GOOD POLICY IS GOOD POLITICS — WHY CANADA NEEDS BANK MERGERS NOW

Stanley H. Hartt

With Ottawa scheduled to announce its new policy on bank mergers by June 30, it's time to bite the bullet and permit consolidation in the financial services industry, or wave goodbye to an increasing number of Canadian corporations, who will finance their international growth abroad rather than at home. "This works to deprive Canada of head-office type jobs for our next generation, not only in the banking sector," writes a prominent Canadian investment banker and former finance mandarin, "but in all the businesses which need financing from banks capable of executing at a global level." Already, in 2003, foreign investment banks received 43 percent of investment banking fees paid by Canadian companies on international transactions. While Canada's major banks have grown in the last decade in terms of their capital, every one of them has fallen off the list of the world's largest banks. "We had three banks among the top 50 global banks in 1990, none in 2003,"Hartt writes. Only mergers will enable Canadian banks to leverage the critical mass needed to be players in a global industry.

On connaîtra d'ici le 30 juin la nouvelle politique d'Ottawa sur les fusions bancaires. Selon l'auteur, il est temps de lâcher du lest en autorisant les regroupements dans le secteur des services financiers, au risque de dire adieu aux nombreuses entreprises canadiennes qui devront faire financer leur croissance internationale à l'étranger. « Le statu quo priverait la prochaine génération d'emplois de haut niveau liés aux sièges sociaux, assure un éminent banquier canadien et ancien mandarin des finances, non seulement dans le secteur bancaire mais dans toutes les sociétés qui ont besoin de l'appui de banques de calibre mondial ». En 2003, les banques d'affaires étrangères touchaient déjà 43 p. 100 des frais bancaires d'investissement sur les transactions internationales des sociétés canadiennes. Et si nos banques ont prospéré depuis dix ans en termes de capital, toutes ont disparu de la liste des grandes banques mondiales : en 1990, trois d'entre elles figuraient parmi les 50 premières, aucune en 2003. Stanley Hartt en est convaincu : seules les fusions permettront aux banques canadiennes de regagner leur place dans l'économie mondiale.

The Canadian government's stance on bank mergers has been based almost exclusively on political considerations and, unfortunately, not on what constitutes the appropriate policy. Characterizing banks solely as providers of retail banking services to individuals and small- and medium-sized businesses, and ignoring their role in capital formation and as intermediaries in the financing of our largest, most successful national and international business enterprises, has led to endlessly deferred decisions on this issue, with serious consequences for our country.

Jean Chrétien was well known for not launching ambitious policy intitiatives when there was no overwhelming popular demand for them. Instead of managing public opinion about bank mergers when they were first proposed in 1998, Liberal MP Tony Ianno was sent out with a delegation of Commons members to ask the redundant question of Canadians, "Do you like the banks?" It would be a strange thing indeed if the ability to initiate business combinations were turned into a popularity contest.

The result has been a drawn-out process of introspection that resembles what happens when one asks a teenager to clean up his room. One excuse after another is advanced, all seemingly well-founded, but adding up to an endless goat rodeo of procrastination.

First, we had to wait for the MacKay Report in September 1998. Failure to follow the timetable for this report, commissioned before the announcement of the first merger, was the ostensible reason then finance minister Martin was so upset at Royal Bank of Canada (RBC) and Bank of Montreal (BMO) for "jumping the gun" by announcing their proposed transaction before the government could demonstrate leadership on the issue. Of course, there was also the problem of not informing the finance minister, Paul Martin, about the planned announcement so he could prepare his reaction before it entered the public domain.

Then, after that merger and the proposed TD-CIBC union were blocked in December 1998, we had a policy White Paper in June 1999, new banking legislation in 2001, a Senate Banking Committee report in December 2002, a House Finance Committee study in March 2003, a public consultation in December 2003, and an 18-month moratorium placed on announcements until September 2004, pending answers to three final policy questions from the Department of Finance in June. The teenager's room is still messy!

The implications of this dilatory route to a definitive policy are grave. Canada's major banks have grown dramatically, as measured by capital, since 1990, but, relatively, Canada's presence has diminished. We had three banks among the global top 50 banks in 1990, none in 2003. Whereas Royal Bank of Canada was number 38 in 1990, with CIBC number 40 and TD Bank number 49, by 2003 Royal had dropped to 51st, and Scotiabank was in 54th place, with BMO at 62nd. CIBC had become 65th in the global bank size sweepstakes, and TD was 70th. By contrast, foreign competitors, including Citibank, J.P. Morgan Chase, Bank of America, HSBC and Mizuho have grown exponentially through consolidation.

There have been no transformational mergers among Canadian banks since the combinations of the Bank of Toronto with the Dominion Bank of Canada in 1955 and the Canadian Bank of Commerce with Imperial Bank of Canada in 1961. In 1985, we lost a number of smaller Schedule A Canadian banks as the result of the regulator-imposed closures of Canadian Commercial Bank and Northland Bank, followed soon after by the absorption of the Bank of British Columbia, Mercantile Bank of Canada and Continental Bank into other institutions. Other banks disappeared from the scene, with the merger of Bank of Alberta and Western and Pacific Bank to form Canadian Western Bank, and the absorption of several exiting Schedule B banks into HSBC Bank Canada.

In the wake of the dramatic events of 1985, Canada led the way in acknowledging the evolution of capital markets by opening the ownership of investment dealers to the banks and

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TABLE 1. CANADA'S DIMINISHING INTERNATIONAL BANKING PRESENCE 1990–2003

Canadian global bank rankings 1990		Market capitalization (US$ million)[1]	Canadian global bank rankings 2003		Market capitalization (US$ million)[2]
Rank	**Name**		**Rank**	**Name**	
38	Royal Bank of Canada	6,136	51	Royal Bank of Canada	30,928
40	Canadian Imperial Bank of Commerce	4,234	54	Scotiabank	26,862
49	Toronto-Dominion Bank	5,027	62	Bank of Montreal	20,012
63	Bank of Montreal	2,693	65	Canadian Imperial Bank of Commerce	18,718
70	Bank of Nova Scotia	2,470	70	Toronto-Dominion Bank	22,521
52	1990 average	4,112	60	Current average	23,808

Source: "The Banker" Financial Times publication, July 1990, July 2003.
Note: Ranked by capital.
[1] Market capitalization as of July 31, 1990.
[2] Market capitalization as of April 14, 2003.

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The bank towers in downtown Toronto. It's time for Ottawa to bite the bullet and permit bank mergers, writes Stanley Hartt, himself a former deputy minister of finance. The alternative is continued shrinkage of Canadian banks among the the world's top players, with even more of Canada's global corporations doing their banking outside the country.

permitting banks to acquire the remaining large trust companies, some of them in difficult straits.

But the result of placing a moratorium on large bank mergers in the late 1990s has been to channel the US ambitions of Canadian banking institutions into a variety of investments which were, by and large, sub-optimal. Since BMO bought Harris Bank of Chicago in 1984, it has made only small add-on acquisitions. CIBC made a bet on Oppenheimer, and a direct investment in Amicus, neither of which has worked out very well. Royal Bank bought a great, tiny bank called Centura, a couple of small investment banks and a mortgage broker. None of these actually give Royal the ability to execute on large financings in the US.

What the banks need is the capital base that would result from a combination of any two of the large Canadian banks to make more meaningful acquisitions south of the border without betting the bank.

Why is this so important? In 2003, foreign-owned investment banks had 43.4 percent of the fees paid to the street by Canadian companies on those transactions for which the international firms compete (i.e. excluding income trusts, domestic equity and debt and small domestic merger and acquistion (M&A) deals). This is an astoninshing phenomenon, considering the size of the Canadian operations of international investment banks, and results from the fact that Canadian lenders are really not able to follow our national champion corporations when, to our enthusiastic approval, they grow beyond our borders and become major international names. Our policy condemns our banks to wave goodbye to their clients at the border, while we encourage the CNs, Nortels, Alcans, JDS Uniphases, Incos and others to expand aggressively in foreign markets.

In turn, this forces our CEOs to discuss their financing plans in US and other foreign bank head offices. Rather than taking their lead advice from Gord Nixon of RBC or Rick Waugh of ScotiaBank or Tony Comper of BMO, they are moving their head offices or executive offices to the US in order to be closer to financial decision-making (IPSCO, Moore-Wallace, Thompson Corp., Laidlaw, Nova Chemicals, etc.) or selecting CEOs who reside in the US (Alcan, CN Rail, Cott, Glamis Gold, etc.). This works to deprive Canada of head office-type jobs for our next generation, not only in the banking sector, but in all of the businesses which need financing from banks capable of executing on a global level.

What is the alternative? A merged Canadian institution would have a market capitalization of over $50 billion US. It could comfortably buy Bank of New York, National City, Sun Trust, PNC, KeyCorp, South Trust or M&T Corp., all excellent institutions, among others. Or, they could choose to buy Lehman Brothers or Bear Stearns to achieve critical mass in investment banking. The execution of transactions would still be in world markets, but the advice would be given and the plan developed in Toronto and not New York.

The implications of viewing financial markets from a Canadian perspective are both concrete — in employment, retention of head offices and retarding the hollowing out of our corporate sector — and intangible, resulting from Canadian considerations being at the forefront of the decision-making. Bankers who have been involved in this process in other countries will confirm that having a proponent of national interest does make a difference.

Holland, with one-half of our population, and Switzerland, with one-quarter of our population, have figured this out. Holland has four banks larger than our biggest bank, the Royal, (ING, ABN AMRO, Rabobank and Fortis) and Switerland has two banks bigger than the Royal (UBS and Credit Suisse). What do they know that we don't?

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It may well be that our banks have not treated the political side of this issue with the care they have devoted to the policy side. In the 1998 round, the bank leaders emphasized synergies and cost savings, including those involving branch closures and employee layoffs. The government has countered by adding to the statutory requirements of approval by the prudential regulator, OSFI (the Office of the Superintendent of Financial Institutions), and the competition regulator (the Competition Bureau), a public interest test in virtue of which merging institutions would have to eschew some of the traditional sources of accretive financial results in favour of selling, not closing, branches (in clusters capable of being managed by existing supervisory staff) and relying more on attrition to shrink their staffs.

There remain the three questions bequeathed to us by former finance minister John Manley after a purported 2002 round of mergers, one between two banks and one a "cross-pillar" merger between a bank and an insurance company, were called off, reportedly on direct orders from the PMO in October of that year. Will the government allow one or two bank mergers, and, if two, should the government set up a 60-day window for merger proposals in order to avoid first-mover advantage? Should the government permit a cross-pillar merger in order to avoid the disappearance of a bank?

The right answer is that the government does itself no favours by maximizing pent-up merger demand through continued policy contemplation. The government was on the right track in the latest revision to

TABLE 2. ESTIMATED FEES PAID TO FOREIGN INVESTMENT BANKS BY CANADIAN COMPANIES (2003) (US$ MILLIONS)

	Fees to Canadian banks	Fees to foreign banks	Total fees paid	Foreign banks' share (%)
Equity	620.0	173.1	793.1	21.8
Debt				
Investment grade	322.5	339.0	661.5	51.3
High-yield	20.0	153.2	173.2	88.5
M&A advisory	112.1	159.8	271.8	58.8
Total fees	1,074.5	825.1	1,899.6	43.4

Source: SDC, company reports.

the Bank Act (adopted in 2001) when it provided for a model for the delivery of banking services, which was more diverse than a handful of monolithic domestic banks and a constrained group of foreign bank subsidiaries. In that statute, provision was made for access by foreign institutions to operate as branches in Canada instead of through the Schedule B subsidiaries required up to that time. Also, the enactment made it easier for qualified new entrants to start up new Canadian banks by lowering the capital requirement for a new bank to $5 million from $10 million.

The government should not try to micromanage the outcomes or pick winners and losers. They should let the managements, boards of directors and shareholders of the institutions, as in every other business, determine when and whether to propose mergers subject to known and clear regulatory criteria. The government should also level with the banks. If it thinks that some of them are too big to be permitted to merge with any partner, it should put them out of their misery by telling them and letting them get on with life.

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In particular, the concept of a cross-pillar merger, tempting to the politicians on the superficial level because it does not result in the "disappearance" of either merger partner, holds great danger for the government on the policy front. Because two banks when merged become a single entity, such a union does not raise issues of ownership restrictions. But an insurance company and a bank can only "merge" by one acquiring the other, or both being owned by a holding company.

Policy-makers have long stated that the limit on ownership of voting shares permitted to any individual or entity (becoming 20 percent under the provisions of the new legislation) can be satified if the top company in the chain is widely held and publicly traded and no shareholder exceeds the allowable holding. But we have never bitten the bullet about whether such a top company can be outside Canada. According to NAFTA, our US and Mexican partners are entitled to "national treatment" in such matters, but that could result in all of our banks and de-mutualized insurance companies disappearing into widely held American entities. A cross-pillar merger would set up the granddaddy of all trade disputes, which we very well might lose.

Let us hope that the government provides its answers as promised by June 30. The government has never acknowledged what everyone knows, namely, that the dates of June 30 and September 30 were chosen to coincide with the then-conventional wisdom about the electoral calendar. It would be a shame to once again postpone the overdue by allowing a deferred election to cause yet more delay.

Banks should use their hard-learned sophistication about what they didn't do right last time to maximize the conditions for approval. They should be lobbying individual MPs, consumer groups, observers and commentators and even their fellow members of the business community in addition to Ottawa insiders and decision-makers.

TABLE 3. MARKET CAPITALIZATION OF REGIONAL US BANKS AND CANADIAN BANKS (US$ MILLIONS)

US banks	Market capitalization	Canadian banks	Market capitalization
Bank of New York	24,284	RBC Financial	30,928
National City	20,058	Scotiabank	26,862
SunTrust Banks	19,467	TD Bank	22,521
BB&T	18,529	Bank of Montreal	20,012
State Street	16,741	CIBC	18,718
PNC Financial Services	14,683	National Bank	6,072
Mellon Financial	13,147		
KeyCorp	11,719		
SouthTrust	10,425		
M&T Corp.	10,185		

(1) Market capitalization as of close on April 14, 2004.
Source: Bloomberg.

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