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Financial Services

Branching Out:

The Urgent Need to Transform Canada's Financial Landscape and How to Do It

Thorsten V. Koeppl
James MacGee

In this issue...

The global financial landscape is changing. Canada's legislative and regulatory framework for financial services must change as well.

The Study in Brief

The federal government's most recent legislative reform in the financial sector, Bill C-37, sidestepped significant change. This is unfortunate because Canada urgently needs regulatory reform that would allow for the creation of a new competitive regime for financial services.

This *Commentary* evaluates the trend to significant consolidation within the global financial industry, and offers new economic perspective on the debate surrounding it. The study evaluates the main arguments for why banks would like to be "large," versus the potential costs of a highly concentrated banking sector.

The study points out that the emphasis on the costs and benefits of post-merger branch rationalization is misguided. First, it is unclear how many additional branches would be cut as a result of a merger, given the branch reductions already carried out by the Big Five banks between 1997 and 2004, when total branches fell from roughly 6,600 to 6,200. Second, it is not clear that fewer branches in the wake of a merger would have a significant adverse impact on access and competition, considering the increased competitive pressure from new players offering new distribution channels, such as PC Financial, and Canadian Tire Bank, and changing technologies.

Further, the market for the distribution of basic financial services has become far more contestable of the last decade implying that mergers may neither lead to a significant increase in market power for leading banks nor lower access to the financial system for businesses and consumers.

The *Commentary* concludes that:

- Banks should be allowed to merge as part of a larger strategy of realizing further efficiency gains and risk reductions mainly through internationalization of their operations;
- Competitive pressure from internet banks or banking services offered by retail chains should be supplemented by legislative action to ensure markets remain contestable through potential foreign entry;
- Mergers of insurance companies and banks should be allowed to foster competition and provide consumers and businesses with access to one-stop financial and insurance services. These mergers should be permitted as long as there are appropriate provisions to limit the exposure of the resulting conglomerate to large, aggregated risks from the insurance business.

Once mergers allow large Canadian banks to play a bigger international role and further entry of foreign banks into Canada is facilitated, the Office of the Superintendent of Financial Institutions (OSFI) should be expected to harmonize and coordinate its regulatory oversight with other national regulators.

The Authors of This Issue

Thorsten V. Koeppl is Assistant Professor, Department of Economics, Queen's University.
James MacGee is Assistant Professor, Department of Economics, The University of Western Ontario.

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The Canadian government recently passed and implemented Bill C-37, *An Act to amend the law governing financial institutions and to provide for related and consequential matters*, with the intention of updating the regulation of the financial sector in Canada. Even prior to its passage, the reforms were perceived as a disappointment.[1] While Bill C-37 implements some needed reforms, it mostly tackles issues at the periphery of the financial sector, leaving other pressing reforms untouched. In particular, it carefully avoids any statement concerning consolidation in the financial sector.

It is not surprising that the government avoided the issue of consolidation. After all, the discussions surrounding the merger proposals of Canadian banks (and their ultimate rejection) in 1998 demonstrated the political sensitivity of the topic. However, ongoing developments show a trend towards significant consolidation within the global financial industry. This *Commentary* evaluates this trend and offers a new economic perspective on the debate surrounding it, which pits arguments for the potential efficiency gains from further consolidation against government concerns about their impact on consumers and employees. Concentrating predominantly on the banking sector, we make four recommendations that push for a more market-based approach to shaping the future of the financial sector in Canada.

(i) *Allow Canadian banks to compete in increasingly globalized and specialized markets.*
Banks need to keep pace with the globalization of financial markets and the demands of more internationally oriented businesses and consumers. In order for banks to develop dynamically in the future, they must be allowed to realize further efficiency gains and risk reductions mainly through specialization and internationalization of their operations. Mergers are an important strategy for some banks to position themselves within such an environment, while they might force other banks to specialize on certain core strengths of their operations.

(ii) *Create competition from outside the Canadian banking sector.*
Independent of bank mergers, competitive pressure is key for ensuring efficiency in the financial system in the long run. Competition "on the fringe" of traditional banking (such as internet banks or banking services offered by retail chains) should be supplemented by legislative action to ensure that markets remain contestable through potential foreign entry. In this context, the government and regulators should review any current regulation (such as ownership restrictions on large financial institutions) that treat domestic banks differently from foreign banks.

(iii) *Prevent risk spillovers from "cross-pillar" consolidation among insurers and banks.*

The authors wish to thank Steven Tapp for excellent research assistance on the data sections of this *Commentary*.

1 See for example Laidler (2006).

Mergers of insurance companies and banks will foster competition and provide consumers and businesses alike with access to one-stop financial and insurance services. Regulators, however, face the task of limiting risk spillover from insurance into banking markets through financial conglomerates. Requiring proper re-insurance of aggregate risk in underwriting, sufficient capital-adequacy requirements and limiting market shares for bank-insurers in the area of property and casualty insurance are effective ways to curb risk increases in the banking sector.

(iv) *Look across sectoral, provincial and national boundaries when regulating and overseeing.*
Current trends in the traditional banking sector increasingly put pressure on the government to integrate regulation and supervision across market segments. As some segments are provincially (and not nationally) regulated, policymakers are well advised to establish common regulatory standards across provinces. Similarly, more internationally integrated financial markets pose new challenges for national regulators. Once mergers allow large Canadian banks to play a bigger international role and further entry of foreign banks into the Canadian market is facilitated, the Office of the Superintendent of Financial Institutions (OSFI) will be forced to harmonize and coordinate its regulatory oversight with other national regulators. Existing regulation and oversight procedures have to be reviewed in order to limit risk spillovers among market segments and from international to domestic financial markets.

Our recommendations are based on an evaluation of the main arguments for why banks would like to be "large" versus the costs of a highly concentrated banking sector. Recognizing the pivotal role of banking for reshaping the financial landscape, we look at other financial institutions only to the extent that they are involved in banking and related services. Our argument points out that banks would like to be larger in order to achieve a wider range of operations, both internationally and across market segments. This would allow them to take increased advantage of new opportunities and better diversification of risks. The benefits of extended scope, however, have to be balanced against the costs in the form of market power, risk spillovers and low access for consumers and businesses that could be associated with having fewer and larger banks.

Starting from its current structure, we outline how the Canadian banking sector is likely to develop if given the chance by regulators and politicians. Our expectation is that some consolidation will then occur, although not for the reasons that have been previously emphasized.[2] We argue that cost efficiencies associated with rationalization of branch networks or other traditional economies of scale or scope[3] will play a minor role. Instead, our expectation is that Canadian banks are more likely to aim for a size that enables them to specialize either as domestic retail banks with broad services or as international financial conglomerates.

2 See for example Mathewson and Quigley (1998) and Clemons, Law and Mihlar (1998).

3 Economies of scale and scope occur when the costs for offering a product or service decline with the size or breadth of a firm's activity.

Such consolidation will be accompanied by a trend that is already slowly reshaping financial intermediation. New distribution channels such as internet banks and retail-store-based banks are already challenging the traditional banking sector. Furthermore, if existing competitors such as credit unions and new potential entrants are not discouraged from contesting the market for banking services, increased market concentration will neither harm consumers nor lead to impaired access to the financial system. However, this will require legislative action to further remove entry barriers. At the same time, regulators will have to cope with new challenges arising from a more integrated and more international financial landscape in Canada. The immediate challenge, however, is for the government to clarify the conditions under which financial consolidation would be permitted to proceed. By publicly issuing clear merger guidelines, the government would reduce the uncertainty for market participants within retail banking and insurance. This would allow Canadian financial institutions to develop and put forward a strong case for further consolidation in the industry which could then be evaluated solely by the Competition Bureau and the Office of the Superintendent of Financial Institutions (OSFI).

The Current Situation

Over the past decade, there has been a general trend towards consolidation in the banking sector worldwide. Many European banks have used mergers to reposition themselves in the larger and more competitive marketplace that followed the introduction of the euro and the removal of protective regulation. In the US, banks operating in single states consolidated into nationwide or regional banks once branching restrictions were lifted, and larger corporations took advantage of new possibilities to operate in different segments of financial markets such as insurance and banking. This process is still going on as the recent merger talks among leading European and US banks show. In contrast, the Canadian banking sector has not seen dramatic changes in recent years. Before proceeding with our analysis, we provide a brief description of the situation in Canada, which is partially a reflection of the current Canadian regulatory regime. This will provide the backdrop against which we evaluate the case for consolidation within the Canadian financial services industry.

Broad Activity

The major banks offer a broad range of financial services, ranging from basic retail banking products to investment banking services. The entire banking sector accounts for roughly three-quarters of all personal deposits held by deposit-taking institutions. About two-thirds of all residential mortgages and consumer loans are intermediated by banks. In the area of small business finance, banks supply less than half of all loans. While credit unions and other finance companies are currently the major competitors in this area, credit card finance (often provided through so-called “mono-line” financial firms) has become an increasingly

important alternative form of finance for small business start-ups and small entrepreneurs.[4]

The large banks have also entered insurance markets. Currently, the big five banks all own insurance subsidiaries through which they sell insurance products in both the life and health insurance and the property and casualty sector. However, their share of the domestic insurance market remains small. The range of insurance products which banks can distribute directly "in-house" (i.e., in their branches) is currently restricted to a few types in minor areas such as creditor insurance and travel protection. Furthermore, all major Canadian banks have begun to use their network of branches to provide other financial services and products such as mutual funds and trusts.

National Focus

Most of the leading Canadian banks are active internationally. Three banks have significant branch networks in regional US markets, while a fourth has an extensive branch network across Latin America and the Caribbean. While all of the big five banks are active in the domestic brokerage business, only three have US brokerage operations. Furthermore, only one Canadian financial group currently offers a full range of financial services abroad ranging from private banking and insurance to corporate banking and investments. In 2003, Canadian banks generated roughly one-third of their net income abroad which seems to be in line with other comparable non-Canadian banks. Their level of international activity, however, remains relatively small compared to the largest global banks.

Market shares of foreign banks in Canada remain low, although they have increased from 5.7 percent to 7.9 percent of value-added services in the banking industry.[5] Several leading international banks have a branch in Canada offering corporate banking services or own a Canadian subsidiary. There is, however, currently only one major foreign-owned bank that is actively building a significant network of retail branches.

High Concentration

The six major banks hold roughly 90 percent of the total assets held by all chartered banks. These banks are also the dominant players in the trust and brokerage business. Concentration is much higher than in most countries, although there are several comparable countries (Australia, Netherlands, and Switzerland) where five or even fewer banks account for a similar share of all banking assets.[6]

4 See Canadian Banking Association (2005).

5 See Hinchley (2006).

6 See Williams (2000).

Stable Profits with Lower Risk and Fringe Competition

Returns on equity have been relatively high for most internationally significant banks during the last decade. Canadian banks have achieved comparable returns. At the same time, variability in profits has decreased, especially for larger banks. There also has been a shift in revenue sources for banks. While the importance of interest margins has decreased, fee income has by now become the most important revenue source for all major banks.

In the last few years, competition in the Canadian banking sector has been shaped by new entrants. Examples include ING, which provides basic financial services as an internet-based bank, and HSBC, which has begun to build a branch network concentrated in major cities. National retailers (such as PC Financial, Sears Bank and Canadian Tire Bank) are now competing with a variety of banking services for the average to low-end customer. Also, current proposed legislation seems to strengthen the role of small- to medium-scale credit institutions. This will increase competition in core market segments such as mortgages and local financing for small and medium-sized enterprises. Finally, some insurance companies have recently diversified by offering banking services through internet-based distribution and mobile consultants, thereby placing increased competitive pressure on the retail and credit market operations of the big banks.

Efficiency in the Banking Sector — What the Recent Academic Literature Has to Say

The issue of efficient structure in the banking sector ultimately boils down to the question: what is the efficient size of a bank? However, size has to be interpreted broadly and refers not only to the scale, but also to the scope of a bank's operation. Consolidation in the banking sector thus includes aspects besides mergers among Canadian banks. A bank could operate solely as a deposit-taking and loan-making institution, or it could be active as a distributor or service provider across different market segments such as insurance and financial markets. This is commonly referred to as "cross-pillar" consolidation. In a geographical context, a bank's operation could be confined to a small area, or its operations could expand across regions or countries. Naturally, the primary focus here is on mergers and acquisitions between Canadian and US banks, even though some Canadian banks focus on different regions. We now briefly summarize the arguments put forward by the recent academic literature on efficiency and size in banking.[7]

Efficient Scale

The academic literature has focused predominantly on economies of scale when assessing whether larger banks are more efficient; i.e., whether larger banks have lower operating costs and, hence, higher productivity than smaller banks. Early contributions that relied upon data up to the early 1990s suggest that banks can

7 Berger et al. (1999) and Berger et al. (2000) both give an extensive review of some of this literature.

realize significant scale economies only up to an upper threshold in the range of US$10-25 billion of assets. Besides suffering from methodological issues, these studies likely underestimate current scale economies in banking for several reasons. First, recent IT developments in the area of retail banking, more sophisticated back-office operations and advances in risk management have pushed scale economies beyond earlier levels. Second, banks have experienced a rapid increase in their assets over the last decade at annual growth rates roughly between 10-15 percent. Third, at the branch level, "over-branching" and inefficient operations of branches are further reasons to believe that banks could realize cost savings from a larger scale.[8] Finally, there is new evidence that economies of scale are service specific, and are especially important in core banking operations such as payment and account services.[9] Overall, this evidence suggests that economies of scale in the banking industry are currently much larger than previous studies have shown. This appears to be one driving force behind the mergers and growth of a number of larger banks, both within and across countries.

Data on the size distribution of banks suggests that internationally operating banks are larger than domestic banks.[10] Such banks have a broader scope of business as well as different primary revenue sources than banks that are predominantly focused on domestic markets. International banks are not only active in retail banking (even though often primarily in their domestic market), but also significant players in worldwide and regional capital markets. As part of their strategy, these banks seek to provide a wide range of services to their increasingly globally oriented clients. Different from being pushed as national champions, these banks position themselves to serve the needs of large companies and private and institutional investors in an increasingly global financial markets environment. Providing such services, however, requires a certain size in the bank's capital, either to directly enter new markets or to have enough capacity for acquiring local or regional banks.[11] Beyond cost considerations, size has, thus, become a crucial factor for banks in taking advantage of new possibilities in more integrated financial markets.

Diversification and Range of Services

Size is also important for a bank in dealing efficiently with financial risk. Larger banks have more ready access to modern risk management techniques that allow them to achieve better diversification and, hence, lower risk. Modern ways of managing bank risk rely increasingly on direct access to international capital markets. Credit risk derivatives, loan syndication and especially securitizing asset positions have become the prevalent tools to reduce the risk that banks take on. However, in order to effectively securitize assets, banks have to offer pools of

8 Berger et al. (1997) for example find inefficiencies for some US banks on the branch level in the range of 20 percent of operational costs.

9 See Bolt and Humphrey (2006).

10 See Focarelli and Pozzolo (2005).

11 These trends are best documented by McCauley et al. (2002).

assets that are well diversified and of sufficient size in order to ensure enough liquidity in the market.[12]

Banks clearly benefit from operating broadly across different segments in their core business of taking deposits and granting loans. But banks can also benefit from diversifying geographically and across different financial products. Historical evidence shows that when banks were able to operate across various regions (such as in Canada and Europe) failure rates were lower than when banks faced geographical branching restrictions (such as until recently in the US). Similarly, as fee revenue has been steadily increasing for banks over the last 15 years relative to interest revenue, the product mix a bank can offer has become an important instrument to hedge general business risk and ensure stable profitability.[13]

Subtly distinct from such diversification, a related benefit for banks is the role that they perform as internal capital markets. "Broad" banks can allocate funds among different market segments or between geographical regions more efficiently than anonymous markets.[14] As discussed below, such banks can disentangle regional or sectoral shocks to their liquidity position and liabilities from the return on their assets in a way that markets are unable to replicate (see Box I). Markets can deal efficiently with each type of risk individually, but cannot condition jointly on both risk factors: liquidity risk is allocated through interbank markets, while asset risk is shared through capital markets. This implies that broad banks have lower overall risk than narrow banks that focus on particular regions or a few financial services. For banks to realize such gains they need to consolidate their operations under a single balance sheet. Benefits will be limited, however, if banks operate under a subsidiary structure where capital cannot be reallocated across subsidiaries.

Competition

While size might be important for banks to achieve an efficient cost structure and high productivity, it may also be (perhaps imperfectly) correlated with other aspects that are important for consumers and businesses. An increase in the size of banks beyond the general growth in the industry would involve the downside that the banking sector would become more concentrated. The main concern for antitrust authorities is that this could lead to reduced competition and, hence, that cost savings and productivity gains for larger banks will not be passed on to consumers. An additional concern is that market power reduces the incentives to seek out innovative ways of reducing costs by investing in cost-saving and productivity-enhancing new technologies.

Competitive pressure, however, need not arise from existing large banks. It could also be exerted through the threat of potential entry from other institutions in the domestic financial system and from foreign banks. Whether such a threat is

12 Minton et al. (2005) have recently documented that size is a pivotal factor for banks to be active in modern risk management techniques.

13 Lown et al. (2002) present recent evidence of the effects of "cross-pillar" consolidation in the US and Europe.

14 Koeppl and MacGee (2005) provide a theory of banks operating internal capital markets.

Box I: *Internal Capital Markets in Banking*

Internal capital markets refer to the allocation of capital across different projects within a firm. In the context of banking, an internal capital market refers to the ability of a bank which operates across a number of regions or markets (or a "broad" bank) to transfer funds internally between these regions or markets. Such internal capital markets may be able to achieve allocations of funds that are not possible for specialized banks through borrowing and lending on an interbank market. More specifically, a broad bank can diversify region-specific risk and at the same time cross-subsidize regional operations in response to regional shocks. To highlight the potential benefits of an internal capital market, we sketch an illustrative example.

There are two regions or market segments, A and B, for which we will compare two alternative banking arrangements. In the first arrangement, "narrow" banks are restricted to operate within a region. However, there is a market for loans between banks active in region A and B. The second arrangement features "broad" banks where banks operate in both regions and decide directly on their allocation of funds across these regions. Both banks face a bank-wide "solvency" test, which requires that the value of outstanding loans plus reserves be at least as large as liabilities to depositors. In both arrangements, we assume that banks can only obtain funds from local depositors or grant loans to local entrepreneurs if they operate within a region.

With narrow banks, local entrepreneurs (think of small and medium-sized enterprises) require funds from locally operating banks to operate their business. Each region faces transitory shocks that lower the return on financial intermediation in the region, but do not affect the long-run productivity of local enterprises so that these businesses are always profitable in the long run. Suppose now that region A is hit by a transitory negative shock large enough so that the losses on non-performing loans would cause the regional bank to become insolvent, if it continued to extend credit to entrepreneurs. Clearly, interbank markets will not be of use here, as the bank in region B has no incentive to subsidize bank A by making a short-term loan at a loss on the interbank market. Hence, to avoid insolvency, bank A will have to curtail lending until local economic conditions improve. As a result, the bad shock to region A leads to a local "credit crunch." In summary, region- or sector-specific shocks cause large declines in bank lending for narrow banks, which in turn causes a decline in business financing and ultimately aggregate output.

Entrepreneurs in both regions, A and B, would prefer an arrangement whereby they were able to continue to borrow during local "credit crunches" by paying higher interest rates on their bank loans during good times, instead of being unable to borrow when bad shocks occur. A broad bank that operates in both regions has an incentive to provide such arrangements to entrepreneurs. The internal capital market allows the broad bank to use gains from areas with high returns to subsidize operations in regions with temporarily high levels of non-performing loans, especially when these loans are for businesses that are profitable in the long-run. Unlike lending through interbank markets, internal capital markets do not have to give incentives for regional banks with good shocks to lend to other banks with temporarily non-performing loans. This ability to cross-subsidize operations can lead to significant reductions in lending fluctuations and, thus, to higher levels of average output.

While Koeppl and MacGee (2005) formalize this relationship in a stylized setting, the recent US experience provides empirical support for the role of internal capital markets to smooth regional shocks. Several studies have confirmed that the removal of barriers to interstate banking in the US has reduced idiosyncratic fluctuations in bank lending, output and investment fluctuations across states. Morgan et al. (2004) find that increased interstate banking in the US during the 1980s and early 1990s was accompanied by a reduction in the idiosyncratic variability of state output. Demyanyk et al. (2004) also document a reduction in idiosyncratic income fluctuations across states in the US following banking deregulation. More importantly, these authors argue that the primary mechanism for this reduction in state-level output volatility is linked to reduced fluctuations in bank loans to small businesses which in turn is the result of more banks operating across several states.

imminent depends on the contestability of markets. The existing evidence suggests that entry regulations are a significant source of bank rents.[15] This highlights the importance of identifying and relaxing regulatory barriers to entry. Other important barriers arise from the business structure of retail banking. Entry often requires an extensive branch network which is costly to build unless an entrant can buy existing branches. Furthermore, customer loyalty gives a clear advantage to market incumbents.

Access to Banking Services

Rationalizing branch networks is one channel for reducing operational costs when banks increase in size through mergers. Fewer branches, however, could result in increased access costs for bank customers. This is especially a concern for remote areas where fewer branches could sharply increase access costs with cheap services becoming unavailable due to local monopoly power.[16] Furthermore, smaller banks tend to lend more to small- and medium-sized enterprises. If concentration leads to larger banks, there could be a concern that such firms will find it harder to obtain loans.

Risk

Consolidation in the banking sector could increase several risk factors which are a concern for regulators. Large banks may be "too-large-to-fail." If such banks face catastrophic losses that would cause it to fail, public authorities would feel compelled to bail out the bank at public expense, as its failure would seriously disrupt economic activity. This creates an incentive for large banks to increase their level of exposure to risk so as to obtain higher expected returns without the actual risk of failing.

Concentration may also increase the linkages between individual institutions, making contagion more likely if a major bank were to suffer large losses. Similarly, cross-border consolidation can lead to an increase in cross-border contagion of financial risk as well as macroeconomic risk. Finally, there is a potential for risk spillovers associated with cross-pillar consolidation. Large losses in some other business area than banking could eat into the financial capital of the bank. Then, banks have to reduce their lending, which leads to lower availability of credit and call backs of existing loans, ultimately magnifying the losses for the economy.

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15 See Degryse and Ongena (2005b).

16 Another problem is access to banking services for certain population groups such as seniors and low-income households. It is not clear, however, how the size of banks and mergers would influence the availability of banking services for such groups. Furthermore, there is the much more general question of whether these services should be provided privately. In the UK, for example, the post office has agreed with the government to provide such services after financial institutions declined their interest in this market segment altogether, even with the promise of a (regulated) monopoly position.

The Case for More Consolidation in the Canadian Banking Sector

We now outline three factors — increased internationalization of banking, the gains from bank-insurance conglomerates and economies of scale — that suggest that there is a case for further consolidation in the Canadian financial sector.

Internationalization

The most important development in the last decade was that banks began to operate in an increasingly international and global market environment. This enters the merger debate in two ways. First, several of the major Canadian banks have argued that mergers are needed to facilitate the creation of financial institutions of sufficient size to compete globally. Second, there seems to be scope for further reducing the barriers for foreign banks (mainly regional US banks and the leading global retail banks) to enter Canadian markets.

The rapid rise in the size of the largest international banks is well known. One measure of this is the sharp decline in the ranking of the big five Canadian banks relative to the largest international banks. The global rank of the largest Canadian bank, in terms of market capitalization, declined from a position in the top 40 in 1990 to below 50 by 2000. If anything, this understates the decline in their size compared to the 10 largest banks, which have grown rapidly in size via mergers and acquisitions.[17] Indeed, even if the two largest Canadian banks were to merge they would barely break into the list of the 25 largest banks. Moreover, their merged size would still put them at roughly half the size of the 10th largest bank in the world.

One rationale for the growth of international banks is that they have to be large enough in order to meet the needs of globally operating corporations and to be active players in global financial markets. The fact that the large Canadian banks currently generate nearly a third of their revenue from international operations indicates that they are attempting to take advantage of opportunities to serve North American and global market demands. Nevertheless, a considerable part of this revenue stems from local business abroad mostly through branch networks in local US markets.[18] This is easy to understand as currently none of the Canadian banks seems to be of a sufficiently large size to seriously compete either with globally operating European banks or even with the leading US banks for cross-border business arising from multinational corporations.[19] A further casual comparison of size suggests that the largest Canadian banks are comparable in size to large regional American bank holding companies, and are roughly only half the size of US banks that are internationally active.

The importance of a large capital base is amplified by the fact that current ownership restrictions seem to prevent Canadian banks from merging with non-

17 See Hartt (2004).

18 See McCauley et al. (2002).

19 Major international banks such as UBS, Credit Suisse, ING or ABN AMRO are far larger in size than the leading Canadian banks despite the fact that they have similar sized home markets.

Canadian banks (regional US banks, for example, are natural partners). The only avenue left open for Canadian banks wishing to enter foreign markets on a larger scale is to take over a large foreign bank. However, this would likely require a capitalization and scale of operation that Canadian banks could only achieve through domestic mergers. Hence, unless ownership rules are relaxed, the only possibility for Canadian banks to enter foreign markets on a larger scale is to merge domestically first.

What are the benefits to Canada of hosting a large bank with the capacity to be an active participant in global financial markets? We wish to emphasize that we do not believe that there is a strong case for doing so simply to create a "national champion" in the banking sector. Rather, we believe that this would increase the access of Canadians and Canadian companies to international-level banking services, which would help Canada compete in the global economy. It is frequently argued that large Canadian firms find Canadian banks too small to meet their needs, and so have to look to the large internationally active banks.[20] Virtually every important developed economy features at least one internationally active bank that is a leader in serving domestic companies with international business. Allowing the creation of larger banks should provide Canadian firms with a similar option to use Canadian-based banks for both their domestic and global needs and, hence, should leave them in a better situation to compete internationally. Furthermore, it would offer some of the leading banks new profit opportunities and risk reductions in times when the traditional banking business faces challenges from new competitors.

Other benefits associated with the creation of larger banks arise in the areas of asset securitization and syndicated loans. These activities are likely to increase fee revenues while lowering overall risk. Larger, more internationally focused Canadian banks would have increased access to US capital markets to securitize their assets. This would enhance their ability to manage risks more efficiently. Such banks could also play a more prominent role in arranging syndicated loans for large Canadian as well as international companies, which have increased their demand for large credit facilities over the last 10 years. Canadian banks increasingly compete domestically with foreign banks for arranging such facilities, while their participation — though still on a small scale — in the far larger US market indicates an interest in expanding their business in that area.[21] A final important benefit comes via the potential for the internal capital market of Canadian banks operating on a global scale to enhance stability in the domestic economy by partially removing lending cycles, thereby dampening economic fluctuations.

It should be emphasized that not all of the top banks are likely to follow such a strategy. After domestic consolidation we expect that only some of the remaining banks will be truly internationally operating banks, with the remaining banks focused on serving mainly domestic markets. Some of the large Canadian banks have recently extended their domestic branch networks against trend, while others have already put more emphasis on international expansion and plan to increasingly serve investment rather than retail markets. A similar trend of

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20 See Hartt (2004).

21 See Armstrong (2003).

specialization can be observed in the US and European banking industries, where some banks primarily serve regional markets while other banks focus more on international markets. Furthermore, having more domestically focused banks will only benefit consumers and small local businesses as these banks will be able to bundle specific assets and services so as to better serve customers in local markets.

Bank-Insurance Conglomerates

There is potential for increased "cross-pillar" integration between commercial banks and insurance companies. Such consolidation would allow Canadian financial institutions to expand the scope of their operations and realize potential economies. This issue actually has two distinct elements: first, whether banks should be allowed to market a wider range of insurance products via their network of retail branches; and, second, whether to allow mergers between large Canadian banks and insurance companies. There is certainly a strong case for allowing banks to distribute insurance products from their branch networks. Since a thorough discussion of regulatory and competitive concerns associated with such a move has recently been provided by Daniels (2003), we focus exclusively on the question of whether to remove the prohibition for mergers between banks and insurers. While banks and insurance companies are still permitted to own subsidiaries that are active in insurance and banking, prohibiting cross-pillar mergers severely limits the extent to which Canadian banks and insurance companies can follow the "bancassurance" model that is becoming more prevalent in both Europe and the United States.

With regard to allowing mergers between large banks and insurance companies, key issues remain unsettled. One concerns the existence and size of economies of scope when operating a large bank-insurance conglomerate.[22] Recent studies do not provide clear evidence for economies of scope between large insurance and banking companies. However, most existing studies use data that predate the recent merger wave towards "bancassurance." Given this ambiguous evidence — unless there are other reasons to block mergers of insurance and banks — the case for mergers should be left to the parties in the best position to evaluate potential efficiency gains: the managers and shareholders of the respective firms.

There is another issue, however, that could provide grounds for blocking mergers between large banks and insurance companies. The question is whether consolidated holding companies with a significant presence in both insurance and banking would tend to destabilize the financial sector. This is not much of a concern for the life and health insurance sector that primarily sells savings products, since most insurance products in this sector bear a limited exposure to aggregate risk. Underwriting of property and casualty insurance and re-insurance, however, is partially based on the intertemporal accumulation of reserves and plays a major part in allocating aggregate risk efficiently in the economy. Mergers between banks and property and casualty insurance and re-insurance insurance companies could lead to a significant increase in the aggregate risk of banks. Large

22 Amel et al. (2004) provide a thorough review of the existing literature on this topic.

losses in an insurance subsidiary related to the underwritten risk could force the holding company to bail out this subsidiary, either directly or via subsidized lending from the banking to the insurance side of the company. This would weaken the capitalization of the banking subsidiary and, thus, transfer substantial aggregate risk into the banking sector — a violation of the principle that aggregate risk should be mainly concentrated in financial markets and not in banking.

Mergers between banks and insurance companies should then be permitted as long as there are appropriate ex-post provisions to severely limit the exposure of such a conglomerate to large, aggregate risk from the insurance business. One way to control for such risk-spillovers is to ensure appropriate capital adequacy requirements, which are often difficult to assess and implement. Alternatively, banks could be limited in how much re-insurance and property and casualty risk without proper re-insurance they could take on. Also, insurers that take on significant values of these risks should be prevented from entering the banking sector. This would leave banks free to participate in areas of the insurance sector that do not have large aggregate risk components, or otherwise force them to transfer such risk to narrowly operating re-insurers.

Scale and National Mergers

We finally turn to an assessment of the argument that larger banks are more efficient due to economies of scale. There is increasing evidence suggesting that the large Canadian banks are not currently operating at their efficient scale in terms of productivity gains and costs savings. A common explanation of these new findings is that recent advances in IT have increased the optimal scale of banking operations.[23] This suggests that there may be direct efficiency gains from domestic bank mergers.

Traditionally, mergers have been seen simply as an efficient means for the large domestic banks to reduce the density of branches both in urban and rural areas.[24] This could lead to lower competition and reduced access to the financial system. We feel, however, that the emphasis on the costs and benefits of post-merger branch rationalization is misguided for two important reasons. First, it is unclear how many additional branches would be cut as a result of a merger above and beyond the current trend of reducing branch networks among most large Canadian banks (see Box II and Figure 1). Incentives for such rationalization are primarily driven by a combination of direct cost savings and competing distribution channels (online banking and ABMs) rather than by competition

23 Allen et al. (2006) and Allen and Liu (2007) are the most recent contributions to this literatures. See also Freedman and Goodlet (2002), Neufeld (2001) and Bolt and Humphrey (2006). Related to this explanation is also the recent growth of narrow, so-called "monoline" financial firms such as credit card companies that only offer specialized services on a large scale.

24 Mathewson and Quigley (1998) argue that individual banks could not unilaterally reduce branches, as this would critically reduce their income from fee revenue. Hence, while competition for fee revenue prevents banks from folding branches, mergers could allow for a coordinated reduction in branch networks. The extent of such rationalization would then depend only upon the number of branches in close proximity to one another for any group of merging banks. For many opponents it was then easy to point out reduced access to banking services and impediments to competition at the local level as intolerable costs for society.

Box II: *Recent Developments in Branch Networks: Canadian and International Evidence*

Even without mergers between the major players, the number of branches operated by the big five domestic banks has been gradually shrinking over time. Between 1997 and 2004, the number of branches fell from roughly 6,600 to 6,200, a decline of roughly 6 percent (see Figure 1). This decline understates the actual reduction in branches for most large banks, as some banks added branches by taking over smaller competitors. The merger of TD and Canada Trust in 2000, for example, added roughly 450 branches. Given that the Canadian population increased, the ratio of bank branches operated by the five big banks relative to population decreased even further, by more than 12 percent. The consolidation of branch networks, hence, accelerated considerably compared to the 1988-1997 period, during which the number of branches remained roughly constant (Clemons et al. 1998).

The reduction in branch networks among the large banks was accompanied by a dramatic increase in the size of their ABM network, as the number of ABMs increased from roughly 13,500 to 17,200 between 1997 and 2004. At the same time, the number of branches of smaller players increased, which partially offset the decline in big five bank branches. The total number of bank branches in Canada thus increased from roughly 8,100 in 1997 to just over 9,000 in 2004. Moreover, the total number of branches and offices of banks, credit unions and trusts increased from 13,600 to 14,200. As a result, the total number branches and offices relative to the Canadian population remained roughly unchanged over this period, while the number of ABMs relative to population increased by about 50 percent. This implies that overall access to the financial system likely improved over the last decade.

Table 1: *Number of Branches and Offices of Banks, Credit Unions and Trusts (per million, population)*

	Canada	United States	United Kingdom	France	Germany	Switzerland	Netherlands
1998	446	285	586	794	733	949	437
2004	444	362	501	643	578	701	253

Source: BIS Statistics on Payment Systems, 2006 and 2000.

The reduction in bank branches by the big five Canadian banks is comparable to the experience in Western Europe (see Table 1). There are two facts that are of particular interest. First, the cross-country evidence does not suggest that Canada is significantly over-branched. Second, the trend in the US appears to be notably different from that of the large Canadian banks: Branches of US banks actually increased from roughly 61,500 in 1997 to nearly 73,000 in 2004. This is an increase of roughly 19 percent, and comes during a period of significant mergers, as the number of banks fell from roughly 9,100 in 1997 to 7,500 in 2004.

The US data suggests that bank mergers need not lead to a reduction in the total number of branches. However, a number of US mergers involved banks which had branch networks with little geographical overlap. Avery et al. (1999) find that mergers and acquisitions of banks in the United States tend to reduce the number of branches of the banks involved which are located in the same area. They report that this is mostly due to a reduction in “duplicate” branches of merged institutions. However, they also find (consistent with the aggregate data) that mergers had little impact on the overall number of branches.

Figure 1: *Number of Big Five Bank Branches: 1997–2004*

Source: Authors' calculations, banks' annual reports.

among the main banks themselves: banks regularly close and open new branches in response to demographic and market changes, indicating that competition does not prevent the closure of branches.

Second, it is not clear that fewer branches in the wake of a merger would have a significant adverse impact on access and competition. Even if the number of branches declined as the result of a merger, the social costs of such a decline seems overstated. Recent industry developments indicate that access and competition issues cannot simply be measured by the densities of the branch networks. Indeed, one of the main driving forces behind shrinking branch networks of the major banks is increased competitive pressure from new players in the sector. One example is the new distribution channel associated with large retail chains such as PC Financial, Canadian Tire Bank and Sears Bank Canada. Moreover, a reduction of bank branches by large banks following a merger would likely be followed by an expansion of branches by smaller institutions. As discussed in more detail below, this suggests that the market for the distribution of basic financial services has become far more contestable over the last decade implying that mergers may neither lead to a significant increase in market power for the leading banks nor to lower access to the financial system for businesses and consumers. Hence, one is tempted to conclude that reducing branch networks is neither the primary motive nor the most important cost of Canadian bank mergers.

A New Competitive Regime

These arguments provide a strong case for efficiency gains that could result from further financial sector consolidation. The main concern for regulators is whether these gains would be passed on to consumers. To address this question requires a clear understanding of the current competitive regime and how this regime will change once mergers have taken place and barriers to competition have been removed. For this reason, we present our predictions on what kind of competitive regime is likely to emerge in order to evaluate post-merger antitrust and access issues.

Competition between Specialized Domestic and Broad Global Banks

In a post-merger world, the traditional banking sector is likely to be dominated by two different types of players. Given the trend towards increased internationalization of financial services, we expect that some (but not all) of the large banks will merge in order to pursue a cross-border or multi-regional strategy with the objective of offering a full range of products, ranging from insurance to retail banking, and active global capital-market participation. The remainder of the domestic market will be split between purely Canadian retail banks offering a full range of services primarily to Canadian customers and specialized competitors focused on limited market segments. Finally, Canadian insurers could seek to merge with domestically operating Canadian banks so as to take advantage of distributing packaged financial services to domestic customers.

Even though these developments are likely to lead to a more concentrated banking sector, international comparisons provide grounds for optimism that the impact on competition may be largely muted. Even after mergers, Canada will retain a level of concentration in many areas of banking services comparable to those observed in other countries. While the level of concentration in Canada at the national level already greatly exceeds that in the US, an important point to consider is that the US banking sector is still widely characterized by regional banks that now compete with banks operating across states. Nonetheless, in states like California and New York — US states with a population base and an economy comparable to that of Canada — the three largest banks account for roughly 50 percent of all retail deposits.[25] Perhaps an even more informative example is that of the Netherlands, which has a highly concentrated banking sector characterized by a small number of very large and internationally active banks. Interestingly, these banks are the product of consolidation among banks and mergers between banks and insurance companies. However, Dutch banking seems to be very competitive, highly contestable and features wide accessibility to the financial system.[26] This suggests that the level of concentration of large banks may not have

25 A similar fact holds for the majority of US metropolitan areas where two or fewer deposit-taking institutions account for more than half of all deposits.

26 See Northcott (2004).

a large negative impact on competition as long as there is easy entry into the banking sector for potential competitors.

Wide Access through Competition "on the fringe"

The aftermath of the merger process will likely see some reduction in the branch density of Canadian retail banks. In the major urban centers, this will leave access and competition largely unaffected. Smaller urban and rural areas, however, could become more monopolized as a result of mergers. This view is based on the observation that both the geographic distance between a bank and its borrowers as well as the distance between the borrower and potential competitors to a bank matter for the availability and the terms of credit. In particular, loan rates increase with the distance between the borrower and competing banks.[27]

There are several reasons why competition is unlikely to be significantly reduced. First, one would expect that once a merged bank started to close branches, there would be an incentive for other competitors to move into any vacated areas — be it rural or urban — unless entry costs are large.[28] We have our doubts, however, about the magnitude of such entry costs, especially since the closure of existing branches as a result of mergers could free up locations and local resources for new entrants. Furthermore, new entrants have an incentive to move into areas where branch density falls sharply, as entry can generate considerable fee income for banks.

Second, advances in information technology have expanded the distance over which banks can compete, eroding potential market power for local bank branches.[29] Similarly, new technology has facilitated access to many financial services. Retail chains have started to offer financial products, virtually every major bank now offers internet banking and credit card companies are gaining an increased share of the market for financing small enterprises.

Finally, niche players are already pushing into most aspects of traditional banking and have strong incentives to increase competition in specific geographical areas or market segments where they can offer specialized services. Smaller chartered banks for example could strengthen their regional branch networks and target customers with a regional focus. Credit unions traditionally provide services in remote areas as well as to a broad range of private and small business clients. These players will likely extend their business as soon as large banks reduce their branch networks.

Contestability and New Entry

Given these observations, ensuring contestability of markets should be a key concern for the Competition Bureau. Facing increased competition, large banks

27 See for example Degryse and Ongena (2005a) or Agarwal and Hauswald (2006).

28 The US experience provides some empirical support for this view. Berger et al. (2004) find that mergers and acquisitions increased the probability of entry into regional bank markets in the US during the 1980s and 1990s.

29 See for example Peterson and Rajan (2002).

will have increased incentives to protect their traditional costumer base. Recently, some banks have begun to bundle financial services in the area of corporate banking so as to block competition by specialized and smaller competitors.[30] Similar strategies in retail banking should not raise too much concern for antitrust authorities. In corporate banking it is merely a tool to compete with international competitors for the business of large companies, while for consumers it simply implies more choice given the presence of alternative local intermediaries.

There remains the concern that an incumbent bank may be able to block new entry into any market via cross-subsidizing service fees. The incumbent could provide services at fees below cost by using profits arising from market power in some other areas. However, it is unclear whether this is likely to be a significant problem. If it were to become a problem, the Competition Bureau could require banks to charge fees for services in areas where there was little local competition that are close to the fees charged in areas with some competition. This would not only prevent banks from undercutting new entrants, but also provide a mechanism through which intensive competition in large urban markets could be "exported" to smaller centers where banks face less intensive local competition.[31]

Finally, entry from two other directions should help to keep the banking sector competitive. Currently, insurance companies are starting to push into the banking sector through direct banking. In the near future, one can expect that some insurers will try to reap the benefits of distributing insurance and banking services jointly by acquiring or building up small local branch networks in key urban areas. Similarly, a pending threat of, or the actual entry of, new foreign competitors into the Canadian retail banking market is an important driving force behind making the financial industry increasingly competitive.[32] As we discuss in more detail below, ensuring that this threat of foreign entry is credible is one of the key challenges facing Canadian policymakers.

Challenges for Canadian Policymakers and Regulators

While showing some promise, the changes implemented in Bill C-37 are too modest to allow for the creation of the "New Competitive Regime" described above. It certainly encourages credit unions to play a more prominent role and attempts to make competition between internet and traditional branch banking more transparent. However, it leaves the core area of bank-insurance conglomerates untouched. The main challenge here is to allow "cross-pillar" mergers with clear rules about how much risk can be transferred between the two

30 Freedman and Goodlet (2002) outline several anecdotes of large Canadian banks deciding to bundle loans and underwriting services, while foregoing business with customers that demand only one of these services.

31 One potential problem with this proposal still remains as banks might not find it profitable to operate in locations which have very high operating costs. Such areas seem to be limited even in Canada and could still be served through remote access and a network of mobile bank consultants.

32 The importance of this channel is supported by the findings of Claessens and Laeven (2004) who document that competition increases with foreign presence in domestic banking markets.

markets within a financial conglomerate. Banks should be required to seek proper reinsurance for most of the aggregate risk arising from underwriting insurance. Similarly, each insurance company should be allowed to build up market share in banking only to a level compatible with the aggregate risk arising from their insurance activities that is not passed on to other re-insurers. Hence, regulators must both establish limits on aggregate risk taking and ensure that appropriate risk management restricts spillover of losses within financial conglomerates. This will require a quantitative assessment of how large the gains from diversified conglomerates are relative to the costs of risk spillovers. But it also implies that regulators should be warier about deals involving property and casualty insurers than life and health insurers entering retail banking.

The recent legislative reform also failed to seriously address foreign entry. Ownership rules and the regulatory structure of classifying banks in three different tiers (or schedules) remain the main barriers for foreign bank entry. The increase in the maximum threshold of capital from $5 billion to $8 billion for closely held banks and the reclassifying of some foreign institutions as non-banks are both steps in the right direction. However, requiring large banks to be widely held with stocks quoted on a Canadian exchange and leaving foreign banks operating under the "branch model" (Schedule III banks) out of the deposit insurance system seems to significantly reduce the competitive threat to Canadian banks from foreign entry into the Canadian marketplace. While the second measure may be justifiable from a regulatory perspective (as argued below), the first is not.[33] Ownership rules all but eliminate the possibility of a foreign bank takeover of a large Canadian bank. They also curtail efforts to build up extensive, country-wide branch networks under a subsidiary structure that is likely to require significant capital resources above the threshold of $8 billion. While it allows, in principle, smaller scale entry and rapid growth afterwards, there is lingering uncertainty about how regulators would react as a foreign bank approached or surpassed the $8 billion threshold. Finally, current ownership rules greatly limit the ability of domestic banks to merge with large foreign banks, leaving domestic banks no other option than becoming large enough domestically in order to compete internationally.

In the event that some restrictions on foreign entry are removed or that bank mergers among large Canadian banks lead to the formation of an internationally oriented bank, OSFI will face the challenge of regulating truly international players that also have a significant share of the Canadian market. Our conjecture is that OSFI will probably resist a situation whereby a large foreign bank assumes a dominant position in the Canadian marketplace. The rationale is that they will try to avoid the international "too-big-to-fail" problem currently faced by some smaller European countries, where a bank is extremely important in a region or country, but not in its core region or home country. In the medium-run, the most reasonable solution to encourage foreign entry is to relax ownership restrictions,

33 If the government embarked on reviewing banking regulation with respect to ownership rules, it would be natural to also review the current coverage and design of the deposit insurance system. Should the deposit insurance system incur fundamental changes in the process, it could lessen concerns about foreign bank branches free-riding on the system.

Box III: *Competition? Current Canadian Entry Regulation for Banks*

Entry into the Canadian Banking sector is currently regulated for both domestic and foreign institutions.[a] Applications for the creation of a bank (or foreign bank branch) must be submitted to OSFI. Section 27 of the *Bank Act* and Section 26 of the *Trust and Loan Companies Act* set out the factors which the Minister of Finance (upon the recommendation of OSFI) should take into account when evaluating an application. Once the Minister has granted their approval, OSFI must also issue an Order to Commence and Carry on Business before a federally regulated financial intermediary may begin operations.

Recent amendments have sought to make the entry process — especially foreign entry — easier. Since 1999, foreign banks have two options for entering the Canadian marketplace: they can either seek approval from the Minister of Finance to open a *foreign bank branch* or create a *foreign bank subsidiary* which is a Canadian bank that is owned by a foreign parent company. Foreign bank branches face significant restrictions which severely limit their ability to compete in the retail markets. *Full-service foreign bank branches* can only accept deposits in excess of $150,000 (with an exception for "sophisticated" investors), while *lending branches* cannot accept deposits of any kind, and can only borrow from other financial institutions.[b] Given the effective limitations on their retail banking operations, most foreign bank branches tend to focus on competing in the market for corporate and investment banking (Hinchley (2006)).

The second channel for foreign entry is the creation of a subsidiary. A key barrier to the large-scale entry of a foreign bank via this channel is the current restrictions on bank ownership. Restrictions on foreign ownership and a requirement that banks be widely held were part of the 1967 amendments to the *Bank Act*. Initially, any single shareholder was prevented from owning more than 10 percent of a Canadian bank, and ownership by non-residents was restricted not to exceed 25 percent (see Garvey and Giammarino (1998)). These ownership rules were relaxed in 2001,[c] with the establishment of three classes of banks (and bank holding companies) differentiated by their size of equity.[d] Large banks (defined as having value of equity in excess of $5 billion) continue to face the requirement that they be widely held. This means that no single investor may own more than 20 percent of voting and 30 percent of any class of non-voting shares, nor is control by any group of shareholders permitted.[e] Medium-sized banks (with equity between $1 billion and $5 billion) can be controlled up to 65 percent by a single shareholder, with at least 35 percent of the shares publicly traded on a Canadian stock exchange and not held

while pursuing an implicit regulatory policy that prevents any foreign bank from assuming a unique and dominant position in Canada.

Once foreign entry occurs on a larger scale there remains the regulatory challenge of how to best limit the likelihood of a foreign bank failing and how to deal with domestic losses should a failure occur. In a global financial environment, the key instruments are the design of deposit insurance, close monitoring of internationally operating banks and communication among national regulators. Canadian deposit insurance currently applies only to Canadian branches or subsidiaries of foreign banks. Extending the coverage to the Canadian retail operations of foreign banks could well provide a reason to overhaul deposit insurance as a whole. Even though consumers might have become more aware of the risks involved in banks, it is hard to see that such a system will be abolished altogether. But in the future, a proper design of the contributions to such an insurance system will have to depend more on the particular risk features of banks. With the market changes we have outlined here, it certainly should be

Box III cont'd: *Competition? Current Canadian Entry Regulation for Banks*

widely by a major shareholder. Finally, small banks (with equity of less than $1 billion) are permitted to be held by a single owner.

While these ownership rules allow foreign banks in principle to operate through subsidiaries, the current equity restrictions on large- and medium-sized banks constrain foreign banks to enter the Canadian market at a scale less than half the size of the big five banks. Moreover, there is uncertainty over how regulators would treat foreign-owned subsidiaries that enter below a threshold, but grow rapidly beyond it.[f] This may help to account for the fact that foreign bank subsidiaries have chosen to restrict their scope of operation either geographically or to focus on specific market niches (such as credit cards or online banking). As a result, foreign banks can provide a viable competitive threat in some limited areas, but are prevented from exerting serious competition in retail banking.

Notes: [a] The federal government has sole jurisdiction over bank regulation, but not over the regulation of other financial institutions such as credit unions or insurance companies.

[b] These institutions are also excluded from deposit insurance offered by the CDIC.

[c] Bill C-8 in 2001 also lowered the capital required to open a new bank from $10mn to $5mn so as to encourage the entry of "community-based banks".

[d] Such ownership rules are relatively uncommon in developed economies. In the OECD, only Australia, Canada, Luxembourg and Norway have formal ownership restrictions on bank shareholdings (see Lai and Solomon (2006)).

[e] The one exception to this is that a large bank may be 100 percent held by a bank holding company — provided the bank holding company satisfies these ownership rules.

[f] The current legislation permits "eligible institutions" to continue to closely hold institutions which grow past the equity threshold for medium-sized banks. What remains unclear is how far past the threshold these institutions will be allowed to grow before facing regulatory pressure to modify their ownership structure.

conditioned on the general *international* circumstances of a particular deposit-taking institution rather than its Canadian situation.

Still, foreign banks could have an incentive to divert liquidity from their Canadian branches or subsidiaries in order to cope with liquidity problems they face in their domestic markets. Efforts to publicly assist such branches or subsidiaries could lead to a liquidity drain out of the country ultimately leaving the costs to be borne, at least partially, by Canadian taxpayers. Obviously, this risk is higher with foreign bank branches than with foreign-owned subsidiaries as the latter are directly under the exclusive oversight of OSFI. Monitoring international banks closely in a cooperative way with other national regulators will become increasingly important. Similarly, in case of a domestic crisis, international banks may lack incentives to channel liquidity to the domestic areas where it is needed. Here, Canada currently enjoys an advantage, as OSFI together with the Bank of Canada is able to coordinate private efforts of a small number of major players to deal efficiently with a financial crisis. Such coordination would be more difficult, if

not impossible, with banks whose major focus is non-Canadian. As long as some Canadian financial institutions remain among the main competitors, however, these concerns should be of minor importance as any emergency measures could be implemented through such institutions.

In general, international cooperation and coordination is crucial to implement proper risk management for international banks and to maintain appropriate monitoring of such banks. However, it is generally hard to achieve multilaterally, and even bilaterally, if one country is much larger than the other (as for example in the Canada-US context). Furthermore, the European experience illustrates that harmonization and coordination is difficult to achieve once cross-border integration is a fait accompli. Hence, it would be wise to follow a coordinated approach with the large-scale entry of foreign institutions and harmonization of cross-border regulation and oversight going hand-in-hand. During this process, it seems reasonable to have OSFI regulate foreign companies differently at first, gradually adjusting the regime to a common standard as long as such an approach is clearly communicated to market participants.

Leaving these issues aside, policymakers and regulators currently face an even more daunting task. It is absolutely necessary to create a homogeneous, uniform regulatory and supervisory framework for financial institutions in Canada. If current efforts in this direction fail, the Canadian financial system lacks the foundation for positive future developments. As soon as insurance and banking become more integrated, it can no longer be the case that chartered banks are regulated nationally, while insurance companies have the choice between differential provincial or national regulation.[34] Indeed, the development of bank-insurance conglomerates in several countries provided the motivation for the creation of a single financial regulator in several other developed countries.[35] This also suggests that policymakers and regulators should carefully examine the experiences of other countries when moving forward with a new regulatory architecture.

The immediate challenge facing Canadian policymakers, however, is to put forward clear and transparent merger guidelines. While banks are in the best position to evaluate their own business strategies, they are poorly situated to judge what banking arrangement would be best for society. Instead, the Competition Bureau and OSFI both have the mandate and the expertise to deal with this question, with the former being in charge of antitrust and access issues and the latter being responsible for regulating and overseeing risks taken on by financial intermediaries. A government move to provide clear guidelines on the merger process and conditions combined with a decision to delegate the evaluation of proposed mergers to the Competition Bureau and OSFI would depoliticize the merger process[36] and put in place the foundation for financial consolidation that could strengthen the financial sector in Canada.

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34 While similar problem exists inside the banking sector where credit unions are provincially regulated, we feel that the scope of this problem is smaller.

35 See Plantin and Rochet (2007).

36 Bond (2003) already called upon the government to stop exerting political influence on the issue of bank mergers.

Conclusion

The government's most recent legislative reform does not generate much optimism for significant changes in the financial sector in the near future. Canadian banks thus have to face the political reality and uncertainty arising from the failed merger proposals in 1998. Nonetheless, our framework suggests that, from an economist's perspective, banks have a strong argument that consumers, the Canadian economy as well as the banking sector would all benefit from further consolidation that creates even larger institutions and financial conglomerates.

While the past and current debate has emphasized the gains from a rationalization of bank branches as the main impetus for banks to merge, we do not believe that this is the pivotal issue. Instead, we see the need for some Canadian banks to pursue strategies that will allow them to become either international banks or specialized full-service domestic retail banks. Should bank mergers and "cross-pillar" mergers ring alarm bells for regulators and politicians? Not necessarily. Such consolidation will be accompanied by a trend that is already slowly reshaping financial intermediation. New distribution channels such as internet banks and retail-store-based banks are already challenging the traditional banking sector. If old competitors such as credit unions, smaller chartered banks and new potential entrants are not discouraged from contesting the market, market power for even larger Canadian banks will not be an issue. But this implies that legislative action is required to further strengthen these forces by removing entry barriers, and that regulators will have to cope with new challenges arising from a more integrated and more international financial landscape in Canada.

In developing our guidelines, we have limited ourselves to the context of banking and the financial services sector. As financial markets are becoming more globally integrated by the minute, pressure is mounting for the whole Canadian financial system to keep pace with this trend. Other markets have embraced these changes by integrating and consolidating national and international infrastructures such as exchanges, settlement, clearing and payment systems. At the same time, Canada is still struggling with basic issues such as harmonizing securities regulation across different provinces. An important lesson to draw from the recent fiasco regarding bank mergers in Canada is that regional interests and special interest groups are likely to loom large in preventing critical steps in the right direction. Again, a different, economic perspective is needed to bring the discussion back to the transparent and unrelenting reality of economic principles.

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C.D. Howe Institute
67 Yonge Street Suite 300
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