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Communiqué

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Cost savings, local markets, regulatory package are key bank merger issues, say participants in debate

The debate on proposed mergers of several large Canadian banks is the subject of a *C.D. Howe Institute Commentary* released today.

The *Commentary* identifies questions over whether large cost savings related to size are realizable with bank mergers, whether nonbank financial institutions and foreign banks can provide new competition in local markets, and what kind of regulatory package may accompany approval as key issues determining whether Canadians will benefit from the proposed mergers of the Royal Bank of Canada with the Bank of Montreal and of the Canadian Imperial Bank of Commerce with the Toronto-Dominion Bank.

The *Commentary*, entitled *The Changing Rules of the Money Game*, provides a summary of a C.D. Howe Institute roundtable discussion on August 26, 1998, involving more than 30 financial industry participants, legal experts, economists, and analysts. It was edited by William B.P. Robson, a Senior Policy Analyst at the Institute.

On the question of the economies of scale and scope that exist in banking, and how readily exploitable they are, many participants in the roundtable described the gains from spreading the cost of large information-technology investments over larger numbers of customers and transactions. Others noted a variety of additional ways in which greater size can lower costs and enhance services. Others, however, pointed out that the empirical record is mixed. Several participants stressed that size can be an obstacle to effective management, and noted the problems of merging organizations with different infrastructure, staff, and customers — particularly if the mergers were accompanied by new regulation.

When it comes to competition, the group identified as key concerns the possible limiting of choices for depositors and reduction of the number of lenders, especially for small businesses. Some participants argued that new forms of service delivery and new sources of credit are emerging quickly in any event. Others urged that policies to encourage new competition should accompany the mergers. And still others doubted that new providers would be willing or able to step in.

One policy question that arose repeatedly in the discussion was what kind of package might accompany a decision on the mergers either way. Several participants argued that approval would likely be part of a package to enhance competition, both from domestic nonbanks and from foreigners. Others, however, expressed concern that approval might bring with it additional regulations in areas such as fees and lending, which — by imposing new burdens on nonmerging institutions, including potential new competitors — would reduce competition.

Not surprisingly, the core conflict over the desirability of the proposed bank mergers made consensus on many of the issues impossible. While there are grounds for believing that mergers could lead to lower-cost and better-quality services to customers, there is clearly no guarantee that any particular merger would do so. The Competition Bureau and the minister of finance face difficult choices: how far into the future to look in judging the capacity of new services and providers to make financial services markets more competitive, and how to balance the costs of reduced competition in some markets with merger-related benefits in others. One strong theme emerging from the discussion was that all industry participants, whether or not they were involved in potential mergers, have looked harder at their own operations, markets, and competitors since the mergers were first proposed. Whether or not the mergers proceed, this re-evaluation promises an even faster pace of innovation in the sector in the future.

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The C.D. Howe Institute is Canada's leading independent, nonpartisan, nonprofit economic policy research institution. Its individual and corporate members are drawn from business, labor, agriculture, universities, and the professions.

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The Changing Rules of the Money Game:

Proceedings of a Roundtable on Canada's Financial Industry after the Bank Merger Proposals

edited by William B.P. Robson

The announcements earlier this year of a proposed merger between the Royal Bank of Canada and the Bank of Montreal (BMO) and between the Canadian Imperial Bank of Commerce (CIBC) and the Toronto-Dominion Bank (TD), sharpened the focus and changed the tone of the ongoing debate over the future of the Canadian financial industry.

Financial services in Canada and around the world have evolved since the mid-1980s. This transformation has been spurred partly by technological developments that have increased consumer options and opened up new opportunities for better and lower-cost services, and partly by increased competition as barriers among countries and among different types of financial service providers have come down. By confronting Canadians simultaneously with the promise of a more efficient industry and with the threat of a more concentrated market, the bank merger proposals have raised to acute levels the hopes and fears associated with these longer-term trends. Whether the mergers go ahead, and what conditions might be placed on them if they do, has become a test case for determining the future direction of financial services in Canada.

In an attempt to shed light on the forces behind the proposed mergers and the stakes involved in the decision to allow or prevent them, the C.D. Howe Institute convened a roundtable on August 26, 1998, inviting a number of financial industry participants, legal experts, economists, and analysts to share their views. This *Commentary* presents a survey of opinion expressed at the session. Its purpose is to draw out the issues as seen by the participants, highlighting areas of consensus and disagreement and, thus, potentially to narrow the range of issues in dispute.

The Institute is grateful to the roundtable participants for allowing their views to be reproduced here. It should be emphasized at the outset that these opinions are those of the participants themselves. They should be attributed neither to the Institute nor to its members.

Summary

The participants in the roundtable first addressed the context of the proposed mergers — the forces behind the proposals, the political environment, the competition issues, and the impact of the debate over the mergers on financial institutions themselves. The discussion then turned to the implications for financial institution operations, for customers and competitors, and for policy — both in the event that the mergers go ahead and in the event they do not. Finally, the participants addressed some overarching issues: whether the merger discussion has forever changed the industry; whether, in view of growing competition from abroad and from other sectors, the bank mergers really matter; and whether other policy changes that could accompany approval of the mergers might promote an unhealthy entanglement of government in the financial industry.

In talking about the forces behind the mergers and the stakes involved if they do or do not proceed, participants repeatedly brought up the question of the economies of scale and scope that exist in banking, and how readily exploitable they are. Many participants described the gains from spreading the cost of large information-technology investments over larger numbers of customers and transactions. Others noted a variety of additional ways in which greater size can lower costs and enhance services. Yet the empirical record is mixed. Several participants stressed that size can be an obstacle to effective management, while others noted that it would be hard to merge organizations with different infrastructure, staff, and customers — particularly if the mergers were accompanied by new regulation. There are many grounds for believing that mergers could lead to lower-cost and better-quality services to customers. But there is equally clearly no guarantee that any particular merger would do so.

The political and legal questions that bear on the mergers' chances of approval are closely tied up with their consequences for competition in various markets. The group identified as key concerns the possibilities that the mergers would limit choices for depositors and reduce the number of lenders, especially for small businesses. Some participants argued that new forms of service delivery and new sources of credit are emerging quickly in any event. Others urged that policies to encourage new competition should accompany the mergers. And still others doubted that new providers would be willing or able to step in. In part, the choice facing the Competition Bureau and the minister of finance in thinking about the mergers is how far into the future to look in judging the capacity of new services and providers to make financial services markets more competitive, and, in part, how to balance the costs of reduced competition in some markets with merger-related benefits in others.

From a broader perspective, the participants questioned whether the contrast between the rapid pace of change in the financial industry and the more leisurely pace of policymaking was a problem. The group generally shared the view that Canadian firms need to move quickly to keep up in the competitive race, but it split over

whether the result of a more deliberate policymaking pace was going to be worth the wait or whether, in the long run, some of the near-term policy decisions really matter at all. One policy question that arose repeatedly was what kind of package might accompany a decision on the mergers either way. Several participants who favored the mergers argued that approval would likely be part of a package to enhance competition, both from domestic nonbanks and from foreigners. Others, however, expressed concern that approval might bring with it additional regulations in areas such as fees and lending, which — by imposing new burdens on nonmerging institutions, including potential new competitors — would reduce competition.

Not surprisingly, the core conflict over the desirability of the proposed bank mergers made consensus on many of the issues impossible. Out of that dissonance, however, emerged one strong theme: all industry participants, whether or not they were involved in potential mergers, have looked harder at their own operations, markets, and competitors in the months since the merger proposals. Whether or not the mergers proceed, this re-evaluation promises an even faster pace of innovation in the sector in the future.

The Context

The Inspiration for the Mergers

Paul Labbé:

I come to this issue concerned as a customer, as a competitor, and as a sometime partner of the Canadian banks. I am also deeply concerned about the Canadian economy and about Canadian public policy towards financial institutions. We are reasonably well served by banks in Canada, but basically we have an oligopoly that is not customer oriented, that is defensive, that is not internationally oriented, and that does not fully reflect where the Canadian economy is going. The banks lack depth in international banking. They are out of sync with the Canadian corporate customer base.

I believe the mergers should go ahead. If they did, however, control of over 60 percent of deposits and assets in Canadian banks would be affected. In view of that level of concentration, Canada requires more foreign competition, because no other Canadian institutions are ready to step in — we don't have second-tier banks in Canada. We need to have a more open market, open to competition and to foreign banks. If we had more competition, banks would be more responsive to customer needs. We should bite the bullet and deal with financial sector reform, decide what the ideal structure ought to be in Canada, and then move aggressively on that basis.

John McCallum:

I would like to ask Paul Labbé what restrictions on foreign banks he was referring to.

Paul Labbé:

There are all sorts of subtle things — to do with size, access to the payments system, Interac — barriers that make it difficult for foreign competitors to break into the Canadian market. Those things are removable.

Box 1: *Roundtable Participants*

Thomas Kierans, C.D. Howe Institute (Chair)
James C. Baillie, Tory Tory DesLauriers & Binnington
David E. Bond, David Bond and Associates
Laurence Booth, University of Toronto
William T. Brock, The Toronto-Dominion Bank
Hugh Brown, Nesbitt Burns Inc.
Paul Cantor, The Toronto International Leadership Centre for Financial Sector Supervision
Jack L. Carr, University of Toronto
Thomas Connell, Standard & Poor's
Lawson Hunter, Stikeman, Elliott
Warren J. Jestin, Bank of Nova Scotia
John A. Kazanjian, Osler, Hoskin & Harcourt
William Knight, Credit Union Central of Canada
Robert Korthals
Paul Labbé, Citibank Canada
Claude Lamoureux, Ontario Teachers' Pension Plan Board
Ted Mallett, Canadian Federation of Independent Business
Brad Martin, Fairfax Financial Holdings Ltd.
John McCallum, Royal Bank of Canada
A. Warren Moysey, First International Asset Management Inc.
Edwin Neave, Queen's University
Tim O'Neill, Bank of Montreal
John Pattison, CIBC
Frank Potter, Emerging Markets Advisors Inc.
Neil Quigley, Victoria University of Wellington
Margaret Sanderson, Charles River Associates Incorporated
Helen Sinclair, BankWorks Trading Inc.
Ken Slemko, Government Policy Consultants
Dominique Vachon, National Bank of Canada
Michael Wenban, The Monitor Institute
Greta Wemekamp, Canada Trust
Larry Wynant, University of Western Ontario

Dominique Vachon:

Bank mergers are not inevitable. The only thing inevitable is competition. We should beware of any claim that the US situation is comparable to that in Canada. In the United States, mergers are to achieve lower unit costs for delivering services. They are geographically extending their networks and increasing the number of products and services delivered in one of the most fragmented markets in the world.

Laurence Booth:

Banking in Canada is already very efficient. The US banks are merging because their system is less efficient. They are catching up to us, not we to them.

Warren Jestin:

In the United States, the leading profit and growth performers are banks with lower merger activity — banks which have grown internally — not those banks which pursue an aggressive merger strategy.

The Political Environment

Ken Slemko:

The minister of finance is taking a tough stand on the mergers because he realizes that the issue is the fundamental capacity of Canada's financial system to serve Canadians. The process the minister has put in place is designed to air all of the major issues surrounding the mergers. That process will include the MacKay Task Force report, the Ianno Committee report, the Competition Bureau report, the House Finance Committee report, the Senate

Banking Committee report, the Department of Finance's assessment of the public policy issues, and OSFI's [the Office of the Superintendent of Financial Institutions] assessment of solvency issues.

We expect the minister will then ask the banks how they plan to deal with those issues. Meeting the minister's challenge may call for major modifications in three areas — retail banking, credit cards, and retail brokerage — and require further delays.

Is there a politically acceptable way out? Entry barriers could come down further, but will this add much to competition in the short term? Could the merging banks sell parts of their business to new or existing competitors to ensure that, post-merger, key financial markets remain competitive? The final shape of Canada's financial sector is anything but clear at this point. All indications are, however, that the solution that best meets the broad array of public policy objectives will also be the right political answer.

John Kazanjian:

The public's interest is broadly sourced — virtually everyone is a financial institution customer, all of us rely upon the predictability and soundness of the financial system, and one in two households directly or indirectly owns bank shares. The public's general perception of banks other than their own is, however, somewhat negative. There is a long-standing perception that banks are more "them" than "us," and mergers in any industry make people feel powerless.

The key government decisionmakers dealing with the mergers are elected and accountable. No one can realistically expect them to act without knowledge of or reference to public attitudes. On the other hand, the public's and the international financial community's more fundamental expectations are that the government's merger decisions should be reasoned, informed, credible, and responsive to the long-term interest of the country and its financial system.

The government has at least positioned itself to meet these expectations. In only a few months, the minister will have before him the Bureau's letter on competition, the House Committee report based in part on its exploration of public attitudes, the Senate Committee report based on its experience and expertise, the Industry Canada e-commerce and technology-related legislative package, as well as the views of his own department. From then on, it would be difficult to explain further waiting, or a "maybe someday if" answer that would delay or complicate implementation processes that, for business reasons alone, are likely to be long and challenging.

James Baillie:

The federal Task Force is already on record in its July 1997 interim report with its views on mergers. That report states that it does not apply to Schedule I banks, but the logic of the analysis seems to me applicable. I doubt the final Task Force report will make any specific recommendations about the two proposed mergers — more likely, it will build on and expand what was said in July. I hope there will be a good discussion of a key issue not canvassed in the interim report — namely, whether it is advantageous for Canadians to participate in global financial markets through Canadian-based institutions.

What May the Competition Bureau Do, and Why?

Brad Martin:

My experience with the Competition Bureau is that it does not say "yes" or "no." There is a spectrum from "yes" to "no" because of the nature of the review. The Bureau will slice and dice the market, advise the parties of the areas of concern, and then negotiation will begin.

I believe the Bureau's decision will not be entirely clear, but will come closer to the "no" end of the spectrum, for three reasons. First, I note the initial skepticism about what were supposed to be the most powerful arguments of the banks for the mergers: foreign competition and new technology. The Bureau will be focused on the here and now. Second, I see a general stiffening of resolve in the face of the wave of mergers. Third, the Bureau will be frugal in its analysis and in its interpretation of what "substantial lessening" of competition means.

What does it mean to be closer to "no" on the spectrum? The Bureau will test the banks' pain threshold in terms of the number of undertakings it will ask from them — both in terms of conditions and time.

Margaret Sanderson:

The Bureau's emphasis will be on whether the mergers are "likely" to lessen or prevent competition substantially. In the United States, there are so many bank mergers that there is almost no analysis undertaken: if a merger will push concentration past key thresholds, the banks will show up with a remedy. Branch divestitures are a standard requirement. In Canada, the Bureau has a detailed analytical framework for applying its general "Merger Enforcement Guidelines to a Bank Merger," which were just released in July. This is the framework which will be applied to the proposed mergers before the Bureau now, and any future merger proposals.

In short, they will focus on whether pricing will increase and whether service levels or quality will decline. One key issue here is the importance of electronic delivery of banking services and whether this will reduce the importance of branch banking for retail and/or small business customers. Another key issue is whether existing regulatory restrictions on competition are having much effect: if we remove restrictions on foreign banks, for example, will there be a great increase in competition?

If the Bureau gives a conditional "yes" to the mergers, the normal pattern would be for it to negotiate remedies with the banks to alleviate the competition concerns or for the case to go to the Competition Tribunal, either on consent proceedings with a negotiated remedy or on a contested basis. But in this case, the minister of finance has the power through the *Bank Act* and through section 94 of the *Competition Act* to approve the ultimate mergers. As a result, the Director of Investigation and Research, Konrad von Finckenstein, has stated that, given the role of the minister of finance, he will make his initial competition findings known to the parties and also to the minister, in November 1998. The minister of finance may also step in with additional demands on the banks quite apart from those related to competition. The Director of Investigation and Research has said that it is not prudent for the Bureau and the banks to negotiate any remedies unless the banks know what else is out there beyond the competition issues — unless they know what the various committees studying this issue will say and what the minister will say. The minister of finance has said that it will be a frosty Friday before he would overrule a negative finding from the Competition Bureau (but there are a lot of frosty Fridays in Ottawa). It is not so clear how ready he would be to overrule a positive finding.

As for the Tribunal, I believe it is unlikely that the merger decision will go to it. Since the minister has the power under the *Bank Act* to approve or disapprove any bank merger, I think it is more likely that any competition or other public policy concerns will be addressed by the parties prior to closing and hence it is unnecessary to proceed to the Tribunal. If the minister of finance does provide approval conditional upon certain competition issues being addressed post-closing, this allows a role for the Tribunal. However, I would suspect that this is not very desirable either for the banks or for the minister, as it would open up the entire approval process again to intervenors and other interested parties.

Tim O'Neill:

There are a number of difficulties facing the Competition Bureau. There are data gaps in market areas and product definition. To include nonbank competitors in any evaluation, you need accurate data, which they often do not have. Thinking about the medium- to longer-term future rather than only the past is not part of the Bureau's normal approach. Finally, the Bureau will examine efficiency gains as well as competitive impacts from the mergers. Efficiency gains constitute the practical assessment of the existence of scale and scope economies from the mergers.

Robert Korthals:

It would be ludicrous for the Competition Bureau to ignore trends in banking, such as reduced use of branches and declining reliance on bank accounts for anything beyond transactional banking, in arriving at its decision.

Dominique Vachon:

Although Canada could not do without alternate distribution networks, particularly those using information technology, these networks operate in narrow product niches such as non-transaction deposits or mortgage loans. They often serve as a less costly information link, but they are based essentially on a low value-added client relationship. That is why, when you analyze competition in the banking sector, you can't accord these networks the same importance as branches. Branches use an integrated approach when serving their clients, and focus on an advisory relationship.

Lawson Hunter:

We tend to make this too complicated. I think the Bureau will have a few issues that it will look at. It will focus on defining local markets. The question there is: will it treat financial services the same way it treated gasoline? It will focus on relatively few products, such as lending to small businesses. There will be some overarching issues, such as technology and efficiency, but they will just add flavor to the decision, not shift the balance crucially one way or the other.

Warren Moysey:

Selling branches to competitors rather than closing them might not be so bad if only the bricks and mortar were mandated to be sold. But the government might view selling or divesting branch customers along with the branches as a way of maintaining sufficient competition. If it does, it would put quite a dent in the positive economics of the proposed mergers.

Jack Carr:

Who owns customers? If, say, the Bank of Montreal had to sell MasterCard, would the purchaser get the customer list? It's not so easy to sell customers. Selling bank branches is not like selling gas stations.

Margaret Sanderson:

If the Competition Bureau embarked on that, it would look to the extensive US experience on divestitures. The big complicating factor here is that there are two simultaneous transactions. In, say, the retail setting, who is going to be forced to sell when two competitors are disappearing?

William Knight:

Isn't it a question of who is going to buy?

Warren Jestin:

Selling a branch is an extremely difficult option, and not just because it involves telling customers they will have to deal with another institution. Customers don't like being told to switch. Cross-marketing, the seller's ability to solicit and to get back into profitable relationships with divested customers — all of this reduces the value of a particular branch to the buyer. To make it a viable alternative, an entire region or product line would have to be divested. But even with this approach, you face the same concerns about the re-acquisition of divested customers.

How Has Merger-Related Thinking Affected Managers of Financial Institutions?

Michael Wenban:

Merger-related thinking is a pervasive influence on management — not just recently, not just for financial institutions, and not just in Canada. This thinking comes in waves, and Canada is a trailing market, not a leading one, so it is instructive to watch what others are doing. Outside Canada, there is no consensus on economies of scale versus economies of scope. Multiple approaches are evident, and the benefits for customers are not clear. An institution's competitiveness derives from its positioning — where and how to compete — and its capabilities relative to competitors. Mergers are one means to align those. How that affects competitive advantage depends on the performance of five types of managed assets.

Starting with financial assets, capital market stakeholders value growth, particularly predictable growth. They expect to see capital fully deployed, or returned. Typically, they ascribe greater value to near-term savings than to longer-term revenue enhancement. They view markets as increasingly homogeneous, and shakeouts as efficient. Often they anticipate geographic growth out from strong home bases. Banks face higher return expectations and are concerned at being left behind in productive deployment of capital: in-market deals look like safer bets.

With tangible or physical assets, one issue is the best use of existing assets. Branches are not an ideal platform for future distribution channels — new selling and relationship-management approaches. Another issue is amortizing infrastructure costs over more transactions and more revenues.

Managing human assets is more difficult for larger institutions. Customers expect personalized service and "empowered" employees. Developing the customer asset is hard: relationships with customers are fragmenting.

Then there are knowledge assets. Customers themselves are becoming more sophisticated. They want unbundling and rebundling of products, and advice. Banks need to use information about customers to lower cost and increase loyalty. But the links to size are unclear. Success in cross-selling is often elusive. The lack of branding in Canadian financial services is striking.

Management of social assets involves relationships with the media, government, regulators, communities, and so on, trading off economic, social, and political considerations, and managing a multiple-stakeholder dialogue. This is arguably where managers have failed the most.

Dominique Vachon:

Merger-related thinking has had a profound effect on managers. In fact, we at the National Bank of Canada realized that we did not know the Canadian financial industry as well as we thought and that we had misread how other major institutions perceived the strengths and challenges of our industry. For sure, everyone knows that National Bank is a small bank. But the outcome of merger-related thinking is that our managers feel more comfortable now than ever before with the size of their bank and with the strategic decision made a few years ago to decentralize its organizational structure.

Greta Wemekamp:

At Canada Trust, we have gone to some lengths to isolate all the speculation regarding the bank mergers from day-to-day operations. Given all the uncertainties as to whether the proposed mergers will be turned down or approved and when they will be completed, it is too early to change direction, to change strategies for lines of business or products, and it is dangerous to distract management from running the business.

We have identified the types of management challenges which Mike Wenban just mentioned. We were focusing on them before the proposed mergers and will continue to do so.

We do have a small group of people who monitor, think about, and plan in regard to the bank mergers. Our major concerns lie in the area of the conditions which might be imposed on approvals. We would expect to see some level of divestiture to remedy Competition Bureau concerns. What worries us are the political conditions which might also be imposed. For example, if the merging banks are required to maintain a freeze on service charges, how do competitors respond? What impact does that have on them? We would also be concerned if additional regulation were placed on the entire industry — for example, community reinvestment regulations or additional privacy regulations.

Paul Cantor:

It is not only an academic debate anymore: everybody is reviewing their strategies. Even those opposed have re-evaluated their own organizations with a greater sense of urgency than they otherwise would have done.

If the Mergers Proceed

Implications for Bank Operations If the Mergers Proceed

Warren Moysey:

The August 19 *Globe and Mail* reported that Fred Lazar of York University had written a report suggesting that more than half of the branches of BMO and TD will exceed the Competition Bureau guidelines for market concentration, and that approximately 300, or 25 to 30 percent, of the BMO branches and approximately 200, or 20 percent, of the TD branches will be closed. This is really not a problem if you accept the analysis by Professors Mathewson and Quigley,[1] which suggests that retaining customers and reducing costs in part through branch closures are a prime rationale for mergers. After all, this is where savings to fund investments in technology and elsewhere come from.

If the proposed mergers were in Europe or the United States, the CEOs involved would, quite aggressively, tell analysts, the press, and others that what the British call "cost-save" was a major reason for the merger. The dollars involved are massive: Mathewson and Quigley estimated $1 billion in the case of the BMO / Royal merger, assuming the cost-save of 20 percent was achieved. Unfortunately for the shareholders and customers in Canada, I think all of this 20 percent would not be achievable because the politicians would, to quote Mathewson and Quigley "entangle the business of banking with social policy and the redistribution of income." A major operational question, then, would be to comply with the constraints on the mergers, whatever they are going to be, while still attaining some cost saving.

Human resource issues are probably an equally critical area. Wells Fargo didn't get this right in its acquisition of First Interstate, with the result that it lost 1 percent of its customer base per month for something between 12 and 18 months. Cultures are different in each of the proposed merger partners. Intensive efforts would be necessary to blend these diverse cultures so that the change looked seamless to the customer: you don't want your customer to walk because personnel in the merged bank are disgruntled and inward-looking.

Hugh Brown:

From the point of view of the financial community, if this was California, we'd assume 20 percent cost savings; if it was Russia, we'd assume zero; in Canada, we assume 10 percent. So the marketplace realizes, and has priced in, that a 20 percent cost saving would not be achieved by the banks and that a 10-percent saving is more realistic. But the market *does* expect the benefit of the other half.

Helen Sinclair:

Information technology represents opportunities for merging banks. But it also presents them with a major management challenge. The most immediate is the ability to integrate financial reporting and risk management. This integration must effectively be in place by the actual date of a merger.

US experience has set very high expectations as to how quickly systems can be merged. Good regional banks can do it in six months in the case of acquisitions of smaller entities; for larger banks, the expectation is that the integration can be done in 18 to 24 months.

The major Canadian banks all have patchy legacy systems which run on inflexible mainframe computers and which are poorly integrated across products. There are theoretically three integration strategies. One: throw the old legacy systems out and install new integrated and customer-centered systems — the kind you would adopt if you were building a bank from scratch. Two: compare the merging banks' respective systems and, for each product grouping, adopt one of the two. Three: run each bank's systems in parallel for a period of time, with middleware bridges linking them and supporting integrated reporting. The second option has been the one generally adopted by most merging US banks, particularly where one is clearly the acquirer.

In Canada, the merging banks tend to be of comparable size, each with different strengths and weaknesses in the systems area. I expect the banks will start off with going with option three — that is, bridging mechanism, particularly with respect to data-intensive systems. This approach will minimize the impact of the mergers on internal computer resources as the banks focus on Y2K issues.[2] It will also allow them to maintain different brands of similar products — for example, the CIBC Aerogold and TD GM Visa cards. Good middleware tools are readily available to allow organizations to cleanse, label, and merge data for purposes of internal and external reporting. This approach prepares them for the eventual adoption of newer, open-systems platforms.

Implications for Customers and Competitors If the Mergers Proceed

Edwin Neave:

I want to approach the implications for customers and competitors by asking a number of questions about the effects on competition, and how competition could be enhanced. Merger impacts are most likely to be manifest in local, not national, markets. Partly, this is because deposits and loans remain the most important financial products for households and small businesses, even after recognizing the phenomenal growth of mutual funds in the past decade. Both households and business usually purchase a cluster of products and services from their local depository institutions.

As far as households go, mergers leading to branch closings would reduce the effective number of competitors in local markets, but this impact might be offset by foreign competition, new forms of delivery, or both. New competition has recently appeared in the form of ING Bank, MBNA, Newcourt Capital, Wells Fargo, and other providers. Deposit brokers and Internet services such as Imoney now provide ways of comparison shopping that may grow in importance. Will the *Interac* decision lead to more nonbank entry via ATMs, for ING, for example? In Canada, electronic retail payments grew from nothing to more than a third of the total in just five years. In Britain, the traditional banks have lost nearly £6 billion in one year to supermarket banks. It is not clear how new forms of competition will affect the Canadian picture longer term, especially if new legislation permits banks to be owned by nonfinancial institutions. The effects of branch closings could also be reduced if banks used mobile officers, as does the Canadian insurance industry and the New Zealand banking industry, as Mathewson and Quigley note. We need to get a grip on these issues before answering questions on price and availability.

In dealing with small business, we should distinguish between the lending of working capital, in which business the banks are in, and the supply of equity, which is not the job of banks. Is there any reason to suppose that providing working capital would be more difficult after mergers? Loss of a growth-oriented local banker can sometimes present significant problems for small businesses, and the reduction of branches in a local market might adversely affect the provision of some small business operating credit. New providers such as Wells Fargo Bank's remote forms of credit approval might increase the competitiveness of this market.

Larry Wynant:

The mergers would produce gainers and losers, but the market should decide which are which. There are three reasons to merge: (a) global presence; (b) economies of scale and scope; and (c) size by itself conveys advantages in some markets such as corporate, treasury and trading and in some retail categories such as mutual funds.

There would be gains for some customers as a result of the mergers. These include lower spreads and fees, which have come down with more competition and efficiency. We would have improved worldwide competitiveness, particularly in relation to the United States. There would be better distribution systems and electronic services, an area in which we are already world leaders. And shareholders would gain.

There would be losers as a result of mergers. Access would be diminished in some markets — for example, rural customers. But how big an issue is this? There are other banking options available to serve those markets. There would be fewer choices among banks, which would affect rural / retail customers and SMEs. But, again, is this really a problem?

Dominique Vachon:

Canadian banks are universal: full-service banks with important economies of scope but no economies of scale beyond the size they have all already reached. The present banking structure is efficient, as is reflected in prices for financial services compared with those in other countries. An appropriate starting point for evaluating the consequences of the mergers is to recognize that we have an efficient organizational structure in a market that is already very concentrated. There is good reason to question the impact on the Canadian economy of such a sudden and extreme increase in the concentration of the banking sector.

Canadian banks play a crucial role in financing the country's small and medium-sized businesses. Their market share is not shrinking: it is very large, especially in the case of commercial operations that require considerable sharing of information between the client and the lender. Small business financing requires sharing the same culture. That is why there is no real substitute for the banks in financing small and medium-sized businesses Canada-wide, and even less so in the various geographic regions. Moreover, the larger the banks, the more centralized their structure and the less they are involved in small business loans. Concentration in the banking sector as a result of mergers could therefore seriously curtail the financing accessible to small and medium-sized businesses.

William Knight:

Customers are also consumers of other products, and they are also voters. Michael Wenban made a reference earlier to managing the social asset as against the need to be competitive in global markets or to get economies of scale. We must talk in the context of the payoffs for individual Canadians from mergers. What would it mean if major financial institutions merge to compete in a global market? Nobody has defined this for Canadians. Would it mean that the Royal Bank, say, is going to be offering domestic banking services to Americans?

We finished some survey research last week. We were taken aback at the level of hostility towards financial institutions. People seem to be a bit schizophrenic on this, since they continue to use the services. But it looks like a challenge if we're trying to build a world presence on a Canadian base. Canadians have been asked to go through a lot of changes over the past few years, and banks were leading supporters of many of them. Where is the payoff? The lack of answers to the question of payoffs for voters from a number of significant, fundamental changes poses the risk that government will move to impede otherwise desirable changes in firm structure.

Must we allow the move so that our institutions are not acquired by foreign buyers? Will changes in rules lead in fact to more competition? Will Canadians honestly see a reduction in service fees? No one is convinced that they're going to get dividends, and that is in danger of stopping the whole process. With due respect to the Competition Bureau, Finance Minister Paul Martin has all kinds of customers, which equals voters, out there. The lack of a perceived payoff may lead to a "no" from the finance minister.

As for competitors, this is an opportunity to get our act together, to get synergies and cost savings. It is a golden opportunity to talk business with our first cousins, like the Mouvement Desjardins, about positioning ourselves in the marketplace. For a long time, credit unions were the "pet rock" of the financial sector: people liked having us there because it made it look as though there was competition. We had 7 to 8 percent of the market; 13 to 15 percent including Desjardins. Now some of the operations have grown to a size where they are big competitors in some areas. They're now a pet rock that some institutions want on their shelves.

Trusts have traditionally been viewed as "alternatives" but not competitors. This is changing as their market share comes to seem more important to larger competitors looking for more customers over which to spread their costs. So they have a short-term opportunity — 18 to 24 months — to become ready to enhance their capacity to deal with enormous, consolidated competitors who are trying to eat their lunch.

John McCallum:

The most important question is the payoff for customers. This is a tough sell because the payoffs to the consumer from the mergers are future-oriented while the person listening to you is thinking about today. What are these payoffs? One: improved products through technology investments — some faster than otherwise; others that wouldn't have been done at all. Two: lower costs — 10-percent savings, say — that would be shared with consumers because of competition and commitments. Three: better ability to serve rural customers with a single institution because of increased capacity. Four: a stronger platform in North America and around the world, which would be better for serving small business in their global business arrangements.

Larry Wynant:

Aren't customers also bank shareholders? Evidence is strong that shareholders had a positive reaction to the merger news, and the analysts have unanimously agreed that there is a favorable outlook for merged share values. It looks a good bet. For bank customers as shareholders, banks with their large market capitalization are a critical component of their financial futures.

William Knight:

Consumers tend not to see themselves also as shareholders. Their pension fund holds the shares. There is no perceived correlation between benefits as shareholders and perceived costs as customers, and Canadian consumers still see themselves as customers. The fact that people do not relate to themselves as shareholders was one of the reasons why we were taken aback by our survey results.

Hugh Brown:

Price of bank shares rose 20 percent relative to the market following the merger announcements. Three-quarters of that runup had nothing to do with merger expectations. As of today [August 26, 1998], they've fallen 20 percent, three-quarters of which had nothing to do with the mergers. The world out there is a dramatic and violent place, and banks are a highly leveraged way of looking at the Canadian economy. People have exaggerated the impact of the mergers on share prices.

Implications for Policy If the Mergers Proceed

James Baillie:

Addressing the topic "if the mergers proceed" enables me to assume that two events will have occurred, because I believe both will be linked with an approval. The first is completion of what might be a very difficult negotiation over commitments the banks will be required to make as the price for approvals. The second is announcement of a package of other developments — for example, approval of demutualization of life companies, providing more than $10 billion of new wealth for Canadians and enhancing the competitive strengths of the companies involved; expanded access to the payments system, enabling a range of financial institutions to develop new products and increase their customer service; implementation of the delayed legislation to make more flexible the regime for entry of foreign banks, perhaps amended to be even more accommodating; and — I hope, but this is probably less likely — some relaxation of our regulatory requirements to allow more structural flexibility without detracting from prudential regulation, the prime example being to allow holding companies for federally regulated financial institutions.

In this context, I see several implications for banks and their customers, for the financial system, and for the Canadian economy as a whole.

Some changes for banks and their customers might take awhile because of focus on Y2K issues and internal organizational arrangements. In addition, commitments in consequence of the negotiations could affect organizational adjustment and customer relations. Certainly, the emphasis on technology is likely to be greater in the merged bank environment. Canadian banks left out might seek alternative arrangements, perhaps mergers with nonbank financial institutions or with foreign banks. I think the government is likely to be receptive to these transactions and to modify the 10-percent restriction on share ownership to accommodate them. This might well have an impact on Canadian banking in the same realm of magnitude as the mergers.

For the financial system, the impact of the new regime is likely to become apparent more quickly with nonbank institutions — the demutualizations would have a major impact, and the new products available after payments system entry is expanded should have a high profile. The sector would be even more of a free-for-all than today — everyone into everyone else's territory — complete abandonment of the four pillars. Restructuring would continue and even accelerate. The barbell structure shaping many elements of the economy — a few large institutions, together with a number of niche players, in each area of activity — would become more apparent.

Among the wider implications for the Canadian economy, the public debate surrounding the bank mergers should help move Canadians towards recognition of the reality of globalization. I'll end on a note of optimism. Perhaps in combination with the fall of the dollar, the public debate surrounding bank mergers and globalization issues will make us realize how badly we need policy changes to make us more internationally competitive. The tax regime, privatization policies, farm product marketing boards — the list goes on. My optimistic and perhaps naive hope is that the process unleashed by the bank mergers will help bring us to the reality of needed change in these areas.

Warren Jestin:

I disagree with Jim Baillie. It is not true that government must accept the mergers if it wants Canadian banks to be global players. You don't need to be a megabank to be successful in global markets. In fact, we already have several Canadian bank success stories. There is TD's discount brokerage operation, already the third-largest in the world. And Scotiabank's success in the US loan syndication market, where we're consistently in the top ten. The reality is that, even with the proposed mergers, Canadian banks are not big by international standards. Citi / Travelers, Bank of America / NationsBank — both with market caps of roughly $200 billion — are larger than the entire Canadian financial services sector. Yet even these banks focus and specialize — they pick niches, like Citicorp's global credit card operations, and obtain success there.

Hugh Brown:

There are big risks in implementing changes, but there are bigger risks in not allowing the financial services marketplace to change with the rest of the world — in not changing with the times. Anyone who thinks you can sit around and do nothing for two years is running a dangerous policy. We just have to look at other countries to see the costs of trying to live in the past.

John Pattison:

Hugh Brown's comments remind me how few countries have done a good job of regulating the financial sector. Think of the US Glass-Steagall Act and France with the Crédit Lyonnais situation. An exception is the United Kingdom, where the sector is perceived as comprising profit-oriented commercial enterprises, and regulation is considered in the context of welfare costs for the whole clientele. We have to reflect on the cost to the country of the politicized regulation of financial institutions.

Ted Mallett:

Looking at the international experience, small business is widely acknowledged to be among the sectors most at risk. Business owners themselves sense this: in a recent survey compiling 11,700 CFIB [Canadian Federation of Independent Business] member responses, 68.4 percent opposed the bank mergers while only 19.6 percent supported them. The policy implications are chiefly related to competition and the ability of the chartered banks to fulfill their role to facilitate production and trade throughout the economy. A series of policy questions arises.

How would a decision on two merger proposals affect the environment for future mergers? If two can merge, then what would stop further concentration from occurring? Would natural barriers become stronger, or would policy barriers be necessary?

Allowing foreign banks to enter the market is seen by many as a necessary conjoint to domestic bank mergers. But what would be the optimal timing — before or after? What could be possible chain reactions? What sub-markets would foreign banks enter? How rational is it to expect that a national credit union or the Business Development Bank could ramp up in the short term?

Technology is seen as a way to introduce banking efficiencies, but what indirect effects could it have on the economy? More "formula" lending could increase the likelihood of wholesale withdrawals from markets or regions. Would fewer banks expose the economy to high risks associated with bad banking decisions on massive loans?

What would be the effects of reduced competition on interest rates, service charges, and loan availability? Banks would continue to demand the ability to offer more financial services through their branch networks. What impact would that have on tied selling? Would merged domestic banks in international markets generate more wealth for Canadians than joint ventures?

For the SME [small and medium enterprise] community, the debate hinges on the competitive makeup of the Canadian domestic banking system and how that would change under a merger scenario. In a system that is already oligopolistic, SMEs have a hard time believing that their interests would be forwarded by fewer institutions.

Tim O'Neill:

The payoff for customers depends on whether by "being globally competitive" we refer only to operations abroad or, rather, to competing effectively in domestic markets with foreign institutions. We are arguing that increased size is critical to being able to compete domestically. If the strategy of increased size for domestic competitiveness is inappropriate, this will create opportunities for competitors to gain market share.

Robert Korthals:

What is missing in Canada is a "prime-plus-three" market for lending to small business. In my last years in the business, the banks matched each other so closely in each market that no one could win or break in. The merged banks won't have management that can cover all markets, so there will be big opportunities for specialists and new entrants like Newcourt.

Warren Jestin:

The reluctance of US banks to enter the market may have more to do with the fact that Canadian spreads are lower. Prime in the United States is two percentage points higher than in Canada. Do we want to widen Canadian spreads by two percentage points in order to attract new foreign competition? I don't think Canadian consumers and businesses would welcome this as a solution to the lost domestic competition resulting from the mergers.

If the Mergers Do Not Proceed

Implications for Bank Operations If the Mergers Do Not Proceed

David Bond:

The mergers could be stopped either because the minister of finance simply says no or because they are approved but with conditions that would obviate any of the potential benefits that would flow from the mergers.

In the first case, an outright rejection, the message would be clear. Investment in banking in Canada would be forced to earn a lower return than other types of economic activity. Shareholder value would only be enhanced by concentration of investment outside Canada. Consumer welfare in Canada would be diminished, a major economic activity in Canada would be stifled in attempting to reach its full fruition, and the economic Luddites would have triumphed. The basis of the decision would either be strictly political or supported by a scholastic definition of market, without any realization of what future markets will be nor how financial services will be provided to Canadians. A selloff of bank shares would be both prudent and warranted.

The second case, where the banks decide not to proceed given the conditions placed upon approval, would send a clear signal that they will not engage in activities which will lead to a reduction in shareholder value. I would expect that the investment pattern of the banks after that decision would be exactly the same as if the minister had rejected the mergers outright.

In either case, Canada would be the worse off for such an illogical action. Had the same populist views been given credence during the last wave of bank mergers at the turn of the last century, Canada would have been worse off — burdened down with small, inefficient regional banks unable to meet the financial needs of an expanding nation. The same basic economic forces that were at work during that period are at work again, and denying them is bound to have the same success that greeted King Canute and his effort to stop the tide.

Thomas Connell:

Standard and Poor's was an exception to what we heard from Larry Wynant earlier about the acclaim for the mergers in the financial community. At Standard & Poor's, we generally confirmed the banks' ratings at current levels. It might be difficult to realize the full upside potential of these mergers for a number of reasons.

Cost-reduction opportunities would be heavily constrained by regional political sensitivities, and opportunities for more pricing flexibility would be similarly constrained. Sectoral and geographic asset concentration would be accentuated in the near-term. The overall regulatory burden on the industry might increase — affecting both merged and existing players, and might favor competing providers. Merged banks might not be able to secure their market shares because customers might not wish to deal with the "Big Two" due to real or perceived shortcomings.

Conversely, even a disallowance of the proposed mergers might provide some impetus for the banks to adapt to their changing environment. Rejection might make the banks less beholden to political support, allowing them to move forward with competitive cost-reduction efforts and more pricing innovation. Mergers having been ruled out, each bank could implement strategy without concern that another would suddenly become a ten-ton gorilla — although that depends on the ownership rules governing foreign participants.

Over the next five years, the banks would be free to focus on key operational and strategic challenges without having to manage a potentially difficult merger integration. For better or worse, future international expansion might be more incremental and niche-oriented. And new competition might not be artificially stimulated to the extent that might accompany the merger scenario.

Laurence Booth:

The evidence on economies of scale is that, beyond a certain minimum size, there are none or they're not significant. People keep saying it is different this time because of technology and so on, but the evidence keeps coming up, from the United States, Europe and everywhere. Where do the savings go? They are bid away by internal organizations. As for computers, in the United States where mortgages are securitized, for example, they are getting economies of scale from back-office activities that they are contracting out. Back-office work for different banks can be done by the same companies.

Tim O'Neill:

The academic literature on economies of scale is showing a changing pattern. A number of studies from the United States, Europe, and Canada show economies of scale. I would be willing to make these studies available to Professor Booth.

Warren Jestin:

If there were economies of scale in Canadian banking, the Royal Bank and CIBC would already be the most efficient. But Scotiabank and TD — the two smallest of the big five — have been the most efficient banks in Canada for well over a decade. As Michael Porter noted recently, modern information technologies have actually diminished the importance of scale, not raised it. And where scale is necessary, you can outsource to specialists.

John Pattison:

Customers are increasingly asking banks: why don't you have systems that perform such and such a task, like that of Fidelity or US banks? The answer is that we're not big enough. Size is important to systems affordability, so economies of scale do matter.

Implications for Customers and Competitors If the Mergers Do Not Proceed

Claude Lamoureux:

What is a bank? To most people, a bank is a physical place you go and leave five dollars, or borrow some money. But that is very narrow. There are over 200 bank-type services, and there has been a lot of consolidation in those services already. If the government is supposed to be stopping it, it has already missed its chance. A decade ago, there were ten trust companies — mostly Canadian ones — bidding for our custodian business. Now there is one Canadian trust, and one semi-Canadian: the rest are non-Canadian. Why did the government not stop that? Look at the payroll business. Twenty years ago, each company did its own payroll; ten years ago, most of the banks did it; today no bank does it. Why did the government not intervene?

Consolidation is clearly needed. Banking is one of the least consolidated businesses in the world. The largest commercial bank in the world has a market share of less than 2 percent. Everyone knows there are too many banks and banks cost too much. They are very inefficient. We benefited from the last wave of mergers, so why stop now?

Nonbank financial institutions have a higher return than banks. If you started a bank from scratch now, you could save about 40 percent in operating costs. No one has defined what is the optimum size of a bank. Why should we let government? The market should figure it out: if one is no good, shareholders will take their money elsewhere. We should let the marketplace decide, not politicians, because we know from the past that politics may not be the best basis to make choices.

Dominique Vachon:

We feel that the banks which want to merge want to protect themselves from the new competitors. The niche players are large because they benefit from the economies that come from specializing: they operate in these segments with lower margins than the industry average. Competing with them with increased size when the banks are already beyond any possibility for additional economies of scale and scope is not realistic.

Moreover, even when they are merged, the new banks would still be smaller than the average size of these players. We have difficulty envisaging what the next argument might be when they face this inescapable competition. The *Competition Act* should not protect competitors within a defined market but, rather, ensure competition. Approving the mergers would seem to serve only the first purpose.

Thomas Connell:

Whether or not the mergers are approved, the banks need to increase their geographic and product diversity, make new investments in information technology and service delivery, and achieve cost structures in line with future competitors. Continuing with what is, in some respects, a closed banking system may not create the pressure for innovation that will be necessary to sustain world class performance.

Warren Moysey:

With the mergers, management might, in fact, become less accountable and more isolated from the customer, despite the trend abroad, owing to the sheer size of the merged entity. Boards of Canadian banks tend not to be very responsive to shareholder concerns and to tolerate mediocre CEOs. There's a danger that bigger institutions would worsen that.

Claude Lamoureux

There are a number of reasons why bigger is not necessarily better and may not help to enhance shareholder value. As the head of one of the merging banks said a while ago, size is not a strategy — it's a statistic.

Implications for Policy If the Mergers Do Not Proceed

Jack Carr:

Thinking about the consequences of the mergers' not proceeding, I find myself agreeing with Jim Baillie in the sense that all the good things Jim said will happen *won't* happen.

Governments operate by putting packages together. The government would put a package together if it said "yes" to the mergers. And it would put a package together if it said "no." For example, after the government put in deposit insurance in 1967, which the trust companies wanted but the banks did not, the 1968 *Bank Act* revisions contained a number of elements to offset the cost of CDIC [Canadian Deposit Insurance Corporation] insurance for the banks: lower reserve requirements and the removal of interest rate caps.

Therefore, if mergers are not allowed, the "no" package would offer some compensation for banks. What are some possible elements of this compensation? The government would continue to prevent foreign competition by, for example, keeping the 10-percent rule. It might weasel out of its commitment to let foreign banks operate through branches. There would be continued restrictions on domestic competition. With mergers, we might have seen the final knocking down of the four pillars; without them, that would not occur. For example, there would be reluctance to allow nonbanks into the payments system. To compensate the banks for not allowing the mergers, the government might remove restrictions on banks in the leasing business and in selling insurance. But the big cost in policy terms is that all the good things that might have gone along with the mergers won't happen.

Robert Korthals:

Most opposition to the mergers has to do with service reductions in Yorkton, Saskatchewan, or Truro, Nova Scotia. But deposit-taking as a central activity of banks is on its way out. Whether or not the mergers proceed, the banks will rationalize in this area. The TD recently put out figures showing that their deposit base is shrinking. Transactions in branches are down 11 percent from a year ago; telephone banking is taking their place. In mature industries, profitability is related to market share. In banks, this is true on a local level. If there are no mergers, there will be a lot of branch consolidation. If they say no to the mergers, the cost pressures, the pressure for greater returns, will still be there. Banks will close branches and rationalize the market themselves.

For many years, going back to the 1930s, retail banking was a deadly dull business. It did not attract bright people — the intellectual capital. Now it's becoming dull again. Banks have moved into wealth management and investment banking. You need a large firm to attract the intellectual capital needed.

In wealth management, Canadian banks are small. Organizations such as Claude's attract intellectual capital. The 20 percent rule [the limit on holdings of foreign property by pension funds] hasn't helped, but it will break down through the use of derivatives — which Canadian banks need to be bigger if they are going to do. In investment banking, our banks are tiny. I don't know if anybody can take on Goldman Sachs and Merrill Lynch, but I know for sure it won't happen if you have five small banks trying to do it. With electronic trading, Canadian banks cannot compete without merging: we will lose the trading elsewhere. To trade Yorkton, Saskatchewan, for that business is a huge price to pay.

Claude Lamoureux:

At Teachers, we are large users of derivatives. Hardly any Canadian banks are in that business: most of our swaps have been done through foreign banks. If the government is worried about banks, it should be worried about Canadian banks' not being involved in these growing markets. But the fact is that globalization is under way and it is the giant nonbanks that are leading the way.

Tim O'Neill:

In the face of increasing competition, how can the banks respond to the need for size? They can do in-market mergers, which is what is being proposed. Or they can achieve size through takeovers by foreign banks. Or they can be niche players in the domestic market, which is the default option if the first two are prohibited. But if the banks take the niche-market strategy, increasing size in some business lines and exiting those they don't feel they can compete in, the result will be that, in selected product markets, there will be less competition and less employment without the mergers than with them. Another suboptimal strategy for gaining size is strategic alliances. But Anderson Consulting found that 70 percent of such alliances fail. They end up being glorified contracts, not partnerships.

Warren Jestin:

Canadian banks are already among the most efficient in the world. How can we improve this? The banks could all retreat into fortress Toronto, dropping lines of business and hoping somebody else will pick up the scraps, but this is a highly objectionable idea. In Toronto, people have choices; in Orillia, ING is not going to provide a full range of services.

Analysts have reacted positively to in-market mergers because of the potential to reduce costs. But you don't tend to see substantial cost savings without downsizing — trimming administrative functions, closing branches, and laying off employees. Not surprisingly, the Canadian public is having trouble seeing what's in it for them. The merging banks have yet to provide any compelling argument why megamergers are good for consumers or small businesses. Ted Neave has raised a number of good questions. I'd like to hear some answers before the government goes ahead and approves these deals.

It cannot be said that there are currently too many banks in Canada. New data from Deloitte & Touche show that the proposed megamergers would give Canada the most concentrated domestic banking system among the major industrialized countries. In fact, the level of concentration would be higher than that found in highly concentrated markets such as Switzerland and the Netherlands. These mergers wouldn't move us closer to the international norm. They would move us closer to a duopolistic situation, towards the leading edge of concentration, which is a place we don't want to be.

John McCallum:

The 70 percent number for market share of the top four we keep hearing is totally wrong and misleading. That number is right only if you look at banks. But when you look at, for example, residential mortgages, it makes no sense to exclude trust companies just because they are not called banks.

David Bond:

I worked for the most profitable and, come to think of it, the largest bank in the world. So maybe the two are linked. The Bank of Nova Scotia did buy Montreal Trust. Why were mergers proposed? Are the managers in a venal game to get monopolistic rents? I don't think so. The merger between Citicorp and Travelers points out that significant costs savings are there.

Robert Korthals:

Rejecting the mergers would be a terrible message to send to the world. There is this great feeling in the media and the public that government is good and that government knows the future. That is a great conceit, a fallacy. If we don't send a signal that we will reverse that, it will be at an enormous cost. Why should anyone bother with this place if they don't happen to live here?

Overarching Issues

Rebottling the Genie: Has the Merger Debate Changed the Financial Industry?

Paul Cantor:

The genie is out of the bottle. Indeed, the genie has ballooned, and stuffing it back in the bottle is impractical, as all sides of the discussion today have indicated. Liberalization is moving at a rapid pace — the failure to deal with that would turn us from "trailing market," as Michael Wenban called Canada, to the tail end of the dog. At the Toronto International Leadership Centre for Financial Sector Supervision, we have used Canada as an example of how market liberalization can be achieved, notwithstanding some depositor bailouts and the failure of an insurance company or two. The question for Canadians is whether they want to continue on the path of market liberalization and get a piece of the $1.3 trillion in potential gains available to consumers from financial market liberalization around the world over the next 10 to 15 years that Wendy Dobson talks about.[3]

With respect to international concerns, the issue is: do we shackle the banks' business judgment in the faint hope of limiting the effect of systemic global failure on Canada's economic base? This is a vain wish for a nation that has pinned its prosperity on global trade. When I was at CIBC, we had huge difficulties operating in international capital markets as a Canadian-dollar-based institution. We scrambled around the edges in Euro and other markets, and always got battered because of currency volatility. Relative stability resided in the major currencies, such as the US dollar, with a deep market of buyers and sellers.

The surprising early success of the euro underscores this risk, particularly if the United Kingdom merges the pound sterling into the euro. The major currencies will be the US dollar, the euro, and perhaps the yen. Canadian banks will be left as masters of the rinky-dink Canadian dollar, and the only G-7 country with a small and insignificant currency. The mergers could help our banks effect the transition toward a US-dollar base and thus ensure their continuing survival as financiers of Canadian international business.

With respect to domestic concerns, for the mergers, non-urban markets are a more challenging issue. Even in these markets, I don't believe the issue is material on the savings and investment side. At National Trust, we found our local branch managers reporting significant competition from many nonbank sources, but in particular from financial planners. Distance investment, through the telephone and through the electronic media, will certainly come to these markets as well.

On the lending side, competition to the local banks is more limited and comes mainly from other banks, local and a very few regional trust companies, and the credit unions. Targeted government-sponsored lending is also part of the Canadian fabric. Is "a bank lender in every strip mall" an inalienable citizen's right just like "a chicken in every pot?" I don't think so. With or without bank mergers, I believe that credit scoring is lowering the threshold of lending decisions that will be made on the local level. So we're going to get less of that kind of flexible local lending from the banks in any event.

William Brock:

We can't isolate the impact of the debate from all other factors in the market and measure it in isolation, but we can make some observations.

To begin with, for the first time in over a decade, the banks are seriously trying to explain to Canadians their role, performance, and future. This is not likely to change because the long-term survival of Canadian-headquartered players is at risk — even if the mergers proceed.

Second, the debate has influenced the thinking about the future of financial services providers in Canada. The processes put in place — consolidation, demutualization, exits by some foreigners, entry by others — will continue, as there is significant excess capacity and excess capital in all financial services sectors.

Third, consumer awareness has been raised and consumer demands have been changing. For example, when we at TD acquired our US discount brokerage operation, it was almost completely telephone based. We offered clients a choice to switch to electronic software-based trading 15 months ago; now, two-thirds of daily trades are electronic. This is higher than in Canada, but the shift is rapid here as well. This demonstrates that consumers are on the leading edge. There is a more sophisticated management of family household finances. TD deposits have been declining for several quarters. We are now the custodians of transaction-related accounts, not the custodians of household wealth. Customers are shopping around more, nowhere more so than in residential mortgages.

Fourth, the debate has accelerated strategic moves towards either monoline or megabank. Mergers are only one strategy in this evolution — in many sectors, banks may not be able to sustain competition in each of their businesses well, even after the mergers. Offering borderless services has become important. Canadian markets are lagging in the evolution of financial services. Canadian markets are being dragged forward by rapid consolidation internationally, and there is a need to reduce part of the excess capacity and capital in the Canadian financial services industry.

John Pattison:

This debate is not just about merger and entry into the industry; it's also about exiting the industry. People are going to exit lines of business. Exit is just as healthy a part of the economic process as entry. The regulatory system must allow response to competitive pressures.

Intersectoral and International Competition: Do the Mergers Really Matter?

Lawson Hunter:

From a public policy and consumer point of view, the mergers matter in the short run. But they do not matter so much in the long run. Canada cannot isolate itself from the forces, such as branding and technology, that we have been talking about today. The danger is that we take too short a time horizon. I am afraid that it would be dangerous to take two years as the assessment period, given the competition from huge players of enormous scope, plus niche players.

Banks are supermarkets. But are they cost efficient in Canada in this environment? Banks are saying they face scope efficiencies on one side and scale efficiencies on the other — they have to choose in order to be cost competitive. Mergers are one way of coming to grips with the problem. (The other is to remove the 10 percent rule, which raises other issues.)

I think that, at the end of the day, the Competition Bureau's decision will come down to a very few product markets where it thinks there is a problem. Wealth management is not a problem. Mortgages are not a problem. Deposit and transaction accounts are more difficult. Small and medium-sized business may matter, but this problem is not as intractable as many people believe. The danger is that the Bureau won't take a forward-looking perspective with respect to changes, such as in technology, faced by the industry.

John Pattison:

The issue we face is: will Canadian banks be able to adjust to their marketplace the way foreign banks or unregulated competitors can? This raises prospects of inefficiency in the economy. Many sectors in the economy gain, or are sheltered by, the inefficient, regulated financial industry. That the Competition Bureau is looking at the competition issue is therefore a healthy development.

There was an implicit social contract formed in the past century which shaped public expectations of the financial sector. How we approach mergers in Canada is a relic of this social contract — for example, the idea that certain services should be offered for free and that there should be cheap geographic dispersion. People don't want to give up something they didn't have to pay for — that is an impediment to the mergers.

Competitors in a lot of the banks' products are intersectoral or international. This means we have to consider the second-order effect of the downsizing which may occur if mergers are not approved. Banks are absorbing fixed social costs, but new entrants aren't burdened with the same social expectations. How does the government invite foreign banks in and saddle existing domestic banks with extra costs? It matters whether or not we are regulating a competitive market.

Neil Quigley:

This notion of a social contract is actually a relatively recent term in Canada, and not one I would use. It is really more a matter of private interests trying to preserve the way things have been done in the past — certain patterns of banking — in order to protect past investments and comfort. Governments have been willing to provide these concessions.

Laurence Booth:

Canadians are not worried about corporate banking and investment banking, where Canadian banks can't go head-to-head with the US giants. Banks have had little success so far in foreign entry into the sectors they have entered. The mergers will not suddenly make banks more competitive.

Mergers will only be good if competition drives savings to the consumer. What is this excess capital that we've heard about today? There's no evidence that banks are unable to earn high rates of return. Return on equity of banks in Canada last year was 18 percent; across the rest of the economy, depending on what measure you take, it was more like 6 percent. There's no evidence that banks are unable to reinvest profitably. It may be true in plain vanilla stuff, but banks make good money in Canada as mid-market lenders to smaller businesses and in retail. Banks dominate mid-market and consumer credit. That's where the problem is in terms of concentration ratios. That's where the profits are and the barriers to entry. That is the area of most concern to Canadians.

Tim O'Neill:

In looking at ROE [return on equity], you have to compare like with like and compare ROE on Canadian banks with that in banks in other countries. With respect to competition, the real evidence lies in the widespread discount pricing on the personal lending side and, in fact, across the entire mid-market spectrum.

John Pattison:

With respect to the competition issue raised by Laurence Booth, average ROE over the past ten years has not been high. Up until two or three years ago, it was abysmal because of large loan losses in small as well as large business loans. On a risk-adjusted basis, these returns don't look all that attractive. The reason that the Citibanks of the world have not been more aggressive in Canada is because, on a risk-adjusted basis, ROE is higher in the United States.

Helen Sinclair:

If the mergers do not proceed, I wonder if we would see a migration to a strategy of "cross-pillar" mergers — banks with life insurers, for example — given the lower political barriers to that type of movement. This is not the preferred route of Canadian institutions, as it is, for example, in Europe. Why isn't the market driving more of this?

James Baillie:

The fact that most of the major life companies are mutuals has been an obstacle. My hunch is that, once the bank mergers are out of the way, there will be new attention to that. I am concerned about the slowdown of demutualization, because that will delay the entry of new competitors in the business.

John McCallum:

Responding to Helen Sinclair, the Royal Bank's looking at London Life is the exception that proves the rule. Great-West got London Life rather than us because there was more scope for savings between two insurance companies than there was with us. Intrasector mergers provide more opportunity for cost savings.

Neil Quigley:

Also responding to Helen, alternatives to mergers include joint ventures. In Australia, two of the big banks that were prevented from merging are looking at joint ventures in backroom operations. No doubt it is less efficient than mergers, but there are some opportunities to achieve gains.

James Baillie:

Also, the new business of major Canadian life insurance companies is increasingly wealth management, but insurance companies in the United Kingdom are more advanced than Canadian ones on this. As wealth management by life insurers grows here, the business of life companies will intersect more with that of the banks.

Lawson Hunter:

It is difficult to generalize about competition across product markets. There probably aren't that many markets where there are problems as defined in the *Competition Act* which produce a "substantial lessening of competition." But that leaves the question "how much competition is enough?" unanswered. By and large, with three remaining players as well as outside niche players, vigorous competition will persist.

Laurence Booth:

I hope that, in assessing the potential for foreign competition, the Competition Bureau will look at facts rather than possibilities. Foreign competition may come, but the history of foreign bankers entering Canada over the past 15 years is spotty, to say the least.

The Banks as Tools of Public Policy: Are We Better Off without the Mergers?

Neil Quigley:

Economists have to think about incentives and property rights. Incentives to lower costs in the market are only there if government respects property rights. The problem with using the banks to achieve social policy objectives is that we want an efficient economy and banking sector. This has property rights implications: that owners can keep the profits reaped from efficiency gains. So the problem is: imposing social policy objectives means efficiency gains are going to be redistributed politically, which affects the incentives which bank owners have to search for efficiency gains. More broadly, the Canadian business community will regard the imposition of social policy objectives on the banks as an act of political opportunism. Political opportunism raises the cost of doing business and reduces economic activity because investors require higher returns to compensate them for the possibility of similar acts in the future.

The balance of evidence says that within-market mergers between banks are efficient, provided that competition is preserved. Even if the finance minister places constraints on the extent to which rationalization of employment and branches can occur, some efficiency gains will be achievable, and Canadians will be better off.

The big issue is planning the evolution of the Canadian financial system. Can and should governments do this, given that markets are fundamental drivers? The mergers are what markets want. This puts a direct challenge before the government: can it stand in the way?

Dominique Vachon:

If mergers go ahead, the banking sector will, without any doubt, be more regulated.

Greta Wemekamp:

Political conditions imposed on the mergers could have anticompetitive effects. Regulations on service charges or types of investments — the entire industry would share in the costs of complying with those types of conditions while only the merging banks would gain an offsetting benefit.

Warren Jestin:

Financial services policy should serve the broad national interest — that is, the interests of a broad range of stakeholders, including consumers, businesses, and communities across Canada, as well as employees and shareholders. The merger debate has effectively hijacked the debate around the larger policy framework, making the debate too bank-centric. At a minimum, the question of megamergers should be deferred until the regulatory playing field has been established and other policy issues, such as insurance demutualization, have been resolved. If not, a first-mover advantage will have been given to the megabanks.

It is hard to believe the claim that going from five major banks to three would not lessen competition. We believe that it would, and the Canadian Federation of Independent Business shares that view. And we just don't buy the claim that credit unions would replace lost competition in small business lending — where they have little presence, currently — or that foreign firms would provide enough competition through niche lending to compensate for the creation of an efffective duopoly in our first-tier banking system.

Mergers also raise the question of institutional solvency — would these megabanks be too big to fail? Recent events in Japan and France show that even the largest banks can get into dire trouble. In fact, of the top 15 global banks by assets, almost half are financially troubled institutions. The experience of Crédit Lyonnais and others also shows how bad credit systems can undermine the entire system. Issues related to solvency would become increasingly important in a post-merger Canada, with high concentration serving to further increase the risks to national policy posed by an individual institution's bad credit decisions. How many credit committees do you want to determine credit decisions in this country? In my view, five or six is better than just two or three — particularly when economic conditions begin to deteriorate, as they now appear to be doing.

There is also the danger of betting on national champions — of putting your money on two rather than five or seven competitors. The merged banks would be more powerful than Canadian banks are today, raising the question of whether they might become too big to regulate. These two mega-institutions could dominate any future debate on the regulation of Canada's financial institutions, with other players forced to the sidelines or with too small a voice to be heard.

And there are economic risks associated with the timing of the mergers. We have seen the urge to merge at the top of the economic cycle before. But the arithmetic that seems to support a merger at the top of the cycle can quickly fall apart in the down phase, triggering much greater internal cutbacks and tougher lending practices to shore up profitability.

Moreover, senior management is already pre-occupied with year 2000 computer issues. Layering on these megamergers — which also focuses attention internally and away from product and technology innovation and customer service — is clearly not in the best national interest.

Jack Carr:

We see small businesses being well served, yet they lobby against the merger. How do we explain that? The explanation is that they are used to lobbying for special treatment in this country and they want loans at lower interest rates — so do we all! Economists say there are rents to be had from the mergers, and small business wants a part of it: if they hold the mergers up, maybe they can get some. This is why there's a problem with a process that involves the minister of finance. You can see why OSFI and the Competition Bureau are there, but having the minister involved invites lobbying groups to come forward because they want part of the gains.

Ted Mallett:

I disagree with that interpretation. Small businesses never lobbied for special treatment, such as asking for preferential interest rates. The small business sector always looks for more, not less, competition and choice. Small business can't easily switch from one institution to another. There are all kinds of costs, as we know already from, for example, when bank managers move around. They are fearful of more need to do so if the mergers happen. Small business is not opposed under all circumstances and forever. They support a *laissez-faire* approach to the market, but they want to see evidence that small business will benefit, for example, from new technology before they will buy in. At this stage, we don't see that evidence.

Robert Korthals:

Banks are not the sole suppliers of credit. In the United States, banks went from supplying 60 percent to 20 percent of business credit, yet business is not short of credit. In Canada, we went from 80 percent to 50 percent now. The market works: there will be other providers; business will get loans.

Tim O'Neill:

Warren's position was appropriate ten or fifteen years ago, but now there are new competitors and new technologies, which gives more power to new competitors. It is being argued that we should wait — wait until the playing field is level; wait for the right point in the business cycle. We'll wait too long. It could even be like waiting for Godot.

John Pattison:

What about the idea of allowing businesses to pursue competitive opportunities — letting businesses lead and innovate? If we don't, it will make for a less competitive Canadian economy.

Ken Slemko:

Small and medium business groups are doing some of these calculations themselves, and these calculations are weighing in the political balance. This discussion is dangerously downplaying the public resistance to mergers.

John Kazanjian:

Before long, the minister will have the Bureau's letter, a House Committee report, a Senate Committee report, an Industry Canada e-commerce and technology-related legislative package, as well as the views of his own department. It will be difficult to explain any further waiting, or a "maybe someday if" answer that would delay, lengthen, or complicate processes that, for business reasons alone, are likely to be long and challenging.

James Baillie:

This whole discussion just confirms that the business community is ahead of the regulator all the time. When I was involved with the Task Force, the assumption was that the whole world would wait pending reports on rules of the game, that we would fire the starting gun and then everybody would race. I shudder at my own naiveté and that of the government, thinking that such a process could work. It is regrettable that the merger announcements took everybody so much by surprise. The world won't wait for government analysis.

Frank Potter:

Why is a thoughtful examination of our circumstances by qualified outsiders such a bad thing? It doesn't imply that the world has stopped moving. I am surprised at the gloom in the room. We underestimate the quality of the review process. It has a good chance of being objective, thoughtful, and to take good policies and politics into account.

Other policy changes have been more difficult for our country. The FTA was more difficult. The GST and UI reforms were more difficult. Mr. Martin will get good advice with respect to the long-term welfare case of the mergers for the economy, which is considerable. The welfare case is long term, while the politics are transitory. I am not pessimistic. I think we stand a good chance of coming out at approximately the right point.

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1 G.F. Mathewson and Neil C. Quigley, *Canadian Bank Mergers: Efficiency and Consumer Gain versus Market Power*, C.D. Howe Institute Commentary 108 (Toronto: C.D. Howe Institute, June 1998).

2 Problems arising from the inability of most legacy software to interpret correctly dates after December 31, 1999.

3 Wendy Dobson and Pierre Jacquet, *Financial Services Liberalization in the WTO* (Washington, DC: Institute for International Economics, 1998).