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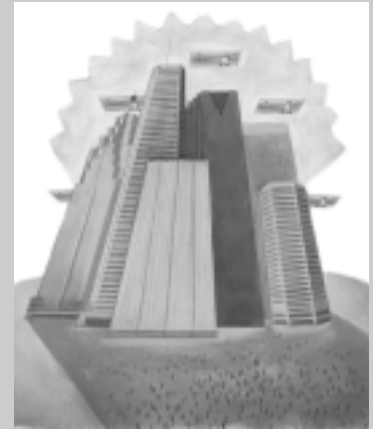
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# CAN CONSUMERS BANK ON MERGERS?

Robert R. Kerton

Canada's large banks are again enchanted by a siren song of mergers that could see the good ship of Canadian banking founder on the rocks, suggests economist Robert Kerton, dean of arts at University of Waterloo and an authority on banking and consumer issues. The big banks may have already captured many of the economies of scale they would purportedly gain from mergers, but would do well to improve their service if they really aspire to be world-competitive. He enumerates five issues, including concentration of power, which proposed mergers should have to deal with, in the public interest—reason enough to retain parliamentary oversight.

Les grandes banques canadiennes sont ravies de voir la question des fusions refaire surface même si, à l'instar des marins charmés par le chant des sirènes, cela risque de faire couler leur navire. Or, il est bien possible que les banques aient d'ores et déjà avoir réalisé la plupart des économies d'échelle qu'elles attendaient des fusions, mais elles tardent toutefois à améliorer les services à la clientèle. Elles devraient y songer sérieusement, si elles désirent vraiment être compétitives à l'échelle mondiale. Dans l'intérêt public, les fusions devraient être soumises à cinq conditions - notamment le niveau de concentration du pouvoir - et cela exige que le Parlement continue d'exercer son rôle de supervision.



**R**elentless is the siren song for mergers among Canada's big banks. Sirens, of course, were sea nymphs who sang so enchantingly that ships would crash on the rocks. In a banking context, such music can be expected from those who earn huge fees putting mergers together, and from repairing them later. Question: Is the faith in eternal economies of scale justified? Is it a siren song of innocent self-delusion,—a belief that helps overcome the discomfort arising from wanting a merger for normal reasons? It is important to look at impartial evidence on the scale issue, but first consider the degree of scrutiny that is given to merger proposals from Canada's largest banks.

A merger among big banks faces three tests: for prudential safety, for competition, and for the public interest. That seems like a lot. Is it? Do we need further protection through a politically driven public interest test? Last October, the minister of finance asked both the Standing Senate Committee on Banking and Finance and the House of Commons Committee on Finance to assess the matter. By December, the report of the Senate committee was out, and it delivered a message that is very clear in recommending the removal of Canada's public interest test for proposed mergers among large banks. It recommended, "parliamentary committee review of specific bank merger proposals no longer be required...."

Evidence on mergers in general is a caution to the song of the Sirens. Most mergers do not pass the market test. In an assessment of about 300 big mergers, a recent *Business Week* analysis shows that 61 percent of buyers destroyed shareholder wealth. Big bank mergers did not achieve the \$100 billion destructive capacity of the AOL Time Warner merger, but Fleet Boston, Bank One, Nationsbank and the others destroyed 10 percent of their value because, as *Business Week* put it, they "envisioned grand synergies that proved illusory or unworkable."

The collapse of the merger movement, and the huge portion of market value destroyed by those mergers, should have caused every analyst to look much more carefully at assertions that mergers among giants will improve the prosperity and competitiveness of the national economy. The competitive race may go to the swift—to the agile—not to the one with the most bulk. When we merge two giants, we paste together two different networks of information; we often add two corporate cultures. This can result in *Tyrannosaurus rex*.

**T**here is a lot to be said for banks of the current size in Canada, or for a few more participants. Indeed, the Senate report noted that barriers to entry need attention. Big banks now offer impressive technological services and they are among the best of corporate citizens in donating to

communities and investing in the future of Canada. Do banks have the competitive agility to compete abroad? Evidence from previous attempts is not reassuring: Unwise loans to the Canary Wharf project in the UK meant that two of our largest banks wrote off losses of about \$800 million per year for five years.

In the last few years, many bankers have been more direct, and more credible, in stating that the issue is simply the growth of the bank, which can be achieved most quickly through mergers. The national interest is not the main job of bankers. The question is: Would mergers among big banks make things better, or worse, for us all?

Historically, Canadian senators and Canadian banks have always been close to each other—the Senate really understands banks—and recent hearings attest to that. But, if the good Senators have a careful understanding of what is good for banks, it does not necessarily follow that their advice is always bad for the rest of us. Their main conclusion was worded in several ways. The most interesting phrasing was, “We concluded that, once the prudential and competition concerns were addressed, a merger would be a net positive for Canadians.”

It raises the issue of whether two other tests are enough to look after the public interest. The Office of the Superintendent of Financial Institutions (OSFI) appraises prudential matters. The Competition Bureau appraises market issues. Factors to be considered by the Bureau and the Tribunal and expressly referred to in the Act include: the amount of foreign competition; whether a party to the merger has failed or is likely to fail; availability of substitute products; any barriers preventing new competition from entering the market; the extent to which effective competition remains in the market; the likelihood of removal of a vigorous and effective competitor; and the nature and extent of change and innovation in a relevant market.

As noted, senators felt that these two assessments were sufficient. Why might consumers agree or disagree that two reviews are enough? There are five issues:

1. *Concentration of power:* Canadians have long been concerned about the concentration of power. Some are anxious about the excessive attention elected officials would have to pay to the new giants, a matter receiving attention among current members of Parliament in response to the prime minister’s proposals on campaign financing.

2. *Sharing the monopoly benefits:* How much of the “value” shareholders anticipate from proposed mergers rests solely on conventional market monopoly? Even if gains existed, consumers and small firms need not see any benefits from bigger banks. Prices reliably rise as competition is reduced. Some proponents, who feel certain that economies of scale exist, cannot explain how the reduced competition will increase loans to small business, or how it will result in more attentive service, or lower bank fees. In fact, much evidence exists from studies on bank mergers elsewhere, to show that, over a certain size level, economies of scale are either absent or unimportant.

3. *Quality:* Banks have not been leaders in customer satisfaction. Remember that it was competition from an independent trust company that obliged banks to offer better hours to customers. In work I supervised for the MacKay Task Force, several service characteristics were identified and service levels in eight countries were assessed. Canadian banks do well in some competitive dimensions such as technology and less well in others, including document clarity. Roger Martin, Dean of the Rotman School of Management at the University of Toronto, undoubtedly has it right when he observes that to succeed in international markets, a firm cannot be a comfortable oligopolist at home. Demanding consumers help a firm achieve excellence through improve-



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**Tower above: The Royal Bank Building at Place Ville Marie in Montreal.**

ments in quality. There is no evidence that the use of higher revenues from monopolizing markets at home will lead banks to success in delivering international levels of service. The contrary is much more likely.

How do Canadian financial institutions do in international markets? The evidence on exports is clear: The big successes have not been banking or their investment houses, both of which have been retreating from a low level of international sales. The winners are Canadian-based insurance companies. In 2001, Canadian life and health insurers earned \$50.2 billion, or 56 percent of their premiums from foreign sources.

A survey of service sector performance conducted by Canada’s National Quality Institute found banks 16th from the top out of 20 service providers in 1996. In 1997, banks were 17th out of 21. More important, evidence indicates that the more monopolized an industry is, the lower

it scores when customers assess service quality. Superior customer satisfaction is the most promising, the most reliable, and probably the *only* path to long-run success.

4. *Innovation*: Do investments in information technology exhibit strong economies of scale? For items that are standardized, this is very often true. Where services have subtle distinctions that matter, scale economies have been hard to find. There is a huge difference between (a) loans, which need special information, and (b) banking machines, which distribute

already too big to fail. Still, it is sobering to contemplate the losses Canadian banks might have made in the US telecom and tech sectors if the 1998 proposals for blockbuster mergers had been approved.

The growth of banks relies fundamentally on the ability to offer new and competitive services at a world level of excellence. To expand abroad, a plausible case exists for sharing managerial expertise through partnerships with firms abroad.

To resolve the issue of scale economies it is worthwhile to listen to

small businesses. This is a robust result. It means that further mergers among big banks will make all small Canadian firms less competitive at home and abroad.

There is every reason for Canadians to want to see our banks succeed abroad. Success, however, must be earned in a way that “helps to improve the prosperity and competitiveness of the national economy,” to quote from the Senate report. Bank mergers may not harm Canada’s biggest borrowers because they have access to competitive international financial markets. Many of the largest corporations have deployed “disintermediation” by skipping Canadian banks and going directly to bond markets to raise funds. The option is not available to low-income Canadians.

However, some rules for basic banking have been created without any direct tie to the merger discussions. All that recognized, the best available evidence indicates that mergers among large banks will harm Canadian consumers and small and medium firms, including potential exporters. It therefore seems impossible to meet the Senate Banking Committee’s requirement that big bank mergers must “improve the prosperity and competitiveness of the national economy.”

In sum, there are factors important to the public interest that are beyond prudential matters addressed by OSFI, and beyond those market issues looked at by the Competition Bureau. Thus, there is still a need for parliamentary oversight of merger proposals to ensure a benefit to Canada.

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standard cash through ATMs. For consumers, ATMs save time (which is important), but information technology also facilitates new and imaginative forms of price discrimination.

The ATM fees are a good example. It is a bit like Mark Twain’s claim for the virtue of fishing at Niagara Falls: You don’t have to go so far to *not* catch a fish. With ATMs you don’t have to go so far to get stung by an innovative fee. Information technology, especially when used with data mining, allows a completely new level of price discrimination. Unless we develop a counterstrategy, the innovation merely shifts power from consumers to sellers.

Many innovations are independent of the merger issue. However, it is by no means certain that mergers that reduce competition can have anything but a negative effect on innovation. After all, innovation is one component of competition.

5. *Too big to fail*: Whenever businesses reach the “Too Big To Fail” level, risks are removed from investors and placed on taxpayers. There is little comfort in the retort that big Canadian banks are

the social philosopher, Yogi Berra, who famously said: “You can see a lot, just by looking.”

We can look at the results of all the studies of economies of scale. Virtually all evidence on economies of scale agrees that banks already at the size of Canada’s big five have captured available scale efficiencies; further increases in size offer little or no additional gains. There is a single study, recently in the *Canadian Journal of Economics*, that suggests there are unexploited scale economies—contrary to all the other evidence. The research is impressive on many points but the main result relies entirely on the assumption that there is *one national market* while most consumers and firms operate in a *local market* that will have fewer competitors after a big merger. This crucial point, local or national market, has already been researched for firms making loans, and what matters is, indeed, the local market. The latter research finds that, when other factors are allowed for, branch closings in Canada are associated with higher interest on loans to