The Life Insurance Industry and Banks Woes – Deregulation of Canada's Financial Industry Part 6

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If you've been reading the past 5 parts of this series, then you have realized, that on the bank mergers, the Finance Minister claimed to have rejected it on the grounds that it would lead to an unacceptable concentration of economic power, along with a significant reduction in competition and reduced policy flexibility for the government to address potential future prudential concerns. The Minister based his decision on the reports from the Competition

Bureau and the OSFI As well as public opinion polling of Canadians, who were against the idea of a bank merger.

The Competition Bureau found that the proposed mergers would result in, "**a substantial lessening or prevention of competition that would cause higher prices and lower levels of service and choice for several key banking services in Canada**." (Competition Bureau, 1998a and 1998b).

The Superintendent of Financial Institutions gave suggestion, that if one of the merged banks ever faced insolvency, it would represent a huge challenge to regulators and the Canadian economy (OSFI, 1998).

The mergers were also opposed by other groups such as by Peter Godsoe, Chairman of the Bank of Nova Scotia (the only remaining big 5 bank without a merger partner), the Canadian Federation of Independent Business, the Retail Council of Canada, the Council of Canadians, the Canadian Community Reinvestment Coalition, the NNDP political party, and many of the Liberal caucus.

A survey done by the Conference Board of Canada in 1998 also suggested that corporate boards across Canada did not favour the bank mergers. And the Canadian Bankers Association, and the Business Council on National Issues, were weakened by the split in their ranks.

Life Insurance Companies

So what role did deregulation play in the efforts of the Life Insurance Companies of Canada? Well, at the time of the bank mergers, Paul Martin declined on the merger proposal, he stated, "**Whereas the merger proponents wanted the mergers to be allowed in order to change the status quo, we believe the status quo must be changed before any merger can be considered…The government will not consider any merger among major big banks until the new policy framework is in place.**"

At that time, Martin was referring to the demutualization of the major insurance companies and the removal of the ban on branches of foreign banks in Canada. These were key aspects of the deregulation.

In 1998, the Acting Assistant Deputy Director of Investigation & Research, **Richard Taylor,** gave a speech to to the Canadian Life Insurance National Conference titled: Evaluating the Impact of Consolidation on the Life Insurance Industry

He said, " **In a limited number of instances, competition issues arise from a merger as a result of there being too few existing competitors left to discipline the market, and minimal likelihood of new entry doing the same due to the presence of significant barriers to entry or expansion in the market. While one of the great strengths of a market economy is its ability to adapt to change, there is a need in mixed economies to ensure that the regulatory framework which**

oversees the market remains adaptive, effective and clearly focused on achieving its intended objectives."

He also makes a crucial point on the issue of regulation vs competition and I believe this is quite insightful.

From a competition policy perspective, competition should act as the fundamental driving force of our economy. Competition within markets provides a much better vehicle than regulation for creating the incentives that encourage the development of new products, services and the methods of delivery to consumers. Competitive market forces drive the prices of goods and services toward their relative costs of production. This minimizes the misallocation of resources in the economy

which in turn enhances economic welfare. This is not to say that market intervention and regulatory oversight is not sometimes warranted. In some instances, market forces alone cannot be relied upon to meet public policy objectives. And, in these instances, the reality is that achieving these public policy objectives may come at the expense of competition.

The subject of much debate happens to be on whether market intervention and regulatory oversight is ***actually warranted****. However this point will be addressed in a subsequent article.*

In 1999, the federal government also passed legislation allowing large federally regulated mutually owned life insurance companies to convert into publicly listed shareholder owned

companies, a process known as ***demutualization***. This measure was intended to grant them access to an important source of financing, as well as giving them greater organizational flexibility.

This also meant that for the following two years, government mandated a breathing period for demutualized firms, with no permission for mergers or acquisitions. The Five largest mutual life insurance companies at the time; Manulife, Sun Life, Canada Life, Mutual Life (renamed Clarica and Industrial-Alliance) then demutualized and issued shares in 1999-2000.

Shortly after the ban of mergers on demutualized insurers had ended (after the two

year period), the life insurance sector saw a large wave of consolidations as well.
In 2002, Sun Life acquired Clarica (formerly Mutual Life), for 7.3$ billion.
In 2003, Great-West Lifeco Inc, part of the Power Corporation empire, struck a $7.3 billion deal to buy Canada Life.
In 2004, Manulife acquired The Maritime Life Assurance Company and this was based on Manulife's acquisition of Maritime's parent company, Boston-based John Hancock Financial Services, Inc.
With this in place, the life insurance space was dominated by three large players; Manulife, Great-West Life, and Sun Life. Assisted by deregulation, demutualization, and the consolidation within the Life Insurance Industry

helped to strengthen the largest life insurance companies as diversified financial groups in order to become solid competitors to the banks.

This was also said by Yvon Charest, CEO of Industrial Alliance, which a is mid-sized Life Insurance company. He presented a report titled: Consolidation in the Life Insurance Industry.. How Does David Compete in a World of Goliaths?

He acknowledged as well, “**the life insurance industry has had the reputation…of being the most boring sector in Canada (one of the reasons being that it’s full of actuaries, like myself)…the life insurance industry is going through a major restructuring process. The industry has gone through**

more changes in the past five years than it has in the past 100 years. Five of the country's largest life insurers have demutualized and the consolidation has accelerated to the point where the three largest life insurers now control more than half of the Canadian market."

He went on to say,

While the life insurance market used to be quite fragmented, with well over 100 companies operating in the marketplace, it's not evolving quickly towards an oligopoly, like the banking sector.

His report is an excellent insight into the way several mid-sized Life Insurance Companies felt about the consolidation that was occurring within the industry.

This “oligopoly” in the Life Insurance industry was seen as a way to combat and curb the big banks and keep the system churning. As we’ll see, this presented some interesting challenges for the banks.

Banks being challenged

From here, the major banks argued that with the domestic competition among themselves, along with regulatory protections for the Life Insurance companies (remember the two year breathing period), they faced increasing competition from foreign entrants to the Canadian market.

Their argument was simply untrue, and the number of foreign bank subsidiaries in Canada was only 27 (OSFI, 2005) compared to 59 in 1987. This demonstrates the level of

consolidation that actually took place over the years which led to a severe reduction in banking subsidiaries.

As you could clearly see from the figures at the time, one could conclude that the threat to domestic banks from foreign competitors was not warranted nor justified. The big five banks had feared that foreign competitors would focus on lucrative sections of the Canadian market. An example is MBNA, which is a large American bank that entered the Canadian credit card market. Another would be ING Bank, a subsidiary of an immensely large Dutch financial services conglomerate that developed a **‘virtual bank’** in Canada, and specialized in higher interest rate savings accounts.

The greatest challenge to banks came not from foreign competitors, but came in investment and corporate banking. The big five banks role as supplier of large corporate loans declined as a result of corporate access to international capital markets, securitization, and the emergence of new suppliers of the funds. This was highlighted in the **MacKay** report, saying, “**there is a clear trend for large businesses to look for their needs to many banking suppliers, and increasingly to foreign financial services providers, who are seen as more innovative and more capable internationally. The traditional relationships of large Canadian businesses with domestic banks have clearly been replaced with more discriminating and more critical ones.**”

Thus, foreign, and primarily American firms, were playing a major role in underwriting international equity and debt issues for Canadian companies and were advising on mergers and acquisitions. This undoubtedly represented a significant loss for the Canadian brokers, as they missed out on the biggest and most lucrative deals. Their size, expertise, and access to American capital markets made the largest American firms extremely tough competition for the Canadian brokers.

However, this does not imply that Canadian banks were being squeezed and could not make ends meet.

During this time frame, new forms of corporate finance, such as ***syndicated loans, securitized instruments,*** and ***credit***

derivatives became increasingly important. For example, the Canadian syndicated loan market developed in the 1990s, allowing for Canadian borrowers to rely relatively less on the US market.

For the Canadian banks, the dominant form of securitization in the country was asset-backed commercial paper (ABCP), which emerged only in the late 1990s, but was worth $63.7 billion at the end of 2002.

This asset-backed commercial paper will be quite significant later on so keep this point in mind. The big banks accounted for 90% of the outstanding asset backed commercial paper in Canada, and three of them (BMO, CIBC, TD) accounted for over 75%.

All this meant that bank profits were starting to grow as a result of a more diverse range of economic activities. The percentage of bank profits obtained through non-interest based activities grew.

In 2004, interest income accounted for only 46% of the total bank profits for the big five banks (CBA, 2004b).

Changes in 2001

The 2001 gave way for an increase in the OSFI's supervisory powers. These powers increased the consequences for any institution that failed to meet certain regulatory or supervisory requirements. OSFI was given the power to remove directors and senior officers from office in certain circumstances, such as in instances of misconduct.

2001 also brought about new consumer protection legislation for the financial sector and consumer and community protections provided through either legislation or guidelines. This included:

-Guaranteed consumer access to a banking account with basic identification

-Access to basic low-cost banking services

-The right to cash a government cheque without paying a fee

-Requirement for annual public accountability statements by all financial institutions with equity above $1 billion

-Creation of a new federal agency – ***Financial Consumer Agency of Canada (FCAC)***. This agency was established in October 2001 to

oversee consumer protection measures and promote consumer awareness.

Some individuals have viewed the Liberal's implementation of regulations and guidelines, as merely a ploy used by the then-Liberal government as a political strategy. A strategy used in order to illustrate to the people their social responsibility and good corporate citizenship. And that with these prudent measures in place, the government could argue that it has in place the prudential regulations and consumer protections in order to allow future consolidations to occur within the sector.

This is evident because as indicated near the beginning of this article, Paul Martin had stated

that the status quo must be changed before any bank mergers could be considered.

Deregulation in Ownership Limits

In order to create common ownership regulations for both banks, and demutualized insurance companies, a new size based ownership set up was also established by the federal government in 2001.

Small financial institutions with equity under $1 billion had no obligation to be widely held. Medium sized financial institutions with equity between $1 billion and $5 billion are allowed to be closely held with only a requirement of floating 35% of shares on the market. These provisions would allow a domestic or foreign commercial enterprise to purchase or establish a small or medium sized bank.

Along with allowing small banks to be closely held, the federal government also reduced the amount of capital needed to apply for a charter from 10 billion to $5 million. These moves were designed to facilitate the creation of new financial institutions.

The first of these new institutions was Bank West, a subsidiary of Western Financial Group, which opened for business in 2003. Other such banks that were created under these rules were the Canadian Tire Bank and Sears Bank.

As indicated earlier, some have viewed all these steps as part of a political strategy. The allowance of foreign bank branches through deregulation, reduced barriers in creating new banks, and all of this has been portrayed by the federal government as increasing the

competition within the Canadian banking sector. It is argued that the state and the banks would like to use this argument in order to permit the bank mergers.

For those large financial institutions with over 5$ billion in equity, the 10% ownership limit per single shareholder can be increased to 20% of voting shares and 30% of non-voting shares. Changing the 10% rule was intended to offer the banks greater flexibility to enter into joint ventures and strategic alliances with other firms.

Some critics had warned however, that the change to 20% made little sense, and would actually rise the possibility of control, while maintaining the fiction of being widely-held. The widely-held rule was applicable to the big

5 Schedule I banks that have been discussed in depth in this series. The widely-held rule at the time meant that no more than 10 % of any class of shares of a bank could be owned by a single shareholder, or by shareholders acting in concert. Throughout the decades, this rule was a key instrument in addressing the prudential concerns relating to banks. Having widely-held financial institutions was seen as one way to limit the risk of self-dealing.

Widely held rules precluded upstream commercial links, which were traditionally perceived to increase the risk of inappropriate self-dealing, including distortions in credit allocation. Widely held banks were also subject to a high degree of market transparency and oversight, something that tended to enhance

governance and moderate the riskiness of management decisions. over the many years.Part 7 will address the impacts, and Canadian banks in expanding overseas thanks to the deregulations that had occurred.