directly subsidize the desired services is that it obviates the need for the complex set of regulations and new bureaucratic structures that flowed out of the 2001 revision to banking legislation.

Second, Open the Doors to Competition

To spur competition and break the logjam caused by the branch network, banks should be allowed to merge with each other or with insurance companies on condition that they agree to make their automatic teller machines (ATMs) fully functional. Full functionality means that anyone owning a bank card with any bank would be able to use any bank-owned ATM to do whatever they can do with the ATMs of their own institution.

Full functionality is essential to enable new deposit-taking entrants to collect deposits. Without that facility how are deposits to be received? ING, the virtual bank, permits mail-in deposits or electronic transfer from existing accounts with other banks, but that is not timely and requires two banks' accounts. Full functionality of the bank-owned ATMs would mean that any new bank entrant would immediately have more than 16,000 locations where its customers could deposit funds, obtain funds, pay bills and transfer funds between accounts. Apparently, the government did consider the question of full functionality in drafting the revisions of legislation in 2001 but rejected it on the basis of complexity. The fact that full functionality is available with at least one network already, The Exchange Network, apparently escaped its notice. (I am grateful to one reviewer for the information that the government at least considered the idea of full functionality.)

With full functionality, telephone and direct mail solicitation by new entrants could result in a substantial increase in competition. After all, MBNA Bank used those very methods to gain the most lucrative 10 percent of the Canadian credit-card market. With full functionality there would probably be new mono-line institutions such as MBNA as well as full-service institutions available wherever there was a connection to the internet or an ATM.

Government should enable the big banks to rationalize the branch network through mergers, while stifling their power to curb entry of new competitors. Put another way, the 21st-century equivalent of a branch is an ATM, so let us use that technology to push the Canadian banking industry into the world of global competition.

An added benefit of this policy would be that the drift of head office activities to the U.S. might be arrested or even reversed. Merged institutions with lower overhead costs would find it cost-effective to keep head office activities in Canada. While expansion abroad, particularly in the U.S., might continue, the reduction in the high costs of doing business in Canada would make domestic investment more attractive. Indeed, with increased competition the new merged entities might well find it imperative to devote greater attention to the domestic sector.

Conclusion

Having the government purchase social goods, allowing competition in banking and developing full functionality is a simple and effective solution to the merger issue, and it will ensure that government will not pander to special interests by using bank shareholders' money; rather, the special interests will have to prove the merit of their case during the annual budget allocations within government. At the same time, government will have to allow banks to concentrate on their primary roles of providing a safe place for holding excess funds, for providing payment services and providing finance, rather than working on the government's social agenda. This rather radical course of action may have limited political payoffs. It would, however, make Canada a more prosperous nation.

What's wrong with that?

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