Outward Expansion – Deregulation of Canada's Financial Industry Part 7

Banking Expansionist Empire

In academia, the risks in financial collapse can arise due to two market failures. One of these market failures is asymmetric information. On this line of reasoning, depository institutions are better informed about the characteristics of investments they make with depositors savings then the depositors.

The characteristics of financial firms, such as their high leverage position, has enhanced the risk of bankruptcy, and each time a bank fails, it creates a lack of confidence in the system, which can lead to a contraction in the process of inter-mediation, leading to further failures…despite the prudence by other banks.

The Canadian approach to guarding against bank failures has been to protect the industry ***from*** competition. This has encouraged an oligopoly in the domestic market. The manner in which it works, is that when competition is lacking, firms earn economic profits that keep them above the break-even point.

The central debate has been, whether an environment allowing for the concentration of economic profits is likely to experience failures among financial enterprises.

However, reducing competition creates another market failure since firms with market power do not allocate resources efficiently.

Thus, there is **tension** between the *risk of bank failure* (i.e. too big to fail) and the *risk of a non-competitive financial sector* and this tension has been evident in the regulations of the Canadian financial sector.

The recent trend has been towards a relaxation of regulation that was previously designed to enhance the stability of the industry. As a result, Government policy towards competition in banking has been more stringent than in the past.

Competition policy, and merger law, has been concerned with ensuring efficiency by examining the potential anti-competitive effects of proposed mergers.

In Canada, the Competition Act and the Bank Act govern bank mergers. The Competition Act is administered and enforced by the Competition Bureau, which is specialized in interpreting the Competition Act and representing the government with regard to competition issues. It also assists the public in understanding how Canadian

law is concerned with competition and how potential mergers will be dealt with. To achieve these goals, the Competition Bureau created the Merger Enforcement Guidelines which were a non-legislative and more practical interpretation of the Competition Act. There were also a special set of merger guidelines for banks.

As emphasized in Historical Context – Deregulation of Canada's Financial Industry Part 2, Canada had traditionally limited it's financial institutions to participate in just one of the following "pillars": commercial banking, trust and mortgages, cooperative credit unions, insurance, or securities. **Ownership limits were inspired by the desire to hold Canadian ownership of financial institutions and prevent links with non financial firms.**

Until 1967 revision of the Bank Act, banks were prohibited from offering mortgage loans and there was also a ceiling on interest rates that further restricted the banks' ability to offer consumer loans.

A sunset clause was introduced in revisions of the Bank Act requiring the re-evaluation of regulations every 10 years. This clause has reflected the Government's recognition of banking as a dynamic industry with very quick changes, thus the government has been committed to act accordingly.

Out of a response to the steady efforts at deregulation, the banks expressed a strong desire to engage in mergers and acquisitions in order to "compete" (as they would argue). This is covered extensively in Banks Prudently Regulated to Teeth - Deregulation of Canada's Financial Industry Part 4 of this series.

Market Trends

To completely understand the impact deregulation has had on competition, it's useful to outline the market trends that have also influenced the financial sector. The globalization effects that affected the financial industry allowed savers and borrowers to go into world markets to find the services they demanded. So, for businesses looking to obtain direct external financing, world capital markets were attractive because they may have provided for cheaper financing options.

Before the changes in regulation, the banks' loans were made up of few mortgage and consumer loans compared to the other institutions. A large part of the mortgages in

Canada were now offered by the banks. The banks share of mortgage grew from 10% in 1970, to 55% in 1996 (Freedman, 1992, p. 22).

National banks had an advantage over mortgage companies in the absence of restrictive regulations.

Consumer loans also moved towards banks as well and this was evident from the increased share the banks had of consumer loans, increasing from approx. 50% in 1970, to 70% by 1996. This all boiled down to one thing, banks wanted to grow even more, and seek even higher profits. This is why expansions were the second way at attempting growth, once mergers and acquisition strategies were employed.

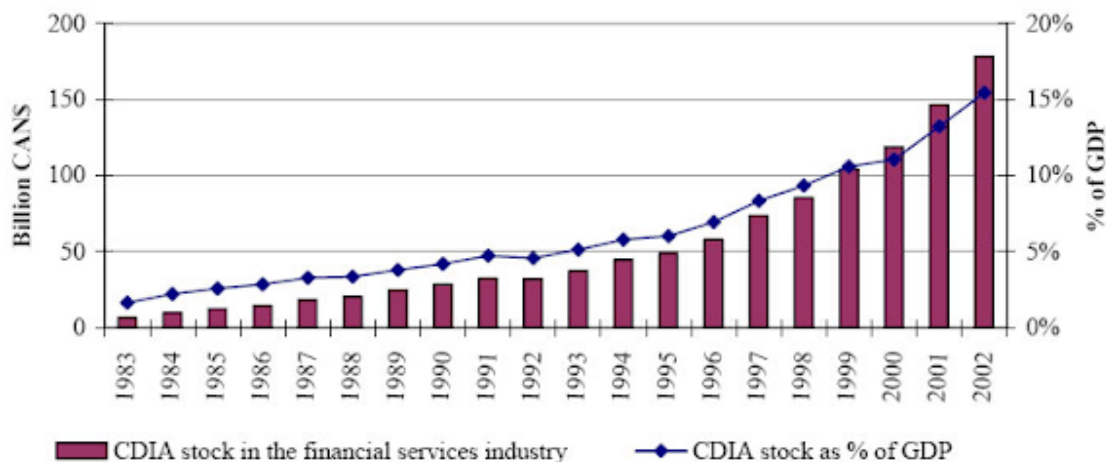
Expansions

The major Canadian banks and insurance companies have been active internationally, and have long been an important source of Canadian direct foreign investment abroad (CDIA). In 2001, within the financial services sector, ***Canadian direct investment abroad*** was **worth** more than 3 times the value of ***foreign direct investment in Canada.***

Altogether, Canadian direct investment abroad in financial services doubled, between 1995 – 2001 as a percentage of Canada's GDP; while foreign direct investment in Canadian financial services remained constant.

FIGURE 4

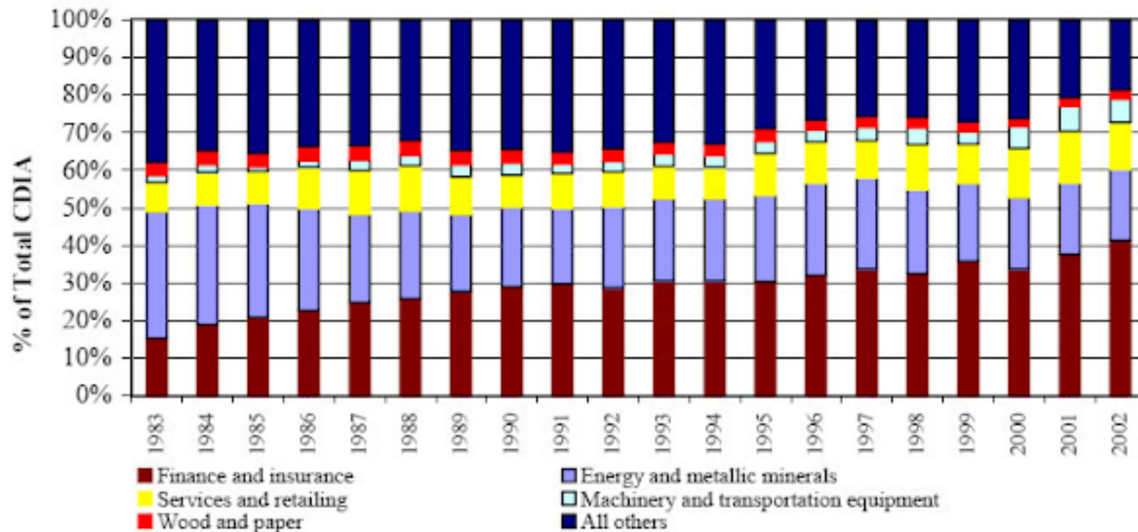
Stock of Canadian Direct Investment Abroad in the Financial Services Industry, 1983-2002



Thus as you can see, Canadian Direct Investment Abroad as a % of GDP almost tripled between 1995 – 2001, and this was occurring thanks to the deregulation of the financial services industry, and the international expansion of the banks.
During the latter part of the 1990’s, 4 of the 5 major Canadian banks focused on North American strategies. The Bank of Nova Scotia was the exception, as it built on its traditional base in Latin America and the Caribbean. It continued to follow this pattern, as shown by it’s acquisition in 2004 of the fourth largest bank in El Salvador. The other major Canadian banks focused their foreign strategies on the American market.

FIGURE 5

Composition of Stock of Canadian Direct Investment Abroad, 1983-2002



This graph also depicts, how the composition of stock of Canadian Direct Investment Abroad was growing more heavily on the finance and insurance industry. The successive wave of deregulation not only improved banks own earning capacity, but it also made it more lucrative to invest in the finance and insurance industry. This would come at the detriment to other, more productive parts of industry such as energy and metallic minerals, and wood and paper.
The Liberalization of the American banking sector to allow inter-state banking, and the combination of commercial and investment banking both opened up opportunities for Canadian banks to engage in consolidation within the US.

Here is a chart showing some of the findings of acquisitions in the U.S.

Table 9: BMO and RBC Acuisitions in the US.

BMO acquisitions in US (1984-2004)

Year	Acquisition	Purchase Price (millions of Canadian $)
1984	Harris Bank	$718
1985	First National Bank of Barrington	$43
1987	Commercial State Bank (Phoenix)	$3
1988	State Bank of St. Charles and First National Bank of Batavia	$31
1990	Frankfort Bancshares	$20
1990	Libertyville Federal Savings & Loan	$7
1994	Suburban Bancorp	$300
1996	Household International	$378
1999	Burke, Christensen and Lewis	$59
2000	Century Bank	$24
2000	Freeman Welwood	$140
2000	Village Banc of Naples	$19
2001	First National Bank of Joliet	$337
2002	my CFO	$61
2002	Self-directed online client accounts of Morgan Stanley	$153
2002	Northwestern Trust	$19
2002	CFSB*direct*	$854
2003	Sullivan, Bruyette, Speros & Blayney	$20
2003	Gerard Klauer Mattison	$40
2004	Mercantile Bancorp	$197
2004	New Lenox State Bank	$314
2004	Lakeland Community Bank	$49

RBC acquisitions in US

Year	Acquisition	Purchase Price (millions of US$)
2000	Prism Financial Corp	$115
2000	Liberty Insurance	$580
2000	Dain Rauscher Corp	$1,456
2001	Centura Banks	$2,300
2001	Tucker Anthony Sutro	$625
2002	Eagle Bancshares	$153
2002	insurance and mutual fund	$220

These acquisitions help illustrate the aggressive nature of the banks in seeking to expand.

However, in the event of the 2008 US financial collapse, Canadian banks have received a badge of honour, for being labelled as prudent and safe. I would like to contend that they are not quite as safe or prudent as one would be led to believe. Although assessing and critiquing Canada's banks will occur in another article, the **Canadian banks had their hands dirty in many fraudulent practices.**

The collapse of the stock market bubble and the bankruptcies of such previous large conglomerates such as Enron, Global Crossing, Adelphia, and WorldCom, demonstrated a large revelation about highly fraudulent business practices and snake accounting procedures that were often perpetrated with the complicity of auditors and bankers

This was because of an intense pressure to boost short-term shareholder value, and the prevalence of stock options as a method of executive compensation encouraged aggressive business practices and ***"creative accounting"***. The banks were under similar pressure to make the big deals and sustain the stock market bubble.

Former Vice President and Chief Economist of the World Bank, Joseph Stiglitz wrote,

in the 90s', the banks became so eager for short-term profit that there was a race to the bottom. Each bank knew that its competitors were engaging in similar practices, and if it didn't compete, it would be left behind; and each banking officer knew what that meant: smaller bonuses, perhaps even being fired…The banks must surely have known that when the bubble burst, many of the loans that they had made would fail. Thus the banks' loan portfolios depended on keeping the stock market bubble going.

American Losses Inflicted on Canadian Banks

By 2005, the biggest deal made by a Canadian financial institution was Manulife's $15 billion takeover of John Hancock Financial Services, including Maritime Life. Through this deal, Manulife became the largest publicly traded firm in Canada, the second largest life insurance company in North America and the 5th largest in the world measured by market capitalization.

Also, Canadian bank executives, for the most part, defended their goal of domestic consolidation on the basis that they needed a larger capital base to expand abroad, particularly in the US.

Therefore it is ironic, that foreign mischief in recent years played havoc with the Canadian banks' balance sheets.

For example, during the 2001-2002 financial crisis in Argentina, Scotiabank faced angry protests after it closed its subsidiary Scotiabank Quilmes. Ultimately, Scotiabank took a $540 million write-down and sold the subsidiary.

In the US, there were meltdowns and scandals in the North American telecommunications and energy sectors that hit TD and CIBC.

The problems experienced in the US market, especially with the high-tech meltdown, led to a $2.9 billion loan-loss provision and an annual net loss for TD in fiscal 2002. This has been a rare event for one of Canada's major banks.

To respond, TD slashed its corporate lending portfolio and restructured the international division of its discount brokerage and its US equity options trading business.

Also occurring in 2002, CIBC closed down its American electronic banking unit, Amicus, and faced a $366 million write-down in the process, including selling off its Oppenheimer brokerage. It also scaled down its US investment banking services.

In 2004, RBC was also hit with difficulties. RBC spent $8 billion over 4 years to expand its American presence but had little return on investment. Also in late 2004, RBC announced it would cut 1,600 jobs and RBC Centura was forced to scale back expansion plans.

Even with the troubles the Canadian banks faced in the US, they were certainly able to rely on their retail banking operations in Canada, which provided them with a steady income year after year.This effective banking oligopoly kept them relatively safe.

In conclusion, Canadian Direct Investment Abroad (CDIA) and Foreign direct investment (FDI) trends indicate that Canadian companies started becoming more globally oriented. The Canadian investments abroad included those such as Alcan's acquisition of Pechiney, the French aluminum giant, and Manulife Financial's $15-billion takeover of John Hancock Financial, a U.S.-based financial services company. On the flip side, foreign entities have also likewise pursued direct investment opportunities in Canada. Examples include the acquisition, in 2000, of Ottawa-based Newbridge Networks by Alcatel, a French telecommunications giant, and the 2001 acquisition of Laval-based BioChem Pharma by Shire Pharma, a pharmaceutical company based in the United Kingdom.

The deregulation in the financial industry outlined the growth in outward-bound Canadian direct investments in the past 20 years, was a trend fueled largely by the financial services industry. This led to Canada increasingly becoming a net direct investor abroad. This phenomenon was driven in large part by financial services, where Canada traditionally enjoyed a competitive advantage because of historical factors.

The deregulation in the financial industry took on a life of it's own, starting with the 2006 Conservative Party's minority government. This will be explored in Part 8.