1998 FRASER INSTITUTE

CRITICAL ISSUES

bulletin

Bank Mergers

The Rational Consolidation of Banking in Canada

by Jason Clemens,
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with Johanna Leigh Francis

THE FRASER INSTITUTE

Critical Issues Bulletins are published from time to time by The Fraser Institute (Vancouver, British Columbia, Canada) as supplements to *Fraser Forum*, the Institute's monthly periodical. Critical Issues Bulletins are comprehensive studies of single issues of critical importance for public policy.

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Date of Issue: September 1998
Printed in Canada

Canadian Publications Mail
Sales Product Agreement #0087246
ISSN 1480-3666

Editing & design:
Kristin McCahon & Lindsey Thomas Martin.

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Acknowledgments

The authors wish to thank Jared Alexander, Dr. Michael Walker, Dr. William Stanbury, Patrick Basham, and an anonymous referee for their comments, suggestions, and criticisms. The authors, of course, take full responsibility for any errors and omissions and, as they have worked independently, their views do not necessarily represent the views of The Fraser Institute or its trustees and members.

Executive Summary

Recent proposals to merge (1) the Royal Bank of Canada and the Bank of Montreal, and (2) the Canadian Imperial Bank of Commerce and the Toronto Dominion Bank have sparked considerable debate in political and policy circles. Supporters of the mergers believe that greater consolidation in the industry is essential for Canadian banks to remain competitive in an increasingly global economy. Opponents argue that greater consolidation will result in reduced competition among Canadian banks, higher prices for banking services, and reduced consumer welfare.

One very important result of bank mergers is the consolidation of branches. The potential for savings from such rationalization are enormous. If we consider only savings likely to be gained from the two currently proposed mergers, we find estimated savings per year of between $2,157 million and $6,471 million—between 30 percent and 91 percent of total profits of the "Big 5" banks (the Royal Bank of Canada, the Canadian Imperial Bank of Commerce, the Bank of Montreal, the Bank of Nova Scotia, and the Toronto-Dominion Bank). The annual savings increases to between $2,971 million and $8,915 million when other merger candidates such as the Bank of Nova Scotia, the Hongkong Bank of Canada, and Canada Trust are included in the estimate.

Even more startling are estimates of the extended savings to be gained from the two currently proposed mergers. Projecting the estimate forward 10 years generates savings of between $29,508 million and $88,523 million—between 3.40 percent and 10.28 percent of the total value of all goods and services (GDP) produced in Canada in 1997. For consumers, the savings are equally striking: $72.83 to $218.50 for each Canadian per year and between $996.39 to $2,989.13 per person over 10 years.

Contrary to popular opinion, branch rationalization in the banking sector is already well under way. After adjusting for overseas branches and trust branches integrated into the banking system, the number of Big-5 domestic bank branches actually declined from 6,192 in 1988 to 5,665 in 1997, an average annual decline of 0.97 percent. The rate of decline has accelerated to 2.26 percent within the last five years as more and more customers are demanding alternative methods of completing financial transactions. The number of customers per branch has increased from 4344 in 1988 to 5345 in 1997, a total increase of 23.05 percent.

Automated Banking Machines (ABMs) are a direct substitute for traditional branch-banking for transactions such as cashing a cheque, paying a bill, and making a deposit or withdrawal from an account. The number of Big-5 ABMs has increased from 4,373 in 1988 to 13,291 in 1997, a total increase of 203.93% and an average annual increase of 13.81 percent. The number of customers per ABM has dramatically declined from 6150 in 1988 to 2278 in 1997, a decrease of 62.96 percent.

Driven by consumer demand for convenient, time-saving, low-cost services, a number of alternative delivery systems are being aggressively developed and marketed. Both telephone banking and Internet banking have experienced a pronounced increase in usage by customers.

The development of alternative delivery systems is not limited to large, national banks nor is it restricted to retail or consumer-based banking. A variety of financial institutions offer a significant breadth of services through alternative delivery systems. Similarly, for their business clients banks are developing a large and growing number of delivery systems that use the same types of innovative delivery systems currently used for retail customers, i.e. ABMs and the Internet.

Although it is clear that there will be transitional job losses, long-term prospects for employment in the sector are positive. Between 1988 and 1997, employment in the banking sector expanded by 16,260 full-time equivalent positions, a 9.14 percent increase or an annual average increase of 1.00 percent. More importantly, both real total wages, and real wages and benefits per employee increased over the same 10-year period. Total real wages increased 89.98 percent over the 10-year period, an annual average increase of 8.13 percent. Wages and benefits per employee increased by 74.07 percent over the 10-year period, an annual average real increase of 6.99 percent. The simultaneous expansion of employment and rise in real wages occurred in the context of a severe recession and two major integrations within the banking sector (brokerage houses and trust companies).

Market definitions are crucial for assessing the competitive effects of a merger because any market can be deemed a monopoly if the market definition is sufficiently narrow. Conversely, any market can be defined as competitive if the definition of the market is sufficiently broad.

The Competition Bureau uses market concentration as a proxy for market power. Significant deviations occur in the level of market power depending on the particular market definition employed. A narrow and specific market definition, whether it is geographic-, product- or customer-defined, results in a relatively high level of market concentration while a broad market definition results in significantly lower market concentration. The key determinant of market concentration, therefore, is not the number of participants but the particular definition used.

Current competition law ignores research on the role contestable markets can play in forcing concentrated industries to behave as if they are perfectly, or nearly perfectly, competitive. All the existing barriers to entry, which reduce the contestability of the market, are of government origin. Of particular importance to the financial services sector is the presence of heavy regulatory restrictions placed on foreign financial institutions.

Policy Recommendations

- The federal government should allow the proposed bank mergers, given the enormous cost savings and efficiencies to be gained by branch rationalization.
- The government, specifically the Minister of Finance in his review of the merger proposals, should not attach branch, employment, or other restrictions on the firms to be formed by the mergers. To inhibit the cost savings and subsequent efficiency gains made possible by rationalization undermines the rationale for consolidation.
- The current discussion of the banking sector must be expanded to include all direct and indirect competitors such as trust companies, loan companies, insurance companies (both life and property and casual), pension managers, mutual fund companies, securities brokers, and financial planners.
- The large-scale restructuring beginning in the insurance sector through de-mutualization should be an integral part of the current discussions. The lack of discussion of the anticipated changes in the life insurance sector means that Canada will be faced with another round of difficult decisions regarding the financial-services sector in one to two years.
- As posited by authors Mathewson and Quigley (1998), the removal of barriers to entry—particularly those barriers imposed on foreign firms—will insure that the lion's share of benefits gained from rationalization flow through to the consumer. The specific regulations that most impede foreign entry are the domestic capitalization requirement, the subsidiary/branch restriction, the 25 percent ceiling on foreign ownership of Schedule I banks, and the 10 percent limit on ownership concentration of Schedule I banks.
- A host of peripheral issues such as the future role of the Canadian Deposit Insurance Corporation and the Canadian Payments Association should be included in the current discussion in order to ensure a coherent and broad re-structuring of the sector.