Banks Prudently Regulated to Teeth - Deregulation of Canada's Financial Industry Part 4

In Into the Boiler Room: Deregulation of Canada's Financial Industry , a general overview from an academic context on the state of deregulation in Canada is provided. It's important to note that such significant changes such as those made in our banking sector, have taken place over a period of many decades. Thus it is hard to root out one sole cause when in fact, another root lies deeper down below it.

Canada's reputation for strong regulation and prudent banks around the world began with policies implemented and enforced nearly a decade ago. Indeed, a change in the landmark decision in 1998 could have decided the fate of the Canadian banking system as we know it today, and could have radically altered the economic conditions.

The Banking Empire Deregulation of Canada's Financial Industry began an introductory look into the bank merger proposals. The two large bank merger proposals in 1998 required review by *two* regulatory bodies; the Competition Bureau and the **Office of the Superintendent of Financial Institutions (OSFI)**. The two proposed large bank mergers announced were direct challenges to the perceived Canadian Government merger policy of "big shall not buy big".

Of course, this policy has been an informally cautious one, that does not allow for big companies to buy other big companies, out of concern for consolidation at the detriment of the consumer.

Had the bank mergers succeeded, they would have fallen into the category of in-pillar mergers, which involve merging parties offering the same or similar products. A key motivation for an in-pillar merger as argued by executives at the big bank, has been on efficiencies of scale and profitability.

However, a bank and an insurance company merging together would be a cross-pillar merger, referring back to: Historical Context - Deregulation of Canada's Financial Industry when the pillar system of financial services was adopted in the earlier parts of Canada's financial services history. This cross-pillar merger was allowed by the Canadian regulatory framework, and the most notable examples would be the mergers between RBC and Royal Trust; Scotia Bank and National Trust, and TD Bank and Canada Trust.

Timeline of Events

On June 1, 1992 the federal government proclaimed its new legislative framework for federally regulated financial institutions: banks, trust and loan companies, insurance companies, and the national organization of the credit union movement. The new legislation changed the landscape within which federally regulated financial institutions operated, by introducing new powers, making changes to the ownership regimes, and instituting new prudential safe guards.

On December 18, 1996 the Minister of Finance at the time had announced the mandate and composition of the Task Force on the Future of the Canadian Financial Services Sector. The Task Force was asked to advise the government on what needed to be done to ensure that the Canadian financial system remained strong and dynamic. It examined a number of substantial policy issues that were not dealt with by the 1996 Government White Paper on Financial Institutions.

In September 1998, the Task Force released it's final report which will be detailed below, which contained 124 recommendations dealing with 4 major themes: Enhancing competition and competitiveness; Improving the regulatory framework; Meeting Canadian's expectations; and Empowering Consumers

Two separate parliamentary committees – the House of Commons Standing Committee on Finance, and the Standing Senate Committee on Banking, Trade, and Commerce had both scrutinized the Task Force's report. Both Committees issued their respective reports in December of 1998.

Following the reports from the Parliamentary Committees, Council of Canadians documents, Competition Bureau's assessments, and the MacKay Task Force, the Minister of Finance at the time (Paul Martin) had reached a decision on denying the merger of the Big 4 banks. The mergers proposed were between BMO and RBC; and TD and CIBC.

In June 1999, the Minister of Finance released the Government White Paper: Reforming Canada's Financial Services Sector: A Framework for the Future, which outlined the Government's vision for the future of the financial services.

MacKay Task Force

On September 15, 1998 the Task Force on the Future of the Canadian Financial Services Sector published their report titled: Task Force Report on Future of Canadian Financial Services Sector

The Report presented a curious blend of 1990s global competitiveness concerns and 1970s government social activism.

The Report tried to balance three main objectives for the financial sector:

- meeting global competition,
- ensuring safety and stability in the system, and
- meeting its social obligations (as defined by the government).

The MacKay Task Force found, that the current financial services framework was not as effective as it should be, in reducing the information and power imbalance between institutions and consumers.

For consumers, the MacKay Task Force report was a god send. It recognized that making sure financial services accessible to all Canadians was an important public value, and that fairness to consumers was consistent with a healthy marketplace, not , as the industry had long argued, was counter to competition. The Task Force offered 124 recommendations that addressed the 4 broad themes of the report:

1) Enhancing Competition and Competitiveness
2) Empowering consumers
3) Canadian expectations and corporate conduct

The report argued, "**Our recommendations will increase competition and choice for Canadians. They will also ensure that the marketplace works more fairly and responsibly.**"

An interesting and remarkable difference between the attitudes of the American and Canadian financial system were emphasized by Pierre Ducros, Vice Chairman of the Task Force, who said it was important to understand that the relationship *between consumers, financial institutions, governments and regulators was an interactive one*.

He wrote in the report, "**More than ever before, to work truly well, the four must be in harmony. Each must better understand the needs of the other and the challenges they are facing. Our conclusions and recommendations are designed to be a cohesive blueprint of how to meet that reality.**"

The report called for life insurance companies, mutual funds, and investment dealers to be given access to the payments system, the network that allowed banks to cash each other's cheques. By opening up the payments system, consumers could use, for example, an automatic bank machine in order to make a withdrawal from a money-market fund.

The report also called for more flexible federal rules on the ownership of smaller banks, both to encourage new banks to start up and let existing ones forge strategic alliance with other companies.

Out of 124 listed recommendations, only a handful are listed here for space saving purposes.

List of Recommendations:

- Legislated privacy regime that will assure consumer protection of sensitive personal information
- Stronger and broader ban on coercive tied selling than now exists
- Better assurance of access to basic banking services for low-income Canadians
- A regime for financial institutions to issue regular Community Accountability Statements that discuss contributions to the community and identify emerging community needs
- New powers for credit unions and credit union centrals to make them more effective, including the power to become or form cooperative banks,
- Integration of deposit insurance for banks and compensation plans for life insurance companies, to reduce the competitive advantage that banks now enjoy
- Strengthening the Office of the Superintendent of Financial Institution's (OSFI) governance structure and reducing regulatory overlap by transferring the regulatory responsibilities of the Canada Deposit Insurance Corporation (CDIC) to OSFI
- Public Interest Review Process for large mergers, with a Public Interest Impact Asssessment that examines the public interest costs and benefits, and legislated power for the Minister of Finance to accept enforceable undertakings from merger proponents with severe sanctions for non-compliance

The Task Force proposed the implementation of a public review process involving the Competition Bureau (with respect to competition matters), the Office of the Superintendent of Financial Institutions (with respect to prudential matters), the Canadian public (with respect to "the public interest") and the Minister of Finance (with respect to the federal government's *interpretation* of "the public interest"). Although lukewarm on the actual need for bank mergers, the Task Force Report concluded that if a proposed merger met competition and prudential standards, it should be approved unless there were overriding public interest concerns.

The report explicitly said, "**While it is not in our mandate to pass judgement on the proposed mergers between major Canadian banks, we did thoroughly examine the merger policy and process issues… The Task Force recognized that mergers can be a valid business strategy…there should be no absolute ban on mergers amoung large banks, insurance companies or other financial institutions. However,**

no such mergers should take place if it is not consistent with the public interest."

The Task Force report was supported by five background papers that discussed in detail, the reasoning that led to the conclusions of the Task Force, as well as 18 research studies it commissioned.

The Task Force Report formed the basis of the 1999 Department of Finance White Paper entitled Reforming Canada's Financial Services Sector: A Framework for the Future.

Thereafter, many of the recommendations of the Task Force Report and the White Paper were included in Bill C-38, which contained a massive update of the *Bank Act* and other federal financial institutions legislation. The Bill died in the chopping block, as a federal election was called for the fall of 2000. When the Liberal government was re-elected, the bill was reintroduced as Bill C-8 in February of 2001 and enacted in June 2001, as the **Financial Consumer Agency of Canada (FCAC) Act.**

2001 changes to the Bank Act and related federal legislation implemented some important safeguards and protection, particularly for retail consumers. These measures included mandatory low-cost accounts, branch closures requiring advance notice and public hearings, cashing government cheques without charge, and related basic services required from banks. These were to be monitored by FCAC.

The tabling of Bill C-8 on February 7, 2001 followed the issuance of a government press release that contained, as a two-page annex to a brief summary of the legislation, the federal government's long-awaited Merger Review Guidelines for large banks (those having more than $5 billion in equity).

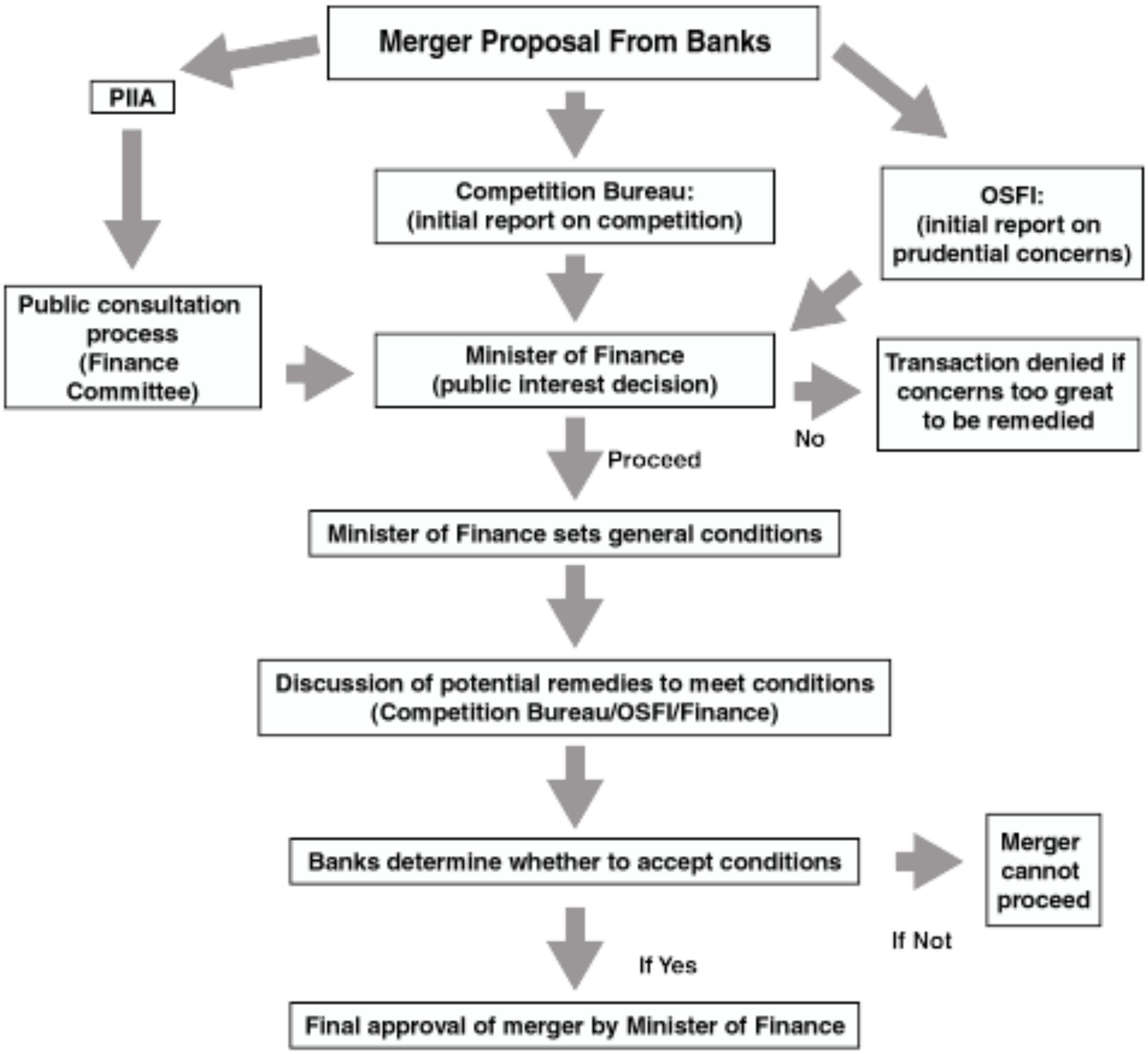
The Guidelines described a three-stage public review process that must be followed for large banks to merge, and it was not much different from those measures outlined in the 1998 Task Force Report.

Merger Review Guidelines

- Stage 1 – Examination of the Proposal. The first stage of this process commences with the submission of a written application for permission to merge. The application is to be accompanied by a comprehensive Public Interest Impact Assessment ("PIIA") prepared by the applicants. Among other things, the Guidelines require the applicants to address the rather toxic issues of job losses, branch closures and access to credit for small and medium-sized businesses.

- Stage 2 – Minister of Finance Decision. After stage 1, initial reviews of the merger application and the PIIA are then carried out by the Competition Bureau, OSFI, the House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade and Commerce, with the latter two bodies expected to hold public hearings on the merger application. The results of these various reviews are then communicated to the Minister of Finance for the second stage of the process, which the Guidelines describe as follows: "Using the reports of the Competition Bureau, OSFI, the Finance Committee and the Senate Committee as inputs, the Minister of Finance will render a decision on whether the public interest, prudential and competition concerns are capable of being addressed. If not, the transaction will be denied and the process stopped at this stage."
- Stage 3 – Negotiation of Remedies. The third stage, if ever reached, consists of negotiations on any steps required by the Competition Bureau, OSFI and the Minister of Finance to remedy specific problems created by the proposed merger.

Here is a diagram of the ***regulatory framework*** for the Merger Proposal from Banks.



The issuance of the Merger Review Guidelines did not stimulate a new round of bank merger announcements. Instead, these guidelines drew criticism from banks and other interested parties, who concluded that the “public interest” was still code for the perceived “political interest” of the Liberal government.The criticism centered on the fact that although the Guidelines purported to create an objective and transparent review process, the final decision would still be made by the Minister of Finance on an ill-defined, and malleable “public interest” basis.

I argue it was wise, and very prudent, of the Minister of Finance to not allow either merger proposals to occur. The differences in the merger between TD Bank and Canada Trust (Bank + Trust Company) were *completely different than that presented between TD Bank and CIBC. The latter, had different implications.*

*The approval of the merger between TD Bank and Canada Trust in early 2000 demonstrated an important point, that it was not a "merger of equals" amoung large banks that was permitted but rather it was a "**Cross-pillar**" acquisition that was allowed. This would serve to demonstrate to naysayers, that the Government was open to large institutions merging in the Canadian financial services sector, just not "inter-pillar" between two existing big banks.*

It is also important point to note that when the TD – Canada Trust transaction occurred, for the permission to the granted, the Government was assured by TD Bank that it would be raising its service levels to levels of Canada Trust as well as handling the employment issues during the integration phase.

Also, certain branch divestitures were required as an anti-competition remedy for government approval of T-D bank acquiring Canada Trust.

Divestitures

Some witnesses at the committee hearings noted that mergers can enhance competition by providing an opportunity for new competitors to emerge or for existing participants to increase market share, including foreign and small Canadian banks, co-operatives and credit unions, and single-product financial service providers. Divestitures, which involve the sale of assets (including branches of banks) of the merging parties to a third party, have provided the potential for an opportunity, not only to ensure that sufficient competition has continued to exist following a large merger, but also to add a significant competitor either by allowing existing institutions to expand or by creating new ones.

The divestiture of *bank branches*, for example, is widely considered among industrialized countries as a successful approach for addressing concerns arising from a bank merger. In the Canadian context, divestitures have helped provide an opportunity to enhance the competitiveness of other competitors such as credit unions or smaller banks.

Conclusions

In summary, this article has sought to emphasize, that at least on a regulatory stage, it wasn't the characteristic of prudent banks, but prudent regulators and ultimately the Finance Minister, that decided the denial of the bank mergers. This quite perhaps may have been the single largest incident that saved the Canadian banking system, and the economy, from a significant crash.

Some great regulatory oversight can be credited to the Competition Bureau, the antitrust regulator/watchdog for Canada. Back in 1998, the Competition Bureau's, Konrad von Finckenstein, told *Maclean's* he expected MacKay's analysis to have a major influence on his findings, especially in assessing the competitive impact of new technology. He was reported to have said, "**The best view we have of some of the market developments, some of the pressures, is the MacKay task force**." However, von Finckenstein was not bound in echoing MacKay's call for allowing mergers.

Unlike MacKay, as per his mandate, von Finckenstein had to apply and enforce strict rules. If either of the two merged banks commanded more than 35 % of a certain local market for a financial service, such as credit cards in one city or home mortgages in another, the bureau's guidelines and models had assumptions that competition might be seriously threatened. According to it's own framework, as part of sound regulatory policy, it would also consider any situation in which any four banks having more than 65 % of a particular market to be too much concentration.

Testimonies from Both Sides of the Divide - Deregulation of Canada's Financial Industry will attempt to further analyze the comments provided by bank executives, and those of public service personnel.