Testimonies from Both Sides of the Divide- Deregulation of Canada's Financial Industry Part 5

Back in 1998, the Parliamentary Committee on Finance published their report and included below were the results.

The **Committee argued** that the mergers of large federally regulated financial institutions **posed a significant policy dilemma to the country.** The Committee was against large banks and large insurance companies from buying each other out.

The reasons for their decision was, “driven by the Committee’s belief that if the major insurance companies and banks merged, **it would result in too much concentration of economic power in too few hands**. The Committee is very uneasy about reducing the financial services sector to only four or five companies. The Committee believes that in a pluralistic society, it is essential that there be a multitude of powerful decision makers. Moreover, allowing excessive concentration across the full range of financial services could well create a level of systemic risk that would be unacceptable. This can create the conditions for what is commonly referred to as the moral hazard problem of "**too big to fail**."

Indeed, looking back to the 2008 crash, **`too big to fail`**was a significant problem among the big Wall St firms which resulted in them receiving a TARP bailout to the detriment of the population that had to bear the costs associated with it.

Full Re-Cap from Previous Articles

The **legislative changes in 1992 to the Bank Act** had drastic changes for the financial services sector leading to the near **elimination of the independent trust company sector.** Similarly, the independent investment dealer sector was quickly dominated by the banks, after the Ontario government removed the restriction on investment in securities dealers by other financial institutions in 1987.

The Parliamentary Committee described that the same **should not be allowed to**

happen with respect to the life insurance sector (as emphasized above).

However, the **Committee did not recommend restrictions be placed on banks** from buying small insurance companies; indeed that was something banks could already do. Rather, the **Committee's recommendations stated that large institutions should not be able to buy another large institution from another pillar.**

However, most **financial services CEOs** who testified before the Committee said that their primary interest was in consolidation within their ***own industry*** rather than ***across pillars***. Their testimonies made it very clear that it was intra-pillar consolidation that yielded the greatest efficiencies and cost reductions, not inter-pillar mergers.

MacKay Task Force

The Task Force was of the view that the Bureau, with minor modifications to the Mergers Enforcement Guidelines (MEGs), was appropriately positioned to examine the potential anti-competitive and abusive dominance implications of proposed mergers in the financial services sector. The Task Force also identified OSFI as the appropriate agency to advise the Minister with respect to the incremental systemic risk, if any, posed by specific business combinations.

The most significant thing, is that the Task Force argued that OSFI should **not** be attempting to ensure that financial institutions **never fail;** and that in considering mergers of large financial institutions, ***OSFI should focus on the doctrine of "too big to fail."***

This was significant, and the Parliamentary Committee criticized this because they understood, that allowing excessive concentration across the full range of financial services could well create a level of systemic risk that would be characterized as "**too big to fail**."

Testimonies in Parliamentary Committee Report

Found in the House of Commons Parliamentary Committee report, here were some of the submissions of testimony among bank executives. It should be noted that these individuals were ***in favour*** of the **MacKay report**. This serves to provide some context into their line of thought, and their perceptions of the regulatory climate at the time. Witnesses who favoured a "**big buy big**" policy generally commented on the validity of mergers as a business strategy.

On October 7, 1998, Peter Godsoe testified, "**Clearly, mergers represent a valid business strategy. In-market mergers are a classic response where companies wish to increase market share and reduce costs through elimination of duplicate networks. That is clear. I have no problem with this in principle…**"

On September 29, 1998 John Cleghorn testified, "**the Royal Bank is in full agreement with the [MacKay] report's conclusions that mergers among institutions are a viable business strategy and should not be prohibited outright. We also fully support the**

report’s proposals for the case-by-case merger review process.”

<u>One witness cautioned that the regulatory process must remain strong and that larger banks are stronger.</u>

Group Chief Executive of Barclays Bank of London, said, “**What if one fails? Again, you must look at the anatomy of why banks fail. In many respects, history indicates that too small to survive is a bigger problem than too big to fail, if the history of bank failures since the 19th century is any indication. To give you an example, a major bank has not failed in Canada since 1920, which means Canada came through the 1930s without a major bank failure. We have an outstanding supervisory and regulatory regime in the country. The two institutions involved are AA rated. They would have a combined capital base of $25 billion before you would ever get anywhere close to there being a loss. I argue that when you combine banks that are strong to begin with you reduce the risk of failure.“**

In a separate statement, Barrett felt that the decision of the bank mergers was becoming politicised. He was reported to have said, "**It's purely political and not about concentration…I think it's a disgrace.**" This is found in the document titled: Depoliticization of Bank Mergers Must Occur

Since he is speaking from a banker's perspective, I hope you can begin to understand, that he was absolutely wrong, in that averting systemic risk is sound policy, not pandering to political objectives.

The Superintendent of Financial Institutions, on the other hand, indicated that the evidence on bank size and financial solvency was inconclusive.

John Palmer former Chief of OSFI testified, "**As a general matter, however, I think it is very hard to determine the simple answer as to whether risk increases, decreases, with things like size, geographic scope, participation in particular business lines or other business lines. I think that the sort of**

experience on this internationally does not support a conclusion one way or another.“ However, some witnesses felt that, at the large end of the size spectrum, bank mergers pose a significant risk in that the remaining institutions are not likely to be able to pick up all the pieces of a failed large bank without taxpayers having to make a contribution.

Peter Godsoe, CEO of Bank of Nova Scotia testified, “**With regard to “too big to fail,” if one of the five of us went under, could the other four, the government, insurance companies, et cetera, subdivide it and, as we have done since 1920, work this out without costing the taxpayer one cent? Probably not.**”

Here Godsoe is attempting to reinforce, that the Canadian banks are already too consolidated and centralized, and in the event of a systemic collapse, a public bailout would probably be required since it is baked into the cake. And infact, as will soon be revealed in an upcoming article, the big Canadian banks did require a certain amount of ‘liquidity injection’ from the *taxpayer which was provided by the Federal Government. Of course, this is not called a 'bail out' by the Government, but you may decide for yourself what you feel about it.*

When evaluating a merger proposal, the OSFI Chief said,

We then tend to try to look at whether the quality of the risk mitigants, the risk control systems, the capital levels, the reserving levels are appropriate for the kind of inherent risks in the activities, and a balance of those two, so that the net risk, if you will, is manageable from the point of view of the overall safety and soundness of the institution. Clearly, for example, there are lot of cases in which expansion of geographic scope can actually reduce risk because it diversifies risk. There are other examples in which expansion of scope can lead to control problems if not managed appropriately and lead to surprises that have occurred, and there is experience of that internationally.

In conclusion, ***for the most part*** the House of Commons (HoC) Parliamentary

Committee report supported the recommendations of the MacKay report. In it's conclusions, the HoC found that if two financial institutions proposed a merger, then 3 different categories of issued would need to be addressed:

1. competition policy issues, [by the Competition Bureau]
2. prudential issues, and [by the Office of the Superintendent of Financial Institutions]
3. stewardship issues (the Task Force calls these latter issues "public interest" issues). [by the Finance Minister]

At the time, the Committee believed that these issues should be addressed sequentially. Also, the Committee report found that the requirement of the Competition Bureau be satisfied that a proposed merger is not anti-competitive, and that OSFI be satisfied that it posed no prudential problems, would be ***necessary prerequisites*** to any merger proceeding. "**Until the necessary conditions are met, it is meaningless to address the additional set of stewardship issues that**

apply to financial institutions," the report read.

At the time, the Finance Minister took much heat not just from banking lobbyists, but also from the opposition party. The Conservatives blamed the governing Liberals as "politicizing" the bank merger process. The Conservative Finance Critic Scott Brison, compiled a scathing report attacking the Liberal government's delays of the bank merger process. The report of the document was titled: De-politicization of Bank Mergers Must Occur.

This process laid out here describes the process and efforts that went into the bank merger decision. It is important to note that each body had it's own purpose to fulfill; OSFI, Competition Bureau, HoC/Senate Parliamentary Committees, and the Finance Minister.

Looking back, it can be said that the prudence of our regulators and Finance Minister are to be applauded for. Thus, I argue that the denial in allowing the bank mergers was one of the main reasons for maintaining the perception of Canadian banks as safe, and stable as they are known today. However, the story doesn't end there. Life insurance companies were the only remnants of the old big-4 pillar remaining; considering that independent trust companies and brokerage firms were quickly overtaken by the big 5 banks.

The reason the banks proposed a merger in the first place, as they stressed, was on a need to combine forces in order to withstand against new foreign competition. Indeed, this is plainly obvious when one reviews the testimony given by numerous bank executives to the Parliamentary Committees. If one were to step back and examine the events taking place in the 1970s and 1980s, one would observe that the trend towards market liberalisation caused this state of affairs.

The Bank of Nova Scotia, part of the Big 5 Banks, and the only bank without a merger partner, attacked the merger deals for concentrating banking clout in its rivals' hands. Comments from a bank executive from Nova

Scotia, as well as others can be viewed in The Banking Empire Deregulation of Canada's Financial Industry of this series.
Also, Life Insurance Companies demanded greater powers to compete with the banks, even if Ottawa decided to block the mergers. This is discussed in more depth in The Life Insurance Industry and Banks Woes – Deregulation of Canada's Financial Industry Pt 6 as consolidation in the Life Insurance also was part of the deregulations that took place within Canada's financial industry.